CHAPTER 7
PARTNERSHIPS: FORMATION, OPERATION, AND BASIS

LECTURE NOTES

7.1 OVERVIEW OF PARTNERSHIP TAXATION

1. Partnerships are not treated as separate tax entities for Federal income tax purposes.
   a. All items of income, gain, loss, deduction, or credit pass through to the partners according to the partnership agreement.
   b. These pass through items are reported to each partner on a Schedule K-1.
   c. Partners report their share of partnership items on their separate tax returns.

2. Partnership tax return (Form 1065) is only an information return.
   a. However, the partnership makes numerous tax accounting elections on its tax return (e.g., cost recovery methods, whether to amortize business start-up costs, tax year selection, and adopting the cash or accrual method of tax accounting).
   b. Such elections are important because they affect the timing and amount of items reported by the partner.

3. Items 1 and 2 illustrate the two conflicting concepts that govern partnerships: the entity and the aggregate concepts.
   a. Under the entity concept, partnerships are treated as independent entities, separate and apart from the aggregate of its partners. Example: A partnership files Form 1065.
   b. Under the aggregate or conduit concept, a partnership is a “common pool” to which each partner contributes capital or services in the pursuit of profit. Example: Each partner receives Schedule K-1 and reports a share of partnership items.

Forms of Doing Business – Federal Tax Consequences

4. Partnerships and S corporations provide tax advantages over regular C corporations.
   a. Partnerships and S corporations are flow-through or pass-through entities because owners are taxed on their proportionate share of the entity’s taxable income; thus avoiding double taxation because they are not separate taxable entities.
b. Administrative and filing requirements are usually simple for a partnership.

c. Partnership offers planning opportunities not available to C or S corporations. For example:

(1) Both C and S corporations have rigorous allocation and distribution requirements. Partnership allocations and distributions are not required to be proportionate.

(2) Gains on appreciated assets are recognized at entity level for both C and S corporations upon liquidation. Partnership liquidation is generally tax-free.

What Is a Partnership?

5. A partnership is defined under common law as a contractual relationship between two or more persons who join together to carry on a trade or business, each contributing money, property, labor, or skill, and with the expectation of sharing in the profits and losses.

a. For tax purposes a partnership includes syndicates, groups, pools, joint ventures, or other unincorporated organizations.

b. Types of entities that may be treated as partnerships for tax purposes are: general partnerships, limited liability partnerships, limited partnerships, limited liability companies, and recently developed limited liability limited partnerships.

c. State law governs

(1) the types of partnerships that can be formed in the state,

(2) the types of business operations a given type of partnership can conduct,

(3) the extent to which the partners are liable for partnership debts, and

(4) whether or not a written partnership or operating agreement is required.

d. Perhaps the major practical distinction (from the partner’s perspective) between types of partnerships is the extent to which owners can be held liable for entity liabilities. See chart on page 10-4 of this outline for a summary of the rules.

Elections Related to Partnership Status

6. The “check-the-box” Regulations allow most unincorporated business entities to select their Federal tax status.

a. Unincorporated entities with two or more owners can generally choose to be taxed as either partnerships or C corporations.

b. Newly formed publicly traded partnerships must be taxed as corporations.

Taxation of Partnership Income

7. As previously stated, a partnership is not a taxable entity. Rather, the tax items flow through to the partners at the end of the entity’s tax year and therefore partnerships pay no Federal income taxes.
Comparison of Types of Partnerships. Various entities are taxed as partnerships. Each state has its own rules for establishing each type of partnership. These entities are not all recognized by each state (e.g., LLLPs can only be formed in about half the states).

<table>
<thead>
<tr>
<th>Description</th>
<th>Owner liability for general liabilities of partnership</th>
<th>Owner liability for tort or malpractice claims</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>General partnership.</strong> All partners are general partners who can participate in management.</td>
<td>All partners are jointly and severally liable for entity debts.</td>
<td></td>
</tr>
<tr>
<td><strong>Limited partnership.</strong> Has at least one general partner and one or more limited partners. General partners participate in management. Limited partners are typically investors and cannot participate in management.</td>
<td>General partners are jointly and severally liable for entity debts. Limited partners have no personal liability for entity debts.</td>
<td></td>
</tr>
<tr>
<td><strong>Limited liability company (LLC).</strong> A special entity that offers the flow-through treatment of partnership taxation and the limited liability of a corporation.</td>
<td>“Members” have no personal liability for entity debts.</td>
<td></td>
</tr>
<tr>
<td><strong>Limited liability partnership (LLP).</strong> A general partnership that has filed under state law to be treated as a limited liability partnership. All partners are eligible to participate in partnership management.</td>
<td>Many states offer full protection from entity debts for all partners.</td>
<td>Partners typically liable for partnership debt arising from claims for tort or malpractice committed by the partner or someone supervised by the partner.</td>
</tr>
<tr>
<td><strong>Limited liability limited partnership (LLLP).</strong> A limited partnership that has filed under state law to be treated as a limited liability limited partnership. General partners are eligible to participate in partnership management. Limited partners do not.</td>
<td>Many states offer full protection from entity debts for all partners.</td>
<td>Partners have no personal liability for entity tort or malpractice claims.</td>
</tr>
</tbody>
</table>

**Qualified spousal joint venture.** If a partnership consists only of a husband and a wife, both of whom materially participate in the business, the partners may elect not to be treated as a partnership for Federal tax purposes. In this case, all partnership items are allocated between the spouses based on their interests in the venture.

a. Many partnership income and deduction items retain their identity as they flow through to the partners. These items are required to be separately stated because
the items might affect any two partners’ tax liabilities in different ways. There are numerous categories of separately stated items.

b. Non-separately stated items include ordinary income and expenses related to the partnership’s trade or business activities.

c. In addition, the partnership provides any information the partners might need to determine their tax liability, such as foreign tax credit information, alternative minimum tax preferences and adjustments, and information needed to calculate the domestic production activities deduction under §199.

**Partnership Reporting**

8. Partnerships file an information tax return, Form 1065, which is 5 pages.

a. For a calendar year partnership, Form 1065 is due on April 15. An automatic 5-month extension is available (to September 15 for a calendar year partnership).

b. Schedule K accumulates all items that must be separately reported to the partners. The amounts on Schedule K are allocated to each partner and reported on Schedule K–1.

c. At the end of the Schedule K is the Analysis of Net Income (Loss). This analysis combines the income and expense items from the Schedule K into a pro forma amount that is equivalent to a partnership’s taxable income if it was a tax paying entity.


e. Partnerships prepare either Schedule M–1 or Schedule M–3 to reconcile book income to the pro forma tax income determined in the Analysis of Net Income (Loss). Schedule M–3 is required if the partnership has $10 million or more in assets at the end of the year, has gross receipts of $35 million or more, or has a 50% -or-more partner that meets one of these conditions.

f. If the partnership is required to file Schedule M-3, it must also file Schedule C to answer a few questions about partnership operations.

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**ADDITIONAL LECTURE RESOURCE**

The IRS matches the amounts reported on each Schedule K-1 to the amounts reported on the individual partner’s return. Taxpayers not properly reporting K-1 items on the Form 1040 are sent a notice from the IRS indicating this failure and assessing additional tax, if applicable. The IRS also wants to reduce the number of individual taxpayers erroneously receiving notices on matching issues. To this end, all partnerships issuing amended K-1s should clearly identify the K-1 as amended. The IRS also asks Form 1040 preparers to avoid netting data from various K-1s on a return unless adequate schedules or explanations are attached.
Conceptual basis for Partnership Taxation

9. Partners and partnerships can be treated under the aggregate and the entity legal concepts. These concepts influence practically every partnership tax rule. They can work in combination.

   a. Aggregate (or Conduit) Concept. Treats partnerships as a channel through which income, credits, deductions, and other items flow to the partners. Under this concept, the partnership is regarded as a collection of taxpayers.

   b. Entity Concept. Treats partners and partnerships as separate units and gives the partnership its own tax character.

   c. Combined Concepts. Rules governing the formation, operation, and liquidation of a partnership contain a blend of both the entity and aggregate concepts.

Partner’s Ownership Interest in a Partnership

10. Partner’s ownership interest consists of a capital interest and a profits interest.

   a. Capital interest is a partner’s capital sharing ratio, which is the partner’s percentage ownership of the partnership’s capital. It determines the percentage of the net asset value a partner would receive on immediate liquidation of the partnership.

   b. Profits (loss) interest is the partner’s percentage allocation of current partnership operating results. Partnerships can change the profit and loss allocations at any time simply by amending the partnership agreement.

   c. Profits and capital interests do not have to be equal, and these interests may not be the same over time. In fact, these interests may vary for different types of income, deduction, etc., during a single tax year.

   d. These ratios are shown on the partners’ Schedules K-1.

   e. There is no single correct way to calculate these ratios, especially if the allocations change over time or differ for various items during the year. The most important consideration is that the method for making the calculations should be used consistently.

   f. On its web site, the IRS has posted a FAQ to provide guidance for making these calculations.

   g. Partnership agreements may provide for special allocations of tax items to specified partners, or it may allocate different items in different proportions.

Inside and Outside Bases

11. The partnership has a basis in each of the assets it owns, whether they were purchased, exchanged, or acquired as a contribution from one of the partners. This basis is termed the “inside basis.”

12. Each partner has a basis in his/her/its partnership interest. This is termed the “outside basis.”
a. When income flows through from the partnership to a partner, the partner’s basis increases.

b. When losses flow through, the basis is reduced.

c. Without basis adjustments, partnership income would be subject to double taxation.

13. Differences between a partner’s outside basis and that partner’s proportionate share of inside basis can occur for various reasons, such as when a partner purchases or inherits an interest from another partner.

14. Each partner also has a capital account.

a. The capital account is an accounting version of the partner’s net investment in the partnership interest. If the partners’ capital accounts are determined on a financial accounting basis, the sum of all partners’ capital accounts should equal total partners’ capital on the partnership’s balance sheet.

b. Items that result in changes between the beginning and ending capital account balance are shown on each partner’s Schedule K-1. These changes are accumulated into an overall reconciliation of the partnership’s capital changes on Schedule M-2. This is similar to the corporate reconciliation of retained earnings on the corporate Schedule M-2.

c. The partner’s capital account may be determined under one of several methods, such as GAAP, tax, “§704(b) book” or other methods. The method used on Schedules K-1 should correspond to the method used on Schedule M-2. Any differences between the amounts on Schedule M-2 and the amounts used in reporting the partnership’s balance sheet amounts on Schedule L should be described in a supporting statement.

d. The partner’s basis and capital accounts will typically be different for various reasons. For example, the partner’s basis includes a share of partnership liabilities. The capital account does not.

Anti-Abuse Provisions

15. Partnership provisions are generally more flexible than S or C corporate provisions. The IRS has responded to potential abuses of these provisions by adopting anti-abuse provisions that are covered in Chapter 11.

7.2 FORMATION OF A PARTNERSHIP: TAX EFFECTS

Gain or Loss on Contributions to the Partnership

16. Formation of a partnership occurs through transactions between a partnership and each of its partners. Partners surrender assets and receive a partnership interest in exchange.

17. Under § 721, the partnership and partners do not recognize gain or loss from the contribution of property in exchange for a partnership interest. The purpose of this provision, like its corporate counterpart (§ 351), is to allow taxpayers a tax-neutral choice in selecting a business form.
18. Basis in a partnership interest acquired by exchanging money and other property for the interest equals the cash exchanged plus the partner’s adjusted basis in the other property contributed.

19. The nonrecognition provision of § 721 is a deferral rather than a tax reduction provision. Any built-in gain or loss is deferred until later disposal of the property or the eventual termination of the partnership.

20. Neither the contributing partner’s tax basis in the partnership nor the partnership’s tax basis in the contributed property is determined by the value recorded on the partnership’s accounting (GAAP) books and records.

Exceptions to § 721

21. Nonrecognition provisions of § 721 do not apply in the following situations.

a. If the property transferred to the partnership consists of appreciated stocks and securities, and the partnership is an investment partnership, gain is recognized by the contributing partner [§ 721(b)].

b. If the transaction is essentially a taxable exchange of properties, it is taxed as such.

c. When assets are contributed to a partnership and the contributing partner then receives a distribution of different assets, this partner may be deemed as having a disguised sale of the contributed property to the partnership.

d. If an unrestricted partnership capital interest is received for services, the nonrecognition rule of § 721 does not apply. Instead, the partner generally is required under § 83 to recognize the fair market value of the interest as ordinary income (compensation for services).

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**ADDITIONAL LECTURE RESOURCE**

Jonas Barenholtz was a real estate agent who decided to form a partnership to operate two of his apartment buildings. [Jonas Barenholtz, 77 T.C. 85 (1981)]. To this end he sold 75% of the buildings to three individuals, and then the four created the partnership and transferred the buildings to the partnership.

However, when Barenholtz realized the tax consequences of his sale, he argued before the Tax Court that he “contributed his entire interest in [the buildings] to [the partnership] and that his partners contributed cash.” Such an interpretation would substantially reduce his assessed tax on the transaction, pursuant to §§ 721 and 731. He claimed that the references to the “seller” and the “purchasers” in the transfer agreement for the buildings were “inaccurate.”

The IRS contended that, even if the transfer was arranged as Barenholtz testified, “the transaction must be considered as occurring between the partnership and one who is not a partner pursuant to § 707(a).” The Tax Court determined that a sale had obviously occurred, and remarked that even though the “framework of partnership taxation” was quite flexible, “that flexibility is not unlimited and the law does not stretch so far as to allow retroactive second guesses.”
This case illustrates the importance of advance planning. The partners attempted to argue the following occurred: (1) property was contributed to a partnership by Barenholtz, (2) cash was contributed by other partners, and (3) cash was distributed to Barenholtz. Under the law in effect at that time, Barenholtz would have paid tax on any cash distribution in excess of his basis in the partnership interest. (Because his basis would have included his share of any debts on the buildings, his tax may have been minimal.)

How would the partnership rules apply today to the transaction Barenholtz argued occurred (i.e., partnership formation, followed by a property contribution and cash distribution)? The disguised sale rules would treat Barenholtz as if he sold a 75% interest in the buildings to the partnership for cash, and contributed a 25% interest. The tax law today would result in essentially the same result as that of the Tax Court in 1981.

**Tax Issues Relative to Contributed Property**

22. Two assets are created out of one when a partnership is formed, namely, the property in the hands of the entity and the partnership interest in the hands of the partner. Both assets are assigned a basis that is derived from the partner’s basis in the contributed property.

   a. Partnership’s basis in the contributed assets is a carryover basis.
   
   b. Partner’s basis in the new partnership interest is a substituted basis.
   
   c. For depreciable and amortizable property contributed to the partnership, the partnership is required to use the same cost recovery method and life used by the partner. The partnership is considered to merely “step into the shoes” of the partner.
   
   d. To prevent partners from converting ordinary income into capital gains, there are restrictions on partnership income recognition for receivables, inventory, and losses.

**Tax Accounting Elections**

23. Most partnership elections are made by the partnership.

   a. Examples of such elections are the following.

      - Inventory Method.
      - Cost or percentage depletion method (other than for oil and gas wells).
      - Accounting method.
      - Tax year.
      - DPAD income, expense, and wage allocation.
      - Optional basis adjustment for property under § 754
      - Section 179 deduction.
      - Postponement of involuntary conversion gains.

   b. Partners individually are required to make the following elections.

      - Reduce first the basis of depreciable property when excluding income from discharge of indebtedness.
      - Cost versus percentage depletion for oil and gas wells.
- Deduction versus credit for foreign taxes paid.

**Initial Costs of a Partnership**

24. Definitions of and treatment of organizational and start-up costs are the same as for C corporations. Also, similar to stock issuance costs, syndication costs cannot be amortized by a partnership.

25. Expenditures incurred when changing the legal title of assets contributed to the partnership are added to the property’s basis and increase the amount the partnership may depreciate. This basis is treated as a new asset placed into service on the date the cost is incurred.

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**ADDITIONAL LECTURE RESOURCE**

The partnership treatment of § 197 intangible assets acquired from partners depends on whether the asset was contributed by the partner or purchased from the partner by the partnership.

**Contributed Assets.** If a partner contributes an existing § 197 intangible asset to the partnership, the partnership will generally “step into the shoes” of the partner for future amortization deductions.

**Sold Assets.** When a partner sells a § 197 intangible asset to the partnership, treatment of the asset will depend on the following factors: the partnership percentage owned by the selling partner, the type of intangible being sold, and whether the partner recognizes a gain and pays tax on the sale. The §197 intangibles (other than goodwill or going-concern assets) purchased from a partner are amortizable by the partnership. Goodwill or going-concern assets acquired from a partner who owns a greater-than-50% interest does not qualify as a § 197 intangible. Goodwill or going-concern assets acquired from a partner owning greater than 20% but less than or equal to 50% may be treated under § 197 if the selling partner (1) recognizes gain on the sale to the partnership and (2) elects to pay tax on the gain at the highest marginal tax rate.

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**ADDITIONAL LECTURE RESOURCE**

A partnership should communicate with its partners before making an election to expense property acquisition costs under § 179. The § 179 deduction is limited both at the partnership level and at the partner level. This same rule applies to shareholders of a Subchapter S corporation.

If the partner (or shareholder) is allocated § 179 deductions from various partnerships and Subchapter S corporations in excess of the maximum permitted for the year, the excess allocation is simply lost. The partner cannot carry the amount forward or treat it as a depreciable asset.

Similarly, if the partner’s § 179-eligible purchases for the year exceed the phaseout range, the partner cannot claim any § 179 deduction allocated from the partnership. Again, the excess allocation is simply lost.
As a result, many partnerships will forego claiming § 179 deductions unless they are familiar with the partners’ situations and can be sure the deduction will be utilized.

### Method of Accounting

26. Newly formed partnerships adopt the cash, accrual or a hybrid of these two accounting methods.

   a. The cash method is generally not available to a partnership that is the following.
      
      - A partnership with a C corporation as a partner.
      - A tax shelter.

   b. However, a partnership with a C corporation partner may use the cash method if the following requirements are met.
      
      - Partnership meets the $5 million gross receipts test (described below).
      - C corporation partner(s) qualify as personal service corporation(s).
      - Partnership is engaged in the business of farming.

   c. Partnerships meet the $5 million gross receipts test if they never have had average annual gross receipts of more than $5 million.

      (1) “Average annual gross receipts” is the average of gross receipts for the 3 prior tax years ending immediately before the tax period in question.

      (2) The partnership must change to the accrual method in the first year after the partnership’s “average annual gross receipts” exceed $5,000,000. The accrual method must be used thereafter.

### Taxable Year of the Partnership

27. Partnership income flows through to each partner at the end of the partnership’s taxable year. Thus, partners include their distributive share of partnership income for the partnership year that ends within the partner’s tax year.

28. To prevent excessive deferrals, § 706(b)(1) requires that the tax year of a partnership be determined by systematic reference to the partners’ tax years. The partnership’s tax year is determined in the following order.

   - Tax year of the majority partners, if partners with a more than 50% aggregate profit and capital interest have the same tax year.
   - Tax year of all principal partners if all partners with a 5% or greater profit or capital interest have the same year-end.
   - Year determined under the least aggregate deferral method (Figure 10.2 and Example 22 in text).

29. If partners are dissatisfied with the required year-end, they may petition IRS for permission to use another tax year if they meet either of the following requirements.
a. Establish to the satisfaction of the IRS that a business purpose exists for selecting an alternate tax year; usually selecting a natural business year-end.

(1) A natural year end occurs when 25% or more of the gross receipts occur in the last two months of a 12-month period for three consecutive years.

(2) If the partnership satisfies this test, it can adopt the last month of this 12-month period as its fiscal year.

(3) If the partnership cannot meet this test, it may be very difficult to establish a business purpose that satisfies the IRS.

b. Elect a year-end that provides no more than a three month deferral under § 444.

(1) Existing partnerships may also elect under § 444. This election is automatic, that is, if the partnership meets the requirements, the IRS will not disallow the year-end.

(2) Under this election, the partnership must maintain a tax deposit account based on the deferred portion of partnership income. The deposit is based on the highest individual tax rate, plus 1%, so the cost of this election may be prohibitive.

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**ADDITIONAL LECTURE RESOURCE**

Rev. Proc. 2006-46, 2006-2 CB 859, provides some administrative rules on the taxable year issue. Among the rules affecting the “required” taxable year are the following:

- Partnerships may elect or change their taxable year-ends to a “required” taxable year without obtaining IRS approval.

- A partnership using a taxable year that corresponds to its “required” taxable year generally must obtain the approval of the IRS to retain the taxable year if its “required” taxable year changes because of a change in ownership.

A partnership desiring a natural business year is affected by the following rules:

- A partnership can automatically adopt a natural business year that satisfies the 25% gross receipts test without obtaining IRS approval.

- A partnership that has previously established a business purpose to the satisfaction of the IRS is not required to obtain approval of the IRS to retain that fiscal year, provided the previously approved year still qualifies as a permitted tax year.
7.3 OPERATIONS OF THE PARTNERSHIP

30. Even though partnerships are not subject to Federal income taxes, they are subject to all other taxes in the same manner as any other business.

Measuring and Reporting Income

31. Measuring and reporting partnership income is a two-step process.
   a. All tax items that are required to be separately stated or which must be specially allocated are removed from the calculation. The remainder is the partnership’s non-separately stated ordinary income or loss.
   b. Each separately stated item is reported on the partnership’s Schedule K (Form 1065), and each partner’s proportionate share is reported on a separate Schedule K-1. A list of many of the required separately stated items is provided on text page 10-21 (See also Example 23).
   c. Passive activity provisions of § 469 and the investment interest expense provisions of § 163(d) necessitate that portfolio income or loss and related deductions be excluded from a partnership’s ordinary income computation.
   d. Domestic Production Activities Deduction (DPAD). Whether an activity qualifies for DPAD is determined at the partnership level.
      (1) Partners are allocated their share of the DPAD items and take the deduction on their personal returns.
      (2) For many partnerships, qualified production activities income (QPAI) and W-2 wages related to production may be calculated at the entity level.
      (3) Guaranteed payments made to partners do not qualify as W-2 wages for DPAD purposes.
   e. Capital withdrawals by partners do not affect income measuring and reporting.
   f. Tax preference items and adjustments must be determined at the partnership level, and then allocated to the partners. The partners make alternative minimum tax determinations on their personal tax returns, after including partnership items.
   g. To encourage partnership return filing, a penalty of $195, per partner, per month (up to 12 months) can be imposed. Certain partnerships may be excluded from the penalties.

Partnership Allocations

32. Partnership income and separately stated items must be allocated under § 704(b).
   a. Section 704(b) provides a safe harbor for allocations that have substantial economic effect. The “economic effect” test has the following three requirements.
      (1) Partner’s capital accounts must be properly maintained. An allocation of income must increase the partner’s capital account; the opposite is true for an allocation of a loss or deduction item.
(2) Liquidating distributions must correspond to the partner’s positive capital account balances.

(3) Any partner with a deficit capital account balance must be required to contribute property (generally cash) to the partnership to make up the deficit.

b. Effect of these requirements is to ensure that a partner bear the economic burden of a loss or deduction allocation (through a lower eventual cash allocation) and receive the economic benefit of an income or gain allocation (through higher eventual cash allocations).

c. The “substantial” portion of this test ensures an allocation is not made solely for tax avoidance reasons.

(1) Example of a tax avoidance motive would be an allocation of all tax-exempt income to a high-bracket taxpayer and an offsetting allocation of taxable income to a taxpayer with expiring net operating loss carryovers.

(2) This allocation meets the letter of the “economic effect” tests, but it does not meet the “substantial” test because there is no purpose, other than tax reduction, for this allocation.

33. Allocations related to precontribution gain or loss property must be made in accordance with § 704(c).

a. Precontribution gains or losses must be allocated to take into account the difference between the fair market value of the property and its basis at the contribution date.

b. For nondepreciable property, this means that when the property is eventually disposed of by the partnership, any recognized built-in gain (as of the contribution date) must be allocated to the contributing partner.

c. Rules for depreciable property are more complex and not discussed in the chapter.

**ETHICS & EQUITY**

**Built-in Appreciation on Contributed Property** (page 10-27). The aggregate theory of taxation supports the § 704(c) required allocation of built-in gain to contributing partners. Each partner is deemed to own a share of the underlying partnership assets—and retains the full share of any unrecognized gains on property the partner contributed.

The S corporation shareholder, on the other hand, is treated as contributing property to a separate entity, with no future tax ramifications to that shareholder except for those that flow from being a partial owner of the S corporation.

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**Basis of a Partnership Interest**

34. Once the partnership begins operations, partners adjust their basis to reflect partnership performance and other items.
a. It is increased by the partner’s share of the following.

- Taxable and nontaxable income.
- Increases in the partner’s share of partnership debt.
- Additional contributions the partner makes to the partnership.

b. Conversely, it is decreased by the partner’s share of the following.

- Deductions, losses, nondeductible and noncapitalizable expenditures of the partnership.
- Decreases in the partner’s share of partnership debt.
- Distributions of cash or property to the partner.

Example. Paige is a 40% partner in the PDQ Partnership. Her basis is $10,000 at the beginning of the year. The partnership reports income for the year of $60,000, of which Paige’s share is $24,000. Assume Paige sells her interest in the partnership for $34,000 the first day of the next tax year. If a basis adjustment was not allowed, Paige’s share of partnership income would be subject to double taxation, as follows.

<table>
<thead>
<tr>
<th>Current year share of partnership income taxed to Paige</th>
<th>$24,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gain on sale of partnership interest next year:</td>
<td></td>
</tr>
<tr>
<td>Selling price</td>
<td>$34,000</td>
</tr>
<tr>
<td>Basis in partnership interest</td>
<td>(10,000)</td>
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<tr>
<td>Gain on sale</td>
<td>$24,000</td>
</tr>
</tbody>
</table>

Absent a basis adjustment, Paige could pay taxes in the current year, when income is earned by the partnership and allocated to Paige, and in the next year, when she sells her interest. However, the basis adjustment allowed ensures that Paige’s share of partnership income is only taxed once (in the year earned) and not again when she sells her interest in the partnership.

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<tr>
<td>Basis in partnership interest: Beginning basis: $10,000</td>
<td></td>
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<tr>
<td>Basis increase for income: 24,000</td>
<td></td>
</tr>
<tr>
<td>Ending basis</td>
<td>(34,000)</td>
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<tr>
<td>Gain on sale</td>
<td>$-0-</td>
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</table>

35. Liabilities of the partnership are considered the obligations of the partners. This is an application of the aggregate or conduit concept.

a. When the partnership’s liabilities increase, each partner’s outside basis increases by the partner’s share of the debt. Correspondingly, when the partnership’s liabilities decrease, each partner’s outside basis decreases by the reduction in the partner’s share of debt.

(1) Thus, whenever assets increase by reason of creditor actions (i.e., loans to the partnership or credit purchases by the partnership), the partners are
treated as contributing money to the partnership and incurring the loans personally.

(2) Similarly, when partnership assets are reduced due to repayment of loans or accounts payable, the partners are treated as having received a cash distribution from the partnership, which they used to retire the debts.

b. Recourse debt is a debt for which the partnership or at least one of the partners is personally liable (has an “economic risk of loss”), whereas for nonrecourse debt no party is personally liable. Upon default of nonrecourse debt, the lender can only claim the collateral.

(1) Recourse debt is shared by the partners in accordance with a constructive liquidation scenario. See text page 31 for a deemed scenario (Example 35).

(2) Nonrecourse debt is allocated in three stages: minimum gain; precontribution gain; and based on the partnership agreement.

(3) Whether a debt is recourse or nonrecourse depends upon the partners’ obligation for repayment in addition to characteristics of the debt itself.

(4) A nominally recourse debt (e.g., partnership accounts payable) would be nonrecourse debt to the members of an LLC, unless one of the LLC members personally guaranteed the debt.

Because partnership assumptions of liabilities are reflected in the partner’s basis, any change in the partner’s share of partnership liabilities affects the partner’s basis. The Regulations specifically define the liabilities considered to be “partnership liabilities.”

Carter contributes property with a basis and value of $4,000 to the CB Partnership in exchange for a 50% interest. He recognizes no gain or loss on the transfer and takes a $4,000 adjusted basis for his partnership interest. Immediately thereafter, Carter transfers a $2,500 personal recourse note to the partnership, which he does not consider to be a “partnership liability” (within the meaning of § 752). Carter would take this position under prior regulations because the debt does not result in the creation of, or increase in, the basis of an asset, does not result in a deductible expense to the partnership, and does not result in a nondeductible, noncapitalizable item at the partnership level.

By claiming that the note is not a partnership liability, Carter does not reduce the adjusted basis for his partnership interest, even though its fair market value is lowered to $1,500 ($4,000 – $2,500). If Carter then sells his partnership interest for $2,750 [$1,500 cash, plus the buyer’s assumption of $1,250 (50%) of the note], he may attempt to recognize a capital loss of $1,250 ($2,750 sales price – $4,000 adjusted basis).

In Reg. § 1.752-7, the IRS holds that Carter’s adjusted basis must be reduced as if the debt is a partnership liability, but no lower than the $2,750 adjusted value of the interest [$1,500 net value of the property and debt plus $1,250 (50%) share of the transferred debt obligation]. Therefore, Carter’s sale of the interest for $2,750 will result in no gain or loss recognition ($2,750 sales
price – $2,750 adjusted basis). This is a reasonable result that can be disputed only by the most aggressive of taxpayers.

Loss Limitations

36. A partner’s distributive share of partnership losses (including capital losses) is deductible on the partner’s tax return, to the extent of the partner’s basis in the partnership at year-end, before considering such losses.

37. The order in which adjustments are made to basis is important, because the partner may be limited in the amount of loss he or she can deduct, and because distributions from the partnership may result in a taxable gain (Chapter 11).
   a. Basis is adjusted first by contributions to the partnership, and income items (including separately stated taxable and nontaxable income items).
   b. Basis is then adjusted by distributions from the partnership.
   c. Losses and separately stated expenses (including nondeductible expenses) are considered last. More specific rules are shown in text Figure 10.3.

Example: The Ellen-Glenn partnership is owned equally by partners Ellen and Glenn. At the beginning of the year, Ellen’s basis for her partnership interest is exactly $0. Her share of partnership income is $10,000 for the year, and she receives a $10,000 distribution from the partnership. Under the basis adjustment ordering rules, Ellen’s basis is first increased by the $10,000 of partnership income; then is decreased by her $10,000 distribution. She reports her $10,000 share of partnership taxable income on her personal tax return and the $10,000 distribution is a tax-free return of basis. Her adjusted basis at the end of the year is $0 ($0 + $10,000 income – $10,000 distribution).

Although the above scenario is easy to follow, the ordering rules can sometimes produce some unusual results.

Example: Assume the same facts, except that Ellen’s share of partnership operations results is a $10,000 loss instead of $10,000 income. She again receives a $10,000 distribution. Under the basis adjustment ordering rules, Ellen’s distribution is considered before the deductibility of the loss is evaluated. Ellen recognizes $10,000 gain on the distribution because she has no basis in her partnership interest. The gain effectively ensures that she still has a $0 basis after the distribution. The loss cannot be deducted under the loss limitation rule because Ellen has no basis in her partnership interest to “cover” the loss.

There is a $20,000 difference in partnership earnings in the two examples ($10,000 income to $10,000 loss). However, Ellen reports $10,000 income (gain) in each case: ordinary income in the first example and probably a capital gain in the second example. She also has a $10,000 suspended loss in the second example. The results are not intuitive and require knowledge of the ordering rules.

38. There are three limitations on the deductibility of losses passed through to the partners and they are applied in the following order.
a. The overall limitation allowing losses only to the extent of the partner’s adjusted basis in the partnership.

   (1) Basis is determined at the end of the partnership’s taxable year.

   (2) Losses not allowed under this rule are suspended and carried forward until the partner’s basis in the partnership increases.

b. The at-risk limitation allowing losses only to the extent of the partner’s economic investment in the partnership.

   (1) Recourse debt is included in the partner’s amount at risk; nonrecourse debt is usually not included in the partner’s amount at risk.

   (2) Qualified nonrecourse financing on real estate, however, is considered an economic investment for the at-risk limitation.

c. The passive loss rules permit the deduction of losses only to the extent of passive income.

   (1) Income must be divided into three baskets: active, portfolio, and passive.

   (2) Rental real estate losses of up to $25,000 in excess of passive income may be deductible when the taxpayer’s AGI is not more than $100,000. The $25,000 deductible amount is phased out at a 50% rate for AGI more than $100,000. Thus, a taxpayer with an AGI greater than $150,000 can only deduct real estate losses to the extent of passive income.

7.4 TRANSACTIONS BETWEEN PARTNER AND PARTNERSHIP

39. Transactions between a partnership and a partner may be treated as being made in the partner’s capacity as a partner, or by an outsider.

Guaranteed Payments

40. Guaranteed payments are compensation for certain services performed by the partner for the partnership (e.g., routine services—salary) or for the use of capital contributed by the partner (interest).

   a. Guaranteed payments are taxable as ordinary income to the partner.

   b. The deductibility of guaranteed payments by the partnership depends on the underlying reason for the payment.

   c. A deductible guaranteed payment is treated as any other deduction. If incurred in the partnership’s trade or business, it reduces the partnership’s taxable income or increases the partnership’s taxable loss. It is deducted in arriving at partnership ordinary taxable income or loss on page 1 of Form 1065.

   d. If the partnership pays the guaranteed payment using appreciated property, the partnership must recognize the gain for tax purposes.
41. Guaranteed payments are taxed to continuing partners on the last day of the partnership’s tax year.
   a. The payment is reported to the partner on the Schedule K-1.
   b. If the partner and the partnership have a different reporting year, there may be a deferral of tax.

Self-Employment Tax of Partners

42. In certain cases, partners who are individual taxpayers are treated similarly to self-employed individuals.
   a. Partners are not treated as employees for tax purposes.
   b. Guaranteed payments for services the partner provides to the partnership are not subject to withholding for Federal taxes. These guaranteed payments are subject to self-employment (SE) tax on the partner’s individual tax return.
   c. Guaranteed payments for use of a partner’s capital are treated similarly to interest on a loan and are not (in 2011 or 2012) subject to SE tax. [These amounts may be subject to the 3.8% “unearned income Medicare contribution” tax of §1411 after 2012.]
   d. If the partner is treated as a general partner, his or her distributive share of partnership income is also subject to SE tax. This tax must be paid whether or not the income is distributed to the partner.
   e. This differs from the rules applicable to shareholders of a Subchapter S corporation. An S Corp shareholder is only subject to “payroll taxes” on the amounts treated as salary from the corporation.
   f. Partnerships (and Subchapter S corporations) cannot deduct payments for partner (shareholder) fringe benefits.

Other Transactions between a Partner and a Partnership

43. Some transactions may treat a partner as an outsider by dealing with the partnership at arm’s length [§ 707(a)]. However, the partnership and the partner are still considered to be related parties under § 267(e).
   a. Therefore, if a transaction results in a deduction to the partnership (e.g., payment of rent), that amount is not deductible until the partner must report the amount as income under that partner’s method of accounting. For a payment to a cash basis partner, an accrual basis partnership cannot deduct such a payment until it is actually paid.
   b. The payment is reported to the partner on a Form 1099 during the year the payment is made.

44. Certain sales of property between the partnership and a partner with at least a 50% capital or profits interest are subject to special rules.
a. Realized losses are not recognized. However, the disallowed loss may be used to offset a subsequent sale of the property which results in a gain.

b. Gains from capital assets are treated as ordinary income to the seller unless the asset is capital to both the buyer and the seller.