**Taxable Year**

**Default**: **IRC 441(a)**: Taxable year of PA is based on the partner’s taxable year

**Partners**: **IRC 441(g)**: If partner keeps no books/records, **calendar year**

If partner keeps books & records, **fiscal year**

**Effect**: **IRC 441(b)(1)**: If Partner uses a calendar or fiscal year, partner

can use its “annual accounting period” as his taxable year

**Business Purpose**: **IRC 706(b)(1)(C)**: If partnership has a “business purpose” (seasonable T/B), it can start/end it’s taxable year whenever it wants

**Partnership**: **IRC 706(b)(1)(B)**: If PA has no business purpose, it’s year is:

**1) Majority Interest Taxable Year (MIT)**

ONLY use if: **A) 1+ partners are on same taxable year**,

**B) They own OVER 50% of BOTH**: ***i) Profits; AND***

***ii) Capital***

**2) If none, do all of the principal partners have the same taxable year?**

***A) Same Taxable Year***: **Use That Year**

***Effect***: use the taxable year of the principal partners

***Principal Partner***: Owns over 5% of either: i) Profits; **OR**

ii) Capital

***B) Different Taxable Years***: Use Calendar Year

***General Rule***: **IRC 706(b)(1)(B)(iii)**: **Use calendar year**

***Exception***: Use another taxable year if that taxable year

would result in a **“smaller deferral of income”**

**Lease Aggregate Deferral**: **RR 1.706-1(b)(3)(i)**: the lowest

of XXX, YYY, and ZZZ is the PA’s taxable year

**If XX/31 Year End**:

Months of Deferral A Gets x A’s Profit Share

+ Months of Deferral B Gets x B’s Profit Share

+ Months of Deferral C Gets x C’s Profit Share

XXX

**If YY/31 Year End**:

Months of Deferral A Gets x A’s Profit Share

+ Months of Deferral B Gets x B’s Profit Share

+ Months of Deferral C Gets x C’s Profit Share

YYY

**If ZZ/31 Year End**:

Months of Deferral A Gets x A’s Profit Share

+ Months of Deferral B Gets x B’s Profit Share

+ Months of Deferral C Gets x C’s Profit Share

ZZZ

**Ex**: A (calendar year) owns 48% of capital, 38% of profits. B

(calendar year) owns 2% of capital, 2% of profits. C (June 30

fiscal year) owns 50% of capital, 60% of profits

1) Majority Interest Taxable Year?

No, C does not own over 50% of capital & profits

2) If none, do all of the principal partners have the

same taxable year? No

A) Use calendar year unless another year

results in a smaller deferral of income

**If 12/31 Year End**:

A: 0 Months x 38% = 0

+ B: 0 Months x 2% = 0

+ C: 6 Months x 60% = 0

3.60

**If 06/30 Year End**:

A: 6 Months x 38% = 2.28

+ B: 6 Months x 2% = .12

+ C: 0 Months x 60% = 0

2.40

B) **Conclusion**: Use 06/30 as PA’s taxable year

bc it results in less deferral of income **(2.40)**

***Holding Periods***

**Substitute Holding Period**: **IRC 1223(1)**: can tack together holding periods of contributed assets if CP contributed a capital asset or **IRC 1231** property

**Carryover Holding Period**: **IRC 1223(2)**: Can NOT tack together holding periods for all other assets (holding period of the assets starts over)

**Split Holding Period**: if CP contributed tackable & non-tackable assets, then a percentage of CP’s partnership interest at sale is LTCG and a percentage is ST

**Ex**: CP contributed $10 cash, $15 Land ($10 AB, 2 years), & $15 inventory

($16 AB) for 25% PA interest. CP sells PA interest 1 day later for $10 Gain

interest 6 months later, making a $10 gain

$15 Taxable Assets (Land) $10 Gain $10 Gain

———————————— = 37.5% LTCG x 37.5% x 62.5%

$40 Total Assets $3.75 LTCG $6.25 STCG

**Accounting Period**

**General Rule**: **IRC 446(a)**: **Gross Receipts Test**: PA may use the cash method of accounting if: 1) The average annual gross receipts of the PA

2) From Past years (i.e. NOT the current year)

3) Is **under $25M**

**Exceptions**: **IRC 448(a)**: MUST use the accrual method if the PA:

1) Is a professional partnerships (i.e. law firms)

2) Has a C Corp as a Partner

**Exception**: **IRC 448(b)(3)**: cash method if meets Gross Receipts Test

3) Is a **Tax Shelter**: **IRC 461(i)(3)**: A) Registered under FG/TX securities law

B) 35%+ of loss given to limited partners

C) Or, PA’s main purpose is tax avoidance

**Non-Recognition of Contributions**

**General Rule**: **IRC 721(a)**: contributions to PA are a **non-recognition event**

**Exception**: **IRC 721(b)**: **Investment Companies**

Investment companies DO recognize gain/loss if they contribute to a PA

**Definition**: **IRC 351(e)**:

1) After contribution, 80% of assets in PA are held for investment

and consist of: A) Money; D) Foreign Currency

B) Stock E) Options, futures

C) Evidence of Debt F) Trust/REIT interest

2) The contribution creates meaningful diversification

**Revenue Ruling 89-11**: Two or more significant contributions

**(2-11%)** of assets are diverse from each other

**PROF**: Diversification is NOT “created” if the portfolio that

was contributed was already diverse

***Bases Formulas***

***Inside Basis***

**IRC 723**: **Carryover Basis**

***Book Basis Formula***

FMV Of Asset At Contribution

(Debt)

Book Basis

***Tax Basis Formula***

Tax Basis of Asset At Contribution

(Debt)

Tax Basis

***Outside Basis (OB) Formula***

Tax Bases of Assets Contributed

+ Debt Partner Took On

(Debt Partner was Relieved Of)

Outside Basis (OB)

***Adjustments to OB Formula***

Starting OB

+ Taxable Income

+ Tax-Exempt Income

+ Contributions

(Distributions)

(PA Losses)

(Non-Deductible Costs)

Adjusted Outside Basis **—> Can NOT go negative!!**

***Liabilities***

**Debt Increase**: **IRC 752(a)**: if A’s share of debt increases, it is a contribution

**Debt Decrease**: **IRC 752(b)**: if A’s share of debt decreases, it is a distribution

**Definition**: **RR 1.752-1(a)(4)(i)(B)**: “liability” is an obligation, **the incurrence** **of which** gives rise to a deduction or change of basis

**Partner’s Own Note**: **Oden Case**: **NOT a liability!!!!**

**Effect**: CP does NOT get extra OB when A contributes his own note

**Exception**: **RR 1.704-1(b)(2)(iv)(d)(2)**: the note is “readily transferrable”

**Accounts Payable (AP)**: **NOT a liability** for OB purposes (A/P)

**PA Assumes CP’s Debt**: **RR 1.704-1(b)(2)(iv)(c)**: contribution by NCPs

**PA Pays Off CP’s Debt**: **RR 1.704-1(b)(2)(iv)(c)**: distribution to CP

***Advanced Distributions***

**RR 1.731-1(a)(1)(ii)**: treat as if distributed on last day of the PA’s taxable year

***Character***

**IRC 724**: If CP contributes these assets, gain/loss PA recognizes is ordinary if the PA sells the asset: **(a) *Unrealized receivables*** (**See** **IRC 735(a)(1)**)

**(b) *Inventory*** (ord. for first 5 years) (**See** **IRC 735(a)(2)**)

**(c) *Capital loss property*** (ordinary for first 5 year)

**Substantial Economic Effect –RR 1.704-1**

**Economic Effect: RR 1.704-1(b)(2)(ii)**

**IRC 704(b)**: apply PIP if: **(1)**  PA agreement doesn't have special allocations; or

**(2)** The allocations don’t have SEE

**RR 1.704-1(b)(2)(ii)(a)**: for an allocation to have EE, it must be consistent with the underlying economic arrangement the partners

Means, if an allocation creates an economic benefit/burden, the partner

who got the allocation should get that economic benefit/burden

***Basic Test***

**All or Nothing**: **All or nothing test.** If PA fails in one year, PA fails in ALL years

***1)*** **RR 1.704-1(b)(2)(ii)(b)(1)**: ***Keep Capital Accounts (CA) Under Regs***

PA maintains in accords with **RR 1.704-1(b)(2)(iv)**

***2)*** **RR 1.704-1(b)(2)(ii)(b)(2)**: ***Liquidation Requirement***

At liquidation, liquidating distribution made in accords with “positive

CA balances” in the partner’s CA

***3)*** **RR 1.704-1(b)(2)(ii)(b)(3)**: ***Deficit Makeup Requirement***

**General Rule**: If, post-liquidation, partner’s CA is **negative**, he must

be unconditionally **obligated to restore** that deficit

**RR 1.704-1(b)(2)(ii)(c)**: **Deficit Restoration Obligation**

**(DRO)** is “unconditionally obligated” and can be

created by either: A) Obligation in **PA** **Agreement**

B) Obligation under **state law**

**Rev Ruling 97-38**: General partner in an LP does NOT

have a duty to repay under local law unless debt is greater than FMV (only *then* is debt recourse for GP)

**Policy**: Bc partner must at some point contribute to eliminate the deficit, he bears the economic burden

**General Partnership**: if general partnership, all partners have

agreed to make up deficits in their capital account

**Limited Partnerships**: always fails Basic Test

***Economic Equivalence Test***

**RR 1.704-1(b)(2)(ii)(i)**: Allocation is “deemed” to have economic equivalence bc, although it does not technically meet the Basic Test, it produces the same economic results as the Basic Test

1) Is it a general partnership?

2) If yes, did it fail (1) or (2) of the Basic Test?

3) If yes, apply Economic Equivalence Test

A) Is there a similar/equivalent result to the basic test?

i) If yes, allocations are respected

ii) If no, apply PIP

***Alternative Test***

*1)* **RR 1.704-1(b)(2)(ii)(b)(1)**: ***Keep Capital Accounts (CA) Under Regs***

*2)* **RR 1.704-1(b)(2)(ii)(b)(2)**: ***Liquidation Requirement***

*3)* **RR 1.704-1(b)(2)(ii)(d)**: ***Alternative Test***

***A) PA Agreement has a* Qualified Income Offset (QIO)**

**Generally**: QIOs protect ***prior*****allocations (below)** by forcing

the PA to eliminate an unexpected deficit ASAP

**Ex**: G and L each contributed $70. Losses split 20-80. Income

split 50-50. In Y1, $50 loss. In Y2, $50 loss

**NO QIO**: G L **Yes QIO**: G L

$70 $70 $70 $70

Y1: ($10) ($40)**<—Respected—>**($10) ($40)

Y2: ($10) ($40) **($20)** **($30)**

$50 **($10) $40 $0   
 |\_\_Reallocate $10 ASAP to G**

**Take $10 away from L**

***B) Allocation* Can NOT Create A Negative CA Balance *in Excess of***

***Partner’s Obligation to Restore a Deficit***

**Anticipated Deficits**: **RR 1.704-1(b)(2)(ii)**: If PA anticipates a CA

CA, reduce the amount the partner gets by the amount of any

“Rly anticipated” future distributions to that partner

**Ex**: G and L each contributed $70. Losses split 20-80. Income

split 50-50. In Y1, $50 loss. In Y2, $50 loss. In Y3, PA expects

to borrow $20 and distribute $10 to each partner

**No Reg**: G L **Yes Reg**: G L

$70 $70 $70 $70

Y1: ($10) ($40)**<—Respected—>**($10) ($40)

Y2: ($10) ($40)  **($30)** **($20)**   
 (Anticipated) Y3: ($10) ($10)  **($10)** **($10)**

$40 **($20)**  **$20** **$0**   
  **|\_\_Reallocate $20 to G in Y2**

**Take away $20 from L in Y2**

**“In Excess of Partner’s Obligation To Restore:”** Often, limited

partners agree to restore a deficit in their CA up to $X

**Effect**: That limited partner can go negative, up to $X

**Ex**: Limited PA. QIO. Each gave $50. $50 depreciation/year. L

agreed to restore a deficit up to $50. All depreciation to L   
 G L

$50 $50

Y1: $0 ($50)

Y2: $0 ($50) **Meets alternative test in Y2 bc**

$50 ($50) **——> L can go up to negative $50**

***Certain Determinations (CD) Rule***

**RR 1.704-1(b)(3)(iii)**: If fails alternative Test, use Certain Determinations Rule

***1) Is there a shifting or transitory allocation?*** If yes, apply PIP

***2) If no, apply certain determinations rule***

**Test**: ***Compare***: A) The amount partner would’ve gotten if PA

liquidated at end of the prior year;

B) The amount partner would’ve gotten if PA

liquidated at end of the current year;

Then, reallocate based on economic reality

**Effect**: Same result as in Alternative Test

**Ex**: Limited PA. Each contributes $70. 80-20 split on losses. 50-50

split on income. In Y1, $50 losses. In Y2, $50 losses. No QIO

**Prior Year**: G L **Apply CD Rule**: G L

$70 $70 $70 $70

**Y1**: ($10) ($40) **Y1**: ($10) ($40)   
 $60 $30 **Y2**: **($20)** **($30)**   
 **Current Year**: G L **$40 $0**

$70 $70 **Means that L only bears $30 of**

**Y1**: ($10) ($40) **the $40 economic burden**

**Y2**: ($10) ($40) **Take away $10 from L**  
 $50 ($10) **——>** **Reallocate ($10) to G**

**Cheat Code**: **Just Apply the Alternative Test**

$70 $70 $70 $70

**Y1**: ($10) ($40)**<—Respected—>**($10) ($40)

**Y2**: ($10) ($40) **($20)** **($30)**

$50 **($10) $40 $0**

**Partner’s Interest in the Partnership (PIP)**

**RR 1.704-1(b)(3)**: if allocation SEE, reallocate in accords with PIP (reallocates to those who actually bear the economic burden/benefit)

**Factors**: **RR 1.70401(b)(3)(ii)**: 1) Relative contributions

2) Interests in economic profits/losses

3) Interest in cashflow/other NL distribution

4) Rights to distribution on liquidation

***Mid-Year Reallocations***

**RR 1.704-1(b)(4)(vi)**: if PA follows X allocations method in prior years, but then switches those allocations for future years, then presume that this Switch was the partner’s intent from the start

If an allocation had SEE, but then the PA agreement was changed, IRS will

closely scrutinize to see if the modification was actually the original deal

If IRS finds that it was the original deal, then prior allocations are

reallocated to meet the Switch’s terms

**Substantiality: RR 1.704-1(b)(2)(iii)**

***Generally***

**RR 1.704-1(b)(2)(iii)**: to be respected, allocations must have an effect other than tax savings, meaning to have EE an allocation must be “substantial”

***Pre-Tax Test***

**RR 1.704-1(b)(2)(iii)(a)**: there must be a “R possibility that the allocation(s) will substantially affect the dollar amounts the partners get, independent of tax consequences

If the only effect of an allocation is to reduce taxes without substantially

affecting partners’ pre-tax CA, then it is NOT substantial

**Shifting Allocations**: **RR 1.704-1(b)(2)(iii)(b)**: Shift income to a partner in a lower bracket, shifts losses to partner in a higher bracket

**General Rule**: Not substantial if partners allocated certain types of income/ loss among themselves solely to reduce taxes

NOT substantial if, at the time of the allocations are put into the PA

agreement, there’s a “strong likelihood” that:

***1) The “net effect” on partner’s CAs are not significantly different in***

***the absence of allocations; and***

***2) Total tax liability of partners (taking into account their personal***

***circumstances) is less than it’d be in the absence of allocation***

**Ex**: A is in 40% Bracket. B is in 0% Bracket. Equal general partners. Shares

all income equally. PA agreement says A gets all TEI up to his 50% share. In

Y1, $110 of TEI, $90 of ordinary income

***1) CAs remain the same***

**CA Balance**: **Special**: A B **Control**: A B

Y1 $100 $100 Y1 $100 $100

Ending Balance $100 $100 Ending Balance $100 $100

**|\_\_\_\_|\_\_\_Same\_\_\_\_\_\_\_\_\_\_\_\_\_| |**

**|\_\_\_\_\_\_\_\_Same\_\_\_\_\_\_\_\_\_\_\_\_\_\_|**

***2) Total tax liability goes down***

**Special**: A B **Control**: A B

Bracket 40% 0% 40% 0%

TEI $100 $10 $50 $50

Ordinary Income $0 $90 $50 $50

Total Taxes $0 $0 $20 $0

**|\_\_\_\_\_\_\_|\_\_\_C Pays $20 Less\_\_\_| |**

**|\_\_\_\_\_\_\_\_Same\_\_\_\_\_\_\_\_\_\_\_\_\_\_|**

**Ex**: C is in 40% Bracket. D is in 25% Bracket. Equal general partners. C has

capital loss carryover of ($100). CG taxed at 20%. PA has $100 of CG, $100

of ordinary income. At Y4 start, PA K amended to allocate CG entirely to C

and that same amount of ordinary income to D. Any excess is split 50-50

***1) CAs remain the same (As long as ord. income exceeds CGs)***

**CA Balance**: **Special**: A B **Control**: A B

Y4 $100 $100 Y4 $100 $100

Ending Balance $100 $100 $100 $100

**|\_\_\_\_|\_\_\_Same\_\_\_\_\_\_\_\_\_\_\_\_\_| |**

**|\_\_\_\_\_\_\_\_Same\_\_\_\_\_\_\_\_\_\_\_\_\_\_|**

***2) Total tax liability goes down***

**Special**: C D **Control**: C D

Bracket 40% 25% 40% 25%

CG $100 $0 $50 $50

Capital Loss ($100) $0 ($50) $0

Ordinary Income $0 $100 $50 $50

Total Taxes $0 $25 $20 $30

**|\_\_\_\_\_\_\_|\_\_\_C Pays $20 Less\_\_\_| |**

**|\_\_\_\_\_\_\_\_D pays $5 Less\_\_\_\_\_\_\_|**

**Gain-Chargeback Provisions**: When asset is sold, the initial gain goes to the partner who got depreciation deductions (makes up for the depreciation that partner already got) 🡪 These DO pass substantiality

**Transitory Allocations**: **RR 1.704-1(b)(2)(iii)(c)**: often if loss expires in future

**Generally**: Occurs when PA makes an **“original allocation”** in Y3, and then cancels out that allocation in another year via an **“offsetting allocation”**

**General Rule**: If a PA has both “original” and “offsetting” allocations, then NOT substantial if, at the time of the allocations:

***1) Effect of “original” and “offsetting” allocations is that CAs will not***

***substantially differ from what they would’ve been if neither allocation***

***2) And, total taxes will be reduced from what it would otherwise be***

**5 Year Rule**: **RR 1.704-1(b)(2)(iii)(c)**: Presume NOT a transitory allocation if:

1) At the time of the “original” and “offsetting” allocations;

2) There is a “strong likelihood” that the “original allocation”

3) Will NOT be “largely offset” by the “offsetting allocation” within 5 years

of the original allocation

**Value-Equals Basis Rule**: **RR 1.704-1(b)(2)(iii)(c) (Flush)**: PA’s assets are irrebuttably presumed to have a value equal to their tax basis

**Ex**: A & B equal partners. Predictable $100 income/year. A has a $100 loss

that expires in Y1. In Y2, A expects to be in 40% bracket. B expects to stay

in 40% bracket. In Y1, PA gives income to A. In Y2, PA gives income to B

***1) CA do NOT “substantially differ”***

**CA Balance**: **Special**: A B **Control**: A B

Y1 $100 $0 Y1 $50 $50

Y2 $0 $10 Y2 $50 $50

Ending Balance $100 $100 Ending Balance $100 $100

**|\_\_\_\_|\_\_\_Same\_\_\_\_\_\_\_\_\_\_\_\_\_| |**

**|\_\_\_\_\_\_\_\_Same\_\_\_\_\_\_\_\_\_\_\_\_\_\_|**

***2) Total Taxes ARE reduced***

**Taxes**: **Special**: A B **Control**: A B

Y1 Income $100 $0 Y1 Income $50 $50

Y1 Loss. ($100) $0 Y1 Loss ($100) $0

Y1 Tax $0 $0 Y1 Tax $0 $20

Y2 Income $0 $100 Y2 Income $50 $50

Y2 Loss $0 $0 Y2 Loss $0 $0

Y2 Tax $0 $40 Y2 Tax $20 $20

Total Tax $0 $40 Total Tax $20 $40

**|\_\_\_\_\_\_\_|\_\_\_C Pays $20 Less\_\_\_| |**

**|\_\_\_\_\_\_\_\_Same\_\_\_\_\_\_\_\_\_\_\_\_\_\_|**

***After Tax Test***

**RR 1.704-1(b)(2)(iii)(a)**: if after-tax effect of an allocation is to enhance the economic consequences of one partner without adversely affecting the other partner, then it is NOT substantial

**General Rule**: Even if meets the pre-tax rule, NOT substantial if, at the

time an allocation becomes part of the PA agreement

***1) The allocation may (in PV terms) enhance after-tax economic***

***consequences of one partner; and***

Does NOT focus on capital accounts, focuses on after-tax

consequences to the partners

***2) “Strong likelihood” that after-tax economic consequences of no***

***partner will be diminished***

**Ex**: A has $100 carryover loss in Y1 and in Y2. PA has $100 of income each

year. In Y3-Y5, A expects to be in 40% bracket. B is in 40% bracket. A and B

agree to allocate all income to A in Y1 and Y2. In Y3-Y5, B gets all income

**Taxes**: **Special**: A B **Control**: A B

Y1 Income $100 $0 Y1 Income $50 $50

Y1 Loss. ($100) $0 Y1 Loss ($50) $0

Y1 Tax $0 $0 Y1 Tax $0 $20

Y2 Tax $0 $0 Y2 Tax $0 $20

Y3 Income $0 $100 Y3 Income $50 $50

Y3 Loss $0 $0 Y3 Loss $0 $0

Y3 Tax $0 $40 Y3 Tax $20 $20

Y4 Tax $0 $40 Y4 Tax $20 $20

Y5 Tax $0 $40 Y5 Tax $20 $20

Total Tax $0 $120 Total Tax $60 $100

**After-Tax Benefit**: **Special**: A B **Control**: A B

Total Income $200 $300 Total Income $250 $250

Total Tax ($0) ($120) Total Tax ($60) ($100)

After-Tax Income: $200 $180 After-Tax Income $190 $150

**|\_\_\_\_|\_\_\_A Benefits by $10\_\_\_\_| |**

**|\_\_\_\_\_\_\_\_B Benefits by $30\_\_\_\_|**

**Analysis**: 1) DOES enhance after-tax consequences for A **($10)** and B **($30)**

2) VERY “strong likelihood” that no partner will be worse off

**Non-Recourse Deductions –****RR 1.704-2**

***Generally***

**Tufts**: when property subject to NR debt is disposed of, the full amount of the NR debt is included in AR

**Effect**: If debtor transfers an asset subject to a NR debt where the NR debt

exceeds debtor’s basis, debtor MUST recognize gain

**Minimum Gain**: Difference between the principal of NR debt and asset’s AB

**NOTE**: PMG Analysis ONLY applies if an asset’s AB is less than its outstanding NR Debt!!!

**RR 1.704-2*****– Safe Harbor***

**RR 1.704-2(e)**: If partnership meets this, deemed to be in accords with PIP:

***1) PA meets the Basic or Alternative Test***

QIO’s are never triggered in the NR deduction world

***2) PA Agreement has a “minimum gain chargeback provision”***

See Below!

***3) Allocation of the NR deduction is “within range” of “other allocations”***

***that have SEE at anytime***

**RR 1.704-2(e)(2)**: NR deductions must be allocated by PA agreement

in a manner that is **“Rly consistent”** with allocations of some other

“significant items” attributable to the property securing the debt

**Within Range**: What is Max amount each partner can get from X

Item under the PA Agreement? What is the Min amount?

Partner A’s Worst Year Allocation \_\_\_\_\_\_\_X% **\_\_\_\_\_\_**

| **| If within**

| **| X% and**

| **| Y%, YES**

| **| “within”**

|  **\_\_\_\_\_\_| range**

Partner A’s Best Year Allocation \_\_\_\_|\_\_\_Y%

**Ex**: PA agreement says to split NR deductions 80-20 between A

and B. Non-liquidating cash distributions are 90-10 to A and B

until profitable. After that, A and B split 50-50. Are the following

NR deduction allocations “within range”?

A B

**50% 50% ———> Yes Within Range**

**10% 90% ———> Yes Within Range**

**1% 99% ———> NOT Within Range**

**X**

A’s Worst Year \_\_**X**\_\_50% B’s Worst Year\_\_\_**X**\_\_10%

| |

| |

| |

| |

A’s Best Year \_\_\_**X**\_\_\_90% B’s Best Year\_\_\_\_**X**\_\_\_50%

**X**

***Minimum Gain Charge-Back Provision***

**Generally**: requires partners who got NR deductions to report an offsetting amount of gain at disposition

If partner got the benefit of a NR deduction/distribution, must recognize

his share of PMG upon disposition

If Net PMG decreases, that partner must recognize the gain

**Partnership Minimum Gain (PMG)**: **RR 1.704-2(d)**: Min amount of gain PA

would realize if disposed of the asset subject to the NR debt

**PMG Recognition Trigger**: If there’s “**net *decrease*”** in PMG (at disposition)

**Total PMG** **Formula**: NR Debt

(Basis in Property)

Total PMG

**Partner’s PMG Share Formula**: NR Deductions Allocated to Partner

(Partner’s Share of Net Decreases to PMG)

Partner’s Share of PMG

**Increases in PMG**: ***1) Depreciation Deductions***

***2) NR Distributions***

**RR 1.704-2(h)**: If PA borrows NR debt, uses asset   
 as collateral, & distributes the NR debt to partner

***3) Secondary financing***

When the PA borrows NR debt and uses an asset as collateral for the NR debt

**Ex**: PA owned Land. $500 FMV, $200 basis.

Later, borrowed $350 NR debt secured by land

NR Debt $350

Basis in Land ($200)

PMG $150

**Exceptions**: **PMG does NOT increase for**:

***1) Conversions & Refinancing (Guarantees)***

Conversion of NR debt into recourse debt for a partner

**RR 1.704-2(f)(2)**: for guaranteeing partner, no PMG

recognition bc he now bears the economic risk

For non-guaranteeing partner, must recognize PMG

**RR 1.704-2(j)(2)(i):** bc there’s no gain to “charge

back,” non-guaranteeing partner must recognize

a pro rata portion of PA’s other items of gain

***2) Contributions of Capital***

**RR 1.704-2(f)(3)**: If partner contributes capital to repay

the NR debt, it does NOT trigger PMG recognition

If partner’s contribution would cause outstanding

NR debt to be less than asset’s AB, apply SEE rules

***3) Revaluations***

**RR 1.704-2(d)(4)**: Applies for **IRC 704(c)**-type gain

**Example**: L contributes $90, G contributes $10. Bought building for $900 NR debt, $100 cash. $100 Deprec./year. Income & distributions split 90-10 until profitable, then 50-50. NR deductions split 80-20 to L and G. In Y4, G and L contribute $40 and $160 to pay off the debt. Building is sold in Y4 for $1,100

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Year | Capital  Accounts | | AB |  | Debt | | Total PMG | PMG | |
| G | L |  |  |  |  | | G | L |
| Y1 Start | 10 | 90 | 1,000 | ≥ | 900 | — | | — | — |
| Y1 Deprec. | (10) | (90) | (100) |  |  |  | |  |  |
| Y2 Start | 0 | 0 | 900 | ≥ | 900 | — | | — | — |
| Y2 Deprec. | (20) | (80) | (100) |  |  | +100 | |  |  |
| Y3 Start | (20) | (80) | 800 | < | 900 | 100 | | 20 | 80 |
| Y3 Deprec. | (20) | (80) | (100) |  |  | +100 | | +20 | +80 |
| Y4 Start | (40) | (160) | 700 | < | 900 | 200 | | 40 | 160 |
| Contribution | +40 | +160 |  |  | (200) |  | |  |  |
| Post-Contr. | 0 | 0 | 700 | ≥ | 700 | 200 | | 40 | 160 |
| Y4 Cumm. P. | +10 | +90 |  |  |  |  | |  |  |
| Y4 Gain | +50 | +50 |  |  |  |  | |  |  |

**Total Gain Recognized**: G L

PMG $40 $160

Cumulative Profit $10 $90

Remaining Gain $50 $50

Total Gain in Y4 $100 $300

**Contributions of Property –** **IRC 704(c)**

**Switching Methods**: **RR 1.704-3(a)(2)**: PA can use different methods for different assets, but must **consistently** apply the same method to an asset once it starts using that method

**IRC 704(c)(1)(A)**: for built-in gain property, CP must be contributed his share of built-in gain that existed when he contributed the property

**Reverse** **704(c)** **Allocations**: When PA assets are revalued (booked up) bc a new partner joins the PA

**Effect**: All PA’s built-in gain/loss realized for book (but not tax) purposes

**RR 1.704-3(a)(6)(i)**: Make allocations in accords with **IRC 704(c)** principals

PA must use a valuation methods to eliminate book/tax disparities

***Traditional Method –* RR 1.704-3(b)**

**Non-Depreciable Property**

**Generally**: NCP is only taxed on gain/loss after formation  
 CP is responsible for the built in loss

**Analysis**: ***1) Calculate Book gain/loss;***

***2) Calculate Tax gains/loss;***

***3) Allocate book gain/loss in accords with the PA agreement;***

***4)* NCP*: Allocate tax gain/loss to NCP* up to *book gain/loss;***

**Ceiling Rule**: **RR 1.704-3(b)(1)**: can ONLY allocate tax gain/

loss ***up to*** the amount of tax gain/loss PA actually recognizes

***5)* CP*: Allocate the remaining tax gain/loss to CP***

**Ceiling Rule**: Same

**Example**: **No Ceiling Rule Issues**

**Ex**: 50-50 PA. 2 years ago, A bought land for $50. Now worth $100.

Contributes to PA. B contributes $50 cash. Sells land for $150

A B

Tax Book Tax Book

Initial Contribution **50** **100** 100 100

(3) Book Gain — 25 — 25

(4) Tax Gain — — 25 —

(5) Remaining Tax Gain 75 — — —

End 125 125 125 125

***1) Calculate Book Gain* AR 150**

**AB (100)**

**Book Gain 50**

***2) Calculate Tax Gain* AR 150**

**AB (50)**

**Tax Gain 100**

***3) Allocate book gain by PA Agreement* (50-50)**

**A: $25 Book gain**

**B: $25 Book Gain**

***4)* NCP*: Give Tax Gain* (100) *up to NCP’s Book Gain* (25)**

***5)* CP*: Allocate remaining tax gain to CP*  (75)**

**A’s Built-In Gain: $50**

**A’s Tax Gain: $25**

**Example**: **Yes Ceiling Rule Issues**

**Ex**: 50-50 PA. 2 years ago, A bought land for $50. Now worth $100.

Contributes to PA. B contributes $50 cash. Sells land for $70

A B

Tax Book Tax Book

Initial Contribution **50** **100** 100 100

(3) Book Loss — (15) — (15)

(4) Tax Loss — — — —

(5) Remaining Tax Gain 20 — — —

End 70 85 100 85

***1) Calculate Book Gain* AR 70**

**AB (100)**

**Book Loss (30)**

***2) Calculate Tax Gain* AR 70**

**AB (50)**

**Tax Gain 20**

***3) Allocate book gain by PA Agreement* (50-50)**

**A: ($15) Book Loss**

**B: ($15) Book Loss**

***4)* NCP*: Give Tax Loss* (0) *up to NCP’s Book Loss* (30)**

***5)* CP*: Allocate remaining tax gain to CP* (20)**

***Traditional Method –* RR 1.704-3(b)**

**Depreciable Property**

**Generally**: Allocates depreciation away from the CP, meaning the NCP gets tax depreciation **up to** his book depreciation

**Analysis**: ***1) Calculate Book Depreciation***

**Book Basis**

**———————————— = Book Depreciation/Year**

**Remaining Recovery Period**

***2) Calculate Tax Depreciation***

**Tax Basis**

**———————————— = Tax Depreciation/Year**

**Remaining Recovery Period**

***3) Allocate book deprecation in accords with the PA agreement***

***4)* NCP: *Allocate tax depreciation to match his book depreciation***

**Ceiling Rule**: **RR 1.704-3(b)(1)**: can ONLY allocate tax gain/

loss ***up to*** the amount of tax gain/loss PA actually recognizes

***5)* CP: *Allocate remaining tax depreciation to CP***

**Example**: **No Ceiling Rule Issues**

**Ex**: 50-50 PA. 5 years ago, A got equipment (10 year recovery time). When

equipment had FMV of $100, basis of $80, A gave to PA. B gave $100 cash.

PA had $10 of net income each year.

A B

Tax Book Tax Book

Initial Contribution **80** 100 100 100

Net Income 10 10 10 10

(3) Book Depreciation — (10) — (10)

(4) NCP Tax Depreciation — — (10) —

(5) CP Tax Depreciation (6) — — —

Y1 End 84 100 100 100

…..

Y5 End 100 100 100 100

***1) Calculate Book Depreciation* $100 Book Basis**

**———————— = $20/Year**

**5 Years**

***2) Calculate Tax Depreciation* $80 Tax Basis**

**———————— = $16/Year**

**5 Years**

***3) Allocate book depreciation by PA Agreement* (50-50)**

**A: (10) Book Depreciation**

**B: (10) Book Depreciation**

***4)* NCP*: Allocate Tax Deprec.* (16)  *up to NCP’s Book Deprec.* (10)**

***5)* CP*: Allocate remaining Tax Depreciation to CP*  (6)**

**Example**: **Yes Ceiling Rule Issues**

**Ex**: 50-50 PA. 5 years ago, A bought equipment for T/B (10 year recovery

period). When equipment had FMV of $100, Basis of $20, A contributed

equipment to PA. B contributed $100 cash. Net income of $10/year

A B

Tax Book Tax Book

Initial Contribution **20** 100 100 100

Net Income 10 10 10 10

(3) Book Depreciation — (10) — (10)

(4) NCP Tax Depreciation — — (4) —

(5) CP Tax Depreciation (0) — — —

Y1 End 30 100 106 100

…..

Y5 End 70 100 130 100

***1) Calculate Book Depreciation* $100 Book Basis**

**———————— = $20/Year**

**5 Years**

***2) Calculate Tax Depreciation* $20 Tax Basis**

**———————— = $4/Year**

**5 Years**

***3) Allocate book depreciation by PA Agreement* (50-50)**

**A: (10) Book Depreciation**

**B: (10) Book Depreciation**

***4)* NCP*: Allocate Tax Deprec.* (4) *up to NCP’s Book Deprec.* (10)**

***5)* CP*: Allocate remaining Tax Depreciation to CP*  (0)**

***Traditional Method with Curative Allocations –*** **RR 1.704-3(c)**

**Non-Depreciable Property**

**Generally**: **RR 1.704-3(c)(3)**: Curative allocations must be “R in amount” and be of the **same character** as the item that was subject to the ceiling rule

If no item of the **same character**, can NOT make a curative Allocation

**Analysis**: ***1) Calculate Book gain/loss;***

***2) Calculate Tax gains/loss;***

***3) Allocate book gain/loss in accords with the PA agreement;***

***4)* NCP*: Allocate tax gain/loss to NCP up to book gain/loss;***

**Ceiling Rule**: **RR 1.704-3(b)(1)**: can ONLY allocate tax gain/

loss up to the amount of tax gain/loss PA actually recognizes

***5)* CP*: Allocate the remaining tax gain/loss to CP;***

**Ceiling Rule**: Same

***6) Calculate Subtotals;***

***7) Perform Curative Allocation:***

***A)* Both*: Allocate book income of* same character *to both***

***B)* NCP*: Allocate tax income of* same character *to NCP in***

***an amount that makes NCP’s tax match NCP’s book***

***C)* CP*: Allocate the remaining Tax Income to CP***

**Example**:

**Ex**: 50-50 PA. 2 years ago, A bought land for $50. Now worth $100.

Contributes to PA. B contributes $50 cash. Sells land for $70. PA also sold

stock for an $80 profit

A B

Tax Book Tax Book

Initial Contribution 50 100 100 100

(3) Book Loss — (15) — (15)

(4) Tax Loss — — — —

(5) Remaining Tax Gain 20 — — —

(6) Subtotals 70 85 100 85

(7)(A) Stock Income — 40 — 40

(7)(B) Curative NCP — — 25 —

(7)(C) Curative CP 55 — — —

End 125 125 125 125

***1) Calculate Book Loss* AR 70**

**AB (100)**

**Book Loss (30)**

***2) Calculate Tax Loss* AR 70**

**AB (50)**

**Tax Gain 20**

***3) Allocate book loss by PA Agreement* (50-50)**

**A: ($15) Book Loss**

**B: ($15) Book Loss**

***4)* NCP*: Allocate Tax Loss up to NCP’s Book* *Loss* (0)**

***5)* CP*: Allocate remaining tax gain to CP* (20)**

***6) Calculate Subtotals***

***7) Perform Curative Allocation***

***A) Allocate book income* (80) *of* same character (stock)**

**A: $40 Stock Income**

**B: $40 Stock Income**

***B)* NCP*: Allocate tax income of* same character (stock)**

***to NCP in way that makes NCP’s tax match book* (25)**

***C)* CP*: Allocate remaining amount of Tax Income* (55)**

***of the same character* (stock) *to CP***

***Traditional Method with Curative Allocations –*** **RR 1.704-3(c)**

**Depreciable Property**

**Generally**: **RR 1.704-3(c)(3)**: lets PA cure ceiling rule disparities bc PA can use “R allocations” of other PA items that have the **same character** as the item that created the disparity

**Analysis**: ***1) Calculate Book Depreciation***

**Book Basis**

**———————————— = Book Depreciation/Year**

**Remaining Recovery Period**

***2) Calculate Tax Depreciation***

**Tax Basis**

**———————————— = Tax Depreciation/Year**

**Remaining Recovery Period**

***3) Allocate book deprecation in accords with the PA agreement***

***4)* NCP: *Allocate tax depreciation to match his book depreciation***

**Ceiling Rule**: **RR 1.704-3(b)(1)**: can ONLY allocate tax gain/

loss ***up to*** the amount of tax gain/loss PA actually recognizes

***5)* CP: *Allocate remaining tax depreciation to CP***

***6) Calculate Subtotals;***

***7) Perform Curative Allocation:***

***A)* Both*: Allocate book income of same character to both***

***B)* NCP*: Allocate tax income of same character to NCP in***

***an amount that makes NCP’s tax match NCP’s book***

***C)* CP*: Allocate the remaining Tax Income to CP***

**Example**:

**Ex**: 50-50 PA. 5 years ago, A bought equipment for T/B (10 year recovery

period). When equipment had FMV of $100, Basis of $20, A contributed

equipment to PA. B contributed $100 cash. Net income of $20/year

A B

Tax Book Tax Book

Initial Contribution **20** 100 100 100

(3) Book Depreciation — (10) — (10)

(4) NCP Tax Depreciation — — (4) —

(5) CP Tax Depreciation 0 — — —

(6) Subtotals 20 90 96 90

(7)(A) Book Income — 10 — 10

(7)(B) Curative NCP — — 4 —

(7)(C) Curative CP 16 — — —

Y1 End 36 100 100 100

…..

Y5 End 100 100 100 100

***1) Calculate Book Deprec.* $100 Book Basis**

**——————— = $20/Year**

**5 Years**

***2) Calculate Tax Deprec.* $20 Tax Basis**

**———————— = $4/Year**

**5 Years**

***3) Allocate book depreciation by PA Agreement* (50-50)**

**A: ($10) Book Depreciation**

**B: ($10) Book Depreciation**

***4)* NCP*: Give tax depreciation up to NCP’s Book* *Deprec.* (4)**

***5)* CP*: Allocate remaining tax depreciation to CP* (0)**

***6) Calculate Subtotals***

***7) Perform Curative Allocation***

***A) Give book income* (20) *of same character* (equip.)**

**A: $10 Stock Income**

**B: $10 Stock Income**

***B)* NCP*: Allocate tax income of same character* (equip.)**

***to NCP in way that makes NCP’s tax match book* (4)**

***C)* CP*: Allocate remaining amount of Tax Income* (16)**

***of the same character* (equip.) *to CP***

***Remedial Allocations Method –*** **RR 1.704-3(d)**

**Non-Depreciable Property**

**Generally**: lets partners ignore the ceiling rule bc tax allocations will always be available to the NCP bc the PA can “create” them (notional item)

**Analysis**: ***1) Calculate Book gain/loss;***

***2) Calculate Tax gains/loss;***

***3) Allocate book gain/loss in accords with the PA agreement;***

***4) NCP: Allocate tax gain/loss to NCP up to book gain/loss;***

**Ceiling Rule**: **RR 1.704-3(b)(1)**: can ONLY allocate tax gain/

loss up to the amount of tax gain/loss PA actually recognizes

***5) CP: Allocate the remaining tax gain/loss to CP;***

**Ceiling Rule**: Same

***6) Calculate Subtotals;***

***7) Perform Remedial Allocation***

***A)* NCP*: Allocate to NCP “fictitious” item of tax loss in an***

***amount that makes NCP’s tax equal his book***

***B)* CP*: Allocate to CP “fictitious” item of tax gain to CP in***

***that same amount***

**Ex**: 50-50 PA. 2 years ago, A bought land for $50. Now worth $100.

Contributes to PA. B contributes $100 cash. Sells land for $70

A B

Tax Book Tax Book

Initial Contribution 50 100 100 100

(3) Book Loss — (15) — (15)

(4) Tax Loss — — — —

(5) Remaining Tax Gain 20 — — —

(6) Subtotals 70 85 100 85

(7)(A) Remedial Loss — — (15) —

(7)(B) Remedial gain 15 — — —

End 85 85 85 85

***1) Calculate Book* *Loss* AR 70**

**AB (100)**

**Book Loss (30)**

***2) Calculate Tax Loss* AR 70**

**AB (50)**

**Tax Gain 20**

***3) Allocate book loss by PA Agreement* (50-50)**

**A: ($15) Book Loss**

**B: ($15) Book Loss**

***4) NCP: Allocate Tax Loss* up to *NCP’s Book Loss* (0)**

***5) CP: Allocate remaining tax gain to CP* (20)**

***6) Calculate Subtotals***

***7) Perform Remedial Allocation***

***A)* NCP*: Allocate to NCP “fictitious” item of tax loss in***

***an* *amount that makes NCP’s tax equal his book* (15)**

***B)* CP*: Allocate to CP “fictitious” item of tax gain to CP***

**In that same amount (15)**

***Remedial Allocations Method –*** **RR 1.704-3(d)**

**Non-Depreciable Property**

**Analysis**: ***1) Break Up Assets Into Pre-Contribution Gain/Loss***

***A) Original Asset***: as if the partner kept the depreciating it

**Recovery Period**: Stay on same depreciation timeline

**Formula**: **Tax Basis**

**———————————— = Depreciation/Year**

**Remaining Recov. Period |\_Divide by Partners#**

***B) Additional Value Asset***: Portion of built-in gain in asset

**Recovery Period**: Recovery period starts over

**Formula**: **Built-In Gain**

**—————————— = Depreciation/Year**

**New Recovery Period |\_Divide by Partners#**

***2) Calculate Book Depreciation***

**Original Asset Y1 Y5 Y10**

**Depreciation Y Y Y Y Y**

**Additional Value |—|—|—|—|—|—|—|—|—|**

**Asset Depreciation X X X X X X X X X X**

**Book Depreciation: XY XY XY XY XY X X X X X**

***3)*** ***Calculate Tax Depreciation***

**Tax Basis**

**———————————— = Depreciation/Year**

**Remaining Recovery Period**

***4) Allocate Book depreciation to the partners***

**Y1-Y5: $X/Year**

**Y5-Y10: $Y/Year**

***5) Allocate Tax Deprec. NCP up to book his book depreciation***

**Y1-Y5: $X/Year**

**Y5-Y10: $0/Year**

***6) Allocate remaining tax depreciation to CP***

***7) Calculate Subtotals***

***8) Perform Remedial Allocation***

**A) NCP: Allocate to NCP *“fictitious”* item of tax *loss* in**

**an amount that makes NCP’s tax equal his book**

**Y1-Y5: ($2)**

**Y6-Y10: ($4)**

**B) CP: Allocate to CP *“fictitious”* item of tax *gain* to CP**

**In that same amount**

**Ex:** 5 years ago, A got equipment for $150 (10 year recovery period). FMV of $100, basis of $20 at contribution. B contributes $100 cash. $10 of net income each year

A B

Tax Book Tax Book

Initial Contribution **20** 100 100 100

Net Income 10 10 10 10

(4) Book Depreciation — (6) — (6)

(5) NCP Tax Deprec. — — (4) —

(6) CP Tax Deprec. (0) — — —

(7) Subtotals 30 104 106 104

(8)(A) Remedial Loss — — (2) —

(8)(B) Remedial gain 2 — — —

Y1 End 32 104 104 104

……

Y5 End 80 120 120 120

Net Income 10 10 10 10

(4) Book Depreciation — **(4)**  — **(4)**

(5) NCP Tax Deprec. — — **(0)** — **<— No more**

(6) CP Tax Deprec. (0) — — — **tax deprec.**

(7) Subtotals 90 126 **130** 126 **left to give**

(8)(A) Remedial Loss — — **(4)** —

(8)(B) Remedial gain **4** — — —

Y6 End 94 126 126 126

……

Y10 End 150 150 150 150

**Analysis**: ***1) Break Up Assets Into Pre-Contribution Gain/Loss***

***A) Original Asset***: Original asset as if the partner kept the

asset and kept depreciating it

**Recovery Period**: Stay on same depreciation timeline

**Formula**: **$20**

**—————— = $4 Depreciation/Year**

**5 Years |\_\_$2/partner**

***B) Additional Value Asset***: Portion of built-in gain in asset

**Recovery Period**: Recovery period starts over

**Formula**: **$80**

**—————— = $8 Depreciation/Year**

**10 Years |\_\_$4/partner**

***2) Calculate Book Depreciation***

**Original Asset Y1 Y5 Y10**

**Depreciation 2 2 2 2 2**

**Additional Value |—|—|—|—|—|—|—|—|—|**

**Asset Depreciation 4 4 4 4 4 4 4 4 4 4**

**Book Depreciation: 6 6 6 6 6 4 4 4 4 4**

***3)*** ***Calculate Tax Depreciation***

***$20 ÷ 5 years = $4/year***

***4) Allocate Book deprec. to partners***

**Y1-Y5: $6/year**

**Y6-Y10: $4/Year**

***5) Allocate Tax Deprec. NCP up to book his book deprec.***

**Y1-Y5: $4/year**

**Y6-Y10: $0/Year**

***6) Allocate remaining tax depreciation to CP (0)***

***7) Calculate Subtotals***

***8) Perform Remedial Allocation***

***A)* NCP*: Allocate to NCP “fictitious” item of tax loss in***

***an* *amount that makes NCP’s tax equal his book***

**Y1-Y5: ($2)**

**Y6-Y10: ($4)**

***B)* CP*: Allocate to CP “fictitious” item of tax gain to CP***

**In that same amount**

***Built-In Loss Property –*** **IRC 704(c)(1)(C)**

***Non-Depreciable Property***

**Generally**: **IRC 704(c)(1)(C)**: If partner contributes a built-in loss property, such built-in loss can ONLY be allocated to the CP

**Policy**: IRC bans CP from shifting built-in loss to NCP

Really, built-in losses aren’t subject to ceiling rule and can't be shifted

**CP**: **IRC 704(c)(1)(C)(i)**: If CP contributes built-in loss asset, PA must

allocated any tax loss from that asset to CP

**NCP**: **IRC 704(c)(1)(C)(ii)**: To find the amount of built-in loss given to NCP,

treat PA as having an “Initial Tax Basis” it equal to FMV at contribution

**Ex**: 50-50 PA. 2 years ago, A bought land for $140. Now worth $100.

Contributes to PA. B contributes $100 cash. Sells land for $120

**Initial Balance Sheet**: Basis Book | Liabilities

Cash 100 100 | Debt 0

Land 100 100 |

| Capital Accounts

| Tax Book OB

| A 100 100 140

| B 100 100 100

**Analysis**: ***1) Divide IRC 704(c)(1)(C) property into:***

***A) Common Inside Basis***: equals the asset’s FMV

**Effect**: No book/tax disparity on Asset side of the

balance sheet and tax CA equals the asset’s FMV

***B) Built-In Loss Basis Adjustment***: equals asset’s built-in loss

**Effect**: increases CP’s OB by the amount of built-in loss

**RR 1.704-3(f)(2)(iii)**: Built-In Loss Basis Adjustment can

ONLY be used solely on CP (accounted for separately) ***2) For Common Inside Basis***

***A) Calculate book gain/loss***

***B) Calculate Tax gain/loss***

***C) Allocate book gain/loss in accords with PA agreement;***

***D)* NCP*: Allocate tax gain/loss to NCP up to book gain/loss;***

***E)* CP*: Allocate the remaining tax gain/loss to CP;***

***3) For Built-In Loss Basis Adjustment***

***A) Subtract Built-In Loss Basis Adjustment from the CP’s OB***

**Ex**: 50-50 PA. 2 years ago, A bought land for $140. Now worth $100.

Contributes to PA. B contributes $100 cash. Sells land for $120

**Book’s Method**: A B

Tax Book OB Tax Book OB

Initial Contribution 100 100 140 100 100 100

(2)(C) Book Gain/Loss — 10 — — 10 —

(2)(D) NCP Tax Gain/Loss — — — 10 — 10

(2)(E) CP Tax Gain/Loss 10 — 10 — — —

(3)(A) CP Built-In Loss — — (40) — — —

End 110 110 110 110 110 110

**Professor’s Method**: A B

Tax Book Tax Book

Initial Contribution 140 100 100 100

(2)(C) Book Gain/Loss — 10 — 10

(2)(D) NCP Tax Gain/Loss — — 10 —

(2)(E) CP Tax Gain/Loss 10 — — —

(3)(A) CP Built-In Loss (40) — — —

End 110 110 110 110

**Analysis**: ***1) Divide IRC 704(c)(1)(C) property into:***

***A) Common Inside Basis***: **(FMV 100, Basis 100)**

***B) Built-In Loss Basis Adjustment***: **(40 built-in loss)**

***2) For Common Inside Basis***

***A) Calculate book gain/loss* AR 120**

**AB (100)**

**Book Gain 20**

***B) Calculate Tax gain/loss*  AR 120**

**AB (100)**

**Tax Gain 20**

***C) Allocate book gain/loss under PA agreement (50-50);***

***D)* NCP*: Give tax gain/loss to NCP up to book gain/loss (10);***

***E)* CP*: Give the remaining tax gain/loss to CP (10);***

***3) For Built-In Loss Basis Adjustment***

***A) Subtract Built-In Loss Basis Adjustment (40 built-in loss)***

***from the CP’s OB***

***Depreciable Property***

**Analysis**: ***1) Divide IRC 704(c)(1)(C) property into:***

***A) Common Inside Basis***: equals the asset’s FMV

**Effect**: No book/tax disparity on Asset side of the

balance sheet and tax CA equals the asset’s FMV

**Formula**: **FMV at Contribution**

**———————————— = Depreciation/Year**

**Remaining Recovery Period |**

**Divide by # of Partners**

***B) Built-In Loss Basis Adjustment***: equals asset’s built-in loss

**Effect**: increases CP’s OB by the amount of built-in loss

**RR 1.704-3(f)(2)(iii)**: Built-In Loss Basis Adjustment can

ONLY be used solely on CP (accounted for separately)

**Formula**: **Built-In Loss**

**———————————— = Depreciation/Year**

**Remaining Recovery Period |**

**ALL allocated to CP**

***2) For Common Inside Basis***

***A) Calculate book gain/loss***

***B) Calculate Tax gain/loss***

***C) Allocate book gain/loss in accords with PA agreement;***

***D)* NCP*: Allocate tax gain/loss to NCP up to book gain/loss;***

***E)* CP*: Allocate the remaining tax gain/loss to CP;***

***3) For Built-In Loss Basis Adjustment***

***A) Subtract Built-In Loss Basis Adjustment from the CP’s OB***

**Ex:** A contributes building ($1,200 basis, $500 FMV). B contributes $55

cash. Building has 20 years of depreciation left

**Professor’s Method**: A B

Tax Book Tax Book

Initial Contribution 1200 500 500 500

(2)(C) Book Gain/Loss — (12.5) — (12.5)

(2)(D) NCP Tax Gain/Loss — — (12.5) —

(2)(E) CP Tax Gain/Loss (12.5) — — —

(3)(A) CP Built-In Loss (35) — — —

End 1,151.5 487.5 487.5 487.5

**Analysis**: ***1) Divide IRC 704(c)(1)(C) property into:***

***A) Common Inside Basis***:

**Formula**: **$500 FMV**

**——————— = $25/Year**

**20 Years |\_\_\_\_\_$12.5/Partner**

***B) Built-In Loss Basis Adjustment***:

**Formula**: **$700 Built-In Loss**

**————————— = $35/Year**

**20 Years |\_\_ALL allocated to A**

***2) For Common Inside Basis***

***A) Calculate book depreciation (25)***

***B) Calculate Tax gain/loss (25)***

***C) Give book deprec. in accord with PA agreement (50-50);***

**A: $12.5**

**B: $12.5**

***D)* NCP*: Give tax deprec. to NCP up to book gain/loss (12.5)***

***E)* CP*: Allocate the remaining tax gain/loss to CP (12.5)***

***3) For Built-In Loss Basis Adjustment***

***A) Subtract Built-In Loss Basis Adjustment from CP (35)***

**Partnership Liability Allocations**

**IRC 704(d)**: Partner can NOT deduct PA losses in excess of his OB

***1) What Type of Liability Is It?***

**RR 1.752-1 Liability**: Non-contingent liabilities – fixed legal obligation

**RR 1.752-7** **Liability**: Contingent liabilities (not covered)

***2) Who Bears the Economic Risk of Loss (EROL)?***

**RR 1.752-2(b)(3)**: Determine who has the EROL by looking at:

**A) Partnership Agreement**: Might specify who bears EROL

**B) Loan Agreements**: Might specify who bears EROL

**C) Side Agreements**: among partners and others

**D) Local Law**: Rules on general versus limited partner liabilities

**General Partnerships**: Often recourse for all partners

**Limited Partnerships**: Maybe recourse for general partner

**LLCs**: NR for all partners absent side agreements

**Rev Ruling 97-38**: General partner in an LP does NOT have duty

to repay under local law unless debt is greater than book value

If LP’s asset is underwater, yes recourse for general partner

If LP’s asset is NOT underwater, NR for the general partner

**Satisfaction Presumption**: **RR 1.752-2(b)(6)**: in determining if a partner

has a “payment obligation,” assume that all partners will do what they

said they were going to do and pay off the loan

**Types of Payment Obligations**:

**De Minimis Rule**: **RR 1.752-2(d)(2)**: Small Partners – if NR debt &

B guarantees it, NOT a recourse against B if B owns 10% (or less)

of PA income, gain, loss, deduction

**Guarantees**: 1+ partner can ALSO be the lender

If recourse & B guarantees, ignore guarantee (unlike **indemnity**)

If NR & B guarantees, the loan is recourse for B

**Indemnifications**:

**Ex**: If A must pay out of pocket, B will reimburse A (B has EROL)

If recourse & B indemnify entire debt, all to B (unlike **guarantee**)

**Pledges**: **RR 1.752-2(h)**

Partner pledges “other property” (i.e. partner pledges an asset

that isn't subject to a security interest) if the PA doesn't pay

Bears EROL up to the FMV (not AB) of “other” collateral

**Effect**: Partner may have a ***partial EROL***

**Bottom Dollar Guarantees**: Ignore bottom dollar guarantees

**RR 1.752-2(f), Example 10**: if B guarantees a certain amount,

but not any particular amount, NOT a bottom loss guarantee

**Ex**: ABC equal partners in LLC. LLC borrows $100 from Bank.

A guarantees up to $30 of any amount of unpaid debt. B

guarantees $20, but only if Bank recovers less than $200

A’s guarantee is NOT a bottom loss guarantee bc A must

pay regardless of what amount goes uncollected

It is OK for A to limit his exposure to $300

B’s guarantee IS a bottom loss guarantee

**Effect**: $30 allocated to A’s OB, the remaining $70 is

allocated to A, B, and C under **RR 1.752-3**

**RR 1.752-2(f), Example 11**: ONLY has EROL if the partner is

exposed to the full amount of his promise

If a partner shifts a little risk to another, that partner loses

ALL of his promise and has no payment obligation

**Ex**: Same. Also C will indemnify A up to $10 on A’s guarantee

A’s guarantee IS a bottom loss guarantee bc A shifted risk

C’s indemnity is unqualified so C DOES bear EROL for $10

**Effect**: $10 allocated to C’s OB, the remaining $90 is

allocated to A, B, and C under **RR 1.752-3**

**Exceptions**: Do NOT apply the Satisfaction Presumption if:

***A) RR 1.752-2(j): Anti-Abuse***

No EROL if the facts/circumstances show that the principal

purpose was a plan to circumvent/avoid the EROL

**Factors**: **(A)** No comm. R contract restriction to protect Bank

**Ex**: B can to sell assets without creditor OK

**(B)** Not required to give financial doc to get loan

**(C)** Payment oblig. ends before loan’s term ends

**(D)** Debtor holds liquid assets that exceeds his Rly

foreseeable needs

**(E)** Lender can't promptly get paid on default

**(F)** Loan’s terms would be substantially the same if

the partner didn’t guarantee the loan\*\*\*

**Ex**: rate doesn't go down after B guarantees

***B) RR 1.752-2(k): No Commercially Reasonable Expectation***

No EROL there’s not a commercially R expectation that the

debtor will have the ability to pay the loan

**PROF**: Burden of proof issue – just show that it’d be

commercially R for partner to pay it back

***3) If Recourse, Apply* RR 1.752-2**

**End of World/Constructive Liquidation Test**: **RR 1.752-2(b)(1)**: Applies

when someone bears the EROL, but only in the amount that is borne

**Effect**: If, after the test, B bears EROL, then give OB to B for the

portion of the EROL that B bears

**Related Parties**: **RR 1.75203(b)(i)**: yes recourse debt is a partner OR a

related party bears the EROL

**IRC 267(b)(2)**: “related parties” include one who owns [10%]+ of the

partner’s outstanding stock

**Test**: **1) All liabilities of the PA are due and payable in full**

**2) All PA assets are worth $0**

**3) All PA assets are sold for $0**

**Exception**: **RR 1.752-2(b)(1)(iii)**: except for debt relief where

creditor’s right to repayment is limited solely to PA assts

**Prof**: Coordinates **RR 1.752-3** if has recourse & NR debt

**4) Allocate gains, losses, deductions under** **RR 1.704**

**5) PA liquidates**

***4) If Non-Recourse, Apply* RR 1.752-3**

**Three-Tier Waterfall**: If nobody bears EROL, apply this

***A) Allocate NR Debt Based on PMG***

***B) Allocate IRC 704(c) Pre-Contrib. Gain (But NOT Loss) To Partners***

If property became worthless, and then sold for the amount of

NR debt it had, how much gain with Partner recognize?

**Formula**: Outstanding NR Debt

(Tax Basis)

**IRC 704(c)** Gain

***C) Excess NR Liabilities***: allocate using one of these methods:

**i) Profits Ratio**: **(Default)**

**ii) NR Deductions Ratio**: The “RANGE” from **RR 1.704-2**, MUST

be specified in the PA agreement

Can do anything within that “range”

**iii) Additional Method**: first, allocate excess to CP, then allocate

leftover **IRC 704(c)** gain to them as well

**Examples – Recourse Debt**

**Ex**: Substantial Economic Effect Issues

**Ex**: A (general partner) and B (limited partner) form LP. A gives $10 cash, B

gives $90 cash. 10-90 split on everything. LP buys asset for $1,000 with

$100 cash, $900 recourse loan.

***1) Type of Liability?*** **RR** **1.752-1 Liability**

***2) Who bears EROL?*** **Facts say recourse**

***3) Apply RR 1.752-2***

***A) All debt ($900) is due and payable in full***

***B) All Assets are worth $0 (Building worth $0)***

***C) All Assets Sold for $0 (Building sold for $0)***

***D) Allocate gain/loss under* RR 1.704 *(Allocate $1,000 loss)***

***E) PA liquidates, who is it allocated?***

A B

Contribution 10 90  **Does NOT have SEE u**

PA K Allocation (100) (900)  **under RR 1.704-1 bc**

End (90) (810) **——> LP goes negative**

**|**

**| Apply Certain Determinations Rule**

**\/** A B

Contribution 10 90

PA K Allocation (910) (90)

End (900) 0

**|**

**| End Allocations**

**\/** A B

Contribution 10 90

Liability Allocation 900 0

Final OB 910 90

**Ex**: Same facts, but B is obligated to contribute up to $900 extra in needed

A B

Contribution 10 90  **DOES have SEE under**

PA K Allocation (100) (900) **RR 1.704-1 bc LP can go**

End (90) (810) **——>up to $900 negative**

**|**

**| End Allocations**

**\/** A B

Contribution 10 90

Liability Allocation 90 810

Final OB 100 900

**Examples – NR Debt**

**Ex**: A (general partner) and B (limited partner) form LP. A gives $10 cash, B gives $90 cash. 90-10 split. PA buys building for $100 cash, $900 NR debt

***1) Type of Liability?*** **RR 1.752-1 Liability**

***2) Who bears EROL?*** **Facts say NR**

***3) Apply*** **RR 1.752-3**

***A) Allocate NR Debt Based on PMG (No PMG)***

***B) Allocate IRC 704(c) Pre-Contrib. Gain To Partners (None)***

**C*) Excess NR Liabilities***

**i) Profits Ratio** A B

Contribution 10 90

PMG Allocation 0 0

704(c) Gain Alloc. 0 0

Liability Allocation 90 810

Final OB 100 900

**ii) NR Deductions Ratio (None)**

**iii) Additional Method (None)**

**Ex**: Same, but B pledges stock (AB of $100, FMV of $200) to secure the debt

***1) Type of Liability?*** **RR 1.752-1 Liability**

2***) Who bears EROL?*** **Partial EROL**

**RR 1.752-2(h)**: B pledged “other property” so gets partial EROL up

to the FMV of the stock

Effect: Recourse for B up to $200

***3) Apply*** **RR 1.752-3**

***A) Allocate NR Debt Based on PMG (No PMG)***

***B) Allocate IRC 704(c) Pre-Contrib. Gain To Partners (None)***

**C*) Excess NR Liabilities***

**i) Profits Ratio** A B

Contribution 10 90

Recourse Pledge. 0 200 **—> 900 NR Debt**

PMG Allocation 0 0  **(200) Pledged Stock**

704(c) Gain Alloc. 0 0 **700 Remaining NR Debt**

Liability Allocation 70 630 **|\_\_90-10 Split**

Final OB 80 920

**ii) NR Deductions Ratio (None)**

**iii) Additional Method (None)**

**Coordination Rule** **Example** - **RR 1.752-2(b)(1)(iii)**

**Ex**: 50-50 PA. A and B contribute $50 each. $150 recourse debt. Buys $200 land, $50 NR debt secures $100 of equipment

A B

Contribution 50 50

Equip. NR Debt 25 25 **Just subtract the**

**Coordination Rule (25) (25)——> NR debt,**

Equip. PA K Alloc. (25) (25) **then do normal**

Land PA K Alloc. (75) (75) **end of world test**

Result (75) (75)

**|  
 | End Allocations**

**\/** A B

Contribution 50 50

Equip. NR Debt 25 25

Land Liability Alloc. 75 75

Ending OB 150 150

**Example – General PA & Recourse Debt**

**Ex**: A and B formed GP in Y1. Each gave $20. 50-50 split. GP bought land ($40 cash, $140 recourse debt). Local law makes each partner liable to repay mortgage and interest on mortgage. What is GP’s basis at Y1 end?

***1) Type of Liability?*** **RR 1.752-1 Liability**

***2) Who bears EROL?*** **Facts say recourse**

***3) Apply* RR 1.752-2**

***A) All debt ($160) is due and payable in full***

***B) All Assets are worth $0 (Land worth $0)***

***C) All Assets Sold for $0 (Land sold for $0)***

***D) Allocate gain/loss under* RR 1.704 *(Allocate $200 loss)***

***E) PA liquidates, who is it allocated?***

A B

Contribution 20 20

PA K Allocation (100) (100)

End (80) (80)

**|**

**| End Allocations**

**\/** A B

Contribution 20 20

Liability Allocation 80 80

Final OB 100 100

**Ex**: Same facts, but A contributed $40 and B contributed $0

A B

Contribution 40 0

PA K Allocation (100) (100)

End (60) (100)

**|**

**| End Allocations**

**\/** A B

Contribution 40 0

Liability Allocation 60 100

Final OB 100 100

**Ex**: Same facts, but PA K said profits split 50-50, but losses split 90% to A

A B

Contribution 20 20

PA K Allocation (180) (20)

End (160) 0

**|**

**| End Allocations**

**\/** A B

Contribution 20 20

Liability Allocation 160 0

Final OB 180 20

**Example – NR Debt & IRC 704(c) Gain**

**Ex**: A, B, C form PA. A and B contribute $100 cash. C contributes Land ($1,000 FMV, $900 NR debt, basis of $300). Everything else split 1/3 each

A B C

Contribution 100 100 100 **—> Land - Debt**

Recourse Pledge. 0 0 0 **NR Debt 900**

PMG Allocation 0 0 0  **AB (300)**

704(c) Gain Alloc. 0 0 600 **——> Gain 600**

Liability Allocation 100 100 100

Final OB 200 200 800

**Example – Limited Partnership & NR Debt**

**Ex**: G (general partner) gave $10 for 10% interest, L (limited partner) gave $90 for 90% interest. LP got building ($100 cash, $900 NR debt). Interest payable in 20 years. $200 depreciation/year. 80-20 split on NR deductions

***Step 1: Normal NR Allocation***

G L

Contribution 10 90

PMG Allocation 0 0

704(c) Gain Alloc. 0 0 **Base on profits**

Liability Allocation 90 810**—> ratio bc no**

**Final OB 100 900** **PMG yet**

**| |**

***Step 2: Calculate PMG in Each Year*** **|\_\_\_\_\_\_\_\_\_|**

**\_\_\_**\_\_\_\_\_\_\_\_\_**\_\_\_\_\_\_\_\_\_|**

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Year | **|** Capital **|**  **|**Account **|** | | AB |  | Debt | Total PMG | PMG | |
| **|**G | L **|** |  |  |  |  | G | L |
| Y1 Start | **100** | **900** | **1,000** | ≥ | 900 | — | — | — |
| Y1 Rec. Dep. | (10) | (90) | (100) |  |  |  |  |  |
| Y1 NR Dep. | (20) | (80) | (100) | < | 900 | +100 | +20 | +80 |
| Y2 Start | 70 | 730 | 800 | < | 900 | 100 | 20 | 80 |
| Y2 NR Dep. | (40) | (160) | (200) |  |  | +200 | +40 | +160 |
| Y3 Start | 30 | 570 | 600 | < | 900 | 300 | 60 | 240 |
| Y3 NR Dep. | (40) | (160) | (200) |  |  | +200 | +40 | +160 |
| Y4 Start | (10) | 410 | 400 | < | 900 | 500 | 100 | 400 |
| Y4 NR Dep. | (40) | (160) | (200) |  |  | +200 | +40 | +160 |
| Y5 Start | (50) | 250 | 200 | < | 900 | 700 | 140 | 560 |
| Y5 NR Dep. | (40) | (160) | (200) |  |  | +200 | +40 | +160 |
| Y5 End | (90) | 90 | 0 | < | 900 | 900 | 180 | 720 |

***Step 3: Add PMG for Each Year to NR Debt Formulas (Change Each Year)***

**Year 0** G L

Contribution 10 90

PMG Allocation 0 0

704(c) Gain Alloc. 0 0

Liability Allocation 90 810

Y1 Starting OB 100 900

**Year 1** G L

Contribution 10 90 **Debt 900**

PMG Allocation 20 80 **PMG (100)**

704(c) Gain Alloc. 0 0 **Remaining Debt 800**

Liability Allocation 80 720 **——>|\_Split 90-10 Based on**

Y1 Ending OB 110 890 **profit %’s (Default)**

**Year 2** G L

Contribution 10 90 **Debt 900**

PMG Allocation 60 240 **PMG (300)**

704(c) Gain Alloc. 0 0 **Remaining Debt 600**

Liability Allocation 60 540 **——>|\_Split 90-10 Based on**

Y2 Ending OB 130 870 **profit %’s (Default)**

**Year 3** G L

Contribution 10 90 **Debt 900**

PMG Allocation 100 400 **PMG (500)**

704(c) Gain Alloc. 0 0 **Remaining Debt 400**

Liability Allocation 40 360 **——>|\_Split 90-10 Based on**

Y3 Ending OB 130 870 **profit %’s (Default)**

**Year 4** G L

Contribution 10 90 **Debt 900**

PMG Allocation 140 560 **PMG (700)**

704(c) Gain Alloc. 0 0 **Remaining Debt 200**

Liability Allocation 20 180 **——>|\_Split 90-10 Based on**

Y4 Ending OB 170 830 **profit %’s (Default)**

**Year 5** G L

Contribution 10 90 **Debt 900**

PMG Allocation 180 720 **PMG (900)**

704(c) Gain Alloc. 0 0 **Remaining Debt 0**

Liability Allocation 0 0 **——>|\_Split 90-10 Based on**

Y5 Ending OB 190 810 **profit %’s (Default)**

***Step 4: Match Y5 Ending OB with the Actual Starting OB in Y0***

G L

Contribution 10 90

Liability Allocation 180 720

Y1 Starting OB 190 810 **Use same deprec.**

Y1 Depreciation (30) (170) **——> #’s as in PMG**

Y2 Start 160 640

Y2 Depreciation (40) (160)

Y3 Start 120 480

Y3 Depreciation (40) (160)

Y4 Start 80 320

Y4 Depreciation (40) (160)

Y5 Start 40 160

Y5 Depreciation (40) (160)

Y5 End 0 0

**LOSS LIMITS**

***Generally***

Once loss is properly allocated, can it actually be taken?

**Limits**: ***1) Losses Are Limited to OB***

**IRC 704(d)(1)**: Partner’s share of loss ONLY allowed up to OB

**IRC 704(d)(2)**: excess loss carries forward

Can use that loss when OB increase (contributions, etc.)

Character of loss carries forward in the same proportion

to the character of losses from that year

**Ex**: In Y1, operating loss of $30, LTCL of $20. A’s OB is

$10, B’s OB is $30

**Total** **Loss**: $50

**Ratios**: LTCL – 40% of Total Losses

$10 OB x 40% = $4

Operating Loss – 60% of Total Losses

$10 x 60% = $6

**Y1** **OB**:

OB $10

(LTCL) ($4)

(Operating Losses) ($6)

Ending OB $0

**Share** **of** **Losses**: $25 of total losses

**LTCL**: $10 - $4 = $6 LTCL carries forward

**Op. Loss**: $15 - $6 = $9 Op. Loss Carries forward

***2) At Risk Limits –*** **IRC 465**

***3) Passive Activity Limits –*** **IRC 469**

***4) Individual Losses*** – Excess Business Losses

**TCJA**: “excess business losses” can NOT be deducted but

must be carried forward

Can deduct aggregate deductions up to aggregate income

plus: 1) If Married, $500,000

2) If Single, $250,000

***Charitable Contributions & Foreign Taxes***

**IRC 704(d)(3)(A)**: in determining the amount of loss partner can take, special rules for charitable contributions and taxes

Basically, there’s no real loss from these items (bc they’re tax exempt)

**Ex**: $30 OB, partner makes $50 charitable contribution

Partner can ONLY get a $30 deduction for the charitable contribution

**Unrealized Gain Contribution**: **IRC 704(d)(3)(B)**: if charitable contribution of asset with unrealized gain, do NOT take that unrealized gain into account

Partner ONLY gets a charitable contribution UP TO his AB in the asset

Individually, partner will get that deduction for unrealized gain

***Sale of A Partnership Interest – Generally***

**General Rule**: **IRC 741**: Gain/loss from sale of PA interest is **Capital gain/loss**

**Exception**: **Revenue Ruling 72-172**: gain from sale of depreciable property to related parties is **ordinary gain** under **IRC 1239** (**RR 1.1239-1**: 90% control)

**Exception**: **IRC 751(a)**: Partner gets **ordinary gain/loss** if any part of selling partner’s AR comes from **“IRC 751 Property,”** meaning:

**(1) *Unrealized Receivables; or***

**Goodwill**: **NOT an unrealized receivable**

**Accounting Method**: if cash method, A/R are unrealized receivable

**Work In Progress**: yes an unrealized receivable

**Cancelable At Will**: If an agreement is cancellable at will by a buyer/

customer, NOT an unrealized receivable

**IRC 751(c)**: **(1) *Goods delivered or to be delivered;***

**(2)**  ***Services rendered or to be rendered; and***

**Ledoux**: Includes the premium value of a long-

term contract held by the PA

If no long-term K in place, it is goodwill

If yes long-term K in place, it is unrealized A/R

**Quantum Merit**: yes unrealized receivable

***3) Recapture Items*** **(Flush)**

Amounts that’d be recaptured at ordinary rates

if the PA sold the property for FMV

**i)** **IRC 1245 recapture** **(personal property)**

**Caution**: **Does NOT include** **IRC 1250 recapture**

**FMV**: ONLY recaptures gain up to the amount of

ordinary income PA would recognize if sold for FMV

Means that the unrealized A/R ***is the lesser of***:

**A) Option 1** **Purchase Price**

**(AB)**

**Option 1 Amount**

**B) Option 2**  **Current FMV**

**(AB)**

**Option 2 Amount**

**Ex**: Got for $75, $25 of deprec., $60 FMV at sale

Include in unrealized A/R **($10)** the lesser of:

A) Option 1 Purchase Price $75

(AB) ($50)

Option 1 Amount $25

A) Option 2 Current FMV $60

(AB) ($50)

Option 1 Amount $10

**Unequal Depreciation**: **RR 1.1245-1(e)**: allocate to

each partner their proportional share of gain

**Ex**: Bought for $300, $300 depreciation allocated

equally to ABC. On sale, total $440 gain ($330 to

A, $110 to B, $0 to C). How to allocate recapture?

A B C

Asset 100 100 100

Depreciation (100) (100) (100)

AB 0 0 0

Gain 330 110 0

Total Gain: $400

**Unrecaptured Deprec**.: $300 How To

A: $100 of recapture Allocate This $100?

B: $100 of recapture |

C: $0 of recapture —> 100 of excess unrecaptured gain

**Calculate Gain Limits**:

B: Total Gain $110 C: Total Gain $330

Amount Recap. ($100) Amount Recap. ($100)

Gain Limit $10 Gain Limit $230

**Formula**: Excess Gain x A’s Share = A’s Hypo Recapture

A: $100 x 25% = $25 **—> B’s Gain limit is $10,** **so**

**B only gets $10 of this $25**

B: $100 x 75% = $75 **—> C’s Gain limit is $230,** **so**

**C only ALL $75**

**Conclusion**: **A**: $110 gain at recapture rates

**B**: $190 gain at recapture rates

$140 gain at CG’s rates

**(2) *Inventory***

**IRC 751(d)**: **(1) *Inventory under*** **IRC 1221(a)(1)**;

**(2) *All other property that, if sold, would NOT give CG***

**(3) *Other property* held by the PA which, if held by the**

**selling/distributee partner, would meet (1) or (2)**

**Ex**: **Dealers** – B is a dealer. PA has stock. If B sold

his PA interest, stock will be treated as inventory

***Seller’s POV***

***1) Determine Total Gain/loss***

***2) Calculate gain/loss from* IRC 751 *Property via a Hypo Transaction***

**Effect**: Amount of gain/loss is ordinary gain/loss under **IRC 751(a)**

**Hypo Transaction**: **RR 1.751-1(a)(2)**: allocate G/L to a partner as if the

PA sold ALL assets for FMV immediately before sale of the PA interest

***3) Subtract Amount in (2) from Amount in (1)***

**Effect**: Amount of gain/loss is capital gain/loss under **IRC 741**

**Look-Through Rule**: **RR 1(h)-1(b)**: bc there’s different CG rates:

A) Tax collectibles gains at 28% C) Tax all other CGs at 20%

B) Tax **IRC 1250** gains at 25%

**Installment Sales**: **IRC 453(a)**: “installment method” for IN Sale income

**IRC 453(b)(1)**: IN Sale if 1+ payment comes in a year after the year of the sale

**IRC 453(c)**: **Installment Method**: Realize income in **year TP is *actually* paid**

**Hot Assets**: Must realize **ALL gain** **in year of sale** (**Year 1**) for the following:

**1) Inventory**: **IRC 453(b)(2)(B)** & **Revenue Ruling 89-108**

**2) Accounts Receivable** (it’s not “property”)

**3) Recapture Amounts**: **IRC 453(i)(2)**

**4) Securities on Established Security Exchange**: **IRC 453(k)(2)**

**Capital Assets**: apply installment method

Total CG Amount Paid in Y1 Amount Paid in Y2

—————— = Z% x Z% x Z%

Selling Price CG in Y1 CG in Y2

**Ex**: ABC is equal PA. In Y1, A sells his PA interest ($50 OB) to X for $100 cash. PA’s balance sheet is: Asset Basis FMV

Inventory $100 **$130**

Capital Asset $50 **$170**

***1)*** ***Determine Total Gain/Loss***  AR $100

AB (A’s OB) ($50)

Total Gain $50

***2) Calculate Gain/loss from IRC 751 Property***

Hot Asset FMV - AB = Gain/Loss x A’s Share = Ordinary G/L

Inventory $130 - $100 = $30 x 1/3 = $10 Gain

***3) Subtract (2) From (1) for CG*** Total Gain $50

Ordinary Gain ($10)

Capital Gains $40

**Ex**: ABC is equal PA. In Y1, A sells his PA interest ($50 OB) to X for $100 cash. PA’s balance sheet is: Asset Basis FMV

Inventory $100 **$40**

Capital Asset $50 **$260**

***1) Determine Total Gain/Loss***  AR $100

AB (A’s OB) ($50)

Total Gain $50

***2) Calculate Gain/loss from IRC 751 Property***

Hot Asset FMV - AB = Gain/Loss x A’s Share = Ordinary G/L

Inventory $40 - $100 = ($60) x 1/3 = ($20) Loss

***3) Subtract (2) From (1) for CG*** Total Gain $50 **minus a**

Ordinary Gain - ($20)**—>** **negative**

Capital Gains $70

**Ex**: ABC is equal PA. Each has OB of $300. Accrual method. In Y1, D sells PA interest to X for $750. Took $75 recapture on machine. Bought building for $600. PA’s balance sheet is: Asset Basis FMV

Cash $150 $150

**$75 is IRC 1245** Stock $150 $450

**recapture —>** Machinery $75 $150

**$300 is IRC 1250—>** Building $300 $750

**recapture**  Inventory $120 $210

A/R $105 $90

Goodwill $0 $450

***1) Determine Total Gain/Loss*** AR $750

AB (A’s OB) ($300)

Total Gain $450

***2) Calculate Gain/loss from IRC 751 Property***

Hot Asset FMV - AB = Gain/Loss x A’s Share = Ordinary G/L

Machinery $150 - $75 = $75 x 1/3 = $25 Gain

Inventory $210 - $120 = $90 x 1/3 = $30 Gain

A/R $90 - $105 = ($15) x 1/3 = ($5) Loss

$50 Total Gain

***3) Subtract (2) From (1) for CG*** Total Gain $450

Ordinary Gain ($50)

Capital Gains $400

**$300 recaptured at 25% Rate under IRC 1250\_\_\_\_\_\_\_|**

**$100 remaining at 20% rate**

***Buyer’s POV***

**Issue**: **IRC 743(a)**: sale of PA interest has no effect on PA’s basis in the assets

**Effect**: Buying partner is (temporarily) under- or over-taxed

**IRC 704(c)(1)(C) *Property***

**Issue**: If A contributes **IRC 704(c)(1)(C)** built-in loss property, and then later sells his PA interest to X, should we allocate all of the built-in loss to X?

**Solution**: Proposed regs eliminate the **IRC 704(c)** loss from the PA’s balance sheet and create an **IRC 704(c)(1)(C)** adjustment solely for CP

**Effect**: The buyer won’t succeed to any part of the built-in loss

**Ex**: ABC form equal PA. A contributes land with FMV of $100, basis of

$500. B and C each contribute $200 cash. Balance sheet is:

Basis Book Tax Book OB

Cash $200 $200 **A** $100 $100 $500

Land $100 $100 B $100 $100 $100

C $100 $100 $100

**Effect**: If A sold PA interest to X for $100, A would realize $400 loss

***If*** ***No*** **IRC 754 *Election***

**RR 1.704-1(b)(2)(iv)(l)**: **Capital Accounts**: Buyer steps into seller’s shoes

**Outside Basis (OB)**: Buyer has a cost basis OB

**Effect**: Disparity between PA’s inside basis and partner’s aggregate OBs

***If Yes*** **IRC 754 *Election***

**IRC 743(b)**: Make an **IRC 743(b)** adjustment if either:

**1) The *partnership*** makes an **IRC 754** election; or

2) There’s substantial built-in loss

A) AB of all PA property exceeds its FMV by $250,000+

B) Or, buyer would get a $250,000 loss if PA sold all assets after sale

**Effect**: **Partnership**: No change in bases or tax capital accounts

**Buying Partner**: Treat as if he got an undivided interest in each asset

**Special Basis Adjustment (SBA)**: buying partner gets SBA for his

benefit, alone to prevent under/over tax

**On Resale**: **Buying Partner’s Share of Gain/Loss**

**(Buying Partner’s SBA in That Asset)**

**Gain/Loss Buying Partner Actually Recognizes**

**IRC 743(b)** **Adjustment**:

***1) PA makes/has made*** **IRC 754 *election or has “substantial built in loss”***

***2) Determine Amount of*** **IRC 743(b)** ***Adjustment***

**Cheat Code**: **IRC 743(b)** basis adjustment is just amount of gain/

loss that the seller realized in Step (1) in Seller’s POV

**Formula**: Seller’s AR **—> Includes debt relief**

(Seller’s OB) **—> Includes debt**

Aggregate **IRC 743(b)** Adjustment

**Formula**: Buyer’s OB

(Buyer’s Share of Inside Basis)

Aggregate **IRC 743(b)** Adjustment

**Gain**: If seller sold at a gain, then positive **IRC 743(b)** adjustment

**Loss**: If seller sold at a loss, then negative **IRC 743(b)** adjustment

**Buyer’s** **OB**: Cost Basis

**Buyer’s Inside Basis**: **RR 1.743-1(d)**: sum of share of “previously

taxed capital” plus his share of liabilities

**Previously Taxed Capital**: Cash He’d Get on Hypo Liquidation

Loss He’d Get on Hypo Liquidation

(Gain He’d Get on Hypo Liquidation)

Previously Taxed Capital

***3) Allocate adjustments among the PA’s assets***

**Goal**: give the buying partner a cost basis in his share of each asset

**RR 1.755-1(b)(2)**: first, divide property between into two classes”

A) Ordinary Income Property; and

B) Capital Gain Property

**Hypothetical Transaction**: **RR 1.755-1(b)(1)(ii)**: calculate G/L for each

asset as if it was immediately sold for FMV

**Formula**:

Asset FMV - AB = G/L x A’s Share = A’s SBA

**A’s SBA**: These are the buyer partner’s SBA for each asset

**Sales at Premium/Discount**: See below

**DEPRECIATION After Adjustment**: **IRC 1.743-1(j)(4)**

**A’s Share of AB**: PA’s Adjustment Basis in Asset

x A’s Share

Depreciation/Year

**A’s Share of SBA**:

A’s SBA In Asset

————————————— = Depreciation/Year

Brand New Recovery Period

**Example – No Election**

**Ex**: ABC equal partners. A’s OB is $250. A sells to X for $500. PA got machine 3 years ago and took $20 of depreciation. PA got building 5 yeas ago. Starting Balance Sheet: Asset Basis FMV Debt

Cash $240 $240 $150

Stock $90 $300

Machinery $55 $100 Tax Book

Building $200 $500 A $200 $500

Inventory $90 $150 B $200 $500

A/R $75 $60 C $200 $500

Goodwill $0 $300 $600 $1,500

$750 $1,650 $750 $1,650

**1) PA makes/has made** **IRC 754** **election? (No!)**

**Balance Sheet**: Asset Basis FMV Debt

Cash $240 $240 $150

Stock $90 $300

Machinery $55 $100 Tax Book

Building $200 $500 **X** **$500** $500

Inventory $90 $150 B $200 $500

A/R $75 $60 C $200 $500

Goodwill $0 $300 $900 $1,500

$750 $1,650 $1,050 $1,650

**|\_\_\_$300 Disparity\_\_|**

**Example – Yes Election**

**Ex**: ABC equal partners. A’s OB is $250. A sells to X for $500. PA got machine 3 years ago and took $20 of depreciation. PA got building 5 years ago. Starting Balance Sheet: Basis FMV Debt

Cash $240 $240 $150

**$20 is IRC 1245** Stock $90 $300

**recapture —>** Machinery $55 $100 Tax Book

**$300 is IRC 1250—>** Building $200 $500 A $200 $500

**recapture**  Inventory $90 $150 B $200 $500

A/R $75 $60 C $200 $500

Goodwill $0 $300 $600 $1,500

$750 $1,650 $750 $1,650

***1)*** **IRC 754 *Election or substantial built-in loss? (Yes)***

***2) Determine Amount of*** **IRC 743(b) *Adjustment***

**Formula**: Seller’s AR $550

(Seller’s OB) ($250)

Aggregate **IRC 743(b)** Adjustment $300

***3) Allocate adjustments among the PA’s assets***

Asset FMV - AB = G/L x X’s Share = X’s SBA

Cash $240 - $240 = $0 x 1/3 = $0

Stock $300 - $90 = $210 x 1/3 = $70

Machinery $100 - $55 = $45 x 1/3 = $15

Building $500 - $200 = $300 x 1/3 = $100

Inventory $150 - $90 = $60 x 1/3 = $20

A/R $60 - $75 = ($15) x 1/3 = ($5)

Goodwill $300 - $0 = $300 x 1/3 = $100

$300

**A’s SBA ($300) < Selling Price ($550) = Apply Discount Rules (see below)**

**Ex**: Same facts, but machinery depreciates at $11/year for 5 years of it’s remaining life. If got brand new, $10 year remaining life. What is X’s share of **depreciation** for the next year?

**AB of $55**: $11 Depreciation/Year

x 1/3 X’s Share of Depreciation

$3.67 Depreciation/Year

**X’s SBA of $15**: $15 Total SBA $3.67

———————— = $1.5/year $1.50

10 Years $5.17 Y1-Y5 Deprec.

**Conclusion**: X B C

Machinery $18.33 $18.33 $18.33

SBA $15 $0 $0

Depreciation ($5.17) ($3.67) ($3.67)

Y1 End $28.16 $14.66 $14.66

…….

Y5 End $7.50 $0 $0

Depreciation ($1.50) $0 $0

Y10 End $6.50 $0 $0

……. .

Y10 End $0 $0 $0

***Sale at Premiums & Discounts***

**Test: If A’s SBA > Selling Price, Apply Premium Rules**

**If A’s SBA < Selling Price, Apply Discount Rules**

***Sales At Discount***

If buyer pays a discounted price:

***1) First, allocate SBA to ordinary income assets***

***2) Second, allocate the balance to capital assets***

**Formula**:

***A) Allocate IRC 743(b) adjustment to hot assets***

Hot Assets FMV - AB = G/L x A’s Share = SBA

Hot Asset #1 $

Hot Asset #2 $

SBA To Hot Assets

***B) Determine Remaining IRC 743(b) adjustment to capital assets***

Total **IRC 743(b)** Adjustment

(SBA to Hot Assets)

Remaining **IRC 743(b)** Adjustment

***C) Determine SBA for Capital Assets***

Capital Assets FMV - AB = G/L x A’s Share = SBA

Capital Asset #1 $

Capital Asset #2 $

SBA To Capital Assets

***D) Determine SBA Shortfall***

SBA to Capital Assets

(Remaining **IRC 743(b)** Adjustment)

SBA Shortfall

***E) Determine Each Capital Asset’s Reduction Amount***

FMV of CA #1

SBA Shortfall x ———————— = CA #1 Reduction

Total FMV of CAs

FMV of CA #2

SBA Shortfall x ———————— = CA #2 Reduction

Total FMV of Cas

***F) Determine Final SBA of Capital Assets***

SBA To Capital Assets - CA Reduction Amount = Final SBA

Capital Asset #1

Capital Asset #2

***Sale at Premiums & Discounts***

If buyer pays a premium over asset value, under **IRC 1060**, we allocate the excess to goodwill & **IRC 197** intangibles

***1) Apply Same Rules as Discount Rules***

***2) After Step B(vi), Determine Amount Allocated to Goodwill***

Seller’s AR SBA to Hot Assets

(Seller’s OB) SBA to Capital Assets

Aggregate **IRC 743(b)** Adjustment Total SBA Allocated

Aggregate **IRC 743(b)** Adjustment

(Total SBA Allocated)

SBA That Goes to Goodwill

**Ex**: Equal PA. ABC has OB of $400. **IRC 754** election. A sells his PA interest to X for $1,150. Balance Sheet is: Asset Basis FMV

A/R $0 $300

Blackacre $300 $600

Whiteacre $600 $1,200

Greenacre $300 $1,800

***1) PA makes/has made*** **IRC 754 *election*** **(Yes)**

***2) Determine Amount*** ***of*** **IRC 743(b)** ***Adjustment*** **($750)**

Seller’s AR $1,150

(Seller’s OB) ($400)

Aggregate **IRC 743(b)** Adjustment $750

***3) Allocate adjustments among the PA’s assets***

Asset FMV - AB = G/L x A’s Share = A’s SBA

A/R $300 - $0 = $300 x 1/3 = $100

Blackacre $600 - $300 = $300 x 1/3 = $100

Whiteacre $1,200 - $600 = $600 x 1/3 = $200

Greenacre $1,800 - $300 = $1,500 x 1/3 = $500

$900

**A’s SBA ($900) < Selling Price ($1,150) = Apply Discount Rules**

***A) Allocate*** **IRC 743(b)** ***adjustment ($750) to hot assets (A/R)***

Hot Asset FMV - AB = G/L x A’s Share = X’s SBA

A/R $300 - $0 = $300 x 1/3 = $100

***B) Determine Remaining*** **IRC 743(b)** ***adjustment to CAs*** **($650)**

Total **IRC 743(b)** Adjustment $750

(SBA to Hot Assets) ($100)

Remaining **IRC 743(b)** Adjustment $650

***C) Determine SBA for Capital Assets***

Capital Assets FMV - AB = G/L x A’s Share = SBA

Blackacre $600 - $300 = $300 x 1/3 = $100

Whiteacre $1,200 - $600 = $600 x 1/3 = $200

Greenacre $1,800 - $300 = $1,500 x 1/3 = $500

$3,600 SBA to Capital Assets $800

***D) Determine SBA Shortfall***

SBA to Capital Assets $800

(Remaining **IRC 743(b)** Adjustment) ($650)

SBA Shortfall $150

***E) Determine Each Capital Asset’s Reduction Amount***

$600

$150 x ———————— = $25 Blackacre Reduction

$3,600

$1.200

$150 x ———————— = $50 Whiteacre Reduction

$3,600

$1,800

$150 x ———————— = $75 Whiteacre Reduction

$3,600

***F) Determine Final SBA of Capital Assets***

SBA To Capital Assets - CA Reduction Amount = Final SBA

Blackacre $100 - $25 = $75

Whiteacre $200 - $50 = $150

Greenacre $500 - $75 = $425

**Distributions**

***Generally***

**IRC 731** is the general rule

**IRC 732(a)** is for non-liquidating distributions (current distribution)

**IRC 732(b)** is for liquidating distributions

**IRC 734(b)** is for basis adjustments with **IRC 754** election in place

**General Rule**: Neither the PA nor the distributee recognize gain/loss

**Goal**: Non-recognition of gain/loss

**Constructive** **Cash**: **IRC 752(b)**: A gets constructive cash if A gets debt relief

**Marketable Securities**: **IRC 731(c)**: If PA distributes marketable securities, treat it as distribution of cash up to (FMV – A’s share of built-in appreciation)

**Ex**: A has OB of $50. AB distributes stock (FMV of $100, AB of $40)

A is treated as if he got $70 in cash FMV $100

(A’s Share of Apprec.) ($30)

Cash $70

***Non-Liquidating Distributions***

***Generally***

**Gain**: **IRC 731**: A **only** recognizes gain if cash distributed is in excess of his OB

**Loss**: **IRC 731**: A **never** recognizes a loss on non-liquidating distributions

**Basis**: **IRC 732(a)(1)**: **Default**: Transferred basis to distributee partner (A)

**Exception**: **IRC 732(a)(2)**: decrease basis if transferred basis is

higher than distributee’s OB – Basis can NOT exceed A’s OB minus cash

**Outside Basis**: **IRC 733**: Decrease OB by amount of money distributed

**Basis Adjustment**: **IRC 734(a)**: unless **IRC 754** election or substantial basis reduction, PA’s basis in it’s property remains the same

***Analysis***

***1) Calculate “Reduced Outside Basis” (ROB)***

OB

(Cash)

(Constructive Cash)

ROB **—> If Negative, Recognize Capital Gain (CG)**

**If Positive, See Below**

***2) If Property Is Also Distributed, Determine Basis of Distributed Property***

***A) Formula***

ROB

(Tax Basis of Property 1)

(Tax Basis of Property 2)

Continuing Outside Basis

**|\_\_\_\_ If Positive: i) COB is A’s new OB**

**|** **ii) A gets transferred basis** **|**

**|\_\_\_\_If Negative: i) A’s new OB is $0**

**ii) If Only 1 IRC 751 Property Distributed,**

**A’s basis in that property is now ROB**

**iii) If 2+ Properties Distributed, then**

**allocate under IRC 732(c) (see below)**

***B) IRC 732(c) Allocation***

**i) Allocate ROB to IRC 751 Property Up to Transferred Basis**

**I) Give Decrease Proportionally to Built-in Loss Properties**

Property 1 Transferred Basis Property 2 Transferred Basis

(Built-In Loss) (Built-In Loss)

Adjusted Property 1 Tax Basis Adjusted Property 2 Tax Basis

**II) Give remaining Decrease To All Other IRC 751 Properties**

**In Proportion To Tax Bases AFTER Reduction For Built-In**

**Loss (unrealized depreciation)**

Adjusted Property 1 Tax Basis

+ Adjusted Property 2 Tax Basis

Total Tax Bases

Adjusted Property 1 Tax Basis Decrease in

Adjusted Property 1 Tax Basis x ————————————— = Property 1’s

Total Tax Bases Tax Basis

Adjusted Property 2 Tax Basis Decrease in

Adjusted Property 2 Tax Basis x ————————————— = Property 2’s

Total Tax Bases Tax Basis

**ii) Allocate Remaining ROB (RROB) to “Other Property”**

**I) Give Decrease Proportionally to Built0in Loss in “Other**

**Property” (see Step 2(B)(i)(I) above)**

**II) Give remaining Decrease To All Other “Other Properties”**

**In Proportion To Tax Bases AFTER Reduction For Built-In**

**Loss (unrealized depreciation) (See Step 2(B)(i)(II) above)**

**Ex**: ABC are equal partners. A’s OB is $40, B’s OB is $30, C’s OB is $20. ABC distributes $10 cash to each, 1/3 inventory, 1/3 of land. Assets are as follows:

Tax FMV

Cash 60 60

Inventory 60 90

A/R 0 30

Land 30 90

***1) Calculate “Reduced Outside Basis” (ROB)***

A B C

OB 40 30 20

(Cash) (10) (10) (10)

(Constructive Cash) (0) (0) (0)

ROB 30 **(Positive)** 20 **(Positive)** 10 **(Positive)**

***2) If Property Is Also Distributed, Determine Basis of Distributed Property***

A B C

ROB 30 20 10

(1/3 Inventory) (20) **—> 20 Basis** (20) **—> 20 Basis** (20) **—> 10 Basis**

RROB 10 0 0

(1/3 Land) (10) **—> 10 Basis** (10) **—> 0 Basis** (10) **—> 0 Basis**

COB 0 **(10) —> 0 OB** **(20) —> 0 OB**

**| | |**

**Positive, so A gets Negative, but only 1 Negative, but only 1**

**Transferred basis in 751 property Distrib. 751 property distrib.**

**751 property so ROB is it’s basis so ROB is it’s basis**

**| | |**

**Yes RROB (10) so No RROB, so “Other No RROB, so “Other**

**RROB goes to “Other Property’s” basis Property’s Basis**

**Property” (Land) (land) goes to 0 (land) goes to 0**

**| | |**

**Positive, so COB (0) Negative, so A’s new Negative, so A’s new**

**Is A’s new OB OB is 0 OB is 0**

**Ex**: Same facts, but ABC distributes $45 cash to A, 1/2 land to each B and C

***1) Calculate “Reduced Outside Basis” (ROB)***

A B C

OB 40 30 20

(Cash) (45) (0) (0)

(Constructive Cash) (0) (0) (0)

ROB (5) **—> 5 CG** 30 **(Positive)** 20 **(Positive)**

(Inventory) (0) (0) (0)  
 RROB 0 30 20

(1/2 Land) (0) (15) **—> 15 Basis** (15) **—> 15 Basis**

COB  **0** **—> 0 OB**  **15** **—> 15 OB**  **5 —> 5 OB**

**| | |**

**ROB negative, so A N/A N/A**

**Recognizes $5 of CG | |**

**| | |**

**N/A Positive, but no 751 Positive, but no 7511**

**| properties Distrib. properties distrib.**

**| | |**

**N/A Yes RROB (30) so Yes RROB (30) so**

**| RROB goes to Other RROB goes to “Other**

**| Prop. (land) Property” (land)**

**| | |**

**Positive, so COB (0) Positive, so COB (15) Positive, so COD (5)**

**Is A’s new OB is A’s new OB is A’s new OB**

**Ex**: ABC gives $50 cash to A (OB is $300) & Whiteacre, reduces A’s interest from 33.3% to 20%. Balance Sheet is: Tax FMV Debt

Cash 300 300 600

Blackacre 60 200

Whiteacre 200 150

Greenacre 100 250

Stock 40 100

Other Assets 200 800

OB 300

(Cash) (50) **Went from being liable for 1/3 of debt (200)**

(Constructive Cash) (80) **—> to being liable for 1/5 of debt (120)**

ROB 170

(Inventory) (0)   
 RROB 170 **Yes RROB (170) so give RROB to “Other”**

(Whiteacre) (200) **—> 170 Basis** — **Property” (land) up to RROB**

**(30)** **—> 0 OB — Negative, so A’s new OB is 0**

***Liquidating Distributions***

***1) Calculate “Reduced Outside Basis” (ROB)***

OB

(Cash)

(Constructive Cash)

ROB **—> If Negative, Recognize Capital Gain (CG)**

**If Positive, See Below**

***2) If Property Is NOT Distributed, Recognize ROB As Capital Loss***

***3) If Property Is Also Distributed, Determine Basis of Distributed Property***

***A) If ROB > Sum of Bases of All 751 Assets, All Get Transferred Basis***

***B) If ROB < Sum of Bases of All 751 Assets, Do A Decrease***

**i) Determine Total Amount of Decrease** ROB

(Tax Basis of Property 1)

(Tax Basis of Property 2)

Total Amount of **Decrease**

**ii) Give Decrease Proportionally to Built-in Loss Properties**

751 Asset #1 Tax Basis 751 Asset #2 Tax Basis

(Built-In **Loss**) (Built-In **Loss**)

Adjusted 751 Asset #1 Tax Basis Adjusted 751 Asset #2 Tax Basis

Total Amount of **Decrease** Adjusted 751 Asset #1 Tax Basis

(Built-In **Loss** from 751 Asset #1) Adjusted 751 Asset #2 Tax Basis

(Built-In **Loss** from 751 Asset #2) Total 751 Property Tax Bases

Adjusted Total Amount of **Decrease**

**iii) If further decrease is needed, allocate among ALL 751 assets in**

**proportion to their tax bases after reduction for unrealized**

**depreciation (built-in loss)**

Adjusted 751 Asset #1 **Tax Basis** **Decrease** in

Adjusted Total x —————————————— = 751 Asset #1’s

Amount of **Decrease** Total Amount of **Decrease** Tax Basis

Adjusted 751 Asset #2 **Tax Basis** **Decrease** in

Adjusted Total x —————————————— = 751 Asset #2’s

Amount of **Decrease** Total Amount of **Decrease** Tax Basis

Adjusted 751 Asset #1 Tax Basis Adjusted 751 Asset #2 Tax Basis (Decrease in 751 Asset #1’s Tax Basis) (Decrease in 751 Asset #1’s Tax Basis)

751 Asset #1’s New Tax Basis 751 Asset #2’s New Tax Basis

***C) If ROB < Sum of Bases of All “Other Assets,” Do A Decrease***

***See Above for Decrease Rules***

***D) If ROB > Sum of Bases of All “Other Assets,” Do An Increase***

**i) Determine Total Amount of Increase** ROB

(Tax Basis of Property 3)

(Tax Basis of Property 4)

Total Amount of **Increase**

**ii) Give Increase Proportionally to Built-in Gain Assets**

OP #3 Tax Basis OP #4 Tax Basis

+ Built-In **Gain** + Built-In **Gain**

Adjusted OP #3 Tax Basis Adjusted OP #4 Tax Basis

Total Amount of **Increase** Adjusted OP #3 **FMV**

(Built-In Gain from OP #3) + Adjusted OP #4 **FMV**

(Built-in Gain from OP #4) Total OP **FMV**

Adjusted Total Amount of **Increase**

**iii) If further increase is needed, give to ALL Other Property Assets**

**in proportion to their tax bases after reduction for unrealized**

**appreciation (built-in gain)**

Adjusted OP #3 Tax **FMV** **Increase** in

Adjusted Total x —————————————— = OA #3’s

Amount of **Increase** Total Amount of **Increase** Tax Basis

Adjusted OP #4 **FMV** **Increase** in

Adjusted Total x —————————————— = OA #4’s

Amount of **Increase** Total Amount of **Increase** Tax Basis

Adjusted OP #3 Tax Basis Adjusted OP #4 Tax Basis

+ Increase in OP #3’s Tax Basis + Increase in OP #4’s Tax Basis

OP #1’s New Tax Basis OP #4’s New Tax Basis

***4) If Any Remaining ROB, Recognize as a Capital Loss***

**Ex**: ABC is equal PA. A’s OB is $170. Liquidating distribution. ABC’s balance sheet is as follows: Tax FMV Debt: Tax FMV

Cash 120 120 150 150

Inventory 30 60

A/R 0 30 Tax FMV OB

Land #1 180 120 A 120 150 170

Land #2 90 120 B 120 150

Unmarketable Stock 90 150 C 120 150

What would happen if A got to following distributions:

**Q1**: A/R and Land #1 **Q3**: 1/2 Inventory and Land #1

**Q2**: A/R and Land #2

Q1 Q2 Q3

OB 170 170 170

Cash 0 0 0

Constr. Cash (50) (50) (50)

ROB 120 120 120

A/R 0 0 0

Inventory 0 0 (15) **—> 15** **Basis**

RROB 120 120 105

Land #1 (180)**—> 120 Basis** 0 (180)**—> 105 Basis**

Land #2 0 (90)**—> 120 Basis**  0

Securities 0 0 0

COB  **(60)—> 0 OB** **30 —> 30 OB** **(75)** **—> 0 OB**

**| | |**

**Negative, so give Positive, so give Negative, so give**

**(60) to built-in (+30) to built-in (75) to built-in loss**

**Loss Property gain property property**

**| | |**

**No 751 Property Can NOT give to No 751 Property with**

**|** **increase to 751 built-in loss (invent.**

**|** **property only has built-in gain)**

**|** **|** **|**

**Land #1 has $60**  **Land #2 has $30** **Land #1 has $60**

**Of built-in loss so**  **of built-in gain so** **Of built-in loss so**

**Give all to Land #1** **give all to Land #2** **Give all to Land #1**

**Ex**: Same facts, but $120 cash, 1/3 inventory, and 1/3 A/R were distributed. A’s OB was $100, $170, or $200

$100 OB $170 OB $200 OB

OB 100 170 200

Cash (120) (120) (120)

Constr. Cash (50) (50) (50)

ROB (70) **—> 70 CG** 0 30

A/R 0 0 0

Inventory (10) **—> 0 Basis** (10) **—> 0 Basis** (10) **—> 10 Basis**

RROB (10) (10) 20

Land #1 00 0

Land #2 0 0 0

Securities 0 0 0

COB  **(10)—> 0 OB** **(10) —> 0 OB** **20** **—> 20 Capital Loss**

**| | |**

**Negative, so N/A N/A**

**recognize all (70) | |**

**as capital gains | |**

**| | |**

**Negative, so give Negative, so give Positive, so give**

**(10) to built-in (30) to built-in (10) to built-in gain**

**Loss Property loss property property**

**| | |**

**No 751 built-in loss No 751 built-in loss Can’t give increase to**

**Property distributed**  **property distributed 751 property**

**|** **|** **|**

**Give to 751 assets**  **Give to 751 assets**  **No built-in gain**

**In proportion to tax** **in proportion to tax**  **“Other Property”**

**Bases**  **bases**  **was distributed**

**| | |**

**Give to Inventory its Give to inventory its RROB remaining (20)**

**Proportional amount Proportional amount is recognized as**

**Of decrease (10) of decrease (10) capital loss**

***Special Basis Adjustments –*** **IRC 734(b)**

**Generally**: PA distributions may create disparity between inside and OB, meaning losses can “disappear,” so we need to adjust for that

Disparities arise whenever a distribution:

1) Recognizes a gain/loss; or

2) Takes a basis in distributed property that differs from that of the PA

**General Rule**: **IRC 734(a)**: no basis adjustment to inside bases

**Exception**: if one of these happens, CAN make **IRC 734(b)** adjustment:

***1) Substantial Basis Reduction; or***

Yes Substantial basis reduction if negative adjustment is $250,000+

***2) PA Has Already Made An IRC 754 Election***

**Exception**: **2 Year Rule** – **IRC 732(d)**: if distributee partner acquired

his interest within the 2 years prior to distribution, he can elect to be

treated as if there was an **IRC 754** election in place at transfer

**Exception**: **Mandatory** **IRC 732(d) Adjustment** – **RR 1.732-2(d)(4)**: no

matter when the distribution takes place, if FMV of all PA property

(excluding cash) is 110%+ of the AB of the assets of the PA

**Policy**: stops basis shifting from non-depreciable to depreciable

**Ex**: ABC is equal PA. Each has OB of $1,000. A sells PA interest to D

for $7,000. One year later, PA distributes 1/3 of Land #1 to each

partner. Balance sheet is: Basis FMV Basis to FMV

Land #1 $1,000 $4,000 300%

Land #2 $2,000 $17,000 850%

**If No IRC 754 Election**: D does NOT get SBA for either asset

D

OB 7,000 **Issue**: if D sold land for

Cash 0 for $1,333.33 (it’s FMV)

ROB 7,000 D gets $1,000 of gain

751 Property 0 even though D paid

Land #1 (333.33)**—> 333.33** full FMV for Land #1

Land #2 0 when D bought his

COB 6,666.66 interest

**Solution**: **IRC 732(d)**: D can step up his basis in Land #1

***What Is The Trigger?***

***1) If Gain/Loss Is Recognized***

***A) If distributee partner recognizes a gain:***

Increase the basis in the PA assets by the amount of the gain

***B) If distributee partner recognizes a loss on a liquidating distribution:***

Decrease the basis in the PA assets by the amount of the loss

***2) If There’s a Basis Increase or Decrease***

***A) If Basis Decrease:***

Increase the basis of the remaining PA property

**Basis Decrease**: distributee partner took basis in distributed

property that is lower than transferred basis

***B) If Basis Increase:***

Decrease the basis of the remaining PA property

**Basis Increase**: distributee partner took basis in distributed

Property that was higher than transferred basis

***Allocating Increases & Decreases***

***1) What Triggered the Gain/Loss Recognition?***

***A) Gain/Loss Recognition***

**RR 1.755-1(c)(1)(ii)**: entire adjustment can ONLY go to CG assets

**RR 1.755-1(c)(4)**: if PA has no CG assets, the adjustment is held

in abeyance until PA acquires CG assets

***B) Basis Increase/Decrease***

**RR 1.755-1(c)(i)**: adjustment ONLY goes to assets in the same class

**RR 1.755-1(c)(4)**: if PA has no assets in same class, adjustment

is held in abeyance until PA acquires CG assets

***2) How to Allocate the Adjustment Among Assets in the Same Class?***

***A) Increases In Basis***

i) Give increase to built-in gain assets (unrealized appreciation)

I) If multiple assets have built-in gain, divide the increase in

proportion to their relative built-in gain

ii) Give any remaining increase to properties in the same class in

proportion to their relative FMVs

***B) Decreases In Basis***

i) Give decrease to built-in loss assets (unrealized depreciation)

I) If multiple assets have built-in loss, divide the increase in

proportion to their relative built-in loss

ii) Give any remaining decrease to properties in the same class in

proportion to their relative adjusted basis

***Character on Resale***

**Unrealized Receivables**: **IRC 735(a)(1)**: if distributee partner later resales unrealized receivables that he got from a distribution, it will always be treated as ordinary gain/loss (**See** **IRC 724(a)**)

**Inventory**: **IRC 735(a)(2)**: if distributee partner later resales inventory that he got from a distribution, it’ll be ordinary gain/loss for 5 years (**See** **IRC 724(b)**)

**Non-Recognition Transactions**: **IRC 735(c)(2)(A)**: If unrealized receivables or inventory is disposed of in a non-recognition transaction, apply these rules (above) to the substituted basis for that property

**Examples** (**See Below**)

**Ex**: ABC is equal PA. A’s OB is $170. Liquidating distribution. ABC’s balance sheet is as follows: Tax FMV Debt: Tax FMV

Cash 120 120 150 150

Inventory 30 60

A/R 0 30 Tax FMV OB

Land #1 180 120 A 120 150 170

Land #2 90 120 B 120 150

Unmarketable Stock 90 150 C 120 150

What would happen if the PA made the following distributions to A?

**Q1**: A/R and Land #1 **Q5**: A/R, 1/2 of Land #1, 1/2 of Land #2

**Q2**: A/R and Land #2

Q1 Q2 Q3

OB 170 170 170

Cash 0 0 0

Constr. Cash (50) (50) (50)

ROB 120 120 120

A/R 0 0 0

Inventory 0 0 0

RROB 120 120 120

Land #1 (180)**—> 120 Basis** 0 (90)**—> 75 Basis**

Land #2 0 (90)**—> 120 Basis**  (45)**—> 45 Basis**

Securities 0 0 0

COB  **(60)—> 0 OB** **30 —> 30 OB** **(15)** **—> 0 OB**

**| | |**

**A’s basis decreased, A’s basis increased, A’s basis decreased,**

**So increase assets So decrease assets So increase PA assets**

**| | |**

**Triggered by basis Triggered by basis Triggered by basis**

**change, so only to change, so only to change, so only to**

**assets in same class assets in same class assets in same class**

**| | |**

**Increase in PA assets Decrease in PA assets Increase in PA assets**

**So first give to assets so first give to assets so first give to assets**

**with built-in gain with built-in loss with built-in gain**

**| | |**

**Built-in Gain Built-In Loss Built-In Gain**

**Land #2: $30 Land #1: $60 Land #2: $15**

**Stock: $60 Stock: $60**

**Total: $90 Total: $60 Total: $75**

**|**

**Land #2 | Land #2**

**$30 | $15**

**$60 x ———— = $20 | $15 x ———— = $3**

**$90 | $75**

**|**

**Stock | Stock**

**$60 | $60**

**$60 x ———— = $40 | $15 x ———— = $12**

**$90 | $75**

**| | |**

**Ending Basis in PA Ending Basis in PA Ending Basis in PA**

**Land #2: $110 Land #1: $150 Land #2: $48**

**Stock: $130 Stock: $102**

**Ex**: ABC is equal PA. A’s OB is $170. Liquidating distribution. ABC’s balance sheet is as follows: Tax FMV Debt: Tax FMV

Cash 120 120 150 150

Inventory 30 60

A/R 0 30 Tax FMV OB

Land #1 180 120 A 120 150 170

Land #2 90 120 B 120 150

Unmarketable Stock 90 150 C 120 150

What would happen if the PA distributed $120 cash, 1/3 inventory, and 1/3 A/R were distributed. A’s OB was $100, $170, or $200

$100 OB $170 OB $200 OB

OB 100 170 200

Cash (120) (120) (120)

Constr. Cash (50) (50) (50)

ROB (70) **—> 70 CG** 0 30

A/R 0 0 0

Inventory (10) **—> 0 Basis** (10) **—> 0 Basis** (10) **—> 10 Basis**

RROB (10) (10) 20

Land #1 00 0

Land #2 0 0 0

Securities 0 0 0

COB  **(10)—> 0 OB** **(10) —> 0 OB** **20** **—> 20 Capital Loss**

**\_\_\_\_\_\_\_\_\_|\_\_\_\_\_\_ | |**

**| | | |**

**Basis decreased, Recognized Basis decrease (10), Recognized Loss (20),**

**increase assets gain, increase so increase assets so decrease PA assets**

**|** **(10)** **assets (70) | |**

**| | | |**

**Triggered by Triggered by Triggered by basis Triggered by loss**

**Basis change, so gain, so ONLY change, so ONLY to recognition, so ONLY**

**Only to assets give to CG assets in same class to CG property**

**In same class property | |**

**| | | |**

**Increase in Increase in Increase in PA assets, Decrease in PA assets,**

**Assets, so first assets, so first so first allocate to so first allocate to**

**Give to built-in give to built-in built-in gain assets built-in loss assets**

**Gain assets gain CG assets | |**

**| | | |**

**Built-In Gain Built-in Gain Built-in Gain Built-In Loss**

**Inven.: $30 Land #2: $30 Inventory: $20 Land #1: $60**

**A/R: $30 Stock: $60 A/R: $20 .**

**Total: $60 Total: $90 Total: $40 Total: $60**

**|**

**Inventory Land #2 Inventory |**

**$30 $30 $20 |**

**$10 x —— = $5 $70 x —— = $23.3 $10 x —— = $5 |**

**$60 $90 $40 |**

**A/R Stock A/R |**

**$30 $60 $20 |**

**$10 x —— = $5 $70 x —— = $46.6 $10 x —— = $5 |**

**$60 $90 $40 |**

**| | | |**

**Ending Basis in PA Ending Basis in PA Ending Basis in PA Ending Basis in PA**

**Inventory: $3 Land #2: $113.3 Inventory: $25 Land #1: $160**

**A/R: $5 Stock: $136.6 A/R: $5**

**Disproportionate Distributions**

**General Rule**: **IRC 751(b)(1)**: treat these distributions as a “sale/exchange” of such property between distributee and the PA:

**1) Unrealized receivables**; and

**2) Substantially appreciated inventory**

**IRC 751(b)(3)**: ONLY “substantially appreciated” if inventory’s total

FMV is 120%+ more than inventory’s total AB

**Trigger**: 1) Partnership holds a “Hot Asset;” and

2) Partnership makes a “non-pro rata” distribution to a partner

Non-Pro Rata = changes partners’ share of hot/cold assets

**Exceptions**: **IRC 751(b)(1)**: **IRC 751(b)** is NOT triggered if:

**(A)** Distributions of property that the distributee partner had contributed

**(B)** Payments to a retiring partner under **IRC 736(a)**

**Policy**: without rule, normal distribution rules would let distributee avoid his share of PA’s ordinary income when a capital asset was distributed to him

***Analysis***

***1) Determine Basis to Value Ratio of Each Asset***

Basis FMV Ratio **Basis**

Hot Asset #1 $X $X HA% **—— = %**

Cold Asset #1 $Y $Y CA% **FMV**

***2) Create A Partnership Exchange Table***

**If A’s Share went from 50% to 33.3%, then: FMV \* (1/3)**

**|** **If Liquidating distribution, all will be $0**

**\/**  **\/**

A’s Post-Distrib. A’s Actual A’s Pre-Distrib. A’s

Interest In PA Distrib. of PA Interest in PA Change In

Asset (FMV) Asset (FMV) Assets (FMV) Interest

Hot Assets

Hot Asset #1 $X + $X — $X = $X

Hot Asset #2 $X + $X — $X = $X

Cold Assets $HA Total

Cash $Y + $Y — $Y = $Y

Constr. Cash $Y + $Y — $Y = $Y

Cold Asset #1 $Y + $Y — $Y = $Y

Cold Asset #2 $Y + $Y — $Y = $Y

$CA Total

***3) Hypothetical Non-Liquidating Distribution of The OPPOSITE ASSET***

**Ex**: If A was distributed a Hot Asset, hypo distribute a Cold Asset

**Ex**: If A was distributed a Cold Asset, hypo distribute a Hot Asset

***A) Determine the Ratio of the Basis that was Distributed***

i) If Cold Asset Distributed ii) If Hot Asset Distributed

$HA Total $CA Total

x HA% x CA%

HA Hypo Basis CA Hypo Basis

***B) Hypo Current Distribution of Opposite Asset***

i) If Cold Asset Distributed ii) If Hot Asset Distributed

OB OB

(HA Hypo Basis) (CA Hypo Basis)

Continuing OB Continuing OB

***C) Determine the Opposite Asset’s New Basis in the PA***

i) If Cold Asset Distributed ii) If Hot Asset Distributed

Starting HA Basis Starting CA Basis

(HA Hypo Basis) (CA Hypo Basis)

Intermediate HA Basis in PA Intermediate CA Basis in PA

***4) IRC 751(b) Exchange of the OPPOSITE ASSET With the ASSET ACTUALLY***

***DISTRIBUTED For HA [or CA] Total***

***A) Determine the Ratio of the Basis that was Distributed***

i) If Cold Asset Distributed ii) If Hot Asset Distributed

$CA Total $HA Total

x CA% x HA%

CA Hypo Basis HA Hypo Basis

***B) Do the Exchange***

***i) Exchange***

FMV Basis

Capital Asset $CA Total $CA Hypo Basis

Hot Asset $HA Total $HA Hypo Basis

***ii) Determine Gain/Loss***

I) If Cold Asset Distributed II) If Hot Asset Distributed

Hot Asset Cold Asset

AR $CA Total AR $CA Total

AB (CA Hypo Basis) AB (CA Hypo Basis)

Distributee’s Gain/Loss Distributee’s G/L

Cold Asset Hot Asset

AR $CA Total AR $HA Total

AB (CA Hypo Basis) AB (HA Hypo Basis)

Other Partners’ Gain/Loss Other Partners’ G/L

**|\_\_\_Divide By Their |\_\_Divide by Their**

**Share Of PA G/L Share of PA G/L**

***iii) Calculate OPPOSITE ASSET’S Basis in the PA***

*I) If Cold Asset Distributed* *II) If Hot Asset Distributed*

Intermediate HA Basis in PA Intermediate CA Basis in PA

+ $HA Total + $CA Total

Partnership’s Basis in HA Partnership’s Basis in CA

***5) Do a Non-IRC 751(b) Distribution For the Balance***

***A) If Non-Liquidating Distribution***

***i) Find the Balance of Basis in DISTRIBUTED ASSET***

*I) If Cold Asset Distributed* *II) If Hot Asset Distributed*

FMV of CA Distributed FMV of HA Distributed

(CA Total) (HA Total)

Remaining FMV Remaining FMV

X CA% x HA%

Balance of the Basis in CA Balance of Basis in HA

***ii) Do a Non-Liquidating Distribution of the DISTRIBUTED ASSET***

Continuing OB

(Cash)

(Constructive Cash)

ROB

(Balance of Basis in Distributed Asset)

New OB

***iii) Determine the Basis of the DISTRIBUTED ASSET***

Balance of the Basis of Distributed Asset

+ HA [or CA] Total

Ending Basis in the Distributed Asset

***iv) Determine any IRC 734(b) Adjustment Needed***

See Above for rules!

***B) If Liquidating Distribution***

***i) Find the [Preliminary] Balance of Basis in DISTRIBUTED ASSET***

*I) If Cold Asset Distributed* *II) If Hot Asset Distributed*

FMV of CA Distributed FMV of HA Distributed

(CA Total) (HA Total)

Remaining FMV Remaining FMV

X CA% x HA%

Preliminary Balance of Basis in CA Prelim Balance of Basis in HA

***ii) Do a Liquidating Distribution of the DISTRIBUTED ASSET***

I) If Distributed Asset’s Basis Increases:

Increased # is Balance of Basis Of Distributed Asset

II) If Distributed Asset’s Basis Decreases:

Decreased # is Balance of Basis Of Distributed Asset

***iii) Determine the Basis of the DISTRIBUTED ASSET***

Balance of the Basis of Distributed Asset

+ HA [or CA] Total

Ending Basis in the Distributed Asset

***iv) Determine any IRC 734(b) Adjustment Needed***

See Above for rules!

**Ex**: ABC partnership. Each contributed $100. A is distributed Inventory, but A’s share of PA income, gain, loss goes from 1/3 to 1/9. B and C’s goes up to 4/9 each. Balance Sheet Is: Basis FMV Book FMV OB

Inventory $30 $150 A 100 200 100

Capital Asset $270 $450 B 100 200 100

C 100 200 100

***1) Determine Basis to Value Ratio of Each Asset***

Basis FMV Ratio

Inventory $30 $150 20% HA%

Capital Asset $270 $450 60% CA%

***2) Create A Partnership Exchange Table***

A’s Post-Distrib. A’s Actual A’s Pre-Distrib. A’s

Interest In PA Distrib. of PA Interest in PA Change In

Asset (FMV) Asset (FMV) Assets (FMV) Interest

Hot Assets

Inventory $0 + $150 — $50 = $100

Cold Assets $HA Total

Land $50 + $0 — $150 = ($100)

$CA Total

***3) Hypothetical Non-Liquidating Distribution of The OPPOSITE ASSET***

***A) Determine the Ratio of the Basis that was Distributed***

ii) If Hot Asset Distributed

$CA Total $100

x CA% x 60%

CA Hypo Basis $60

***B) Hypo Current Distribution of Opposite Asset***

ii) If Hot Asset Distributed

OB $100

(CA Hypo Basis) ($60)

Continuing OB $40

***C) Determine the Opposite Asset’s New Basis in the PA***

ii) If Hot Asset Distributed

Starting CA Basis $270

(CA Hypo Basis) ($60)

Intermediate Land Basis in PA $210

***4) IRC 751(b) Exchange of the OPPOSITE ASSET With the ASSET ACTUALLY***

***DISTRIBUTED For HA [or CA] Total***

***A) Determine the Ratio of the Basis that was Distributed***

ii) If Hot Asset Distributed

$HA Total $100

x HA% x 20%

HA Hypo Basis $20

***B) Do the Exchange***

***i) Exchange***

FMV Basis

Capital Asset $100 $60

Hot Asset $100 $20

***ii) Determine Gain/Loss***

II) If Hot Asset Distributed

Cold Asset

AR $100

AB ($60)

$40 CG to A

Hot Asset

AR $100

AB ($20)

$80 Gain to B/C

**B: $40 Ordinary G**

**C: $40 Ordinary G**

***iii) Calculate OPPOSITE ASSET’S Basis in the PA***

*II) If Hot Asset Distributed*

$210 Intermediate Land Basis in PA

+ $100 + $CA Total

$310 Partnership’s Basis in Land

***5) Do a Non-IRC 751(b) Distribution For the Balance***

***A) If Non-Liquidating Distribution***

***i) Find the Balance of Basis in DISTRIBUTED ASSET***

*II) If Hot Asset Distributed*

FMV of HA Distributed $150

(HA Total) ($100)

Remaining FMV $50

x HA% x 20%

Balance of Basis in HA $10

***ii) Do a Non-Liquidating Distribution of the DISTRIBUTED ASSET***

Continuing OB $40

(Cash) ($0)

(Constructive Cash) (0)

ROB $40

(Balance of Basis in Distributed Asset) ($10)

New OB $30

***iii) Determine the Basis of the DISTRIBUTED ASSET***

Balance of the Basis of Distributed Asset $10

+ HA [or CA] Total $100

Ending Basis in the Distributed Asset $110

***iv) Determine any IRC 734(b) Adjustment Needed***

See Above for rules!

**Ex**: ABC partnership. Each contributed $100. A is distributed 1/3 of Capital Asset, but A’s share of PA income, loss goes from 1/3 to 1/9. B and C’s goes up to 4/9 each. Balance Sheet Is: Basis FMV Book FMV OB

Inventory $30 $150 A 100 200 100

Capital Asset $270 $450 B 100 200 100

C 100 200 100

***1) Determine Basis to Value Ratio of Each Asset***

Basis FMV Ratio

Inventory $30 $150 20% HA%

Capital Asset $270 $450 60% CA%

***2) Create A Partnership Exchange Table***

A’s Post-Distrib. A’s Actual A’s Pre-Distrib. A’s

Interest In PA Distrib. of PA Interest in PA Change In

Asset (FMV) Asset (FMV) Assets (FMV) Interest

Hot Assets

Inventory $16.67 + $0 — $50 = $100

Cold Assets $HA Total

Land **$33.33** + $150 — $150 = ($100)

$CA Total

$450 Land FMV

($150) 1/3 of Land Distributed

$300 Leftover Value

x (1/9) A’s New Ownership %

**$33.33 A’s Post-Distrib. Interest**

***3) Hypothetical Non-Liquidating Distribution of The OPPOSITE ASSET***

***A) Determine the Ratio of the Basis that was Distributed***

i) If Cold Asset Distributed

$HA Total $33.33

x HA% x 20%

HA Hypo Basis $6.66

***B) Hypo Current Distribution of Opposite Asset***

i) If Cold Asset Distributed

OB $100

(HA Hypo Basis) ($6.66)

Continuing OB $93.33

***C) Determine the Opposite Asset’s New Basis in the PA***

ii) If Cold Asset Distributed

Starting HA Basis $30

(HA Hypo Basis) ($6.66)

Intermediate Land Basis in PA $23.33

***4) IRC 751(b) Exchange of the OPPOSITE ASSET With the ASSET ACTUALLY***

***DISTRIBUTED For HA [or CA] Total***

***A) Determine the Ratio of the Basis that was Distributed***

i) If Cold Asset Distributed

$CA Total $33.33

x CA% x 60%

CA Hypo Basis $20

***B) Do the Exchange***

***i) Exchange***

FMV Basis

Capital Asset $33.33 $20

Hot Asset $33.33 $6.66

***ii) Determine Gain/Loss***

I) If Cold Asset Distributed

Hot Asset

AR $33.33

AB ($6.66)

$26.67 Ordinary Gain to A

Cold Asset

AR $33.33

AB ($20)

$13.33 CG to B/C

**B: $6.67 CG**

**C: $6.67 CG**

***iii) Calculate OPPOSITE ASSET’S Basis in the PA***

*I) If Cold Asset Distributed*

Intermediate Land Basis in PA $23.33

+ $HA Total + $33.33

Partnership’s Basis in Inventory $56.67

***5) Do a Non-IRC 751(b) Distribution For the Balance***

***A) If Non-Liquidating Distribution***

***i) Find the Balance of Basis in DISTRIBUTED ASSET***

*I) If Cold Asset Distributed*

FMV of CA Distributed $150

(CA Total) ($33.33)

Remaining FMV $116.67

x CA% x 60%

Balance of Basis in CA $70

***ii) Do a Non-Liquidating Distribution of the DISTRIBUTED ASSET***

Continuing OB $93.33

(Cash) ($0)

(Constructive Cash) (0)

ROB $93.33

(Balance of Basis in Distributed Asset) ($70)

New OB $23.33

***iii) Determine the Basis of the DISTRIBUTED ASSET***

Balance of the Basis of Distributed Asset $70

+ HA [or CA] Total $33.33

Ending Basis in the Distributed Asset $103.33

***iv) Determine any IRC 734(b) Adjustment Needed***

See Above for rules!

**Partner-Partnership Transactions**

***1) Is Partner Acting In His Capacity As A Partner?***

**Generally**: Usually the distinction is drawn between:

A) Managerial Services (yes partner capacity)

B) Giving Partner’s Technical Expertise (NOT Partner capacity)

***Disguised Payment For Services***

**If Yes**: It is a stranger transaction under **IRC 707(a)(1)**

**Cons**: Partners do NOT want this bc prefer distribution treatment

**If No**: It is either a distribution under **IRC 704(b)** or **IRC 707(c)**

**Ex**: ABC PA builds a building. A acts as general contractor. To pay A, ABC

distributes A the first $60 of income. Building’s costs are $50

If **IRC 707(a)** Payment: If **IRC 704(b)** Payment:

A gets $60 distribution A gets $20 distrib. & $60 income

$60 is a CE $0 is a CE

Building’s basis is $110 Building’s basis is $60

B and C get $20 distribution B and C get $0 distribution

**IRC 707(a)(2)(A)**: IRS can make regs to ID if it’s disguised payment

**Proposed RR 1.707-2(b)(1)**: treat as **IRC 707(a)** stranger transaction

(disguised payment for services) if:

A) Partner B performs Services to Partnership

B) Partner B gets a distribution; and

C) These events, taken together, are property characterized as a

transaction between unrelated parties

**Factors**: Main theme is entrepreneurial risk

i) Payment subject to **significant entrepreneurial risk\*\***

Most important bc, if yes SER, then NOT **IRC 707(a)**

stranger transaction unless other factors show it is

**Factors**: under all facts/circumstances, if PA meets

just one of these factors, presume no SER, rebutted

by C&C evidence

I) Capped alloc. Rly expected to apply most years

II) Alloca. for 1+ years & B’s share is Rly certain

III) Allocation of gross income

IV) Allocation (fixed/formula) of Rly determinable

& amount , or assumes there’s net profits to B

V) B waives his right to a fee for future services

that’s not binding

ii) Partner’s status as a partner is short-term/transitory

iii) Distrib. timing is similar to when non-partner gets paid

iv) Partner is a partner solely for tax benefits

v) Partner’s interest is small relative to the distribution

***2) Yes, Partner Is Acting In His Capacity As A Partner***

***A) IRC 704(b): Services or Capital In Exchange for PA Income***

***i) Treatment***: treat payments as B’s **distributive share** in **IRC 704**

**Concept**: pay. determined with respect to PA’s income

***ii) Character***: Character flows through

***iii) Partner Inclusion***: Include on last day of PA’s taxable year

**Exception**: Sales to a Controlled Partnership (**see below**)

***iv) PA Deduction***: No deduction

***v) Capital Expenditure***: do NOT capitalize

***B) IRC 707(c): Guarantee Payments***

***i) Treatment***: Hybrid approach (some distrib., some stranger)

**Concept**: pay. NOT determined with respect to PA’s income

***ii) Character***: Ordinary income to B

***iii) Partner Inclusion***: Include on last day of PA’s taxable year

***iv) PA Deduction***: maybe a deduction

**Ex**: If payment is for O&N T/B expense, PA can deduct it

***v) Capital Expenditure***: maybe a CE

**Ex**: If paid B for B’s contribution as a CE, MUST capitalize

***3) No, Partner Is NOT Acting In His Capacity As A Partner***

***A) IRC 707(a)(1): Stranger Payments – Payments for Services***

***i) Treatment***: treat as if it was a transaction between strangers

***ii) Character***: ***I) Services Transactions***: Ordinary Character

***II) Some Sales***: CG treatment if sale results in CG

***iii) Partner Inclusion***: Include on the partner’s accounting method

**Ex**: Cash method partner will include the payment in his

income on the day that he gets paid

***iv) PA Deduction***: Maybe a deduction

**Ex**: If payment is for O&N T/B expense, PA can deduct it

**Timing**: **IRC 267(a)(2)**: PA ONLY gets a deduction when B

includes the payment in his income

***v) Capital Expenditure***: maybe a CE

**Ex**: If paid B for B’s contribution as CE, MUST capitalize

**Ex**: A is cash-method partner. ABC is accrual method PA. Both calendar year. “$10,000 for services in A’s capacity as a partner (not a CE). After this, A gets 1/3 of income or loss.” In 2010, ABC has ordinary income of $19,000

**A’s POV**: $10,000 Guaranteed payment **Character**: Ordinary

**Inclusion**: Last day of ABC’s year

**Deduction**: yes deduction

$3,000 Distributive Share **Character**: Ordinary

**Inclusion**: Last day of ABC’s year

**Deduction**: no deduction

**BC POV**: $3,000 Distributive Share, Each **Character**: Ordinary

**Inclusion**: Last day of ABC’s year

**Deduction**: no deduction

**Ex**: Same facts, but ABC had $4,000 ordinary income and $15,000 LTCG.

**A’s POV**: $10,000 Guaranteed payment via **IRC 707(c)** (Same as above)

$2,000 Ordinary Loss (required to give A Guaranteed payment)

$5,000 Distributive Share **Character**: LTCG

**Inclusion**: Last day of ABC’s year

**Deduction**: no deduction

**BC’s** **POV**: $2,000 Ordinary Loss (required to give A guaranteed payment)

$3,000 Distributive Share, Each **Character**: LTCG

**Inclusion**: Last day of ABC’s year

**Deduction**: no deduction

**Ex**: Same facts, but $10,000 payment was made to A on January 4th, 2011

**A’s POV**: A would include the income in 2010

**ABC’s POV**: ABC would get a deduction in 2010

***Minimum Guarantees***

**Proposed Regs**: **Proposed RR 1.707-1(c), Example 2**: ALWAYS treat the amount of the minimum guarantee as a guaranteed payment

**Current Regs**: **RR 707-1(c), Example 2**: if service partner’s distributive share exceeds “minimum guarantee,” entire payment is treated as a distribution in **IRC 704(b)** and no part of it is treated as a guaranteed payment

If the service partner’s distributive share is less than the minimum

guarantee, then: 1) Treat partner’s distributive share like a distributive

share under **IRC 704(b)**

2) Treat the remaining part (up to the min guarantee

amount) as a guaranteed payment under **IRC 707(c)**

**Chart**:

**\_\_\_\_\_ Partner’s Min Guarantee \_\_\_\_\_\_\_\_X**

**/\** **/\** | X = Partner’s

**|** **|** | Distributive

**Treat** **as**  **|** **Treat as an IRC 707(c)** | Share

**IRC 704(b)**   **|** **Guarantee Payment** |

**Distributive** **|** **|** |

**Share** **|** **<——————————————X**

**|** **Treat as an IRC 704(b)** |

**|** **Distributive Share** |

**|** **|** |

**\/** **\/** $0

**Ex**: ABC Partnership. A is entitled to 1/3 of PA income, “but not less than

$10,000.” What happens if PA has **$60,000 income?** **$12,000 income?**

**\_\_\_\_\_ $10,000 Min Guarantee \_\_\_\_$20,000**

**/\** **/\** | X = Partner’s

**Treat ALL**  **|** **|** | Distributive

**$20,000**  **|** **Treat $6,000 as an IRC 707(c)** | Share

**IRC 704(b)**   **|** **Guarantee Payment** |

**Distributive** **|** **|** |

**Share** **|** **<—————————————$4,000**

**|** **Treat $4,000 as an IRC 704(b)** |

**|** **Distributive Share** |

**|** **|** |

**\/** **\/** $0

***Sales To Controlled Partnership***

**Loss Disallowed**: **IRC 707(b)(1)**: loss is disallowed from the sale/exchange of property between: **(A)** Controlling Partner and the Controlled PA; or

**(B)** Two PAs which have the same Controlling Partner

**Controlling Partner**: Partner owns more than 50% of capital **OR** profits

**Basis Adjustment**: **IRC 707(b)(1)**: if transferee later sells, apply **IRC 267(d)(1)**

**IRC 267(d)(1)**: adjust the related party’s basis up to original seller’s basis

**Delayed Deduction**:

**IRC 704(b)** **Distributive Share Payments**: **IRC 267(a)(2)**: PA does NOT get

deduction until B includes the payment in B’s income under B’s method of

accounting if: 1) There’s a sale to a controlled PA;

2) B & PA are on different accounting methods; and

3) B and PA are related

**IRC 707(c)** **Guaranteed Payments**: **IRC 267(e)(4)**: use normal rules

**Partner retirement**

***Capital Intensive Partnerships***

**Concept**: Capital IS a material income producing factor

**General Rule**: **IRC 736(b)**: treat payments as **distributions** under **IRC 732(b)**

***Service Partnerships***

**Concept**: **Capital is NOT a material** income producing (MIP) factor

**General Rule**: **IRC 736(b)**: treat payments as **distributions** under **IRC 732(b)**

**Exception**: **IRC 736(a)**:

1) If retiring partner is **general partner** (**IRC 736(b)(3)(B)**)

2) And, partnership is a **service** partnership (**IRC 736(b)(3)(A)**)

3) And, the payment is for either:

A) **Unrealized receivables** under **IRC 751(c)**; or

**Recapture**: **IRC 751(c)(2) (Flush)**: NOT unrealized receivable

B) The Partnership’s [unspecified] **goodwill**

**Exception**: Partnership agreement has a provision on goodwill

**IRC 1060**: Use residual method to value

4) Then, treat the payment for unrealized receivables/GW as either:

A) Partner’s **Distributive share** under **IRC 704(b)**; or

B) Partner’s **Guarantee payment** under **IRC 707(c)**

***IRC 736(a) Payments – General Partner of Service Partnership***

**Trigger**: **IRC 736(a)** ONLY applies to liquidating payments for unrealized receivables and goodwill to a retiring general partner of a service partnership

**Treatment**: ***1) If Payment Is Determined With Respect to PA’s Income***

**Effect**: treat as **IRC 704(b)** Payment **(Services for PA income)**

***i) Treatment***: treat as B’s **distributive share** in **IRC** **704**

***ii) Character***: Character flows through

***iii) Partner*** ***Inclusion***: Include on last day of **PA’s year**

***iv) PA Deduction***: **No deduction**

***v) Capital Expenditure***: **do NOT capitalize**

***iv) Goodwill***: **IRC 197**: **deduct pro rata over 15 years**

***2) If Payment Is NOT Determined With Respect to PA’s Income***

**Effect**: treat as **IRC 707(c)** Payment **(Guarantee Payment)**

***i) Treatment***: Hybrid approach

***ii) Character***: **Ordinary** **income** to retiree

***iii) Partner*** ***Inclusion***: Include on last day of **PA’s year**

***iv) PA Deduction***: **ALWAYS a deduction (unlike IRC 704(b))**

**RR 1.736-1(a)(4)**: unlike partner-partner transactions

**(above)**, PA always gets a deduction!!

***v) Capital Expenditure***: **NEVER capitalized**

**RR 1.736-1(a)(4)**: unlike partner-partner transactions

**(above)**, PA always gets a deduction!!

***iv) Goodwill***: **immediate deduction** **(unlike IRC 704(b))**

**Ex**: ABC is services PA. A is retiring general partner & gets $370, but all in Y1 in complete liquidation. A liable for 1/3 of debt. In Y1, balance sheet is: Basis FMV Debt: $390

Cash $150 $150

A/R $0 $300

Equip. $75 $75 Tax FMV OB

Building $240 $330 A $120 $370 $250

Land $60 $120 B $120 $370

Goodwill $0 $300 C $120 $370

***1) Does Retiring General Partner*** **(A) *Get Any*** **IRC 736(a)** ***Payments?*** **(Yes)**

***A) What Are*** **IRC 736(a)** ***Payments?*** **(1/3)** Unrealized A/R $100

**(1/3)** Goodwill $100

Total $200

***B) Are the Payments Determined With Respect to ABC’s Income?*** **(No)**

**Effect**: Treat as Guarantee Payment under **IRC 707(c)**

***i) Character***: Ordinary income to A **($200)**

***ii) Partner Inclusion***: A includes on last day of ABC’s year

***iii) PA Deduction***: ABC gets a deduction **($100)**

***iv) Capital Expenditure***: ABC does NOT capitalize

***iv) Goodwill***: immediate deduction **($100)**

***2) Any*** **IRC 736(b)** ***Payments?*** **(Yes)**

***A) What Are the*** **IRC 736(b)** ***Payments?*** Cash $170

Debt Relief $130

Total $300

***B) Perform a Liquidating Distribution under*** **IRC 732(b)**

OB $250

Cash ($170)

Constructive Cash ($130)

ROB ($50) **—> $50 CG**

**IRC 751(b)** Property ($0)

Other Property ($0)

COB **($50)** **—> $0 OB**

**|**

**$50 IRC 734(b) Adjustment**

***Deferred Payment Obligations***

***IRC 734(b) Payments***

**Interest Rate**: Installment sale Ks must state a minimum rate of interest, or one will be imputed under **IRC 483**

**Basis Recovery**: **IRC 731(a)(1)**: under distribution rules, partner is allowed to recover his basis first

**Debt Relief**: bc retiring partners remain a partner (and thus liable for debt) until he gets his last payment, report all debt relief in the last year

**Ex**: ABC is capital intensive PA. A has OB of $250. PA will make 4 payments to A ($370 total), $100 in Y1-Y3, $70 in Y4. A is liable for 1/3 of debt. Balance sheet in Y1 is: Basis FMV Debt: $390

Cash $150 $150

A/R $300 $300 Tax FMV OB

Building $240 $330 A $120 $370 $250

Land $60 $420 B $120 $370

Goodwill $0 $300 C $120 $370

Y1 Y2 Y3 Y4

OB $250 $150 $50 $0

Cash ($100) ($100) ($100) ($70)

Constr. Cash ($0) ($0) ($0) ($130)

ROB $150 $50 ($50) **–> $50**($200) **–> $200**

**IRC 751(b)** Prop. ($0) ($0) ($0) **CG** ($0) **CG**

Other Prop. ($0) ($0) ($0) ($0)

COB **$150–>$150** **$50** **–> $50 ($50)** **–> $0** **($200)** **–> $0 OB**

**\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_| \_\_\_\_\_\_|**

**$50 IRC 734(b) Adjustment $200 IRC 734(b) adjustment**

***IRC 736(a) Payments***

**Ex**: ABC is services PA. A is retiring general partner & gets $370 over 4 years ($100 in Y1-Y3, $70 in Y4) in complete liquidation. A liable for 1/3 of debt. In Y1, balance sheet is: Basis FMV Debt: $390

Cash $150 $150

A/R $0 $300

Equip. $75 $75 Tax FMV OB

Building $240 $330 A $120 $370 $250

Land $60 $120 B $120 $370

Goodwill $0 $300 C $120 $370

***1) What Is the Ratio of*** **IRC 736(a)** ***&*** **IRC 736(b) *Payments to Total Payments?***

***A) What Are*** **IRC 736(a)** ***Payments?*** **(1/3)** Unrealized A/R $100

**(1/3)** Goodwill $100

Total $200

***B) What Are the*** **IRC 736(b) *Payments?*** Cash $170

Debt Relief $130

Total $300

***C) What Is the Ratio?***

**IRC 736(a)** Payments $200 **IRC 736(b)** Payments $300

———————————— = 40% ————————————— = 60%

Total Payments $500 Total Payments $500

***2) Does Retiring General Partner*** (A) ***Get Any*** **IRC 736(a) *Payments?*** **(Yes)**

***A) Are the Payments Determined With Respect*** ***to ABC’s Income?*** **(No)**

**Effect**: Treat as Guarantee Payment under **IRC 707(c)**

***i) Character***: Ordinary income to A **($200 total)**

***ii) Partner*** ***Inclusion***: A includes on last day of ABC’s year

***iii) PA Deduction***: ABC gets a deduction **($100 total)**

***iv) Capital Expenditure***: ABC does NOT capitalize

***iv) Goodwill***: immediate deduction **($100 total)**

***B) When Are the Payments Included/Deducted?***

**Y1**: $40 **Y3**: $40

**Y2**: $40 **Y4**: $80

***3) Any*** **IRC 736(b) *Payments?*** **(Yes)**

***A) Perform a Liquidating Distribution*** ***under*** **IRC 732(b)**

Y1 Y2 Y3 Y4

OB $250 $190 $130 $70

Cash ($34) ($34) ($34) ($68)

Constr. Cash ($26) ($26) ($26) ($52)

ROB $190 $130 $70 ($50) **–> $50 CG**

**IRC 751(b)** Prop. ($0) ($0) ($0) ($0)

Other Prop. ($0) ($0) ($0) ($0)

COB **$190 $130 $70 ($50) –> $0 OB**

**|**

**$50 IRC 734(b) Adjustment**

**Disguised Sales**

**Issue**: pushed to it’s limit, **Subchapter K** rules would allow TPs to use a PA to exchange one type of property for another without recognizing any gain

**The Situation**: 1) CP contributes (usually appreciated) property to a PA

2) Then, there’s either a:

A) Cash distribution to CP; or

B) Distribution of different property to CP; or

C) Distribution of the contributed property to NCP

**Solutions**: 1) **IRC 707(a)(2)(B)**: enacted to recharacterize these as sales

2) **IRC 704(c)(1)(B)**

3) **IRC 737**

**Effect**: **RR 1.707-3(a)(2)**: if **recharacterized as a sale**, treat it as a sale under the normal IRC provisions, such as **IRC 453**, **IRC 1001**, **IRC 1012**, **IRC 1031**

**Simultaneous Transfers**: **RR 1.707-3(a)(2)**: deemed on contribution date

**Non-Simultaneous Transfers**: **RR 1.707-3(a)(2)**: deemed installment oblig.

***Solutions***

**IRC 707(a)(2)(B)**: IRS can draft regs to ID when two transfers are “sufficiently related” and are more “properly characterized as a sale of property”

**Elements: RR 1.707-3(b)(1)**: recharacterize transaction as sale/exchange of property if, based on all of the facts and circumstances:

1) PA would not have transferred the money/property to the partner “but

for” the transfer of the property by the partner to the PA; AND

**Equalizing CAs**: NOT sufficient justification for distribution (yes sale)

2) If a transfer is not simultaneous, the later transfer is NOT dependent on

the **entrepreneurial risks** of the PA’s operations

**Simultaneous Transfers**: auto suspect and often recharacterized

**Two Year Presumption**:

A) **RR 1.707-3(c)**: if the 2nd transfer occurs **within 2 years** of the

1st transfer, **presume that it is a sale**

B) **RR 1.707-3(d)**: if the 2nd transfer occurs **more than 2** **years**

after the 1st transfer, **presume that it is NOT a sale**

**Factors**: **RR 1.707-3(B)(2)**: factors that help show a sale include:

1) Certainty of the timing and amount of the 2nd transfer

2) 2nd transfer is legally enforceable

3) 2nd transfer is secured in any way

4) 3rd party must contribute to PA to help it make the 2nd transfer

5) 3rd party must loan money to PA to help it make the 2nd transfer

6) PA has incurred debt to be able to make the 2nd transfer

7) PA has excess liquid assets expected to be used on the 2nd transfer

8) PA distributions, allocation, or control is designed to facilitate the

exchange of benefit/burdens of ownership of the contributed property

9) Partner’s distribution is disproportionately big compared to his interest

10) Partner has no duty to return distributions to the PA

***Normal Distributions***

**Issue**: without special rules, all PA distributions within 2 years to a CP would be presumed to be a sale

**Solution**: Treasury has created tons of exceptions:

1) **RR 1.707-4(b)**: NOT a disguised sale if distribution is out of cash flow

2) **RR 1.707-4(a)**: NOT a disguised sale if it is a “reasonable” guaranteed

payment or preferred return

**Ex**: ABC form equal PA. A contributes Land ($1,000 FMV, $300 basis). BC each contribute $750 cash. To equalize their capital accounts, A gets an immediate cash distribution of $250

**Analysis**: PA would NOT have made the $250 distribution to A had A not

contributed land bc the facts say that it is to equalize capital accounts

**Effect**:

**Sale Portion**: A is treated as if he sold 25% of Land to PA **(250 ÷ 1,000)**

FMV $250 **25% of Land’s $1,000 FMV**

Basis $75 **25% of Land’s $300 basis**

**Contribution Portion**: A is treated as if contributed 75% of land to PA

FMV $750 **75% of Land’s $1,000 FMV**

Basis $225 **75% of Land’s $300 basis**

**A’s POV**:

A recognizes $175 of gain from the sale **($250 - $75)**

A’s OB in the partnership is $225 **(Contribution’s $225 AB)**

**ABC’s POV**:

ABC’s basis in the Land is now $475 **($225 Cost Basis + $250 Basis)**

**Ending Balance Sheet**: Basis Book Tax Book OB

Cash $1,250 $1,250 A $225 $750 $225

Land $475 $1,000 B $750 $750 $750

C $750 $750 $750

***Liabilities***

**Issue**: When encumbered property is contributed to a PA, \***\*the CP deemed to receive a cash distribution of the amount of net debt relief\*\*** that CP got

**Question**: How do we treat these deemed distributions of net debt relief?

**Solution**: **RR 1.707-5(a)(6)**: if the liability is a qualified liability, then the net debt disqualified is NOT treated as a disguised sale

**Ex**: A contributes Land (FMV of $1,000, basis of $600, $800 debt) to AB for

50% interest. B contributes $200 cash

**If Qualified Liability**: NOT a disguised sale

**If Non-Qualified Liability**: yes a disguised sale

**Effect**:

**Sale Portion**: A sold 40% of Land for $400 **($400 debt relief ÷ $1k)**

FMV $400 **40% of Land’s $1,000 FMV**

Basis $240 **40% of Land’s $600 basis**

Debt $400 **Amount of Net Debt Relief A got**

**Contribution** **Portion**:

FMV $600 **60% of Land’s $1,000 FMV**

Basis $360 **60% of Land’s $300 basis**

Debt $400 **Remaining Amount of Debt**

**A’s POV**:

A recognizes $160 of gain from the sale **($400 - $240 AB)**

A’s OB in the partnership is $360 **(Contribution’s $360 AB)**

**ABC’s POV**:

ABC’s basis in Land is $760 **($400 Cost Basis + $360 Basis)**

**Ending Balance Sheet**: Basis Book Debt: $800

Cash $200 $200

Land $475 $1,000 Tax Book OB

A **($40) $200 $360**

B $200 $200 $200

**A’s Tax**: Contributed asset’s basis **($360) minus** debt **($400)**

**A’s Book**: Contributed asset’s FMV **($600)** **minus** debt **($400)**

**A’s OB**: Contributed asset’s basis **($360)** **minus** contributed asset’s

debt **($400)** **plus** CP’s share of ALL Partnership Debt **($400)**

***Qualified Liabilities —*** **RR 1.707-5(a)(6)**

1) When was the liability incurred?

A) If debt was **incurred 2+ years prior** to transfer to the PA:

**RR 1.707-5(a)(6)(i)(A)**: **conclusively presumed** qualified liability

If “Old & Cold Debt,” it doesn't matter WHY it was incurred

B) If debt was incurred **within 2 years** of transfer to the PA:

i) Where did the loan’s proceeds go?

It is ONLY a qualified liability if either:

I) Debt was capitalized into the contributed property’s

basis as a CE (capital expenditure); or

Debt was used to acquire/improve the asset

**Policy**: bc TP invested debt in the asset, TP hasn’t

in any way “sold” his investment

II) Debt was incurred in ordinary course of T/B and

substantially all of T/B’s assets are transferred to PA

***Share of Non-Qualified Liabilities***

**Issue**: If CP contributes property subject to a non-qualified liability, CP is treated as having AR of the amount of CP’s debt relief

Determining CP’s share of debt relief is SUPER important

**General Rule**: Similar to **RR 1.752-3**, but we ONLY use “Excess NR Liabilities”

**RR 1.752-3(a)**: allocate “Non-Qualified Liability” according to Profits Ratio

***Partial Disguised Sales***

**Issue**: Circumstances when a contribution of an asset with a qualified liability is treated as a partial sale

**Trigger**: CP is treated as having received “additional consideration” if:

1) CP contributes property subject to a qualified liability; and

2) CP receives an actual distribution from the PA that’d turn it into

a disguised sale under normal rules (**see above**)

**Additional Consideration**: if partial sale, CP gets extra consideration in the **lesser of**: 1) Amount of debt that would’ve been treated as consideration

had the debt been a non-qualified liability; or

2) Net Equity Percentage times Amount of liability

**Formula**: **RR 1.707-5(a)(5)(ii)**

FMV of Asset Distribution Extra

(Qualified Liability) Qualified x —————— = Consideration

Net Equity Liability Net Equity

Distribution Total Consideration Percentage

+ Extra Consideration ————————— = Deemed To Be A

Total Consideration FMV of Property Disguised Sale

**Ex**: A contributes Land (FMV of $1,000, basis of $600, $800 debt) to AB for

50% interest. B contributes $150 cash. Also, immediately after formation,

AB distributes $50 to A

FMV of Asset $1,000 $50 Distribution

(Qualified Liability) ($800) $800 x ———————— = $200

Net Equity $200 $200 Net Equity

Distribution $50 $250 Total Consideration 25% Deemed

+ Extra Consideration $200 ———————————— = To Be A

Total Consideration $250 $1,000 FMV of Property Disguised Sale

**Sale Portion**: A is treated as if he sold 25% of Land to PA

FMV $250 **25% of Land’s $1,000 FMV**

Basis $150 **25% of Land’s $600 basis**

Debt $200 **25% of Land’s $800 debt**

**Contribution Portion**: A is treated as if contributed 75% of land to PA

FMV $750 **75% of Land’s $1,000 FMV**

Basis $450 **75% of Land’s $600 basis**

Debt $600 **75% of Land’s $800 debt**

**A’s POV**:

A recognizes $100 of gain from the sale

A’s OB in the partnership is $225

**ABC’s POV**:

ABC’s basis in the Land is now $700 **($250 Cost Basis + $450 Basis)**

**Ending Balance Sheet**: Basis Book Tax Book OB

Cash $100 $100 A **($150)** **$150 $250**

Land $700 $1,000 B $150 $150 $150

**A’s Tax**: Contributed asset’s basis **($450) minus** debt **($600)**

**A’s Book**: Contributed asset’s FMV **($750)** **minus** debt **($600)**

**A’s OB**: Contributed asset’s basis **($450)** **minus** contributed asset’s

debt **($600)** **plus** CP’s share of ALL Partnership Debt **($400)**

***Distribution of Loan Proceeds***

**Issue**: If, immediately after CP contributes debt free asset to PA, PA incurs a debt and distributes all/part of that debt’s proceeds to CP

Without a special rule, the entire distribution would be treated as

consideration for the disguised sale of that property

BUT, if CP had incurred the debt on the property 1 day before

contributing the property, only CP’s debt relief would be treated as

consideration for the disguised sale of that property

**Solution**: Distribution to a partner is ONLY taken into account to the extent that it exceeds CP’s “allocable share” if:

1) CP contributes unencumbered asset to a PA; and

2) PA incurs a debt;

3) PA distributes all/part of the proceeds from that debt to the partner; &

4) That distribution takes place **within 90 days\*\*\*** of incurring that debt

**Allocable Share**:

Amount Distributed That’s Traceable to the Debt

CP’s Share x —————————————————————— = Allocable

Of Debt Total Amount of Debt Share

**Ex**: A contributes Land (FMV of $1,000, basis of $600, $0 debt) to AB for

50% interest. B contributes $200 cash. The next day, AB incurs $800 debt,

secured by the Land, & distributes $800 to A. All $800 is traceable to debt

$800 Traceable to the Debt

$400 x ———————————————= $400 Allocable Share

$800 Total Amount of Debt  **|**

**\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_|**

**|**

**|** **Sale Portion**: A is treated as if he sold 40% of Land to PA for $400

**|** FMV $400 **40% of Land’s $1,000 FMV**

**|** Basis $240 **40% of Land’s $600 basis**

**|\_\_\_\_\_** Debt **$400** **Allocable** **Amount of Net Debt Relief A got**

**Contribution Portion**:

FMV $600 **60% of Land’s $1,000 FMV**

Basis $360 **60% of Land’s $300 basis**

Debt $400 **Remaining Amount of Debt**

**A’s POV**:

A recognizes $160 of gain from the sale

A’s OB in the partnership is $360

**ABC’s POV**:

ABC’s basis in Land is $760 **($400 Cost Basis + $360 Basis)**

**Ending Balance Sheet**: Basis Book Debt: $800

Cash $200 $200

Land $475 $1,000 Tax Book OB

A **($40) $200 $360**

B $200 $200 $200

**A’s Tax**: Contributed asset’s basis **($360) minus** debt **($400)**

**A’s Book**: Contributed asset’s FMV **($600)** **minus** debt **($400)**

**A’s OB**: Contributed asset’s basis **($360)** **minus** contributed asset’s

debt **($400)** **plus** CP’s share of ALL Partnership Debt **($400)**

***Mixing Bowl Transactions***

**Issue**: A contributes Land to PA, B contributes Stock to PA, PA distributes Land to B and Stock to A

**Situation 1**: A contributes built-in gain/loss property. PA distributes it to B

**Effect**: A exchanged all of his interest in the **IRC 704(c)** property for an

undivided interest in the PA’s other assets

**Solution**: **IRC 704(c)(1)(B)**

**Situation 2**: A contributes built-in gain/loss property. 2+ years later, PA

distributes other property to A

**Effect**: A exchanged **IRC 704(c)** property for the distributed property

**Solution**: **IRC 737**

***IRC 704(c)(1)(B)***

**Elements**: 1) CP **contributes** **IRC 704(c)** built-in gain/loss property

**2) Within 7 years**, NCP is distributed that property

**Effect**: CP must recognize gain/loss as if the property had been sold to NCP (distributee) at FMV on the date of the distribution

***Gains***

**CP’s OB**: CP’s OB is increased by any gain that CP recognized

**PA’s Basis**: PA’s basis in the **IRC 704(c)** property is increased by any gain that

the CP recognized

**Ex**: In Y1, A contributes Land #1 ($40 basis, $100 FMV). B contributes Stock

($60 basis, $100 FMV). C contributes $100 cash. PA buys Land #2. In Y3, C

gets a liquidating distribution of Land #1 from the PA. Balance sheet at

distribution is: Basis Book FMV Tax Book FMV OB

Land #1 $40 $100 **$150**  A $40 $100 $150 $40

Land #2 $100 $100 $150 B $60 $100 $150 $60

Stock $60 $100 $150 C $100 $100 $150 $100

***1) Calculate Book Gain* AR 150 —> Treat as if**

**AB (100) sold to C for**

**Book Gain 50 FMV (150)**

***2) Calculate Tax Gain* AR 150**

**AB (40)**

**Tax Gain 110**

***3) Allocate book gain by PA Agreement* (33-33-33)**

**A: $25 Book gain**

**C: $25 Book Gain**

***4)* NCP*: Allocate Tax Gain up to NCP’s Book Gain* (25)**

***5)* CP*: Allocate remaining tax gain to CP*  (85)**

**A’s Built-In Gain: $60 \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

**A’s Tax Gain: $25 |**

***6)* CP: *Recognizes Their Built-In Gain That Would’ve Been*  |**

***Allocated to CP as a Capital Gain* (60) \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |**

***7)* CP*: CP Increases Their OB By That Same Built-In Gain* (60)*\_\_\_*|**

**PA: PA Increases Basis in Distributed Asset By That Same |**

**Amount Of Built-In Gain (60) *\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_*|**

**A’s OB $40 Land #1’s Basis $40**

**Built-In Gain $60 Built-In Gain $60**

**A’s New OB $100 Land #1’s New Basis $100**

**Key: BOTH Of These Increases Are Treated As If They**

**Occurred Right Before C Was Distributed The Asset**

***8) Determine the New Balance Sheet***

Basis Book FMV Tax Book FMV OB

Land #1 **$100** $100 $150 A **$100** $100 $150 **$100**

Land #2 $100 $100 $150 B $60 $100 $150 $60

Stock $60 $100 $150 C $100 $100 $150 $100

***9) Perform the Distribution to NCP*** **(See Distribution Rules)**

**Ex**: In Y1, A contributes Land #1 ($40 basis, $100 FMV). B contributes Stock

($60 basis, $100 FMV). C contributes $100 cash. PA buys Land #2. In Y3, C

gets a liquidating distribution of Land #1 from the PA. Balance sheet at

distribution is: Basis Book FMV Tax Book FMV OB

Land #1 $40 $100 **$70** A $40 $100 $150 $40

Land #2 $100 $100 $150 B $60 $100 $150 $60

Stock $60 $100 $150 C $100 $100 $150 $100

***1) Calculate Book Loss* AR 150 —> Treat as if**

**AB (70) sold to C for**

**Book Loss 30 FMV (30)**

***2) Calculate Tax Gain* AR 70**

**AB (40)**

**Tax Gain 30**

***3) Give book gain by PA Agreement* (33-33-33) A: (15) Book Loss**

**C: (15) Book Loss**

***4)* NCP*: Allocate Tax Gain up to NCP’s Book Gain* (0)**

***5)* CP*: Allocate remaining tax gain to CP*  (30)**

**A’s Built-In Gain: $30 \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

**A’s Tax Gain: $0 |**

***6)* CP: *Recognizes Their Built-In Gain That Would’ve Been*  |**

***Allocated to CP as a Capital Gain* (30) \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |**

***7)* CP*: CP Increases Their OB By That Same Built-In Gain* (30)*\_\_\_*|**

**PA: PA Increases Basis in Distributed Asset By That Same |**

**Amount Of Built-In Gain (30) *\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_*|**

**A’s OB $40 Land #1’s Basis $40**

**Built-In Gain $30 Built-In Gain $30**

**A’s New OB $70 Land #1’s New Basis $70**

**Key: BOTH Of These Increases Are Treated As If They**

**Occurred Right Before C Was Distributed The Asset**

***8) Determine the New Balance Sheet***

Basis Book FMV Tax Book FMV OB

Land #1 **$70** $100 $150 A **$70** $100 $150 **$70**

Land #2 $100 $100 $150 B $60 $100 $150 $60

Stock $60 $100 $150 C $100 $100 $150 $100

***9) Perform the Distribution to NCP*** **(See Distribution Rules)**

**Ex**: In Y1, Z gives Land #1 ($600 basis, $1,000 FMV), Y gives Stock ($200 basis, $1,000 FMV), Z gives $1,000. XYZ buys Land #2. In Y4, liquidating distribution of Land #1 to Z. Balance Sheet in Y4 is:

Basis Book FMV Tax Book FMV OB

Land #1 $600 $1,000 $1,500 X $600 $1,000 $1,500 $600

Land #2 $1,000 $1,000 $1,500 Y $200 $100 $1,500 $200

Stock $200 $1,000 $1,500 Z $1,000 $1,000 $1,500 $1,000

***1) Calculate Book Gain* AR 1,500 —> Treat as if**

**AB (1,000) sold to C for**

**Book Gain 500 FMV (1,000)**

***2) Calculate Tax Gain* AR 1,500**

**AB (600)**

**Tax Gain 900**

***3) Give book gain by PA Agreement* (33-33-33) A: 250 Book Gain**

**C: 250 Book Gain**

***4)* NCP*: Allocate Tax Gain* (900) *up to NCP’s Book Gain* (250)**

***5)* CP*: Allocate remaining tax gain to CP*  (650)**

**A’s Built-In Gain: $400 \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

**A’s Tax Gain: $250 |**

***6)* CP: *Recognizes Their Built-In Gain That Would’ve Been*  |**

***Allocated to CP as a Capital Gain* (400) \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |**

***7)* CP*: CP Increases Their OB By That Same Built-In Gain* (400) *\_*|**

**PA: PA Increases Basis in Distributed Asset By That Same |**

**Amount Of Built-In Gain (400) *\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_*|**

**A’s OB $600 Land #1’s Basis $600**

**Built-In Gain $400 Built-In Gain $400**

**A’s New OB $1,000 Land #1’s New Basis $1,000**

**Key: BOTH Of These Increases Are Treated As If They**

**Occurred Right Before C Was Distributed The Asset**

***8) Determine the New Balance Sheet***

Basis Book FMV Tax Book FMV OB

Land #1 **$1,000** $1,000 $1,500 X **$1,000** $1,000 $1,500  **$1,000**

Land #2 $1,000 $1,000 $1,500 Y $200 $100 $1,500 $200

Stock $200 $1,000 $1,500 Z $1,000 $1,000 $1,500 $1,000

***9) Perform the Distribution to NCP*** **(See Distribution Rules)**

***IRC 737***

**Elements**: 1) CP contributes asset

2) Within 7 years, CP is distributed asset

3) The asset CP is distributed is **NOT the same asset** CP contributed

**Effect**: CP must recognize gain (but NOT loss) in the amount equal to the **lesser of**: ***1) The “excess distribution;”*** or

**RR 1.737-1(b)(1)**: this is the excess of the asset’s FMV at

distribution mins the distributee’s OB

**Formula**: FMV of Property Distributed

(Distributee’s OB)

Excess Distribution

***2) CP’s Net Pre-Contribution Gain***

The amount distributee would recognize if there was an **IRC**

**704(c)(1)(B)** (**see above**) distribution to him of the assets

that distributee contributed

**Ex**: In Y1, A contributes Land #1 ($40 basis, $100 FMV). B contributes Stock

($60 basis, $100 FMV). C contributes $100 cash. PA buys Land #2. In Y3, B

gets a liquidating distribution of Land #1 from the PA. Balance sheet at

distribution is: Basis Book FMV Tax Book FMV OB

Land #1 $40 $100 **$150**  A $40 $100 $150 $40

Land #2 $100 $100 $150 B $60 $100 $150 $60

Stock $60 $100 $150 C $100 $100 $150 $100

***1) Distributee recognizes gain the lesser of* (40)*:***

***A) Excess Distribution*** **(90)**

**FMV of Property Distributed $150**

**(Distributee’s OB) ($60)**

**Excess Distribution $90**

***B) Distributee’s* (Stock) *Net Pre-Contribution Gain* (40)**

***i) Calculate Book Gain* AR 150 —> Treat as if**

**AB (100) sold to C for**

**Book Gain 50 FMV (150)**

***ii) Calculate Tax Gain* AR 150**

**AB (60)—> Stock**

**Tax Gain 90**

***iii) Allocate book gain by PA Agreement* (33-33-33)**

**A: $25 Book gain**

**C: $25 Book Gain**

***iv)* NCP*: Allocate Tax Gain* (90) *up to NCP’s Book Gain* (25)**

***v)* CP*: Allocate remaining tax gain to CP*  (65)**

**A’s Built-In Gain: $40 \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

**A’s Tax Gain: $25 |**

***vi)* CP: *Recognizes Their Built-In Gain That Would’ve Been*  |**

***Allocated to CP as a Capital Gain* (40) \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |**

***2) Distributee: Increases OB by the gain that distributee recognized* (40)**

***Partnership: Increases the basis in distributee’s contributed asset* (Stock)**

***by that same amount of recognized gain* (40)**

**B’s OB $60 Stock’s Basis $60**

**Built-In Gain $40 Built-In Gain $40**

**A’s New OB $100 Land #1’s New Basis $100**

**Key: BOTH Of These Increases Are Treated As If They**

**Occurred Right Before C Was Distributed The Asset**

***3) Determine the New Balance Sheet***

Basis Book FMV Tax Book FMV OB

Land #1 $40 $100 $150 A $40 $100 $150 $40

Land #2 $100 $100 $150 B **$100** $100 $150 **$100**

Stock **$100** $100 $150 C $100 $100 $150 $100

***4) Perform the Distribution to NCP*  (See Distribution Rules)**

**Ex**: In Y1, Z gives Land #1 ($600 AB, $1,000 FMV), Y gives Stock ($200 AB, $1k FMV), Z gives $1,000 Cash. PA buys Land #2 with Z’s cash. In Y4, liquidating distribution of Land #2 to Y. Balance Sheet in Y4 is:

Basis Book FMV Tax Book FMV OB

Land #1 $600 $1,000 $1,500 X $600 $1,000 $1,500 $600

Land #2 $1,000 $1,000 $1,500 Y $200 $100 $1,500 $200

Stock $200 $1,000 $1,500 Z $1,000 $1,000 $1,500 $1,000

***1) Distributee recognizes gain the lesser of* (800)*:***

***A) Excess Distribution*** **(1,300)**

**FMV of Property Distributed $1,500**

**(Distributee’s OB) ($200)**

**Excess Distribution $1,300**

***B) Distributee’s* (Land #2) *Net Pre-Contribution Gain* (800)**

***i) Calculate Book Gain* AR 1,500 —> Treat as if**

**AB (1,000) sold to C for**

**Book Gain 500 FMV (1,500)**

***ii) Calculate Tax Gain* AR 1,500**

**AB (200)—> Stock**

**Tax Gain 1,300**

***iii) Allocate book gain by PA Agreement* (33-33-33)**

**A: $250 Book gain**

**C: $250 Book Gain**

***iv)* NCP*: Allocate Tax Gain* (1,300) *up to NCP’s Book Gain* (250)**

***v)* CP*: Allocate remaining tax gain to CP*  (1,050)**

**A’s Built-In Gain: $800 \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

**A’s Tax Gain: $250 |**

***vi)* CP: *Recognizes Their Built-In Gain That Would’ve Been*  |**

***Allocated to CP as a Capital Gain* (800)\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_|**

***2) Distributee: Increases OB by the gain that distributee recognized* (800)**

***Partnership: Increases the basis in distributee’s contributed asset* (Stock)**

***by that same amount of recognized gain* (800)**

**B’s OB $200 Stock’s Basis $200**

**Built-In Gain $800 Built-In Gain $800**

**A’s New OB $1,000 Land #1’s New Basis $1,000**

**Key: BOTH Of These Increases Are Treated As If They**

**Occurred Right Before C Was Distributed The Asset**

***3) Determine the New Balance Sheet***

Basis Book FMV Tax Book FMV OB

Land #1 $600 $1,000 $1,500 X $600 $1,000 $1,500 $600

Land #2 $1,000 $1,000 $1,500 Y **$1,000** $100 $1,500 **$1,000**

Stock **$1,000** $1,000 $1,500 Z $1,000 $1,000 $1,500 $1,000

***4) Perform the Distribution to NCP*  (See Distribution Rules)**

**Timing of Year Change**

**Closing a Partnership’s Taxable Year**

***Partnership Termination***

**General Rule**: **IRC 706(c)(1)**: PA’s year closes if the PA “terminates”

**Terminates**: **IRC 708(b)(1)**: No part of the business, financial operation, or

venture of the PA continues to be carried on by any partners

**Effect**: If PA shuts down it’s business mid-year, it may shift the partner’s

share of income into an earlier year

**Ex**: A (calendar year partner) owns 30% interest in ABC (fiscal year, ending

June 30th). ABC liquidates on November 15, 2020

**A’s POV**: include A’s share of income from 07/01 - 11/15 on 2020 return

**ABC’s POV**: would close it’s taxable year on November 15, 2020

***Transfer of a Partnership Interest***

**General Rule**: **IRC 706(c)(2)**: PA’s (but ONLY with respect to the outgoing partner) closes on the date of partner’s sale, transfer, exchange, liquidation of his ***ENTIRE*** PA share (or his death)

**Ex**: A (calendar year partner) owns 30% interest in ABC (fiscal year, ending

June 30th). On December 28, 2020, A sells his entire 30% interest to B

**A’s** **POV**: include A’s share of income from 07/01 - 12/28 on 2020 return

**ABC’s POV**: closes its taxable year on 12/28, but ONLY for A

**Ex**: A (calendar year partner) owns 30% interest in ABC (fiscal year, ending

June 30th). On January 2, 2021, A sells his entire 30% interest to B

**A’s POV**: include A’s share of income from 07/01 – 01/02 on 2021 return

**Effect**: A can defer income recognition until April 2022

**ABC’s POV**: closes its taxable year on 01/02, but ONLY for A

**Example – Varying Interest Rule (Below)**

**Ex**: ABC (calendar year) is equal PA (06/30 year). On 11/27/2019, A sells 1/3 to D. From 07/01/2019 to 11/15/2019, ABC had $90,000 of income. From 07/01/2019 to 06/30/2020, BCD had total of $366,000 of income. On 04/15/2020, BCD sold Stock at $30,000 capital loss. 2020 is a leap year

***Interim Closing Method***: ***Semi-Monthly***

**ABC’s POV**: closes books on 11/15/2019

**A’s** **POV**: Include $30,000 on 2019 Tax Return

$90,000 Income Until 11/16

1/3 A’s Share

$30,000 A’s Inclusion

**D’s POV**: Includes $92,000 on 2020 Tax Return

Allocate $10,000 capital loss on 2020 Tax Return

$366,000 Total Income $276,000

($90,000) Segment 1 Allocation x 1/3

$276,000 Remaining Income $92,000

***Proration Method***:

***Simple* *Items***: **Proration Period #1**: 07/01/19 to 11/27/19 (150 days)

$366,000 $1,000

————— = $1,000/day x 1/3 A’s Share

366 Days $333.33 Share/Day

x 150 Days

$50,000 A’s Inclusion

**Proration Period #2**: 11/28/18 to 06/30/20 (216 days)

$366,000 $1,000

————— = $1,000/day x 1/3 D’s Share

366 Days $333.33 Share/Day

x 216 Days

$72,000 D’s Inclusion

***Extraordinary* *Items***: **A’s POV**: $0 included (not a partner on 04/15/20)

**D’s POV**: $10,000 included (yes partner on 04/15)

**Allocation of Income In Year Change**

**Varying Interest Rule**

***Generally***

**Concept**: Whether a transfer terminates PA’s taxable year during the year is necessary to compute the amount of income partners include for that year

**General** **Rule**: **IRC 704(d)(1)**: Partners’ relative shares of income, gain, loss must be determined by taking into account their “varying interests”

**RR 1.706-4(a)(1)**: PA must taken into account certain “variations” in

determining the partners’ shares of income/loss

**Variations**: sale of PA interest, liquidation of PA interest, retirement

**Flexibility**: **RR 1.706-4(a)(3)(iii)**: PA can use both methods in the same year

**Effect**: On the deemed day of the “variation,” the **PA must close its books**

***Methods***

To account for these variations, regs let PAs use two methods

***1) Interim Closing Method; OR***

**Trigger**: **RR 1.706-4(c)(1)**: PA uses the interim closing method if there

is no agreement by ALL partners to use proration method

**Methods**: PA must adopt one of three conventions to determine

when this “variation” is deemed to have occurred:

***A) Calendar Day Convention***

**RR 1.706-4(c)(1)(i)**: Variation deemed to occur on the day

that the variation **actually occurs**

***B) Semi-Monthly Convention:***

**RR 1.706-4(c)(1)(ii)**: variation is deemed to have occurred:

***i) If Variation Occurs on 1st to 15th of Month*** ***2***:

On the **last day of Month 1**

***ii) If Variation Occurs on 16th-31st of Month 2***:

On the **15th of Month 2**

***iii) If Variation Occurs First 15 Days of PA’s Taxable Year***:

**RR 1.706-4(c)(2)**: On the 1st day of PA’s taxable year

***C) Monthly Convention***

**RR 1.706-4(c)(1)(iii)**: variation is deemed to have occurred:

***i) If Variation Occurs on 1st to 15th of Month*** ***2***:

On the **last day of Month 1**

***ii) If Variation Occurs on 16th-31st of Month 2***:

On the **last day of Month 2**

***iii) If Variation Occurs First 15 Days of PA’s Taxable Year***:

**RR 1.706-4(c)(2)**: On the 1st day of PA’s taxable year

**Ex**: Calendar year PA has one variation on September 20th

The variation is deemed to have occurred on:

**Calendar Day Convention**: September 20th

**Semi-Monthly Convention**: September 15th

**Monthly Convention**: September 30th

***2) Proration Method***

***Trigger***: **RR 1.706-4(d)(3)(iii)**: PA can use if ALL partners agree

***Simple* *Items***: **RR 1.706-4(a)(3)(xiii)**: PA waits until end of PA’s taxab.

year & prorates annual income on daily between proration periods

***Extraordinary Items***: **RR 1.706-4(e)(1)**: **do NOT prorate,** **MUST**

**account** for extraordinary items **on the day that it occurred**

**RR 1.706-4(e)(2)**: income/loss from dispositions of the following,

NOT in ordinary course of T/B*:* ***A)*****IRC 1221*****capital assets***

***B)*****IRC 1231(b)*****assets used in T/B***

***C) Sale of all/substantially all A/R***,

***inventory, patents, inventions***

***Exceptions***

Varying interest rule does NOT apply to:

***1) “Permissible Changes Amount Contemporaneous Partners” Exception***

**RR 1.704-4(b)**: partners can reallocate items among themselves

during the year so long as allocations would otherwise be respected

**Elements**:  ***A) The change is for PA’s entire taxable year;***

***B) The change is among contemporaneous partners***

***C) Any change is NOT bc of a contribution/distribution***

***of money/property to/by a partner; and***

***D) The allocations have SEE***

***2) Service Partnerships Exception***

**RR 1.706-4(b)(2)**: Service PA account for varying interests using “any

R method,” so long as the allocations are respected under **IRC 704(b)**

**Elements**: ***A) Capital is NOT material income-producing factor; &***

***B) The allocations have SEE***

**Effect**: PA can change interests up at any time until tax due date

**Ex**: A works hard than BC and brings in 60% of all business

At Year end, ABC can give A 60% of the profits from entire year