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Taxation Essentials of LLCs and Partnerships

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TAXATION ESSENTIALS OF LLCS AND PARTNERSHIPS

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Chapter 1

Overview: Basic Tax Structure of Partnerships and LLCs

Learning objectives

- Distinguish between the various types of partnerships and limited liability companies (LLCs).
- Identify the effects of investor contributions and distributions on their basis in a partnership or LLC interest.
- Determine how partnerships and LLCs opting to be treated as partnerships report their federal taxable income to the IRS and to investors.
- Identify considerations related to the application of the check-the-box rules when electing to treat an entity as a partnership, LLC, or corporation.
- Compute the tax consequences of converting from a corportion to an LLC (or partnership);
- Recognize when pass-through income from a partnership or LLC is subject to the self-employment tax.

What is a partnership for federal income tax purposes?

For tax purposes, a partnership exists when two or more taxpayers join together, without incorporating, to carry on business or investment activities for their mutual (or "joint") benefit. Partnerships can be used to conduct active businesses or to carry on investment activities. Moreover, the partnership can be structured in such a way that some partners participate actively in partnership operations while others play the role of passive investors, content to share in the profits (or losses) derived from partnership operations while playing no active role in day-to-day management activities. The primary strength of the partnership as a vehicle for conducting business is its flexibility. Partners can, for example, agree to share differently in the risks and rewards associated with partnership business activity. Yet, the partnership can still provide limited exposure to business risks for certain of its partners (for example, limited partners), providing the best of both worlds: (*a*) highly flexible arrangements for sharing in the risks and rewards of business activities and (*b*) limited liability for members. Moreover, unlike corporations, partnership income is subject only to one layer of tax-imposed at the partner level. For these reasons, partnerships are the preferred form of organization for a wide variety of business activities.

Partnerships versus other entities

Legal protection

There are several types of partnerships, each with different levels of liability protection for their partners. The first, and most basic, type of partnership is the *general partnership*. In a general partnership, all partners participate in management of the partnership, and all partners have the legal authority to enter into binding legal relationships on behalf of the partnership. Therefore, for example, if a law firm were organized as a general partnership, each of its partners would have the authority to enter into attorney-client relationships on behalf of the firm. Each of the firm's clients, even if they deal with only one attorney, is represented by the partnership, rather than by an individual attorney. The downside to this arrangement is that claims against the firm, even if due to the actions of only one partner, can be enforced against any and all partners of that firm, to the extent that the partnership's assets are insufficient to satisfy the claim.

Example 1-1

In 1990, Leventhal & Horwath, then the eighth largest accounting firm in the United States, filed for bankruptcy protection under pressure from several lawsuits stemming from the failure of many of its audit clients. Like all accounting firms at the time, the firm was organized as a general partnership. The firm eventually dissolved, but its partners remained responsible for damage assessments awarded to claimants against the firm. Most of these partners had not been personally involved in the engagements targeted by the various lawsuits. Nonetheless, in addition to losing their jobs, each of the partners was left with personal responsibility for tens of thousands of dollars of partnership liabilities stemming from the lawsuits that drove the firm out of business. According to published reports, these liabilities generally exceeded the personal assets of most of the partners, meaning that many partners faced the prospect of personal bankruptcy following dissolution of the firm.

Due to concerns about partner liability, it can be very difficult to attract investment capital to businesses organized as general partnerships. Moreover, there are many activities in which it is neither necessary nor desirable for all partners to be involved in management of the partnership or its affairs. For example, partnerships are often used to raise capital to purchase real estate (office buildings, apartment complexes, and the like), or to drill oil or gas wells. These activities require large amounts of money, but do not necessarily require the input of each partner in deciding which properties to acquire or where to drill for oil and gas. Organization of the operating or drilling companies as corporations would alleviate concerns over liability and participation in management but would raise new concerns over double taxation and lack of flexibility. *Limited partnerships* are designed to accommodate the business needs of these activities while still allowing them to be conducted in partnership form.

In a limited partnership, the power to bind the partnership contractually, and to make all management decisions, is vested in the hands of the general partners. Other partners, referred to as limited partners, make capital investments in the partnership but are not allowed to participate in management and cannot enter into binding contracts on behalf of the partnership. Reflecting their restricted ability to influence partnership affairs, these partners are shielded from responsibility for partnership obligations. Full liability for partnership debts rests with the general partners, who control the partnership's actions. Therefore, limited partners are in much the same position as shareholders in a corporation. They invest money in the partnership's business without expressing any voice in how the business is conducted. If the venture is profitable, the partners share in the profits. If it fails, they stand to lose their entire investment. However, their losses are limited to the amounts directly invested in the firm. Unlike a general partner, partnership liabilities do not follow the limited partners individually, and therefore their exposure is limited to the amounts actually invested (or legally pledged) to the firm.

Example 1-2

Last year, Marge invested $10,000 as a limited partner in an oil and gas drilling partnership. The general partner of the partnership was Ted, a business acquaintance of Marge's. Early this year, a mishap on the drilling site caused a fire, which eventually spread to thousands of acres, causing significant losses of livestock and some farm and ranch buildings in the area. The damages resulted in lawsuits against the partnership. Unfortunately, the well being drilled by the partnership turned out to be dry, and the partnership did not have sufficient assets to satisfy the damage assessment resulting from the lawsuit. Although Marge will lose her entire $10,000 investment in the partnership, as a limited partner she has no personal responsibility for the damages awarded against the partnership. In contrast, Ted, the general partner, is personally responsible for the outstanding debts of the partnership. Therefore, in addition to any capital he invested directly in the partnership, Ted will be liable to the farmers and ranchers whose livestock and buildings were lost in the fire started at the drill site.

Knowledge check

1. Midge is a 10% limited partner in Wild Catter, an oil and gas drilling partnership. She received her partnership interest in exchange for a $10,000 investment in the partnership. The balance in her capital account as of the beginning of the current year was $10,000. She has made no additional contributions to the partnership and received no distributions. In January, a pipe burst on one of the partnership's properties and several thousand gallons of crude oil leaked onto surrounding pastureland. The resulting damage rendered the land unusable and rendered all the partnership's assets worthless. The landowner sued the partnership, demanding actual and punitive damages of $2,500,000. Under the terms of the partnership agreement, Midge receives 5% of partnership losses and 10% of partnership profits. She is not obligated to restore deficits in her capital account. What does Midge stand to lose if the suit is successful?

    a. $2,500,000.
    b. $250,000.
    c. $10,000.
    d. $0.

2. In the preceding question, assume that Midge was the only general partner of the partnership, and that the partnership allocated 50% of partnership losses to her, but only 10% of partnership profits. In addition to her initial investment of $10,000, how much would she stand to lose if the lawsuit against the partnership is successful?

    a. $2,500,000.
    b. $1,250,000.
    c. $10,000.
    d. $0.

As noted, a limited partnership offers liability protection to limited partners, whereas general partners remain fully liable for unsatisfied claims of the partnership's creditors. Two other forms of partnerships are available which provide some protection for general partners as well. The first, called a limited liability partnership (LLP), did not exist until after the failure of Leventhal & Horwath discussed in example 1-1. Following the bankruptcy of the nation's eighth largest accounting firm in 1990, states began to yield to the pressure of professional services organizations (principally accounting and law firms) and passed laws allowing for LLPs. In an LLP, the partnership itself remains liable for all the actions taken by its partners and employees. However, individual partners in the partnership are shielded from personal liability for losses caused by the actions of partners other than themselves.[1] That is, each partner is personally responsible for losses or other liabilities stemming from his or her own actions but is shielded from personal risk for the actions of his or her partners. Therefore, in an LLP, every partner enjoys at least some of the protections provided to limited partners in a limited partnership. The partners do not have to give up their voice in management, nor their rights to bind the partnership contractually, however, in order to obtain this protection. The LLP therefore moves a substantial step closer to a corporation in terms of the benefits and protections it provides to its members.

Example 1-3

Carl is a partner in a multi-state accounting firm organized as a limited liability partnership. Two years ago, one of his partners in Florida took a bribe in exchange for rendering a clean audit report on one of the firm's newer clients. Last year, the client filed for bankruptcy protection, and its stockholders sued Carl's accounting firm. After it was discovered that a partner in the firm had taken bribe money to issue a clean report, the stockholders won a significant settlement from the firm. The settlement was so large, in fact, that it caused Carl's firm to become bankrupt. Carl will lose his entire investment in the firm but will not suffer any additional liability for the settlement obligation because he had no involvement in issuing the fraudulent audit report. In contrast, the partner who issued the fraudulent report will not only lose his or her investment in the firm but will also remain personally liable for the portion of the settlement obligation remaining unsatisfied after bankruptcy of the accounting firm.

[1] In many states, only a limited shield of liability protection is available to partners in LLPs. That is, liability protection is available only against losses attributable to acts committed by other partners. In these states, LLP partners retain full, unlimited personal liability for acts of the partnership (for example, defective performance) or acts of non-partner employees of the partnership. This is a primary reason for the popularity of LLCs, which generally carry a full liability shield for owners against liability for acts committed by others, whether or not they have equity stakes in the company.

A relatively new type of limited partnership, the limited liability limited partnership (LLLP), is available in some states.[2] Unlike the LLP, which is a general partnership that registers in the LLP form, an LLLP is a limited partnership in structure that registers with the state in LLLP form. Therefore, the primary difference between an LLLP and the more familiar LLP is the extent to which the partners participate in management. An LLLP is essentially a limited partnership in which all partners, including the general partner(s), have limited liability. Therefore, unlike an LLP, not all partners in an LLLP can participate in management. All do, however, have limited liability for losses incurred as a result of the actions of other partners.

A final type of entity which can be treated for tax purposes as a partnership is the limited liability company (LLC). An LLC, like an LLP or LLLP, extends liability protection to all partners without requiring that they forfeit their ability to participate in management or act as the firm's representative in dealings with parties outside the partnership. Moreover, LLCs, like general partnerships, can elect to be taxed as either partnerships or corporations (including S corporations). In all states and the District of Columbia, an LLC can exist with only one owner. In contrast, LLPs and LLLPs, like all other partnerships, are required to have two or more partners.[3]

Knowledge check

3. Which is **not** a difference between a limited liability company and a limited liability partnership?
   a. An LLC, unlike an LLP or LLLP, can exist with only one owner.
   b. All members of an LLC have limited liability, without requiring that they forfeit their ability to participate in management.
   c. An LLC has members rather than partners, and does not have a general partner.
   d. An LLC does not have a general partner.

[2] Alabama, Alaska, Arizona, Arkansas, Colorado, Delaware, District of Columbia, Florida, Georgia, Hawaii, Idaho, Illinois, Iowa, Kansas, Kentucky, Maine, Maryland, Minnesota, Missouri, Montana, Nevada, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Dakota, Tennessee, Texas, Virginia, Washington, Wyoming, and the U.S. Virgin Islands allow firms to organize in the LLLP form. Although LLLPs cannot be formed in California, those formed in other states are recognized in California.

[3] A single-owner LLC will not be taxed as a partnership. It is a *disregarded entity* and will instead be treated as a sole proprietorship, or if owned by a corporation, as a division of the corporation. However, the legal protection afforded to members of an LLC will be available to a single-owner LLC as well, allowing the sole proprietor to receive limited liability protection similar to that of a corporate shareholder without paying corporate income tax.

Example 1-4

Bonnie and Roy started a delivery service last year, which they organized as a limited liability company. This year, one of their drivers was driving recklessly and caused an accident. Although the company can be sued, and all its assets forfeited in the resulting lawsuit, Bonnie and Roy's personal assets will be protected because they were not personally involved in the accident. Therefore, like limited partners (or corporate shareholders), the couple's risk of loss is limited to their net investment in the company. Assets held outside the company are not subject to claims against the company.

Knowledge check

4. What is the difference between a limited partnership and a limited liability limited partnership?

   a. Limited partners in a limited partnership do not participate in management, whereas those in a limited liability limited partnership do.
   b. General partners in a limited liability limited partnership have limited personal liability.
   c. All the partners in a limited liability limited partnership have more protection from the liabilities of the partnership than in a limited partnership.
   d. Limited partners in a limited liability limited partnership have limited personal liability.

Layers of taxation

From a tax perspective, the primary benefit of forming as a partnership (or an LLC treated as a partnership) rather than a corporation is that partnership income is subject to only one layer of taxation at the federal level.[4] Partnership income is allocated to the partners each year and taxed on their returns. It is important to note that partners must pay tax on their shares of partnership income whether or not that income is distributed to them. Indeed, because partnership or LLC income is taxed to the partners or investors as it is earned by the entity, subsequent distributions of that income are tax-free. This scheme is quite unlike the corporate tax system in which corporate income is taxed at the corporate level, and subsequent distributions of that income are taxed again to the shareholders as dividend income.

[4] An LLC is taxed as a partnership at the federal level unless an election is made to be taxed as a corporation. How the entity is taxed at the state level will depend upon the state(s) in which it is operating.

Example 1-5

Dawn is a one-half partner in Sunrise Partnership. This year, the partnership reported taxable income of $100,000, of which Dawn's share was $50,000. The partnership made monthly distributions to Dawn of $2,000 ($24,000 total). When Dawn files her individual tax return for the current year, she will include her $50,000 share of the partnership's income (on Schedule E of her Form 1040). The distributions will not affect her taxable income. Therefore, her involvement with the partnership will increase her taxable income by her full $50,000 share of partnership income, even though only $24,000 of this income was distributed to her during the year. In effect, the remaining $26,000 of undistributed taxable income has been reinvested by Dawn in the partnership's business activities.

Losses also flow through to the partners and can be deducted by them on their own tax returns. Again, this is a departure from the corporate tax scheme, in which losses can be carried forward to offset future corporate income but provide no tax benefits until actually offset against positive corporate taxable income. In contrast, partnership losses are reported by the partners on their own tax returns, and if deductible, provide immediate tax benefits in the form of a reduced tax burden on the partners' other income in the year of the loss.

Example 1-6

Robert is an attorney with current-year income from his law practice of $175,000. In addition, he owns a 25% general partnership interest in an oil and gas partnership. The oil and gas partnership drilled a number of dry holes this year and reported a net taxable loss of ($200,000). Robert's one-fourth share of this loss is ($50,000). Assuming his share of the loss is fully deductible, and that he is in the 35% tax bracket this year, the loss will reduce his current-year tax liability by $17,500 ($50,000 × 0.35). He does not have to carry the loss forward to be offset against partnership income which may be reported in a future year. Rather, he can deduct the loss this year against his other business or personal income. As a result, he receives the full benefit of the partnership loss in the current year, when the loss was actually incurred.

Flexibility

Another important advantage of the partnership and LLC form of business is its flexibility. Unlike the corporate form of organization, in which each share of stock (within classes) must provide for its owner an identical interest in the corporation's assets and income, investors in a partnership or LLC can share in entity assets, or entity income, in any way they see fit. Investors' interests in different partnership assets or activities may differ, and these differences may change from one year to the next.

Example 1-7

J, D, and R are individual general partners in an oil and gas drilling partnership. The partners each own one-third of the first well drilled by the partnership, which was successful. However, when D and R wanted to invest a portion of the income from well 1 to drill an additional well on an adjacent property, J opted not to participate. As a result, he or she has no interest in the second well, or in any income generated by that well. That is, J has a one-third interest in the first well and zero interest in the second one. D and R each have one-third interests in the first well, and one-half interests in the second well. If the partners decide to drill a third well, they may have still different interests in that well. They might even decide to bring in another partner to the partnership to participate in drilling the third well, and the new partner may or may not be allowed to share in the profits associated with the first two wells. Each partner's share of partnership profit or loss in each property will be governed by the partnership agreement signed by all the partners. This agreement can be changed with the consent of the partners, and the sharing ratios of the partners can be revised after the fact. This degree of flexibility would be very difficult to obtain if the company had been organized as a corporation and would not be possible at all if the corporation opted to be taxed as an S corporation.[5]

Similarly, a partnership or an LLC may allow its investors to share differently in the risks and rewards of entity operations. Investors with varying tastes for risk may be willing to assume a greater portion of the risk of losses, while sharing profits in accordance with their contributions to capital. One partner, for example, may be willing to be allocated 50% of partnership losses, while sharing in only 33% of partnership profits. Partnerships or LLCs offer complete flexibility to the partners to enter into these kinds of arrangements. The result is that it is often easier to bring investors with different backgrounds together into a partnership or LLC than in other forms of organization.

[5] By law, an S corporation can have only one class of stock and each share of that stock must have an equal interest to all the other shares in every item of S corporation income, loss, credit, and the like. Section 1361(b)(1)(D).

Example 1-8

Lynn owns a large tract of ranch land that she would like to develop into a dude ranch. Unfortunately, she does not have sufficient cash resources to develop the property herself, and she cannot obtain bank financing with favorable terms. She decides to approach the owner of a dude ranch in another state whom she met while on vacation last year. The other ranch owner is interested but is a little wary about investing in an area with which he is unfamiliar. Lynn, however, is confident that a dude ranch on her property would be successful. She is so confident that the venture will succeed that she offers to bear 75% of the risk of loss, while taking only 50% of the profits from the venture, if the other partner will invest the $250,000 needed for improvements to make the dude ranch operable. Assume the other partner makes the necessary investment, and that the dude ranch loses ($50,000) in its first year of operations. Lynn will be allocated 75% of this loss, or ($37,500). Her partner will bear only ($12,500) of the loss. If the dude ranch turns around in its second year, and generates taxable income of $40,000, Lynn's share of the second-year profit will be $20,000 (50%). Therefore, although the partnership's net profit or loss for the two-year period is ($10,000), Lynn has been allocated a loss of ($17,500) [$37,500 - $20,000], whereas her partner has been allocated profits of $7,500 [$20,000 second-year profit less ($12,500) first-year loss]. Lynn is indeed assuming a much larger portion of the risk of loss from their joint activities than is her partner. This disparity may, however, be worthwhile if Lynn is right and the dude ranch develops into a profitable enterprise.

Finally, note that it is possible in a partnership or an LLC to share differently in profits and losses from one year to the next. For example, it is not unusual for a partner to receive a disproportionate share of partnership profits until he or she receives a pre-determined amount, and for profits to be shared equally after that point. To illustrate, in the preceding example, the partners might write the partnership agreement to provide that Lynn's partner will receive 60% of profits until he has recouped his $250,000 investment in the venture, with profits realized after that point being shared equally. Again, this type of flexibility is extremely difficult to achieve in any other form of organization.

Electing to be taxed as a partnership: The "check-the-box" rules

Prior to 1997, entities had to satisfy the cumbersome and highly complex requirements of Reg. Sec. 301.7701 to be classified as partnerships for federal income tax purposes. These regulations required that the entity could not be taxed as a partnership if it possessed more than two of a list of four so-called "corporate" characteristics (limited liability, unlimited life, free transferability of interests, and centralized management).[6] However, the criteria were rendered largely meaningless by the numerous exceptions and limitations imposed in the regulations, so that entities that truly wished to be taxed as partnerships could write their partnership agreements in such a way that partnership status was virtually guaranteed. The result was that the regulations served principally as a trap for the unwary.

To simplify the classification process, and to eliminate the potential that taxpayers who thought they were operating as legitimate partnerships would be subjected to onerous penalties upon discovering that they did not satisfy the technical criteria of the regulations, the IRS in 1996 implemented new rules under which eligible entities will be classified as partnerships unless they file Form 8832, *Entity Classification Election*, and elect to be classified as a corporation or different type of entity.[7] These rules remove any uncertainty about the classification process, and are particularly helpful for limited liability companies, which may freely choose between being taxed as either partnerships or corporations (including S corporations). Uncertainty is further reduced by Reg. Sec. 301.7701-3(b)(1)(i), which provides that in the event an entity neglects to properly file an election, the default classification for domestic entities with at least two members is a partnership. Such entities will automatically be treated as partnerships for federal income tax purposes unless they elect to be classified as a different type of entity.[8] Further reducing uncertainty is the rule that any entity that is incorporated under state law is treated as a corporation for tax purposes. If that entity wants some of the benefits of having its income pass through to the shareholders, it can elect S corporation status.

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[6] The regulations actually identified six corporate characteristics: two or more associates, profit motive, free transferability of interests, limited liability, unlimited life, and centralized management. However, the regulations noted that the first two of these characteristics (associates and profit motive) were common to both partnerships and corporations, and so based the classification criteria on the remaining four characteristics. If the entity possessed more than two of these four remaining characteristics, it was classified as a corporation for federal income tax purposes.

[7] Note that certain *publicly traded* partnerships are classified as corporations for federal income tax purposes, regardless of their preference under the check-the-box rules. A publicly traded partnership is one which conducts an active trade or business and the shares of which are traded on an established securities market or a secondary market. See IRC Section 7704 of the Internal Revenue Code and the Treasury Regulations thereunder.

[8] In some cases, an entity which technically constitutes a partnership may desire not to be recognized as such for federal income tax purposes. Reg. Sec. 1.761-2 provides that such entities can elect not to be taxed as partnerships (and therefore avoid having to file a partnership tax return) if they are formed for investment purposes (rather than to conduct joint business activities) or for the joint production, extraction or use of property, but for the purposes of selling services or property produced or extracted.

Moreover, the regulations provide that the entity choice election is not permanent. Once an entity elects its tax status, it retains such status so long as it does not make an election to change to a different status. Revised status generally cannot be elected during the 60-month period following the previous election, although the commissioner is authorized to permit a change in status if more than 50% of the ownership interests in the entity as of the effective date of the subsequent election are owned by persons that did not own any interests in the entity on the filing date or on the effective date of the entity's prior election.

Therefore, an LLC can elect to be taxed as a partnership for the first five years of its life and then change its status to a corporation for federal income tax purposes thereafter. It is important to recognize, however, that a change in status will not necessarily be tax free. The regulations treat the election to change an entity's status as a liquidation of the old entity accompanied by the formation of a new one.[9] In the case of a partnership electing to be taxed as a corporation, the regulations treat the partnership as if it transferred all its assets and liabilities to a newly formed corporation (requiring a new taxpayer identification number) in exchange for stock, and then liquidated, distributing the corporate stock to its partners. Because liquidation of a partnership is generally a tax-free transaction, this deemed transaction will seldom have any tax consequences for the members.[10]

Example 1-9

L is a 50% partner in the LT Partnership. L's tax basis in his partnership interest was $200,000 when the partnership opted to be classified as a corporation and made the election to be taxed under subchapter S. (The partners hoped to reduce their self-employment tax liability by making this change in status.) To accomplish the conversion to a regular corporation, the partnership transferred all its assets to a newly formed corporation in exchange for stock. Assume that the partnership had no liabilities at the date of the conversion. The partnership then liquidated, distributing the newly acquired stock to its partners in liquidation of their interests in the partnership. L received stock with a tax basis to the partnership of $350,000 and a fair market value of $425,000 in liquidation of his interest in the LT Partnership. L will recognize no gain or loss on the transaction and will take a tax basis in his stock in the new corporation of $200,000.

[9] See Reg. Sec. 301.7701-3(g).

[10] One important exception will apply where one or more partners have a deficit balance in their capital accounts as of the date of the deemed liquidation of the partnership. Partners with deficit capital balances will be required to make contributions to the partnership to restore their capital balances to $0. Forgiveness of this obligation by the entity will likely result in cancellation of debt income to such partners.

In contrast, where the entity has been operating as a corporation, the election to change its status to a partnership is treated under the regulations as if the corporation first liquidates, distributing all its assets and liabilities to its shareholders, who then transfer these assets and liabilities to a new partnership (again requiring a new taxpayer identification number) in exchange for interests in the partnership. Because corporate liquidations are generally fully taxable to both the corporation and its shareholders,[11] the election to change status from a corporation to a partnership may have significant tax consequences.

Example 1-10

Q and R each own 50% of the shares of Pheasant Ridge, LLC, formed four years ago. Following its formation, the company elected to be taxed as a corporation. Q and R each have tax bases of $120,000 in their LLC interests. The company owns assets with an aggregate tax basis of $250,000 and an aggregate value of $350,000. It has no liabilities. Effective January 1 of the current year, Pheasant Ridge, LLC filed Form 8832 electing to change its status from a corporation to a partnership for federal tax purposes.

Pheasant Ridge will be deemed to liquidate on January 1 of the current year, distributing its assets to Q and R equally. This deemed distribution to Q and R is taxable to Pheasant Ridge as if it had sold its assets for their fair market values and distributed the proceeds to its shareholders. Accordingly, the LLC will recognize a $100,000 gain on the deemed sale and will owe federal income tax of $21,000 on its final income tax return. (The company has no other income in the year of liquidation, as it liquidated on January 1.)

Q and R will also recognize taxable gain on the deemed liquidation. They will be deemed to have received a net distribution of $329,000 ($350,000 FMV of assets, less $21,000 tax liability to the federal government) in exchange for their shares in Pheasant Ridge. Their combined tax basis in these shares is $240,000 ($120,000 each). Therefore, they must recognize a combined gain of $89,000 ($44,500 each). Because they have held their shares for four years, the gain will be taxed as a long-term capital gain, subject to a maximum tax rate of 20%, plus a possible additional 3.8%, depending on the taxable income of the partners. Assuming they have no capital losses and their tax rate on long-term capital gains is 20%, they will each owe $8,900 in additional income taxes on the capital gains. Therefore, the combined tax cost of changing the LLC's federal tax status from a corporation to a partnership will be $38,800 ($21,000 corporate tax, plus $8,900 tax to Q, plus $8,900 tax to R).

The election to change tax status should clearly not be made without full consideration of the potential costs and consequences.

Practical insight: Typically, a practitioner and a taxpayer would not be inclined to incur the federal income tax cost associated with the liquidation of a corporation so that the business form could be switched to a partnership form unless some other significant non-tax business purpose existed.

[11] See IRC Sections 311(b) and 331.

Overview of the basic framework of partnership taxation

The partnership tax framework allows partners and partnerships wide latitude in structuring their companies and in dealing with one another. Formation of a partnership, like formation of a corporation, is generally a tax-free transaction. Indeed, the rules governing partnership formation are even more lenient than those governing corporate formation, in that there is no requirement that contributing partners have "control" of the partnership in order for the transaction to be tax-free. Also, like corporate formations, the partners' bases in assets contributed to the partnership carry over to the partnership (that is, the partnership takes a "carryover" basis in contributed properties), and the partners' initial bases in their partnership interest is generally equal to the basis of cash and other property contributed to the partnership in exchange for that interest. (However, a partner's basis in his partnership interest is also increased by his share of partnership liabilities, unlike the shareholder or corporation treatment of liabilities.)

A major difference between partnerships and corporations, of course, is that the taxable income of the partnership is taxable to the partners, rather than to the partnership itself. Therefore, the reporting process by which the partnership's taxable income is reported to the IRS, and to its partners, is rather complex. Moreover, the process of accounting for partnership income is more complex in that the partners must account for their shares of partnership income or loss each year, whether or not any distributions of that income are received or additional contributions are made by the partners.

Another major difference between partnerships and corporations is the treatment of distributions to partners. Because the partners are taxed directly on their shares of partnership income, distributions of that income are generally tax-free. Most distributions are treated as decreases in the basis of their partnership interests rather than as taxable income. To ensure that the distribution to a partner of his or her share of partnership income does not inadvertently trigger recognition of taxable gain, partners are required to adjust their bases in their partnership interests to reflect their shares of the partnership's income or loss each year. The result of these basis adjustments is that a partner will generally have sufficient basis to absorb a subsequent distribution of his or her share of partnership profit without triggering gain recognition.

Example 1-11

Arthur contributed property with a tax basis of $100,000 and a fair market value of $500,000 to the newly formed AY Partnership this year in exchange for a 50% interest therein. For its first year, the partnership reported taxable income of $600,000, of which Arthur's share was $300,000. The partnership distributed half its income to the partners and reinvested the other half in its operations. Therefore, Arthur received a distribution of $150,000. Absent an adjustment to his basis in his partnership interest to reflect his $300,000 share of the partnership's income, the distribution to Arthur of $150,000 of his share of partnership profits would trigger recognition of a $50,000 taxable gain. (His initial tax basis in the partnership interest was only $100,000, which would not be sufficient to absorb a $150,000 distribution).

However, because Arthur's tax basis in his partnership interest is increased by his $300,000 share of partnership income (to $400,000), the $150,000 distribution will be tax-free. His remaining tax basis in the partnership interest will be $250,000 ($400,000 - $150,000). Looked at another way, his basis in the partnership interest was increased by the $150,000 share of partnership profits which he did not withdraw from the partnership. By not withdrawing this portion of his share of profits, he essentially contributed those profits back to the partnership. His basis in the partnership interest is increased accordingly.

Note that one result of the preceding framework is that the partners' aggregate bases in their partnership interests (outside basis) generally equal the partnership's aggregate bases in its assets (inside basis). This equality is important because it prevents taxpayers from using partnerships to manipulate the tax consequences associated with the sale or other disposition of property. Because the partners' outside bases in their partnership interests generally equal the partnership's aggregate inside basis in its assets, the same amount of gain or loss is recognized when a partner sells his or her interest in a partnership as would have been recognized if he or she had sold the asset(s) contributed to the partnership in exchange for that interest. Likewise, the partnership will recognize the same amount of gain or loss from the sale of its assets as the partners who contributed those assets would have recognized had they sold them directly, rather than through the partnership.

Example 1-12

Jamie contributed property with a tax basis of $28,000 and a fair-market value of $50,000 to the JQL partnership in exchange for a one-third interest therein. She will recognize no gain or loss on exchange of the property for the partnership interest. Her basis in her partnership interest is $28,000, and the partnership takes a $28,000 basis in the property contributed by Jamie. Assuming that Jamie subsequently decides to sell her interest in the partnership for its $50,000 value, she will recognize a taxable gain of $22,000. This is the same amount of gain she would have recognized had she sold the property rather than contributing it to the partnership. Likewise, if the partnership sells the property contributed by Jamie for its $50,000 fair market value, it will also recognize a $22,000 gain. Therefore, transfer of the property to the partnership does not change the tax consequences associated with a later sale of the property or of the partnership interest received in exchange for the property.

Partnership operations

Measuring and reporting partnership income

Although partnership income is taxed at the partner level, it must be measured and reported by the partnership. The partnership files an annual tax return, Form 1065, with the IRS. Attached to the return is a Schedule K-1 for each partner in the partnership, reporting that partner's share of each item of partnership income or loss. Two copies of each Schedule K-1 are filed—one with the IRS and one with the partner. The K-1 identifies the partner, his or her social security number (or other identification number), and his or her address, along with such partner's share of partnership items of income, loss, gain, deduction and other information (for example, alternative minimum tax preferences, and the like). The partners then include their shares of each item of partnership taxable income, as reported to them on Schedule K-1, on their individual tax returns. They pay tax on their shares of partnership taxable income whether or not those shares are distributed to them during the year.

The computation of partnership taxable income is complicated by the need to ensure that all items of partnership income are treated the same on the partners' returns as if those items had been earned or incurred by the partners directly rather than through the partnership. For example, for individuals, the deduction for net capital losses is limited to $3,000 per year. This limitation applies both to net capital losses incurred directly and those incurred by partnerships and allocated to the individual partners.

Example 1-13

Lucy and Ethel are equal 50% partners in the LE Partnership. This year, Lucy incurred net capital losses of ($2,000) from the sale of stock (outside the partnership). Ethel realized a net capital gain of $4,500. In addition, the LE Partnership incurred a net capital loss of ($10,000). Lucy's share of this loss is ($5,000), as is Ethel's. On their individual tax returns, however, Lucy will be able to deduct only ($1,000) of her share of this loss because she already had ($2,000) of net capital losses before considering her share of the partnership loss. Individuals are not allowed to carry net capital losses back but may carry them forward indefinitely. Therefore, Lucy will carry the remaining ($4,000) net capital loss forward to next year. Ethel, on the other hand, can deduct her entire ($5,000) share of the partnership's net capital loss. When added to her net capital gains of $4,500 generated outside the partnership, Ethel's total net capital loss is only ($500), well within the ($3,000) annual limit.

There are many items of income, gain, loss, or deduction that may be subject to similar limitations or special treatment on the partners' individual tax returns. For example, charitable contributions are subject to limitations on the returns of individuals and corporations. Similarly, the Section 179 deduction available to individuals is subject to annual limitations. Losses from rental real estate are subject to the passive loss rules. To allow these limitations to be applied properly on the partners' tax returns, each partner's share of these items must be reported separately from other partnership taxable income.

Knowledge check

5. J.D. Rackmore received a Schedule K-1 from a partnership reporting the following items of income, gain, loss, and deduction for the current year:

Share of partnership ordinary income	$ 4,500
Capital gains (net)	1,500
Interest income	700
Charitable contributions	(1,000)

J.D., who does not itemize deductions, has no other investments in partnerships or other pass-through entities. By how much will her investment in this partnership increase her taxable income for the current year?

a. $4,500.
b. $6,000.
c. $6,700.
d. $5,700.

Other items may allow the partners to use a greater portion of expenses or losses incurred outside the partnership when preparing their tax returns. A partner with capital losses outside the partnership, for example, may be allowed to deduct some or all of these losses against his or her share of partnership capital gains. Partners with "excess" investment interest expense may be able to deduct some of this interest against investment income allocated from the partnership. Passive losses incurred outside the partnership may be deductible against passive income reported by the partnership. For corporate partners (that is, partners who are corporations), the dividends-received deduction may be increased by a portion of dividends received through the partnership.

Reflecting the numerous special provisions which must be considered when preparing the partners' individual tax returns, partnership income is reported to the partners in pieces, rather than as a single number labeled "partnership taxable income." In essence, the partnership's taxable income is reported in three parts. The front page of Form 1065 reports those items of income and deduction that are not subject to special treatment on any partner's tax return. These items result in net partnership "ordinary business income (loss)." Note that although all of the items that make up partnership ordinary business income are ordinary (otherwise they would be subject to special treatment by the partners), there are some ordinary income items, such as interest income, which are specially treated and therefore not included in partnership "ordinary business income." On page 4 of Form 1065 is Schedule K, which reports to the IRS both net partnership ordinary business income or loss (from page 1 of Form 1065), and the totals of each item of income, gain, loss, deduction, credit, and the like, which may be subject to special treatment on one or more of the partners' tax returns. Therefore, the partnership's actual total net income or loss is derived from Schedule K, rather than from page 1 of the Form 1065.

Finally, each line item on Schedule K is divided among the partners and reported to those partners on Schedule K-1s. Each partner receives a copy of his or her Schedule K-1 (an additional copy is attached to partnership tax return filed with the IRS) reporting his or her share of each of these items (net ordinary business income and each other item which may be subject to special treatment). From the K-1, each partner then determines how partnership activities affect his or her individual taxable income.

Example 1-14

The JD Partnership reported the following items of income, gain, loss, and deduction for the current year:

Sales	$450,000
Cost of goods sold	(150,000)
Gross profit	$300,000
Long-term capital gains (net)	15,000
Interest income	7,000
Salaries paid to employees	(50,000)
Depreciation expense	(25,000)
Taxes (payroll and property taxes paid to the state)	(18,000)
Charitable contributions	(10,000)

J and D are each 50% partners. The partnership will report ordinary business income of $207,000 ($300,000 – 50,000 – 25,000 – 18,000) on page 1 of Form 1065. This amount will be carried to Schedule K (line 1), which will also report, on separate lines, the partnership's long-term capital gains of $15,000, interest income of $7,000 and charitable contributions of ($10,000). Each of the partners will receive a Schedule K-1 (see the appendix to this course for a sample) showing his or her $103,500 share of partnership ordinary income, $7,500 share of partnership long-term capital gain, $3,500 share of partnership interest income and ($5,000) share of partnership charitable contributions. This result is illustrated in the following table:

Description	Form 1065, p.1	Schedule K	Schedule K-1, J	Schedule K-1, D
Net ordinary business income	$207,000	$207,000	$103,500	$103,500
Separately stated items:				
Long-term capital gains		15,000	7,500	7,500
Interest income		7,000	3,500	3,500
Charitable contributions		10,000	5,000	5,000
Analysis of net income (Loss)			$219,000	

Example 1-15

Consider the facts of example 1-14. Assume partner J incurred net capital losses outside the partnership of ($5,500) and had net investment interest expense (in excess of investment income) of ($2,000). D, the other partner, had no capital gains or losses outside the partnership, and no investment interest expense. For the current year, J's share of partnership income (and the items thereof) will cause her taxable income to increase by $102,000 ($103,500 ordinary income, plus $7,500 long-term capital gain, plus $3,500 interest income, less ($5,000) charitable contributions, less additional capital loss deduction of ($5,500) and additional investment interest expense deduction of ($2,000)). D's share of partnership items, in contrast, will increase her current year taxable income by $109,500 ($103,500 + $7,500 + $3,500 – $5,000). Having no capital losses or excess investment interest expense outside the partnership, her share of partnership items does not increase her other deductions as it did for J.

Effect on the partners: Basis

Partners are taxable on their shares of partnership income whether or not that income is distributed to them. Where some or all of a partner's share of partnership income is not distributed (that is, is retained by the partnership) the excess represents an additional investment by the partner in the partnership. Accordingly, under Section 705(a)(1), a partner's share of items of partnership income, including nontaxable income (for example, municipal bond interest) increases his or her basis in the partnership interest. Basis is then reduced by the portion, if any, of that income which is distributed to the partner during the year.

Example 1-16

Elaine and Jerry formed a partnership early last year to purchase rental properties. They each contributed $25,000 to the partnership, which then borrowed $150,000 on a recourse loan, and purchased rental real estate. Each partner's initial basis in the partnership interest was therefore $100,000 ($25,000 contributed plus $75,000 share of debt). In its first year, the partnership reported net income of $30,000, and made distributions to Elaine and Jerry of $8,000 each. Elaine and Jerry will each report $15,000 income on their individual returns (their shares of the partnership's $30,000 income) even though they received only $8,000 in distributions. Their bases in their partnership interests will be $107,000 at year-end ($100,000 initial basis, plus $15,000 share of partnership income, less $8,000 distribution received).

At first glance, it may seem unusual for the partner to be allowed to increase basis in the partnership interest by his or her share of nontaxable income. This basis adjustment, however, is necessary to prevent the tax-exempt income from indirectly becoming taxable when the partner later sells or otherwise disposes of his or her interest in the partnership.The tax-exempt income increases the partnership's net assets, and therefore, presumably, the value of the equity interests in the partnership. An increase in value, without a corresponding increase in basis, would cause more gain to be recognized upon a subsequent sale of the interest.

Example 1-17

Tim is a 20% partner in Sparrowhawk Partners. He contributed $40,000 to the newly-formed partnership in exchange for his interest early this year. The partnership invested all its capital in municipal bonds. For the year, Tim's share of the partnership's municipal bond interest income was $2,000. The partnership had no other items of income or loss. Although this income is not taxable, it increases Tim's share of partnership assets to $42,000. If he were not required to increase his tax basis in the partnership interest by his share of the tax-exempt municipal bond interest, a subsequent sale of that interest for its $42,000 value would trigger a $2,000 taxable gain to Tim. (His initial basis in the partnership interest was $40,000.) The basis adjustment preserves the tax-exempt nature of the income allocated to Tim.

If the partnership reports a loss, rather than a profit, each partner's share of the loss reduces his or her interest in the partnership's remaining partnership assets. Section 705(a)(2) requires that the partner's basis in the partnership interest be reduced by his or her share of each item of partnership loss or expense, including nondeductible losses or expenses. The reason nondeductible expenses reduce the partner's basis in the partnership interest is similar to the reason tax-exempt income increases basis. If a partner's basis was not reduced for nondeductible expenses, the partner would presumably have a greater loss or lower gain on the sale of the partnership, which would be essentially equivalent to making the expenses deductible.

Example 1-18

Dennis is a 10% partner in Dame Partners. At the beginning of the year, his basis in Dame was $25,000. For the year, Dennis received a K-1 from Dame Partners reporting that his share of partnership ordinary income or loss was ($12,000), and his share of partnership interest income was $2,500. Dennis' basis in his partnership interest at the end of the year will be $15,500 ($25,000 - $12,000 + $2,500).

In summary, partners include their shares of each item of partnership income, gain, loss, or deduction on their own tax returns each year, whether distributed to them or not. A partner's basis in his or her partnership interest is adjusted upward by his or her share of items of partnership income or gain. It is adjusted downward for his or her share of items of partnership loss or deduction. Finally, as the partner withdraws his or her share of partnership income, or portions thereof, basis is adjusted downward to reflect the distributions. In this way, the partner's basis in the partnership interest reflects the partner's net investment, direct and indirect, in the partnership.

Effect on the partners: Rights to partnership assets

A partner's share of partnership income or loss usually affects his or her rights to partnership assets. For example, if a partner contributes $12,000 to a partnership, and is allocated a $10,000 share of partnership income in the first year, he or she has a claim to $22,000 of the partnership's assets. If the partner receives no distributions in the current year, he or she expects to receive at least $22,000 in the future. Likewise, if the partner's share of partnership income or loss had been a ($2,000) loss, he or she would have a remaining claim against partnership assets of only $10,000 (the original $12,000 contribution, less the ($2,000) share of the partnership's operating loss). Note that the partner's claim against the partnership's assets is not the same as the partner's basis in his or her partnership interest. One reason these amounts differ is that the latter includes the amount the partner might have to pay should the partnership fail (that is, the partner's share of partnership liabilities).

The partner's share of the partnership's basis in partnership assets is called the *inside basis.* The partner's basis in the partnership interest, which includes the share of partnership liabilities, is referred to as the *outside basis.*

The partners' contributions to the partnership, and their rights to partnership assets, are reflected in the capital section of the partnership's balance sheets. For tax purposes the partnership maintains two sets of books and records. The first set reflects the partnership's tax basis in its assets and is used to determine the tax consequences of its transactions. The second set of records reflects the book value of the partnership's assets and is used to determine the economic consequences of partnership transactions.[12]

Example 1-19

Dale and Roy formed a partnership early this year. Dale contributed $100,000 cash in exchange for a 50% interest in the partnership. Roy contributed land with a tax basis of $60,000 and a fair market value of $100,000 in exchange for the remaining 50% interest in the partnership. The partnership will establish two sets of books and records. The first will record the land contributed by Roy at its $60,000 tax basis (which becomes the partnership's tax basis in the property under Section 723), along with the $100,000 cash contribution by Dale. In addition, this balance sheet will record Dale's capital contribution at $100,000, and Roy's at $60,000. The second set of records maintained by the partnership will reflect the book values of the two partnership assets, as well as Dale's and Roy's relative interests in those assets. On this set of books, the land will be recorded at its date of contribution value of $100,000, as will the cash. Dale's and Roy's capital accounts will each be $100,000. Therefore, the partnership's initial balance sheets will be as follows (amounts in thousands):

[12] Many partnerships also maintain a set of GAAP books and records, which may differ from the "book" records required under Section 704(b).

Example 1-19 (continued)

	Section 704(b)		
	Tax	Book	GAAP*
Cash	$100	$100	$100
Land	60	100	100
Total Assets	$160	$200	$200
Capital, Dale	$100	$100	$100
Capital, Roy	60	100	100
Total Liabilities and Capital	$160	$200	$200

Interpretation of the balance sheets is straightforward. The tax balance sheet indicates that the partnership has an aggregate basis in its assets of $160,000. Dale contributed $100,000 of this, and Roy contributed $60,000. Therefore, Dale stands to lose $100,000, although Roy stands to lose only $60,000, measured in historical cost terms. (Although Roy stands to lose $100,000 economically, $40,000 of this loss would be an opportunity loss.) In contrast, review of the book balance sheet indicates that the partnership has total assets with a market value (at date of contribution) of $200,000, of which $100,000 would go to Roy and $100,000 to Dale upon liquidation.

* The partnership's initial balance sheet, reported on Schedule L of Form 1065 should generally agree with the partnership's books and records, which should be based on generally accepted accounting principles (GAAP). However, as discussed in a subsequent course, there are certain occasions in which the partnership is allowed to "revalue" its book balance sheet for tax purposes. Such revaluations may result in the partnership maintaining three sets of books and records—one accounting for the tax basis of partnership assets, another accounting for the Section 704(b) book value of those assets, and a third accounting for the GAAP book value of those assets.

As illustrated in the previous example, capital accounts are maintained separately for each partner in the partnership. The capital account is increased by net contributions (that is, net of debt) to the partnership, and by the partner's share of partnership net income. It is decreased by net distributions received from the partnership, and by the partner's share of net partnership losses (if any). Therefore, the tax capital accounts summarize the basis of what each partner has invested in the partnership (tax balance sheet). The book capital accounts summarize what each partner is entitled to receive from the partnership at liquidation (book balance sheet).

Example 1-20

Lisa and Bill formed a partnership to purchase an office building. Lisa contributed $50,000 cash to the partnership in exchange for a 50% interest therein. Bill contributed land with a tax basis of $25,000 and a fair market value of $50,000 for the remaining 50% interest. The partnership then borrowed $400,000 and purchased an office building for $450,000. The partnership's balance sheets will look as follows immediately after formation:

		Section 704(b)
	Tax	Book
Land	$25,000	$50,000
Building	450,000	450,000
Total assets	$475,000	$500,000
Mortgage, Building	$400,000	$400,000
Capital, Lisa	50,000	50,000
Capital, Bill	25,000	50,000
Total liabilities & capital	$475,000	$500,000

The initial tax balance sheet indicates that Lisa contributed $50,000 toward the tax basis (remaining cost) of the partnership's assets, and Bill contributed $25,000 of this amount. Yet, as indicated on the book balance sheet, Lisa and Bill would each be entitled to receive $50,000 if the partnership were to liquidate. Now assume that in its first year of operations, the partnership earns net income (book and tax) of $120,000 and distributes $40,000 of this amount to Lisa and Bill ($20,000 each). Assuming no change in debt, the partnership's balance sheets would now have the following balances:

		Section 704(b)
	Tax	Book
Total assets	$555,000	$580,000
Mortgage, Building	$400,000	$400,000
Capital, Lisa	90,000	90,000
Capital, Bill	65,000	90,000
Total liabilities & capital	$555,000	$580,000

Example 1-20 (continued)

As illustrated, Lisa and Bill's capital accounts would each be increased by $40,000 on both balance sheets ($60,000 share of partnership net income, less $20,000 distribution received). Therefore, Lisa's $90,000 capital balance on the tax basis balance sheet reflects her total direct investments in the partnership of $50,000 at formation plus her $40,000 of reinvested profits. Bill's capital account on the tax basis balance sheet reflects the $25,000 basis of the land initially contributed to the partnership, plus $40,000 of reinvested profits. The book balance sheet, in contrast, indicates that if the partnership were to sell all its assets at their $580,000 year-end book value, each partner would receive $90,000, after payment of the partnership's creditors. This balance sheet reflects the partners' legal and economic rights to partnership assets, which are based on the fair market values of the properties each contributed (as of the date of contribution), adjusted for additional investments (reinvested profits) and distributions made since that time.

Therefore, the partner capital accounts play a crucial role in determining the consequences for the partners of partnership activities. Because a partner's share of partnership income is credited to his or her capital account, therefore giving him or her a right to withdrawal of a like amount, he or she is taxable on that income even if it is not currently distributed by the partnership. Any income not withdrawn remains in the partner's capital account, and constitutes an additional investment by the partner in the partnership. The partner's basis in the partnership interest is increased to reflect this additional investment. Finally, because the partner retains the right to withdraw his or her capital, including reinvested earnings, from the partnership in the future, his or her interest in partnership assets, as reflected on the book balance sheet, is also increased by any portion of that share of earnings which is not withdrawn (that is, received as a distribution) in the current year.

Knowledge check

6. Dale and Roy formed a partnership early this year. Dale contributed $150,000 cash in exchange for a 50% interest in the partnership. Roy contributed land with a tax basis of $90,000, and a fair market value of $150,000 in exchange for the remaining 50% interest in the partnership. What will be the balance in Roy's book capital account in the partnership's balance sheet?

   a. $150,000.
   b. $90,000.
   c. $60,000.
   d. $75,000.

Self-employment tax issues

Generally speaking, a significant disadvantage of the partnership form relative to the S corporation form is the self-employment tax. A shareholder's share of pass-through income from an S corporation is generally not treated as earned income,[13] and therefore does not trigger self-employment (SE) taxes; in contrast, a general partner's share of ordinary income (but not capital gains, interest income, and the like) from a partnership is subject to self-employment tax.

Different rules apply to limited partners. Because limited partners are not allowed to participate in management, their shares of partnership income are not classified as earned income and therefore do not trigger self-employment tax.[14] This provision does not apply to guaranteed payments received in exchange for services rendered to or on behalf of the partnership.

For this reason, it is not uncommon for some general partners to structure a portion of their interest in a limited partnership as a limited partnership interest. For example, a partner may own a 1% general partnership interest and a 9% limited partnership interest. This structure does not protect the general partner from personal liability for partnership losses, but does result in the portion of partnership income attributable to the partner's limited partnership interest to be classified as unearned income, not subject to the self-employment tax. As long as the partner is fairly compensated for any services (for example, management services) provided in his or her capacity as a general partner, the IRS should not challenge this arrangement.

Although it is clear how these provisions apply to general and limited partnerships, it is much less clear how they should be applied to limited liability companies. The proposed regulations under Section 1402 attempt to provide some guidance on this question. As a general rule, the proposed regulations treat an investor in an LLC (or any other type of entity) as a limited partner unless such investor

- has *personal liability* for the debts of or claims against the LLC by reason of being a partner or member;
- has authority under state law to contract on behalf of the LLC; or
- participates in the LLC's trade or business for more than 500 hours during the entity's taxable year.[15]

The proposed regulations establish two exceptions to these rules. First, no individual who is a *service partner* in a service partnership (including an LLC electing to be taxed as a partnership) can be classified as a limited partner. Therefore, members of LLCs engaged in the practice of health, law, engineering, architecture, accounting, actuarial science, or consulting will generally not be treated as limited partners (and therefore will be subject to SE taxes) unless they provide no services to or on behalf of the LLC.[16]

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[13] Note, however, that if the shareholder does not withdraw a reasonable salary as compensation for any services rendered on behalf of the S corporation, some or all of his or her pass-through income may be reclassified as wages or salary income.
[14] Section 1402(a)(13).
[15] Proposed Reg. Sec. 1.1402(a)-2(h)(2), issued January 13, 1997, and not yet replaced by permanent regulations as of the date of this publication.
[16] Proposed Reg. Sec. 1.1402(a)-2(h)(5) and (6)(iii), issued January 13, 1997, and not yet replaced by permanent regulations as of the date of this publication.

Second, the proposed regulations provide that a member of an LLC can be treated as a limited partner even if he or she participates in the LLC's trade or business for more than 500 hours if

- the member would be treated as a limited partner if not for his or her participation in the LLC's trade or business for more than 500 hours;
- other members who are treated as limited partners own a substantial continuing interest in the LLC; and
- such other members have rights and obligations with respect to their membership interests in the LLC that are identical to those of the member participating in the LLC's activity for more than 500 hours during the taxable year.[17]

Note that Proposed Reg. Sec. 1.1402(a)-2(h) have expired and to date the IRS has not issued new regulations regarding the classification of investors in LLCs. However, the expired regulations do give us some guidance regarding the IRS opinion in these matters.

Example 1-21

A, B, and C are members of an LLC that has elected to be taxed as a partnership for federal income tax purposes. The LLC is not a service partnership as defined in the proposed regulations under Section 1402. A and B each own one unit in the LLC; C owns two units. Therefore, A and B are each entitled to share in 25% of the company's profits and losses, but C receives 50%. In addition, B and C perform services on behalf of the LLC. B worked 600 hours in the current year, but C worked 1,000 hours. C, as the managing "partner" of the LLC, has the authority under state law to contract on the LLC's behalf. B and C each received guaranteed payments from the LLC as compensation for services rendered. None of the members has personal liability for entity debts or claims against the entity.

The proposed regulations provide that A, who is not authorized to contract on behalf of the LLC, does not provide services to or on behalf of the LLC, and has no personal responsibility for LLC debts, will be treated as a limited partner. Therefore, his or her distributive share of LLC ordinary income will be excluded from his or her net earnings from self-employment.

Likewise, B will also be classified as a limited partner. Although B performed more than 500 hours of service for the LLC, he or she is not authorized to contract on the LLC's behalf and is not personally liable for LLC debts. Moreover, his or her rights and obligations as a member of the LLC are identical to A's. Because A's interest in the LLC is substantial, and A is treated as a limited partner, B will also be treated as a limited partner. His or her distributive share of LLC income will not be subject to SE tax, although the amounts received as guaranteed payments for services rendered to the LLC will be subject to SE tax.

Unlike A and B, C will not be treated as a limited partner, because he or she has the authority to contract on behalf of the LLC. Accordingly, both his or her distributive share of LLC ordinary income and any amounts received as guaranteed payments for services rendered to the LLC will be classified as earned income.[18]

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[17] Proposed Reg. Sec. 1.1402(a)-2(h)(4), issued January 13, 1997, and not yet replaced by permanent regulations as of the date of this publication.

[18] Proposed Reg. Sec. 1.1402(a)-2(i) Example (i), issued January 13, 1997, and not yet replaced by permanent regulations as of the date of this publication.

These rules appear to be consistent with proposed regulations under IRC Section 469 issued in November 2012. Proposed Reg. Sec. 1.469-5(e)(3)(i) change the rules for determining whether an LLC member should be treated as a limited partner for purposes of the passive loss limitations. Unlike the existing regulations under IRC Section 469, which base the determination of limited partnership status on the issue of whether the partner or LLC member enjoys limited liability for the entity's activities, the proposed regulations base this determination instead on the LLC member's right to "manage" the entity.[19] Presumably, an LLC member should be classified consistently regardless of the statute under which his or her status is being evaluated. Therefore, a member of an LLC who does not have the right to participate in management is properly classified as a limited partner whose allocable share of LLC losses will be subject to the passive loss limitations of IRC Section 469, but whose allocable share of profits will not be subject to self-employment taxes. In contrast, if the member does have the right to participate in management (whether or not exercised), his or her allocable share of LLC losses will not be subject to the passive loss limitations and any allocable share of LLC profits will be subject to SE taxes.

[19] Proposed Reg. Sec. 1.469-5(e)(3)(i)(B).

Chapter 2

Tax Consequences of Partnership or LLC Formation

Learning objectives

- Calculate the tax basis of assets transferred to a partnership or limited liability company (LLC) at formation.
- Recognize the tax consequences of a transfer of liabilities to a partnership or LLC in connection with property transfers at formation.
- Identify the required tax year for a partnership or LLC.
- Determine the tax consequences associated with the exchange of an interest in a partnership or LLC for services.

Determination of basis

The rules governing the determination and subsequent adjustment of a partner's basis in his or her partnership interest are generally straightforward. Consistent with the provision in Section 721 that no gain or loss is recognized upon a transfer of property to a partnership in exchange for an interest in the partnership, Section 722 provides that a partner takes an initial basis in his or her partnership interest equal to the amount of money and the basis of property he or she contributed. Section 723 provides that the partnership takes a carryover basis in property contributed.[1] Therefore, initially, the partnership's aggregate basis in its assets is equal to the sum of the partners' bases in their partnership interests. The same provisions apply to limited LLCs electing to be taxed as partnerships.

[1] An exception to these rules provides that, where the partnership would be treated as an *investment* corporation were it incorporated, Section 721 does not apply. Consequently, in these cases the contributing partner will recognize gain on the transfer of, say, appreciated securities to the partnership, and she will take a fair market value basis in her partnership interest. The partnership's basis in its assets is increased by any such gain recognized by the partner.

Effect of entity operations

The results of subsequent partnership operations are reflected in each partner's basis in his or her partnership interest. Section 705 provides that a partner's basis is increased by his or her share of partnership income, including nontaxable income. Because it increases the net assets of a partnership, nontaxable income should also increase the value of a partnership interest. The positive basis adjustment for nontaxable income is necessary to maintain its tax-exempt status; otherwise, such income would later be converted to taxable income in the form of gain from disposition of the partnership interest. A partner's basis in his or her interest is also increased by subsequent contributions of cash or property to the partnership. Finally, basis is increased by the excess of percentage depletion over an asset's cost in order to preserve the deductibility of excess percentage depletion (because deductions cannot exceed the partner's basis in the partnership interest).

Basis is decreased by the partner's share of subsequent partnership taxable losses or deductible expenses. Note that the qualified business income deduction of Section 199A is computed at the partner level, rather than by the partnership it is not a partnership deduction). Accordingly, to the extent a partner claims this deduction with respect to her share of partnership or LLC income, the deduction does *not* reduce her tax basis in the partnership or LLC interest. A partner's basis is further decreased by his or her share of the partnership's nondeductible expenditures, for the same reason that nontaxable income increases basis. Basis is also decreased by the amount of money, and the basis to the partner under Section 732 of any property distributed to the partner by the partnership.

The basis computation essentially keeps track of a partner's tax investment in the partnership. Basis represents the amount of a partner's potential tax loss in the event the partnership's assets become completely worthless. Additionally, it represents the *tax cost* of the partnership interest for purposes of determining gain upon disposition.

Effect of liabilities

General

Because general partners are liable for partnership debts, liabilities increase the amount those partners stand to lose in the event of a partnership failure. Accordingly, partnership liabilities are included in the partners' bases in their partnership interests. The rules governing the adjustment of partner basis to take into account partnership liabilities are provided by Section 752.

Section 752(a) provides that increases in a partner's share of partnership liabilities, or the assumption by a partner of partnership liabilities (for example, in connection with a distribution of property), are treated as contributions of money by the partner to the partnership. Such deemed contributions increase the partner's basis in his or her partnership interest. Similarly, Section 752(b) provides that decreases in a partner's share of partnership debt, or assumptions by the partnership of a partner's debt, are treated as distributions of money by the partnership to the partner. Deemed distributions under Section 752(b) decrease the partner's basis in his or her partnership interest.

Gain under Section 731: Deemed distributions

Section 752(b) poses a potentially dangerous trap for the unwary. Distributions in excess of a partner's basis in his or her partnership interest trigger taxable gain under Section 731(a). This gain is taxed as gain from the sale of the partnership interest. Because Section 752(b) treats a decrease in a partner's share of partnership debts as a distribution of cash, an unexpected gain under Section 731(a) may often arise as a result of a partnership's payment of its debts or as the result of a change in the partners' liability sharing ratios.

Example 2-1

A and B form the equal AB Partnership with the following contributions. A contributes property with a basis of $100,000 and a fair market value of $600,000, but subject to a debt of $300,000. B contributes property with a basis of $200,000 and a fair market value of $400,000. It is subject to a debt of $100,000. Six months later, C is admitted as a 25 percent partner in exchange for $200,000 cash.

Neither partner A or B recognizes income or loss as a result of his original contribution to the partnership. The partnership takes a carryover basis of $100,000 in A's property and $200,000 in B's property. A's basis in her partnership interest is zero ($100,000 property contributed + $200,000 increase in her share of partnership debt – $300,000 debt transferred to the partnership). B takes a basis of $300,000 in his partnership interest ($200,000 property contributed + $200,000 increase in his share of partnership debt—$100,000 debt transferred to the partnership).

Example 2-1 (continued)

C's subsequent entry, however, changes the partners' debt sharing ratios. C now shares 25% of the partnership debt, reducing A's and B's shares by 12.5%, or $50,000, each. This reduction is treated as a cash distribution under Section 752(b) of $50,000 each to A and B. This deemed distribution reduces B's basis in his partnership interest to $250,000. A, however, has no basis in her partnership interest. Therefore, the deemed $50,000 distribution triggers a $50,000 gain to A under Section 731(a).

Contribution of encumbered property

Section 731(a) gain can also be triggered as a result of the application of Section 752(b) when a partner contributes property encumbered by a liability in excess of its basis. Such gain is not precluded by Section 721 because it does not arise from the contribution of property in exchange for a partnership interest, but rather from a deemed distribution under Section 752(b) resulting from the partnership's assumption of the partner's liability. It should be noted, however, that in computing the amount of gain (if any) recognized under Section 731(a) upon a partner's entrance into the partnership, the provisions of Section 752(a) and Section 752(b) are applied simultaneously.[2] Therefore, Section 731(a) gain arises only to the extent that the amount of liability shifted from the contributing partner to the other partners exceeds the sum of the basis of property contributed by the contributing partner plus such partner's share of other debts of the partnership (if any).

Example 2-2

A and B form the AB Partnership with the following contributions of property and cash. A contributes land with a basis of $100, and a fair market value of $300, but encumbered by a debt of $200. B contributes $100 cash. A and B are equal partners. As such, they share liability for the new partnership debt 50:50. Application of the provisions of Section 752(b) will treat A as if he received a distribution of $200 cash when the partnership assumes the $200 debt that was formerly A's. A recognizes no gain under Section 731(a); however, he is also treated, under Section 752(a), as if he had contributed $100 cash, representing his share of the partnership debt, in addition to the land. Therefore A's $200 Section 752(b) distribution was accompanied by a Section 752(a) contribution of $100 cash in addition to the Section 722 contribution of land. After application of Section 752(b), A's basis in his partnership interest is reduced to zero. B has a $200 basis in his partnership interest. ($100 cash contributed directly plus $100 deemed contribution under Section 752(a).)

[2] Revenue Ruling 87-120, 87-2 CB 161.

Knowledge check

1. Gary contributed property to the GHK Partnership in exchange for a one-third interest in partnership capital, profits, and losses. Gary's tax basis in the property contributed to the partnership was $50,000. The fair market value of the property at the date of contribution was $145,000, and it was encumbered by a $40,000 mortgage, for which the partnership assumed responsibility in connection with the transfer. What will be the partnership's tax basis in the property received from Gary?

    a. $10,000.
    b. $50,000.
    c. $105,000.
    d. $145,000.

Example 2-3

Assume the same facts as example 2-2, but B contributes $200 cash. Now B has a two-thirds interest in the partnership and assumes liability for two-thirds of the partnership's debt. Because A is responsible only for one-third of the partnership's debt, his basis immediately prior to the Section 752(b) distribution is only $167. ($100 basis in land plus $67 deemed contribution under Section 752(a).) Therefore, the $200 deemed distribution under Section 752(b) triggers a $33 Section 731(a) gain to A.

Knowledge check

2. E and F form the equal general EF Partnership, with E contributing property with a basis of $350,000 and a fair market value of $300,000, and F contributing property with a basis of $200,000, and a fair market value of $300,000. The partnership then borrowed $100,000. What is E's basis in the partnership after these transactions?

    a. $325,000.
    b. $350,000.
    c. $400,000.
    d. $450,000.

Section 752(c)

One restriction on the inclusion of nonrecourse debt in basis is provided by Section 752(c). Section 752(c) provides that, with respect to transfers of property between partners and partnerships, nonrecourse liabilities encumbering the transferred property are themselves considered transferred only to the extent of the fair market value of the property. This provision, which was apparently intended to prevent partners from artificially inflating the basis of their partnership interests, is potentially more restrictive than the principle established in case law. Most of the relevant cases on the legitimacy of nonrecourse debt deal with transactions in which the value of the property, and therefore the purchaser's equity, was inadequate from the start to justify the amount of the debt transferred.[3] Section 752(c) certainly could apply in such a situation as well, but it also extends to a transfer of depreciated property, the original value of which was sufficient to justify the initial loan, between a partner and a partnership.

Knowledge check

3. Which correctly describes the consequences of a contribution of property to a partnership when the property is encumbered by a liability?

   a. Overall, the liability increases the partner's tax basis in the partnership interest.
   b. The partnership's assumption of the liability is treated as a distribution of money by the partnership to the partner.
   c. The basis of the associated property to the partnership will be reduced by the amount of the liability.
   d. The partner's overall increase in his or her basis in the partnership will be the basis of the property minus the liability.

Example 2-4

A, a 10 percent partner in the AJ partnership, has a $5,000 basis in her partnership interest consisting of a $1,500 negative capital balance plus a $6,500 share of the partnership's debt. In complete liquidation of her interest, A receives property with a basis and value of $50,000, but subject to a nonrecourse mortgage of $65,000. Applying Section 752(c), A will be considered to assume a debt of $50,000 as a result of the distribution. This represents a $43,500 increase over her share of partnership debt before the distribution, which is treated as a contribution of cash to the partnership. Assumption of this debt temporarily increases her basis in the partnership interest to $48,500. Under Section 732(b), she will take a basis of $48,500 in the distributed property, and her basis in her partnership interest will be reduced to zero.

[3] For example, in *Crane,* 47-1 USTC Section 9217, 331 U.S. 1 (1947), the Supreme Court ruled that the full amount of a nonrecourse mortgage on real property was includable in the owner's amount realized when the property was sold. The Court noted, however, that: "Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot" (footnote 47). In *Tufts,* CA-5,81-2 USTC Section 9574, 651 F.2d 1058 (1981), however, the Supreme Court determined that IRC Section 752(c) applies only to the transfer of property between a partner and a partnership and therefore does not operate to limit the amount of consideration realized on a sale or exchange of the partnership interest by a partner to a third person under IRC Section 752(d).

Determination of tax year

Section 706(b)(1)(B) governs the determination of the partnership's taxable year. In general, the statute requires that the partnership's tax year conform to that used by its partners. Specifically, Section 706 requires determination of the partnership tax year according to the following requirements:

- *Majority interest rule*. A new partnership must adopt the same tax year as used by those partners owning aggregate interests exceeding 50% in profits and capital.
- *Principal partners rule*. If there are no majority interest partners, the partnership is required to adopt the same tax year as that of all those partners owning at least 5% interests in profits or capital (this is possible only if all greater-than-5 percent partners have the same tax year).
- *Other allowable year*. If neither of the preceding rules can be applied, the partnership generally must adopt as its taxable year the year that results in the least aggregate deferral of income to its partners. Aggregate deferral is measured by totaling, for all partners, the product of each partner's months of deferral of partnership income and that partner's percentage ownership. A partner's months of deferral are the number of months from the end of the partnership's taxable year to the end of the partner's taxable year (the months of partnership income that will not be recognized by the partner until the partner's following taxable year).

Example 2-5

A and B form equal partnership AB on January 1, Y1. Partner A has a tax year ending on June 30, whereas partner B's tax year ends on July 31. Because A and B each have a 50% interest in the partnership, neither the majority interest rule nor the principal partners rule apply. Therefore, the partnership must use a June 30 tax year because that year results in the least aggregate deferral of income for the partners:

6/30 Year-end				
Partner	Ptr yr. end	Partnership interest	Mo. Deferral for 6/30 yr. end	Aggregate deferral
A	6/30	50%	0	0.0
B	7/31	50%	1	0.5
				0.5 months

7/31 Year-end				
Partner	Ptr yr. end	Partnership interest	Mo. Deferral for 7/31 yr. end	Aggregate deferral
A	6/30	50%	11	5.5
B	7/31	50%	0	0.0
				5.5 months

Exceptions

There are two exceptions to the rules of Section 706(b)(1)(B). One exception allows partnerships to file Form 1128 to request to use another taxable year if they can show that they have a "natural business year." Generally, in order to qualify for this exception, the partnership must show that the alternative year conforms to the partnership's natural business cycle. Under Revenue Procedure (Rev. Proc.) 2002-39 (2002-1 CB 1046), this can be done using one of three tests: (*a*) the annual business cycle test, (*b*) the seasonal business test, and (*c*) the 25 percent of gross receipts test.

Under the annual business cycle test, if the taxpayer's gross receipts from sales and services for the short period (ending with the proposed year-end) and the three immediately preceding taxable years indicate that the taxpayer has a peak and a non-peak period of business, the taxpayer's natural business year is deemed to end at, or soon after, the close of the highest peak period of business. Under a safe harbor rule, for this test, one month is deemed to be "soon after" the close of the highest peak period of business.

Under the seasonal business test, if the taxpayer's gross receipts from sales and services for the short period and the three immediately preceding taxable years indicate that the taxpayer's business is operational only for part of the year (for example, due to weather conditions) and, as a result, the taxpayer has insignificant gross receipts during the period the business is not operational, the taxpayer's natural business year is deemed to end at, or soon after, the operations end for the season. Under a safe harbor rule, for purposes of this test, an amount equal to less than 10% of the taxpayer's total gross receipts for the year will be deemed to be "insignificant," and one month will be deemed to be "soon after" the close of operations.

Under the 25 percent gross receipts test, a partnership may substantiate a natural business year by showing that gross receipts for the last two months of the requested year constitute 25% or more of its total gross receipts for such year. This requirement must be satisfied for the current year and the prior two years.[4]

The other exception to the rules of Section 706(b)(1)(B) allows a partnership to adopt, or to change to, an alternative tax year without showing a "natural business year." Under Section 444, however, in order to use the alternative year, the partnership must make required payments, which approximate the amount of the tax deferral for the alternative tax year. These payments must be made annually on May 15, accompanied by Form 8752. The required payments for each year are determined by multiplying the partnership's deferral period income by the highest statutory individual tax rate plus1%. Such amount must be paid to the IRS for the first year in which the alternative year is to be used. Additional payments must be made annually if the required prepayment increases greater than this initial amount by $500 or more.

[4] To substantiate a natural business year under the 25 percent gross receipts test, a taxpayer must have a 47-month history of gross receipts — 12 months for the current and two prior years, plus 11 additional months to be used to compare the requested natural year with other potential tax years. Where more than one year qualifies as a natural business year under this test, the partnership must use the fiscal year with the highest percentage of gross receipts occurring in the final two months (that is, the "most natural" business year).

Knowledge check

4. R and Q form equal partnership RQ on February 15. Partner R has a tax year ending on July 31, whereas partner Q's tax year ends on October 31. What taxable year must the partnership use?

   a. February 15.
   b. July 31.
   c. October 31.
   d. December 31.

5. On February 1, Q and L form QL, a limited liability company choosing to be taxed as a partnership. The two investors have equal interests in the LLC's capital, profits, and losses. Q's tax year ends on January 31, whereas L has a tax year ending on March 31. What taxable year must the partnership use?

   a. December 31.
   b. January 31.
   c. March 31.
   d. February 1.

Partnership interests obtained for services

Section 721

The scope of Section 721 does not extend to compensatory transfers of partnership interests to individuals in exchange for services rendered (or to be rendered). The regulations under Section 721,[5] like their counterparts under Section 351,[6] expressly forbid the application of that section to exchanges for services, making such an exchange taxable to the partners providing the services.

> To the extent that any of the partners give up any part of their right to be repaid their contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), Section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under Section 61.

Section 83

Proposed regulations issued under Section 721 in both 1971 and 2005 provide that Section 83, rather than Section 721, applies to partners who receive a partnership interest in exchange for services.[7] Section 83 provides that taxable income must be recognized when a taxpayer receives property in connection with the performance of services. If the property received is subject to a substantial risk of forfeiture (for instance, if the right to it does not vest for a number of years), then the income is not recognized until the risk of forfeiture lapses. Income is recognized when the risk of forfeiture lapses in an amount equal to the fair market value of the property at such time.

Proposed Regulation Section (Reg. Sec.) 1.721-1(b)(2) disallows a deduction to the partnership in connection with the transfer of an interest in the partnership for services, "except as provided in Section 83(h) and 1.83-6(c)." Section 83(h) allows a deduction to the partnership in an amount equal to the income recognized by the service partner. The statute further requires that the deduction must be claimed in the same year that the service partner recognizes income in connection with the transfer. Therefore, under Section 83, the service partner recognizes income, and the partnership takes a deduction in the same amount, in the first year in which the transfer of the partnership interest is not subject to a substantial risk of forfeiture. The partnership deduction is treated as a guaranteed payment under Section 707(c).[8]

[5] Reg. Sec. 1.721-1(b)(1).
[6] Reg. Sec. 1.351-1(a)(1).
[7] Proposed Reg. Sec. 1.721-(1)(b)(1), issued in 1971, and revised (slightly) and reissued on May 24, 2005.
[8] Proposed Reg. Sec. 1.721-1(b)(4).

Under this framework, the transfer of a non-forfeitable interest in the partnership in exchange for services is taxable immediately to the recipient partner (and deductible by the partnership as a guaranteed payment). Where the transfer is subject to risk of forfeiture (for example, it does not vest for a specified period of time) the transaction is treated in a manner similar to the issuance of a non-qualified stock option under Subchapter C. At the date the service partner's interest in the partnership vests, he or she includes the value of the interest in income and the partnership is entitled to a guaranteed payment in the same amount. If the interest does not vest (for example, the option expires due to the failure of the recipient partner to satisfy the vesting requirements) no income is recognized and no deduction is allowed to the partnership.[9]

Capital versus profits interest

Although the proposed regulations issued in 2005 clarify the IRS's position with respect to the tax consequences of an exchange of a partnership interest for services, unanswered questions remain. In particular, practitioners have struggled with the distinction between the transfer of an interest in partnership capital and the transfer of an interest in partnership profits only. The primary issue is that of valuation. Determining the value of an interest in partnership capital is a relatively well-established process, whereas the value of an interest in future profits is often speculative. In the next section of this chapter, we discuss the tax consequences of an exchange of a capital interest for services because this area of the law is well-established. The discussion then turns to the tax consequences, if any, associated with the transfer of an interest in future partnership profits in exchange for services.

[9] Proposed Reg. Sec. 1.721-1(b)(2)(ii).

Transfer of a capital interest

Effect on the service partner

Where a taxpayer receives an unrestricted capital interest in a partnership in exchange for services, the application of Section 83 is relatively straightforward. The service partner recognizes ordinary income in an amount equal to the excess of the fair market value received over any amounts paid for such interest.[10] The fair market value of the interest should generally be equal to the liquidation value of the service partner's capital interest. The liquidation value of the partner's capital interest is the amount he or she would receive if the partnership liquidated immediately after the transfer.[11]

The service partner will take an outside basis in his or her partnership interest equal to its fair market value. Although the IRS and the courts have not addressed the issue, it also seems reasonable that the service partner should have a share of inside basis in the same dollar amount. However, for this result to hold, the partnership would be required in many situations to recognize some gain as well (offset by an appropriate deduction for compensation depending on the nature of the service partner's services). The IRS has expressly rejected this view.

Proposed Reg. Sec. 1.721-1(b)(2) provide that no gain or loss shall be recognized by the partnership in connection with the transfer of a partnership interest to a partner in exchange for services rendered. The regulations further provide that the same rule holds upon the substantial vesting of a previously transferred interest to a service partner. Therefore, under this interpretation of Sections 83 and 721, the partnership treats the transfer of a partnership interest to a partner in exchange for services as a guaranteed payment in an amount equal to the fair market value of the interest transferred. This value, in turn, is presumably equal to the liquidation value of the interest transferred. The service partner recognizes ordinary income in a like amount and takes a basis in the newly acquired partnership interest equal to the income recognized. To the extent the partnership owns appreciated or depreciated assets as of the date of the service partner's entry into the partnership, the built-in gains or losses associated with these assets are allocated to the original partners, and not to the service partner, under Section 704(c) when those assets are subsequently sold.[12]

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[10] Section 83(a).
[11] Proposed Regulation Section 1.83-3(l) provides that qualified partnerships may elect to treat the liquidation value of the interest as the fair market value of that interest. Such an election will be available "on or after the date final regulations are published." See also *Mark IV Pictures, Inc.*, 92-2 USTC Section 50,365; 969 F.2d. 669.
[12] Assuming that the partnership elects under Section 704(b) to revalue its assets upon admission of the service partner.

Consequences for other partners

With regard to the non-service partners, the effects of Section 83 are just as straightforward. As noted previously, the non-service partners are deemed to have made a guaranteed payment (consisting of a ratable share of partnership property) to the service partner. This entitles them to a deduction under Section 162 unless the services rendered were of a capital nature.

Example 2-6

A, an individual, receives a 25% interest in partnership BCD in exchange for services rendered by A to the partnership. Prior to the transaction, BCD had the following balance sheets (tax and book):

	Tax basis	Book value
Assets	$210,000	$300,000
Capital, B	$70,000	$100,000
Capital, C	70,000	100,000
Capital, D	70,000	100,000
	$210,000	$300,000

Assume the fair market value of the partnership's assets is equal to their book value. A's % interest in these assets is therefore valued at $75,000. A is deemed to have received assets valued at $75,000 in a transfer governed by Section 707(c) and must recognize $75,000 of ordinary income. A is deemed to simultaneously re-contribute these assets back to the partnership in exchange for a 25 percent partnership interest. A will take a $75,000 outside basis in his or her partnership interest under Section 722.

The partnership is entitled to a $75,000 deduction under Section 707(c). The deduction will presumably be allocated one-third each to partners B, C, and D. The partnership's balance sheets, immediately after the admission of Partner A, will be as follows:

	Tax basis	Book value
Assets	$210,000	$300,000
Capital, A	$75,000	$75,000
Capital, B	45,000	75,000
Capital, C	45,000	75,000
Capital, D	45,000	75,000
	$210,000	$300,000

Example 2-6 (continued)

The deduction allocated between partners B, C, and D reduces their capital accounts by $25,000 each. The transaction has the effect of transferring $25,000 of capital (each) from partners B, C, and D to partner A. She recognizes $75,000 ordinary income, and they each recognize $25,000 deductions. If the assets are subsequently sold for their $300,000 book value, the resulting $90,000 tax gain will be allocated equally among partners B, C, and D under Section 704(c), effectively equalizing the partners' capital balances and eliminating the difference between the book and tax values of the partnership's assets.

Risk of forfeiture

If the service partner's interest is subject to a substantial risk of forfeiture (for example, if future services are required before the interest vests), the effects differ from those described previously primarily with regard to timing. Rather than the service partner recognizing income and the other partners receiving deductions in the year of initial transfer, the transaction is held open and no income or deductions are triggered until such time as the restrictions lapse. The amount of income and deductions triggered is based upon the fair value of the service partner's capital interest at the time the restrictions lapse.

Section 83(b) allows the service partner to elect to close the transaction at the date the interest is awarded and thereby avoid inclusion in income under Section 83 of any subsequent appreciation in partnership assets during the period between initial transfer and lapse of the restrictions. If the service partner makes the election under Section 83(b), he or she must recognize income in the initial year of transfer in an amount equal to the fair market value of the capital interest at that time. The partnership will be allowed a deduction in the same amount. Note, however, that if the partner makes the election under Section 83(b) and later forfeits his or her claim to the partnership interest, no deduction will be allowed to such a partner in the later year, although the partnership will have to recapture into income any amounts previously deducted in the year the Section 83(b) election was made.[13] For many partners, the value of the partnership interest will be much lower in the initial year of the transfer than in the later year when the partner's claim to the interest vests.[14] Therefore, Section 83 can be seen as an improvement over prior case law from the taxpayer's perspective in that it allows the taxpayer the opportunity to close the transaction if he or she so desires.

[13] Reg. Sec. 1.83-6(c).

[14] Indeed, the value of the interest in the year of the initial transfer may well be zero. If the partnership is relatively new or has incurred substantial losses at the time the interest is granted, the initial liquidation value of the service partner's capital account may be zero. A Section 83(b) election in this circumstance will allow the service partner to avoid recognition of gain until the interest is sold or otherwise disposed of.

Example 2-7

If A's interest in example 2-6 does not vest for five years, the initial transfer has no immediate tax consequences unless A makes the election under Section 83(b). Assume no election is made. At the end of five years, the partnership's assets have appreciated to $400,000 and its basis in those assets has declined to $120,000. Upon lapse of the restrictions (that is, at the end of five years), A will recognize a $100,000 of ordinary income (25% of $400,000) and will take a $100,000 basis in the partnership interest. The non-service partners will be entitled to a $100,000 deduction, allocated equally (one-third to each of the original three partners). If an election under Section 83(b) had been made, the consequences of the transaction would have been exactly the same as in example 2-6. By not making the Section 83(b) election, A's share of the appreciation in partnership assets over the preceding five years has been converted from capital gain (presumably) to ordinary income.

Transfer of a profits interest

IRS "safe harbor"

Because of the problems inherent in valuing a profits interest, the IRS has taken the position in Rev. Proc. 93-27 (1993-2 CB 343) that a receipt of a profits interest in exchange for services will not generally be taxable. Rev. Proc. 93-27 does not apply, however, if

- the profits interest relates to a substantially certain and predictable stream of income;
- the service partner disposes of the profits interest within two years; or
- the profits interest is in a publicly traded partnership.

If any one of these three conditions apply, the transfer of a profits interest in exchange for services rendered will continue to draw close scrutiny from the IRS and could be considered taxable either when received or when vested.

The IRS reiterated its position regarding the non-taxability of a transfer of a profits interest in Rev. Proc. 2001-43 (2001-2 CB 191). Rev. Proc. 2001-43 clarifies Rev. Proc. 93-27 by providing that the determination of whether an interest granted to a service partner is a profits interest is tested at the time the interest is granted even if the interest is substantially nonvested at the grant date. Proposed Reg. Sec. 1.83-3(l)(1)(i) and Notice 2005-43 (2205-24 IRB 1221) further clarify the treatment of profits interests transferred to a service partner, establishing a "safe harbor" election for the partnership and all of its partners under which the fair market value of a partnership interest transferred in connection with the performance of services would be treated as equal to the liquidation value of that interest. This election would apply to any safe harbor partnership interest transferred by a partnership if the transfer is made during the period in which the safe harbor election is in effect (even if the safe harbor partnership interest is not substantially vested on the date of transfer). Because the owner of an interest solely in future partnership profits generally would receive nothing upon liquidation, a profits interest under these Proposed Regulations would not result in income when received. These Proposed Regulations become effective upon finalization. As of the date of this writing, they have not been finalized, so the provisions of Rev. Proc. 93-27 are still controlling. Note that under this revenue procedure, the conditions necessary for the safe harbor election are the same.

Exception for fee waivers

Proposed regulations issued in July 2015 (REG-115452-14) provide guidance in determining whether an allocation and distribution should be re-characterized as a disguised payment for services. The preamble to the proposed regulations provides that IRS intends to issue further guidance clarifying that Rev. Proc. 93-27 and Rev. Proc. 2001-43 will not apply to situations in which managers of a PE fund waive their rights to management fees in exchange for an interest in future profits of the fund. Treasury notes that in a typical fee waiver transaction, the fund manager waives its management fees and a related person (usually a group of employees of the management company) receives a profits interest of approximately equal value. Such cases do not fall under the purview of Rev. Proc. 93-27 because: i) the person receiving the profits interest (the general partner) is not providing services to the partnership, and ii) the person providing the services (the management company) has effectively disposed of the partnership interest (through a constructive transfer to the related general partner) within two years of receipt.

Background—Valuation of profits interests in general

Prior to 1971, the common interpretation by tax authorities was that Section 721 applied to an exchange of services for a partnership profits interest, but not to an exchange of services for a partnership capital interest. This interpretation was based on a parenthetical distinction in the regulations under Section 721 between a share in partnership profits and an interest in partnership capital. The regulations strongly imply that only the latter falls outside the scope of Section 721.

The courts did not always follow this distinction strictly,[15] but not until 1971 was it challenged directly. *Sol Diamond*, 74-1 USTC Section 9306, 492 F.2d. 286 (CA-7, aff'g TC), involved a mortgage broker who helped another party obtain the necessary financing to purchase an office building. In return, Diamond received an interest in the future profits derived from ownership of the building. Diamond subsequently sold his interest for $40,000 and reported the income as a short-term capital gain from the sale of a partnership interest. The Seventh Circuit Court of Appeals, siding with the Tax Court and the IRS, ruled that Diamond realized ordinary income in the amount of $40,000 when he received the profits interest. This gave him a basis of $40,000 in the interest and the subsequent sale therefore generated no capital gain.

Post-*Diamond* activity

Subsequent to the *Diamond* decision, the IRS proposed a revenue ruling[16] declaring that it would not follow *Diamond* "to the extent that it holds that the receipt of an interest in partnership profits as compensation for services results in taxable income." The proposed ruling went on to compare a profits interest to "an unfunded, unsecured promise to pay deferred compensation," which therefore does not constitute property for tax purposes. Although this ruling was never issued, the IRS took the same position in a 1986 Tax Court case,[17] conceding that a profits interest received for services rendered was nontaxable.

[15] See *United States v. Frazell* (67-2 USTC Section 9530; 269 F.Supp. 885), in which the taxpayer received profits interests in oil and gas partnerships in exchange for geological services. Under his arrangement with the partnerships, the taxpayer was not entitled to share in partnership profits until the cash investors recouped their initial investments. The court ruled that no transfer occurred until such time as the cash investors recouped their initial investments, at which time a capital interest was transferred to the taxpayer as compensation for past services. See also *Vestal v. U.S.* (74-1 USTC Section 9407; 498 F.2d. 487, CA-8, rev'g DC) in which the same position was taken in similar circumstances.
[16] GCM 36346, 7/25/77.
[17] *National Oil Co. v. Commissioner* (52 TCM 1233).

The IRS took a different position in *St. John* (84-1 USTC 9458), and again in *Campbell* (supra), arguing that the receipt of a partnership profits interest in exchange for services rendered it a taxable event under Section 83. The courts were of little help to tax advisers in these cases. In *St. John*, the court agreed that the transfer was a taxable event under Section 83, but ruled that the profits interest had no value, therefore relieving the taxpayer of any liability for taxes. In *Campbell*, however, the Tax Court took a decidedly stronger position, ruling that the transfer was taxable, and that the value of the taxpayer's profits interest could be determined by reference to projections provided in the offering prospectus distributed to prospective investors. Based on such forecasts, the Tax Court found that Campbell's profits interests had a substantial fair market value and ruled that this value should have been included in his taxable income in the year(s) received. Fortunately for taxpayers, the Eighth Circuit Court of Appeals disagreed.

Campbell

The Tax Court's decision in *Campbell* signaled that service partners would be taxable upon the receipt of partnership profits interests but left in doubt the question of valuation. Campbell's interests appeared relatively easy to value compared to those in other cases, but it still was not clear that the court's determination of value was correct, as evidenced by the appellate court's reversal discussed as follows. For other taxpayers, where partnership offering prospectuses may not be available, the questions remained whether income should be recognized upon receipt of a profits interest, and if so, how much?

In reversing the Tax Court, the Eighth Circuit Court of Appeals provided much-needed guidance on both questions. Although the court's ruling relied on the valuation issue for direct support, its discussion of the first question—whether income should be recognized if the interest is capable of valuation—strongly suggested that the answer should be no. Equally important, it provides a cogent analysis of the rationale for not taxing such transactions.

Application of Section 721

Perhaps the most astonishing aspect of the appeal was the IRS's concession "that the tax court erred in holding that the receipt of a profits interest in exchange for services to the partnership should be considered ordinary income" to the service partner. The IRS went on to argue that Campbell received his profits interests in return for services performed in the capacity of an employee rather than in his capacity as a partner.

The court sided with the IRS on the first point (that the receipt of a profits interest for services performed in one's capacity as a partner is not a taxable event), but not on the second (that Campbell was acting in an employee capacity). More importantly, it provided a theoretical rationale for deferring recognition of income from the receipt of the profits interest.

Relevance of Section 707

The court's reasoning was based on the statutory rationale for Section 707(a)(2). That statute provides that where an allocation and distribution of income to a partner is related to such partner's performance of services for a partnership, and in performing those services, the partner was acting other than in his capacity as a partner, then the allocation and distribution will be recharacterized as a payment to an unrelated third party. The court noted that Section 707(a)(2) does not apply when a service provider acts within his capacity as a partner. Accordingly, if Section 707(a)(2) is to have any relevance, the transfer of a profits interest (an allocation and distribution of profits) as compensation for services provided in one's capacity as a partner must be a nontaxable event under Section 721. Otherwise, all compensatory transfers of partnership interests would be taxable upon receipt, and there would be no need for Section 707(a)(2).

Employee versus partner

As noted previously, the IRS acknowledged the tax-free status of the transfer of a profits interest to a partner but asserted that Campbell received his interests in his capacity as an employee. The court did not directly rule on this issue, but its discussion strongly implied disagreement. It noted that in *Diamond*, the taxpayer received money equal to the value of his services shortly after performing them (when he sold his profits interest back to the other partner), and "apparently did not intend to function as or remain a partner." Therefore, the transfer of the interest served as compensation for services provided other than in a partner capacity.

Campbell, in contrast, received profits interests which "were not transferable and were not likely to provide immediate returns." Therefore, in order to profit from the performance of his services, Campbell would have to function as or remain a partner for an indefinite period. Accordingly, the court expressed doubt that he could have been acting in a capacity other than as a partner and the profits interest he received was determined to be not taxable.

Importance of valuation

Despite its discussion of the preceding issues, the appellate court's reversal of the Tax Court in *Campbell* ultimately rested on its determination that the profits interest received by Campbell had "only speculative, if any, value." In reaching this conclusion, the court emphasized that Campbell's profits interest was subordinate to those of the other limited partners, and therefore could not be valued by reference to the price those other partners were willing to pay for those interests. Moreover, the court noted that the IRS's valuation (and the Tax Court's as well) of the projected stream of tax benefits, and cash distributions, provided in the offering prospectus was inappropriate because those projections were merely predictions. Because the tax benefits in particular were highly speculative, their computed value should have been sharply discounted. In this regard, the court emphasized that many of the projected tax deductions were, in fact, ultimately disallowed by the IRS. Accordingly, the court held that the profits interests received by Campbell "were without fair market value at the time he received them and should not have been included in his income."

This decision ultimately reflects the perspective underlying the IRS' position in Rev. Procs. 93-27, 2001-43 and 2005-43, in which it asserts that the value of a profit's interest cannot generally be reliably determined. Practitioners should note that this perspective has come under increasing scrutiny in recent years, as so-called "carried interests" in financial and investment partnerships have allowed investment managers to apply favorable tax rates to payments that many policy makers view as compensation. The new proposed regulations on disguised compensation for services are likely to be followed by additional regulatory, administrative, and perhaps legislative efforts to more closely evaluate the proper tax classification of profits interests in investment partnerships.

Lessons for tax advisers

Although the appellate court's ruling ultimately rested on the issue of valuation, the case provides important guidelines for tax advisers. First, if the "safe harbor" of Rev. Proc. 93-27 does not apply, it is imperative that services performed by the recipient of the profits interest be performed in his or her capacity as a partner. The following of safeguards should be followed:

- The services must be performed for, or for the benefit of, the partnership.[18]
- The contractual arrangement under which the services are provided, or the partnership agreement, should clearly indicate that the profits interest is transferred in exchange for services performed for the partnership (and not for any of the partners individually).
- The service partner should indicate his intent to function as, and remain, a partner by not disposing of the profits interest for an appropriate period of time.[19]

[18] This will be much easier to substantiate where the profits interest is awarded for current or future services rather than for past services.

[19] Under Treas. Reg. Sec. 1.707-3, transfers between the partnership and a partner occurring within two years of one another are deemed to be related and therefore part of a disguised sale or exchange. Therefore, service partners should plan on waiting at least two years to dispose of the interest in order to avoid having the initial transfer treated as a taxable exchange.

Chapter 3

Partnership Distributions

Learning objectives

- Distinguish between current and liquidating distributions.
- Determine the basis in the investor's hands of property received as a distribution from a partnership or limited liability company (LLC).
- Calculate the partner's or member's remaining basis in his or her interest following a distribution of cash or property from the partnership or LLC.
- Indicate the effects of liabilities assumed by a partner or LLC member in connection with a property distribution.
- Determine the proper tax treatment of retirement payments to a partner.

Introduction

Distributions of partnership assets are classified as either current distributions or liquidating distributions. Distributions are current when the partners receiving the distributions retain all or part of their partnership interest.[1] Even if a distribution reduces a partner's interest from 50% to 1%, it still would be a current distribution. Distributions are liquidating only when a partner's entire interest in the partnership is liquidated.

Partnership distributions can be further divided into distributions that do not change the partners' *proportionate* interests in the "hot assets" of the partnership (*proportionate distributions*), and distributions that do change the partners' proportionate interest in the "hot assets" of the partnership (*disproportionate distributions*).[2] "Hot assets" or "Section 751 assets" are those assets of the partnership that would generate ordinary income if sold by the partnership. They include unrealized receivables (principally zero-basis accounts receivable and depreciation recapture inherent in partnership depreciable property) and substantially appreciated inventory items.

This chapter is concerned solely with distributions that do not change the partners' proportionate interests in the hot assets of the partnership (in other words, distributions where Section 751(b) does not apply). This discussion applies to all distributions by partnerships which have no hot assets. It also applies to distributions in which the recipient partner receives his or her proportionate share of the hot assets of the partnership.

A partnership distribution can consist of cash, property, or a combination of both cash and property. Under Section 752(b), decreases in a partner's share of partnership liabilities are also treated as distributions of cash to the partner from the partnership. A constructive cash distribution triggered by Section 752(b) is equivalent in all respects to an actual distribution of cash.[3]

For purposes of determining gain or loss on partnership distributions, all of a single partner's partnership interests (that is, general and limited) are aggregated into a single interest. This follows the rules of capital account maintenance under Section 704(b).[4]

Neither gain nor loss is recognized by the partnership (as opposed to individual partners) in a proportionate distribution of property, including money, from the partnership.[5]

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[1] IRC Section 761(d), Regulation Section 1.761-1(d), and Reg. Sec. 1.731-1(a)(1).
[2] IRC Section 751(b).
[3] IRC Section 731(a).
[4] Reg. Sec. 1.704-1(b)(2)(iv)(b).
[5] IRC Section 731(b).

Current distributions—Proportionate

General

A *current distribution* is a distribution that does not liquidate a partner's entire interest in the partnership and is not part of a series of distributions intended to liquidate the partner's interest.

Generally, a current distribution of cash or property is not taxable to the recipient partner if that partner has sufficient basis in his or her partnership interest to absorb the distribution. Under Section 731(a), the recipient partner never recognizes loss in connection with the receipt of a current distribution. In contrast, the recipient partner may recognize gain, but only to the extent that cash distributed to the partner exceeds the basis of the partnership interest immediately before the distribution. For example, if $10,000 in cash is distributed to a partner whose basis in his or her partnership interest was $6,000 immediately before the distribution, he or she would have a taxable gain of $4,000.

Gain is not recognized by the recipient partner, however, on the receipt of a distribution of property other than money, regardless of the value of the distributed property in relation to the partner's basis in the partnership interest.[6] No gain would be recognized by a partner, for example, on the distribution of real property valued at $10,000, even though the partner's basis in his or her partnership interest was only $6,000. This is a major advantage of the partnership form of business relative to S corporations or regular corporations. Distributions of property from S Corporations and regular corporations are fully taxable transactions in which the property is deemed to have been sold to the shareholder for fair market value (FMV), followed by a distribution of the net sales proceeds.

Timing of cash distributions

In determining whether cash distributions exceed a partner's basis, all advances and drawings against a partner's distributive share of income are deemed to be current distributions made on the last day of the partnership's taxable year.[7] It is not necessary to determine a partner's basis or to determine gain recognition as each distribution occurs. Instead, distributions are accumulated during the year and offset against the sum of the partner's opening basis, his or her share of current year profits, any year-end capital contributions and his or her share of increases in partnership liabilities less any reduction by losses.[8]

An advance or "draw" against a partner's share of partnership income can be distinguished from a distribution by reference to the impact of the payment on the partner's share of income, loss, or profits. A distribution will generally reduce the partner's capital interest in the partnership relative to the other partners. A reduction of the partner's capital interest will generally (but not necessarily always) reduce the

[6] IRC Section 731(a) requires gain recognition only in the case of distributions of money.
[7] Reg. Sec. 1.731-1(a)(1)(ii).
[8] Reg. Sec. 1.704-1(d)(2).

partner's share of future profit and loss. In contrast, a draw against a partner's current year share of partnership earnings does not reduce her capital interest in the partnership and should not reduce her share of future partnership profit or loss.

Knowledge check

1. Which is the best description of a partnership "current" distribution?

    a. A current distribution is a distribution of the partner's share of the partnership's current year (or current) profits.
    b. A current distribution is any distribution that does not liquidate the partner's interest in the partnership.
    c. A current distribution is the distribution of any of the current assets of the partnership.
    d. A current distribution is one that is distributed at the same time to all the partners.

Example 3-1

A and B share equally in the profits and losses of AB Partnership. On January 1, A's basis in his or her partnership interest was $30,000 and B's basis was $5,000. Each partner received a partnership distribution of $20,000 cash on July 1.

Partnership taxable income for the year was $24,000. Neither of the partners made any contributions to the partnership during the year, and their shares of partnership liabilities did not change.

Based on these facts, each partner's basis in his or her partnership interest at December 31 is computed as follows:

	A	B
Basis at January 1	$30,000	$5,000
Distributive share of partnership ordinary income (50% of $24,000)	12,000	12,000
Partnership distribution	(20,000)	(20,000)
Basis in partnership interest	$22,000	($3,000)

Therefore, B must recognize a $3,000 capital gain, in addition to his or her share of partnership income for the year, "restoring" his or her basis in his or her partnership interest to $0.

In example 3-1, note that B could have avoided the $3,000 taxable gain from excess distributions had he or she contributed $3,000 to the partnership by December 31. The determination of the partner's basis in his or her partnership interest is typically made at the end of the partnership taxable year. In determining the amount of gain to be recognized by B, current distributions were offset against B's beginning basis and his or her share of current partnership income regardless of the actual distribution dates.

Distribution of non-cash assets: General

The recipient partner recognizes no gain on the distribution of non-cash assets as long as the distribution does not alter the partners' proportionate interest in Section 751 assets. This is the case regardless of the value of the distributed property in relation to the recipient partner's basis in his partnership interest.

The recipient partner's basis in property received in a current distribution is generally the same as the basis of the property in the hands of the partnership. In other words, the partnership's basis in the property generally carries over to the recipient partner.[9]

Example 3-2

Assume that F is an equal partner in the EF partnership. Her basis in her partnership interest is $5,000. On December 31, the partnership distributes land to F with an adjusted basis (to the partnership) of $3,000, and an FMV of $15,000. F recognizes no gain, and takes a $3,000 basis in the property. Her basis in her partnership interest is reduced to $2,000.

Note that had F been a shareholder in an S corporation, rather than a partner in a partnership, the preceding distribution would have triggered recognition of $12,000 gain at the S corporation level, $6,000 of which would then be allocable to F as a 50% shareholder. After accounting for her share of the S corporation gain, F's basis in her S corporation stock would be increased (temporarily) to $11,000. The land would come to her with a $15,000 basis (its FMV), triggering recognition of an additional gain of $4,000. Her post-distribution basis in her stock would be $0.

As indicated in the preceding example, upon the receipt of a current distribution, the partner reduces his or her basis in the remaining partnership interest by the amount of cash distributed and the basis of distributed property in the partner's hands.[10] Basis, however, is not reduced less than zero. If the partner receives cash in excess of the basis of the partnership interest, he or she must recognize gain in the amount of the excess. As discussed previously, gain is recognized only if the partner receives cash in an amount exceeding his or her basis in the partnership interest. If property is received with a basis in excess of the basis of the partnership interest, the partner adjusts the basis of the property received in order to defer the recognition of gain on the distribution. The treatment of property distributions is discussed in subsequent sections of this document.

[9] IRC Section 732(a).
[10] IRC Section 733.

Knowledge check

2. Susan is a one-third partner in Anders Mountain Partners. Last month, she received a non-liquidating cash distribution of $25,000. Her basis in her partnership interest prior to the distribution was $30,000. The partnership had no liabilities or "hot assets." How much gain or loss will Susan recognize on receipt of the distribution?

   a. $0 gain or loss.
   b. $25,000 gain.
   c. $25,000 loss.
   d. $5,000 loss.

3. In the previous question, what will be Susan's remaining basis in her partnership interest in Anders Mountain Partners?

   a. $30,000.
   b. $15,000.
   c. $5,000.
   d. $0.

Accounting for distributions when basis in property exceeds basis in partnership interest

The general carryover-basis rule of Section 732(a) is limited when the recipient partner's basis in his or her partnership interest is less than the partnership's adjusted basis in property distributed in a current distribution.[11] In such cases, the recipient partner's basis in the distributed property is limited to his basis in his partnership interest, reduced by any cash distributed to him or her in addition to the distributed property. This event leaves the distributee partner with a $0 basis in the remaining partnership interest.

Example 3-3

Assume that a partner whose basis in her partnership interest is $40,000 receives a non-liquidating distribution of property with a basis to the partnership of $50,000. The fair market value of the property is $75,000.

[11] IRC Section 732(a)(2).

Example 3-3 (continued)

Although the fair market value of the property exceeds the partner's tax basis in the partnership interest, no gain is recognized by the partner. Under the general rule, the partner would take a carryover basis in the property received and reduce the basis of the partnership interest by a like amount. However, in this case, the partner has insufficient basis for the general carryover rule to apply. The partner's basis in the property received is limited to the $40,000 tax basis of the partnership interest even though the partnership's basis in the property was $50,000. The partner's remaining basis in her partnership interest is reduced to $0. The excess basis of the distributed property is lost—the partnership is not allowed to recognize a loss.[12]

Distribution of multiple properties

If more than one item of property is distributed, and the limitation of Section 732(a)(2) is applicable, the transferee partner's basis in the partnership interest must be allocated among the distributed assets. The partner's basis in his partnership interest is allocated among the distributed assets as follows:[13]

- The partner's basis in the partnership interest is first reduced by the amount of any cash received.
- The partner's remaining basis in the partnership interest is then allocated to unrealized receivables and inventory items up to the amount of the basis of those assets in the hands of the partnership. If the partner's remaining basis in the partnership interest is less than the partnership's combined basis in these assets, the basis of the partnership interest is allocated among the unrealized receivables and inventory items in proportion to the partnership's relative bases in these assets. In this case, any other property distributed takes a basis of $0.
- Any remaining basis in the partnership interest which is not applied to unrealized receivables and inventory items is allocated to other distributed assets.

These allocation rules are illustrated in example 3-4.

[12] If the partnership makes an election under Section 754, it may be able to increase its tax basis in its remaining assets under Section 734(b). That topic is beyond the scope of this course.
[13] IRC Section 732(c).

Example 3-4

Partner A, with an adjusted basis in her partnership interest of $15,000, receives the following assets in a current (non-liquidating) distribution. Assume that the distribution does not alter Partner A's interest in Section 751 property.

	Basis
Cash	$5,000
Inventory	6,000
Property Y (realty)	8,000
Total basis to partnership	$19,000

The $5,000 cash distribution reduces A's basis in her partnership interest to $10,000. This remaining basis is then allocated first to the inventory received ($6,000), leaving $4,000 in remaining basis. The remaining $4,000 basis is allocated to property Y. A's basis in her partnership interest is reduced to $0.

Distributions of encumbered property

When a partner receives a distribution of property encumbered by liabilities, the consequences are slightly more complicated. Under Section 752(a), the assumption by the partner of partnership liabilities is treated as a contribution of cash by the partner to the partnership. This deemed contribution must be taken into account for purposes of applying the basis determination rules of Sections 732 and 733.

The problem is further complicated by Section 752(b), which treats a decrease in a partner's share of partnership liabilities as a cash distribution by the partnership to the partner. Because a distribution of encumbered property will generally decrease the partnership's outstanding liabilities, it will decrease every partner's share of partnership debt. The actual distribution of encumbered property to a single partner will therefore be accompanied by a deemed cash distribution to all partners. The distributee-partner must account for both the deemed cash contribution and the deemed cash distribution in addition to the actual distribution of property received from the partnership.

Example 3-5

ABC Partnership had the following balance sheets as of December 31:

	Basis	FMV		Basis	FMV
Cash	$45,000	$45,000	Mtg, P1	$15,000	$15,000
Prop 1	30,000	95,000	Mtg, P2	30,000	30,000
Prop 2	15,000	55,000	Capital, A	15,000	50,000
			Capital, B	15,000	50,000
			Capital, C	15,000	50,000
	$90,000	$195,000		$90,000	$195,000

On that date, the partnership distributed property 2 to C, reducing his or her interest in the partnership from one-third to one-fifth. C took property 2 subject to the mortgage thereon.

Under Section 731(a), C recognizes no gain on the distribution of property 2, because he did not receive cash in excess of his basis in his partnership interest. His basis in the distributed property and his remaining basis in the partnership interest are summarized as follows.

Beginning capital account (tax)		$15,000
Share of partnership liabilities (one-third)		15,000
Beginning basis in partnership interest		$30,000
Deemed cash distribution:		
Pre-distribution share of partnership debt (one-third)	$15,000	
Post-distribution share of partnership debt (one-fifth)	(3,000)	
Reduction in share of partnership debt (treated as distribution)		(12,000)
Deemed cash contribution – assumption of Mtg, P2		30,000
Basis in property distributed from the partnership (carryover)		(15,000)
Remaining basis in partnership interest		$33,000

As illustrated, prior to the distribution, C's basis in his interest was $30,000 (his $15,000 tax basis capital account plus his one-third share of the partnership's liabilities). The distribution reduces his interest in the partnership from one-third to one-fifth. It also reduces the partnership's outstanding liabilities from $45,000 to $15,000. Therefore, his share of partnership debt falls from $15,000 (one-third of $45,000) to $3,000 (one-fifth of $15,000),

Example 3-5 (continued)

and he is treated under Section 752(b) as having received a distribution of $12,000 cash from the partnership. At the same time, his assumption of the partnership's $30,000 mortgage on property 2 is treated as a cash contribution to the partnership. Therefore, after the distribution, he has a $15,000 carryover basis in property 2, and a $33,000 remaining basis in his partnership interest (original $30,000 basis, plus $30,000 deemed cash contribution, less $12,000 deemed cash distribution, less $15,000 basis in property 2 received from the partnership). Note that C's assumption of the mortgage on property 2 is reflected in his basis in the partnership interest, rather than in property 2. Under Section 752(a), C's assumption of the mortgage is treated as a contribution of cash to the partnership. Therefore, in this case, the distribution of property 2 to C, encumbered by the mortgage thereon, actually increases his basis in the partnership interest.

Liquidating distributions: Proportionate

In general

A liquidating distribution is a distribution that liquidates a partner's entire interest in the partnership or is part of a series of distributions intended to liquidate the partner's interest.[14] Liquidating distributions that do not alter the partners' proportionate interests in Section 751 assets are generally tax-free to both the recipient partner and the partnership.

As in the case of a current distribution, the partner whose interest is completely liquidated recognizes gain only if he or she receives money in an amount that exceeds the basis of the partnership interest.[15] However, unlike in current distributions, a partner can, in certain circumstances, recognize loss in connection with the receipt of a liquidating distribution.

Recognition of loss

In contrast to the nonrecognition rule for losses on current distributions, losses may be recognized on certain liquidating distributions.[16] A loss may be recognized upon complete liquidation of a partner's interest if only money, unrealized receivables, and inventory are distributed. The loss, if any, would be the excess of the recipient partner's basis in his partnership interest more than the sum of any money distributed and the partnership's basis for the unrealized receivables and inventory distributed. If the partner whose interest is liquidated receives any property other than money, unrealized receivables, or inventory, no loss may be recognized.[17]

Example 3-6

Assume that John's tax basis in his partnership interest is $10,000 when he decides to retire from the partnership. In complete liquidation of his partnership interest, John receives a distribution consisting of $5,000 in cash and property with a tax basis to the partnership of $3,000. The property has an FMV of $15,000.

If the property distributed to John includes only inventory items, he will take a basis in the property of $3,000 and will recognize a $2,000 loss ($10,000 basis less $5,000 cash and $3,000 basis in the property received).

If, on the other hand, the property distributed to John is unimproved realty, he will recognize no loss on the transaction because he received property other than money, unrealized receivables, or inventory. In this case, rather than recognizing a loss, John will take a basis of $5,000 in the distributed property.

[14] IRC Section 761(d) and Reg. Sec. 1.731-1(a)(2).
[15] Reg. Sec. 1.731-1(a)(1)(i).
[16] IRC Section 731(a)(2).
[17] IRC Section 731(a)(2).

Depending on the facts, these rules may permit a partner to recognize a taxable loss even though the partner has an economic gain on the transaction – that is, even though the market value of the distributed assets exceeds the basis of his or her partnership interest.

Example 3-7

A has a basis in her partnership interest of $100,000. In complete liquidation of that interest, A receives $50,000 cash and her proportionate share of partnership inventory, which has a basis to the partnership of $30,000 and an FMV of $60,000. Although A receives total consideration for her interest of $110,000 (FMV), she will recognize a $20,000 loss upon receipt of the distribution because she is prohibited from taking a tax basis in the inventory in excess of the partnership's basis in that inventory. A's loss is computed as follows:

Pre-distribution basis in the partnership interest		$100,000
Property distributed:		
Cash	$50,000	
Inventory (basis)	30,000	80,000
Recognized loss (capital		($20,000)

The basis of the inventory in A's hands is $30,000. Upon the subsequent sale of the inventory for $60,000, A will recognize $30,000 of ordinary income. Therefore, in the aggregate, A will have a $20,000 capital loss and $30,000 of ordinary income as a result of the distribution and subsequent sale of the distributed inventory.

Series of distributions

If a partner's interest is liquidated in a series of distributions which are intended to liquidate his or her entire partnership interest, all the distributions are treated as liquidating distributions.[18] Under the general rule, cash distributions reduce basis. Only after the partner's basis has been reduced to $0 do further cash distributions result in taxable gain. If the liquidation of the interest results in a loss, and only money, unrealized receivables, and inventory are distributed, the loss is recognized when the liquidation is complete and the partner's entire interest in the partnership is terminated. Gain, on the other hand must be recognized in any year in which the partner receives a distribution of cash in excess of his or her basis in the partnership interest, even if additional liquidation payments are to be received in future years.

[18] Reg. Sec. 1.761-1(d).

Basis in property received

Under Section 732(b), the recipient partner's basis for property received in liquidation of his or her partnership interest is equal to the partner's basis in the partnership interest immediately before the distribution, reduced by any cash received. Under Section 732(c), if the partner's basis in the partnership interest (reduced for any cash received) is less than or equal to the partnership's basis in unrealized receivables and inventory distributed, the basis is allocated entirely to these assets. On the other hand, if the partner's basis in the partnership interest (reduced for any cash received) exceeds the partnership's basis in unrealized receivables and inventory distributed, these assets are allocated basis equal to their basis in the hands of the partnership. Any remaining basis is allocated to other distributed assets.

Mechanically, these allocation rules are the same as those applicable to current distributions when the partnership's basis for the distributed property exceeds the recipient partner's basis for his partnership interest. However, in the case of a liquidating distribution, the effect of these rules may be to give the partner a basis in the distributed property (other than unrealized receivables and inventory) that is greater than the partnership's pre-distribution basis in those assets.

Example 3-8

Assume that partner A, who has a basis in his partnership interest of $5,000, receives a distribution of property with a basis to the partnership of $2,000. The property does not constitute inventory or unrealized receivables to the partnership.

If the distribution is a current distribution, the carryover basis rule applies: the property takes a carryover basis of $2,000 to A, and the basis of his partnership interest is reduced to $3,000 ($5,000 original basis less $2,000 property distribution).

In contrast, if the distribution is a liquidating distribution, A's entire basis in his partnership interest ($5,000) is allocated to the property received. Because A is no longer a partner in the partnership, he no longer has an interest in the partnership, and therefore has nothing other than the property to which to assign the basis he previously had in the partnership interest.

When a partnership distributes encumbered property (property subject to liabilities) to a partner in a liquidating distribution, the debt received is treated as a cash contribution to the partnership by the partner, momentarily increasing the partner's basis in the partnership. However, the simultaneous distribution of the property reduces the partner's basis in the partnership, and the end result is that the recipient partner's basis in the property distributed is increased by the liabilities distributed to the partner.

Example 3-9

Assume that A, a one-third partner in the ABC Partnership, receives a liquidating distribution of property with a basis to the partnership of $15,000. The property, which is not inventory or unrealized receivables, is encumbered by a $30,000 liability for which A assumes responsibility. A's basis in her partnership interest prior to the distribution was $30,000, consisting of her $15,000 capital account and $15,000 share of partnership liabilities.

Because this is a liquidating distribution, A's basis in her partnership interest after the distribution will be $0. A's basis in the property received is computed as follows:

A's initial basis in the partnership interest	$30,000
Assumption by A of partnership debt	30,000
Decrease in A's share of partnership liabilities	(15,000)
A's basis in the property received	$45,000

Note that A's basis in the distributed property, $45,000, exceeds the partnership's basis in the property ($15,000) prior to the distribution.

Compare this result with example 3-5 in the previous section of this chapter, in which the facts are the same except the distribution is a current distribution (not in liquidation of A's interest). In that case, A took carryover basis in the property received ($15,000) and reduced her basis in the partnership interest by a like amount. Because she remained a partner, A could retain tax basis in the remaining partnership interest rather than allocating that entire basis to the property received in the distribution.

Holding period of distributed property

In determining the holding period of assets received in a distribution from the partnership, Section 735(b) generally permits the partner to include the partnership's holding period in his or her holding period.[19] This tacking rule applies both to property received in a current distribution and to property received in a liquidating distribution. If the property has been contributed to the partnership by a partner, then the period that the property was held by the contributing partner will be included in the recipient partner's holding period for the property.

Example 3-10

J acquired her one-third interest in JDR partners six months ago. This month, due to disagreements with the other partners, she accepted a tract of real estate in complete liquidation of her interest. The partnership had acquired the real estate five years ago. Although J has been a partner only for six months, she will take a five-year holding period in the real estate received from the partnership. This outcome will be the same whether J receives the distribution in a liquidating or non-liquidating distribution.

[19] Holding period is not relevant for ordinary income assets.

Sale of distributed property

If a partner could change ordinary income assets into capital gain assets by withdrawing them from a partnership, the partnership form could be used as a vehicle for tax avoidance. To prevent this, Section 735(a) provides that certain ordinary income assets retain their character in the partner's hands after distribution. Section 735(a) is designed to prevent abuse through the distribution of unrealized receivables or inventory items by a partnership.

Under Section 735(a)(1), distributed *unrealized receivables* retain their ordinary income character in the hands of the recipient partner. Whenever the partner disposes of these assets received from a partnership, the gain or loss on the disposition will be characterized as ordinary income or ordinary loss.

Under Section 735(a)(2), distributed *inventory* items retain their ordinary income character in the hands of the recipient partner for five years. This rule applies to inventory items regardless of whether they have appreciated in value. If the inventory items are sold by the recipient partner within five years after the date of the distribution, the gain or loss on the sale will be ordinary income or ordinary loss. If the sale of the inventory items by the recipient partner occurs five years or more after the date of the distribution, the character of the gain or loss is determined by reference to the character of the asset in the hands of the partner. Capital gain or loss will be realized if the asset is then a capital asset in the hands of the partner.

Example 3-11

The ABC Partnership was in the business of developing real estate and distributed a piece of developed property to partner C, an individual with no experience in real estate development. ABC had held the property as inventory, but C held the property as an investment for four years before selling it for a gain of $30,000. The gain would be ordinary income to C because it was inventory to ABC and it was sold within five years of its distribution. If C had waited five years to sell the property, the $30,000 gain would have been taxed as long-term capital gain.

Section 736: Death or retirement of a partner from professional services partnerships or LLCs

General application of Section 736

In many cases, rather than selling a partnership or LLC interest outside the partnership, the partner or LLC member "sells" the interest to the entity. Although structured as a liquidating distribution, the economic effects of such a transaction are indistinguishable from a sale. The tax consequences are also quite similar.

Under Section 736, payments to departing partners are segregated into those received in exchange for the partner's interest in the value of partnership property (Section 736(b) payments) and other payments (Section 736(a) payments). Although Section 736 does not dictate the tax treatment of such liquidating distributions, partners should be aware that payments under section 736(b) are subject to the general distribution rules of Subchapter K and therefore may or may not trigger taxable income to the recipient. If they include an amount of money that exceeds the partner's basis in the partnership interest, for instance, they will create a capital gain equal to the excess. In contrast, Section 736(a) payments are taxable to the retiring partner as either distributive shares of partnership income (if determined by reference to such income) or as guaranteed payments. Guaranteed payments are deductible by the partnership in calculating ordinary income, whereas payments treated as distributive shares reduce the amount of taxable income to the remaining partners, and retain the same character as the items of income earned by the partnership.

Section 736(b) payments are payments for the value of the retiring partner's interest in the partnership's assets. In general, if the retiring partner is a general partner in a service partnership (one in which capital is not an income-producing factor), partnership assets (for this purpose) do not include unrealized receivables or goodwill, and payments for the partner's interest in these will be Section 736(a) payments. However, if the partnership agreement provides for the payment of retirement payments for goodwill, then payments for the partner's share of goodwill will be Section 736(b) payments for property. This latter provision effectively allows the partnership to choose whether goodwill payments received by a departing partner will be subject to Section 736(a) or Section 736(b), because it has the power to amend the partnership agreement.

Note that although the partner might prefer that goodwill payments be treated as Section 736(b) payments (typically resulting in tax-free return of capital or capital gain), the partnership will often prefer that they be treated as Section 736(a) payments (which are typically deductible or at least reduce the income allocated to the remaining partners).

Example 3-12

Until April 30, C was a 25 percent general partner in the ABC Partnership, an engineering firm. On that date, C opted to retire from the partnership. The partnership agreement stated that partners leaving the partnership were entitled to receive a lump sum payment equal to their capital balance on the partnership's books (Section 704(b) capital balance—equivalent to their interest in partnership property), plus a share of unrealized receivables at the date their interest is terminated. The agreement was silent regarding partnership goodwill. The parties negotiated a severance payment of $250,000, of which $50,000 represented C's capital balance and $75,000 represented his share of unrealized receivables. The remaining $125,000 payment must be allocated to partnership goodwill. Of the total amount, $50,000 is for his interest in partnership property and will be taxed according to the general rules for taxation of distributions. It will therefore generate capital gain or loss to C under Section 731(a) (and possibly ordinary income under Section 751). For example, if C's basis in his partnership interest was $35,000, he would recognize a $15,000 capital gain. The remaining $200,000 is a Section 736(a) payment. Under Section 736(a), C will recognize ordinary income of $200,000 upon receipt of the payment and the partnership will be entitled to a $200,000 deduction.[20] If the partnership amends the partnership agreement to provide for compensatory payments to departing partners for goodwill, C would recognize ordinary income only to the extent of the $75,000 payment for his share of unrealized receivables.

Note that in example 3-12, $200,000 of the $250,000 payment to C is treated as a guaranteed payment under Section 736(a). Accordingly, the partnership will be allowed a deduction for this amount, substantially reducing the after-tax cost of terminating C's interest. If the Section 736(a) payments had been variable (for example, dependent on partnership income) rather than fixed in amount, the payments would be treated as a distributive share of partnership income, rather than a guaranteed payment. This would reduce the amount of every type of income allocated to the remaining partners.

If capital is a material income-producing factor for the partnership, then payments received by a general partner (or LLC member treated as a general partner for tax purposes) for his or her share of unrealized receivables and partnership goodwill are deemed to be received for such partner's interest in partnership property and are Section 736(b) payments.[21]

Example 3-13

J is a 20 percent member of JDR, LLC, an LLC electing to be treated as a partnership for federal income tax purposes. Capital is a material income-producing factor for the LLC. J is treated for tax purposes as a general partner in the LLC.

[20] Note that, as a guaranteed payment, this income will be earned income and will therefore be subject to self-employment tax as well as income tax.
[21] Section 736(b)(3).

Example 3-13 (continued)

This year, J decided to retire from the LLC. The members' agreement requires that retiring members are entitled to receive a lump sum payment equal to their capital balances on the entity's books (Section 704(b) capital balance), plus a share of unrealized receivables at the date their interest is terminated. The agreement also requires that retiring members be compensated for their shares of the company's "goodwill," calculated by reference to a formula in the agreement. Following the procedure described in the membership agreement, the parties agree that J is entitled to receive a payment of $250,000, of which $50,000 represents J's capital balance, $75,000 represents her share of unrealized receivables, and $125,000 represents J's calculated share of the LLC's "goodwill." Because capital is a material income-producing factor for the partnership, payments to J for both her share of partnership unrealized receivables and her share of partnership goodwill are deemed to constitute payments for her share of partnership property. Accordingly, none of the payments will be subject to Section 736(a). However, under Section 751(b), amounts received by J for her share of partnership unrealized receivables will trigger ordinary income to J. The remainder of the distribution, $175,000 will be subject to the normal rules governing liquidating distributions. For example, if J's basis in her LLC interest is $135,000, she will recognize a $40,000 taxable gain in addition to the $75,000 ordinary income recognized under Section 751.

Structuring the transaction to avoid Section 736

Whether Section 736 applies to a particular partner's exit payments will be largely dependent on how the exit transaction is structured. As previously noted, at least two alternatives are available to the departing partner to avoid ordinary income recognition. First, the partner can negotiate to have the transaction structured as a sale of his or her interest to the remaining partner(s) or to an outside party (subject to the provisions of the partnership agreement). Because transactions like these would not be between the departing partner and the partnership, Section 736 would not apply. Nonetheless, Section 751(a) would still require that the partner recognize ordinary income to the extent of payments for his or her share of unrealized receivables or inventory items. Note, however, that any payments in excess of the departing partner's basis attributable to partnership goodwill would result in capital gain whether or not capital is a material income-producing factor for the partnership or LLC.

Alternatively, for partnerships in which capital is not a material income-producing factor, the partner can seek to have the partnership agreement amended to provide that goodwill be explicitly considered in computing compensation to be received by departing partners. Note that if payment is made from the partnership's business account, rather from the individual account(s) of the remaining partner(s), the latter alternative may be preferred to avoid the goodwill provisions of Section 736(b). Alternatively, if the payment is drawn from the individual account of one or more remaining partners, it may be difficult for the partnership to later assert that the payment should be governed by Section 736. To ensure that the transaction be viewed in the desired manner, a written agreement between the partners specifying the parties involved in the exchange should be considered.

Chapter 4

Compensatory Payments to Partners

Learning objectives

- Determine whether payments to a partner will be treated as guaranteed payments, distributive shares, or payments to a third party.
- Identify the tax treatment of payments to a partner in his or her capacity as a third party.
- Recognize the tax treatment, both at the partner and the partnership level, of guaranteed payments to a partner.
- Calculate the amount of the guaranteed payment when the partner is to receive the lesser of a fixed dollar amount or a fixed percentage of partnership income.
- Indicate the correct treatment of partnership income by a partner for self-employment tax purposes.

Introduction

Distinguishing between acting as a partner and acting as a third party

Often partnerships will want to compensate particular partners by making payments to them that are not dependent either on the income of the partnership or their ownership in the partnership. These payments might occur only once, as might be the case if a partner performs nonrecurring services for the partnership. An example of this might be payments for one-time legal or accounting services provided to the partnership by the partner. On the other hand, these payments might be continuing, as would be the case with payments to a partner who actively manages a business for a partnership. Depending on the circumstances surrounding the payments, if the payments are not dependent on the income of the partnership, they will generally be treated as either payments to a partner in their capacity as a third party (as an independent contractor, for example) or as payments to a partner in their capacity as a partner (guaranteed payments).

Payments to partners in their capacity as an independent third party

The authority for determining when a partner will be treated as acting as a third party is somewhat ambiguous and conflicting. The Tax Court and the Fifth Circuit Court of Appeals have indicated that where the partner receiving the payments is performing basic duties of the partnership business pursuant to the partnership agreement, he or she will be treated as a partner, even if the payments received are not based on overall income, but only on an item of income. In *Pratt v. Commissioner*,[1] taxpayers were the managing general partners of two limited partnerships formed to purchase, develop, and manage shopping centers. As the general partners, they were responsible for managing the shopping centers and were compensated with fees equal to a percentage of gross lease revenues. The Tax Court determined, and the Fifth Circuit agreed, that the general partners were acting in their capacity as partners in managing the shopping centers, and therefore the payments were not deductible by the partnership under Section 707(a). The Tax Court further asserted that, because the fees were "based on a fixed percentage of the partnership's gross rentals which in turn constitute partnership income," they were not deductible by the partnership as guaranteed payments under Section 707(c).[2] Rather, the court essentially treated the payments as special allocations of partnership income, in this case as a special allocation of partnership gross rents (accompanied by a distribution of the special allocation to each general partner).

[1] *Pratt, Edward v. Com.*, 64 TC 203 (1975), aff'd on this issue, 39 AFTR 2d 77-1258, 550 F2d 1023, 77-1 USTC paragraph 9347 (1977, CA5).

[2] On appeal, the taxpayer's argument was limited to the question of whether the payments were received by the taxpayer other than in his capacity as a partner (under Section 707(a)), and the Fifth Circuit did not address the question of whether the payments should have been deductible under Section 707(c) as guaranteed payments.

The IRS subsequently issued two revenue rulings further explaining its position with regard to how payments to general partners should be treated. In Revenue Ruling 81-300,[3] it flatly disagreed with the Tax Court that the payments received in *Pratt* were not guaranteed payments. The IRS concluded that "a payment for services determined by reference to an item of gross income will be a guaranteed payment if, on the basis of all the facts and circumstances, the payment is compensation rather than a share of partnership profits." Therefore, this ruling explicitly suggests that Section 707(c) is applicable where payments to a partner are not based on the partnership's net income. In determining whether the payment is compensatory, the IRS suggested that it would consider the reasonableness of the payment for the services provided, and whether the partnership would use a similar method to determine the appropriate compensation for the services rendered if such services had been rendered by an unrelated third party.

In Revenue Ruling (Rev. Rul.) 81-301,[4] the IRS addressed the question of when a partner is acting in his or her capacity as a partner, rather than as an unrelated third party. This distinction is important in determining whether Section 707(a) applies to a payment, as opposed to Section 707(c).

Rev. Rul. 81-301 involves a corporate "adviser general partner" who provides investment management services to a partnership in exchange for 10% of the partnership's gross income. The IRS took into consideration that (1) the adviser also provided similar investment management services to others as part of its regular trade or business, (2) its management of the partnership's investments was supervised by the partnership's directors, (3) the adviser paid its own expenses and was not liable to the other partners for any losses incurred with respect to the partnership's assets, and (4) the partnership agreement explicitly allowed the partners to terminate the arrangement with the adviser general partner and hire another party to manage its portfolio. The IRS ruled that the investment services performed by the adviser are not performed in the capacity of a partner, even though the payments are dependent on an item of gross income. The payments to the partner for investment management services are therefore not guaranteed payments or a distributive share of income, but were ruled to be analogous to payments to a third party (and therefore deductible under Section 707(a)).

If a partnership makes a payment to a partner in such partner's capacity as an independent third party, the partner will include the payment in income at the time that is appropriate under the partner's accounting method. Because most individual taxpayers are on the cash basis, most individual partners would recognize a payment as income when the payment is received. The partnership, however, is not allowed to deduct the payment until the later of

a. the date the partner has included it in income, or
b. the date the payment is deductible under the partnership's regular accounting method.[5]

[3] Rev. Rul. 81-300, 1981-2 CB 143.
[4] Rev. Rul. 81-301, 1981-2 CB 144.
[5] IRC Section 267(a)(2) and Section 267(e).

Example 4-1

In November Y1, A (a cash basis, calendar-year taxpayer), a member of the ABCD LLC (an accrual basis, November 30 fiscal year partnership for tax purposes) performed nonrecurring legal services for the limited liability company (LLC). A was paid $25,000 (the fair value of the services) by the LLC on January 5, Y2. The legal services provided by A to the LLC were nonrecurring, and the services were performed under the same terms under which A would have provided them to anyone else. If the services were performed in the capacity of someone who is not acting as a partner, A would include them in income in Y2. ABCD would also have to wait until FYE November 30, Y2, to deduct the payments.

Knowledge check

1. In Rev. Rul. 81-301, which of the following is **not** a factor considered by the IRS in determining whether a partner receives payments in her capacity as a partner, or is instead acting as a third party?
   a. The partner's services are supervised by the partnership's directors.
   b. Payments to the partner are based on one or more items of partnership income.
   c. The adviser also provided similar investment management services to others as part of its regular trade or business.
   d. The other partners could terminate the service agreement.

2. In October, Y1, T (a cash basis, calendar-year taxpayer), a member of the STUV LLC (an accrual basis, October 31 fiscal year partnership for tax purposes), performs nonrecurring legal services for the LLC. T is paid $40,000 (the fair value of the services) by the LLC on January 10, Y2. If the services were performed in the capacity of someone who is not a partner, when would T include the $40,000 as income, and when would STUV deduct it?
   a. T would include it in Y2 and STUV would deduct it in FYE October 31, Y2.
   b. T would include it in Y2 and STUV would deduct it in FYE October 31, Y1.
   c. T would include it in Y1 and STUV would deduct it in FYE October 31, Y1.
   d. T would never have to include the $40,000 in income.

Section 707(a)(2): Disguised payments

Often the partners in a partnership do not care how a payment for services is taxed because payments to third parties and guaranteed payments are generally deductible, and allocating a share of income to the service provider achieves much the same effect (from the other partners' point of view) as a deduction. This is not the case, however, if the service payments should be capitalized and not deducted, or if the service provider is allocated capital gains instead of ordinary income. Section 707(a)(2) was enacted to prevent partners in these cases from getting (in effect) a deduction for capital expenditures, or transforming ordinary income into capital gains. Under Section 707(a)(2), if (*a*) a partner performs services for a partnership or transfers property to a partnership, (*b*) there is a related direct or indirect allocation and distribution to such partner, and (*c*) the performance of the services (or the transfer) and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership, then the allocation and distribution shall be treated as a transaction between a partnership and one who is not a partner.

When the preceding provision was enacted in 1984, Congress authorized the Treasury Department to issue any regulations that might be necessary to carry out the provision's intended purposes. The primary purpose of Section 707(a)(2) is to prevent a partner and a compliant partnership from converting capital expenditures (such as organization expenses, which must be capitalized by the partnership) into what are equivalent to deductions from the point of view of the other partners. Absent Section 707(a)(2), the distributive share of partnership income allocated to the partner providing the capital services reduces the distributive shares of the other partners just as if the partnership deducted the payments to the service partner. To prevent this outcome, the statute requires that certain allocations to a partner acting other than in his or her capacity as a partner must be reclassified as payments to such partner, capitalized by the partnership and not deductible by any of the partners (other than in the form of amortization expense where appropriate).

The legislative explanation for this law indicated that the following factors should be considered in determining whether or not the partner is acting in his capacity as a partner:[6]

Factor	Indicates that a partner is acting as a partner	Indicates that a partner is not acting as a partner
The amount of the payment is subject to appreciable risk.	Yes	No
The partner status of the recipient is transitory.	No	Yes
The distribution and allocation that are made to the partner are close in time to the partner's performance of services for or transfers of property to the partnership.	No	Yes
The recipient became a partner for the tax benefits of being a partner.	No	Yes
The value of the recipient's interest in general and continuing partnership profits is small in relation to the allocation in question.	No	Yes

[6] Senate Explanation to the Tax Reform Act of 1984, PL 98-369, 7/18/84.

Congress indicated that the first factor, risk, is the most important factor. Other than that, it gave no indication as to how any of the factors should be weighted.

Disguised payments for services

Proposed regulations under Section 707(a)(2)(A) issued in July 2015 provide that certain payments from a partnership to a partner should be treated as disguised payments for services rendered rather than as a distributive share of partnership income. This is a significant issue for many partnerships because treating an allocation of income as a disguised payment for services rendered has the effect of converting a partner's distributive share of capital gain and other investment income into ordinary income. It also converts this allocation into a deductible guaranteed payment for the other partners.

As previously stated, the presence of significant entrepreneurial risk is accorded more weight than the other factors. Arrangements that lack significant entrepreneurial risk will always be treated as disguised payments for services. The proposed regulations also incorporate the previously listed factors that should be considered in determining whether the payment or distribution is part of a disguised payment for services.

In addition, the regulations introduce two "new" factors to be considered in determining whether an allocation and distribution should be treated as a disguised payment for services (1) whether the arrangement provides for different allocations or distributions with respect to different services received in cases where the services are provided either by a single person or by persons that are related under Sections 707(b) or 267(b), and (2) whether the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly.

The proposed regulations specify that the weight given to each of the factors other than risk depends on the facts and circumstances of the particular case, and the absence of a particular factor is not necessarily determinative of whether an arrangement will trigger the provisions of Section 707(a)(2)(A).

If, after considering all of these factors, the allocation and distribution of an item of partnership income is deemed to be compensation for services rendered, such item will be re-characterized as a payment from the partnership to someone who is not a partner, and the tax consequences to both parties (the partnership and the partner) will be determined accordingly.[7]

[7] The proposed regulations appear to be targeted primarily at the common practice among private equity funds of waiving management fees in exchange for an interest in future profits of the fund. The Treasury warns in the preamble to the proposed regulations that it plans to issue a new revenue procedure in the near future announcing that the waiver of fees in an exchange for an interest in future profits may itself be treated as a taxable transaction, not sheltered from income recognition under either the Section 83 regulations or Rev. Proc. 93-27 (1993-2 CB 343).

Payments to partners in their capacity as partners

If payments to a partner for services are not dependent on partnership income, and the partner is acting in his or her capacity as a partner, the payments should be treated as guaranteed payments. On the other hand, if payments to a partner for services are dependent on partnership income and the partner is acting in his capacity as a partner, the payments should be treated as a distributive share of partnership income.

Example 4-2

Partner A agrees to actively manage the business of the ABC partnership on a full-time basis; no other partners are involved in the day-to-day management of the business. Under these circumstances A might negotiate a fixed payment for his services from the partnership, similar in amount to the salary an employee might receive. Because the services being performed are an integral part of the business, but are not dependent on partnership income, the payments involved would be treated as guaranteed payments.

Another situation where such payments would be called for is when one partner contributes more capital than the other partners, but is given the same proportional share of partnership income as the others. In order to compensate the partner for the extra capital contributed, the partnership could pay him or her fixed payments, similar in amount to interest, instead of allocating a larger share of partnership income. Payments such as those described previously, whereby a partner provides services or capital to a partnership in his or her capacity as a partner and receives payments that are not dependent on the income of the partnership are called *guaranteed payments*.[8]

Usually a guaranteed payment will be fixed in amount, but it does not have to be. As discussed previously, the IRS has taken the position that under certain circumstances even a contingent payment for services, the amount of which is determined by reference to an item of partnership gross income (for example, percentage of rents collected), can be characterized as a guaranteed payment. Such a payment would be a guaranteed payment if, on the basis of all of the facts and circumstances, the payment is compensation rather than a share of partnership profits. According to the IRS, whether a payment is compensation or a share of partnership profits depends on the reasonableness of the payment for the services provided and whether the method used to determine the amount of the payment would have been appropriate to use to compensate an unrelated party for the services.[9] Before the IRS issued its

[8] IRC Section 707(c).

[9] *Rev. Rul. 81-300*, 1981-2 CB 143.

ruling on the matter, the Tax Court ruled that a payment that was dependent on the gross rentals from shopping centers was not a guaranteed payment.[10]

Example 4-3

According to the IRS, it is not an uncommon practice to base the compensation of a manager of real property on some percentage of the gross rental income that the managed property produces. Such a method of calculating compensatory payments is reasonable because it is designed to accurately measure the value of the services that are provided. In addition, the method used to determine the amount of the payment in such a case would have been appropriate to use to compensate an unrelated party for the services in question. Any payments determined in this manner under these circumstances should be treated as guaranteed payments, according to the IRS.[11] Note that this treatment may result in what would otherwise have been a distributive share of partnership capital gain being classified as ordinary income to the manager-partner.

Knowledge check

3. F is a partner in an investment partnership. She receives a payment equal to 10% of the partnership's income in exchange for advising services rendered to the partnership. In the current year, the partnership had income of $1,000,000, of which the first $100,000 was paid to F in exchange for her advising services. This payment is treated as received by F for her advising services, and is not received in her capacity as a partner. Assume that all $1,000,000 of the partnership's income was properly characterized as net long-term capital gain. How should F characterize the income from the $100,000 payment on her individual tax return?

   a. As long-term capital gain.
   b. As compensation income.
   c. As a return of capital.
   d. As 90% long-term capital gain, and 10% compensation income.

4. Partner L of the LMN Partnership agrees to actively manage the partnership in return for a $6,000 distribution from the partnership each month. How should the $6,000 monthly payment be treated by L?

   a. As a guaranteed payment to L.
   b. As a distributive share of income to L.
   c. As a payment to one not acting as a partner.
   d. As a guaranteed payment, but only after subtracting L's share of the partnership's deduction of the payment.

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[10] *Pratt, Edward v. Com.*, 64 TC 203 (1975), aff'd on other issue, 39 AFTR 2d 77-1258, 550 F2d 1023, 77-1 USTC paragraph 9347 (1977, CA5).
[11] Rev. Rul. 81-300, 1981-2 CB 143.

Tax treatment of guaranteed payments

Character of income and deduction

Guaranteed payments are treated as ordinary income by the partner who receives them and are not treated as a share of partnership income.[12] In general, the partnership is entitled to an ordinary deduction for such payments, although they must be capitalized in situations where the services provided by the partner are more properly characterized as capital expenditures by the partnership (for example, organization or defense-of-title expenses).

Example 4-4

The ABC Company is a partnership equally owned by A, B, and C. Assume that the income and deductions of ABC are allocated equally between the three partners. ABC has the following items of income, gain and expense for the year:

Operating business income	$120,000
Long-term capital gain	24,000
Tax-exempt interest	48,000
Total	$192,000

Because C manages the partnership's operations, she receives a guaranteed payment of $90,000 from ABC during the year. The income of the partnership will be allocated as follows:

	Total	C	A and B (each)
Ordinary taxable income	$30,000*	$10,000	$10,000
Guaranteed pmt. (ordinary)	90,000	90,000	
Long-term capital gain	24,000	8,000	8,000
Tax-exempt interest	48,000	16,000	16,000
Total	$192,000	$124,000	$34,000

* ($120,000 operating business income - $90,000 deduction for guaranteed payment = $30,000).

C will recognize a total of $100,000 of ordinary income, consisting of the $90,000 guaranteed payment she receives and her $10,000 share of the $30,000 ordinary income of the partnership.

[12] Regulation Section 1.707-1(c).

Timing of inclusion of a guaranteed payment in a partner's income

A partner must include guaranteed payments as ordinary income in the partner's taxable year that includes the end of the partnership taxable year in which the guaranteed payments were deducted as paid or accrued under the partnership's method of accounting.[13]

Example 4-5

Partner A reports income using a calendar year, although the partnership of which A is a partner reports its income using a fiscal year ending May 31. The partnership reports its income and deductions under the cash method of accounting. During the partnership taxable year ending May 31, 2017, the partnership made guaranteed payments of $120,000 to A for services and for the use of capital provided during that taxable year. Of this amount, $70,000 was paid to A between June 1 and December 31, 2016, and the remaining $50,000 was paid to A between January 1 and May 31, 2017. The entire $120,000 paid to A is includable in A's taxable income for the calendar year 2017.[14] If the partnership had been on the accrual basis, partner A in this example would recognize the full $120,000 in 2017 even if A was not actually paid the full $120,000 until late in 2017 (after the partnership's May 31, 2017, year-end) or even in 2018.

The critical factor in determining the timing of a guaranteed payment's inclusion in income of a partner is the partnership year in which the partnership deducts the guaranteed payment, not the year in which it is actually paid. Indeed, if the partner erroneously fails to include the guaranteed payment in income in the year in which the partnership deducted it, the partner is not required to include the guaranteed payment in income in the actual year of payment, even if the deduction year is closed by the statute of limitations.[15] Note that this is different from the timing of inclusion in income when a partner acting other than in her capacity as a nonpartner receives a payment from the partnership. In that case, it is the accounting method of the partner, not the partnership, which determines the timing of the income inclusion for the partner.

[13] Regulation Section (Reg. Sec.) 1.707-1(c).
[14] Reg. Sec. 1.706-1(a)(1).
[15] *Leon L. Sicard*, et ux., TC Memo 1996-173.

Effect of the guaranteed payment on a partner's basis and capital account

The receipt of a guaranteed payment has no direct effect on the recipient partner's basis in the partnership interest, or on the balance in his or her capital account. It's only impact on basis or capital is indirect—the deduction allowed the partnership in connection with the payment is generally allocated to all partners and reduces both their capital balances and their tax bases in their partnership interests accordingly. The partnership is allowed a deduction in the year the guaranteed payment is included in the income of the partner. On that year's partnership tax return, the related deduction is allocated to the partners in accordance with the terms of the partnership agreement. Each partner's share of the deduction for guaranteed payments decreases both the partner's tax basis in the partnership interest and the balance in his or her capital account.[16]

Note that if the deduction for the guaranteed payment is specially allocated to the recipient partner, the transaction will be treated as a distribution, and not as a guaranteed payment. Consider how the transaction affects the recipient partner:

- Receipt of the payment would be taxable as ordinary income to the recipient
- Allocation of the partnership deduction to the recipient would offset the income recognized completely

Moreover, allocation of the deduction would reduce the balance in the recipient partner's capital account, whereas receipt of the guaranteed payment would not be reflected in the partner's capital account. Thus, the net effect of the transaction is to reduce the recipient partner's capital account, with no impact on the partner's tax return. The transaction is therefore a distribution and the consequences to both the partner and the partnership will be determined under the rules applicable to partnership distributions.

Guaranteed payments and self-employment income

The self-employment tax will apply to guaranteed payments received from a partnership for services rendered (or capital provided, in the case of a general partner) as long as the payments are determined without regard to the income of the partnership, and the partnership is engaged in a trade or business (within the meaning of section 1402(c) and §1.1402(c)-1). If a guaranteed payment is self-employment income, it will be recognized as such in the year in which the guaranteed payments are included in the taxable income of the partner.[17]

[16] Reg. Sec. 1.704-1(b)(2)(iv)(o).
[17] Reg. Sec. 1.1402(a)-1(b), Proposed Reg. Sec. 1.1402(a)-2(g).

Payments for rent and royalties

Because a guaranteed payment is defined in part as a payment for services rendered or capital provided, payments a partnership makes to a partner for rent or royalties are not guaranteed payments. Such payments are characterized as payments to a partner acting other than in his or her capacity as a partner, and the time of inclusion of these payments in the partner's income depends on the accounting method used by the recipient partner.

Capitalized guaranteed payments

The normal rules used to determine whether a payment for services should be either capitalized or expensed also apply to guaranteed payments. For example, guaranteed payments for services related to the following have been required to be capitalized, instead of being immediately expensed:

- A finder's fee for a loan (amortized over the life of the loan)[18]
- Management fees to a general partner that were in actuality a reimbursement of organizational expenses originally paid by the partner[19] (although a taxpayer may generally elect to deduct up to $5,000 in organizational expenses)[20]
- Pre-opening expenses of an apartment project[21]

Whether or not a guaranteed payment must be capitalized by the partnership has no effect on when it must be included in the income of the partner.

Example 4-6

In June 2017, partner A (a calendar year taxpayer) provides $10,000 worth of tax advice to the ABC partnership as part of its organization. On September 4, 2017, A receives a $10,000 payment as compensation for the tax advice, and the payment is appropriately classified as a guaranteed payment. ABC uses a fiscal year ending September 30. If the payment qualifies as an organizational expense and ABC makes the proper election, ABC will deduct $5,000 in organizational expense and amortize the remaining $5,000 over a 180-month period. No matter how ABC is required to treat it, however, the full $10,000 must be included in A's 2017 taxable income.

[18] Rev. Rul. 80-234, 1980-2 CB 203.
[19] *William Egolf*, (1986) 87 TC 34.
[20] IRC Section 195(b) and 709(b). Taxpayer may elect to deduct up to $5,000 in start-up and organizational expenditures. Any remaining start-up or organizational costs can be deducted over a 180-month period, starting with the month the active trade or business begins. IRC Section 195(b). The $5,000 limitation is reduced dollar-for-dollar to the extent total start-up or organizational expenditures exceed $50,000.
[21] *Gordon S. Sorrell, Jr.*, 64 AFTR 2d 89-5662 (882 F.2d 484).

Minimum guaranteed payments

At times a partner may want to be guaranteed some minimum level of compensation, although still being allowed to share in any partnership income that might occur in excess of this amount. For example, she might request that she be allocated 25% of the partnership profits, but not less than a fixed dollar amount of $100,000. In that case the guaranteed payment is the excess, if any, of the amount received by the partner over what would have been her share of partnership income (calculated before subtracting the guaranteed payment).[22]

Example 4-7

Partner A manages the business of the ABCD Partnership. According to the partnership agreement, partner A will be allocated the greater of $200,000 or 25% of partnership income each year. The other partners each receive one-third of the partnership's income or loss after making the required allocation to A.

Assume that during the current year the partnership reports net ordinary trade or business income of $500,000. Further assume that it has no other items of income or loss. Under the terms of the partnership agreement, A will be allocated a total of $200,000 from the partnership because $200,000 is greater than 25% of the partnership's $500,000 net income.

Absent this guarantee, A would have been allocated a distributive share of partnership income of only $125,000 (25% of the partnership's $500,000 in operating profits). Of the total amount distributed to A, therefore, $75,000 will be classified as a guaranteed payment (the $200,000 received more than the $125,000 she would have received absent the guarantee).

A's total ordinary income from the partnership will be $200,000, consisting of her $75,000 guaranteed payment and a $125,000 share of partnership income. The other partners will each be allocated $100,000 of ordinary income (($500,000 – $200,000) ÷ 3).

The calculation of a partner's distributive share (excluding the income from the guaranteed payment) in these types of circumstances is more complicated when more than one type of income is earned by the partnership. In such cases, the partner's distributive share must be split into the various types of income by multiplying the partner's total distributive share by a fraction consisting of the amount of each type of partnership income divided by the total partnership income (computed after subtracting out the guaranteed payment).[23]

[22] Reg. Sec. 1.707-1(c), Ex (2); Rev. Rul. 69-180, 1969-1 C.B. 183.
[23] Rev. Rul. 69-180, 1969-1 C.B. 183.

Example 4-8

Assume the same facts as in the previous example, except that ABCD earns $100,000 of capital gains during the year in addition to the $500,000 of ordinary trade or business income. As before, the $200,000 minimum guarantee exceeds A's 25% share of partnership income, which would now be $150,000 (25% of $500,000 ordinary income plus 25% of $100,000 capital gain). Therefore, A's guaranteed payment is now $50,000 ($200,000 – (25% × $600,000)), and her distributive share of partnership income is $150,000 ($200,000 – $50,000).

On its tax return for the year, the partnership will now report ordinary income of $450,000 ($500,000 – $50,000 guaranteed payment to A) and net long-term capital gain of $100,000. A will be allocated a $150,000 distributive share of the partnership's total income. This distributive share will have to be split between capital gain and ordinary income as follows:

Capital gain = $150,000 × ($100,000 ÷ $550,000) = $27,272.73
Ordinary income = $150,000 × ($450,000 ÷ $550,000) = $122,727.27

A's total income will be as follows:

Guaranteed payment (ordinary income)	$50,000
Capital gain	27,272.73
Ordinary income	122,727.27
Total	$200,000

Self-employment income of partners

Compensatory payments to partners are generally treated as self-employment income. The amount of self-employment income a partner must recognize depends on several factors, one of which is whether the partner is a general partner or a limited partner.

General partners

A general partner's self-employment income includes his distributive share (whether or not actually distributed) of non-separately stated income or loss from any trade or business carried on by the partnership.[24] As indicated previously, self-employment income of a general partner also includes guaranteed payments (even if made for the use of capital), as long as the partnership making the guaranteed payments is engaged in a trade or business.

Limited partners

The self-employment income of a limited partner does not include her distributive share of the limited partnership's non-separately stated income or loss, but does include any guaranteed payments received, as long as such payments are in return for services rendered to the partnership and the partnership is engaged in a trade or business. Proposed regulations, explained later in this chapter, describe circumstances under which a partner will be treated as a limited partner for this purpose.[25] If a limited partner is also a general partner in the same partnership, the distributive share received as a general partner is self-employment income, but the distributive share received as a limited partner is not.[26]

Similarly, guaranteed payments received by an LLC member will likely be considered to be self-employment income, absent unusual circumstances. For example, guaranteed payments to a spouse from an LLC formed and wholly-owned by a married couple were by the Tax Court as self-employment income. The couple had originally reported the related payments as guaranteed payments on the LLCs' returns, and tried to recharacterize them as the wife's distributive share of partnership income only after the IRS raised the self-employment tax issue. In addition, the facts indicated that the payments were for services the wife performed for the LLC (although such services were relatively small compared to her husband's). The services she provided included marketing advice, signing of documents, entering into contracts for the LLC, and allowing the LLC the use of her credit card and credit rating.[27]

[24] Reg. Sec. 1.1402(a)-1.
[25] IRC Section 1402(a)(13), Proposed Reg. Sec. 1.1402(a)-2(g) and (h).
[26] H. Rept. No 95-702 (PL 95-216), 12/20/77, p 11.
[27] *Lauren A. Howell* (2012), TC Memo 2012-303

Example 4-9

The ABCD partnership has the following items of income:

Ordinary income from a trade or business	$100,000
Long-term capital gains	40,000
Dividend income	30,000

A, B, C, and D are equal partners, entitled to 25% shares of each item of partnership income or loss. A and B are general partners, although the other partners are limited partners. A and C each receive a $10,000 guaranteed payment for services rendered, although B and D each receive a $10,000 guaranteed payment for additional capital they have contributed. They each have the following self-employment income:

Partner	Self-employment income
A	$10,000 + .25 × ($100,000 - $40,000) = $25,000
B	Same as A, $25,000
C	$10,000
D	None

As a general partner, A will have self-employment income equal to A's guaranteed payment ($10,000) plus A's 25% share of the partnership's non-separately stated income (.25 × ($100,000 - $40,000 total guaranteed payments) = $15,000).

Because B is also a general partner, B's self-employment income is the same as A's, even though B's guaranteed payment is for capital contributed.

As a limited partner, C's self-employment income will not include her distributive share of the partnership's non-separately stated income, but will include C's guaranteed payment because it is in return for services provided to the partnership.

Finally, as a limited partner whose guaranteed payment is a return on capital contributed, D will have no self-employment income.

Community property

Even if some portion of a partner's distributive share of the non-separately stated income or loss from a partnership is community income or loss under local community property laws (and therefore taxable partly to their spouse), the entire distributive share is included in the net earnings from self-employment of the partner. No part of the distributive share will be included in the self-employment income of the partner's spouse.[28]

[28] IRC Section 1402(a)(5)(B).

Proposed regulations concerning limited partners' self-employment income

Proposed regulations under Section 1402 were issued in 1997 to clarify the rules concerning the determination of self-employment income for limited partners.[29] The proposed regulations defined the characteristics of partners (including LLC members) that determine whether a partner should be treated as a limited partner (versus treatment as a general partner). The proposed regulations made clear that state law characterizations of a partner as a "limited partner" are not determinative of a partner's classification as limited or general for purposes of the self-employment tax.

However, the proposed regulations generated a considerable amount of controversy, ultimately culminating in legislation in which Congress declared that "No temporary or final regulation with respect to the definition of a limited partner under Section 1402(a)(13) of the IRC of 1986 may be issued or made effective before July 1, 1998."[30] As of 2016, the proposed regulations have not been finalized and Congress has not passed legislation defining the term limited partner for purposes of the self-employment tax. Therefore, the proposed regulations remain the only guidance available to taxpayers at this time.

General definition of a limited partner

Under the Proposed Regulations, for purposes of the self-employment tax an individual will be treated as a limited partner unless the partner

- has personal liability for the debts of or claims against the partnership by reason of being a partner;
- has authority to contract on behalf of the partnership; or
- participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year.[31]

The Proposed Regulations further provide that an individual who is a "service partner" in a "service partnership" may not be a limited partner even if the partner meets the requirements of the preceding general definition.[32] A "service partner" is a partner who provides services to or on behalf of the service partnership's trade or business. A partner is not considered to be a service partner if that partner provides only a *de minimis* amount of services to or on behalf of the partnership.[33] A "service partnership" is a

[29] Proposed Reg. Sec. 1.1402(a)-2(d)-(j), published in the Federal Register on January 13, 1997. As of the date these materials were written, the proposed regulations have still not been finalized and have expired.
[30] Taxpayer Relief Act of 1997, Pub. L. 105-34, sec. 935, 111 Stat. 882.
[31] Proposed Reg. Sec. 1.1402(a)-2(h).
[32] Proposed Reg. Sec. 1.1402(a)-2(h)(5).
[33] Proposed Reg. Sec. 1.1402(a)-2(h)(6)(ii).

partnership in which substantially all the activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.[34]

Exception for holders of more than one class of interest

An individual holding more than one class of interest in the partnership who is not treated as a limited partner under the general definition is still treated as a limited partner with respect to a specific class of partnership interest held by the individual if, immediately after the individual acquires that class of interest,

a. there exist limited partners (within the meaning of the general definition) who own a substantial, continuing interest in that specific class of partnership interest; and
b. the individual's rights and obligations with respect to that specific class of interest are identical to the rights and obligations of that specific class of partnership interest held by the limited partners described in item *a*.[35]

Exception for holders of only one class of interest

This exception applies only to an individual who does not qualify as a limited partner under the general definition solely because he or she participated in the partnership's trade or business for more than 500 hours during the partnership's taxable year. He or she will be treated as a limited partner if, immediately after the individual acquires his or her interest,

a. there exist limited partners (under the general definition) who own a substantial, continuing interest in his or her specific class of partnership interest; and
b. his or her rights and obligations with respect to his or her specific class of interest are identical to the rights and obligations of the specific class of partnership interest held by the limited partners described in item *a*.[36]

[34] Proposed Reg. Sec. 1.1402(a)-2(h)(6)(iii).
[35] Proposed Reg. Sec. 1.1402(a)-2(h)(3).
[36] Proposed Reg. Sec. 1.1402(a)-2(h)(4).

Example 4-10

A, B, and C form LLC, a limited liability company that is not a service partnership, but is classified as a partnership for federal tax purposes. LLC allocates all items of income, deduction, and credit of LLC to A, B, and C in proportion to their ownership of LLC. A and C each contribute $1,000 for one LLC unit. B contributes $2,000 for two LLC units. Each LLC unit entitles its holder to receive 25% of LLC's tax items, including profits. A does not perform services for LLC; however, each year B receives a guaranteed payment of $6,000 for 600 hours of services rendered to LLC and C receives a guaranteed payment of $10,000 for 1,000 hours of services rendered to LLC. C also is elected LLC's manager. C has the authority to contract on behalf of LLC.

A is treated as a limited partner in LLC because A is not personally liable for the debts of LLC, A does not have authority to contract for LLC, and A does not participate in LLC's trade or business for more than 500 hours during the taxable year. Because A is treated as a limited partner, A's distributive share attributable to A's LLC unit is excluded from A's net earnings from self-employment.[37]

B is treated as a limited partner, and because B's guaranteed payment of $6,000 is in return for services it is included in B's net earnings from self-employment. B is not treated as a limited partner under the general definition because, although B is not liable for the debts of LLC and B does not have authority to contract for LLC, B does participate in LLC's trade or business for more than 500 hours during the taxable year. However, B is treated as a limited partner under the exception for holders of only one class of interest because

- B is not treated as a limited partner under the general definition solely because B participated in LLC's business for more than 500 hours; and
- B's rights and obligations are identical to those of A, a limited partner under the general definition who owns a substantial interest.

In this example, as a limited partner B's distributive share is deemed to be a return on B's investment in LLC and not remuneration for B's service to the LLC. Therefore, B's distributive share attributable to B's two LLC units does not constitute net earnings from self-employment

In contrast, C's guaranteed payment of $10,000 is included in C's net earnings from self-employment. Likewise, C's distributive share of LLC's net income is also classified as net earnings from self-employment because C is not a limited partner under the general definition or the two exceptions explained previously. C is not treated as a limited partner under the general definition because C has the authority to enter into a binding contract on behalf of LLC and because C participates in LLC's trade or business for more than 500 hours during the taxable year. Further, C is not treated as a limited partner under the "more than one class of interest" exception because C does not hold more than one class of interest in LLC. Finally, C is not treated as a limited partner under the "only one class of interest" exception because C has the power to bind LLC. C is treated as a general partner, and as such C's guaranteed payment and distributive share are both included in C's self-employment income.[38]

[37] IRC Section 1402(a)(13).

[38] Proposed Reg. Sec. 1.1402(a)-2(i).

LLC members

A major area of uncertainty is the question of how members of an LLC should be treated for purposes of the SE tax. Should LLC members be treated as limited partners because they have no personal liability for claims against the LLC? Or should their proper classification be based instead upon the degree of input and responsibility they bear in managing the LLC? In CCA 201436049, the IRS explained the proper treatment for self-employment tax purposes of members of an LLC that acted as an investment management company. The question was whether management fees received by the management company and distributed to its members constituted earned income for purposes of the SE tax. Relying on two relatively recent tax cases (*Renkmeyer*[39] and *Riether*[40]), the IRS concluded that because the services provided by the members of the LLC were extensive and directly correlated to the income earned by the LLC, their distributive shares of LLC income could not be considered analogous to passive investment income. The LLC members could not be reasonably viewed as limited partners, and each member's share of the LLC's income was therefore classified as self-employment income.

[39] *Renkemeyer, Campbell & Weaver, LLP v. Commr*, 136 TC 137 (2011) involved the applicability of the SE tax to income generated by a law practice which organized as a limited liability partnership. The Tax Court determined that "in essence, an LLP is a general partnership that affords a form of limited liability protection for all its partners by filing a statement of qualification with the appropriate state authorities." Therefore, because the partners' distributive shares of the law firm's income arose from legal services they performed on behalf of the law firm rather than as a return on the partners' investment, the Tax Court ruled that the partners' individual shares of the partnership's income are properly subject to the SE tax.

[40] In *Riether v. United States*, 919 F. Supp. 2d 1140 (D. N.M. 2012), the court ruled that husband and wife members of an LLC were "not members of a limited partnership, nor do they resemble limited partners, which are those who 'lack management powers but enjoy immunity from liability for debts of the partnership'" (citing *Renkemeyer* supra).

Chapter 5

At-Risk and Passive Activity Limits

Learning objectives

- Differentiate the limitations that apply to partners' or limited liability company (LLC) members' distributive share of losses from those of a partnership or LLC.
- Identify the treatment of deductions that are denied under different limitation provisions.
- Calculate the basis and amount at risk in a partnership or LLC interest for purposes of those loss limitation rules.
- Distinguish between a passive activity that would be subject to the passive loss rules, and an active activity that would not be subject to passive activity rules.

Overview

Statutory limitations on the deductibility of losses

The deductibility of pass-through losses from a partnership or LLC is subject to three separate limitations. First, under Section 704(d), the loss may not exceed the partner or member's tax basis in the partnership or LLC interest. Second, any losses that survive the Section 704(d) limitation are subject to the *at-risk limitation* of Section 465. Finally, losses may be disallowed under the *passive loss limitations* of Section 469 even if they do not exceed the partner or member's tax basis or amount at-risk in the partnership or LLC. As implied in the preceding discussion, these limitations are applied *sequentially*. The Section 704(d) limitation is applied first, followed by the Section 465 limitation, and finally the Section 469 limitation. Amounts disallowed under each separate section are subject to different carryforward provisions.

Example 5-1

Carrie Winslow is a 10 percent member in Wing Tree LLC. Wing Tree has elected to be treated as a partnership for federal income tax purposes. Her tax basis in her Wing Tree interest is $14,000, consisting of her $5,000 contribution to capital and her $9,000 share of the LLC's nonrecourse debt. Assume that none of this debt is qualified nonrecourse debt (and is therefore not included in Carrie's at-risk amount). This year, her distributive share of the company's loss was ($20,000). Assume that Carrie's interest in Wing Tree is a passive activity and that she has no passive income from any other source.

Under Section 704(d), $6,000 of Carrie's pass-through loss will be disallowed ($20,000 total loss - $14,000 tax basis). Of the ($14,000) loss allowed under Section 704(d), an additional ($9,000) will be disallowed under Section 465 ($14,000 Section 704(d) loss - $5,000 at-risk amount). Finally, the remaining ($5,000) of the pass-through loss will be disallowed under Section 469, because passive losses can generally be deducted only against passive income from other sources. Her total disallowed loss is ($20,000): ($6,000) under Section 704(d) basis rules, ($9,000) under the Section 465 at-risk rules, and ($5,000) under the Section 469 passive activity loss rules].

Note. It is important to note in the preceding example that, although Carrie's entire pass-through loss was denied under various statutory limitations of the IRC, her tax basis in the LLC interest is still reduced to $0, as is her amount at risk. Because losses were allowed under Sections 704(d) and 465, respectively, those losses reduce her basis and at-risk amounts, even though the losses were subsequently disallowed under different statutes.

Disallowed losses are carried forward

Carryforwards under Section 704(d)

Any loss passed through to a partner or member in excess of his or her basis in the partnership or LLC interest is carried forward indefinitely until such time as the partner or member obtains additional basis sufficient to allow the deduction. Carryforward losses unused as of the date of sale or disposition of the partnership or LLC interest are lost—they do not carry over to the transferee (if any) of such interest, and they do not directly reduce the gain (if any) from such sale or disposition. At first this disallowance of carryforward losses might seem like an oversight, but keep in mind that because basis can't be reduced less than $0, these carryforward losses have never served to reduce the basis of the related interest. Under usual circumstances a loss reduces the basis of the interest, and the gain on the later sale of the interest is larger because of this reduction (because basis is subtracted to calculate gain). However, where the loss is limited because of the lack of basis, any gain from the sale of the interest would therefore be smaller than otherwise because the basis had not been reduced below $0 through deduction of the full loss. Allowing the deduction of carryforwards under Section 704(d) upon sale would essentially allow the double counting of the losses.

Example 5-2

Eddie is a 25 percent partner in Elkland Partnership as of January 1, 2018. His original tax basis in his partnership interest was $25,000, but pass-through losses of ($36,000) in 2017 reduced that basis to $0. The ($11,000) excess of his distributive share of partnership losses over his tax basis in the partnership interest is carried forward under Section 704(d), and will be deductible when (and if) he obtains additional tax basis (for example, as the result of an additional contribution to partnership capital or if additional basis is created by pass through income items in a future tax period after 2018).

On February 1, 2018, Eddie sold his interest in the partnership for $2,500. He will recognize a $2,500 capital gain because his tax basis was $0 on the date of the transaction. The gain does not increase his tax basis in the partnership interest because he no longer has an interest in the partnership. The $11,000 loss carryforward under Section 704(d) is lost. This is because the suspended loss never reduced Eddie's basis less than $0. Note that the gain of $2,500 is $11,000 less than it would have been if the basis had been reduced less than $0.

Carryforwards under Section 465

Losses disallowed under Section 465 are carried forward indefinitely just as are those denied under Section 704(d). Carryforwards under the two statutes have different effects on the partner or LLC member, however. As noted previously, to the extent deductible under Section 704(d), a partner or member's allocable share of the entity's loss reduces his or her tax basis in the partnership or LLC interest whether or not it is ultimately deductible under Sections 465 and 469. Therefore, a partner's or member's tax basis in his or her entity interest is reduced by losses even if they are disallowed under Section 465 (at-risk rules). As a result, the partner or member's gain upon a subsequent disposition of that interest is increased by losses that have previously been disallowed under the at-risk rules (because these losses reduced tax basis with no corresponding tax benefit). Therefore, when a partner or LLC member sells his or her interest in the partnership or LLC, losses carried forward under Section 465, unlike those carried forward under Section 704(d), are deductible in full, regardless of the amount of gain or loss recognized by the partner or member on the transaction.

Example 5-3

Colleen is a 5 percent limited partner in Hunter Down Properties, a limited partnership. She has a $0 tax basis in her partnership interest and her amount at risk is also $0. She has an $8,000 loss carryforward under Section 704(d) and a $3,500 loss carryforward under Section 465. She sold her interest in the partnership this year for $25,000, recognizing a $25,000 capital gain.

Note that had the losses previously disallowed by Section 704(d) been allowed, her tax basis in the partnership interest would have been negative $8,000, rather than $0, and she would have recognized a $33,000 gain on the sale, rather than $25,000. Therefore, the loss carryforward under Section 704(d) is disregarded. It cannot be deducted against her gain on the sale, and because she is no longer a partner in Hunter Down, she will never have additional basis in the interest. The Section 704(d) carryforward is essentially forfeited upon her sale of her interest in this partnership.

In contrast, Colleen's loss carryforward under Section 465 consists of losses previously allowed under Section 704(d) before being disallowed by Section 465. Accordingly, these losses have reduced her tax basis in the partnership interest, even though they have not actually been deducted. As a result, Colleen's recognized gain of $25,000 exceeds the economic gain actually realized on the investment by the amount of the loss disallowed under Section 465. This imbalance is corrected by allowing Colleen to deduct her Section 465 loss carryforward in full on sale or disposition of her interest. This carryforward loss is not offset against the gain, if any, recognized on the sale or disposition of the interest. Moreover, the carryforward loss retains its character. Colleen will therefore report a $25,000 capital gain and a ($3,500) ordinary loss on her tax return for the year of sale.

Example 5-4

Sven Bjorland is a 10 percent member of Raven's Glen LLC, a limited liability company that has elected to be treated as a partnership for federal income tax purposes. His tax basis in his LLC interest is $25,000, consisting of his $10,000 contribution to capital and his $15,000 share of the LLC's non-qualified nonrecourse debt. For the current year, Sven's distributive share of the LLC's taxable loss was ($32,000). Under Section 704(d), only ($25,000) of this loss will be allowed; the remaining $7,000 will be carried forward indefinitely. Because non-qualified nonrecourse debt is not included in Sven's at-risk amount, however, only ($10,000) of the loss allowed under Section 704(d) will be deductible under Section 465. Sven's tax basis in his LLC interest will be $0 at the end of the year, and he will have loss carryforwards of ($7,000) under Section 704(d) and ($15,000) under Section 465.

Example 5-5

Assume in example 5-4 that the LLC has positive income in its second year of operations, of which Sven's distributive share is $10,000. This income gives Sven additional tax basis (and at-risk amount) in his LLC interest. Because the additional basis exceeds the ($7,000) loss carryforward under Section 704(d), that entire carryforward is deductible in year two. After deducting the Section 704(d) loss carryforward, Sven's net income from the LLC in year two is $3,000. This income, in turn, increases Sven's amount at-risk in the LLC, allowing Sven to use $3,000 of his Section 465 carryforward. Therefore, for year two, Sven will report no net income from the LLC, and will have a remaining Section 465 carryforward of ($12,000) (calculated as- $15,000 – $7,000 + $10,000). His basis in the LLC interest will be $3,000 ($10,000 income minus ($7,000) loss carryforward), and his amount at-risk will be $0 ($3,000 net income minus ($3,000) at-risk carryforward used).

Example 5-6

Assume the same facts as in the previous two examples. Going into year three, Sven has a $3,000 tax basis in his LLC interest, and a ($12,000) Section 465 carryforward. Assume that in year three, Sven sells his interest in the LLC for $8,000 cash, plus assumption of his $15,000 share of the entity's non-qualified nonrecourse debt. Subtracting his $3,000 tax basis from the $23,000 net selling price yields a $20,000 taxable gain. This gain presumably will be capital in nature. Sale of the LLC interest triggers Sven's ($12,000) Section 465 carryforward. This carryforward loss will be deductible in full, and will retain its character as ordinary loss (assuming it was ordinary in nature in years one and two when originally passed through to Sven). Therefore, in year three, Sven will recognize a capital gain of $20,000 and an ordinary loss of ($12,000).

Knowledge check

1. If a partner's pass-through losses from a partnership meet the tests of Section 704(d) (basis limitations), will the provisions of Section 465 (at-risk limitations) apply to that same pass-through loss?

    a. No.
    b. Yes.
    c. Only under certain fairly restrictive circumstances.
    d. Pass-through partnership losses are not subject to the Section 704(d) limitations.

Carryforwards under Section 469 (passive loss carryforwards)

For individuals, losses from passive activities are deductible only to the extent of income from other passive activities. Any excess passive losses are not allowed in the current year. Losses disallowed under the passive loss limitations are carried forward indefinitely until such time as the partnership or LLC has sufficient passive income from other sources to absorb the carryforward. If the partner or LLC member completely disposes of his or her interest in the entity, any passive loss carryforward attributable to that investment (the specific investment in the partnership or LLC) is deductible in full in the year of disposition.

Example 5-7

Carla is a limited partner in Breakout LLP. Her partnership interest in Breakout is a passive activity for Carla and is subject to the passive loss limitations. She has no interest in any other passive activities. Assume that in the first year of her ownership of the Breakout limited partner interest her distributive share of the partnership's loss is ($18,000). Further assume that her tax basis and at-risk amount are both $20,000. Because Breakout is a passive activity for Carla, she is not allowed a deduction for the pass-through loss. Note that although the loss is disallowed under the passive loss rules, it still reduces her basis and at-risk amounts to $2,000.

In year two, assume Carla sells her entire interest in the LLP, recognizing a $15,000 capital gain. Disposition of her entire interest in the activity will trigger the deduction of her passive loss carryforward. As in the preceding example, this loss retains the character of the original pass-through loss in year one, even though her gain on sale of the partnership interest is capital in nature. To the extent the suspended loss exceeds the gain on disposition, the excess loss is allowed against other nonpassive income.

Knowledge check

2. Which statement regarding net passive losses is accurate?

   a. Net passive losses do not reduce a partner's basis and at-risk amounts, because the partner is not allowed to deduct them.
   b. No current deduction is allowed for passive losses in excess of passive income from all other sources.
   c. Passive losses become active if they are carried forward to future years.
   d. Net passive losses can be carried forward only 10 years.

Basis and at-risk limitations

The concept of tax basis as a limit to the deductibility of losses

A general rule of taxation is that a taxpayer may not claim a deduction for losses or expenses in excess of the amount which he or she stands to lose in connection with the investment. Therefore, a partner or LLC member cannot deduct partnership or LLC losses that exceed his or her basis in the partnership or LLC interest. Similarly, losses or depreciation deductions cannot be claimed in excess of the taxpayer's actual investment in depreciated or depreciable property.

Example 5-8

Joe purchased an office building in the city several years ago for a total cost of $165,000. He claimed depreciation deductions totaling $65,000 prior to this year, when the building was destroyed by a tornado. When the building was destroyed, its fair market value had increased to approximately $250,000. Nonetheless, Joe's tax loss cannot exceed $100,000. He paid only $165,000 for the building, and his total deductions with respect to it cannot exceed that figure. Because he has already deducted $65,000 in depreciation expense, his tax basis—the amount he stands to lose with respect to the property—was only $100,000 at the date of the loss. He cannot deduct a loss in excess of his remaining basis even though the building was worth far more at the date of its destruction.

Accounting for indebtedness

The fact that a taxpayer has directly paid only a portion of the total cost of an asset as of the date of loss does not affect the computation of his or her tax basis in that asset, and accordingly, the upper limit on any deductible loss associated with it. A taxpayer's tax basis in an asset represents the amount which he or she stands (potentially) to lose should the asset decline in value. The taxpayer's risk of loss encompasses not only amounts which he or she has directly paid in connection with acquisition and improvement of the asset, but also any amounts he or she is obligated to pay in the future. Therefore, liabilities incurred in connection with the purchase of an asset are generally included in determining its tax basis.

Example 5-9

Hope purchased rental property for $115,000. She paid $25,000 cash and financed the remainder with a $90,000 mortgage from an unrelated lender. Although Hope made a direct payment of only $25,000 for the property, her tax basis in the property is equal to its purchase price of $115,000. This figure includes both the $25,000 she has already paid and the $90,000 she is obligated to pay in the future. Note that if the property declines in value after Hope's purchase, she will still be obligated to repay the entire $90,000 debt. Therefore, her total investment in the property—the amount she stands to lose if it becomes totally worthless—is $115,000.

Nonrecourse debt

Inclusion of liabilities in the tax basis of property is conceptually well-founded because debt generally increases a taxpayer's economic risk of loss. The issue becomes less clear, however, when debt is structured as "nonrecourse" debt. A nonrecourse debt is one for which the borrower has no individual responsibility to repay the lender. That is, the lender has no personal recourse against the borrower in the event the debt is not repaid.

Instead, with a nonrecourse debt the lender agrees to look solely to the property serving as collateral for the debt in the event of default. The lender can foreclose on the property, but should the property turn out to be worth less than the remaining debt balance, the lender has no further recourse against the borrower.[1]

Example 5-10

Barbara purchased an apartment complex for $675,000. She paid $175,000 down, and borrowed the remaining $500,000 from an unrelated lender to finance the remainder of the purchase price. The $500,000 mortgage was structured as a nonrecourse debt, so that Barbara assumed no personal responsibility to repay the debt. The building subsequently declined in value to $300,000, and Barbara stopped making payments on the mortgage. Although the outstanding (or unpaid) balance of the mortgage at the date of default was $450,000, Barbara cannot be required to continue making payments. The lender's only recourse is to foreclose on the apartment complex, taking it in complete satisfaction of the remaining debt. If it can sell the property for no more than $300,000, it will lose the remaining $150,000 it advanced to Barbara to make the original purchase.

[1] Generally, with a nonrecourse debt, the borrower must make a larger down payment, and pay a higher rate of interest, relative to recourse loans.

At-risk rules of Section 465

Obviously, in the preceding example, Barbara's tax basis in the apartment complex, which includes the entire $500,000 in nonrecourse indebtedness, exceeds her actual risk of loss with respect to the apartment complex. The at-risk rules were originally designed to address this issue. Unfortunately, from a policy perspective, they are not particularly effective.

Section 465, which applies only to individuals and closely held corporations, provides that a taxpayer may not claim deductions for losses in excess of the amount that the taxpayer actually has "at risk" with respect to the activity generating the losses.[2] For this purpose, a taxpayer's amount at risk is computed in the same manner as is his or her tax basis except that it does not include nonqualified nonrecourse debt.

Under Section 465(b)(6), a qualified nonrecourse debt (that is, one that is included in the taxpayer's amount at risk) is one which

- is borrowed by the taxpayer with respect to the activity of holding real property and which is secured by that real property;
- is borrowed from a lender who is in the business of lending money and who has no interest in the activity for which the money is borrowed, other than as a creditor; and
- is not convertible into stock or other securities of the taxpayer.

In essence, Section 465 prohibits inclusion of nonrecourse debts in the taxpayer's amount at risk only if the proceeds of the loan are not invested in real estate, or if the lender is related to the borrower, or has an interest in the activity in which the loan proceeds are to be invested.

One of the primary concerns of Congress in enacting Section 465 was the case in which a seller sells real estate to a buyer and finances the purchase him or herself by issuing a nonrecourse loan to the buyer or borrower. In this case, because the lender is so integrally tied to the transaction, there is no way for the IRS to know whether the sales price is reasonable. The borrower can easily inflate the apparent purchase price and thereby secure larger depreciation deductions, with no risk that the inflated price will ever be paid.

Example 5-11

Jones and Day, both doctors, approach Doris, owner of a motel, with a purchase offer. Although the value of the motel is about $125,000, Jones and Day offer to purchase the property from Doris for $1,250,000. They offer to pay $100,000 down. Doris will finance the remaining $1,150,000 with a nonrecourse note, requiring the doctors to pay $115,000 per year in interest expense for the next 15 years, with a balloon payment of $1,250,000 due at the end of that period. They then propose to lease the motel back to Doris for $115,000 per year.

[2] Section 465(b).

Example 5-11 (continued)

The lease payments owed by Doris will offset the interest owed by Jones and Day, and therefore no cash payments will actually be made by either party. At the end of 15 years, if the motel has appreciated sufficiently in value, Jones and Day will make the balloon payment to pay off the loan. If not, then Doris will foreclose, taking back ownership of the motel.

In the interim, Jones and Day hope to deduct depreciation expense of $32,000 per year (the motel is depreciable over 39 years). If they are both in the 39.6 percent tax bracket, these deductions would save them $12,672 per year in income taxes. Over 15 years, they would save a total of $190,080 in income taxes.

Doris, unlike an unrelated lender, has not advanced any real funds to Jones and Day, and therefore will be less concerned if they decide not to make the final balloon payment. In the end, she will retain ownership of the motel, and will have $100,000 cash as an incentive for joining in the transaction.

Although this transaction is a sham, and would not be recognized for tax purposes if the true value of the motel was known by the IRS, it is often difficult for the IRS to assess value accurately. Section 465 eliminates this problem. Because Doris is both the seller of the motel and the lender, the nonrecourse debt is not a qualified nonrecourse debt, and is not included in Jones' and Day's amount at risk. Accordingly, they cannot deduct more than $100,000 in depreciation and other expenses related to the motel.

Passive loss limitations

General

In 1986 Congress enacted Section 469, which denies deductions for net losses from so-called "passive" activities.[3] Congress was concerned in particular with losses realized from rental activities and with losses "allocated" to nonparticipatory (or, limited) partners in partnership, and now LLC, activities. For example, landlords often recognize tax losses on residential rental property even though out-of-pocket costs (for example, mortgage payments) are covered by rental proceeds and the underlying property appreciates in value.

[3] The statute also applies to tax credits generated by passive activities. Section 469(a)(1).

Example 5-12

Jamie Dean purchased a rental house at a total cost of $178,000. She rents the house to tenants for $1,200 per month. This year, she paid mortgage interest of $6,750, insurance of $800 and $2,200 in property taxes. In addition, she is allowed a depreciation deduction of $6,180, giving her total deductions of $15,930. Offsetting these deductions was her rental income of $14,400 ($1,200 × 12 months), yielding a tax loss of ($1,530). Note that, although she realizes a tax loss of more than $1,500, she actually had a positive cash flow from the rental activity: because depreciation is a non-cash cost, Jamie's total cash outlays were $9,750, and her total cash inflows (rent income) were $14,400. (Assume her principal payments on the mortgage were less than $4,650.)

The rationale behind the statute is pretty basic. Where a taxpayer is not personally involved in the daily operations associated with an activity (as in the case of a limited partner or an LLC member treated as a limited partner for tax purposes) or where an activity does not require a substantial amount of personal attention from the taxpayer (as in the case of rental property), the activity is more akin to an investment than to a business activity. Therefore, any loss realized by the taxpayer as a result of his or her investment in the activity can be accurately measured only when the investment is liquidated. At that point, the taxpayer can measure his or her total cash outflows against total cash inflows and determine whether the investment resulted in a net gain or a net loss. Accordingly, under Section 469, *net losses* (passive losses in excess of passive income) from passive activities are disallowed. As discussed previously, disallowed losses are carried forward and can be deducted only against future passive income or when the taxpayer fully disposes of his or her interest in the passive activity.

Example 5-13

Consider the facts in example 5-12. Jamie Dean purchased rental property for $178,000. She had total cash outflows of $9,750 and total cash inflows of $14,400. Assume that at the beginning of next year, she sells the house. If she sells the house for $180,000, she will have realized a total net profit of $6,650. That is, she paid out a total of $187,750 ($178,000 original cost plus $9,750 in interest expense, insurance and property taxes), and received a total of $194,400 ($180,000 sales price plus $14,400 rent income), leaving her $6,650 better off.

If the passive loss limitations do not apply to Jamie's rental activity, she will deduct a ($1,530) loss in year one, and recognize a $8,180 gain from the sale of the house in year two ($180,000 selling price less $171,820 adjusted tax basis, measured as the original $178,000 purchase price less $6,180 depreciation expense). The net result is a $6,650 profit ($8,180 year-two gain, less $1,530 year one loss).

If the passive loss rules apply to Jamie's investment, she will recognize no loss in year one, and will recognize a $6,650 net gain in year two, consisting of the $8,180 capital gain from sale of the house, and the ($1,530) ordinary carryforward loss from year one.

Example 5-13 (continued)

As discussed previously, these items will not be netted on the tax return, but will each retain their character as capital or ordinary. Therefore, the passive loss limitations do not change the net result to Jamie Dean or the government. The only difference is in timing.

Passive activity losses

Under Section 469, passive activity losses are deductible only from passive activity income. As noted previously, excess losses are carried forward indefinitely until the taxpayer has passive income, or until the taxpayer disposes of his or her entire interest in the activity in a fully taxable transaction.

Note. Also, as discussed previously, the passive loss limitation is applied after application of the at-risk rules. Therefore, any loss disallowed under Section 465 is not considered in applying the passive loss rules. This may result in losses from other activities, including other investments in partnerships or LLCs, being allowed.

Example 5-14

Joyce owns interests as a limited partner in three partnerships: Oak Creek Investments, Knob Hill Apartments, and Cranberry Partners. Assume that all three activities constitute passive activities for Joyce. In the current year, she has basis, at-risk amounts, and pass-through income or loss from each activity as follows:

Partnership	Tax basis	At-risk amount	Pass-through income/(loss)
Oak Creek Investments	$28,000	$20,000	($18,000)
Knob Hill Apartments	$25,000	$25,000	$15,000
Cranberry Partners	$12,000	$0	($7,500)

Because Joyce has no at-risk amount in Cranberry Partners, none of the ($7,500) loss is allowed under Section 465. In contrast, the Oak Creek Investments loss is less than Joyce's basis and amount at-risk, and therefore the entire loss survives the limitations of Sections 704(d) and 465. Under Section 469, this loss will be allowed only to the extent of Joyce's passive income from other sources. Assuming that she has no passive income from any other source other than her limited partnership investments, her total passive income is $15,000. Therefore, $15,000 of the Oak Creek loss will be deductible under Section 469. Joyce will have a ($3,000) loss carryforward under that statute. None of the Cranberry loss carryforward is a passive loss carryforward. Rather, it is a Section 465 carryforward, although should it be allowed under the at-risk limitations in a subsequent year, it will still be subject to the passive loss limitations (and therefore may not be deductible).

Passive activity credits

Credits passed through from passive activities can be applied only against the tax from net passive income. Passive activity credits include the general business credit and other special business credits, such as the credit for fuel produced from a non-conventional source. Like passive losses, credits from passive activities that exceed the tax on net income from passive activities are carried forward indefinitely and may be used to offset income taxes on net passive income in future years. Unlike passive loss carryforwards, however, passive activity credit carryovers are not triggered upon the disposition of a partner or LLC member's entire interest in the partnership or LLC. Rather, they continue to be carried forward, indefinitely, to be applied against taxes on passive income in future years.

Allowable credits from passive activities are computed on Form 8582-CR.

Knowledge check

3. Carol owns 50 percent limited partnership interests in two partnerships. Both interests are properly classified as passive activities. This year, Carol's share of income (loss) from each of the partnerships was as follows:

Partnership 1	($15,000) net loss
Partnership 2	$20,000 net income

How much of the pass-through loss from Partnership 1 will Carol be allowed to deduct on her current year's tax return? (Assume that Carol had no other income or loss from any other passive activity.)

a. $0.
b. $15,000.
c. $20,000.
d. $7,500.

Gross income from passive activities

Net income or loss from a passive activity is computed as the excess of *passive activity income* over *passive activity deductions*. Passive activity income includes all income from passive activities including gain from disposition of an interest in a passive activity or from disposition of property used in a passive activity.

Income from the following sources is not passive activity income:

- From any activity that is not a passive activity (for example, income from activities in which the taxpayer "materially participates," defined as follows).
- Portfolio income—interest, dividends, annuities, and royalties not derived in the ordinary course of a trade or business, including gain or loss from the disposition of property that produces these types of income or that is held for investment.[4]
- "Personal services income"—salaries, wages, commissions, self-employment income from non-passive trade or business activities, deferred compensation, guaranteed payments from partnerships or LLCs, taxable social security and other retirement benefits, and similar payments.
- Income from working interests in oil or gas properties.
- Income from intangible property, such as a patent, copyright, or literary, musical or artistic composition, if the taxpayer's personal efforts significantly contributed to the creation of the property.
- A partner's distributive share of net income from a publicly traded partnership.[5]

Gain from sale or disposition of property

Gain on the sale or disposition of property is generally classified as passive activity income if, at the time of the disposition, the property was used in a passive activity. For property used in more than one activity during the preceding 12 months, the gain must be allocated between the two activities based on the property's use during that period. Any portion of the gain allocated to a passive activity is passive income.

In some cases, it is acceptable to allocate the gain solely to the activity in which the property was primarily used. Such an allocation is allowable if the fair market value of the taxpayer's interest in the property is not more than the lesser of

- $10,000; or
- 10% of the total of the fair market value of all property used in that activity immediately before the disposition (including the property that has been disposed of).[6]

[4] The exclusion for portfolio income does not apply to self-charged interest treated as passive activity income. See Regulation Section (Reg. Sec.) 1.469–7.
[5] The passive loss rules are applied separately to each interest owned by a partner in a publicly traded partnership. See Section 469(k).
[6] Reg. Sec. 1.469-2T(c)(2)(ii).

Gain from sale of an interest in a partnership or LLC

Similar rules apply to the classification of gain recognized on the sale of an interest in a partnership or LLC. If the partnership or LLC was engaged in a passive activity, gain (or loss) recognized on the sale or disposition of the partner or member's interest in the entity will be classified as passive gain (or loss). If the entity is engaged in more than one activity (for example, a passive activity and a portfolio activity), the gain or loss must be allocated between the entity's different activities and classified accordingly. Such allocation is generally based on the relative amounts of gain or loss which would have been recognized by the partner or LLC member if the entity had sold its entire interests in each of its activities just prior to the partner or member's sale of his or her partnership or LLC interest.[7]

Example 5-15

Richard is a 10 percent member in El Camino, LLC, a real estate development company. Richard is classified as a limited partner for federal income tax purposes, so that his share of the company's income or loss from its rental real estate activities is passive. This year, he sold his interest in El Camino to an unrelated buyer, recognizing a $25,000 gain. Assume that review of the company's balance sheet indicates that 20% of this gain is attributable to portfolio assets held by the company and 80% is attributable to the company's rental real estate activity. Richard's gain will be allocated similarly between passive and portfolio income—$20,000 passive income and $5,000 portfolio income.

Special rule for substantially appreciated property

Gain recognized on the sale of "substantially appreciated" property cannot be classified as passive income unless[8]

- the property was used in a passive activity for 20% of the time the taxpayer owned the property (or owned an interest therein); or
- the property was used in a passive activity for the entire 24-month period preceding the disposition.

"Substantially appreciated property" is property which has a fair market value that exceeds 120% of its adjusted basis. Therefore, the transfer of appreciated property to a passive activity followed shortly thereafter by sale of such property will not generate passive income. Similar rules apply to the transfer of

[7] Reg. Sec. 1.469-2T(e)(3)(ii). Note that a default rule provides that allocation of a partner or member's gain among the entity's activities may be made on the basis of the relative fair market values of each activity if it is not possible to determine how much gain or loss would be allocated to such partner or member from the sale of the entity's entire interest in each of its activities.

[8] Reg. Sec. 1.469-2(c)(2)(iii).

substantially appreciated property to a partnership, LLC, or other pass-through entity within the same taxable year the contributor sells his or her interest in the entity or the previous taxable year.[9]

Example 5-16

Virginia is a 50 percent partner in Prairie Dog Partners, formed several years ago to invest in rental residential realty. The partnership is a passive activity for Virginia. Last year, she transferred investment property to the partnership that she had held for several years. The investment property was valued at $120,000 at the date of contribution; her tax basis in the property was $50,000. The partnership planned to construct additional rental property upon the property.

This year, Virginia sold her partnership interest to an unrelated buyer for $250,000. Her tax basis in the partnership interest was $160,000. Assume that the value of the investment property she had previously contributed to the partnership was unchanged from the date of contribution.

Virginia will recognize a total gain on sale of her interest in Prairie Dog Partners of $90,000. Of this, $70,000 ($120,000 FMV - $50,000 tax basis) is attributable to the appreciated property contributed to the partnership within two years of sale of her interest. Because she did not use the property in a passive activity prior to its contribution to the partnership, this portion of her gain is not classified as passive income. The remainder of her gain, $20,000, is attributable to the sale of her interest in a passive activity and will be classified as passive income.

[9] Reg. Sec. 1.469-2T(e)(3)(iv)(B).

Passive activity deductions

Passive activity deductions include both deductions associated with passive activities incurred during the current tax year and prior year deductions from passive activities that are carried forward to the current tax year. They also include losses from dispositions of property used in a passive activity and losses from the disposition of the taxpayer's interest, or a portion thereof, in a passive activity.

Passive activity deductions do not include the following items:

- Qualified home mortgage interest, capitalized interest expenses, and other interest expenses other than self-charged interest treated as a passive activity deduction[10]
- Deductions for expenses that are clearly and directly allocable to portfolio income
- Losses from dispositions of property that produce portfolio income or property held for investment
- State, local, and foreign income taxes
- Miscellaneous itemized deductions that may be disallowed because of the 2% of adjusted gross income limit
- Charitable contributions[11]
- Net operating loss deductions
- Percentage depletion carryovers for oil and gas wells
- Capital loss carry-backs and carryovers[12]

[10] Reg. Sec. 1.469-7.
[11] Reg. Sec. 1.469-2T(d)(2).
[12] Reg. Sec. 1.469-2(d)(2)(ix).

Who is subject to the passive loss limitations?

The passive loss rules apply only to individuals, certain trusts and estates, personal service corporations and closely-held corporations.[13] Note that although the rules do not technically apply to LLCs, partnerships, and S corporations directly, they do apply to the owners of these entities, assuming the owners would be subject to the limitations if they held their interests in the activity directly rather than through the LLC, partnership, or S corporation.

Note. Unlike individuals, closely held corporations are allowed to deduct net passive losses against active income.[14] Similarly, they can offset the tax attributable to net active income with passive activity credits. However, closely held corporations cannot offset portfolio income with net passive losses. Therefore, certain closely held partnerships and LLCs involved in passive activities may consider electing to be taxed as corporations rather than partnerships in order to avoid some of the passive loss limitations.

[13] Section 469(a)(2). Corporations that are not closely held are not subject to these provisions.
[14] Section 469(e)(2). Net active income is the corporation's taxable income computed without regard to any income or loss from a passive activity or any portfolio income or loss.

What are passive activities?

Although targeted primarily at rental real estate activities and activities conducted through limited partnerships, "passive" activities under Section 469 are rather broadly defined. In fact, the primary standard for determining whether an activity is passive is the level of participation required of the taxpayer with regard to the activity. Specifically, a passive activity is one in which the taxpayer does not "materially participate" during the taxable year. In addition, most rental activities are deemed to be passive regardless of the taxpayer's level of participation, though there is a rather significant exception for taxpayers who are engaged primarily in the real estate business.[15]

Material participation

The first step in determining whether the passive loss rules apply to a particular taxpayer is to determine which of his or her activities are passive in nature. As indicated previously, Section 469 is really targeted at real estate activities and limited partnership activities. However, Section 469 is so broadly written that other activities can easily fall under its umbrella. In general, the statute defines an activity as passive unless the taxpayer "materially participates" in the activity. Material participation is defined as involvement, by the taxpayer or his or her spouse, which is "regular, continuous and substantial." [16] The statute further provides that a limited partner cannot satisfy this requirement. Accordingly, interests held as a limited partner are generally classified as passive.[17]

The "regular, continuous and substantial" preceding standard is rather ambiguous, but fortunately the regulations provide additional guidance on what constitutes "material participation." In general, the determination of whether a taxpayer's participation is material is made by reference to the number of hours the taxpayer actually spent participating in the activity. The general standard is 500 hours—that is, taxpayers spending at least 500 hours in an activity during the taxable year are deemed to have materially participated in the activity. In order to make it easier for family-run small businesses to qualify as active, participation by the spouse is treated as participation by the taxpayer.

The 500-hour standard would create problems for taxpayers who are starting a business outside of their regular employment which takes a while to get off the ground. In recognition of this issue, alternative tests impose a 100-hour standard under which, in conjunction with other conditions, a taxpayer's participation in an activity can be deemed material.

[15] Section 469(c)(3). The code also provides that working interests in oil and gas properties are *not* passive activities whether or not the taxpayer materially participates.
[16] Section 469(h)(1).
[17] Section 469(h)(2).The regulations provide exceptions in some cases in which the limited partnership interest generates profits rather than losses or in which a formerly nonpassive interest in an activity is converted into a limited partnership interest. See Reg. Sec. 1.469-5.

Finally, the regulations provide a number of other exceptions under which taxpayers who do not participate in an activity for at least 500 hours during the taxable year will nonetheless be deemed to have materially participated. These rules are designed primarily to prevent taxpayers from classifying profitable activities as passive activities, thereby allowing them to use losses from other passive activities.[18] Taxpayers trying to avoid classification of an activity as passive will not be affected by these provisions. These provisions are discussed more fully as follows.

The standards for material participation

The regulations establish a number of tests under which taxpayers may be deemed to have "materially participated in an activity." Satisfaction of any one of the following tests constitutes material participation:

- The taxpayer's participation in the activity exceeded 500 hours (during the tax year).
- The taxpayer's participation constituted substantially all the participation in the activity, including the participation of individuals who did not own any interest in the activity (for example, a part-time business with no or very few employees).
- The taxpayer's participation exceeded 100 hours during the tax year, and was at least as much as any other person's participation in the activity (again, including people who did not own an interest in the activity) (for example, a part-time business with a minimum level of employees).
- The activity is a "significant participation activity" defined as follows, where participation in all "significant participation activities" during the year exceeds 500 hours.
- The taxpayer materially participated in the activity for any five of the preceding 10 taxable years (for example, a retiree or variable-participation activity).
- The activity is a personal service activity (involving personal services in the fields of health, veterinary services, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business in which capital is not a material income-producing factor), and the taxpayer has materially participated in it for any three preceding taxable years (for example, a recent retiree).
- The facts and circumstances support that the taxpayer participated in the activity on a "regular, continuous, and substantial basis" during the taxable year.[19]

A significant participation activity is one in which the individual participates for more than 100 hours during the year, but does not meet any of the other tests for material participation.

[18] See Reg. Sec. 1.469-5T(f).
[19] Reg. Sec. 1.469-5T(a).

Example 5-17

Robert has a full-time job as an architect. In addition, he and a friend have started a fledgling home improvement business which they operate after regular working hours and on weekends. The business is organized as an LLC, owned 50% each by Robert and his friend. During the current year, Robert and his partner each worked about 160 hours during this taxable year making home improvements. Their income was unfortunately not sufficient to offset their costs (primarily tools and materials), and they incurred a loss for the year. Because Robert and his friend each worked more than 100 hours, and both worked the same amount of time, their home improvement business is not a passive activity, and they may deduct their loss without limitation.

A partner or LLC member cannot be deemed to have materially participated in an activity under test 7 unless he or she participated in the activity for more than 100 hours during the year.[20] Participation in managing the activity does not count in determining material participation under this test if

- any other person received compensation for managing the activity; or
- any other individual spent more hours during the tax year managing the activity (regardless of whether the individual was compensated for such management services).

What constitutes participation?

In general, any work performed by the taxpayer in connection with an activity is treated as participation in the activity.[21] Work performed by a taxpayer's spouse counts as work performed by the taxpayer, even if the spouse has no direct interest in the activity and even if the taxpayer and spouse do not file a joint return.

There are two exceptions to the general rule that any work performed by the taxpayer or spouse counts as participation. First, work that is not of a type customarily done by an owner in that type of activity is not counted as participation unless the taxpayer can demonstrate that avoiding disallowance of related passive losses is not a primary reason for doing the work. For example, if a taxpayer's spouse works as a secretary in a real estate developer's office, the taxpayer is not deemed to be an active participant in the development activity by reason of his or her spouse's work for the developer.

Second, work performed in the taxpayer's capacity as an investor in an activity does not count as participation unless the taxpayer is directly involved in the day-to-day management or operations of the activity. Work performed as an investor includes

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[20] Reg. Sec. 1.469-5T(b)(2)(iii).

[21] Taxpayers can use any reasonable method to support their participation in an activity. A daily log, time report, or the like is not necessary; although written records, such as an appointment book or similar document, are recommended.

- studying and reviewing financial statements or reports on operations of the activity;
- preparing or compiling summaries or analyses of the finances or operations of the activity for the taxpayer's own use; and
- monitoring the finances or operations of the activity in a non-managerial capacity.

Limited partners

Limited partners generally are not treated as material participants in the activity conducted by the partnership. This rule does not apply, however, if the limited partner (or LLC member treated as a limited partner) satisfies the requirements of tests (1), (5), or (6). These exceptions are meant to prohibit profitable activities from being classified as passive, thereby allowing the taxpayer to deduct passive losses from other sources.[22]

The rule also does not apply if the taxpayer owns interests as both a limited and general partner in the same activity. A limited partner who also holds a general partner interest during the entire year in the same activity is not treated as holding a limited partnership interest.[23]

Under proposed regulations, an interest in an entity will generally be treated as an interest in a limited partnership as a limited partner if

- the entity in which such interest is held is classified as a partnership for federal income tax purposes; and
- the holder of the interest does not have rights to manage the entity at all times during the entity's taxable year.[24]

This would generally allow limited partners and LLC members who have significant possible managerial responsibilities to be treated as material participants.

Rental activities

As noted previously, Section 469 automatically classifies most rental activities as passive, regardless of the taxpayer's level of participation. For this purpose, a rental activity is one involving the long-term rental of property to tenants and for which the taxpayer does not provide substantial additional services.[25] Therefore, rental activities under the passive loss rules are primarily those involving the rental of residential and commercial real estate (apartment complexes, rental houses, office buildings, and the like). In contrast, the operation of hotels, motels, golf courses, and the like does not constitute a passive activity, because the rental periods are usually short, and the taxpayer is required to provide a substantial

[22] Reg. Sec. 1.469-5T(e)(2).
[23] Reg. Sec. 1.469-5T(e)(3)(ii).
[24] Proposed Reg. Sec. 1.469-5(e)(3).
[25] See Reg. Sec. 1.469-1T(e)(3).

amount of personal services in connection with the rental (for example, cleaning rooms, making beds, maintaining greens, and the like).[26]

An activity is a rental activity if tangible property (real or personal) is used by customers or held for use by customers, and the gross income (or expected gross income) from the activity represents amounts paid (or to be paid) mainly for the use of the property. It does not matter whether the use is under a lease, a service contract, or some other arrangement.

Exceptions

The regulations provide a number of exceptions under which certain activities are not treated as rental activities. These exceptions primarily apply to situations where the rental activity requires a large degree of necessary participation by the partners or members of the LLC, or by their employees. Under the regulations, the following activities are not rental activities:[27]

- The average period of customer use of the property is seven days or less (for example, hotels, motels, short-term equipment, or vehicle rentals, and the like).
- The average period of customer use of the property is 30 days or less and significant personal services are provided with the rentals. The regulations do not define the term *significant personal services*, indicating only that all relevant facts and circumstances must be taken into consideration, including the frequency of the services, the type, and amount of labor required to perform the services, and the value of the services relative to the amount charged for use of the property.[28] The regulations do provide that significant personal services do not include
  - services necessary to permit the lawful use of the property;
  - services to repair or improve property that would extend its useful life for a period substantially longer than the average rental; or
  - services that are similar to those commonly provided with long-term rentals of real estate, such as cleaning and maintenance of common areas or routine repairs.
- Extraordinary personal services are provided by or on behalf of the owner(s) of the property in making such property available for customer use. Services are extraordinary personal services if they are performed by individuals and the customers' use of the property is incidental to their receipt of the services (for example, medical care provided at a hospital).
- The rental is incidental to a non-rental activity. Rental is incidental if the main purpose of holding the property is either to realize a gain from its appreciation or for use in a trade or business activity, and the rental income from the property is a minimal percentage of its cost or value. This standard is satisfied if the gross rental income from the property is less than 2% of its *unadjusted basis* (that is, cost without adjustment for depreciation or other cost recovery) or fair market value, whichever is smaller. For example, leasing grazing rights on raw land held for investment is an incidental rental activity if the lease payments are less than 2% of the cost or value of the property (whichever is less).
- The rental property is customarily made available during defined business hours for nonexclusive use by various customers (for example, health clubs).

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[26] One exception to these rules applies where the taxpayer leases property to a partnership, S corporation, or joint venture in which he or she has an interest. In this case, the rental activity does not constitute a passive activity regardless of the length of the rental period.

[27] Reg. Sec. 1.469-1T(e)(3)(ii).

[28] Reg. Sec. 1.469-1T(e)(3)(iv).

- The property is provided for use in a non-rental activity in the owner's capacity as an owner of an interest in a partnership, S corporation, or joint venture conducting that activity. Therefore, an LLC member may not lease property to his or her LLC in the hopes of generating passive income.

Real estate professionals

When first enacted, the passive loss limitations created much discomfort among full-time real estate professionals. These taxpayers argued that the acquisition, improvement, and rental of commercial and residential real estate constituted their full-time occupations, and should not be subject to the passive loss limitations. In 1993, Congress agreed, amending Section 469 so that taxpayers in the "real property business" are no longer subject to the passive loss restrictions.[29] For this purpose, a taxpayer is in the real property business if he or she

- spends more than half of his or her time in real property businesses in which he or she materially participates; and
- performs more than 750 hours of services during the taxable year in real property trades or businesses in which he or she materially participates.

For this purpose, the term "real property trade or business" includes the development or redevelopment, construction or reconstruction, acquisition and sale, conversion, rental, rental management, or brokerage of real property. Participation of the taxpayer's spouse does not count towards the taxpayer meeting the preceding requirements.

Real estate professionals must also materially participate in the rental real estate activity in order to be able to deduct losses attributable to them. For all other taxpayers, rental activities will be treated as passive activities.

Exemption for rental activities in which taxpayer "actively" participates

Section 469 also provides relief for middle-income taxpayers with rental property. For taxpayers who "actively participate" in the management of rental property, the first $25,000 of net losses generated by such property are exempted from Section 469. Two points must be emphasized here. First, the losses are still passive losses; however, they are not subject to the passive loss limitations. Second, the exemption applies only if the taxpayer "actively" participates in management of the property.

Note that "active" participation is a lesser standard than material participation. Active participation requires the following:

- The taxpayer must have at least a 10% interest in the rental activity.
- The taxpayer must not own the interest as a limited partner.
- The taxpayer must participate in the activity in a significant and bona fide manner.

[29] Section 469(c)(7).

The latter requirement is usually interpreted as requiring that the taxpayer participate fully in all management decisions made with regard to the property (for example, establishing rents, approving new tenants, approving repairs, and the like). Limited partners are not treated as actively participating in a partnership's rental real estate activities.

Note. Active participation is not required to take the low-income housing credit, the rehabilitation investment credit, or the commercial revitalization deduction from rental real estate activities. The phase-out of the rehabilitation credit begins at adjusted gross income (AGI) of $200,000 rather than $100,000. The low-income housing credit and the deduction for commercial revitalization expenses are not phased out. Therefore, for these two items, a deduction or credit is allowed regardless of the taxpayer's level of participation in the activity and regardless of his or her income level.[30]

The exemption is targeted at lower and middle-income taxpayers. To ensure that higher income individuals do not benefit, the $25,000 exemption amount is phased out as the taxpayer's adjusted gross income (computed before taking into account the rental loss) exceeds $100,000. Specifically, the exemption amount is reduced by 50 cents for each dollar that the taxpayer's "modified AGI" exceeds $100,000. Therefore, once "modified AGI" exceeds $150,000, no exemption is allowed.[31]

Example 5-18

Lynn is a limited partner in a real estate partnership. She has a 20% interest in the partnership's profits and losses. This year, her share of the partnership's losses was ($18,000). She also owns a duplex which she holds out for rent. She is the sole owner of the duplex, and makes all management decisions. This year, she realized a ($14,000) loss from renting the duplex. Her adjusted gross income, before considering the preceding losses, is $130,000. She has no passive income from any other source. She is not a real estate professional. On her current year tax return, Lynn's loss from the limited partnership will be disallowed under the passive loss rules. Her loss on the duplex is also passive, but some will be exempted from the passive loss rules because Lynn actively participates in the rental activity. Ordinarily, her allowable exemption would be $25,000, an amount which would allow the entire ($14,000) loss on the duplex. However, because Lynn's AGI is $130,000, her allowable exemption amount will be reduced by $15,000 (.5 × $30,000, the excess of her AGI more than $100,000). Therefore, she will be able to deduct only ($10,000) of her loss from rental of the duplex. Accordingly, her current AGI, after considering her rental losses, will total $120,000, and she will have a ($18,000) passive loss carryover attributable to the limited partnership interest, and a ($4,000) passive loss carryover attributable to the rental duplex.

[30] Note that the allowable low-income housing credit and the rehabilitation credit under Section 469(h) are computed as "deduction equivalents." The credit amount allowed under this provision is equal to the amount of tax savings that would be associated with a $25,000 deduction.
[31] The AGI level at which the phase-out begins is $200,000 for taxpayers claiming the rehabilitation credit, and there is no phase-out for taxpayers claiming the low-income housing credit or the commercial revitalization deduction. Section 469(i)(3).

Modified adjusted gross income

Modified AGI for the purpose of computing the phase-out is regular AGI, computed without regard to the following:

- Taxable social security and tier 1 railroad retirement benefits
- Deductible contributions to individual retirement accounts (IRAs) and Section 501(c)(18) pension plans
- The exclusion from income of interest from qualified U.S. savings bonds used to pay qualified higher education expenses
- The exclusion from income of amounts received from an employer's adoption assistance program
- Passive activity income or loss included on Form 8582
- Rental real estate losses allowed because taxpayer is a "real estate professional"
- Net losses from publicly traded partnerships
- The deduction for one-half of self-employment tax
- The deduction for interest on student loans
- The deduction for qualified tuition and related expenses

Example 5-19

Carlos is a 20 percent partner in a real estate partnership. He is not a real estate professional, but he does actively participate in the partnership's rental real estate activities. For the current year, his share of the partnership's net loss was ($35,000). In addition, he had tax-exempt interest income of $4,800, and net self-employment income of $120,000. He paid self-employment taxes of $16,128, properly claiming a deduction (for AGI) of $8,064 for half of this amount. Carlos' modified AGI is $120,000, computed as follows:

Adjusted gross income:	
Self-employment income	$120,000
Tax-exempt income	0
Total income	$120,000
Less ½ SE tax	(8,064)
Adjusted gross income	$113,120
Add back adjustment for ½ SE tax	8,064
Modified AGI	$120,000

Example 5-19 (continued)

Carlos will be allowed to deduct ($15,000) of the pass-through loss from the partnership:

"Modified" adjusted gross income	$120,000
Minus amount not subject to phase-out	100,000
Amount subject to phase-out rule	$20,000
Multiply by 50%	× .50
Reduction in $25,000 exemption amount	10,000
Allowable deduction for rental real estate loss	$15,000

The remaining $20,000 loss will be carried forward under Section 469 and will be deductible when Carlos has sufficient passive income to absorb it, or when he sells his interest in the partnership.

Knowledge check

4. K is a partner in an accounting firm. Her salary and other income totals $250,000 for the current year. In addition, she owns residential rental properties. For the current year, Property A generated a loss of $18,000, and Property B generated a loss of $30,000. She is the sole owner of these properties and actively participates in their management. How much rental loss will be deductible on her current year return?

    a. $25,000.
    b. $18,000.
    c. None.
    d. $48,000

Activities that are not passive activities

Because passive losses are deductible only against passive income, it is important to distinguish activities that are not classified as passive. Essentially, there are five categories of trade or business activities that will not be treated as passive activities. (Income from investment activities is called "portfolio income" and may not be offset with passive losses.) The following are not passive activities:

- Trade or business activities in which the taxpayer materially participated for the tax year (as defined previously).
- A working interest in an oil or gas well held by the taxpayer directly or through an entity that does not limit liability (such as a general partner interest in a partnership or LLC). The taxpayer's level of

participation in the activity is irrelevant for this purpose. Therefore, losses from working interests in oil and gas properties are always deductible unless the interest is held by a limited partner, or LLC member treated as a limited partner.[32]

- Rental of a *vacation home* (that is, a home or other "dwelling unit" both held for rental and used for personal purposes for more than the greater of 14 days or 10% of the number of days during the year that the home was rented at a fair rental).
- Trading activities involving personal property traded for the account of those who own interests in the activity.[33]
- Rental real estate activities of real estate professionals where the owner materially participates in the rental activity.

Re-characterization of passive activities as nonpassive

Finally, the regulations provide for reclassification of some profitable passive activities as non-passive activities. The rationale for these provisions is to prevent passive losses from other passive activities from being deducted against profits from these profitable activities. If a taxpayer has net income from any of the following passive activities, all or part of that income (depending on the following type of passive activity) will be reclassified as non-passive trade or business income:[34]

- Significant participation passive activities (activities in which the taxpayer's participation exceeds 100 hours during the taxable year)[35]
- Rental of substantially non-depreciable property (property for which less than 30% of the unadjusted basis is depreciable)[36]
- Equity-financed lending activities
- Rental of property that is incidental to real estate development activities
- Rental of property to non-passive activities
- Licensing of intangible property by pass-through entities

[32] See Temporary Reg. Sec. 1.469-1T(e)(4)(ii).
[33] See Temporary Reg. Sec. 1.469-1T(e)(6).
[34] Reg. Sec. 1.469-2(f)(5).
[35] Temporary Reg. Sec. 1.469-2T(f)(2).
[36] Temporary Reg. Sec. 1.469-2T(f)(3).

Rules of application

Conceptually, the passive loss limitations are relatively straightforward. Taxpayers first total all their income from passive activities. They then total their losses from passive activities. If the losses exceed the income, they have a net passive loss, which is disallowed unless subject to the exemption for rental activities in which the taxpayer materially participates. The taxpayer must then allocate the disallowed passive loss back to the passive activities which generated the loss. These losses carry forward indefinitely, and can be deducted if the taxpayer either earns net passive income in a subsequent year, or sells or otherwise disposes of his or her entire interest in the passive activity to which the loss has been allocated.

Example 5-20

Joyce is a member in four different limited liability companies. She is classified as a limited partner in all four companies, and all four are engaged in rental activities. This year, LLC #1 reported a net profit, whereas the other three companies each reported net losses. Joyce's share of these profits and losses were as follows:

LLC #1	$24,000
LLC #2	(10,000)
LLC #3	(20,000)
LLC #4	(30,000)
Net Loss	($36,000)

As indicated previously, Joyce has a net passive loss of ($36,000), none of which will be deductible on her current year tax return. Note, however, that $24,000 of the losses attributable to LLCs 2, 3, and 4 were deducted against the $24,000 income attributable to LLC 1. The ($36,000) passive loss carryover generated this year is allocable ($6,000) to LLC 2 (10,000 ÷ 60,000), ($12,000) to LLC 3 (20,000 ÷ 60,000), and ($18,000) to LLC 4 (30,000 ÷ 60,000). If one of the LLC interests is sold, this allocation will affect the amount of the carryover that can be deducted due to the sale.

Note. The statute under Section 469 is relatively taxpayer friendly with respect to the use of passive loss carryovers upon the disposition of a taxpayer's entire interest in a passive activity. Section 469(g) provides that the loss carryforward from the terminated activity is applied against passive income from other passive activities and that only the excess of such loss over income from other such activities is characterized as loss from non-passive activities. However, Section 469(g)(1)(A)(ii) provides that passive loss carryovers from other passive activities are applied against passive income from such activities before application of the carryover from the terminated activity. In other words, carryover losses from an activity which the taxpayer has completely disposed of do not crowd out passive loss carryovers from those activities in which the taxpayer still maintains an interest.

Example 5-21

Assume the same facts as in example 5-20. Joyce has a ($36,000) passive loss carryforward from year one, of which ($6,000) is attributable to LLC 2, ($12,000) to LLC 3 and ($18,000) to LLC 4. In year two, Joyce sold her interest in LLC 3, realizing no gain or loss on the sale. In year two, Joyce is allocated a loss of $10,000 from LLC 3 for the period preceding the sale. Her profit and loss allocations from the other three companies are as follows:

LLC #1	$55,000
LLC #2	(15,000)
LLC #4	(15,000)
Net Profit	$25,000

Although she realized no taxable gain or loss on the sale of her interest in LLC 3, Joyce's passive loss carryover attributable to that interest is fully deductible in year two. The entire ($12,000) carryover from LLC 3 is allowable in this year, along with the current $10,000 loss from LLC 3. The $22,000 total losses from LLC 3 would first be applied against any gain from the sale of LLC 3. There being no gain from the sale, the entire $22,000 loss is applied against Joyce's net passive income from other activities in year two, after reducing that net income by any of the loss carryovers from her interests in LLCs 2 and 4. Her net passive income for other activities for year two is $25,000 - $6,000 (LLC 2 carryover) - $18,000 (LLC 4 carryover) = $1,000. The $22,000 loss from LLC 3 is used to offset this income, leaving $21,000 of LLC 3 loss that is no longer characterized as passive (and is therefore deductible in full).

Example 5-22

Assume that in year three Joyce has no income or loss from LLC 1, but has passive losses of $4,000 from LLC 2 and $12,000 from LLC 4. She has no other passive income in year three, so in year four Joyce has passive loss carryovers from LLCs 2 and 4 of ($4,000) and ($12,000) respectively. In year four, she is allocated profit and loss from her remaining LLC investments as follows:

LLC #1	$50,000
LLC #2	(25,000)
LLC #4	(15,000)
Net Income	$10,000

In year four, Joyce has net passive income of $10,000 as noted previously. Under Section 469, she is allowed to deduct ($10,000) of her passive loss carryovers. Of the ($10,000), ($2,500) will come out of the LLC 2 carryover (4,000 ÷ (4,000 + 12,000)), and ($7,500) will come out of the LLC 3 carryover (12,000 ÷ (4,000 + 12,000)). On her tax return for year four, then, Joyce will report net passive profit or loss of $0. She will have passive loss carryovers from LLC 2 of ($1,500) = (4,000 - 2,500) and ($4,500) from LLC 4 (12,000 - 7,500).

Note: Capital losses realized on disposition of an interest in a passive activity are subject to the capital loss limitations. The provisions allowing deduction of passive loss carryovers upon the disposition of a taxpayer's complete interest in a passive activity do not override the capital loss limitations.

Example 5-23

Carla sold her entire interest in a limited partnership activity in the current year to an unrelated person for $30,000. Her adjusted basis in the partnership interest was $42,000, and she had $10,000 of passive loss carryforwards from the activity. Carla also had salary income from her job of $75,000. Carla will be entitled to a ($13,000) deduction on her current year return, computed as follows:

Selling price of the limited partnership interest	$30,000
Basis of the limited partnership interest	(42,000)
Capital loss on sale	(12,000)
Capital loss limitation	(3,000)
Passive loss carryforwards deductible upon disposition of entire interest	(10,000)
Total deductible loss in year of sale	(13,000)

The remaining $9,000 of Carla's capital loss on sale of the partnership interest will be carried over under the capital loss carryover rules. It will not be subject to the passive activity loss limitations.

Knowledge check

5. Jorge has investments in two limited partnerships, both of which constitute passive activities. This year, Jorge's distributive share of income or loss from each partnership is as follows:

Partnership 1	($22,000)
Partnership 2	$25,000

In addition to the current year income or loss, Jorge has a passive loss carryforward from prior years of ($10,000). How much of the passive loss carryforward can Jorge deduct on his current year tax return?

a. $10,000.
b. $3,000.
c. $0.
d. $7,000.

Installment sales

Disposition of a taxpayer's interest in a passive activity in an installment sale transaction is treated as a disposition of the taxpayer's interest in the activity. However, in such cases, the passive loss carryovers will also be subject to the installment method. That is, a ratable portion of such carryforwards will be allowed in each year equivalent to the portion of the taxpayer's gain from sale of the activity that is taken into income in that year.

Example 5-24

This year, Elizabeth sold her entire interest in a real estate limited partnership for a total gain of $50,000. She will receive payments from the buyer over five years—under the installment method, she will recognize 20% of her gain each year. Her passive loss carryforwards associated with the limited partnership interest will be deductible as a result of the sale; however, following her treatment of the gain recognized on the sale, she will be allowed to deduct only 20% of her passive loss carryforwards in the year of the sale, with an additional 20% being allowed in each of the remaining years in the installment agreement.

Gifts

Passive loss carryforwards are not triggered when a taxpayer gives away his or her interest in a passive activity. Instead, the basis of the transferred interest is increased by the amount of the carryforward losses.

Example 5-25

Edmundo owns an interest in a limited partnership. His tax basis in the partnership interest is $8,000. He has a $10,000 passive loss carryforward with respect to the interest. The market value of the partnership interest is $30,000. For estate planning purposes, he gave his interest in the partnership to his daughter, Maria.

Maria will take a carryover basis in the interest under Section 1015. Ordinarily, this would be $8,000. However, the passive loss carryover represents losses previously allocated to Edmundo that were never actually deducted by him. Previous reductions in his basis in the interest attributable to these losses were therefore artificial, and they are added back to his basis in the partnership interest for purposes of determining the basis of that interest in Maria's hands. She will take a "carryover" basis in the partnership interest of $18,000.

Dispositions by death

Death does trigger the deduction of any unused carryforward losses or credits under Section 469. However, the carryforwards are first reduced by the amount of the step-up in basis of the passive activity interest in the hands of the beneficiaries of the estate.

Example 5-26

Juanita died earlier this year, leaving her limited partnership interest in a real estate investment partnership to her son, Manuel. Juanita's tax basis in the limited partnership interest prior to her death was $22,000. It was valued at $50,000 in her estate. Therefore, Manuel will take a $50,000 basis in the interest under Section 1014. If Juanita had passive loss carryforwards of $30,000 from the activity, only $2,000 of those carryforwards will be deductible as a result of her death. This $2,000 will be deducted on her final income tax return. The remainder of the loss carryforward is not assumed by Manuel; instead, these carryforwards will simply expire.

Grouping activities

Taxpayers can aggregate one or more trade or business activities, or rental activities, as a single activity if those activities constitute an appropriate economic unit for measuring gain or loss under the passive activity rules.

Grouping of activities can yield benefits for taxpayers, but may also have unforeseen costs. For example, by grouping two activities into one larger activity, a taxpayer need only show material participation in the activity as a whole; whereas if the two activities are separate, he or she must demonstrate material participation in each one. Similarly, grouping an activity in which a taxpayer owns less than 10% with one in which he or she owns more than 10% may allow the taxpayer to claim 10% ownership in the combined activity. The disposition of the taxpayer's complete interest in one activity but not the other, however, will prevent the taxpayer from claiming a deduction for the carryforward losses associated with that activity (because his or her entire interest in the two activities as a group has not been eliminated).

Appropriate economic units

There are no firm rules to determine whether activities form an appropriate economic unit. The regulations provide that any reasonable method can be used to apply the relevant facts and circumstances in grouping activities. The regulations further provide a list of factors which should be accorded the greatest weight in determining whether two or more activities form an appropriate economic unit.[37] All of the following factors do not have to be present to group two or more activities, but all should be considered:

- Similarities and differences in types of trades or businesses
- The extent of common control
- The extent of common ownership
- Geographical location
- The interdependencies between or among activities (for example, the extent to which the activities buy or sell goods between or among themselves, involve products or services that are generally provided together, have the same customers or employees, or commingle their accounting systems)

Example 5-27

Deer Ridge, LLC, is a limited liability company that has elected to be treated as a partnership for federal income tax purposes. The company operates a bookstore and coffee shop in a shopping mall in Texas and a bookstore and coffee shop in California. Considering the factors listed previously, Deer Ridge may group all of these into a single activity (both the bookstore and coffee shop have the same customers, and likely use the same accounting system). Alternatively, the company may group the activities into a bookstore activity and a coffee shop activity, a Texas activity and a California activity, or four separate activities.

[37] Reg. Sec. 1.469-4(c)(2).

Note. If a partnership or LLC groups two or more activities together into a single activity, the partners or LLC members are bound by this decision. They may not treat the activities as separate activities on their own returns.

Limitations on grouping certain activities

Rental versus trade or business activities

The regulations generally prohibit grouping rental activities (inherently passive) with trade or business activities (inherently nonpassive for most taxpayers). An exception applies if the two activities constitute an appropriate economic unit and either the rental activity or the trade or business activity is insubstantial in relation to the other. Alternatively, if both activities form an appropriate economic unit and have common ownership, a portion of the rental activity which involves the rental of property to the trade or business activity may be grouped with the trade or business activity.[38]

Example 5-28

Stacy and Alan Jackman are married and file a joint return. Stacy is the sole owner of Grocery Mart, LLC, which has opted to be taxed as a sole proprietorship. Alan is the sole owner of Cross Town Development, LLC, also treated as a sole proprietorship for federal income tax purposes. Grocery Mart owns and operates a grocery store. Cross Town Development owns the building leased by Grocery Mart to house its grocery business. The two activities are not insubstantial to one another. Because Stacy and Alan file a joint return and are treated as a single taxpayer, the two activities have common ownership. Therefore, the two activities can be grouped together as a single activity. Note, however, that if Cross Town Development owns other rental real estate, it must treat its other rental real estate activities as a separate activity from the grocery activity.

Knowledge check

6. Western High Country, LLC, is a limited liability company that has elected to be treated as a partnership for federal income tax purposes. The company operates a copy center in Pennsylvania and a copy center in California. Which statement is incorrect?

   a. Because of their geographic separation, the two businesses can be treated as two separate activities.
   b. Because of the similarity of the businesses, the copy centers can be treated as one activity.
   c. Because of their geographic separation the businesses must be treated as separate activities.
   d. The partnership can choose how to group the activities, within certain parameters.

[38] Reg. Sec. 1.469-4(d)(1).

Real versus personal property rentals

Rental real estate activities generally may not be grouped with activities involving the rental of personal property. The only exception applies when the personal property is provided to customers in connection with the rental of real property or when the real property is provided to customers in connection with the rental of personal property. For example, a partnership or LLC engaged in the rental of furnished apartments can treat the rental of furniture and the rental of apartments as a single activity.

Limited partners

Limited partners are not allowed to group activities from an activity in any of the following trades or businesses with any activity in a different type of business:

- Holding, producing, or distributing motion picture films or video tapes
- Farming
- Leasing Section 1245 property
- Exploring for, or exploiting, oil and gas or geothermal resources

It is acceptable to group more than one limited partnership activity from the same type of trade or business. For example, a limited partner with interests in two separate oil and gas limited partnerships may treat the two limited partnership interests as a single activity, but may not include in that activity an investment in a real estate limited partnership.[39]

Publicly traded partnerships

The passive loss rules of Section 469 are applied separately to each interest in a publicly traded partnership (PTP) owned by a partner or LLC member. Therefore, an activity conducted through a PTP may not be grouped with any other activity in which the partner or LLC member participates outside the PTP.

Consistency is required

Although the IRS has the authority to regroup activities, taxpayers are generally bound by their own grouping decisions. Once a decision has been made to group activities into appropriate economic units, those activities may not be regrouped in a later tax year.

One exception applies when the original grouping was clearly inappropriate or where there is a material change in the facts and circumstances that makes the original grouping clearly inappropriate. In such cases, the taxpayer is required to regroup the activities and to disclose the regrouping and the reason for that regrouping to the IRS.

[39] These rules also apply to “limited entrepreneurs,” defined as any taxpayer other than a limited partner who does not actively participate in the management of the enterprise. Thus, LLC members, whether or not classified as limited partners, will have to demonstrate that they actively participate in management in order to group certain activities into a single group.

Chapter 6

Overview of Profit and Loss Allocations: General Rules and Restrictions

Learning objectives

- Determine whether special allocations called for in a partnership agreement will be allowable under the Sec tion 704(b) regulations, and when they will not be recognized by the IRS.
- Distinguish the difference between "book" allocations required under Section 704(b) and "tax" allocations required under Section 704(c).
- Identify the potential economic consequences to a partner or LLC member of a special allocation.
- Recognize the relationship between partnership and LLC allocations of profit and loss and the allocation of the risks and rewards of entity operations.
- Identify the types of special allocations that are allowed in a family partnership context and those that are not.

Introduction

Most partnership and LLC allocations are governed by Section 704. Section 704 affords investors a wide degree of latitude in dividing partnership and LLC profits and losses among the partners or members. Section 704(a) allows the partners or members to divide items of entity income or loss in any manner they choose,[1] subject only to the constraints of Sections 704(b), 704(c) and 704(e).[2] Section 704(b) imposes the requirement that partnership allocations have "substantial economic effect," and do not merely affect partner tax consequences. Section 704(c) requires that gains or losses inherent in partnership property at the time they were contributed to the partnership be allocated to the partner(s) who contributed the property to the partnership. In effect, this provision prohibits taxpayers from using a partnership or LLC to share the tax benefits or burdens associated with economic gains or losses incurred before formation of the partnership.[3] Section 704(e) restricts the ability of family partnerships to shift tax gains or losses among family members.

This chapter begins with a brief overview of the requirements of Section 704(b), followed by a short discussion of the limitations imposed on tax allocations by Section 704(c). Finally, the chapter closes with a review of the basic restrictions on allocations in family partnerships.

The basic premise of Section 704(b) is very straightforward. The tax consequences of partnership or LLC allocations must follow the economic consequences of those allocations. A partner or LLC member who receives the economic benefit of a partnership or LLC gain must be allocated the associated tax burden. Conversely, an investor cannot be allocated the tax benefits of an entity loss unless he or she bears the economic burden of that loss. If an allocation has no significant economic consequence, it will be disregarded for tax purposes.

Section 704(c) is likewise based on a relatively simple premise: profits or losses economically accrued prior to formation of the partnership, or prior to the contribution of appreciated or depreciated property to the partnership by one or more partners, must remain with the partner(s) who owned the property at the time the gains or losses were economically accrued. Partners or LLC members may share in the post-contribution appreciation or depreciation of partnership property (if any), but may not share in "built-in" gains or losses inherent in property at the date of contribution.

Finally, Section 704(e) provides that family partnerships may not be used as vehicles for splitting earned income among family members. The primary requirement of this statute is that family members be fairly compensated for services provided to the partnership. A family partnership may be used to divide income from property among family members, but not income from personal services.

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[1] Special allocations should be clearly spelled out in the partnership or LLC agreement.

[2] Section 704(d) limits the deductibility of pass-through losses from a partnership or LLC to the partner or member's tax basis in the partnership or LLC interest. It has nothing to do with the allocation of losses among partners, only their usability.

[3] This prohibition is further strengthened by Section 761, which prohibits a partnership or LLC from allocating profits or losses to partners who were not members of the partnership or LLC at the time such profits were earned (or the time such losses were incurred).

Section 704(b): Allocations must have "substantial economic effect"

General requirements: "Economic effect"

For an allocation to have economic effect, it must affect the amount the partner or LLC member will ultimately receive upon liquidation of the entity. Therefore, if an LLC member is allocated all of the LLC's depreciation expense, he or she must be entitled to a lesser share of the proceeds from an eventual liquidation of the LLC. That is, he or she must bear the economic burden of any depreciation in the value of LLC property.

This means that the entity must accurately reflect income or loss allocations in the investors' capital accounts and must tie the investors' rights at liquidation to the balances in those capital accounts. Accordingly, the regulations set forth the following three requirements that must be met in order for an allocation to have economic effect:[4]

- The partnership or LLC agreement must provide for the proper determination and maintenance of partner or member capital accounts throughout the life of the entity.
- The agreement must provide that upon liquidation of either the entity, or of an individual investor's interest, liquidating distributions must be made in accordance with the positive capital balances of the investors.
- The agreement must require investors with negative balances in their capital accounts at liquidation to restore the deficits in those accounts.

The third requirement assures that sufficient funds will be available to the partnership or LLC to repay its creditors and to liquidate the interests of those partner or members with remaining positive capital balances.

Maintenance of capital accounts

Because tax basis capital accounts seldom reflect fair market values, the regulations require the creation and maintenance of a separate set of investor capital accounts. These capital accounts are similar to the partnership's generally accepted accounting principles capital accounts with a few minor differences. They are intended to reflect as accurately as possible the economic interest that each partner or member has in the partnership.

The regulations therefore impose a set of accounting requirements to be followed in maintaining partner capital accounts. These requirements are generally straightforward: property contributions are reflected in the partnership's Section 704(b) books at fair market value (net of liabilities) and partner allocations of book income, gain, loss, and deduction are added to or subtracted from individual partner capital

[4] Regulation Section 1.704-1(b)(2)(ii)(b).

accounts as allocations are made. The only notable departure from generally accepted accounting principles is that distributions of property must also be recorded at fair market value, rather than remaining book value. As with contributions, distributions must also be recorded net of liabilities. As a result, the distribution of property by a partnership or LLC generally requires that either a gain or loss be recorded for Section 704(b) purposes.

Example 6-1

A and B form the AB Partnership with equal cash contributions of $50,000. The partnership then borrows $200,000 and purchases two parcels of real estate at a total cost of $250,000. Immediately after the acquisition, the partnership's Section 704(b) balance sheet appears as follows:

Assets:	
Cash	$50,000
Parcel 1	40,000
Parcel 2	210,000
	$300,000
Liabilities:	$200,000
Capital A	50,000
Capital B	50,000
	$300,000

Over the next two years, the partnership reports total taxable income of $100,000, which it allocates equally between the two partners. At the end of year 2, Parcel 1 is distributed to A in a non-liquidating distribution. Assume that Parcel 1 is worth $120,000 at the date of distribution and that its tax basis to the partnership is still $40,000.

A's Section 704(b) capital account must be reduced by $120,000, the fair market value of Parcel 1. In order for the partnership's Section 704(b) books to remain in balance, the $80,000 appreciation in the value of Parcel 1 at the date of distribution must first be recorded as a gain and the partners' capital accounts increased accordingly. Therefore, assuming the partners share partnership profits and losses equally, their capital accounts will be adjusted as follows:

Example 6-1 (continued)

	Capital, A	Capital, B
Beginning balance	$50,000	$50,000
Income, Years 1 & 2	50,000	50,000
Gain on distribution of P1	40,000	40,000
Distribution of P1	(120,000)	0
Post-distribution balances	$20,000	$140,000

Although not required by the regulations, the partnership would be advised to revise the partners' profit and loss-sharing ratios to reflect their new interests in partnership capital.

Knowledge check

1. L and M form the LM Partnership with equal cash contributions of $300,000. The partnership then borrows $1,400,000 and purchases several tracts of land at a total cost of $1,900,000. Immediately after the acquisition, the partnership's Section 704(b) balance sheet appears as follows:

Assets:	
Cash	$100,000
Tract 1	200,000
Tract 2	1,320,000
Tract 3	380,000
	$2,000,000

Liabilities:	$1,400,000
Capital L	300,000
Capital M	300,000
	$2,000,000

Tract 1 is subsequently distributed to L in a nonliquidating distribution. If Tract 1 is valued at $320,000 at the date of distribution, what will L's Section 704(b) capital account be after the distribution, assuming no other assets are revalued?

a. $100,000.
b. $40,000.
c. $20,000.
d. $0.

Optional revaluation of partnership assets

The regulations allow a partnership or LLC to revalue all its property to fair market value (FMV) rather than just the property being distributed.[5] Revaluations are also allowed when property is contributed to the partnership, as well as when a service partner is admitted to the partnership.[6] Such revaluations are generally a good idea as they allow the capital accounts to be adjusted to reflect the partners' new interests in partnership capital. In the case of a distribution, a revaluation may be especially appropriate as it may prevent the distributee partner's capital account from falling less than zero (triggering the deficit restoration provision if the distribution liquidates such partner's interest in the partnership).

Example 6-2

The ABC Partnership has the following balance sheet at year-end:

	Section 704(b) Book Value	FMV
Cash	$50,000	$50,000
Parcel 1	40,000	120,000
Parcel 2	210,000	270,000
	$300,000	$440,000
Liabilities	$200,000	$200,000
Capital A	50,000	120,000
Capital B	25,000	60,000
Capital C	25,000	60,000
	$300,000	$440,000

The partnership distributes Parcel 1 to A in complete liquidation of her interest. Under Section 704(b), this parcel must be deducted from A's capital account at its FMV of $120,000. Therefore, the partnership must increase the partners' capital accounts by $80,000 just prior to the distribution. This will presumably increase A's capital account to $90,000 ($50,000 + .5($80,000)). The distribution will still leave A with a deficit of $30,000 ($90,000 - $120,000). To avoid this problem the partnership will have to revalue Parcel 2 as well; otherwise, the liquidating distribution to A will not be tied to the balance in her capital account.

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[5] Under Proposed Reg. Sec. 1.7514-1(b)(2)(iv), issued in November 2014, these revaluation provisions would be mandatory if a partnership distributes money or other property to a partner as consideration for an interest in the partnership, and the partnership owns Section 751 property immediately after the distribution.

[6] Reg. Sec. 1.704-1(b)(2)(iv)(f)(5)(i) and (iii).

Liquidating distributions

The economic effect of an allocation under the regulations is tied directly to the effect of that allocation on a partner or member's rights in the event of a liquidation of either the entity or the investor's interest therein. Therefore, even if capital accounts have been established and properly maintained over the life of the partnership or LLC, allocations will not be considered to have economic effect unless the partner or members' rights in liquidation are tied to the balances in those capital accounts. Section 704(b) requires that liquidating distributions be made in accordance with the positive Section 704(b) capital account balances of the investors. Only in this way do special allocations affect the rights of the investors in liquidation.

Restoration of deficit capital balances

A corollary to the requirement that liquidating distributions be made in accordance with positive balances in the partner or members' capital accounts is that partners or members with deficit balances in their capital accounts must be obligated to restore those balances upon liquidation. The partnership or LLC agreement must require such restoration by the later of 90 days after the date of liquidation or the end of the partnership or LLC year in which the liquidation occurs.[7] Absent such a requirement, allocations to a partner or member of losses or deductions in excess of his or her capital contribution(s) would not affect his or her rights in a liquidation of the entity and therefore could not have economic effect. In addition, absent this requirement there might not be sufficient assets in the partnership to redeem the positive capital account balances of the other partners.

Deemed economic effect

The regulations generally require that each of the preceding criteria be clearly spelled out in the partnership or LLC agreement. Where the agreement is silent with regard to these issues, but the allocations are made in such a way that a liquidation of the partnership or LLC at the end of each taxable year would have the same consequences as if these requirements had been met, the allocations will be deemed to have economic effect.[8]

Alternate test for economic effect

The regulations recognize that even if a partner or LLC member is not obligated to restore deficits in his or her capital account, the allocation of profits or losses to such a partner or member will still have economic effect to the extent that they do not create or enlarge a deficit in his or her capital account—as long as the first two requirements of Section 704(b) are met. That is, as long as liquidation proceeds must be distributed in accordance with positive balances in the partners' or members' capital accounts, and as long as those capital accounts are properly maintained, allocations that do not reduce a partner's or member's capital account less than zero will affect his or her rights at liquidation. Accordingly, the regulations provide an alternate test for economic effect under which the requirement that partners restore deficits in their capital accounts is replaced with a requirement that deficits not be allowed to

[7] Reg. Sec. 1.704-1(b)(2)(ii)(c).
[8] Reg. Sec. 1.704-1(b)(2)(ii)(i).

arise in partners' capital accounts. In the event that a partner does have a deficit in his or her capital account, it must be immediately eliminated via a special allocation of partnership income. This latter requirement is labeled a "qualified income offset" in the regulations.

Partial economic effect

It is important to note here that the regulations under Section 704(b) specifically provide that allocations may have partial economic effect.[9] Allocations will be disregarded only to the extent that they reduce an investor's capital account less than the amount he or she is required to restore upon liquidation. To the extent the allocation does not reduce the investor's capital account less than this level, it will be considered to have economic effect. Where an allocation is only partially reallocated, however, both the portion that is reallocated and the portion that is considered to have economic effect shall consist of a proportionate share of all items making up the allocation.

Example 6-3

A and B form a limited liability company to purchase video arcade equipment. The investors each contribute $1,500 cash to the LLC, which then borrows $12,000 and purchases the equipment for $15,000. A is to be allocated all of the depreciation expense. All other items of partnership income or loss are to be allocated equally. A is not required to restore any deficit in his capital account.

Assume that in the LLC's first year of operations, it reports income before depreciation of $2,000. It reports depreciation expense of $3,000. Absent Section 704(b), the investors' capital accounts at the end of the first year would be as follows:

	A	B
Beginning balances	$1,500	$1,500
Income before depreciation	1,000	1,000
Depreciation expense	(3,000)	0
Ending balances	$(500)	$2,500

[9] Reg. Sec. 1.704-1(b)(2)(ii)(d).

Example 6-3 (continued)

Because A is not obligated to restore the deficit in his capital account, the preceding allocations will not be considered to have economic effect under the general provisions of Section 704(b). If the partnership agreement meets the requirements of the alternate test, however, the allocations to A will be considered to have economic effect to the extent they do not reduce the balance in his capital account less than zero (because he is not obligated to restore a deficit balance in his capital account). Therefore, under the alternate test only ($500) of the net allocation must be reallocated. Because A's total allocation was ($2,000), one fourth of each item allocated to A must be reallocated to B. Accordingly, B will be allocated approximately $250 of the income before depreciation that was originally allocated to A, and $750 of the depreciation originally allocated to A. This will leave A with a zero balance in his capital account. B's capital balance will be $2,000.

Knowledge check

2. L and M are the only partners in LM Partnership. They decided to liquidate the partnership at a time when the balances in the two partners' capital accounts were ($10,000) and $50,000, respectively. The partnership sold its assets for their aggregate book value of $40,000. The partnership agreement satisfies the requirements of Section 704(b). How much will partner M be entitled to receive in liquidation of his interest?

   a. $20,000.
   b. $40,000.
   c. $50,000.
   d. $0.

3. In the preceding question, how will liquidation of the partnership affect partner L?

   a. She will have to pay $10,000 to the partnership.
   b. She will receive her half of the liquidation proceeds, $20,000.
   c. She will receive all $40,000 of the liquidation proceeds.
   d. She will receive nothing from the partnership and have to pay nothing to the partnership.

Substantiality

Once an allocation has been determined to have economic effect, it must be determined whether that economic effect is "substantial." The substantiality criterion requires that the allocation "substantially" affect the dollar amounts to be received by the investors upon liquidation, independent of tax consequences. For example, an allocation is a "shifting" allocation and will not be substantial if it reduces the partners' aggregate tax liability without materially affecting the pre-tax economic consequences to the partners (the balances in their capital accounts). Under the "shifting tax consequences" test,[10] a

[10] Reg. Sec. 1.704-1(b)(2)(iii)(b).

special allocation of capital gain to one partner, economically offset by a special allocation of ordinary income to another partner, will potentially lack substantiality.

Example 6-4

A and B are equal partners in the AB Partnership. Each is in the 30 percent tax bracket. At the beginning of Y5, the balance in each of their capital accounts was $9,000. For Y5, the partnership reported taxable income consisting of $6,000 of ordinary income from the rental of residential real property and $6,000 of capital gains. The partnership has been in existence since Y1.

The partners agree to allocate all of the rental net income to A and all of the capital gain to B. Assume the allocations have economic effect. If both partners have the same tax attributes outside the partnership (for example, assume that neither has passive losses from any other source, neither has net capital loss carryforwards, and both are in the same tax bracket), then the preceding allocations may be considered to have substantial economic effect. However, if A has passive losses from other sources, so that the allocation of the partnership passive income will not increase his tax liability (and the capital gain would), or if B has capital loss carryforwards so that the capital gain allocation does not increase his tax liability (though it would increase A's tax liability), then the allocations would reduce the combined tax liability of the partners. Because the balances in the partners' capital accounts do not differ from those that would result from an equal allocation of each item of partnership income, yet the combined tax liability of the partners declines, the allocations do not have substantial economic effect (although they may have economic effect). In other words, the special allocations reduce the partners' aggregate tax liability, but do not affect the pre-tax economic consequences to the partners. Each would receive the same amount at liquidation, $15,000, as if the special allocations did not occur. The only effect of the allocations was to reduce the partners' aggregate tax liability. Therefore, they will not be recognized under Section 704(b).

Similarly, under the "transitory allocations" test, the special allocation of a particular item of income or loss to one partner, economically offset by a similar allocation to a different partner in a subsequent year, within five years, will lack substantiality.[11]

[11] Reg. Sec. 1.704-1(b)(2)(iii)(c). Note, however, that, under the regulations, the book value and fair market value of partnership property are presumed to be equal. Therefore, a "balancing" allocation of future gain or loss on disposition of partnership property will not violate the transitory allocations test—the future gain or loss will be presumed to be zero. This allows depreciation allocated disproportionately to one partner to be offset by an allocation to that partner of any future gain on the sale of the asset that is being depreciated.

Example 6-5

A and B are equal partners in the AB partnership. Each is in the 30 percent tax bracket. At the beginning of Y5, the balance in each of their capital accounts was $9,000. For the current year, the partnership reported taxable income consisting of $26,000 of ordinary income from the rental of residential real property and $6,000 of capital gains. Partner A is retiring from her regular job next year, and expects her income (and therefore her tax rate) to drop substantially. Accordingly, she and B agree to amend the partnership agreement so that all $26,000 of the partnership's ordinary income is allocated to B this year. Next year, the first $26,000 of ordinary income will be allocated to A. The net balances in the partners' capital accounts will not be substantially affected by these two allocations; however, A's tax liability will be reduced. Unless B's tax liability is substantially increased over the two-year period as a result of these special allocations, they will fail the "transitory allocations" test and will therefore not be recognized.

Under a final "catch-all" test, the overall tax effects test,[12] the economic effect of an allocation will be deemed to lack substantiality if it enhances the present value of the after-tax economic consequences of any partner, without substantially diminishing the after-tax economic consequences of any other partner, again in present value terms.

Essentially, these provisions provide that allocations that leave some partners or members better off after taxes, while leaving no partner or members worse off after taxes, will generally not be recognized. As with all the substantiality tests, in applying these rules the interaction between entity allocations and the investors' individual tax attributes outside the entity will be taken into account.

[12] Reg. Sec. 1.704-1(b)(2)(iii)(a).

Knowledge check

4. Q and L are equal partners in the QL Partnership. Each is in the 28 percent tax bracket. At the beginning of the year, the balance in each of their capital accounts was $50,000. For the current year, the partnership reported taxable income consisting of $25,000 of ordinary income from the rental of residential real property and $30,000 of long-term capital gains. The partners amended the partnership agreement so that the ordinary income would be allocated entirely to Q and the capital gains entirely to L. Neither has passive or capital loss carryforwards, but L is Q's daughter, and Q is interested in shifting the benefit associated with the lower tax rates applicable to capital gains to her to maximize the family's long-term financial position. Will the special allocations described previously be recognized under Section 704(b)? Assume the partnership agreement properly provides for the correct maintenance of capital accounts, that liquidating distributions will be based on the balances in partner capital accounts, and that it requires restoration of deficit balances in those capital accounts.

    a. No, because the allocations lack substantiality. The partners are intentionally shifting a greater portion of the tax burden associated with partnership operations to Q, without substantially altering Q's or L's relative economic consequences.
    b. Yes, because the allocations do not reduce the aggregate tax liabilities of the partners, and one partner is economically hurt by the allocations, so they do not violate the substantiality tests of the Section 704(b) regulations.
    c. No, because these are transitory allocations, so there is a possibility they will be reversed in future years.
    d. Yes, because any allocation between related parties is deemed to be substantial.

Nonrecourse deductions

Overview

Nonrecourse debt creates special problems under Section 704(b). For a partnership or LLC loss allocation to have economic effect, those partners or members sharing in the allocation must bear the economic burden of that loss. Generally, this requires that the allocation of loss either reduce the amount to which the recipient investors are entitled at liquidation or increase the amount they are obligated to contribute in the event of a partnership or LLC liquidation. If the loss being allocated is supported by nonrecourse debt (for example, depreciation), neither of these conditions will be satisfied.

For example, if tax depreciation on a building purchased with nonrecourse debt is matched by actual economic depreciation (as is presumed under Section 704(b)), depreciation in excess of the partners' or members' original contributions (plus any undistributed partnership or LLC income) will not be borne by the partners or LLC members. Because the partners are not personally liable on a nonrecourse note, only the creditor(s) can bear the economic burden of the depreciation. Therefore, the depreciation allocations would not have economic effect under the general provisions of Section 704(b).

However, because the outstanding balance of a nonrecourse note is treated as part of the amount realized upon the disposition of the encumbered property (even in foreclosure), nonrecourse deductions will affect the tax consequences to the investors if the partnership or LLC disposes of all its assets and liquidates. Because nonrecourse deductions (for example, those deductions related to assets financed with nonrecourse debt) will reduce the entity's basis in the encumbered property, they increase the tax gain to be recognized upon disposition of such property. Therefore, nonrecourse deductions will increase the eventual tax liability of the partners or members upon liquidation of the entity, and, as a result may be considered to have economic effect if certain requirements are met.

The regulations under Section 704(b) establish the following four conditions which must be satisfied for an allocation of nonrecourse deductions to have economic effect:[13]

- The first two requirements of the general test for economic effect (capital account maintenance and distribution of liquidation proceeds) must be satisfied.
- The allocation of nonrecourse deductions must be "reasonably consistent" with allocations of some other significant partnership or LLC item(s) attributable to the encumbered property and those other allocations must have substantial economic effect.
- The partnership or LLC agreement must either require that partners or members are obligated to restore deficit balances in their capital accounts, without limitation, or contain a minimum gain chargeback.
- All other material entity allocations and capital account adjustments must be recognized under the regulations.

Minimum gain chargeback

Partnership or LLC minimum gain is that minimum amount of gain that will result from the disposition of the property securing the nonrecourse debt. Because the forgiveness (by the lender) or assumption (by the buyer) of nonrecourse liabilities is considered an amount realized from the sale of the encumbered property, in no case can the partnership or LLC recognize less gain than the difference between the property's basis and the remaining principal balance of the nonrecourse note upon disposition or abandonment of the property. Therefore, minimum gain is computed as the difference between the basis (or book value, if different) of the securing property and the remaining balance of the nonrecourse note.

Each investor's share of partnership or LLC minimum gain is the sum of the nonrecourse deductions previously allocated to such investor (or his or her predecessor in interest), reduced by his or her share of previous decreases in minimum gain.[14] Such minimum gain increases (more than the investor's deficit restoration obligation) the maximum deficit that can be allowed to accumulate in such investor's capital account. Therefore, minimum gain increases the amount of losses that can be allocated to a partner or LLC member without creating an improper deficit.

The minimum gain chargeback provision then plays the same role as the qualified income offset provision in the alternate test for economic effect. The minimum gain chargeback provisions are triggered not only when the property encumbered by the nonrecourse debt is sold, but also in certain circumstances in which there is a decrease in partnership or LLC minimum gain due to some other event (for example, as when the entity repays a portion of the loan). Where a partner or member's capital

[13] Reg. Sec. 1.704-2(e).
[14] Reg. Sec. 1.704-2(g).

account "unexpectedly" falls less than the permissible deficit, as a result of a decrease in entity minimum gain,[15] the minimum gain chargeback provision requires that such partner or member must be allocated sufficient income (including gross income) to eliminate the excess deficit in his or her capital account.

Example 6-6

J and D are partners in JD Development, a real estate partnership. The partners each contributed $50,000 cash to the partnership, which purchased an apartment complex for $1,000,000. The acquisition was financed with a $900,000 nonrecourse mortgage obtained from an unrelated lender. The partnership agreement allocates depreciation expense 75% to J and 25% to D. All other items of partnership income, gain, loss, and deduction are shared equally by the two partners.

Over its first five years of operations, the partnership reported income before depreciation of $100,000 and depreciation expense of $175,000. It made no principal payments on the debt. At the end of five years, the two partners' capital accounts will have the following balances:

	J	D
Initial contributions	$50,000	$50,000
Income before depreciation (50:50)	50,000	50,000
Depreciation expense (75:25)	(131,250)	(43,750)
Balances, end of year five	($31,250)	$56,250

Assume the partnership defaults on the nonrecourse note at the beginning of year six, surrendering the apartment complex to the lender in foreclosure. Regardless of the value of the complex, the transaction will be treated as a sale of the apartment complex to the nonrecourse lender for the remaining unpaid principal balance of the note ($900,000).

The tax basis of the property is $825,000 ($1,000,000 purchase price less $175,000 depreciation expense). Therefore, the partnership will recognize a taxable gain of $75,000. This is the minimum gain amount. In no case will the partnership recognize less gain than this. Note that it is large enough to fully offset the deficit balance in J's capital account.

If allocated equally, as indicated in the generic description of the allocations clause in the partnership agreement, the partners' capital balances will be increased by $37,500 each—to a positive $6,250 for J and a positive $93,750 for D. The partnership should have other assets of $100,000 (from the partnership's income before depreciation).

These assets will be distributed in accordance with the positive balances in the partners' capital accounts. Therefore, most of the remaining assets will be distributed to D. This unequal distribution reflects the differences in the depreciation allocations between the two partners. These allocations clearly had a significant economic effect.

[15] Decreases in minimum gain generally result from principal payments on the nonrecourse note.

Allocations with respect to contributed property: Section 704(c)(1)(A)

Overview

Section 704(b), requiring allocations to have substantial economic effect, has as its primary purpose the prevention of tax avoidance by the use of economically meaningless allocations of partnership or LLC income or loss. Partners and LLC members can reduce their tax liabilities by use of special partnership allocations, but only if those allocations are associated with real economic costs. Section 704(c), on the other hand, requires special allocations that are not accompanied by nontax economic costs, in order to prevent the use of partnerships and LLCs as tax avoidance vehicles.

Section 704(c) applies whenever an investor contributes property to a partnership or LLC with a fair market value that differs from its tax basis. In such a case, tax gains and losses, and depreciation and depletion with respect to the contributed property differ from the amounts recorded under Section 704(b). To the extent of these differences, the tax consequences of a partnership or LLC allocation do not reflect the economic cost or benefit associated with that allocation. Accordingly, Section 704(b) cannot, by itself, prevent investors from using partnerships or LLCs to manipulate their tax liabilities.

General rules

Section 704(c) requires that the partnership or LLC allocate built-in gain or loss inherent in contributed property to the contributing partner. This is accomplished by mandatory special allocations of tax gain or loss recognized on the sale or disposition of the contributed property, or by special allocations of tax depreciation or other cost recovery deductions with respect to the contributed property.

Gain or loss on sale of contributed property

When the partnership sells Section 704(c) property, it will generally recognize a different amount of gain or loss in its Section 704(b) books and records than it will report on its income tax return. For example, if a partnership sells property with a tax basis of $150 and a book value of $200, it will recognize $50 more gain for tax than it does for book. Section 704(c) requires that this excess tax gain be allocated to the partner who contributed the property. The allocation of the remainder of the tax gain follows the allocation of the book gain.

Example 6-7

J contributed land to JD, Ltd., an LLC, opting to be taxed as a partnership for federal income tax purposes. The tax basis of the land at the date of contribution was $150 and its fair market value was $200. D contributed $200 cash. The LLC agreement allocates all items of profit and loss equally between the partners. Two years later, the LLC sold the land contributed by J for $250, recognizing a tax gain of $100. Under Section 704(c), the first $50 of this gain (the built-in gain of $50, measured as the difference between the property's $150 tax basis and its $200 Section 704(b) "book" value) must be allocated to J. The remaining gain of $50 is allocated equally between J and D under Section 704(b). Therefore, the two investors will receive the following allocations of gain on sale of the property contributed by J:

	J	D
Section 704(c) gain (for example, "built-in" gain)	$50	$0
Remaining gain (equal to "book" gain)	25	25
Total gain reported to each member on K-1	$75	$25

A problem arises if the property depreciates in value after contribution to the partnership. In such cases, the partnership will have a loss for book purposes and a gain (or a smaller loss) for tax purposes. The amount of gain or loss allocated to the partners in these situations depends on the method of accounting used by the partnership for Section 704(c) gains and losses.

Under the traditional method, the partnership merely allocates whatever tax gain or loss it recognizes to the contributing partner to the extent of the built-in gain inherent in the property contributed by such partner. If the partnership's total gain or loss is less than the built-in gain or loss, the total amount recognized is allocated to the contributing partner and any discrepancy with his or her actual built-in gain or loss is disregarded.

Of course, any excess of the contributor's built-in gain over the total gain recognized by the partnership on the sale of the asset represents economic losses realized by the other partners, because this excess represents a decline in the value of the asset since its contribution. Disregarding these losses for tax purposes allows the contributing partner to shift some of the tax burden associated with the original built-in gain to his or her partners—they do not receive the tax benefits associated with their shares of the post-contribution economic loss.

Example 6-8

J contributed land to JT, Ltd., a limited liability company opting to be taxed as a partnership for federal income tax purposes. The tax basis of the land at the date of contribution was $150 and its fair market value was $200. T contributed $200 cash. The LLC agreement allocates all items of profit and loss equally between the partners. Two years later, the LLC sold the land contributed by J for $180, recognizing a tax gain of $30 and a book loss of ($20). Under the traditional method, J would be allocated all $30 of the partnership's gain. T, however, will not receive a deduction for his share of the partnership's ($20) loss realized over the two years since J contributed the property to the partnership, even though T's capital account will be reduced by T's share of the loss.

The regulations under Section 704(c) identify two approaches to solve this problem. The first involves the use of "curative allocations" of other items of gain or loss to or away from the non-contributing partner in an amount necessary to "cure" the discrepancy.[16] For example, the partnership in example 6-8 might allocate an additional $10 of gain from the sale of some other property away from partner T and to partner J to offset the missing ($10) loss allocation to T (half of the $20 book loss). This approach works, however, only if the partnership has other items of gain or loss (of the same character) that it can use to cure the discrepancy. Absent such alternative items of gain or loss, curative allocations will not solve the problem.

A second alternative is the "remedial allocations" method described in the regulations.[17] Under this method, all non-contributing partners are first allocated tax gain or loss in amounts equivalent to their book allocations; the contributing partner receives an allocation of gain or loss necessary to equalize the aggregate allocated gain or loss with the actual amount recognized for tax purposes. Although it is beyond the scope of this course, it should be noted that if the remedial allocations method is used, book depreciation must be calculated by using the remaining useful life for depreciating the tax basis and the total useful life for depreciating the excess of book basis over tax basis.

[16] Reg. Sec. 1.704-3(c).
[17] Reg. Sec. 1.704-3(d).

Example 6-9

Assume the same facts as example 6-8. J contributed land to JT, Ltd., a limited liability company opting to be taxed as a partnership for federal income tax purposes. The tax basis of the land at the date of contribution was $150, and its fair market value was $200. T contributed $200 cash. The LLC agreement allocates all items of profit and loss equally between the partners. Two years later, the LLC sold the land contributed by J for $180, recognizing a tax gain of $30 and a book loss of ($20). Under the remedial allocations method, T will be allocated a tax loss of ($10), representing his half of the book loss on sale of the property. J, as the contributing partner, will be allocated a tax gain of $40, the $30 gain recognized by the partnership, plus an additional $10 to offset the loss allocated to T. The total allocations to the two partners will equal the $30 gain recognized by the partnership for tax purposes.

Knowledge check

5. M contributes land with a tax basis of $150,000 and a fair market value of $190,000 to the MP Partnership. P contributes $190,000 cash. The partners agree to share all items of partnership gain and loss equally. The property contributed by M is subsequently sold for $165,000. How much gain will P be allocated for tax purposes from the sale? Assume the partnership uses the *traditional method* (without any curative allocations) to make allocations under Section 704(c).

   a. $0.
   b. $7,500.
   c. $15,000.
   d. $40,000.

6. A, B, and C form the ABC Partnership with the following contributions. A contributes depreciable personal property with a basis of $54,000 and a fair market value of $72,000. B and C each contribute $72,000 cash. The partnership agreement provides that all items of partnership gain, loss, income, and deduction will be shared equally by the three partners. The property contributed by A has a remaining depreciable life of three years and is depreciated using the straight-line method. The partnership opts to use the traditional method to make allocations under Section 704(c). How much depreciation expense will be allocated to partner A for tax purposes in the partnership's first year of operations?

   a. $8,000.
   b. $6,000.
   c. $2,000.
   d. $18,000.

Cost recovery deductions

Where a partner contributes depreciable property to a partnership with built-in gains or losses, the built-in gain or loss is recovered by the contributor in the form of special allocations of tax depreciation. The same approaches are applied as with gain or loss.

Example 6-10

A, B, and C form the ABC Partnership with the following contributions. A contributes depreciable personal property with a basis of $33 and a fair market value of $45. The property is subject to a $15 debt. B and C each contribute $30 cash. The partnership agreement provides that all items of partnership gain, loss, income, and deduction will be shared equally by the three partners. The property has a remaining depreciable life of three years and is depreciated using the straight-line method.

Depreciation expense in the partnership's first year of operations will be $15 for book and $11 for tax. It will be allocated among the partners as follows:

	A		B		C	
	Book	Tax	Book	Tax	Book	Tax
Book depreciation	$5		$5		$5	
Tax depreciation		$1		$5		$5

Under Section 704(b), each partner will be allocated $5 of book depreciation. Under Section 704(c), the non-contributing partners (B and C), will be allocated $5 tax depreciation, the same amounts as they are allocated for book purposes. The remaining tax depreciation of $1 will be allocated to A. Therefore, A alone bears the tax burden associated with the $12 built-in gain inherent in the property at the date of contribution. Over the remaining three-year depreciable life of the asset, A will recognize the entire $12 tax gain in the form of reduced deductions for tax depreciation. Therefore, at the end of each year the book basis, tax basis, and built-in gain are as follows:

	(1) Book basis	(2) Tax basis	(1) – (2) Built-in gain
End of year 1:	$30	$22	$8
End of year 2:	15	11	4
End of year 3:	0	0	0

Note that if tax depreciation had been inadequate to allow B and C their full $5 shares, the discrepancy could be made up under the regulations either by allocating depreciation on other properties away from A and toward B and C (curative allocations), or by giving A a negative depreciation allocation (remedial allocations method).

Example 6-11

A contributes depreciable property to the AB limited partnership with a tax basis of $3,000 and a fair market value of $10,000. B contributes $10,000 cash. Assume that book depreciation for the partnership's first year of operations with respect to the property contributed by A is $5,000, and that this depreciation is allocable 50% to each partner. Tax depreciation with respect to this property is $1,500 annually. Finally, assume the partnership breaks even before depreciation expense.

Under the remedial allocations method of Section 704(c), B will be allocated $2,500 of tax depreciation. As this is $1,000 more than the total available depreciation expense, A must be allocated $1,000 of remedial income. The effects on the partners' capital accounts would be as follows:

	A		B	
	Book	Tax	Book	Tax
Initial contribution	$10,000	$3,000	$10,000	$10,000
Depreciation	(2,500)	0	(2,500)	(1,500)
Remedial depreciation				(1,000)
Remedial income		1,000		
Ending balances	$7,500	$4,000	$7,500	$7,500

Note that this leaves B's book and tax capital accounts in balance, indicating that no income has been shifted from A to B (because B has received the same allocations of income for book and tax).

Allocations in family partnerships: Section 704(e)

Different considerations arise when evaluating the consequences of allocations in family partnerships. The requirement that allocations have substantial economic effect under Section 704(b) depends heavily on the premise that partners have competing economic incentives. An allocation that increases the rights at liquidation of one partner reduces those of other partners; therefore, the government can rely on the self-interest of the partners as a safeguard against abuse of special allocations. In the context of a family partnership, this safeguard may not be reliable. The self-interests of the partners may be indistinguishable from the interest of the family unit.

Section 704(e) establishes limitations on the allocation of partnership income and loss among members of a family partnership. The statute distinguishes between partnerships in which capital is a material income-producing factor and service partnerships. Long-standing principles establish that taxpayers may not shift income from the performance of services to other taxpayers, and Section 704(e) follows these principles, allowing the shifting of income only for those partnerships requiring a significant investment of capital.

Section 704(e) begins with the premise that the transfer of an interest in a family partnership (in which capital is a material income-producing factor) to a family member, whether by gift or by sale, is sufficient to transfer the income attributable to that interest as well. As long as the transfer is economically valid (and complete), the tax burdens and benefits associated with the transferred interest will be transferred to that partner as well. In fact, Section 704(e)(3) provides that a family member who buys his or her interest in a family partnership is treated the same as one who receives his or her interest by gift.

The statute does, however, place significant restrictions on special allocations to family partners. First, Section 704(e)(2) requires that for any allocation of income to the donee partner to be valid, reasonable compensation must be recognized by the donor partner for services rendered to the partnership. The second limitation on family partnership allocations is perhaps more significant. Under Section 704(e)(2), the donee partner may not be allocated a greater return on donated capital than the donor partner receives on his or her capital. The practical effect of this provision is that special allocations of income to junior members of the partnership will be quite difficult. Similarly, the special allocation of partnership loss, depreciation, and the like, to senior members of a family partnership will likely violate this provision unless each member of the partnership obtained his or her interest via a contribution of cash or property to the partnership, or by inheritance from such a partner.

Example 6-12

The Smith family formed a real estate management partnership last year. Gina Smith contributed real estate with a fair market value of $1.2 million and a tax basis of $800,000 in exchange for a 60% interest in the partnership. She gave each of her four children a 10% interest in the partnership. Assume the partnership had net income before depreciation of $150,000, and depreciation expense of $100,000. Further assume that the partnership established initial capital accounts of $120,000 for each child (10% of the partnership's net assets). If the partnership agreement allocates net income before depreciation pro rata among the partners (60:10:10:10:10), but depreciation is allocated entirely to Gina, the allocations will violate the requirements of Section 704(e). Gina's net allocation will be negative ($90,000 net income before depreciation less $100,000 depreciation expense), whereas each of her children will be allocated $15,000 in income. Likewise, a disproportionate allocation of income before depreciation to the children will violate the requirements of Section 704(e). Note that a special allocation of depreciation expense to the children would be acceptable, as would a special allocation of net income before depreciation to Gina.

Chapter 7

Reporting Taxable Income for Partnerships and LLCs

Learning objectives

- Identify the federal income tax forms that must be filed with the IRS by an average partnership or limited liability company (LLC), and what forms must be sent to the investors.
- Recognize what information should be disclosed on a Schedule K-1 received from a partnership or LLC.
- Determine where each partnership item of income or deduction should be reported on the partnership income tax return.
- Indicate how the information provided on Schedule K-1 can be used to calculate the adjustment to a partner or LLC member's basis and amount at-risk.

Overview: Partnership tax return

The partnership tax return

Form 1065, *U.S. Return of Partnership Income*, must be filed annually by most entities classified as partnerships. Form 1065 is an information return only, summarizing the income, deductions, gains, losses, and the like from the entity's business and investment activities. The partnership generally does not pay tax on its income; rather that income or loss is "passed through" to the partners or members, who must add or subtract their shares of each item on the return when computing their own taxable incomes. Therefore, the partners pay tax on the partnership's profits or receive any tax benefits associated with partnership items of loss and deduction.

Note. Certain partnerships may elect to be classified as "large partnerships." These electing large partnerships file Form 1065-B, *U.S. Return of Income for Electing Large Partnerships*. The reporting requirements for electing large partnerships are not discussed in this course.

Note. Publicly traded partnerships are treated as corporations and must file Form 1120, rather than Form 1065. See Section 7704 for the definition of "publicly traded partnerships."

A Schedule K-1 for each partner or LLC member is filed with Form 1065. A partner's Schedule K-1 summarizes his or her share of each item of income, gain, loss, deduction, and the like, reported on the Form 1065. Separate K-1s are filed for each partner or member; the amounts reported on each K-1 must add to the aggregate amounts reported on the Form 1065. These schedules are sent to both the IRS (as part of the Form 1065) and to each partner or LLC member.

Form 1065 and accompanying Schedules K-1 must generally be filed by the 15th day of the third month following the close of the partnership or LLC's taxable year (by the 15th day of the fourth month for tax years that begin before Jan. 1, 2016). If this day falls on a Saturday or Sunday, the deadline is extended to the following Monday.

An automatic six-month extension to file the partnership tax return can be obtained by filing Form 7004, *Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns*. For tax years that begin before Jan. 1, 2016, there is an automatic five-month extension of time for filing a partnership return. Form 7004 must be filed by the original due date of the partnership return.

Note that an extension of time to file the partnership tax return does not extend the filing period for any of the entity's partners or members, nor does it extend the time for payment of taxes by any of the partnership's partners. Partners wishing to extend the filing deadlines for their own returns must make separate requests of the IRS.

For partnerships or LLCs that maintain their books and records outside the United States and Puerto Rico, a two-month extension of time to file is automatically granted to the 15th day of the 6th month following the close of the partnership or LLC's taxable year[1]. The partnership or LLC is not required to file a form requesting this two-month extension. It is automatically granted to all eligible partnerships. Form 7004 may be filed by such partnerships requesting the automatic five-month extension of time to file, but it must be noted that this five-month extension period includes the two-month extension granted to those partnerships maintaining their books and records outside the United States and Puerto Rico.

Knowledge check

1. Under Subchapter K, the partnership files Form 1065 reporting its income to the IRS. Which statement is true?

   a. The partners pay income tax on the portion of that taxable income that is distributed to them.
   b. The partnership pays tax only on that portion of income that is not distributed to the partners.
   c. The partners pay tax on their distributive shares of partnership income regardless of distributions.
   d. The partners pay tax only on the excess of distributions over their basis.

Who must file?

Generally speaking, all domestic partnerships, including limited liability companies classified as partnerships must file Form 1065 unless they have no income and do not incur any expenditure that could be treated as a deduction or credit. Foreign partnerships may also be required to file Form 1065 if they have U.S. source income or income effectively connected with the conduct of a trade or business in the United States.

Note that a partnership return must be filed only for unincorporated businesses owned by more than one person. Where two or more people jointly own investment or other nonbusiness property (for example, vacation property), and conduct no joint trade or business activities, no partnership return is required. For co-owners seeking added protection from the requirement that a partnership return be filed, Section 761(a) allows certain joint ventures and other unincorporated organizations to elect out of Subchapter K (that is, to elect not to file a partnership return) if they satisfy any of the following requirements:

- They are formed for investment purposes only and not for the active conduct of a business.
- They are formed for the joint production, extraction or use of property, but not for the purpose of selling services or property produced or extracted.
- They are formed by dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities.

[1] Regulation Section 1.6081-5. This regulation might need to be updated by the IRS to correlate with the new due date of the Form 1065.

The election out of Subchapter K is made by filing a blank Form 1065, attaching a statement describing the organization's qualification to make the election, identifying the co-owners, and affirmatively electing not to be subject to the provisions of Subchapter K. The election must be signed by all the co-owners.

Exception: Spouses jointly operating a business

An exception applies to spouses who jointly own and operate an unincorporated business. Generally speaking, such spouses would be required to file a partnership return. However, spouses can elect to treat a jointly owned and operated business as a qualified joint venture rather than a partnership. To make the election, spouses should split all items of income, gain, loss, and deduction equally (or in accordance with each spouse's interest in the venture if unequal), and file separate Schedule Cs and Schedule SEs in their joint return. No special form or statement need be attached to the return affirmatively stating the election, filing separate Schedules C and SE is sufficient.[2]

Note. If spouses jointly operate a rental real estate business and do not wish to file Form 1065, each spouse's share of the income from such business must be reported in separate columns of Schedule E checking the "QJV" box on line 2 for each property.[3]

Filing requirements

Domestic partnerships must file Form 1065 with the Cincinnati, Ohio, or Ogden, Utah, IRS Service Centers.[4] If the partnership or LLC has more than 100 partners or members, it is generally required to file electronically unless it can demonstrate that electronic filing would create a hardship. To obtain a waiver from electronic filing, the partnership or LLC must file a written request with the Ogden Service Center.

The tax return must be signed by a general partner of the partnership. For limited liability companies, only member-managers are treated as general partners, and one of them must sign the Form 1065. A member-manager is any owner of an interest in the LLC who has, either alone or in conjunction with other members, the continuing and exclusive authority to make management decisions on behalf of the LLC. Where no members of the LLC have been elected or designated by the entity as member-managers, all members have management authority; and therefore, all members are treated as member-managers.

[2] Instructions to Form 1065, p. 2.
[3] 2016 Instructions for Schedule E (Form 1040).
[4] Partnerships or LLCs with total assets of less than $10 million, who do not file Schedule M-3, and whose primary place of business is located in Connecticut, Delaware, the District of Columbia, Florida, Georgia, Illinois, Indiana, Kentucky, Maine, Maryland, Massachusetts, Michigan, New Hampshire, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South Carolina, Tennessee, Vermont, Virginia, West Virginia, or Wisconsin are required to file their returns in Cincinnati, Ohio. All other domestic partnerships or LLCs must file with the Ogden Service Center.

The penalty for failure to file a timely and complete partnership tax return is equal to $200 (now adjusted for inflation[5]) times the total number of partners in the partnership during the taxable year times the number of months that the return is overdue. For this purpose, a partial month is treated as a whole month. The penalty can be imposed for a maximum of 12 months (for a total limitation of $2,400 per partner), and can be avoided if the partnership shows reasonable cause for the failure to file. This penalty, imposed under Section 6698 of the Internal Revenue Code, is imposed on the partnership rather than the partners. In addition, where the failure to file is willful, Section 7203 provides for the imposition of additional penalties of up to $25,000.

Warning. This penalty can be applied even when a return is timely filed if that return is incomplete. That is, where it omits certain information required by the IRS to be included in the return. Practitioners should therefore be very careful to make certain that all questions on the return, including informational questions (on Form 1065 pp. 2 and 3, and Schedule M-3) are accurately answered.

Warning. The IRS asks practitioners not to write "See Attached" in lieu of providing the requested information in the space on the form. It implies that this approach might cause the return to be deemed incomplete, triggering penalties under Section 6698.

Note. The late filing penalty does not apply if the partnership or LLC is not subject to the consolidated audit procedures (see the next section) and all partners or members file their tax returns on time and fully report their shares of partnership or LLC income, deductions and credits.

Finally, under Section 6722, penalties may be imposed on the partnership for failure to furnish copies of Schedule K-1 to all of its partners or for providing its partners with incomplete or incorrect Schedules K-1. This penalty is equal to $270 times the number of missing or incorrect K-1s, and is limited to $3.2825 million per taxable year, unless the failure is deemed intentional. This penalty is now subject to inflation adjustment.[6] Where the partnership's failure to provide each of its partners with a complete and correct Schedule K-1 is deemed intentional, the penalties are increased (to $540 times the number of missing or incorrect K-1s, or, if greater, 10% of the aggregate amount of items to be reported), and the $3.2825 million maximum is disregarded.

Note. A copy of Schedule K-1 is required to be furnished to each partner in the partnership (or member in an LLC) by the due date of the partnership or LLC's tax return.

[5] Section 6698(e).
[6] Section 6722(f).

Knowledge check

2. License to Drill, LLP, is a limited liability partnership in the irrigation business. The partnership was formed several years ago and has five partners and several employees. This year, which form will each partner receive reporting his or her share of partnership activity?

    a. Schedule K-1.
    b. Schedule K.
    c. Schedule M-1.
    d. Form 1040.

Unified audit procedures

Section 6231 authorizes the IRS to conduct a single audit at the partnership level and to determine the correct treatment of items of partnership income, gain, loss or deduction to the partners or members in a single, unified audit proceeding (as opposed to conducting separate proceedings with each partner). The unified audit provisions generally do not apply to small partnerships or LLCs, defined as those with less than 10 members or partners at all times during the taxable year. Small partnerships or LLCs are subject to the unified audit procedures only if (*a*) they elect to be subject to these procedures; or (*b*) one or more of their partners or members was a nonresident alien or was a nonqualified partner or member at any time during the taxable year. For this purpose, a nonqualified partner is any partner other than an individual, an estate of a deceased partner, or a regular corporation.

Accounting methods and other elections

Section 703(b) provides that all elections affecting the computation of the partnership's taxable income shall be made by the partnership, except for the following:

- The election to defer recognition of discharge of indebtedness income under Section 108(b)(5) or (c)(3)
- The election to expense certain mining exploration expenditures under Section 617, as well as the election regarding recapture under that statute
- The election to take the foreign tax credit under Section 901

In addition, Section 613A(c)(7)(D) provides that depletion of oil and gas property is computed at the partner, rather than the partnership, level. Accordingly, the election to use percentage (versus cost) depletion must be made by the partners rather than the partnership.

All other elections affecting the computation of partnership taxable income are made at the partnership level. Therefore, for example, the election to defer recognition of gain on involuntary conversions under Section 1033 must be made at the partnership level, rather than by the individual partners.

Example 7-1

A and B are equal partners in the AB partnership, formed several years ago to purchase and operate a ranch in West Texas. This year, the state forced the partnership to sell its ranchland to the Corps of Engineers so that a new lake could be constructed in the area in which the partnership's land was located. The partnership sold the land to the Corps for a sizable profit. A decided to take her share of the proceeds and retire. B, on the other hand, would like to reinvest the proceeds in new property and continue ranching. In order for B to defer any of her share of the partnership's gain on the forced sale under Section 1033, the partnership must make the election to defer the gain and repurchase like-kind property. If the partnership dissolves, and A and B each take their share of the proceeds and go their own way, neither A nor B will be able to defer recognition of any portion of the gain.

Similarly, the partnership must make elections under Section 446 whether to use the cash or accrual method of accounting, as well as any subsequent election to change accounting methods. It must make any election under Section 754 to adjust its basis in partnership property upon the sale of a partnership interest or in the event of certain distributions of property. And the partnership, rather than the individual partners, must make the election to expense the cost of newly acquired equipment under Section 179, as well the election regarding the appropriate depreciation method (straight-line versus Modified Accelerated Cost Recovery System) for newly acquired assets. Note, however, that for property contributed to the partnership by a partner, the appropriate depreciation method has already been elected, and cannot be changed by the partnership. Under Section 168(i)(7), the partnership must step into the shoes of the contributor partner with respect to the depreciation of contributed property.

Example 7-2

C and D form a new partnership. C contributes cash, and D contributes five-year depreciable property acquired two years ago. On his individual tax return for the year of acquisition, D elected to use the straight-line method to depreciate the property. D originally paid $65,000 for the property. The partners formed the partnership effective as of January 1, this year. The property's value as of the date of formation was $45,000. The partnership's current year tax deduction for depreciation expense on the property contributed by D will be $13,000 ($65,000 ÷ 5), the same amount as would have been deductible by D had the property not been contributed to the partnership.

The tax matters partner

Under the unified audit procedures, the IRS deals with the partnership rather than with the individual partners when challenging the tax treatment of an item on a partnership tax return. Consistent with this practice, all notices sent by the IRS must be sent to a single partner as a representative of the partnership. This partner, known as the tax matters partner (TMP), should be selected by the partnership or LLC and named in the partnership tax return. The name and address of the tax matters partner should be provided at the bottom of the third page of the partnership tax return each year. Note that the tax matters partner should be identified on the partnership return every year even if the partnership chooses to name the same partner each year. The partner or member designated as the tax matters partner must be a general partner (or a manager-member, as discussed previously), and generally must be a U.S. person.

Should the partnership not name a tax matters partner, the IRS will send all notices to that general partner (or manager-member) having the largest interest in partnership profits at the close of the entity's tax year. If two or more partner or members have the same interest in partnership profits, the one whose name comes first alphabetically will be designated the tax matters partner by the IRS. Regardless of how the tax matters partner is selected, he or she will be the only partner notified by the IRS in the event it questions the partnership or LLC's treatment of any item(s) on a particular tax return.

Note. Partners and LLC members should be aware that the statute of limitations during which the IRS can assess a deficiency on an individual partner or member's tax return resulting from the inclusion of income or pass-through of a deduction from the partnership or LLC is based on the filing date of the partnership return, rather than on the filing date of any partner's individual return. Moreover, the tax matters partner can agree to extend the statute with respect to the partnership return without the consent of the other general partners, and that extension will be binding on all partners or members. Therefore, it is important that the partners are comfortable with the choice of who is to be the tax matters partner.

General tax payment and reporting scheme

Payment of tax liability

Section 702 provides that the partners or LLC members, rather than the partnership or LLC, are responsible for payment of income taxes on the entity's income. The purpose of Form 1065 is to report to the IRS the nature and amount of partnership or LLC income, and to report how that income is allocated among the partners or LLC members. Simultaneously with the filing of the return with the IRS, the partnership or LLC also notifies each partner or member of his or her share of the entity's ordinary business income as well as his or her share of other items of the partnership or LLC income, gain, loss, or deduction. Partners or LLC members must include their shares of each item of partnership or LLC income or loss in their own taxable income whether such shares are distributed to them or not. Indeed, because a partner or member's distributive share of income or loss is included in his or her taxable income each year, regardless of whether such share has actually been distributed, most partnership or LLC distributions are not themselves taxable. Only cash distributions received by a partner or member in excess of his or her basis in the partnership or LLC interest, and certain distributions under Sections 704(c)(1)(B), 737, and 751(b), trigger the recognition of income or gain by the recipient partner or member in excess of such partner or member's distributive share of partnership or LLC taxable income. Accordingly, there is seldom an exact correlation between the amount of distributions received during a given year by a partner or LLC member from a partnership or LLC and the amount of income or loss such partner or member must report on his or her individual tax return from partnership or LLC operations.

Example 7-3

J is a member in the JDR limited liability company. JDR has opted to be treated as a partnership for federal income tax purposes. For the LLC's first year of operations (last year), J's distributive share of LLC taxable income was $18,000. She received distributions totaling $1,000 per month. In the current year (JDR's second year of operations), J's monthly draw increased to $1,200 per month. Due to a downturn in the LLC's business, however, her share of the entity's income declined to $10,000 this year. For last year, J must include $18,000 income from her interest in the LLC in her individual taxable income, even though she received distributions totaling only $12,000. For this year, she must report as her share of LLC income only $10,000, though she received distributions totaling $14,400.

Knowledge check

3. JD is a member in the Canyons North limited liability company. The LLC has opted to be treated as a partnership for federal income tax purposes. At the beginning of the taxable year, JD's basis in her LLC interest was $50,000. For the current year, her distributive share of Canyons North's taxable income was $18,000. She received distributions totaling $2,000 per month. How much income will JD report on her current year individual tax return from her interest in Canyons North?

    a. $18,000.
    b. $24,000.
    c. $42,000.
    d. $0.

Aggregated versus separately stated items: Form 1065 versus Schedule K

In reporting its taxable income or loss to the IRS and its partners, Section 702 requires that the partnership segregate and report separately those items which might be subject to limitations or other special treatment on the tax returns of any of its partners. For example, the partnership is required to separately report the following items:

- Net ordinary income or loss from trade or business activities
- Net income or loss from rental real estate activities
- Net income or loss from other rental activities
- Long-term capital gains and losses
- Short-term capital gains and losses
- Section 1231 gains and losses (from the disposition of business-use assets)
- Charitable contributions
- Dividends
- Interest income
- Foreign taxes paid or accrued
- Any other items potentially subject to special treatment on a partner's tax return, such as intangible drilling costs, mining and exploration expenditures.

Therefore, page 1 of Form 1065, used to report partnership or LLC taxable income, actually reports only the net *ordinary business* income or loss from partnership or LLC activities which are not subject to special treatment by the partners. A complete summary of the partnership or LLC's items of income or loss is reported on Schedule K, which is attached to Form 1065. Schedule K summarizes the entity's items of income, loss, gain, or deduction from each of its activities and classifies those items into categories identified by the IRS as potentially subject to special treatment by the partners. The section following Schedule K (Analysis of Net Income (Loss)) actually summarizes the partnership or LLC's net income or loss from all sources and reports the type of partner the income or loss is allocated to. Each partner or member's share of each line item on Schedule K is reported to the IRS and to each partner or member on a corresponding box on Schedule K-1. A separate Schedule K-1 must be completed for each partner or member, with copies being sent both to the IRS (as attachments to Form 1065) and to the individual partners or members. Each partner or member is required to receive only one Schedule K-1, reporting his or her individual share of each item of the entity's income or loss. As a practical matter, many partnerships and LLCs send a copy of the Form 1065 and accompanying Schedule K to each partner or member as well. Specific requirements for completing these forms and schedules are discussed later.

Schedules L, M-1, M-2, and M-3

Before proceeding to a discussion of the specific requirements for reporting partnership or LLC income, deductions, gains and losses, it is instructive to discuss briefly the other major components of the Form 1065—the entity's balance sheets and reconciling schedules. Beginning and ending balance sheets are reported on Schedule L (page 5) of Form 1065. The balance sheets themselves are relatively straightforward. The primary question concerns which balance sheets should be reported. The tax law essentially requires partnerships to maintain at least two sets of books and records, one reflecting the tax basis of the partnership or LLC's assets, and measuring its income by reference to this tax basis, and the other reflecting the values, at the date of formation or contribution, of the entity's assets and measuring its income by reference to these amounts. The latter set of records is required under Section 704(b) and is used to determine each partner or member's economic interest in the partnership and its assets. Under Section 704(b), the partnership or LLC agreement must clearly tie each partner or member's rights to entity assets upon termination of such partner or member's interest in the partnership or LLC to his or her capital account on this balance sheet. Partnerships or LLCs whose agreements do not comply with this requirement are not allowed to make "special" allocations of items of income, gain, loss or deduction to any partner or member. Although these balance sheets may not reflect the entity's taxable income, the IRS has made it clear in the instructions to Form 1065 that Schedule L should be prepared using generally accepted accounting principles (GAAP) or "book" values rather than tax basis.

Schedule M-1 on page five of Form 1065 reconciles the entity's book and taxable income. This schedule is relatively simple to complete, as it merely summarizes differences in the accounting methods used by the partnership or LLC for financial statement versus tax purposes. Examples of book or tax differences that might be reconciled here are depreciation, book gains and losses on distributions of assets, and the deduction for meal and entertainment expenses.

Schedule M-2 reconciles the total book partner or member capital account balance from the beginning to the end of the year. Here, the change in capital is classified into changes resulting from partner or member contributions, withdrawals, and partnership or LLC income. The ending capital balance reported on this schedule should tie back to the end-of-year total reported on Schedule L. Therefore, where the entity's book and tax records differ, the former should be used as the basis for completing Schedule M-2.

Partnerships and LLCs are not required to complete Schedules L, M-1, and M-2 only if all of the following are satisfied: (*a*) total receipts are less than $250,000, (*b*) total assets are less than $1,000,000, (*c*) Schedules K-1 are filed with the partnership or LLC tax return and mailed to partners or members by the due date of the entity's tax return (including extensions), and (*d*) the partnership does not file or is not required to file Schedule M-3. Although "small" partnerships are excepted from completing these schedules, as well as from the requirement that each partner's or member's capital account be reconciled on the Schedule K-1 received by such partner or member, many partnerships and LLCs decide not to forgo reconciliation of the partners or members' capital accounts on Schedules K-1. Such information is often necessary in order for the individual partners or members, or their tax advisers, to compute the individual partners or members' bases in their partnership or LLC interests.

Schedule M-3 of Form 1065 must be filed instead of Schedule M-1 if any one of the following is true:

- Total assets are equal to or greater than $10 million.
- Adjusted total assets (basically total assets plus distributions plus any other negative adjustments to capital from Schedule M-2) are equal to or greater than $10 million.
- Total receipts for the year equal or exceed $35 million.
- Any of the greater-than-50-percent partners of the partnership are themselves required to file Schedule M-3.

In fact, the very first section of the Schedule M-3 requires the disclosure of the reason the partnership is filing the M-3 and the name of all reportable entity partners.

Part I of Schedule M-3 is meant to make it easier for the IRS to establish what types of financial statements the partnership prepares and determine the partnership's share of income relative to the other entities that are in its consolidated group. It requires the disclosure of certain items related to the partnership's financial statements, such as whether or not the partnership filed SEC Form 10-K for the year, whether or not the partnership prepared a certified audited income statement for the year, and whether or not the partnership's income statement has been restated in the last five years. It also reconciles worldwide financial statement net income for any consolidated financial statement group in which the partnership might be included to the net income of the partnership per the income statement. It does this by

- beginning with worldwide consolidated net income for the consolidated group (line 4);
- removing the net income (loss) from non-includable foreign and U.S. entities (lines 5 and 6);
- including the net income (loss) from U.S. and foreign "disregarded" entities (line 7);
- making adjustments to eliminate transactions between entities in the group and to reconcile the income statement period to the tax year (lines 8 and 9); and
- making other necessary reconciling adjustments (line 10).

Parts II and III of Schedule M-3 make it easier for the IRS to spot questionable items by requiring a reconciliation of book income or deductions to the related tax return income or deductions. Part II is designed to highlight the temporary and permanent differences between net income (loss) per the partnership's income statement and taxable income (broadly construed). To do that, Part II requires disclosures in the following four columns:

- A calculation of net income per the income statement (column a).
- Temporary differences (column b).
- Permanent differences (column c).
- A calculation of total taxable income (loss) from the partnership (column d). This amount should equal the amount from Form 1065, page 5, Analysis of Income, line 1.

A partnership does not have to disclose the information requested in columns (a) and (d) (calculations of book income and taxable income, respectively) in the first year it is required to file Schedule M-3, but it will have to disclose the information reported in those columns in any later year in which the partnership is required to file Schedule M-3. In addition, columns (a) and (d) are not required if Schedule M-3 is being filed voluntarily, unless the partnership was required to file Schedule M-3 in some prior year. If the partnership files Schedule M-3, it must always disclose columns (b) and (c)—temporary and permanent differences, respectively, between book and taxable income. Although all temporary and permanent differences are required to be disclosed, some that are specifically listed on Schedule M-3 are

- income (loss) from equity method foreign corporations;
- income (loss) from U.S. partnerships;
- mark-to-market income (loss);
- income recognition from long-term contracts; and
- original issue discount and other imputed interest.

Part III of Schedule M-3 is designed to highlight temporary and permanent differences only with respect to expense or deduction items. In Part III, book expenses are reported in column (a), temporary differences in column (b), permanent differences in column (c), and deductions per the tax return in column (d). The same requirements for disclosure of the information requested in these columns that apply in Part II also apply in Part III. Although all temporary and permanent differences in expenses must be disclosed, some that are specifically listed are

- state and local current income tax expense;
- meals and entertainment;
- fines and penalties;
- guaranteed payments;
- oil and gas depletion;
- depreciation; and
- bad debt expense.

Note that the qualified business income deduction under new IRC Section 199A is computed at the partner, rather than the partnership, level. As a result, the Sec. 199A deduction is not a partnership deduction and creates neither a permanent or a temporary difference between book and tax. Accordingly, nothing is reported on Schedule M-3 in connection with IRC Section 199A.

Form 1065: Income

Gross profit from sales

Line 1 of Form 1065 reports the entity's gross receipts from sales and all other trade or business activities other than farming. For service businesses, this line should reflect total receipts from the partnership or LLC's service activities. Gross rents from rental activities should not be reported here, however. Rental activities are subject to the passive loss rules at the partner level; and therefore, are reported separately on Form 8825 and Schedule K.

From gross receipts, the partnership or LLC subtracts its cost of goods sold. The allowable deduction for cost of goods sold is computed on Form 1125-A. This computation is relatively simple, although two lines are worthy of special mention. First, in computing purchases, the partnership is compelled to reduce this amount for items withdrawn for personal use. These items should be treated as distributions and reported on Schedule M-2, and on line 19b of Schedule K and in box 19 (Code C) on the appropriate partner or member(s)' Schedules K-1.

More complex to compute is the information requested on line 4 of Form 1125-A. Partnerships and LLCs (as well as other taxpayers) are required to apply the uniform capitalization rules of Section 263A in valuing their inventory. The regulations under that statute, in Section 1.263A-1, allow partnerships (and others) to elect a simplified method of computing their inventory costs under the uniform capitalization rules. Partnerships (and other taxpayers) making such an election are required to complete line 4. For those partnerships, line 4 is used to report such additional capitalizable costs that may be incurred in storing inventory off-site, purchasing inventory, handling, processing assembling and packaging products, and such general and administrative costs as may be allocable to inventory under Section 263A.

Income from other pass-through entities

On line 4 of Form 1065, the partnership or LLC reports its distributive share of ordinary trade or business income from other pass-through entities. Only the amount(s) reported to the partnership or LLC in box 1 of the K-1(s) received from other entities is reported here. Amounts reported in other boxes of the K-1(s) are reported on the corresponding line(s) of Schedule K.

Net farm profit (loss)

Line 5 reports the partnership or LLC's net ordinary profit or loss from its own farming activities. Gain or loss from the sale of assets used in the trade or business of farming is reported elsewhere. The partnership or LLC's share of the ordinary profit or loss from farming activities of another partnership, LLC or other pass-through entity is reported on line 4.

Sale or exchange of property

Business-use assets: Form 4797

Information regarding the partnership or LLC's tax basis and holding period for trade or business assets sold during the year, along with information regarding the sales price, are reported on Form 4797. Any portion of the gain from such sales which is taxed as ordinary income under the depreciation recapture rules is reported on line 6, Form 1065. (However, gains from dispositions of Section 179 assets should instead be reported on line 20 of Schedule K and in box 20 of Schedule K-1, using Code L.) The portion of such gains which is governed by Section 1231, net of losses from such sales, is reported on Schedule K, line 10. Recapture income which is specially allocated to one or more partners or members is not to be reported on line 6 of Form 1065, but is instead to be reported on line 11 of Schedule K (other income or loss).

Example 7-4

Y contributed depreciable five-year property to the YZ Partnership with a tax basis of $120 and a fair market value of $180. Y had originally purchased the property for $210. Six months later, the partnership sold the property for $175. The partnership had yet to deduct depreciation expense with regard to the property, so its tax basis remained $120 at the date of sale. The partnership recognizes a $55 gain on the sale ($175 - $120), all of which is ordinary income under the depreciation recapture rules of Section 1245. Moreover, this income is allocable entirely to Y under Section 704(c). The IRS apparently takes the position that this sale should not be reported by the partnership on Form 4797. The instructions to Form 1065 (under "Special Allocations") state clearly that it should not be reported on line 6 of Form 1065. Instead, it is to be reported as an element of other income on line 11 of Schedule K with supporting information provided on a schedule to be attached to the tax return.

Capital assets: Schedule D

Detailed information regarding the tax basis, holding period, and sales price of capital assets disposed of by the partnership or LLC during the year is to be reported on Schedule D of Form 1065. No capital gain or loss is actually reported on page 1 of Form 1065, however. Rather, any net short-term capital gain (loss) that qualifies as portfolio income (loss) is to be reported on line 8 of Schedule K and in box 8 of Schedule K-1. Any net long-term capital gain (loss) that is portfolio income (loss) is to be reported on line 9a of Schedule K and in box 9a of Schedule K-1. Any short-term or long-term capital gains that do not qualify as portfolio income should be reported on line 11 of Schedule K and in box 11 (code F) of Schedule K-1. The instructions to Schedule D indicate that amounts which are specially allocated to a partner or partners are not to be reported on Schedule D. Such amounts should, instead, be reported on Schedule K, lines 8, 9a or 11. Collectibles gains and losses should be reported on line 9b, and unrecaptured Section 1250 gains should be reported on line 9c, of Schedule K. Partners' shares of these items are reported in boxes 9b and 9c respectively of Schedule K-1.

Assets used in rental activities

Gain or loss from the sale of assets used in rental activities must be reported separately from other gains and losses. Because such activities may be treated as passive activities under Section 469, they must be segregated from gains or losses from the sale of assets used in other activities. Generally, gain or loss from the sale of assets used in a rental real estate activity must be reported on Form 8825, attached to the partnership tax return, and included in the net income or loss from rental real estate activities on line 2, Schedule K. Gain or loss from the sale of assets used in other rental activities are reported on line 3a of Schedule K. Separate Form 4797s should probably be prepared for gains and losses from the sale of these assets with the notation that the totals are forwarded to the appropriate lines on Schedule K.

In preparing the partners' Schedules K-1, supporting schedules should be attached separating the portion (if any) of the net income from rental activities which consists of Section 1231 gain or loss. No portion of the net rental income or loss should constitute gain or loss from the sale of capital assets—these assets by definition would not be assets used in the rental activity. However, some portion could qualify for treatment as capital gain under Section 1231; and therefore, must be so identified in the supporting schedule accompanying Schedule K-1. Such amounts have dual status as both passive income and capital gain, which explains the complexity associated with these items in preparing the partnership or LLC tax return.

Recapture under Section 179

Under Section 179(d)(10), if the partnership or LLC elects to expense depreciable property, and in a subsequent year, the business use of such property falls to 50% or less, a portion of the Section 179 deduction must be recaptured as ordinary income. Although this income does not arise from the sale of property, but only from a conversion in usage, it is reported on Form 4797, part IV. This recapture income is not reported on page 1 of Form 1065, however. Rather, the partnership or LLC should report it on line 20c of Schedule K. When preparing Schedules K-1 for the partner or members, a statement should be attached with reference to box 20, reporting the amount of the deduction under Section 179 which was originally passed through to the partner or members, the year in which the election to expense the property was made, and whether the recapture was triggered by a disposition of the property (code L) or merely by a decline in its business usage (code M). This special treatment is necessary because the Section 179 limitation is applied at both the partnership or LLC level and partner or member level; if a partner or LLC member has Section 179 deductions from other pass-through entities, or from other trade or business activities, in the year of the original pass-through, he or she may not have been able to deduct the entire amount passed through from the partnership or LLC. Inclusion of the recapture amount in income will be dependent on how much (if any) of the original Section 179 amount was originally deducted by the partner or member.

Knowledge check

4. Which statement, regarding the method of reporting gains or losses from the sale of partnership assets is correct?

    a. Gain or loss from the sale of assets used in rental activities is separately stated and included in net rental income reported on Schedule K.
    b. Income from Section 179 recapture is reported in the same manner as ordinary income from depreciation recapture.
    c. Net Section 1231 gains are not separately stated and are reported on page 1 of Form 1065.
    d. Depreciation recapture must be separately stated on Schedule K.

Sale or exchange between the partnership or LLC and a partner or member

In general, Subchapter K allows the partnership or LLC to treat gains or losses from the sale of assets to a partner or member the same as if the sale had been between the partnership or LLC and an unrelated buyer. Gains and losses from the sale of property to a partner or member are usually reported as described earlier. However, for sales to partner or members owning more than 50% of the total interests in partnership or LLC profits or capital, losses are disallowed under Section 707(b)(1). These losses should be reported on line 18c of Schedule K (nondeductible expenses).

Other income

Partnership ordinary income (losses) from trade or business activities other than those described previously should be reported on line 7, Form 1065 (page 1). Only ordinary trade or business income or loss should be reported here. Examples of items which might be reported here are interest income on trade receivables (and other nonportfolio interest income), depreciation recapture under Section 280F (triggered when the business use of a partnership or LLC automobile falls to 50% or below), recovery of bad debts previously written off, and other ordinary income items recognized by the partnership or LLC.

Form 1065: Expenses

Salaries and wages

The deduction for salaries and wages paid to employees of the partnership or LLC is reported on line 9 of Form 1065. Consistent with the method of reporting income, only those salaries and wages paid to employees in the course of the partnership or LLC's nonrental trade or business activities is reported on Form 1065. Wages and salaries allocable to rental real estate activities are reported on Form 8825 and Schedule K. Wages and salaries allocable to other rental activities are reported on line 3b of Schedule K. It is also important to note that payments to partners or LLC members are never classified as salaries or wages. A partner or member cannot be an employee of the partnership or LLC for tax purposes. However, the partnership can make payments to partners for services rendered in their capacity as non-partners. Examples would be for services, such as legal or accounting work, that are contractual in nature and are not a part of the partner's responsibility to the partnership's primary business. Payments for such services would be included on line 20 of Form 1065 and would also generally be reflected on a Form 1099 that would be sent to the service partner.

Payments to partners

Guaranteed payments to partners or LLC members are deductible by the partnership or LLC on line 10 of Form 1065. Guaranteed payments are payments to partners or LLC members as compensation for services rendered in their capacity as partners or LLC members or for the provision of capital. Therefore, guaranteed payments are quite similar in nature to payments of salaries or interest expense. Because partners or members cannot be employees, however, such payments are not subject to withholding or employment taxes. Moreover, no Form W-2 or 1099 is required to be filed. Form 1065 and the accompanying Schedules K-1 fulfill that role.

Guaranteed payments are deducted by the partnership as part of nonseparately stated income on Form 1065, but then are reported as income to the receiving partner on Schedule K (line 4) and Schedule K-1 (box 4). Each partner or member's K-1 reports to him or her the amount of guaranteed payments taxable to such partner (in box 4).

Note that where a partnership transfers property, rather than cash, in partial or full satisfaction of its obligation to make a guaranteed payment, the distribution is treated as a fully taxable sale of such property and must be reported on Form 4797 or on Schedule D of Form 1065.[7] In such cases, the

[7] Although distributions of property by a partnership to a partner are generally not taxable to either party, the transfer of property to satisfy the partnership's obligation to make a guaranteed payment is not a "distribution" as that term is used in subchapter K. Therefore, Section 731(b), which provides that the partnership shall not recognize gain or loss on a distribution to a partner, is not applicable in this scenario.

partnership will be entitled to a deduction for the guaranteed payment in an amount equal to the fair market value of the property (net of liabilities, if any). It will also recognize gain or loss on the deemed sale. Essentially, the transfer will be treated as two transactions: (*1*) sale by the partnership of the property to the partner for its fair market value; and (*2*) distribution in the form of a guaranteed payment to such partner of the proceeds of the deemed sale.

Example 7-5

Q is a general partner in the QLR Partnership. The partnership agreement obligates the partnership to pay Q $25,000 as a guaranteed payment in the current year. The partnership finds itself short on cash, and Q agrees to accept a distribution of property valued at $25,000 in satisfaction of this obligation. The property, which is classified as Section 1231 property, has a tax basis to the partnership of $12,000 and is not encumbered by debt. Transfer of the property to Q will trigger recognition of a $13,000 capital gain by the partnership under Section 1231 just as if it were sold to Q for its $25,000 fair market value. The partnership will then be entitled to an ordinary deduction of $25,000 in connection with the deemed distribution of the proceeds of the deemed sale of the property to Q. Therefore, the net result of the transfer will be a $25,000 ordinary deduction and a $13,000 capital gain. The former will be reported as a deduction by the partnership on line 10 of Form 1065, and as income to Q on line 4 of Schedule K-1. The capital gain will be reported on Form 4797, attached to the partnership's Form 1065, and the net gain or loss will be reported on line 10 of Schedule K. Q's share of both the deduction and the gain or loss will be reported to her on Schedule K-1, along with her income from the guaranteed payment.

It is important to distinguish between guaranteed payments and distributions to partners or LLC members. Although guaranteed payments generally take the form of a payment to a partner or LLC member, all payments to a partner or members are not guaranteed payments. IRC Section 707(c) provides that guaranteed payments are payments made to a partner or LLC member the amount of which is determined without regard to partnership or LLC income. Therefore, payments made under an agreement calling for compensation in a fixed amount in exchange for a partner or member's services or capital will be treated as guaranteed payments. In contrast, where the agreement calls for a partner or member to receive a specified percentage of partnership or LLC income as compensation, accompanied perhaps by an equal share of remaining income, such payments will not be treated as guaranteed payments. Payments to a partner or LLC member which are not guaranteed payments are treated as distributions. As such, they are not deductible by the partnership, but are instead reported on lines 19a and b of Schedule K and box 19 of Schedule K-1.

Knowledge check

5. Q is a 20 percent member in Lynn Properties, LLC. Because she is more involved than the other members in the LLC's activities, she receives a guaranteed payment from the LLC in the amount of $25,000 per year. She also receives 20% of remaining LLC profits after payment of the guaranteed payment. For the current year, Lynn Properties reported net income of $75,000 after deducting the $25,000 guaranteed payment to Q. How much income will Q report on her individual tax return from Lynn Properties, LLC?

    a. $40,000.
    b. $25,000.
    c. $20,000.
    d. $0.

Example 7-6

A is a 25 percent member in Quatro Ranches, LLC. Because A is more involved than the other members in the LLC's ranching activities, he receives a larger relative share of the LLC's income. The LLC agreement calls for A to receive compensation of $20,000 per year for his services. He also receives 25% of remaining LLC profits after payment of his "salary." For the current year, the LLC reported net income of $110,000 before the $20,000 payment to A. On its tax return, the LLC will deduct the $20,000 payment to A, leaving it with ordinary business income of $90,000. Of this amount, $22,250 will be allocated to A and reported to him on Schedule K-1. A will also include the $20,000 guaranteed payment (also reported to him on Schedule K-1) in his individual taxable income. Therefore, A's total taxable income arising from his participation in the LLC will be $42,250.

Example 7-7

Assume the same facts as in example 7-6, except that the LLC agreement calls for A to receive compensation for his services in an amount equal to 25% of the LLC's net income before considering the payment to A. A is also entitled to receive a 25% share of any income remaining after payment of the compensation. If the LLC's net income before the compensatory payment to A remains $110,000, A will receive compensation of $27,500 (.25 × $110,000). In addition, he will be allocated 25% of the remaining income, or $20,625. Because the compensatory payment to A in this case is determined by reference to partnership income, it will not be treated as a guaranteed payment. Accordingly, on its Form 1065, the LLC will report net ordinary business income of $110,000. A's total share of this income, $48,125, will be reported to him on Schedule K-1 as his distributive share of LLC income (box 1 of Schedule K-1 in this example). Any portion of this amount actually distributed to A will be reported in box 19 of Schedule K-1 as a distribution.

Because partners and LLC members cannot be employees of the partnership or LLC for tax purposes, payments by the entity for health insurance on the partners' or members' behalf (whether for coverage for the partner or LLC member, or for his or her spouse or children), as well as contributions to Keogh or other retirement plans on behalf of partners or LLC members, should be treated by the entity as guaranteed payments. Therefore, these payments should not be deducted by the partnership or LLC on lines 18 (retirement plans) or 19 (employee benefit programs) of Form 1065. Instead, these payments made on behalf of a partner or LLC member should be classified as guaranteed payments, deducted on line 10 of Form 1065, and reported to the recipient partner or member(s) on line 4 and in box 4, respectively, of Schedules K and K-1. In order for the partner to be able to take the related deduction for health insurance premiums of the self-employed, these payments should also be reported on line 13d of Schedule K and in box 13 (code M) of Schedule K-1.

Repairs

Line 11 on Form 1065 is used to report noncapitalizable repairs and maintenance expenses incurred by the partnership or LLC. Expenditures which substantially increase the value or useful life of the property must generally be capitalized and recovered through depreciation.

Bad debts

Bad debt expenses are deductible on line 12 of Form 1065. The entity is required to use the specific charge-off method to compute bad debt expense and may deduct expenses only for those receivables or other debts which become wholly or partially worthless during the tax year. Note that for partnerships or LLCs using the cash method of accounting, no deduction is allowed for worthlessness of receivables which have not previously been included in income. Also note that bad debts arising from loans made to partner or members or others which do not arise as part of the partnership's ordinary trade or business activities should not be deducted on Form 1065. These transactions should be treated as nonbusiness bad debts and reported separately on Schedule K. Noncorporate partners must generally treat their shares of such losses as capital losses under Section 166(d).

Rents

The deduction for rent expense claimed on line 13 should be limited to rents paid on properties used in a trade or business. Note that lease payments paid for business-use automobiles are deductible here, but must be reduced by the appropriate "inclusion amount" under Section 280F. See Pub. 463 for the appropriate reduction.

Taxes and licenses

On line 14, the partnership or LLC should report expenditures for taxes and licenses. The most common expenditures in this category are employment taxes (social security taxes, unemployment taxes, and the like) and property taxes. Again, the deduction on the front page of Form 1065 is limited to expenditures incurred in the partnership or LLC's nonrental trade or business activities. Taxes incurred in rental activities should be reported on Form 8825 for rental real estate activities (and reduce the total net income reflected on Schedule K, line 2), and on Schedule K, line 3b for other rental activities. Taxes paid on investment assets should be reported on line 13d and 20b of Schedule K (deductions related to portfolio income and investment expenses, respectively). Some taxes may be capitalizable as part of the partnership or LLC's inventory costs under Section 263A. Also note that under Section 164, real estate taxes paid in a year in which realty was acquired or sold must be prorated between the buyer and the seller, regardless of who actually pays the taxes. Taxes paid by the partnership on behalf of the other party in such a transaction must be recharacterized as an adjustment to the sales price of the underlying realty.

Interest expense

Interest expense traceable to the partnership or LLC's nonrental trade or business activities is reported on line 15 of Form 1065. The tax return preparer must be especially careful here to properly classify partnership interest expense. Portfolio interest expense (interest on debts used to carry portfolio assets) must be reported on Schedule K, line 13b, rather than on Form 1065. Likewise, interest on debts used to acquire rental property must be reported on the appropriate forms as discussed earlier. As with taxes, some portion of a partnership or LLC's interest expense is often required to be capitalized into its inventory costs.

In addition to these items, the instructions to Form 1065 provide that interest on debts used to finance distributions to partners or LLC members should not be deducted on line 15 of Form 1065. Instead, interest on these debts should be reported on line 13d of Schedule K. In contrast, interest paid to a partner or LLC member for the use of his or her capital is generally treated as a guaranteed payment and should be deducted on line 10 of Form 1065 rather than line 15.

The Tax Cuts and Jobs Act of 2017 (TCJA) enacted a limit on the deduction of interest for certain taxpayers. For taxable years beginning after December 31, 2017, taxpayers with average annual gross receipts for the three-taxable-year period ending with the prior taxable year that equal or exceed $25 million will be subject to this limitation. The limitation does not apply to any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. In the case of any taxpayer to whom the limitation applies, the deduction for business interest is limited to the sum of (1) business interest income, (2) 30% of the adjusted taxable income of the taxpayer for the taxable year, and (3) the floor plan financing interest of the taxpayer for the taxable year. Any disallowed business interest deduction can be carried forward indefinitely (with certain restrictions for partnerships). In the case of any partnership, this provision is applied at the partnership level.

With respect to this limitation, business interest is any interest paid or accrued on indebtedness properly allocable to a trade or business. Business interest income is the amount of interest includible in the gross income of the taxpayer for the taxable year that is properly allocable to a trade or business. Business interest does not include investment interest expense, and business interest income does not include investment interest income. Floor plan financing interest is interest paid or accrued on indebtedness used to finance the acquisition of motor vehicles held for sale or lease to retail customers and secured by the inventory acquired. Adjusted taxable income is the taxable income of the taxpayer computed without regard to (1) any item of income, gain, deduction, or loss that is not properly allocable to a trade or business; (2) any business interest or business interest income; (3) the amount of any net operating loss deduction; and (4) any deduction allowable for depreciation, amortization, or depletion.

Example 7-8

The partnership agreement for the AB Partnership guarantees B a 5% return on the average balance in her capital account. Any partnership income in excess of this return is divided equally between partners A and B. This year, the average balance in B's capital account was $50,000. Accordingly, the partnership paid her $2,500 in "interest" on her capital. This interest is deductible by the partnership as a guaranteed payment rather than as interest expense. It must be deducted by the partnership on line 10 of Form 1065, and added back to partner's income on line 4 of Schedule K. B's Schedule K-1 should report the entire $2,500 guaranteed payment received by her (in box 4).

Depreciation and amortization

Depreciation and amortization expense are computed on Form 4562. The total depreciation expense from that form is carried to line 16a of Form 1065. Depreciation claimed elsewhere on the return, including on Schedule K, is subtracted on line 16b, leaving the net balance on line 16c. Depreciation which is specially allocated to one or more partners or LLC members under Sections 704(b) or 704(c) should generally be subtracted from the total on line 16b, and reported on Schedule K, line 11 (other income (loss)) and allocated among the partner or members (in accordance with the partnership or LLC agreement) on their Schedules K-1.

Example 7-9

The QLR Partnership was formed last year to drill for oil and gas. Depreciation on the partnership's drilling equipment, which was contributed by partner Q, is specially allocated under Section 704(c). Pursuant to that section, Q is allocated depreciation of $1,200 for the current year, whereas L and R each receive a $6,000 share of depreciation expense. On the partnership's tax return, total depreciation deductions of $13,200 are claimed on Form 4562 and carried to line 16a of Form 1065. This entire amount is specially allocated, however, and therefore, should be backed out on line 16b, leaving the partnership with a net deduction for depreciation on Form 1065 of $0. The entire $13,200 should be reported on Schedule K, line 11. Q's Schedule K-1 (box 11) in turn should report to her a deduction for depreciation of $1,200, whereas L and R each receive K-1s reporting depreciation allocations of $6,000.

The partnership or LLC must also back out of the amount on line 16a any amounts which are attributable to a rental activity. Depreciation expense attributable to a rental real estate activity should be reported on Form 8825, whereas depreciation attributable to other rental activities should be reported with other related expenses on Schedule K, line 3b.

Finally, amounts deducted under Section 179 are not reported on page one of Form 1065. These amounts should not be entered on line 16a. Instead, they are reported on Schedule K, line 12 so that partners and LLC members can compute their total Section 179 limitations outside the partnership or LLC. The Schedules K-1 distributed to partners or members, however, should clearly indicate which, if any, portion of each partner or member's share of the Section 179 deduction is attributable to rental activities.

Example 7-10

Morgan Properties, LLC, has three individual members, F, G, and H. In the current year, the LLC placed into service $700,000 of depreciable property. It did not take any bonus depreciation, but elected to deduct the maximum $500,000 allowable under Section 179. This deduction was allocated equally among its three partners ($166,667 each). F placed an additional $400,000 in depreciable property into service outside the LLC, all of which she elected to deduct under Section 179. Because the Section 179 limitation is applied at both the member and the entity level, F's total deduction under Section 179 cannot exceed $500,000. Accordingly, she will not benefit from her entire $166,667 share of the LLC's Section 179 deduction. She can deduct only $100,000 of this amount on her current year tax return. The remaining $66,667 is lost.

Depletion

Depletion of partnership or LLC timber properties is claimed on line 17 of Form 1065. Depletion of oil and gas properties owned and operated by a partnership or LLC is not deducted on Form 1065.Under Section 613A(c)(7), depletion of partnership oil or gas properties is computed by the partners rather than the partnership. Rather than compute depletion, the partnership or LLC allocates to each partner or member such partner or member's proportionate share of the adjusted basis of each partnership oil and gas property and revenue eligible for percentage depletion. This information is conveyed to the partner or members via box 20 and manual schedules attached to the Schedules K-1. Those partners or LLC members who are eligible to claim percentage depletion can then make the appropriate computations. Those not eligible for percentage depletion must compute the appropriate cost depletion deductions.

Retirement plans and employee benefit programs

Contributions to retirement plans and employee benefit programs on behalf of non-partner or member employees of the partnership or LLC are reported on lines 18 and 19 of Form 1065. As noted earlier, no deduction is allowed for contributions to such plans on behalf of partners or LLC members. If such contributions are required under the terms of the partnership or LLC agreement, they may be treated as guaranteed payments, deducted on line 10 of Form 1065 and added back to partnership income on Schedule K, line 4. The recipient partners receive no tax benefits as a result of these contributions unless they can be deducted on their individual returns (for example, deductible Keogh contributions).

Other deductions

Expenses which are properly deducted from the partnership or LLC's ordinary business income but which cannot be classified into any of the preceding categories are deducted on line 20 of Form 1065. Items such as insurance, utilities, postage, and other general and administrative expenses are reported here. Also reported here are the deductible portions of expenditures such as business meals and entertainment. The nondeductible portions of such expenditures are reported on Schedule K, line 18c. These amounts should also be entered in the appropriate box on Schedule M-1.

Section 199A Qualified business income deduction

As noted previously, partnerships and LLCs are not allowed a deduction under Section 199A. There is no line on Form 1065 to report this deduction; instead, the partnership or LLC must report qualified business income, W-2 wages paid by the partnership, and other items that may figure into the computation of the qualified business income deduction on line 20 (Other information) of Schedules K and K-1 as explained in the following discussion.

Schedules K and K-1

General scheme

As noted previously, Schedule K, rather than Form 1065, summarizes all of the partnership or LLC's items of income and loss. Income and expense amounts are segregated into categories reflecting the special rules that may be applied to particular income or loss items on the partners' or members' individual returns. In addition, Schedule K provides supplementary information which may be necessary or helpful to the partners or LLC members in preparing their own returns. Therefore, for example, Schedule K provides information on the entity's net investment income (used by the partners or members to determine the limitations to be applied to their investment interest expense deductions), net self-employment income (used to compute their individual liabilities for self-employment taxes), and tax preferences and alternative minimum tax adjustments (used in the computation of the alternative minimum tax). It also provides information regarding any foreign taxes paid by the entity as well as any credits which may be claimed by the partners or members on their individual returns.

The partnership is required to provide each partner or member with a Schedule K-1 reporting his or her share of each line item on Schedule K. In addition, one copy of each Schedule K-1 must be attached to Form 1065 and filed with the appropriate IRS Center. (A copy of the Form 1065 and all attachments—including Schedules K-1—must also be retained by the partnership or LLC.) The sum of the amounts reported to all the partners in each box of Schedule K-1 should equal the total amount reported on the related line of Schedule K.

Example 7-11

Partnership ABCD owns and operates a small apartment complex. This year, it reported a net loss of ($50,000) for tax purposes. Assume that the loss is entirely due to managing and operating the apartment complex. No part of the loss will be reported on page 1 of Form 1065. Specific information regarding the loss will be reported on Form 8825, and the total net loss will be reported on line 2 of Schedule K. Assume that the partnership agreement allocates 50% of this loss to Partner A, 20% to Partner B and 15% each to Partners C and D. The partners will receive K-1s reporting the following on line 2:

Partner A	($25,000)
Partner B	($10,000)
Partner C	($7,500)
Partner D	($7,500)
Sum of amounts reported on Schedule K-1, line 2	($50,000)

Note that the sum of the amounts reported on the partners' Schedules K-1 (line 2 of each) is equal to the amount reported on Form 1065, Schedule K, line 2 (page 4 of Form 1065).

Schedule K-1 also reports to each partner his or her share of partnership liabilities, the profit and loss percentages used to determine the partner's allocated shares of the income and loss items on Schedule K-1, and a reconciliation of his or her capital account. This information is necessary to help confirm the accuracy of the allocation of the various items of income and loss, and to compute each partner's basis and amounts at risk. Due to the complexity of the partnership reporting process, partners should review the amounts reported to them carefully to verify their accuracy.

Net income from Form 1065 and allocation among partners

Net ordinary business (partnership) income from Form 1065 is carried to line 1 of Schedule K, and is allocated to the partners in box 1 of their Schedules K-1. The allocation of this income among the partners is guided principally by Sections 704(b) and 706(d). In general, partnership income is allocated among the partners in accordance with the partnership agreement. Partners can agree among themselves to allocate partnership income or loss, or any item thereof, in any manner they see fit, as long as those allocations have "substantial economic effect" as defined in Section 704(b) and the regulations thereunder. "Substantial economic effect" essentially requires that the allocations be reflected in the partners' fair value capital accounts (maintained separately from the partnership's tax basis financial statements) and that those capital accounts be used to determine the partners' legal rights to withdraw partnership assets upon dissolution of the partnership, or termination of any individual partner's interest therein. Where the partnership agreement is silent on this issue, Section 704(b) generally requires that all items of income, loss, gain, deduction, or credit be allocated in accordance with the partners' relative contributions to partnership capital.

Example 7-12

A and B form a partnership with cash contributions of $150,000 each. Although the partners contributed equal amounts of capital to the partnership, they are not required to allocate all items of partnership income and loss equally. If the partnership agreement satisfies the requirements of the regulations under Section 704(b), they can make special allocations of income or loss to one partner. Assume in this example, that A and B agree to share in partnership profits equally, but to allocate losses 75% to A and 25% to B. For this special allocation of losses to stand, A must actually bear the economic impact of 75% of the partnership's losses. Therefore, for example, if the partnership loses ($60,000) in its first year of operations, A must bear the economic burden of ($45,000) of that loss. That means that if the partnership were to liquidate at the end of year one, A would be entitled to receive only $105,000 of its remaining assets, whereas B would receive $135,000.

Additional restrictions are placed on partnership allocations under Section 706(d). Section 706(d) prohibits the allocation to a partner of any portion of any partnership item (income, deduction, gain, loss or credit) attributable to a portion of the year during which he or she was not a partner. Therefore, partners joining the partnership during the month of December cannot share in partnership losses incurred from January through November, nor can they share in partnership credits "earned" during that period. Likewise, allocations must reflect any changes in the partners' relative interests during the taxable year.

Example 7-13

A and B formed the equal partnership AB on January 1, 2016. On August 1, 2016, A sold half her interest in the partnership to individual C, making A and C one-fourth partners in the partnership. For 2016, the partnership reported net taxable income of $120,000. The partnership agreement does not provide for special allocations of any kind among the partners. Pursuant to Section 706(d), C cannot be allocated any portion of the partnership's taxable income incurred prior to August 1, 2016. Moreover, after that date, A's share of partnership income must be determined by reference to her reduced interest in the partnership. Accordingly, partnership income will be allocated $47,500 to A (50% of the $70,000 income accrued through July 31, plus 25% of the $50,000 income earned from August 1 through December 31), $60,000 to B (50% of the partnership's $120,000 income from January 1 through December 31), and $12,500 to C (25% of partnership income earned from August 1 through December 31).

Rental real estate activities

Income and losses, including ordinary gains and losses from the sale or other disposition of assets, from a partnership's rental real estate activities are reported in detail on Form 8825. The net ordinary profit or loss from this form is carried to Schedule K, line 2.This information is segregated due to the requirements of Section 469, which restricts taxpayers' deductions for passive losses to the amount of passive income and gains recognized during the year. Because most rental activities are deemed passive, net profits or losses from these activities must be reported separately. It is important to note here that Section 1231 gains or losses from the sale of assets used in the partnership's rental activities are also passive (assuming the rental activities are passive). These gains and losses, however, are not reported on Schedule K, line 2, but rather on line 10, where they must be netted with any other Section 1231 gains or losses recognized by the partnership. The partnership should attach appropriate statements to the Schedules K-1 sent to partners notifying the partners what portion, if any, of their shares of the partnership's net Section 1231 gain or loss is derived from the sale of assets used in passive activities.

Other rental activities

Under Section 469, most rental activities are presumed to be passive activities. There are two exceptions to this presumption, however, both involving rental real estate activities. Under Section 469(c)(7) rental real estate activities engaged in by certain taxpayers in the real property business escape classification as passive activities. To qualify, taxpayers must be able to substantiate that more than one-half of the personal services they provided during a particular taxable year were performed in real estate trades or businesses in which they materially participate, and that the total personal services so provided consumed more than 750 hours of their time during the taxable year. They must also materially participate in the rental activity itself.

Additionally, for taxpayers who "actively" participate in rental real estate activities, up to $25,000 of losses generated by such activities in the taxable year may be exempted from Section 469 each year.[8] Both of these exceptions to the passive loss limitations are available only for rental real estate activities. Accordingly, a partnership's other rental activities must be reported separately from both its ordinary trade or business activities (Form 1065, page 1) and its rental real estate activities (Schedule K, line 2). Net income or loss from these other rental activities is reported in summary fashion on lines 3a-3c of Schedule K. A supplementary schedule detailing expenses incurred in such activities must be attached. And, as discussed previously with regard to rental real estate activities, the portion of any net Section 1231 gains or losses which is attributable to non-real estate rental activities should be indicated to the partners in a supplementary statement attached to their Schedules K-1.

Guaranteed payments to partners

The general treatment of guaranteed payments to partners was discussed earlier. Guaranteed payments are deducted from partnership ordinary business income on page 1 of Form 1065. These payments, however, are conceptually different from expenditures for capital or services obtained from sources unrelated to the partnership. Accordingly, they are added back to partnership income allocated to the partners on line 4 of Schedule K. Only the Schedules K-1 for those partners actually being allocated guaranteed payments from the partnership will have amounts entered in box 4; the amounts appearing in box 4 on the Schedule K-1 received by each partner will match the guaranteed payment, if any, allocated to that partner and deducted by the partnership in that taxable year. The K-1 therefore acts as a Form 1099 for the recipient partner(s), informing them of the amounts paid by the partnership for services rendered or the use of capital.

Portfolio income

Section 469 also requires partnerships to classify income from certain, mostly investment, sources as portfolio income. Certain closely held corporations are subject to a limited application of the passive loss rules. They are allowed to use passive losses to offset income from "active" sources, but not from portfolio sources. Therefore, partnerships must separately report (on Schedule K) income from portfolio sources such as interest (line 5), dividends (line 6), and royalties (line 7). Note that income from the previous sources is not portfolio income if the partnership is in the business of investing and managing funds.

[8] See Section 469(i).

Dividend income is reported as ordinary dividends (line 6a) and qualified dividends (line 6b). The amount for "Ordinary dividends" on line 6a includes the amount for qualified dividends on line 6b. Qualified dividends are dividends from domestic corporations, the shares of which were held more than 60 days during the 121-day period surrounding the ex-dividend date. Qualified dividends are subject to a 0%, 15%, or 20% tax rate (depending on the ordinary marginal tax rate of the partner, with an additional 3.8% tax on investment income for some taxpayers) and are not treated as investment income unless the taxpayer makes an election to forgo the special tax rates. All of the "ordinary" dividends on line 6a are, however, treated as portfolio income.

As indicated previously, any net short-term capital gain (loss) that qualifies as portfolio income (loss) is to be reported on line 8 of Schedule K and in box 8 of Schedule K-1. Any net long-term capital gain (loss) that is portfolio income (loss) is to be reported on line 9a of Schedule K and in box 9a of Schedule K-1. Any short-term or long-term capital gains that do not qualify as portfolio income should be reported on line 11 of Schedule K and in box 11 (code F) of Schedule K-1.

Portfolio income not reported on lines 5 through 10 of Schedule K should be reported on line 11 of Schedule K and in box 11 (code A) of Schedule K-1. Expenses, other than interest expense, related to portfolio income are reported on line 13d of Schedule K and in box 13 of Schedule K-1 (codes K and L). Interest expense related to portfolio income is reported on line 13b of Schedule K and line 13 (code H) of Schedule K-1.

Section 1231 gain or loss

Section 1231 applies to gains from the sale or exchange of assets used a taxpayer's trade or business activities. Under that statute, all gains from such sales are first netted against losses from such sales. If the net result is a gain, it is treated on the taxpayer's tax return as a capital gain. If the net result is a loss, it is treated on the taxpayer's return as an ordinary loss. A partner's share of a partnership's net Section 1231 gain or loss must be netted with his or her Section 1231 gains and losses from other sources in determining whether the partner's total Section 1231 transactions resulted in a net gain or loss. Accordingly, the partnership must separately report its net Section 1231 gain or loss (Schedule K, line 10), as well as each partner's share of the net gain or loss (Schedule K-1, box 10).

Other income (loss)

The partnership reports income or loss from other sources on line 11 of Schedule K and box 11 of Schedule K-1. This category includes items of income which are potentially subject to special treatment at the partner level, but are not included on lines 2 through 10 of Schedule K. (Recall that line 1 reflects partnership net ordinary business income from page 1 of Form 1065.) For example, the partnership would report income from the cancellation of indebtedness (COD) on this line. COD income can be excluded under Section 108 where the borrower is insolvent [Section 108(a)], or the debt is qualified real estate indebtedness [Section 108(c)] or qualified farm indebtedness [Section 108(g)]. The Section 108 election is made, however, at the partner level based on each individual partner's eligibility for the exclusion. Partners can elect to exclude COD income under Section 108(a), for example, only if they themselves are insolvent, regardless of the solvency of the partnership. Therefore, COD income must be separately reported.

Similarly, the partnership should report on line 11 income from certain transactions which are not entered into as part of the partnership's normal trade or business. For example, Section 751(b) triggers recognition of income by the partnership on so-called "disproportionate" distributions which alter the distributee-partner's (and therefore the partnership's) interests in partnership ordinary-income assets relative to his or her interest in partnership capital assets.

Likewise, Sections 704(c)(1)(B) and 737 trigger recognition of certain built-in gains inherent in assets contributed to the partnership by partners when those assets are distributed to other partners, or when the contributor-partners receive distributions of other property. These gains would be reported on line 11 of Schedule K as well, and allocated to the appropriate partners in box 11 of Schedule(s) K-1.

Section 179 deduction

As discussed previously, the election to expense depreciable property under Section 179 is made at the partnership, rather than the partner, level. The limitation on the maximum allowable deduction under that statute, in contrast, is applied at both the partnership and partner level. Accordingly, the partnership should report any amounts expensed under Section 179 separately. These amounts are reported on line 12 of Schedule K and box 12 of Schedule K-1.

Charitable contributions

Charitable contributions are subject to a multitude of limitations at the individual partner level and so must be separately reported to partners on line 13a of Schedule K and box 13 (codes A through G) of Schedule K-1. Where applicable, the partnership should attach a statement to the partners' K-1s identifying that portion of the total contributions reported which is subject to the 20%, 30%, and 50% limitations under Section 170. Partnerships should be aware that, like individuals, they are required to obtain contemporary, written acknowledgements from charitable organizations to which they make contributions of $250 or more. Also, like individuals, partnerships must complete Form 8283 for contributions of property other than cash if the total amount of such contributions exceeds $500. If the deduction for any item or group of similar items of property is greater than $5,000, a copy of Form 8283 must be attached to each partner's Schedule K-1, even if their allocated amount is $5,000 or less.

Before the TCJA, a partner was allowed to deduct his or her distributive share of partnership loss only to the extent of the adjusted basis of the partner's interest in the partnership at the end of the partnership year in which such loss occurred. The IRS took the position in a PLR 8405084 that the Code Sec. 704(d) loss limitation on partner losses did not apply to limit the partner's deduction for its share of the partnership's charitable contributions. Under the TCJA, in determining the amount of a partner's loss, the partner's distributive shares under Code Sec. 702(a) of partnership charitable contributions are taken into account. However, in the case of a charitable contribution of property with a fair market value that exceeds its adjusted basis, the partner's distributive share of the excess is not taken into account.

Investment interest expense

Section 163(d) limits an individual taxpayer's deduction for interest expense incurred on debts used to carry or finance investment assets to the taxpayer's net investment income. A partner's share of partnership investment interest expense is included with his or her investment interest on other debts in applying this limitation. Likewise, the partner's share of partnership investment income is pooled with investment income from other sources in determining the allowable deduction for investment interest. Partnership investment interest expense is therefore reported to the partners and the IRS separately on line 13b of Schedule K and in box 13 (Code H) of Schedule K-1. As additional information, the partnership is required to indicate on lines 20a and 20b the portion of income and expenses (except for interest), respectively, reported elsewhere on Schedule K which is appropriately classified as investment income and expense. Note that the information reported on lines 20a and 20b is duplicative. Amounts reported here are provided for informational purposes only, to help partners classify other items on their Schedules K-1 as investment or non-investment related.

Section 59(e)(2) expenditures

Under Section 59(e), taxpayers are allowed the option to capitalize and amortize certain qualified expenditures which otherwise would be expensed in the current year. Qualified expenditures include the following:

- Circulation expenditures
- Research and experimental expenditures
- Intangible drilling and development costs
- Mining exploration and development costs

Amortizing these expenditures may provide individual partners with tax benefits because amortization is not treated as a tax preference item, and therefore does not increase the partners' Alternative Minimum Tax (AMT) liabilities. The election to amortize rather than expense these expenses is made at the partner level. Information necessary to make this decision is reported on line 13c of Schedule K and box 13 (Code J) of Schedule K-1. In addition, a statement should be attached identifying the type of expenditures and the applicable property for which the expenses were incurred.

Other deductions

The partnership reports other expenditures not deductible from ordinary income and not included in any of the preceding separate categories on line 13d of Schedules K and box 13 of Schedule K-1. Here the partnership should report deductions such as those related to royalty income and portfolio income. In addition, partner benefits such as partners' medical insurance premiums, educational assistance benefits, dependent care benefits, and pensions and IRAs should also be reported here.

Taxpayers are allowed a deduction equal to 9% of the lesser of (*a*) qualified U.S. domestic production activities (generally, manufacturing or agricultural activities) income or (*b*) the taxpayer's taxable income (adjusted gross income for individuals). However, the deduction cannot be greater than 50% of the taxpayer or employer's W-2 wages for the year. For pass-through entities such as partnerships, these limitations will apply at the owner or partner level. This means that, in order to compute the deduction, a partner may need to know (*a*) their share of the partnership's qualified production activities income (QPAI) and (*b*) their share of the partnership's W-2 wages. The information necessary for the partners to compute their qualified production activities deduction should be disclosed on line 13d of Schedule K and in box 13 (Codes T, U, and V) of Schedule K-1.

In order for the partners to be able to calculate the production activities deduction, the partnership will need to disclose other detailed information on line 13d, including domestic production gross receipts, gross receipts from all sources, cost of goods sold allocable to domestic production gross receipts, and cost of goods sold allocable to all other sources.

The Tax Cuts and Jobs Act of 2017—The pass-through income deduction

For tax years after 2017, the 9 percent Section 199 domestic production activities deduction has been repealed. In its place a "pass-through income deduction" of 20% has been enacted under Section 199A. Under this provision, individuals will be allowed to deduct 20% of "qualified business income" that passes through from a partnership, S corporation, or sole proprietorship, as well as 20% of qualified real estate investment trust (REIT) dividends, qualified cooperative dividends, and qualified publicly traded partnership income. C corporations will not be eligible for the Section 199A 20% deduction (C corporation maximum tax rates have been reduced instead). The deduction reduces taxable income, rather than adjusted gross income, but is available to taxpayers who take the standard deduction.

Items are treated as qualified items of income, gain, deduction, and loss only to the extent they are effectively connected with the conduct of a trade or business within the United States. The determination of qualified items of income, gain, deduction, and loss takes items into account only to the extent they are included or allowed in the determination of taxable income for the year. If the net amount of qualified business income from all qualified trades or businesses during the taxable year is a loss, it is carried forward as a loss from a qualified trade or business to the next taxable year. For example, assume a taxpayer has qualified business income of $20,000 from qualified business A and a qualified business loss of $50,000 from qualified business B in Year 1. The taxpayer is not permitted a deduction for Year 1 and has a carryover qualified business loss of $30,000 to Year 2.

Qualified business income does not include any amount paid by an S corporation that is treated as reasonable compensation of the taxpayer. Similarly, qualified business income does not include any guaranteed payment for services rendered with respect to the trade or business, and does not include any amount paid or incurred by a partnership to a partner who is acting other than in his or her capacity as a partner for services.

"Specified service" trades or businesses (and the trade or business of being an employee) are excluded from the definition of a qualified trade or business. A specified service trade or business is any trade or business involving the performance of services in the fields of health; law; engineering; architecture; accounting; actuarial science; performing arts; consulting; athletics; financial services; brokerage services, including investing and investment management, trading, or dealing in securities, partnership interests, or commodities; and any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees.

The exclusion from the definition of a qualified business for specified service trades or businesses does not apply for taxpayers with taxable incomes less than a threshold amount, so taxpayers with taxable incomes below the threshold amount will be eligible for the deduction, even if the trade or business is a "specified service" trade or business. The threshold amount is $157,500 ($315,000 in the case of a joint return), indexed for inflation. The exclusion from the definition is fully phased in for a taxpayer with taxable income in excess of the threshold amount plus $50,000 ($100,000 in the case of a joint return).

There is also a limitation on the deduction based on the W-2 wages paid in the production of trade or business income. For each qualified trade or business, the taxpayer is allowed a deductible amount equal to the lesser of 20% of the qualified business income with respect to such trade or business or the greater of (*a*) 50% of the W-2 wages paid with respect to the qualified trade or business or (*b*) the sum of 25% of the W-2 wages with respect to the qualified trade or business plus 2.5% of the unadjusted basis, immediately after acquisition, of all qualified property (the "wage limit"). The wage limit begins to be phased in when taxable income exceeds a "threshold amount," so if the taxpayer's taxable income is below the "threshold amount," the deductible amount for each qualified trade or business is equal to 20% of the qualified business income with respect to each respective trade or business. The threshold amount and phase-in for the wage limit is identical to that of the exclusion from the definition of a qualified business for specified service trades or businesses.

Partnerships must provide their partners with supplemental information (qualified business income, W-2 wages paid by the partnership, property basis, REIT dividends, and PTP income if applicable) to facilitate the calculation of the qualified business income deduction by the partners. This information is reported in Box 20 on the partners' K-1s. Each dollar amount reported in Box 20 is assigned a code from Z to AD to indicate to the partners what that amount represents as follows:

Code Z – Section 199 income
Code AA – Section 199A W-2 wages
Code AB – Section 199A *unadjusted* basis of partnership property
Code AC – Section 199A REIT (Real Estate Investment Trust) dividends
Code AD – Section 199A PTP (Publicly Traded Partnership) income

As with any new tax legislation, be sure to watch for additional guidance from the IRS or Treasury Department.

Knowledge check

6. A taxpayer has qualified business income of $50,000 from partnership A and a qualified business loss of $30,000 from partnership B. Wages allocable to the taxpayer's interest in partnership A were $30,000. What is the pass-through income deduction the taxpayer is eligible for, assuming the taxpayer's taxable income is $100,000, and she files married, filing jointly?

   a. $0.
   b. $4,000.
   c. $6,000.
   d. $15,000.

Self-employment income

The partnership is also responsible on Schedules K and K-1 for classifying income and loss from all the various sources as earned versus unearned. Net income or loss from the former category flows through to partners and is used in computing their individual liabilities, if any, for self-employment taxes.

The determination of whether a partner's share of income is earned or unearned is dependent on both the source of the income and the nature of the partner's investment in the partnership. In general, no portion of a limited partner's distributive share of partnership income is subject to the self-employment tax. Therefore, a limited partner will generally have self-employment income from the partnership only to the extent he or she has received guaranteed payments from the partnership for services rendered. In contrast, a general partner's entire share of partnership ordinary business income will be treated as self-employment income, as will any amounts received as guaranteed payments for services rendered to the partnership. A general partner's share of partnership income from rental real estate activities constitutes self-employment income only if the rental real estate is being held for sale in the ordinary course of business or if significant services are rendered to the occupants. In contrast, a general partner's entire share of partnership ordinary income from other rental activities (other than that portion attributable to the sale of business-use assets) is treated as self-employment income. Therefore, a general partner's self-employment income will generally equal the sum of the amounts reported in boxes 1, 3, and 4 of Schedule K-1, less any portion attributable to net gains from Form 4797, Part II, line 17 (depreciation recapture), less any Section 179 expense in box 12,[9] and plus any portion of the amount reported on line 2 which constitutes earned income.

In preparing line 14a, Schedule K, the partnership essentially reverses the process used to complete the other lines and boxes on Schedules K and K-1. Rather than computing the appropriate amount to enter on Schedule K, and then allocating this amount to the various K-1s, a better approach is to determine the amounts which should be treated on each partner's Schedule K-1 as self-employment income, and then add these amounts to arrive at the total which should be reported on Schedule K. Note that this amount,

[9] Rev. Rul. 65-272, 1965-2 CB 217.

which can be negative, is duplicative. Line 14a merely classifies information which is reported on other lines and boxes of Schedules K and K-1.

Credits

Lines 15a through 15f of Schedule K are used to report expenditures of the partnership which are eligible for various tax credits. On these lines, the partnership should report information necessary for the partners to claim credits for withheld taxes, qualified investments in low-income housing, expenditures eligible for the jobs credit, or for the energy or reforestation credits, and the like. Consistent with the requirements of Section 469, the partnership must separately report credits related to rental real estate activities and other rental activities. Note, however, that information on the foreign tax credit is not reported here. Rather, all the information necessary for partners to compute the foreign tax credit is reported on line 16, parts a through n.

Adjustments and tax preference items

Income and deduction items used to determine an individual partner's liability for the AMT are reported on line 17 (parts a through f) of Schedule K and box 17 of Schedule K-1. On lines 17a and b, the partnership reports the AMT adjustments for depreciation expense and the related adjustment for gain or loss on disposition of depreciable equipment. Line 17c is used to report the adjustment for depletion on properties other than oil and gas properties. (Recall that oil and gas depletion is computed by the partners rather than the partnership.) Information on the partnership's oil and gas gross income and deductions, necessary to compute AMT adjustments and preferences for IDC, depletion, and the like, is reported on lines 17d and 17e. All other AMT adjustments and tax preference items are reported on line 17f. A supporting schedule should be attached to each K-1, providing detailed information on amount(s) reported on line 17f.

Other information

Reported in this section of Schedule K is information regarding the partnership's nontaxable income and expenses (lines 18a, 18b, and 18c of Schedule K, box 18 of Schedule K-1). Any distributions of cash and marketable securities are disclosed on line 19a, and any distributions of other property are reported on line 19b. The Schedule K-1 reports any distributions in box 19 (code A for cash or marketable securities distributions and code C for other property distributions). To help compute the investment interest expense limitation, investment income and investment expenses are reported on lines 20a and 20b, respectively, of Schedule K, and in box 20 of Schedule K-1. In addition, any other information which may be necessary or helpful to the partners in computing their tax liabilities (for example, information necessary to compute oil and gas depletion—code T) should be reported in box 20 of Schedule K-1.

Classification of Schedule K amounts

The first section of page 5 of Form 1065 [*Analysis of Net Income (Loss)*] summarizes the partnership's total income and analyzes it by type of partner. The partnership's total net taxable income is computed as the sum of lines 1 through 11 of Schedule K, less amounts on lines 12 through 13d, and 16l. This total is then classified by reference to the type of partner to whom it is allocated. For this purpose, partners are first classified by taxable entity (corporations, individuals, partnerships, exempt organizations, and other). A second division is made between general and limited partners. Finally, for individual partners, the income or loss must be categorized as passive versus nonpassive.

Interpreting Schedule K-1

Information provided in Parts I and II of Schedule K-1

Each partner's K-1 should report the name, address, and identifying number of the partnership (as well as identification of the individual partner for whom the K-1 is prepared), and the nature of the partner's investment in the partnership (that is, as a general or limited partner). More importantly, the K-1 also summarizes the partner's interest in partnership profits, losses and liabilities, and reconciles his or her capital account. The capital account reconciliation of Part II, Item L analyzes the change in capital from the beginning to the end of the year, and classifies changes as attributable to additional contributions of capital, allocation of partnership income and loss, or capital withdrawals made by the partner during the year. All of this information is of vital interest to the partner in determining the current year tax consequences to the partner arising from his or her investment in the partnership. In particular, this information is generally necessary for the partner to assess the accuracy of the information reported in the Schedule K-1, and to compute his or her basis in the partnership interest and amount at risk.

Basis

Under Section 704(d), a partner's deductions for partnership losses cannot exceed his or her basis in his or her partnership interest at the end of the year in which such losses are incurred. The determination of a partner's basis in the partnership interest is dependent on the manner in which such interest was acquired. Where the interest is acquired in exchange for a contribution of property to the partnership, Section 722 provides that the partner's initial basis in the partnership interest is equal to the partner's basis in the property, including cash, transferred to the partnership in exchange for such property. If the interest is acquired by purchase, the partner takes a cost basis in the interest under Section 1012. Cost in such cases is measured by reference to the amount of cash and the fair market value of other property paid for the interest. If the interest is acquired by gift, the transferee takes a carryover basis in the interest under Section 1015 equal to the transferor's basis immediately prior to the transfer. Finally, where the interest is acquired by inheritance, the beneficiary takes a basis under Section 1014 equal to the fair market value of the partnership at the decedent's date of death (or at the alternate valuation date six months after the date of death).

The partner's basis is subsequently increased under Section 722 by his or her basis in property, including cash, subsequently contributed to the partnership, and decreased under Section 733 by the basis taken by the partner in property, including cash, subsequently distributed to the partner. In this regard, Section 752(a) provides that an increase in a partner's share of partnership liabilities (or the assumption by a partner of liabilities of the partnership) is treated as a contribution of money to the partnership by such partner. Likewise, Section 752(b) provides that a reduction in a partner's share of partnership liabilities (or the assumption by the partnership of the partner's liabilities) is treated as a distribution of money by the partnership to the partner. Additionally, Section 705(a) provides that a partner's basis in his or her partnership interest is increased by his or her share of partnership income and gain, including tax-exempt income, and decreased by his or her share of partnership losses and deductions, including nondeductible expenditures. The net result of these adjustments is that a partner's basis in his or her partnership interest is equal to that amount which the partner stands to lose, for tax purposes, as a result of his or her investment in the partnership.

These adjustments are very difficult for many partners to keep up with over time. Indeed, in order to accurately measure basis in the partnership interest, partners would be required to account for all post-formation contributions or withdrawals of partnership assets, distributive shares of partnership income and loss, and changes in their shares of partnership liabilities from the date of their entry into the partnership until the date of termination of their interests. Most partners are unwilling or unable to accurately maintain the necessary records to make these computations. Fortunately, the partnership is also required to account for the same transactions. Contributions, withdrawals, and income or loss allocations are all reflected in a partner's capital account maintained by the partnership. This capital account is reconciled annually on the Schedule K-1 received by the partner. Moreover, the K-1 also reports the partner's share of partnership liabilities as of the end of each year. As a result, a partner's basis in his or her partnership interest can generally (but not always) be computed from information reported on the K-1. Basis in the partnership interest will generally equal the sum of the partner's end-of-the-year capital account balance plus his or her share of partnership liabilities. Where the partnership's book and tax balance sheets do not match, practitioners should consider attaching a statement to each partner's Schedule K-1 which reconciles the partner's tax capital account. Otherwise, partners will be unable to calculate their bases in their partnership interests from the information provided on Schedule K-1.

Example 7-14

A contributes property worth $150,000 to the AB Partnership. Her basis in the property is $75,000, and it is subject to a $45,000 liability, which the partnership assumes. B contributes $105,000 cash. The partners share profits and losses equally. Similarly, each partner bears equal risk for partnership liabilities. A's initial basis in her partnership interest is $52,500, computed as follows:

Basis in property contributed to partnership	$75,000
Partner liability assumed by the partnership	(45,000)
A's share of partnership liabilities (50%)	22,500
Initial basis in partnership interest	$52,500

Assume the partnership reports a tax loss of ($28,000) in its first year of operations. A's share of this loss is ($14,000), reducing her basis in her partnership interest to $38,500 ($52,500 – $14,000).

Example 7-14 (continued)

Now consider A's capital account on the partnership's tax basis financial statements. On the partnership's tax basis balance sheet, A's initial capital balance will be $30,000 ($75,000 tax basis in property contributed to the partnership, less ($45,000) debt assumed by the partnership in connection with the contribution). At the end of the partnership's first tax year, the balance in A's capital account will be $16,000 ($30,000 – A's $14,000 share of the partnership's loss). A's share of the partnership's liabilities (assuming the mortgage on the property contributed by A is the partnership's only liability) will be $22,500 (50%). The sum of her ending capital balance and her share of partnership liabilities is $38,500, which equals her basis in her partnership interest.

In contrast, consider the capital account information reported to A on her Schedule K-1. In the capital reconciliation reported to A on Schedule K-1, her initial capital balance will be reported as $105,000 (the $150,000 FMV of the property contributed by A, less the ($45,000) mortgage). After accounting for her share of the partnership's loss, her ending capital account will be reported as $91,000. If A computes her basis in the partnership interest by adding this balance to her $22,500 share of partnership liabilities, she will overestimate basis by $75,000.

Note that it is important that the partnership attach an analysis of the partner's tax capital account to the K-1 even when the instructions to Form 1065 do not require that the capital account analysis of Item L be completed. This information is vital to the partners in computing their bases in their partnership interests. Even when the partnership is profitable (so that the Section 704(d) limitation on the deductibility of losses is irrelevant), partners will need to accurately compute basis in their partnership interests in order to measure the amount of taxable gain or loss to be recognized in the event they sell their partnership interests.

Amount at risk

Further restrictions are placed on the deductibility of a partner's share of partnership losses by Section 469. Section 469 restricts the partner's deduction for losses to the amount the partner actually has at risk as a result of his or her investment in the partnership. Generally, the amount at risk is computed in the same manner as the partner's tax basis, except that nonrecourse debts are not added to the partner's capital account unless "qualified." Qualified nonrecourse debts are loosely defined as nonrecourse debts obtained from unrelated third-party financial institutions and used to finance the acquisition of real estate. The partner's share of partnership nonrecourse liabilities, qualified nonrecourse liabilities, and other (recourse) liabilities are separately reported in Item K of the Schedule K-1. If the K-1 is properly prepared, the partner can easily compute his or her amount at risk each year, assuming the calculation of the capital account in Item L is calculated on the tax basis. Particular attention should be focused on whether the capital account in Item L of Schedule K-1 is prepared on the tax basis, GAAP basis or Section 704(b) book basis.

Appendix A

SAMPLE PARTNERSHIP TAX RETURN

Facts and financial data

Kachina Properties is a New Mexico General Partnership with the following three general partners:

Name	SS Number
Louis Griego	455-81-5151
4825 Hackberry	
Las Cruces, NM 88001	
(Tax Matters Partner)	
Ellen Harkin	454-66-3333
1750 Madison	
Albuquerque, NM 87131	
Kathleen Martin	459-34-5939
1519 Harness	
Las Cruces, NM 88003	

The partnership was formed on February 1, 2018. Its federal identification number is 75-3185725, and its address is 1701 E. Lohman, Las Cruces, NM 88005. The partners contributed cash and property as follows to form the partnership:

Louis:	Parkway Place Office Center	
	Original Cost—Building	$984,555
	Accumulated Depreciation (39/SL—purchased 2/08)	97,824
	Original Cost—Land	115,445
	At Date of Contribution: Building Fair Market Value	984,555
	Land Fair Market Value	115,445
	Outstanding Mortgage Balance	910,000
	Remaining Depreciable Life	35 years
Ellen:	$225,000 cash	
Kathleen:	$225,000 cash	

The partnership will lease the 2nd and 3rd floors of the Parkway Place Office Center to unrelated tenants. On the 1st floor, it used the cash contributed by Ellen and Kathleen to make the necessary improvements and purchase the necessary equipment to open two separate businesses. On one side of the 1st floor, the partners opened a restaurant. On the other side, they opened a retail store specializing in office supplies, furniture and equipment. Ellen will oversee the operations of the restaurant, Kathleen will manage the retail center, and Louis will be responsible for leasing and managing the remainder of the building.

The partnership agreement allocates all items of income, deduction, gain or loss, except depreciation on the Parkway Place Office Center, 35.15 percent to Kathleen, 35.15 percent to Ellen, and 29.70 percent to Louis. Depreciation on the Parkway Place Office Center (not including such leasehold improvements as are made to the areas in which the restaurant and retail center are located) is allocated 100 percent to Louis. Ellen is guaranteed a salary of $25,000 per year for her efforts in managing the restaurant, and Kathleen will receive a salary of $32,000 per year. Louis will not be compensated directly for his efforts. The profit and loss shares described previously are applied after payment of the salaries to Ellen and Kathleen.

Partnership trial balance

The partnership has the following trial balance at December 31. Note that these numbers reflect Sec. 704(b), or "book," amounts.

	Trial Balance		Balance Sheet		Income Statement	
	Dr	Cr	Dr	Cr	Dr	Cr
Cash	10,671		10,671			
Accounts Receivable	60,000		60,000			
Allowance for Bad Debts		2,500		2,500		
Short-term Investments	2,800		2,800			
Equipment	121,000		121,000			
Accumulated Depr, Equip		12,100		12,100		
Land	115,445		115,445			
Building	984,555		984,555			
Accumulated Depr, Bldg		25,245		25,245		
Leasehold Improvements	213,408		213,408			
Accumulated Depr, LHI		3,420		3,420		
Accounts Payable		26,000		26,000		
Tenant Deposits		36,000		36,000		
Mortgage Payable		901,000		901,000		

	Trial Balance		Balance Sheet		Income Statement	
	Dr	Cr	Dr	Cr	Dr	Cr
Capital, Louis		190,000		190,000		
Capital, Ellen		225,000		225,000		
Capital, Kathleen		225,000		225,000		
Sales		212,500				212,500
Purchases	147,961				147,961	
Rent Income		54,000				54,000
Bad Debt Expense	2,500				2,500	
Insurance	12,000				12,000	
Employee Wages	35,600				35,600	
Partner Salaries	57,000				57,000	
Employee Medical Expenses	4,000				4,000	
Payroll Taxes	2,800				2,800	
Charitable Contributions	1,760				1,760	
Interest Expense	61,000				61,000	
Property Tax, Building	7,200				7,200	
Property Tax, F&F, Inv.	4,300				4,300	
Gain on Sale of ST Investments		16,000				16,000
Depreciation Expense, Bldg	25,245				25,245	
Depreciation Expense, Equipment	12,100				12,100	
Depreciation Expense, LHI	3,420				3,420	
Partner Draws:						
Louis	13,068		13,068			
Ellen	15,466		15,466			
Kathleen	15,466		15,466			
	$1,928,765	$1,928,765				

Notes to accompany trial balance

The partnership uses the accrual method of accounting for tax purposes.

The trial balance reflects the partnership's allocation of the value of Parkway Place Office Center between the building and land. Interest expense, insurance, property taxes, and depreciation on the building should be allocated $^{1}/_{3}$ to the partnership's retail or restaurant activity and $^{2}/_{3}$ to its rental activity.

Assume that tax and book depreciation are the same. That is, the preceding depreciation numbers are the same as those which would be reported on Form 4562. Further assume that the alternative minimum tax (AMT) adjustment for depreciation expense on the equipment is $0 for the current year. Also, there is no AMT adjustment for depreciation on the building and leasehold improvements. The partnership has chosen not to make the Section 179 election to expense a portion of the equipment acquired during the taxable year.

The partnership's ending inventory balance is $58,961. This represents the combined inventory of the retail center and restaurant.

The short-term capital gain on the trial balance resulted from the sale of stock in GCX Corporation. The partnership purchased the stock on March 12 for $20,000 and sold it on May 18 for $36,000. Both figures are net of commissions.

The partnership's bad debt expense under the specific charge-off method would be $0 for the current year.

The partnership takes the position that because of the extensive services it provides to tenants, its rental activities constitute a trade or business (but should not be aggregated with the other trade or business). As a result, they treat their rental income as qualifying for the qualified business income (QBI) deduction. All wages are considered W-2 wages for the QBI deduction, and all assets are considered to be associated with the QBI activity. Ninety percent of the W-2 wages and one-third of the assets are allocated to the restaurant/retail trade or business. The remainder of the W-2 wages and assets are allocated to the rental business.

Kachina Properties: 2018 tax return and accompanying forms and schedules

The partnership's 2018 Form 1065, *U.S. Return of Partnership Income*, along with 2018 Schedules K-1, *Partner's Share of Income, Deductions, Credits, etc.*, for each partner are reproduced on the following pages. The tax return and accompanying Schedules K-1 are followed by an explanation of the rationale and calculation of each figure reported on the return.

Form **1065**
Department of the Treasury
Internal Revenue Service

U.S. Return of Partnership Income

For calendar year 2018, or tax year beginning ____________, ending ________________.
▶ **Go to *www.irs.gov/Form1065* for instructions and the latest information.**

OMB No. 1545-0123
2018

A Principal business activity: Retail Sales	Name of partnership: Kachina Properties	**D** Employer identification number: 75-3185725
B Principal product or service: Office Supplies	Type or Print — Number, street, and room or suite no. If a P.O. box, see instructions.: 1701 E. Lohman	**E** Date business started: 2/1/2018
C Business code number: 453210	City or town: Las Cruces; State: NM; ZIP code: 88005; Foreign country name; Foreign province/state/county; Foreign postal code	**F** Total assets (see instructions): $ 1,523,575

G Check applicable boxes: **(1)** [X] Initial return **(2)** [ ] Final return **(3)** [ ] Name change **(4)** [ ] Address change **(5)** [ ] Amended return
H Check accounting method: **(1)** [ ] Cash **(2)** [X] Accrual **(3)** [ ] Other (specify) ▶
I Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year. ▶ 3
J Check if Schedules C and M-3 are attached . . . ▶ [ ]

Caution: Include **only** trade or business income and expenses on lines 1a through 22 below. See instructions for more information.

Income	1a	Gross receipts or sales	1a	212,500		
	b	Returns and allowances	1b			
	c	Balance. Subtract line 1b from line 1a			1c	212,500
	2	Cost of goods sold (attach Form 1125-A)			2	89,000
	3	Gross profit. Subtract line 2 from line 1c			3	123,500
	4	Ordinary income (loss) from other partnerships, estates, and trusts (attach statement)			4	
	5	Net farm profit (loss) (attach Schedule F (Form 1040))			5	
	6	Net gain (loss) from Form 4797, Part II, line 17 (attach Form 4797)			6	
	7	Other income (loss) (attach statement)			7	
	8	**Total income (loss).** Combine lines 3 through 7			8	123,500
Deductions (see instructions for limitations)	9	Salaries and wages (other than to partners) (less employment credits)			9	32,040
	10	Guaranteed payments to partners			10	57,000
	11	Repairs and maintenance			11	
	12	Bad debts			12	
	13	Rent			13	
	14	Taxes and licenses			14	9,500
	15	Interest (see instructions)			15	20,333
	16a	Depreciation (if required, attach Form 4562)	16a	40,765		
	b	Less depreciation reported on Form 1125-A and elsewhere on return	16b	25,245	16c	15,520
	17	Depletion **(Do not deduct oil and gas depletion.)**			17	
	18	Retirement plans, etc.			18	
	19	Employee benefit programs			19	4,000
	20	Other deductions (attach statement)			20	4,000
	21	**Total deductions.** Add the amounts shown in the far right column for lines 9 through 20			21	142,393
	22	**Ordinary business income (loss).** Subtract line 21 from line 8			22	-18,893
Tax and Payment	23	Interest due under the look-back method—completed long-term contracts (attach Form 8697)			23	
	24	Interest due under the look-back method—income forecast method (attach Form 8866)			24	
	25	BBA AAR imputed underpayment (see instructions)			25	
	26	Other taxes (see instructions)			26	
	27	**Total balance due.** Add lines 23 through 27			27	0
	28	Payment (see instructions)			28	
	29	**Amount owed.** If line 28 is smaller than line 27, enter amount owed			29	
	30	**Overpayment.** If line 28 is larger than line 27, enter overpayment			30	

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than partner or limited liability company member) is based on all information of which preparer has any knowledge.

▶ ____________________ Signature of partner or limited liability company member ▶ ________ Date

May the IRS discuss this return with the preparer shown below? See instructions. [ ] Yes [ ] No

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check [ ] if self-employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	
City	State		ZIP code	

For Paperwork Reduction Act Notice, see separate instructions. Form **1065** (2018)
HTA

Schedule B Other Information

		Yes	No
1	What type of entity is filing this return? Check the applicable box: **a** [X] Domestic general partnership **b** [ ] Domestic limited partnership **c** [ ] Domestic limited liability company **d** [ ] Domestic limited liability partnership **e** [ ] Foreign partnership **f** [ ] Other ▶		
2	At the end of the tax year:		
a	Did any foreign or domestic corporation, partnership (including any entity treated as a partnership), trust, or tax-exempt organization, or any foreign government own, directly or indirectly, an interest of 50% or more in the profit, loss, or capital of the partnership? For rules of constructive ownership, see instructions. If "Yes," attach Schedule B-1, Information on Partners Owning 50% or More of the Partnership		X
b	Did any individual or estate own, directly or indirectly, an interest of 50% or more in the profit, loss, or capital of the partnership? For rules of constructive ownership, see instructions. If "Yes," attach Schedule B-1, Information on Partners Owning 50% or More of the Partnership		X
3	At the end of the tax year, did the partnership:		
a	Own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of stock entitled to vote of any foreign or domestic corporation? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (iv) below		X

(i) Name of Corporation	**(ii)** Employer Identification Number (if any)	**(iii)** Country of Incorporation	**(iv)** Percentage Owned in Voting Stock

		Yes	No
b	Own directly an interest of 20% or more, or own, directly or indirectly, an interest of 50% or more in the profit, loss, or capital in any foreign or domestic partnership (including an entity treated as a partnership) or in the beneficial interest of a trust? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (v) below		X

(i) Name of Entity	**(ii)** Employer Identification Number (if any)	**(iii)** Type of Entity	**(iv)** Country of Organization	**(v)** Maximum Percentage Owned in Profit, Loss, or Capital

		Yes	No
4	Does the partnership satisfy **all four** of the following conditions?		
a	The partnership's total receipts for the tax year were less than $250,000.		
b	The partnership's total assets at the end of the tax year were less than $1 million.		
c	Schedules K-1 are filed with the return and furnished to the partners on or before the due date (including extensions) for the partnership return.		
d	The partnership is not filing and is not required to file Schedule M-3		X
	If "Yes," the partnership is not required to complete Schedules L, M-1, and M-2; item F on page 1 of Form 1065; or item L on Schedule K-1.		
5	Is this partnership a publicly traded partnership, as defined in section 469(k)(2)?		X
6	During the tax year, did the partnership have any debt that was canceled, was forgiven, or had the terms modified so as to reduce the principal amount of the debt?		X
7	Has this partnership filed, or is it required to file, Form 8918, Material Advisor Disclosure Statement, to provide information on any reportable transaction?		X
8	At any time during calendar year 2018, did the partnership have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? See instructions for exceptions and filing requirements for FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR). If "Yes," enter the name of the foreign country. ▶		X
9	At any time during the tax year, did the partnership receive a distribution from, or was it the grantor of, or transferor to, a foreign trust? If "Yes," the partnership may have to file Form 3520, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts. See instructions		X
10a	Is the partnership making, or had it previously made (and not revoked), a section 754 election? See instructions for details regarding a section 754 election.		X
b	Did the partnership make for this tax year an optional basis adjustment under section 743(b) or 734(b)? If "Yes," attach a statement showing the computation and allocation of the basis adjustment. See instructions		X

Schedule B **Other Information** *(continued)*

		Yes	No
c	Is the partnership required to adjust the basis of partnership assets under section 743(b) or 734(b) because of a substantial built-in loss (as defined under section 743(d)) or substantial basis reduction (as defined under section 734(d))? If "Yes," attach a statement showing the computation and allocation of the basis adjustment. See instructions		X
11	Check this box if, during the current or prior tax year, the partnership distributed any property received in a like-kind exchange or contributed such property to another entity (other than disregarded entities wholly owned by the partnership throughout the tax year) . . . ▶ ☐		
12	At any time during the tax year, did the partnership distribute to any partner a tenancy-in-common or other undivided interest in partnership property? . . .		X
13	If the partnership is required to file Form 8858, Information Return of U.S. Persons With Respect To Foreign Disregarded Entities (FDEs) and Foreign Branches (FBs), enter the number of Forms 8858 attached. See instructions . . . ▶		
14	Does the partnership have any foreign partners? If "Yes," enter the number of Forms 8805, Foreign Partner's Information Statement of Section 1446 Withholding Tax, filed for this partnership. ▶ 0		X
15	Enter the number of Forms 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships, attached to this return. ▶ 0		
16a	Did you make any payments in 2018 that would require you to file Form(s) 1099? See instructions . . .	X	
b	If "Yes," did you or will you file required Form(s) 1099? . . .	X	
17	Enter the number of Form(s) 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations, attached to this return. ▶ 0		
18	Enter the number of partners that are foreign governments under section 892. ▶ 0		
19	During the partnership's tax year, did the partnership make any payments that would require it to file Form 1042 and 1042-S under chapter 3 (sections 1441 through 1464) or chapter 4 (sections 1471 through 1474)? . . .		X
20	Was the partnership a specified domestic entity required to file Form 8938 for the tax year? See the Instructions for Form 8938 . . .		X
21	Is the partnership a section 721(c) partnership, as defined in Treasury Regulations section 1.721(c)-1T(b)(14)?		X
22	During the tax year, did the partnership pay or accrue any interest or royalty for which the deduction is not allowed under section 267A? See instructions. If "Yes," enter the total amount of the disallowed deductions. ▶ $		
23	Did the partnership have an election under section 163(j) for any real property trade or business or any farming business in effect during the tax year? See instructions . . .		X
24	Does the partnership satisfy one of the following conditions and the partnership does not own a pass-through entity with current year, or prior year, carryover excess business interest expense? See instructions . . .	X	
a	The partnership's aggregate average annual gross receipts (determined under section 448(c)) for the 3 tax years preceding the current tax year do not exceed $25 million, and the partnership is not a tax shelter, or		
b	The partnership only has business interest expense from (1) an electing real property trade or business, (2) an electing farming business, or (3) certain utility businesses under section 163(j)(7). If "No," complete and attach Form 8990.		
25	Is the partnership electing out of the centralized partnership audit regime under section 6221(b)? See instructions. If "Yes," the partnership must complete Schedule B-2 (Form 1065). Enter the total from Schedule B-2, Part III, line 3. ▶ ______ If "No," complete Designation of Partnership Representative below.		X

Designation of Partnership Representative (see instructions)

Enter below the information for the partnership representative (PR) for the tax year covered by this return.

Name of PR ▶	Louis Griego	U.S. taxpayer identification number of PR ▶	455-81-5151
U.S. address of PR ▶	4825 Hackberry Las Cruces NM 88001	U.S. phone number of PR ▶	
If the PR is an entity, name of the designated individual for the PR ▶		U.S. taxpayer identification number of the designated individual ▶	
U.S. address of designated individual ▶		U.S. phone number of designated individual ▶	

		Yes	No
26	Is the partnership attaching Form 8996 to certify as a Qualified Opportunity Fund? . . . If "Yes," enter the amount from Form 8996, line 13. ▶ $		X

Form **1065** (2018)

Schedule K Partners' Distributive Share Items

					Total amount
Income (Loss)	1	Ordinary business income (loss) (page 1, line 22)		1	-18,893
	2	Net rental real estate income (loss) (attach Form 8825)		2	-19,857
	3a	Other gross rental income (loss)	3a		
	b	Expenses from other rental activities (attach statement)	3b		
	c	Other net rental income (loss). Subtract line 3b from line 3a		3c	0
	4	Guaranteed payments		4	57,000
	5	Interest income		5	
	6	Dividends and dividend equivalents: a Ordinary dividends		6a	
		b Qualified dividends	6b		
		c Dividend equivalents	6c		
	7	Royalties		7	
	8	Net short-term capital gain (loss) (attach Schedule D (Form 1065))		8	16,000
	9a	Net long-term capital gain (loss) (attach Schedule D (Form 1065))		9a	
	b	Collectibles (28%) gain (loss)	9b		
	c	Unrecaptured section 1250 gain (attach statement)	9c		
	10	Net section 1231 gain (loss) (attach Form 4797)		10	
	11	Other income (loss) (see instructions) Type ▶ Code I-Oth inc (loss)		11	-8,415
Deductions	12	Section 179 deduction (attach Form 4562)		12	
	13a	Contributions		13a	1,760
	b	Investment interest expense		13b	
	c	Section 59(e)(2) expenditures: (1) Type ▶ (2) Amount ▶		13c(2)	
	d	Other deductions (see instructions) Type ▶		13d	
Self-Employment	14a	Net earnings (loss) from self-employment		14a	26,132
	b	Gross farming or fishing income		14b	
	c	Gross nonfarm income		14c	
Credits	15a	Low-income housing credit (section 42(j)(5))		15a	
	b	Low-income housing credit (other)		15b	
	c	Qualified rehabilitation expenditures (rental real estate) (attach Form 3468, if applicable)		15c	
	d	Other rental real estate credits (see instructions) Type ▶		15d	
	e	Other rental credits (see instructions) Type ▶		15e	
	f	Other credits (see instructions) Type ▶		15f	
Foreign Transactions	16a	Name of country or U.S. possession ▶			
	b	Gross income from all sources		16b	
	c	Gross income sourced at partner level		16c	
		Foreign gross income sourced at partnership level			
	d	Section 951A category ▶ e Foreign branch category ▶		16e	
	f	Passive category ▶ g General category ▶ h Other (attach statement) ▶		16h	
		Deductions allocated and apportioned at partner level			
	i	Interest expense ▶ j Other ▶		16j	
		Deductions allocated and apportioned at partnership level to foreign source income			
	k	Section 951A category ▶ l Foreign branch category ▶		16l	
	m	Passive category ▶ n General category ▶ o Other (attach statement) ▶		16o	
	p	Total foreign taxes (check one): ▶ Paid ☐ Accrued ☐		16p	
	q	Reduction in taxes available for credit (attach statement)		16q	
	r	Other foreign tax information (attach statement)			
Alternative Minimum Tax (AMT) Items	17a	Post-1986 depreciation adjustment		17a	
	b	Adjusted gain or loss		17b	
	c	Depletion (other than oil and gas)		17c	
	d	Oil, gas, and geothermal properties—gross income		17d	
	e	Oil, gas, and geothermal properties—deductions		17e	
	f	Other AMT items (attach statement)		17f	
Other Information	18a	Tax-exempt interest income		18a	
	b	Other tax-exempt income		18b	
	c	Nondeductible expenses		18c	
	19a	Distributions of cash and marketable securities		19a	44,000
	b	Distributions of other property		19b	
	20a	Investment income		20a	
	b	Investment expenses		20b	
	c	Other items and amounts (attach statement)			

Form 1065 (2018)

Analysis of Net Income (Loss)

1	Net income (loss). Combine Schedule K, lines 1 through 11. From the result, subtract the sum of Schedule K, lines 12 through 13d, and 16p					1	24,075
2	Analysis by partner type:	(i) Corporate	(ii) Individual (active)	(iii) Individual (passive)	(iv) Partnership	(v) Exempt Organization	(vi) Nominee/Other
a	General partners		24,075				
b	Limited partners						

Schedule L Balance Sheets per Books

	Assets	Beginning of tax year (a)	(b)	End of tax year (c)	(d)
1	Cash				10,671
2a	Trade notes and accounts receivable			60,000	
b	Less allowance for bad debts		0	2,500	57,500
3	Inventories				58,961
4	U.S. government obligations				
5	Tax-exempt securities				
6	Other current assets (attach statement)				2,800
7a	Loans to partners (or persons related to partners)				
b	Mortgage and real estate loans				
8	Other investments (attach statement)				
9a	Buildings and other depreciable assets			1,318,963	
b	Less accumulated depreciation		0	40,765	1,278,198
10a	Depletable assets				
b	Less accumulated depletion		0		0
11	Land (net of any amortization)				115,445
12a	Intangible assets (amortizable only)				
b	Less accumulated amortization		0		0
13	Other assets (attach statement)				
14	Total assets		0		1,523,575
	Liabilities and Capital				
15	Accounts payable				26,000
16	Mortgages, notes, bonds payable in less than 1 year				
17	Other current liabilities (attach statement)				36,000
18	All nonrecourse loans				
19a	Loans from partners (or persons related to partners)				
b	Mortgages, notes, bonds payable in 1 year or more				901,000
20	Other liabilities (attach statement)				
21	Partners' capital accounts				560,575
22	Total liabilities and capital		0		1,523,575

Schedule M-1 Reconciliation of Income (Loss) per Books With Income (Loss) per Return

Note: The partnership may be required to file Schedule M-3. See instructions.

1	Net income (loss) per books	-35,425	6	Income recorded on books this year not included on Schedule K, lines 1 through 11 (itemize):	
2	Income included on Schedule K, lines 1, 2, 3c, 5, 6a, 7, 8, 9a, 10, and 11, not recorded on books this year (itemize):	0	a	Tax-exempt interest $	0
3	Guaranteed payments (other than health insurance)	57,000	7	Deductions included on Schedule K, lines 1 through 13d, and 16p, not charged against book income this year (itemize):	
4	Expenses recorded on books this year not included on Schedule K, lines 1 through 13d, and 16p (itemize):	See Statement	a	Depreciation $	0
a	Depreciation $		8	Add lines 6 and 7	0
b	Travel and entertainment $	2,500	9	Income (loss) (Analysis of Net Income (Loss), line 1). Subtract line 8 from line 5	24,075
5	Add lines 1 through 4	24,075			

Schedule M-2 Analysis of Partners' Capital Accounts

1	Balance at beginning of year		6	Distributions: a Cash	44,000
2	Capital contributed: a Cash	450,000		b Property	
	b Property	190,000	7	Other decreases (itemize):	
3	Net income (loss) per books	-35,425			
4	Other increases (itemize):	0	8	Add lines 6 and 7	44,000
5	Add lines 1 through 4	604,575	9	Balance at end of year. Subtract line 8 from line 5	560,575

Form **1065** (2018)

Form **8825** (Rev. November 2018) Department of the Treasury Internal Revenue Service

Rental Real Estate Income and Expenses of a Partnership or an S Corporation

▶ Attach to Form 1065 or Form 1120S.

▶ Go to *www.irs.gov/Form8825* for the latest information.

OMB No. 1545-0123

Name	Employer identification number
Kachina Properties	75-3185725

1 Show the type and address of each property. For each rental real estate property listed, report the number of days rented at fair rental value and days with personal use. See instructions. See page 2 to list additional properties.

	Physical address of each property—street, city, state, ZIP code	Type—Enter code 1–8; see page 2 for list	Fair Rental Days	Personal Use Days
A	Parkway Place Office Center - 1701 E. Lohman Las Cruces, NM 88005	4		
B				
C				
D				

			Properties A	Properties B	Properties C	Properties D
	Rental Real Estate Income					
2	Gross rents	2	54,000			
	Rental Real Estate Expenses					
3	Advertising	3				
4	Auto and travel	4				
5	Cleaning and maintenance	5				
6	Commissions	6				
7	Insurance	7	8,000			
8	Legal and other professional fees	8				
9	Interest (see instructions)	9	40,667			
10	Repairs	10				
11	Taxes	11	4,800			
12	Utilities	12				
13	Wages and salaries	13	3,560			
14	Depreciation (see instructions)	14	16,830			
15	Other (list) ▶	15				
16	Total expenses for each property. Add lines 3 through 15	16	73,857	0		
17	Income or (loss) from each property. Subtract line 16 from line 2	17	-19,857	0		

18a	Total gross rents. Add gross rents from line 2, columns A through H	18a	54,000
b	Total expenses. Add total expenses from line 16, columns A through H	18b	(73,857)
19	Net gain (loss) from Form 4797, Part II, line 17, from the disposition of property from rental real estate activities	19	
20a	Net income (loss) from rental real estate activities from partnerships, estates, and trusts in which this partnership or S corporation is a partner or beneficiary (from Schedule K-1)	20a	
b	Identify below the partnerships, estates, or trusts from which net income (loss) is shown on line 20a. Attach a schedule if more space is needed.		

(1) Name	(2) Employer identification number

21	Net rental real estate income (loss). Combine lines 18a through 20a. Enter the result here and on: • **Form 1065 or 1120S:** Schedule K, line 2	21	-19,857

For Paperwork Reduction Act Notice, see instructions. Form **8825** (Rev. 11-2018)

HTA

Form **1125-A** (Rev. November 2018) Department of the Treasury Internal Revenue Service

Cost of Goods Sold

► Attach to Form 1120, 1120-C, 1120-F, 1120S, or 1065.
► Go to *www.irs.gov/Form1125A* for the latest information.

OMB No. 1545-0123

Name	Employer identification number
Kachina Properties	75-3185725

1	Inventory at beginning of year	1	
2	Purchases	2	147,961
3	Cost of labor	3	
4	Additional section 263A costs (attach schedule)	4	
5	Other costs (attach schedule)	5	
6	**Total.** Add lines 1 through 5	6	147,961
7	Inventory at end of year	7	58,961
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on Form 1120, page 1, line 2 or the appropriate line of your tax return. See instructions	8	89,000

9 a Check all methods used for valuing closing inventory:

(i) [X] Cost

(ii) [ ] Lower of cost or market

(iii) [ ] Other (Specify method used and attach explanation.) ►

b Check if there was a writedown of subnormal goods ► [ ]

c Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ► [ ]

d If the LIFO inventory method was used for this tax year, enter amount of closing inventory computed under LIFO **9d**

e If property is produced or acquired for resale, do the rules of section 263A apply to the entity? See instructions [X] Yes [ ] No

f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? If "Yes," attach explanation [ ] Yes [X] No

For Paperwork Reduction Act Notice, see instructions.
HTA

Form **1125-A** (Rev. 11-2018)

Form **8949**

Department of the Treasury
Internal Revenue Service

Sales and Other Dispositions of Capital Assets

► Go to *www.irs.gov/Form8949* for instructions and the latest information.

► File with your Schedule D to list your transactions for lines 1b, 2, 3, 8b, 9, and 10 of Schedule D.

OMB No. 1545-0074

2018

Attachment Sequence No. **12A**

Name(s) shown on return	Social security number or taxpayer identification number
Kachina Properties	75-3185725

Before you check Box A, B, or C below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either will show whether your basis (usually your cost) was reported to the IRS by your broker and may even tell you which box to check.

Part I **Short-Term.** Transactions involving capital assets you held 1 year or less are generally short-term (see instructions). For long-term transactions, see page 2.

Note: You may aggregate all short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 1a; you aren't required to report these transactions on Form 8949 (see instructions).

You *must* check Box A, B, *or* C below. Check only one box. If more than one box applies for your short-term transactions, complete a separate Form 8949, page 1, for each applicable box. If you have more short-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

[X] **(A)** Short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)

[ ] **(B)** Short-term transactions reported on Form(s) 1099-B showing basis **wasn't** reported to the IRS

[ ] **(C)** Short-term transactions not reported to you on Form 1099-B

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis. See the **Note** below and see *Column (e)* in the separate instructions	Adjustment, if any, to gain or loss. If you enter an amount in column (g), enter a code in column (f). See the separate instructions. (f) Code(s) from instructions	(g) Amount of adjustment	(h) **Gain or (loss).** Subtract column (e) from column (d) and combine the result with column (g)
GCX Corporation Stock	3/12/2018	5/18/2018	36,000	20,000			16,000
2 Totals. Add the amounts in columns (d), (e), (g), and (h) (subtract negative amounts). Enter each total here and include on your Schedule D, **line 1b** (if **Box A** above is checked), **line 2** (if **Box B** above is checked), or **line 3** (if **Box C** above is checked) . ►			36,000	20,000		0	16,000

Note: If you checked Box A above but the basis reported to the IRS was incorrect, enter in column (e) the basis as reported to the IRS, and enter an adjustment in column (g) to correct the basis. See *Column (g)* in the separate instructions for how to figure the amount of the adjustment.

For Paperwork Reduction Act Notice, see your tax return instructions.

HTA

Form **8949** (2018)

SCHEDULE D (Form 1065)

Department of the Treasury
Internal Revenue Service

Capital Gains and Losses

▶ Attach to Form 1065 or Form 8865.
▶ Use Form 8949 to list your transactions for lines 1b, 2, 3, 8b, 9, and 10.
▶ Go to *www.irs.gov/Form1065* for instructions and the latest information.

OMB No. 1545-0123

2018

Name of partnership	Employer identification number
Kachina Properties	75-3185725

Part I Short-Term Capital Gains and Losses—Generally Assets Held One Year or Less (see instructions)

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
1a Totals for all short-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 1b . .				0
1b Totals for all transactions reported on Form(s) 8949 with **Box A** checked	36,000	20,000		16,000
2 Totals for all transactions reported on Form(s) 8949 with **Box B** checked				0
3 Totals for all transactions reported on Form(s) 8949 with **Box C** checked				0

4 Short-term capital gain from installment sales from Form 6252, line 26 or 37	4	
5 Short-term capital gain or (loss) from like-kind exchanges from Form 8824	5	
6 Partnership's share of net short-term capital gain (loss), including specially allocated short-term capital gains (losses), from other partnerships, estates, and trusts	6	
7 **Net short-term capital gain or (loss).** Combine lines 1a through 6 in column (h). Enter here and on Form 1065, Schedule K, line 8 or 11; or Form 8865, Schedule K, line 8 or 11	7	16,000

Part II Long-Term Capital Gains and Losses—Generally Assets Held More Than One Year (see instructions)

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part II, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
8a Totals for all long-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 8b . .				0
8b Totals for all transactions reported on Form(s) 8949 with **Box D** checked				0
9 Totals for all transactions reported on Form(s) 8949 with **Box E** checked				0
10 Totals for all transactions reported on Form(s) 8949 with **Box F** checked				0

11 Long-term capital gain from installment sales from Form 6252, line 26 or 37	11	
12 Long-term capital gain or (loss) from like-kind exchanges from Form 8824	12	
13 Partnership's share of net long-term capital gain (loss), including specially allocated long-term capital gains (losses), from other partnerships, estates, and trusts	13	
14 Capital gain distributions (see instructions).	14	
15 **Net long-term capital gain or (loss).** Combine lines 8a through 14 in column (h). Enter here and on Form 1065, Schedule K, line 9a or 11; or Form 8865, Schedule K, line 9a or 11	15	0

For Paperwork Reduction Act Notice, see the Instructions for Form 1065.
HTA

Schedule D (Form 1065) 2018

651118

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

Schedule K-1 (Form 1065) **2018**

Department of the Treasury
Internal Revenue Service

For calendar year 2018, or tax year

beginning ________ ending ________

Partner's Share of Income, Deductions, Credits, etc.

► See back of form and separate instructions.

Part I Information About the Partnership

A Partnership's employer identification number
75-3185725

B Partnership's name, address, city, state, and ZIP code
Kachina Properties
1701 E. Lohman
Las Cruces, NM 88005

C IRS Center where partnership filed return
e-file

D ☐ Check if this is a publicly traded partnership (PTP)

Part II Information About the Partner

E Partner's identifying number Partner: 1
459-34-5939

F Partner's name, address, city, state, and ZIP code
Kathleen Martin
1519 Harness
Las Cruces, NM 88003

G ☒ General partner or LLC member-manager ☐ Limited partner or other LLC member

H ☒ Domestic partner ☐ Foreign partner

I1 What type of entity is this partner? Active Individual

I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here ☐

J Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	35.150000%	35.150000%
Loss	35.150000%	35.150000%
Capital	35.150000%	35.150000%

K Partner's share of liabilities:

	Beginning	Ending
Nonrecourse	$	$
Qualified nonrecourse financing	$	$ 316,701
Recourse	$	$ 21,793

L Partner's capital account analysis:

Beginning capital account	$
Capital contributed during the year	$ 225,000
Current year increase (decrease)	$ -3,578
Withdrawals & distributions	$ (15,466)
Ending capital account	$ 205,956

☐ Tax basis ☐ GAAP ☒ Section 704(b) book
☐ Other (explain)

M Did the partner contribute property with a built-in gain or loss?
☐ Yes ☒ No
If "Yes," attach statement (see instructions)

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)		-6,641
2	Net rental real estate income (loss)		-1,064
3	Other net rental income (loss)		
4	Guaranteed payments		32,000
5	Interest income		
6a	Ordinary dividends		
6b	Qualified dividends		
6c	Dividend equivalents		
7	Royalties		
8	Net short-term capital gain (loss)		5,624
9a	Net long-term capital gain (loss)		
9b	Collectibles (28%) gain (loss)		
9c	Unrecaptured section 1250 gain		
10	Net section 1231 gain (loss)		
11	Other income (loss)		
12	Section 179 deduction		
13	Other deductions	A	618
14	Self-employment earnings (loss)	A	25,359
15	Credits		
16	Foreign transactions		
17	Alternative minimum tax (AMT) items		
18	Tax-exempt income and nondeductible expenses		
19	Distributions	A	15,466
20	Other information	Z	24,295
		AA	12,513
		AB	489,865

*See attached statement for additional information.

For IRS Use Only

For Paperwork Reduction Act Notice, see Instructions for Form 1065. www.irs.gov/Form1065 Schedule K-1 (Form 1065) 2018
HTA

Kathleen Martin 459-34-5939

K-1 Statement (Sch K-1, Form 1065)

Line 2 - Net Rental Real Estate Income (Loss)

Description	Property Type		Net Income (Loss)
Parkway Place Office Center	4		-1,064
			0
Total Net Rental Real Estate Income (Loss)		2	-1,064

Line 13 - Deductions

A Code A - Cash contributions (60%)	A	618

Line 14 - Self-Employment

A Code A - Net earnings (loss) from self-employment	A	25,359

Line 19 - Distributions

A Code A - Cash and marketable securities	A	15,466

Line 20 - Other Information

Section 199A Information	Service	Non-Service	Total
Z Code Z - Section 199A income Z	0	Z -7,705	Z -7,705
AA Code AA - Section 199A W-2 wages AA	0	AA 12,513	AA 12,513
AB Code AB - Section 199A Unadjusted basis AB	0	AB 463,616	AB 463,616
Retail	-		
Z Code Z - Section 199A income Z	0	Z -6,641	Z -6,641
AA Code AA - Section 199A W-2 wages AA	0	AA 11,262	AA 11,262
AB Code AB - Section 199A Unadjusted basis AB	0	AB 154,539	AB 154,539
Rental	-		
Z Code Z - Section 199A income Z	0	Z -1,064	Z -1,064
AA Code AA - Section 199A W-2 wages AA	0	AA 1,251	AA 1,251
AB Code AB - Section 199A Unadjusted basis AB	0	AB 309,077	AB 309,077

651118

Final K-1 ☐ Amended K-1 ☐ OMB No. 1545-0123

Schedule K-1 (Form 1065) **2018**

Department of the Treasury
Internal Revenue Service

For calendar year 2018, or tax year beginning ______ ending ______

Partner's Share of Income, Deductions, Credits, etc.

▶ See back of form and separate instructions.

Part I Information About the Partnership

A Partnership's employer identification number
75-3185725

B Partnership's name, address, city, state, and ZIP code
Kachina Properties
1701 E. Lohman
Las Cruces, NM 88005

C IRS Center where partnership filed return
e-file

D ☐ Check if this is a publicly traded partnership (PTP)

Part II Information About the Partner

E Partner's identifying number Partner: 2
454-66-3333

F Partner's name, address, city, state, and ZIP code
Ellen Harkin
1750 Madison
Albuquerque, NM 87131

G [X] General partner or LLC member-manager ☐ Limited partner or other LLC member

H [X] Domestic partner ☐ Foreign partner

I1 What type of entity is this partner? Active Individual

I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here ☐

J Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	35.150000%	35.150000%
Loss	35.150000%	35.150000%
Capital	35.150000%	35.150000%

K Partner's share of liabilities:

	Beginning	Ending
Nonrecourse	$	$
Qualified nonrecourse financing	$	$ 316,702
Recourse	$	$ 21,793

L Partner's capital account analysis:

Beginning capital account	$
Capital contributed during the year	$ 225,000
Current year increase (decrease)	$ -3,578
Withdrawals & distributions	$ (15,466)
Ending capital account	$ 205,956

☐ Tax basis ☐ GAAP [X] Section 704(b) book
☐ Other (explain)

M Did the partner contribute property with a built-in gain or loss?
☐ Yes [X] No
If "Yes," attach statement (see instructions)

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)	-6,641
2	Net rental real estate income (loss)	-1,064
3	Other net rental income (loss)	
4	Guaranteed payments	25,000
5	Interest income	
6a	Ordinary dividends	
6b	Qualified dividends	
6c	Dividend equivalents	
7	Royalties	
8	Net short-term capital gain (loss)	5,624
9a	Net long-term capital gain (loss)	
9b	Collectibles (28%) gain (loss)	
9c	Unrecaptured section 1250 gain	
10	Net section 1231 gain (loss)	
11	Other income (loss)	
12	Section 179 deduction	
13	Other deductions	
A		619
14	Self-employment earnings (loss)	
A		18,359
15	Credits	
16	Foreign transactions	
17	Alternative minimum tax (AMT) items	
18	Tax-exempt income and nondeductible expenses	
19	Distributions	
A		15,466
20	Other information	
Z		17,295
AA		12,513
AB		489,866

*See attached statement for additional information.

For IRS Use Only

For Paperwork Reduction Act Notice, see Instructions for Form 1065. www.irs.gov/Form1065 Schedule K-1 (Form 1065) 2018
HTA

Ellen Harkin 454-66-3333

K-1 Statement (Sch K-1, Form 1065)

Line 2 - Net Rental Real Estate Income (Loss)

Description	Property Type		Net Income (Loss)
Parkway Place Office Center	4		-1,064
			0
Total Net Rental Real Estate Income (Loss)		2	-1,064

Line 13 - Deductions

A Code A - Cash contributions (60%)	A	619

Line 14 - Self-Employment

A Code A - Net earnings (loss) from self-employment	A	18,359

Line 19 - Distributions

A Code A - Cash and marketable securities	A	15,466

Line 20 - Other Information

Section 199A Information		Service		Non-Service		Total
Z Code Z - Section 199A income	Z	0	Z	-7,705	Z	-7,705
AA Code AA - Section 199A W-2 wages	AA	0	AA	12,513	AA	12,513
AB Code AB - Section 199A Unadjusted basis	AB	0	AB	463,615	AB	463,615
Retail						
Z Code Z - Section 199A income	Z	0	Z	-6,641	Z	-6,641
AA Code AA - Section 199A W-2 wages	AA	0	AA	11,262	AA	11,262
AB Code AB - Section 199A Unadjusted basis	AB	0	AB	154,538	AB	154,538
Rental						
Z Code Z - Section 199A income	Z	0	Z	-1,064	Z	-1,064
AA Code AA - Section 199A W-2 wages	AA	0	AA	1,251	AA	1,251
AB Code AB - Section 199A Unadjusted basis	AB	0	AB	309,077	AB	309,077

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☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

Schedule K-1 (Form 1065) **2018**

Department of the Treasury
Internal Revenue Service

For calendar year 2018, or tax year

beginning ____ ending ____

Partner's Share of Income, Deductions, Credits, etc.

▶ See back of form and separate instructions.

Part I Information About the Partnership

A Partnership's employer identification number
75-3185725

B Partnership's name, address, city, state, and ZIP code
Kachina Properties
1701 E. Lohman
Las Cruces, NM 88005

C IRS Center where partnership filed return
e-file

D ☐ Check if this is a publicly traded partnership (PTP)

Part II Information About the Partner

E Partner's identifying number Partner: 3
455-81-5151

F Partner's name, address, city, state, and ZIP code
Louis Griego
4825 Hackberry
Las Cruces, NM 88001

G [X] General partner or LLC member-manager ☐ Limited partner or other LLC member

H [X] Domestic partner ☐ Foreign partner

I1 What type of entity is this partner? Active Individual

I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here ☐

J Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	29.700000%	29.700000%
Loss	29.700000%	29.700000%
Capital	29.700000%	29.700000%

K Partner's share of liabilities:

	Beginning	Ending
Nonrecourse	$	$
Qualified nonrecourse financing	$	$ 267,597
Recourse	$	$ 18,414

L Partner's capital account analysis:

Beginning capital account	$
Capital contributed during the year	$ 190,000
Current year increase (decrease)	$ -28,269
Withdrawals & distributions	$ (13,068)
Ending capital account	$ 148,663

☐ Tax basis ☐ GAAP [X] Section 704(b) book
☐ Other (explain)

M Did the partner contribute property with a built-in gain or loss?
[X] Yes ☐ No
If "Yes," attach statement (see instructions)

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)	-5,611
2	Net rental real estate income (loss)	-17,729
3	Other net rental income (loss)	
4	Guaranteed payments	
5	Interest income	
6a	Ordinary dividends	
6b	Qualified dividends	
6c	Dividend equivalents	
7	Royalties	
8	Net short-term capital gain (loss)	4,752
9a	Net long-term capital gain (loss)	
9b	Collectibles (28%) gain (loss)	
9c	Unrecaptured section 1250 gain	
10	Net section 1231 gain (loss)	
11	Other income (loss)	
I		-8,415
12	Section 179 deduction	
13	Other deductions	
A		523
14	Self-employment earnings (loss)	
A		-14,026
15	Credits	
16	Foreign transactions	
17	Alternative minimum tax (AMT) items	
18	Tax-exempt income and nondeductible expenses	
19	Distributions	
A		13,068
20	Other information	
Z		-31,755
AA		10,573
AB		413,912

*See attached statement for additional information.

For IRS Use Only

For Paperwork Reduction Act Notice, see Instructions for Form 1065. www.irs.gov/Form1065 Schedule K-1 (Form 1065) 2018
HTA

Louis Griego 455-81-5151

K-1 Statement (Sch K-1, Form 1065)

Line 2 - Net Rental Real Estate Income (Loss)

Description	Property Type		Net Income (Loss)
Parkway Place Office Center	4		-17,729
			0
Total Net Rental Real Estate Income (Loss)		2	-17,729

Line 11 - Other Income (Loss)

I Code I - Other income (loss)

Building depreciation specially allocated to Louis Griego		-8,415
Total Code I - Other income (loss)	I	-8,415

Line 13 - Deductions

A Code A - Cash contributions (60%)	A	523

Line 14 - Self-Employment

A Code A - Net earnings (loss) from self-employment	A	-14,026

Line 19 - Distributions

A Code A - Cash and marketable securities	A	13,068

Line 20 - Other Information

Section 199A Information		**Service**		**Non-Service**		**Total**
Z Code Z - Section 199A income	**Z**	0	**Z**	-31,755	**Z**	-31,755
AA Code AA - Section 199A W-2 wages	**AA**	0	**AA**	10,573	**AA**	10,573
AB Code AB - Section 199A Unadjusted basis	**AB**	0	**AB**	391,732	**AB**	391,732
Retail						
Z Code Z - Section 199A income	**Z**	0	**Z**	-5,611	**Z**	-5,611
AA Code AA - Section 199A W-2 wages	**AA**	0	**AA**	9,516	**AA**	9,516
AB Code AB - Section 199A Unadjusted basis	**AB**	0	**AB**	130,577	**AB**	130,577
Rental						
Z Code Z - Section 199A income	**Z**	0	**Z**	-17,729	**Z**	-17,729
AA Code AA - Section 199A W-2 wages	**AA**	0	**AA**	1,057	**AA**	1,057
AB Code AB - Section 199A Unadjusted basis	**AB**	0	**AB**	261,155	**AB**	261,155

Form **4562**

Department of the Treasury
Internal Revenue Service (99)

Depreciation and Amortization

(Including Information on Listed Property)

► **Attach to your tax return.**

► **Go to *www.irs.gov/Form4562* for instructions and the latest information.**

OMB No. 1545-0172

2018

Attachment Sequence No. **179**

Name(s) shown on return	Business or activity to which this form relates	Identifying number
Kachina Properties	1065 - Retail Sales	75-3185725

Part I Election To Expense Certain Property Under Section 179

Note: If you have any listed property, complete Part V before you complete Part I.

1	Maximum amount (see instructions)	1	
2	Total cost of section 179 property placed in service (see instructions)	2	
3	Threshold cost of section 179 property before reduction in limitation (see instructions)	3	
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	0
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions	5	0

6 (a) Description of property	(b) Cost (business use only)	(c) Elected cost

7	Listed property. Enter the amount from line 29	7	
8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	0
9	Tentative deduction. Enter the **smaller** of line 5 or line 8	9	0
10	Carryover of disallowed deduction from line 13 of your 2017 Form 4562	10	
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5. See instructions	11	
12	Section 179 expense deduction. Add lines 9 and 10, but don't enter more than line 11	12	0
13	Carryover of disallowed deduction to 2019. Add lines 9 and 10, less line 12 ►	13	0

Note: Don't use Part II or Part III below for listed property. Instead, use Part V.

Part II Special Depreciation Allowance and Other Depreciation (Don't include listed property. See instructions.)

14	Special depreciation allowance for qualified property (other than listed property) placed in service during the tax year. See instructions	14	
15	Property subject to section 168(f)(1) election	15	
16	Other depreciation (including ACRS)	16	

Part III MACRS Depreciation (Don't include listed property. See instructions.)

Section A

17	MACRS deductions for assets placed in service in tax years beginning before 2018	17	23,935
18	If you are electing to group any assets placed in service during the tax year into one or more general asset accounts, check here ► ☐		

Section B - Assets Placed in Service During 2018 Tax Year Using the General Depreciation System

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19 a 3-year property						
b 5-year property						
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property			25 yrs.		S/L	
h Residential rental			27.5 yrs.	MM	S/L	
property			27.5 yrs.	MM	S/L	
i Nonresidential real			39 yrs.	MM	S/L	
property				MM	S/L	

Section C - Assets Placed in Service During 2018 Tax Year Using the Alternative Depreciation System

(a) Classification of property	(b)	(c)	(d)	(e)	(f)	(g)
20 a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 30-year			30 yrs.	MM	S/L	
d 40-year			40 yrs.	MM	S/L	

Part IV Summary (See instructions.)

21	Listed property. Enter amount from line 28	21	
22	**Total.** Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instructions	22	23,935
23	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	23	

For Paperwork Reduction Act Notice, see separate instructions.

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Form 4562 (2018)

Form **4562** | Department of the Treasury Internal Revenue Service (99)

Depreciation and Amortization

(Including Information on Listed Property)

► **Attach to your tax return.**

► **Go to *www.irs.gov/Form4562* for instructions and the latest information.**

OMB No. 1545-0172 | **2018** | Attachment Sequence No. **179**

Name(s) shown on return	Business or activity to which this form relates	**Identifying number**
Kachina Properties	8825: 01 - Parkway Place Office Center	75-3185725

Part I — Election To Expense Certain Property Under Section 179

Note: If you have any listed property, complete Part V before you complete Part I.

1	Maximum amount (see instructions)	1	
2	Total cost of section 179 property placed in service (see instructions)	2	
3	Threshold cost of section 179 property before reduction in limitation (see instructions)	3	
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	0
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions	5	0

6 (a) Description of property	(b) Cost (business use only)	(c) Elected cost

7	Listed property. Enter the amount from line 29	7	
8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	0
9	Tentative deduction. Enter the **smaller** of line 5 or line 8	9	0
10	Carryover of disallowed deduction from line 13 of your 2017 Form 4562	10	
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5. See instructions	11	
12	Section 179 expense deduction. Add lines 9 and 10, but don't enter more than line 11	12	0
13	Carryover of disallowed deduction to 2019. Add lines 9 and 10, less line 12 ►	13	0

Note: Don't use Part II or Part III below for listed property. Instead, use Part V.

Part II — Special Depreciation Allowance and Other Depreciation (Don't include listed property. See instructions.)

14	Special depreciation allowance for qualified property (other than listed property) placed in service during the tax year. See instructions	14	
15	Property subject to section 168(f)(1) election	15	
16	Other depreciation (including ACRS)	16	

Part III — MACRS Depreciation (Don't include listed property. See instructions.)

Section A

17	MACRS deductions for assets placed in service in tax years beginning before 2018	17	16,830
18	If you are electing to group any assets placed in service during the tax year into one or more general asset accounts, check here ► X		

Section B - Assets Placed in Service During 2018 Tax Year Using the General Depreciation System

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19 a 3-year property						
b 5-year property						
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property			25 yrs.		S/L	
h Residential rental			27.5 yrs.	MM	S/L	
property			27.5 yrs.	MM	S/L	
i Nonresidential real			39 yrs.	MM	S/L	
property				MM	S/L	

Section C - Assets Placed in Service During 2018 Tax Year Using the Alternative Depreciation System

20 a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 30-year			30 yrs.	MM	S/L	
d 40-year			40 yrs.	MM	S/L	

Part IV — Summary (See instructions.)

21	Listed property. Enter amount from line 28	21	
22	**Total.** Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instructions	22	16,830
23	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	23	

For Paperwork Reduction Act Notice, see separate instructions. Form 4562 (2018)

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Form **8453-PE**

Department of the Treasury
Internal Revenue Service

U.S. Partnership Declaration for an IRS *e-file* Return

▶ **File electronically with the partnership's return. Do not file paper copies.**
▶ **Go to *www.irs.gov/Form8453PE* for the latest information.**

OMB No. 1545-0123

2018

For calendar year 2018, or tax year beginning , 2018, and ending , 20 .

Name of partnership	Employer identification number
Kachina Properties	75-3185725

Part I Return Information (Whole dollars only)

1	Gross receipts or sales less returns and allowances (Form 1065, line 1c)	1	212,500
2	Gross profit (Form 1065, line 3)	2	123,500
3	Ordinary business income (loss) (Form 1065, line 22)	3	-18,893
4	Net rental real estate income (loss) (Form 1065, Schedule K, line 2)	4	-19,857
5	Other net rental income (loss) (Form 1065, Schedule K, line 3c)	5	

Part II Declaration of Partner or Member (see instructions)

Be sure to keep a copy of the partnership's Return of Partnership Income.

Under penalties of perjury, I declare that I'm a partner or member of the above partnership and that the information I've given my electronic return originator (ERO), transmitter, and/or intermediate service provider (ISP) and the amounts in Part I above agree with the amounts on the corresponding lines of the partnership's 2018 federal return of partnership income. To the best of my knowledge and belief, the partnership's return is true, correct, and complete. I consent to my ERO, transmitter, and/or ISP sending the partnership's return, this declaration, and accompanying schedules and statements to the IRS. I also consent to the IRS sending my ERO, transmitter, and/or ISP an acknowledgement of receipt of transmission and an indication of whether or not the partnership's return is accepted and, if rejected, the reason(s) for the rejection. If the processing of the partnership's return is delayed, I authorize the IRS to disclose to my ERO, transmitter, and/or ISP the reason(s) for the delay.

Sign Here ▶ Signature of partner or member | Date ▶ Title

Part III Declaration of Electronic Return Originator (ERO) and Paid Preparer (see instructions)

I declare that I've reviewed the above partnership's return and that the entries on Form 8453-PE are complete and correct to the best of my knowledge. If I'm only a collector, I'm not responsible for reviewing the return and only declare that this form accurately reflects the data on the return. The partner or member will have signed this form before I submit the return. I'll give the partner or member a copy of all forms and information to be filed with the IRS, and I've followed all other requirements in **Pub. 3112,** IRS *e-file* Application and Participation, and **Pub. 4163,** Modernized e-file (MeF) Information for Authorized IRS *e-file* Providers for Business Returns. If I'm also the Paid Preparer, under penalties of perjury, I declare that I've examined the above partnership's return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. This Paid Preparer declaration is based on all information of which I've any knowledge.

ERO's Use Only					
	ERO's signature ▶	Date	Check if also paid preparer ☐	Check if self-employed ☐	ERO's SSN or PTIN
	Firm's name (or yours if self-employed), address, and ZIP code ▶			EIN	
				Phone no.	

Under penalties of perjury, I declare that I've examined the above partnership's return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. This declaration is based on all information of which I've any knowledge.

Paid Preparer Use Only					
	Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
	Firm's name ▶			Firm's EIN ▶	
	Firm's address ▶			Phone no.	

For Privacy Act and Paperwork Reduction Act Notice, see instructions. Form **8453-PE** (2018)

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Line 20 (1065) - Other Deductions

1	Insurance	1	4,000
2	Total other deductions	2	4,000

Line 11, Sch K (1065) - Other Income (Loss)

I	Code I - Other income (loss)		
	Building depreciation specially allocated to Louis Griego		-8,415
	Total Code I - Other income (loss)	I	-8,415
	Total other income (loss)	11	-8,415

Line 13a, Sch K (1065) - Contributions

A	Code A - Cash contributions (60%)	A	1,760
	Total contributions	13a	1,760

Line 19, Sch K (1065) - Distributions

		Adjusted Basis		Fair Market Value
A	Code A - Distributions of cash and marketable securities			
	Distributions of cash			44,000
	Total distributions of cash and marketable securities		A	44,000

Line 20c, Sch K (1065) - Other Information

			Service		Non-Service
Z	Code Z - Section 199A income	Z	0	Z	-38,750
AA	Code AA - Section 199A W-2 wages	AA	0	AA	35,600
AB	Code AB - Section 199A unadjusted basis	AB	0	AB	1,393,643

Line 6, Sch L (1065) - Other Current Assets

			Beginning	Ending
1	Short-term investments	1		2,800
2	Total other current assets	2	0	2,800

Line 17, Sch L (1065) - Other Current Liabilities

			Beginning	Ending
1	Tenant Deposits	1		36,000
2	Total other current liabilities	2	0	36,000

Line 4, Sch M-1 (1065) - Expenses on Books Not on Sch K, lines 1 through 13d and 16p

1	Bad debt expense	1	2,500
2	Total expenses on books not on Sch K, lines 1 through 13d and 16p	2	2,500

Discussion of key figures in return

Form 1065, *U.S. Return of Partnership Income*

Identifying information at the top of the return largely comes from the facts provided in the sample problem. Some information reported at the top of the return, however, must be determined by the preparer:

Box A—Principal business activity: For this item, we need additional information clarifying the breakdown of financial data between the partnership's retail activity and its restaurant activity. Lacking that information, we are assuming that the partnership's retail activity generates the largest amount of revenue and constitutes its principal business activity.

Box B—Principal product or service: Because we are assuming that the retail activity is the partnership's principal business activity, we list office supplies as its principal product.

Box C—Business code number: This number is a six-digit number used by the IRS to classify information from the return for record-keeping purposes. This number comes from the instructions to Form 1065.

Box E—Date business started: This date may be difficult to find if it is not accurately reported on prior year returns. In this case, this is the partnership's first year, so the date is relatively easily identified (and is provided in the facts).

Box F—Total assets: This figure comes from Schedule L, Line 14 (page 5 of Form 1065).

Boxes G, H and I: This is Kachina Properties' initial tax return, and the facts state that the partnership uses the accrual method of accounting. Note that the method of accounting is a partnership-level election and that any subsequent change in accounting methods will require permission from the IRS and amortization of any effect on income resulting from such change. Line I requires that the partnership report the number of partners for whom Schedules K-1 will be filed.

Line 1a—Gross receipts or sales: Kachina Properties is engaged in three activities: rental of the top two floors of the office building, operation of a retail office supplies store, and operation of a restaurant, both on the first floor. Income from the rental activity is reported separately on Form 8825, and Schedule K, Line 2. Therefore, on page 1 of Form 1065, we report only the sales revenue from the restaurant and retail activities.

Line 2—Cost of goods sold: Cost of goods sold is calculated on Form 1125-A. From the trial balance, we see that Kachina Properties had purchases of $147,961 in 2018. The ending inventory of $58,961 is typically not reported on the trial balance unless the company uses a perpetual inventory system. Here, the figure presumably arises from a year-end inventory count. Preparers should be sure to check the appropriate boxes on Form 1125-A, Lines 9a through 9f.

Line 9—Salaries and wages: This figure comes directly from the trial balance for Kachina Properties.

Line 10—Guaranteed payments to partners: The partnership made two types of payments to its partners: (1) payments structured as salaries; and (2) distributions. The first category is contractually guaranteed by the partnership, generally but not always in the form of a promise to pay a fixed amount in exchange for services provided by the partnership. The proper classification of such payments is dependent on whether or not they are dependent on partnership income. For example, if the partnership promised to pay Ellen 10 percent of net income from the restaurant, the payment would not constitute a guaranteed payment and therefore would not be deductible by the partnership. In this case, Ellen is guaranteed a fixed amount—$25,000, and Kathleen is guaranteed a fixed payment of $32,000. Therefore, the partnership is entitled to a deduction of $57,000 on Line 10.

Line 12—Bad debts: Note that Kachina Properties cannot deduct its $2,500 bad debt expense because the IRC requires use of the specific charge-off method for tax purposes. The notes accompanying the trial balance indicate that the partnership's deduction using the specific charge-off method would be $0.

Line 14—Taxes and licenses: This figure consists of the following amounts from the trial balance:

$2,800	in payroll taxes
$2,400	(one-third of the total) in property taxes on the building (The remaining two-thirds are allocable to the rental activity.)
$4,300	in property taxes on the furniture and fixtures and inventory
$9,500	

Line 16a—Depreciation: This figure consists of total depreciation expense less the depreciation expense on the building. See the attached Form 4562.

Line 16b—Less depreciation reported on Schedule A and elsewhere on return: Depreciation expense on the building, which is allocated 100 percent to Louis Griego, is subtracted from total depreciation on page 1 and separately reported on Schedule K and Form 8825.

Line 19—Employee benefit programs: This figure comes directly from the trial balance for Kachina Properties.

Line 20—Other deductions: This figure represents one-third of the partnership's insurance expense, allocable to the retail or restaurant activities. The partnership should attach a statement to the return itemizing all amounts included on this line. In this case, it would ordinarily be sufficient to write "insurance expense" to the left of the box on Line 20.

Schedule B—Other Information: The preparer should be careful to answer each question in this part of the return, including the type of entity as requested on Line 1, boxes a–f. Of particular interest for many partnerships is question 6. If the partnership has gross receipts of less than $250,000, total assets less than $1,000,000, timely files its tax return, along with all related Schedules K-1, and is not filing and is not required to file Schedule M-3, Schedules L, M-1 and M-2 do not have to be completed. Kachina Properties satisfies the gross receipts requirement, but its total assets are well in excess of $1,000,000.

Schedule K Partners' Distributive Share Items

Line 1—Ordinary business income: This figure comes directly from Form 1065, page 1, Line 22.

Line 2—Net rental real estate income (loss): This figure comes from Form 8825, and consists of Kachina's rental income less one-third of the insurance, interest and depreciation expense associated with the building. Depreciation specially allocated to Louis Griego is fully deducted by the partnership in computing its net rental real estate income. Louis's special allocation will be reflected in his share of Kachina's net rental income on Schedule K-1.

Line 4—Guaranteed payments: On this line the partnership reports guaranteed payments paid to partners. Though deducted in computing net trade or business income, guaranteed payments are reported again here; they will be added back to trade or business income, and netted against other separately stated items, in computing the partnership's total net income (loss) at the top of page 4. They are also included in partnership self-employment income on Schedule K, Line 14a.

Line 8—Net short-term capital gain (loss): This figure comes from Form 1065, Schedule D.

Line 11—Other income (loss): This figure is the depreciation expense on the first floor of the building, which is specially allocated to Louis Griego. The instructions to Form 1065 (page 29) require that specially allocated items of trade or business income or expense are separately stated on Schedule K, Line 11.

Line 13a—Contributions: This figure comes directly from the trial balance for Kachina Properties. It is not deducted in computing the partnership's trade or business income on page 1 of Form 1065.

Line 14a—Net earnings (loss) from self-employment: This figure is the sum of the net loss reported on Schedule K, Line 1, the guaranteed payments paid to Ellen and Kathleen, and the depreciation expense attributable to the partnership's retail or restaurant activities which is specially allocated to Louis. Note that the instructions to Form 1065 (see page 34, "Worksheet for Figuring Net Earnings (Loss) From Self-Employment") do not directly address inclusion of the specially allocated depreciation in computing net self-employment income. However, because this amount would be deducted in computing the partnership's net trade or business income if it had not been specially allocated to Louis, it should be deducted in computing net earnings from self-employment.

Line 17a—Post-1986 depreciation adjustment: For property placed in service after 1988, an AMT adjustment for depreciation is required only if the property is depreciated using the 200 percent declining balance method. Therefore, there will be no depreciation adjustment for real estate placed in service after 1988 (or for leasehold improvements placed in service after that date). Kachina Properties will not have a depreciation adjustment for 2018 because the equipment was depreciated on the straight line method of accounting. For AMT purposes, the 150 percent declining balance method must be used, rather than the 200 percent declining balance method typically used for regular tax purposes. The notes accompanying the trial balance indicate that this adjustment is assumed to be $0 for 2018.

Line 18c—Nondeductible expenses: Although there are $2,500 of bad debt expenses that are nondeductible because they have yet to be specifically charged off, the instructions for Line 18c indicate that deductions which are deferred until a later year should not be included on this line. This keeps the partners from reducing their basis twice for the same item—once if included on Line 18c and once when actually deducted. Bad debts in this case would fall into that category.

Line 19a—Distributions of cash and marketable securities: This figure comes directly from the trial balance for Kachina Properties.

Line 20c—Qualified business income deduction information: These disclosures allow the partners to calculate the deduction. The items are allocated as follows:

Item	Code	Restaurant/retail	Rental
Income	Z	-$22,453	-$16,297
W-2 Wages ($35,600)	AA	$32,040 (90%)	$3,500 (10%)
Assets ($1,278,198 + $115,445)	AB	$464,548 (1/3)	$929,095(2/3)

Analysis of net income loss (top of page 5)

Line 1—Net income (loss): This figure is the sum of the partnership's net trade or business income, its net income or loss from rental real estate activities, guaranteed payments made to the partners (added back here as discussed previously), the short-term capital gain from sale of GCX stock, the depreciation attributable to the retail or restaurant activity specially allocated to Louis, and the charitable contribution(s) reported on Line 13a.

Line 2—Analysis by partner type: All three partners in Kachina Properties are individual general partners. Therefore, the entire amount reported on Line 1 goes on Line a, Column (ii).

Schedule L—Balance sheets per books: Schedule L reports the partnership's beginning and ending balance sheets. Because this is Kachina Properties' first year of operations, its beginning balance sheets are blank. Most figures on the ending balance sheet come from the trial balance. Note, however, the following items which require additional computation:

- The balance in inventories (Line 3) comes from the year-end inventory count reported in the notes accompanying Kachina Properties' trial balance.
- The balance in Partners' capital accounts (Line 21) comes from Schedule M-2, at the bottom of Form 1065, page 5.

Schedule M-1, Reconciliation of Income (Loss) per Books with Income (Loss) per Return

Line 1—Net income (loss) per books: This figure is calculated from the partnership's trial balance and the accompanying notes. In computing book income, all items are netted together without regard to whether or not they are separately stated in the partnership's tax return. In Kachina Properties' case, this figure is equal to the sum of the ($22,453) trade or business loss, the ($16,297) rental real estate loss, the $1,760 charitable contributions, the $16,000 short-term capital gain, per Form 8949, ($8,415) in the specially allocated depreciation, and the $2,500 in bad debt expense not deductible for tax purposes (because the IRC requires use of the specific charge-off method).

Line 3—Guaranteed payments: Guaranteed payments are added back to book income to arrive at net income (loss) per return. This is not surprising because these payments are also added back when computing net taxable income or loss on Line 1 at the top of Form 1065, page 5.

Line 4—Expenses recorded on books this year not included on Schedule K: This figure represents the bad debt expense recorded on Kachina Properties' books, but not deductible in computing taxable income.

Schedule M-2, Analysis of Partners' Capital Accounts

Line 1—Balance at beginning of year: This figure is $0 because this is the partnership's first year of operations.

Line 2—Capital contributed: Ellen and Kathleen each contributed $225,000 cash, for a total of $450,000 in cash contributions. Louis contributed the office building, subject to the liability. Because Schedule L represents the partnership's book balance sheets, Schedule M-2 reconciles the partners' book capital accounts. Under Section 704(b), the partnership records the property contributed by Louis at its fair market value at the date of contribution. His capital contribution is therefore equal to the FMV of the property contributed ($1,100,000) less the $910,000 outstanding mortgage encumbering the property at the date of contribution.

Line 3—Net income (loss) per books: This figure is the same as computed on Line 1 of Schedule M-1. The computation is explained in the preceding text.

Line 6a—Distributions cash: This figure comes directly from the trial balance for Kachina Properties.

Line 9—Balance at end of year: Note that this figure must tie to Schedule L, Line 21.

Schedule D—Capital gains and losses: The figures and dates reported on Schedule D come from the notes accompanying the trial balance for Kachina Properties.

Schedule K-1 (Form 1065)

Part I—Information about the partnership: The information in items A and B comes from the front page of Form 1065, and must be the same as reported on that Form. The instructions to Form 1065 tell the partnership where to file its return. This location is reported in Part 1, item C.

Part II information about the partner

Items E through I—The preparer should be very careful to ensure that the information regarding the partner's name, identifying number, address and type of partner are accurately stated in items E through I.

Item J—The information reported on Item J should be verified by reviewing the partnership agreement if possible to ensure that the amounts reported on each Schedule K-1 are accurate. As will be discussed in subsequent text, the amounts reported to each partner can require complex calculations.

Item K—Partner's share of liabilities at year-end: Special rules apply to the allocation of partnership liabilities among the partners. See Regulations Section 1.752. For Kachina Properties, liabilities have been allocated in accordance with the partners' profit and loss sharing ratios. It is very important to recognize that this approach may not yield the proper allocation—preparers should review the regulations as well as other sources of information regarding the allocation of partnership liabilities.

Item L—Partner's capital account analysis: This item reconciles the partner's capital account. For Kachina Properties, the capital account reconciliation is based on the partners' Section 704(b) book capital accounts. Capital contributions and withdrawals are relatively straightforward and have been computed previously. It should be noted, however, that guaranteed payments made to Ellen and Kathleen are not treated as distributions or withdrawals. The line labeled "current year increase (decrease)" reports each partner's share of the partnership's book income. Note that the allocations reflect the special allocation of depreciation. Therefore, Louis's share is equal to 29.70 percent of the partnership's book income before deducting the depreciation allocable to the building (29.7 percent of ($35,425 − 25,245 = $10,180)). This depreciation is then deducted from his 29.7 percent share and the result is his share of partnership book income. Similarly, Ellen and Kathleen's shares reflect only their 35.15 percent interests in the partnership's book income before deduction of the depreciation specially allocated to Louis.

Note that because we reconcile the partners' Section 704(b) capital accounts, they will be unable to use these figures to calculate their outside basis in their partnership interests.

Item M—Contribution of property with a built-in gain or loss: If a partner contributed property during the year with a built-in gain or loss, the appropriate box should be checked and a required schedule should be attached.

Part III partner's share of current year income, deductions, credits, and other items

Box 1—Ordinary business income (loss): This box represents each partner's share of the ($22,453) loss reported on Form 1065, Schedule K, Line 1 (and Form 1065, page 1, Line 22).Therefore, Louis's K-1 reports (6,669), or 29.7 percent of this amount, although Ellen and Kathleen's K-1s each report 35.15 percent of this figure, or (7,892).

Box 2—Net rental real estate income (loss): In this box, each partner's share of Schedule K, Line 2 (and Form 8825, Line 21) should be reported. Note that this calculation requires the preparer to take into account the special allocation of depreciation to Louis. The partnership's net rental real estate income before depreciation was $533 ($16,297 loss plus $16,830 in depreciation expense allocated wholly to Louis). Therefore, Ellen and Kathleen each have $187 of the partnership's rental real estate income (loss). Louis's share is equal to 29.7 percent of $533 ($159) less $16,830 in depreciation expense.

Box 4—Guaranteed payments: Only guaranteed payments received by the specific partner for whom the K-1 is prepared should be reported in box 4.

Box 8—Net short-term capital gain (loss): This figure is equal to each partner's profit ratio (29.7 percent or 35.15 percent) of the partnership's $16,000 net short-term gain.

Box 11—Other income (loss): In this box, the partnership reports to Louis his special allocation of depreciation allocable to the retail or restaurant activity. His special allocation of depreciation attributable to the rental real estate activity is included in box 2.

Box 13—Other deductions: In this box, Kachina Properties reports each partner's share of the charitable contribution. Note that Code A in the box at the left of the amount reported indicates that these were cash contributions subject to the 50 percent of adjusted gross income limitation. See the instructions to Schedule K-1 for box 13.

Box 14—Self-employment earnings (loss): Louis's self-employment earnings from the partnership consist of the sum of the amounts reported in boxes 1 and 11. Ellen and Kathleen's self-employment income includes the amounts reported to them in boxes 1 and 11, increased by the guaranteed payments reported for each of them in box 4. In this box, Code A indicates that the self-employment income represents net earnings from self-employment (other codes are used to indicate that the amounts reported are gross farming or fishing income, or gross non-farm income). See the instructions to Schedule K-1.

Box 17—Alternative minimum tax items: For Kachina Properties, the only AMT adjustment is for depreciation of the partnership's equipment which is assumed to be $0. Because this depreciation is not specially allocated (only the depreciation on the building is specially allocated to Louis), the AMT adjustment should follow the partner's profit and loss-sharing ratios (used to allocate depreciation on the equipment). Code A indicates that this adjustment represents post-1986 depreciation expense. See the instructions to Schedule K-1.

Box 18—Tax-exempt income and nondeductible expenses: The partnership claimed a deduction for book of $2,500 for an addition to the allowance for bad debts. For tax purposes, no deduction for bad debts is allowed until accounts are written off. However nondeductible expenses that are essentially timing differences should not be included in box 18, so the nondeductible bad debt expenses are not recorded here.

Box 19—Distributions: In this box, the partnership reports the total distributions received by each partner. Code A indicates that the distributions consisted of cash or marketable securities or both. See the instructions to Schedule K-1.

Box 20—Other information: In this box, the partnership reports the information necessary for each partner to compute their qualified business income (QBI) deduction. The codes are Z – qualified business income; AA – W-2 wages; and AB – "unadjusted" basis of assets. Note that since allocation of rental income does not follow the ownership percentages because of the special allocation to Louis Griego, neither will the allocation of QBI. W-2 wages and the unadjusted basis of assets are, however, allocated according to ownership percentages.

Form 8825, *Rental Real Estate Income and Expenses of a Partnership or an S Corporation*

The figures reported on Form 8825 come directly from the trial balance for Kachina Properties. Recall that the partnership allocates two-thirds of the amounts incurred for insurance, interest expense, depreciation and taxes to the rental activity.

Tax Glossary

401(k) plan – A qualified retirement plan to which contributions from salary are made from pre-tax dollars.

Accelerated depreciation – Computation of depreciation to provide greater deductions in earlier years of equipment and other business or investment property.

Accounting method – Rules applied in determining when and how to report income and expenses on tax returns.

Accrual method – Method of accounting that reports income when it is earned, disregarding when it may be received, and expense when incurred, disregarding when it is actually paid.

Acquisition debt – Mortgage taken to buy, hold, or substantially improve main or second home that serves as security.

Active participation – Rental real estate activity involving property management at a level that permits deduction of losses.

Adjusted basis – Basis in property increased by some expenses (for example, by capital improvements) or decreased by some tax benefit (for example, by depreciation).

Adjusted gross income (AGI) – Gross income minus above-the-line deductions (such as deductions other than itemized deductions, the standard deduction, and personal and dependency exemptions).

Alimony – Payments for the support or maintenance of one's spouse pursuant to a judicial decree or written agreement related to divorce or separation.

Alternative minimum tax (AMT) – System comparing the tax results with and without the benefit of tax preference items for the purpose of preventing tax avoidance.

Amortization – Write-off of an intangible asset's cost over a number of years.

Applicable federal rate (AFR) – An interest rate determined by reference to the average market yield on U.S. government obligations. Used in Sec. 7872 to determine the treatment of loans with below-market interest rates.

At-risk rules – Limits on tax losses to business activities in which an individual taxpayer has an economic stake.

Backup withholding – Withholding for federal taxes on certain types of income (such as interest or dividend payments) by a payor that has not received required taxpayer identification number (TIN) information.

Bad debt – Uncollectible debt deductible as an ordinary loss if associated with a business and otherwise deductible as short-term capital loss.

Basis – Amount determined by a taxpayer's investment in property for purposes of determining gain or loss on the sale of property or in computing depreciation.

Cafeteria plan – Written plan allowing employees to choose among two or more benefits (consisting of cash and qualified benefits) and to pay for the benefits with pretax dollars. Must conform to Sec. 125 requirements.

Capital asset – Investments (such as stocks, bonds, and mutual funds) and personal property (such as home).

Capital gain/loss – Profit (net of losses) on the sale or exchange of a capital asset or Sec. 1231 property, subject to favorable tax rates, and loss on such sales or exchanges (net of gains) deductible against $3,000 of ordinary income.

Capitalization – Addition of cost or expense to the basis of property.

Carryovers (carryforwards) and carrybacks – Tax deductions and credits not fully used in one year are chargeable against prior or future tax years to reduce taxable income or taxes payable.

Conservation reserve program (CRP) – A voluntary program for soil, water, and wildlife conservation, wetland establishment and restoration and reforestation, administered by the U.S. Department of Agriculture.

Credit – Amount subtracted from income tax liability.

Deduction – Expense subtracted in computing adjusted gross income.

Defined benefit plan – Qualified retirement plan basing annual contributions on targeted benefit amounts.

Defined contribution plan – Qualified retirement plan with annual contributions based on a percentage of compensation.

Depletion – Deduction for the extent a natural resource is used.

Depreciation – Proportionate deduction based on the cost of business or investment property with a useful life (or recovery period) greater than one year.

Earned income – Wages, bonuses, vacation pay, and other remuneration, including self-employment income, for services rendered.

Earned income credit – Refundable credit available to low-income individuals.

Employee stock ownership plan (ESOP) – Defined contribution plan that is a stock bonus plan or a combined stock bonus and money purchase plan designed to invest primarily in qualifying employer securities.

Estimated tax – Quarterly payments of income tax liability by individuals, corporations, trusts, and estates.

Exemption – A deduction against net income based on taxpayer status (such as single, head of household, married filing jointly or separately, trusts, and estates).

Fair market value – The price that would be agreed upon by a willing seller and willing buyer, established by markets for publicly-traded stocks, or determined by appraisal.

Fiscal year – A 12-month taxable period ending on any date other than December 31.

Foreign tax – Income tax paid to a foreign country and deductible or creditable, at the taxpayer's election, against U.S. income tax.

Gift – Transfer of money or property without expectation of anything in return, and excludable from income by the recipient. A gift may still be affected by the unified estate and gift transfer tax applicable to the gift's maker.

Goodwill – A business asset, intangible in nature, adding a value beyond the business's tangible assets.

Gross income – Income from any and all sources, after any exclusions and before any deductions are taken into consideration.

Half-year convention – A depreciation rule assuming property other than real estate is placed in service in the middle of the tax year.

Head-of-household – An unmarried individual who provides and maintains a household for a qualifying dependent and therefore is subject to distinct tax rates.

Health savings account (HSA) – A trust operated exclusively for purposes of paying qualified medical expenses of the account beneficiary and thus providing for deductible contributions, tax-deferred earnings, and exclusion of tax on any monies withdrawn for medical purposes.

Holding period – The period of time a taxpayer holds onto property, therefore affecting tax treatment on its disposition.

Imputed interest – Income deemed attributable to deferred-payment transfers, such as below-market loans, for which no interest or unrealistically low interest is charged.

Incentive stock option (ISO) – An option to purchase stock in connection with an individual's employment, which defers tax liability until all of the stock acquired by means of the option is sold or exchanged.

Income in respect of a decedent (IRD) – Income earned by a person, but not paid until after his or her death.

Independent contractor – A self-employed individual whose work method or time is not controlled by an employer.

Indexing – Adjustments in deductions, credits, exemptions and exclusions, plan contributions, AGI limits, and so on, to reflect annual inflation figures.

Individual retirement account (IRA) – Tax-exempt trust created or organized in the U.S. for the exclusive benefit of an individual or the individual's beneficiaries.

Information returns– Statements of income and other items recognizable for tax purposes provided to the IRS and the taxpayer. Form W-2 and forms in the 1099 series, as well as Schedules K-1, are the prominent examples.

Installment method– Tax accounting method for reporting gain on a sale over the period of tax years during which payments are made, such as, over the payment period specified in an installment sale agreement.

Intangible property– Items such as patents, copyrights, and goodwill.

Inventory – Goods held for sale to customers, including materials used in the production of those goods.

Involuntary conversion – A forced disposition (for example, casualty, theft, condemnation) for which deferral of gain may be available.

Jeopardy – For tax purposes, a determination that payment of a tax deficiency may be assessed immediately as the most viable means of ensuring its payment.

Keogh plan – A qualified retirement plan available to self-employed persons.

Key employee – Officers, employees, and officers defined by the Internal Revenue Code for purposes of determining whether a plan is "top heavy."

Kiddie tax – Application of parents' maximum tax rate to unearned income of their child under age 19. Full-time students under 24 are also subject to the kiddie tax.

Lien – A charge upon property after a tax assessment has been made and until tax liability is satisfied.

Like-kind exchange – Tax-free exchange of business or investment property for property that is similar or related in service or use.

Listed property – Items subject to special restrictions on depreciation (for example, cars, computers, cell phones).

Lump-sum distribution – Distribution of an individual's entire interest in a qualified retirement plan within one tax year.

Marginal tax rate – The highest tax bracket applicable to an individual's income.

Material participation – The measurement of an individual's involvement in business operations for purposes of the passive activity loss rules.

Mid-month convention – Assumption, for purposes of computing depreciation, that all real property is placed in service in the middle of the month.

Mid-quarter convention – Assumption, for purposes of computing depreciation, that all property other than real property is placed in service in the middle of the quarter, when the basis of property placed in service in the final quarter exceeds a statutory percentage of the basis of all property placed in service during the year.

Minimum distribution – A retirement plan distribution, based on life expectancies, that an individual must take after age 70 ½ in order to avoid tax penalties.

Minimum funding requirements – Associated with defined benefit plans and certain other plans, such as money purchase plans, assuring the plan has enough assets to satisfy its current and anticipated liabilities.

Miscellaneous itemized deduction – Deductions for certain expenses (for example, unreimbursed employee expenses) limited to only the amount by which they exceed 2 percent of adjusted gross income.

Money purchase plan – Defined contribution plan in which the contributions by the employer are mandatory and established other than by reference to the employer's profits.

Net operating loss (NOL) – A business or casualty loss for which amounts exceeding the allowable deduction in the current tax year may be carried back two years to reduce previous tax liability and forward 20 years to cover any remaining unused loss deduction.

Nonresident alien – An individual who is neither a citizen nor a resident of the United States. Nonresidents are taxed on U.S. source income.

Original issue discount (OID) – The excess of face value over issue price set by a purchase agreement.

Passive activity loss (PAL) – Losses allowable only to the extent of income derived each year (such as by means of carryover) from rental property or business activities in which the taxpayer does not materially participate.

Passive foreign investment company (PFIC) – A foreign based corporation subject to strict tax rules which covers the treatment of investments in Sections 1291 through 1297.

Pass-through entities – Partnerships, LLCs, LLPs, S corporations, and trusts and estates whose income or loss is reported by the partner, member, shareholder, or beneficiary.

Personal holding company (PHC) – A corporation, usually closely-held, that exists to hold investments such as stocks, bonds, or personal service contracts and to time distributions of income in a manner that limits the owner(s) tax liability.

Qualified subchapter S trust (QSST) – A trust that qualifies specific requirements for eligibility as an S corporation shareholder.

Real estate investment trust (REIT) – A form of investment in which a trust holds real estate or mortgages and distributes income, in whole or in part, to the beneficiaries (such as investors).

Real estate mortgage investment conduit (REMIC) – Treated as a partnership, investors purchase interests in this entity which holds a fixed pool of mortgages.

Realized gain or loss – The difference between property's basis and the amount received upon its sale or exchange.

Recapture – The amount of a prior deduction or credit recognized as income or affecting its characterization (capital gain vs. ordinary income) when the property giving rise to the deduction or credit is disposed of.

Recognized gain or loss – The amount of realized gain or loss that must be included in taxable income.

Regulated investment company (RIC) – A corporation serving as a mutual fund that acts as investment agents for shareholders and customarily dealing in government and corporate securities.

Reorganization – Restructuring of corporations under specific Internal Revenue Code rules so as to result in nonrecognition of gain.

Resident alien – An individual who is a permanent resident, has substantial presence, or, under specific election rules is taxed as a U.S. citizen.

Roth IRA – Form of individual retirement account that produces, subject to holding period requirements, nontaxable earnings.

S corporation – A corporation that, upon satisfying requirements concerning its ownership, may elect to act as a pass-through entity.

Saver's credit – Term commonly used to describe Sec. 25B credit for qualified contributions to a retirement plan or via elective deferrals.

Sec. 1231 property – Depreciable business property eligible for capital gains treatment.

Sec. 1244 stock – Closely held stock whose sale may produce an ordinary, rather than capital, loss (subject to caps).

Split-dollar life insurance – Arrangement between an employer and employee under which the life insurance policy benefits are contractually split, and the costs (premiums) are also split.

Statutory employee – An insurance agent or other specified worker who is subject to social security taxes on wages but eligible to claim deductions available to the self-employed.

Stock bonus plan – A plan established and maintained to provide benefits similar to those of a profit-sharing plan, except the benefits must be distributable in stock of the employer company.

Tax preference items – Tax benefits deemed includable for purposes of the alternative minimum tax.

Tax shelter – A tax-favored investment, typically in the form of a partnership or joint venture, that is subject to scrutiny as tax-avoidance device.

Tentative tax – Income tax liability before taking into account certain credits, and AMT liability over the regular tax liability.

Transportation expense – The cost of transportation from one point to another.

Travel expense – Transportation, meals, and lodging costs incurred away from home and for trade or business purposes.

Unearned income – Income from investments (such as interest, dividends, and capital gains).

Uniform capitalization rules (UNICAP) – Rules requiring capitalization of property used in a business or income-producing activity (such as items used in producing inventory) and to certain property acquired for resale.

Unrelated business income (UBIT) – Exempt organization income produced by activities beyond the organization's exempt purposes and therefore taxable.

Wash sale – Sale of securities preceded or followed within 30 days by a purchase of substantially identical securities. Recognition of any loss on the sale is disallowed.

Index

TAXATION ESSENTIALS OF LLCS AND PARTNERSHIPS

BY LARRY TUNNELL, PH.D., CPA,
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Solutions

The AICPA publishes *CPA Letter Daily*, a free e-newsletter published each weekday. The newsletter, which covers the 10-12 most important stories in business, finance, and accounting, as well as AICPA information, was created to deliver news to CPAs and others who work with the accounting profession. Besides summarizing media articles, commentaries, and research results, the enewsletter links to television broadcasts and videos and features reader polls. *CPA Letter Daily*'s editors scan hundreds of publications and websites, selecting the mostrelevant and important news so you don't have to. The newsletter arrives in your inbox early in the morning. To sign up, visit smartbrief.com/CPA.

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Solutions

Chapter 1

Knowledge check solutions

1.

a. Incorrect. As a limited partner, the partnership does not require Midge to restore deficit balances in her capital account.

b. Incorrect. As a limited partner, the partnership does not require Midge to restore deficit balances in her capital account.

c. Correct. As a limited partner, with no deficit restoration obligation, Midge can lose no more than her existing investment in the partnership.

d. Incorrect. As a limited partner, with no deficit restoration obligation, Midge can lose up to her existing investment in the partnership.

2.

a. Correct. As the only general partner, Midge is personally responsible for all the partnership's debts.

b. Incorrect. Remember, Midge is the only general partner in this partnership and is responsible for all of its debts.

c. Incorrect. As a general partner, Midge is personally responsible for the partnership's debts, in addition to her investment.

d. Incorrect. As a general partner, Midge is personally responsible for all the partnership's debts. Only limited partners may escape liability for partnership debts.

3.

a. Incorrect. LLCs can exist with only one member. In contrast, LLPs and LLLPs are required to have two or more partners.

b. Correct. All members of both LLCs and LLPs have limited liability, without the requirement that they be prohibited from participating in management.

c. Incorrect. An LLC does have members rather than partners.

d. Incorrect. LLCs do not have general partners, whereas LLPs do.

4.

a. Incorrect. Although it is true that limited partners in a limited partnership do not participate in management, the same is true for limited partners in a limited liability limited partnership.
b. Correct. A limited liability limited partnership extends legal protections against personal liability to general partners as well as limited partners. General partners in a regular limited partnership retain personal liability.
c. Incorrect. The limited partners in a limited liability limited partnership do not have additional protection from the liabilities of the partnership.
d. Incorrect. Limited partners in a limited partnership also have limited liability.

5.

a. Incorrect. She will also have to report her share of partnership capital gains and interest income on her current return.
b. Incorrect. She will also have to report her share of partnership interest income on her current return.
c. Correct. Because J.D. does not itemize deductions, her share of partnership charitable contributions will not affect her taxable income, but the other items passed through to her will.
d. Incorrect. Because she does not itemize, she will not benefit from the charitable contribution.

6.

a. Correct. Roy's book capital account is increased by the fair market value of property contributed to the partnership.
b. Incorrect. Roy's book capital account is not increased by the tax basis of property contributed to the partnership.
c. Incorrect. Roy's book capital account is not increased by the difference between the fair market value and the tax basis of property contributed to the partnership.
d. Incorrect. Roy's book capital account is increased by the fair market value of the property contributed.

Chapter 2

Knowledge check solutions

1.

   a. Incorrect. Under Section 723, the partnership takes a carryover basis in property contributed by a partner, not reduced by any liability associated with the contribution.
   b. Correct. Under Section 723, the partnership takes a carryover basis in property contributed by a partner.
   c. Incorrect. This is the fair value of the property, reduced by the mortgage. This will be the initial balance in Gary's Section 704(b) capital account. The partnership's tax basis in the property received from Gary will be $50,000, carried over from Gary.
   d. Incorrect. The partnership takes a carryover basis in property contributed by a partner.

2.

   a. Incorrect. E's basis is the basis of property E contributed, plus E's share of the partnership's liabilities.
   b. Incorrect. You must also account for the liabilities.
   c. Correct. E's basis is the basis of property E contributed ($350,000), plus E's share of the partnership's liabilities ($50,000).
   d. Incorrect. E's basis in the partnership is the basis of property E contributed, plus E's share of the partnership's liabilities. $450,000 includes the full value of the liabilities, not E's share.

3.

   a. Incorrect. Assumption by the partnership of a debt formerly owed by the partner will, overall, decrease the partner's tax basis in his or her partnership interest.
   b. Correct. Under Section 752(b), assumption by a partnership of a partner's liability is treated as a distribution of money to the partner.
   c. Incorrect. The basis of the property to the partnership is unaffected by the liability transferred.
   d. Incorrect. The assumption by a partnership of a partner's liability is treated as a distribution of money to the partner, but the retention by the partner (through the partnership) of their share of the liability will be treated as an offsetting contribution to the partnership.

4.

a. Incorrect. The February 15 partnership year-end would create a greater deferral period for the partners than would a July 31 year-end.
b. Correct. The partnership must use the taxable year ending July 31 that minimizes the aggregate tax deferral for its partners.
c. Incorrect. The partnership cannot choose the taxable year ending October 31.
d. Incorrect. December 31 is a year-end that would be used by the individual partners when preparing their personal income tax returns. The partnership must use the taxable year ending July 31 because it has the least aggregate deferral.

5.

a. Incorrect. A December 31 year-end does not minimize the aggregate deferral of income for the LLC's members.
b. Correct. A January 31 year-end minimizes the aggregate deferral of income for the LLC's members.
c. Incorrect. A March 31 year-end does not minimize the aggregate deferral of income for the LLC's members.
d. Incorrect. Because the two principal partners or members have different year-ends, the LLC must choose the tax year that minimizes the aggregate deferral of income for its members.

Chapter 3

Knowledge check solutions

1.

a. Incorrect. A current distribution is not one that is best described as a distribution of the partner's share of the partnership's current year profits because, quite often, distributions do not equal what is reported on the partner's K-1 as partnership profit and loss.
b. Correct. Any distribution that does not liquidate the partner's interest in the partnership is a current distribution.
c. Incorrect. A current distribution is not one that is best described as the distribution of any of the current assets of the partnership.
d. Incorrect. A distribution does not need to be made at the same time to all partners in order for it to qualify as a current distribution. It does need to be non-liquidating in nature.

2.

a. Correct. Susan recognizes no gain or loss on the distribution.
b. Incorrect. Susan does not recognize $25,000 of gain because cash distributions from a partnership trigger gain only to the extent they exceed the partner's basis in the partnership interest.
c. Incorrect. The distribution did not liquidate her interest in the partnership; Susan does not recognize any loss on the distribution.
d. Incorrect. The cash distribution of $25,000 is not recognized, and cannot trigger a loss.

3.

a. Incorrect. Her basis in her interest in the partnership is reduced by the $25,000 distribution.
b. Incorrect. Her basis in her interest in the partnership is reduced by the distribution.
c. Correct. The $25,000 cash distribution reduces her basis in the partnership interest from $30,000 to $5,000.
d. Incorrect. Her basis in her interest in the partnership is reduced by the amount of the distribution, but this does not reduce it to zero in this case.

Chapter 4

Knowledge check solutions

1.

a. Incorrect. This is one of three factors identified by the IRS in Revenue Ruling 81-301.
b. Correct. Whether or not a payment to a partner is based on partnership income is not a factor considered by the IRS in determining whether the payment is received in the partner's capacity as a partner. Indeed, in Revenue Ruling 81-301, the IRS determined that a partner who received a payment equal to 10 percent of partnership income in exchange for investment advisory services provided to the partnership did not receive the payment in his capacity as a partner.
c. Incorrect. This is one of the factors the IRS will consider.
d. Incorrect. This is one of the factors the IRS considered in Revenue Ruling 81.301.

2.

a. Correct. T would recognize it in the year received, and STUV would deduct it in the same year.
b. Incorrect. STUV must deduct it in the year T includes it in income.
c. Incorrect. STUV must deduct it in the year T includes it in income, and T will include it in income in the year received.
d. Incorrect. T will include the $40,000 in income in the year received, and STUV would deduct the $40,000 in the same year.

3.

a. Incorrect. Because the income is not received by F in her capacity as a partner, it is not treated as a distributive share of partnership income and does not retain its character as long-term capital gain on her individual return.
b. Correct. Under Section 707(a), the payment is taxable to F as compensation income, and is deductible by the partnership.
c. Incorrect. Under Section 707(a), the payment is taxable to F as compensation income, not as a return of capital.
d. Incorrect. Under Section 707(a), the entire payment is taxable to F as compensation income, F's 10 percent interest in the partnerships income does not change the character of payments received for her personal services.

4.

a. Correct. Because the services are integral to the business they are in his role as a partner, and they are not dependent on the income of the partnership, and therefore treated as a guaranteed payment.
b. Incorrect. The payments are not dependent on the income of the partnership, so they are not a distributive share.
c. Incorrect. Because the services are integral to the business they are in his role as a partner.
d. Incorrect. The $6,000 monthly payments are each treated as a guaranteed payment to L in their entirety.

Chapter 5

Knowledge check solutions

1.
   a. Incorrect. The at-risk limitations are applied after the basis limitations.
   b. Correct. Losses that are allowed under Section 704(d) may still be disallowed under Section 465.
   c. Incorrect. Losses may still be disallowed under Section 465 that are allowed under Section 704(d).
   d. Incorrect. The Section 704(d) limitations apply to pass-through partnership losses.

2.
   a. Incorrect. Passive losses do reduce basis and at-risk amounts.
   b. Correct. Passive losses from one activity may be deducted against passive income from other sources.
   c. Incorrect. Passive losses do not become active if they are carried forward to future years.
   d. Incorrect. Passive losses from one activity may only be deducted against passive income from other sources and the excess can be carried forward indefinitely.

3.
   a. Incorrect. Carol can deduct the Partnership 1 loss against the income from Partnership 2.
   b. Correct. Combining the income from Partnership 2 with the loss from Partnership 1, Carol has net passive income.
   c. Incorrect. Only the loss of $15,000 can be deducted.
   d. Incorrect. Although Carol owns 50 percent shares, the amounts stated in the problem represent her full share of partnership income and loss. Reducing the loss by 50 percent would be incorrect.

4.
   a. Incorrect. K's modified AGI exceeds $150,000, so the $25,000 deduction is completely phased-out.
   b. Incorrect. K's modified AGI exceeds $150,000, so the potential $25,000 deduction is completely phased-out. The losses may be carried forward to subsequent years.
   c. Correct. K is not eligible for the $25,000 deduction once her modified AGI exceeds $150,000.
   d. Incorrect. K is not eligible to deduct the combined losses of $48,000 due to the AGI phaseout.

5.

a. Incorrect. The carryover is deductible only to the extent of net passive income for the current year.
b. Correct. Jorge has net passive income this year of $3,000, and a $10,000 passive loss carryforward; therefore, he can deduct $3,000 of the passive loss carryforward.
c. Incorrect. Jorge has net passive income of $3,000, and can use the carryforward to offset that income.
d. Incorrect. $7,000 is the amount of excess passive loss carryforward that Jorge can deduct against passive income in subsequent years.

6.

a. Incorrect. This answer is true because the LLC can, for example, treat the two centers as a Pennsylvania activity and a California activity.
b. Incorrect. The two centers are geographically separated and may be treated as separate activities.
c. Correct. This answer is incorrect, because they can still be treated as one activity in spite of the distance between them.
d. Incorrect. This statement is true because the partnership does have this authority.

Chapter 6

Knowledge check solutions

1.

a. Incorrect. The adjustment to L's capital account is based on the value of the property distributed, rather than on the pre-distribution balance in that account.
b. Correct. L's capital account must be reduced by the fair market value of the property distributed to her, after first increasing it by L's share of the book gain on the distribution.
c. Incorrect. L's capital account must be increased by the book gain on the distribution before reducing it by the fair market value of the property distributed.
d. Incorrect. L's capital account will be $40,000 ($300,000 + $60,000 – $320,000) after the distribution.

2.

a. Incorrect. In accordance with Section 704(b), M is entitled to receive an amount equal to the positive balance in his capital account.
b. Incorrect. M is entitled to receive an amount equal to the positive balance in his capital account.
c. Correct. M will receive the entire $40,000 proceeds from sale of the partnership's assets, plus $10,000 to be contributed by L.
d. Incorrect. M is entitled to receive $50,000 in liquidation of his interest.

3.

a. Correct. L must make up the deficit in her capital account, and without the required contribution from L, M would not be able to receive the $50,000 to which she is entitled.
b. Incorrect. Under Section 704(b), L will have to make payment to the partnership.
c. Incorrect. Under Section 704(b), L will have to restore the deficit balance in her capital account.
d. Incorrect. Under Section 704(b), L will have to make payment to the partnership to restore the deficit balance in her capital account.

4.

a. Incorrect. The allocations will significantly affect the two partners' relative after-tax economic positions.
b. Correct. As a result of this allocation, Q will be $18,000 better off after tax ($25,000 × .78), whereas L will be $25,500 better off ($30,000 × .85). Therefore, they will substantially affect the relative economic circumstances of the two partners.
c. Incorrect. In order to be transitory there must be some assurance that they will be reversed in future years, not merely the possibility that they will be reversed.
d. Incorrect. The allocations will significantly affect the relative economic circumstances of the two partners, and that is the reason they are recognized under Section 704(b).

5.

a. Correct. All the gain will be allocated to M under Section 704(c) because the property was sold at less than the FMV of the property at the time it was contributed to the partnership.
b. Incorrect. Section 704(c) will require that all of the gain be allocated to partner M.
c. Incorrect. Section 704(c) will require that none of the gain be allocated to partner P.
d. Incorrect. $40,000 represents the difference between M's tax basis in the property and the FMV of the property at the time it was contributed to the partnership. This amount does not represent gain to M on sale of the property by the partnership.

6.

a. Incorrect. Section 704(c) will limit A's share of tax depreciation.
b. Incorrect. Section 704(c) gives B and C a larger share of the depreciation and will limit A's share of tax depreciation to $2,000.
c. Correct. Total tax depreciation will be $18,000 ($54,000 ÷ 3). Partners B and C will each be entitled to $8,000 of depreciation expense for book (1/3 of $72,000 ÷ 3) and tax. A will be allocated the remaining tax depreciation of $2,000.
d. Incorrect. $18,000 represents A's basis divided by 3. A would not be able to deduct this amount as depreciation under Section 704(c).

Chapter 7

Knowledge check solutions

1.

a. Incorrect. The partners pay tax on their distributive shares of partnership income.
b. Incorrect. The partners, not the partnership, pay tax on their distributive shares of partnership income, whether or not such income is actually distributed to them.
c. Correct. The partners, not the partnership, pay income tax on the partnership's income, whether or not such income is distributed to them.
d. Incorrect. The partners pay tax on their distributive shares of partnership income, whether or not such income is actually distributed to them.

2.

a. Correct. Each partner will receive Schedule K-1 reporting his or her share of partnership income, loss, and other items.
b. Incorrect. Schedule K is part of Form 1065 and summarizes the total amount of partnership ordinary income, separately stated items, total income, and total partnership capital.
c. Incorrect. Schedule M-1 is a part of Form 1065 and reconciles book income to tax income.
d. Incorrect. Form 1040 is used by each partner to file their respective income tax returns.

3.

a. Correct. The distributions received by JD from the LLC do not exceed her tax basis in the LLC interest and are therefore nontaxable.
b. Incorrect. JD is taxable on her distributive share of Canyon North's taxable income.
c. Incorrect. JD is only taxable on her distributive share of Canyon North's taxable income, not the distributions themselves.
d. Incorrect. JD is taxable on her $18,000 distributive share of Canyon North's taxable income.

4.

a. Correct. Gain or loss from the sale of assets used in rental activities should be reported on Form 8825 and included in net income or loss from partnership rental activities on line 2 of Schedule K.
b. Incorrect. Section 179 expenditures may not have been fully deducted by all partners (depending on the other amounts of Section 179 deductions claimed by individual partners) in the original year of the election, Section 179 recapture is reported separately to each partner.
c. Incorrect. Net Section 1231 gains are separately stated and included on Schedules K and K-1.
d. Incorrect. Depreciation recapture is included with ordinary income on page 1 of Form 1065.

5.

a. Correct. Q must report both the guaranteed payment and her distributive share of LLC income on her individual return.
b. Incorrect. Q must also report her distributive share of LLC income on her individual return.
c. Incorrect. Q's distributive share of Lynn Properties' income is equal to 20 percent of the $75,000 net income. She must also report the guaranteed payment as income on her individual return.
d. Incorrect. Q must report $40,000 of LLC income on her individual return.

6.

a. Incorrect. The pass-through income deduction is 20 percent of net qualified business income.
b. Correct. Net qualified business income is $50,000 – $30,000 = $20,000, and the deduction is 20 percent of that, or $4,000.
c. Incorrect. The pass-through income deduction is 20 percent of $20,000, not 20 percent of the qualified business loss.
d. Incorrect. Net qualified business income is $50,000 – $30,000 = $20,000, but the deduction is 20 percent of that, or $4,000. Note that the taxpayer is beneath the taxable income threshold for which the wage limitation would apply. However, even under the wage limitation test, the deduction is equal to the *lessor of* 20 percent of qualified business income or 50 percent of wages paid.

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