PART VII: LIMITED PARTNERSHIPS

7699. How is a publicly traded partnership taxed?

A *publicly traded partnership* is taxed as a corporation unless 90 percent of the partnership's income is passive-type income and has been passive-type income for all taxable years beginning after 1987 during which the partnership (or any predecessor) was in existence. For this purpose, a partnership (or a predecessor) is not treated as being in existence until the taxable year in which it is first publicly traded.[1] On the first day that a publicly traded partnership is treated as a corporation under these rules, the partnership is treated as having transferred all of its assets (subject to its liabilities) to a new corporation in exchange for stock of the corporation, followed by a distribution of the stock to its partners in liquidation of their partnership interests.[2] A publicly traded partnership is a partnership that is (1) traded on an established securities market, or (2) is readily tradable on a secondary market or the substantial equivalent thereof (discussed below).[3] In general, "passive-type income" for this purpose includes interest, dividends, real property rents, gain from the sale of real property, income and gain from certain mineral or natural resource activities, and gain from the sale of a capital or IRC Section 1231 asset.[4] ("Passive-type income" should therefore be distinguished from income from a passive activity under the passive activity loss rules.)

The passive-type income exception is not available to a publicly traded partnership that would be treated as a regulated investment company as described in IRC Section 851(a) if the partnership were a domestic corporation. Regulations may provide otherwise if the principal activity of the partnership involves certain commodity transactions.[5]

A partnership that fails to meet the passive-type income requirement may be treated as continuing to meet the requirement if: (1) the Service determines that the failure was inadvertent; (2) no later than a reasonable time after the discovery of the failure, steps are taken so that the partnership once more meets the passive-type income requirement; and (3) the partnership and each individual holder agree to make whatever adjustments or pay whatever amounts as may be required by the Service with respect to the period in which the partnership inadvertently failed to meet the requirement.[6]

A grandfather rule provided that partnerships that were publicly traded, or for which registrations were filed with certain regulatory agencies, on December 17, 1987 ("existing partnerships"), were exempt from treatment as a corporation until taxable years beginning after 1997. (See Q 7701 for treatment of electing 1987 partnerships after 1997.) However, the addition of a substantial line of business to an existing partnership after December 17, 1987, would terminate such an exemption. For purposes of the 90 percent passive-type income requirement above, an existing partnership is not treated as being in existence before the earlier of (1) the

1. IRC Sec. 7704(c)(1); Notice 98-3, 1998-1 CB 333.
2. IRC Sec. 7704(f).
3. IRC Sec. 7704(b).
4. IRC Sec. 7704(d)(1).
5. IRC Sec. 7704(c)(3).
6. IRC Sec. 7704(e).

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first taxable year beginning after 1997 or (2) such a termination of exemption due to the addition of a substantial new line of business. In other words, an existing partnership need not meet the 90 percent requirement while it was exempt under the transitional rules in order to meet the 90 percent requirement when its exemption has expired.[1]

A publicly traded partnership taxed as a corporation under the above rules is treated, in general, as a taxable entity and tax benefits are taken at the partnership level. Individual investors are unable to take tax benefits such as depreciation deductions and tax credits on their own tax returns. A publicly traded partnership that is taxed as a corporation should not be subject to the "at risk" rules (see Q 7911) or the "passive loss" rules. See Q 7918. Also, a publicly traded partnership would not qualify to make an election to be treated as an S corporation. See Q 7736.

A publicly traded partnership that is not taxed as a corporation under the above rules is treated, in general, as a flow-through entity, whose partners are taxed under the partnership rules contained in Q 7703 through Q 7735. Partners in such a partnership are subject to the "at risk" rules (see Q 7911) and the "passive loss" rules (see Q 7918). As noted above, an electing 1987 partnership is also subject to tax at the partnership level.

7700. What is an electing 1987 partnership and how is it taxed?

The Taxpayer Relief Act of 1997 added a new exception to corporate taxation for a publicly traded partnership. This exception is available if the publicly traded partnership is an electing 1987 partnership. An electing 1987 partnership is (1) an existing partnership (as described above), (2) that had not been taxed as a corporation (and would not have been taxed as a corporation without regard to the passive income exception) for all prior taxable years beginning after 1987 and before 1998, and (3) that elected to be exempt from corporate taxation. An electing 1987 partnership is taxed at a rate of 3.5 percent on its gross income from the active conduct of its trades and businesses. No credits are allowed to be applied against this tax. If a partnership is a partner in another partnership, its gross income will include its distributive share of the gross income from the active conduct of trades or businesses of the other partnership. A similar rule applies in the case of lower-tiered partnerships. The election may be revoked by the partnership without the consent of the IRS; but, once revoked, it may not be reinstated. If a partnership adds a substantial new line of business it will no longer be considered an electing 1987 partnership. The 3.5 percent tax is an exception to the general rule that a partnership does not pay taxes. See Q 7703.[2]

7701. How is whether a partnership is readily tradable on a secondary market or the substantial equivalent thereof established for purposes of determining whether a partnership is publicly traded?

The rules set out in this section apply to the taxable years of a partnership beginning after December 31, 1995, unless the partnership was actively engaged in an activity

1. TRA '87, Sec. 10211(c), as amended by TAMRA '88, Sec. 2004(f)(2).
2. IRC Sec. 7704(g).

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before December 4, 1995. In that case, these rules apply to taxable years beginning after December 31, 2005, unless the partnership added a substantial new line of business (as defined in Treasury Regulation Section 1.7704-2, see Q 7699, but substituting December 4, 1995, for December 17, 1987) after December 4, 1995, in which case these rules apply to taxable years beginning on or after the addition of the new line of business.[1] Different transitional rules applied to certain pre-1996 partnerships.[2]

Generally, a partnership that is not traded on an established securities market will be treated as readily tradable on a secondary market or the substantial equivalent thereof if, taking into account all of the facts and circumstances, the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market. This occurs if: (1) partnership interests are regularly quoted by any person making a market in the interests; (2) any person regularly makes bid or offer quotes pertaining to the interests available to the public and stands ready to effect buy or sell transactions regarding same for itself or on behalf of others; (3) a partnership interest holder has a readily available, regular, and ongoing opportunity to sell or exchange the interest through a public means of obtaining or providing information of offers to buy, sell, or exchange interests in the partnership; or (4) prospective buyers and sellers have the opportunity to buy, sell, or exchange partnership interests in a time frame and with the regularity and continuity that is comparable to that described in (1)-(3) above. The fact that a partnership fails to satisfy the safe harbors set out in Q 7702 does not create a presumption that the partnership is publicly traded.[3]

However, interests in a partnership will not be treated as readily tradable on a secondary market or the substantial equivalent thereof unless (1) the partnership participates in the establishment of the market or the inclusion of its interests thereon, or (2) the partnership recognizes transfers made on that market.[4]

Generally, percentage of partnership interest calculations take into account both general and limited partnership interests. However, if at any time during the taxable year, the general partner and persons related in certain ways to the general partner (under IRC Section 267(b) or IRC Section 707(b)(1)) own more than 10 percent of the outstanding interests in partnership capital and profit, such calculations are made without regard to interests owned by the general partner and the related persons.[5]

The percentage of partnership interests traded in a taxable year is equal to the sum of the monthly percentages. The percentage of partnership interests traded during a month is determined by reference to partnership interests outstanding during the month. Any reasonable and consistently used monthly convention may be used (e.g., first of month, 15th of month, end of month). In the case of "block transfers," see Q 7702, the determination of percentage of

1. Treas. Reg. §1.7704-1(l). Notice 88-75, 1988-2 CB 386, (see below) generally applies to partnerships exempted from the rules in this section.
2. See Notice 88-75, 1988-2 CB 386.
3. Treas. Reg. §1.7704-1(c).
4. Treas. Reg. §1.7704-1(d).
5. Treas. Reg. §1.7704-1(k)(1).

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partnership interests traded during a thirty day period is made with reference to partnership interests outstanding immediately prior to the block transfer.[1]

7702. Are there any safe harbor provisions that allow a partnership to avoid a finding that its interests are readily tradable on a secondary market (or the substantial equivalent thereof)?

Yes. *Private Transfers Safe Harbor*. Certain transfers not involving trading (private transfers) are disregarded in determining whether interests in a partnership are readily tradable on a secondary market or the substantial equivalent thereof.[2] These include:

(1) transfers in which the basis of the partnership interest in the hands of the transferee is determined by reference to the transferor's basis or is determined under IRC Section 732;

(2) transfers at death, including transfers from an estate or testamentary trust;

(3) transfers between members of a family as defined in IRC Section 267(c)(4);

(4) the issuance of partnership interests for cash, property, or services;

(5) distributions from a qualified retirement plan or individual retirement account;

(6) transfers by a partner during a 30 day period of interests exceeding 2 percent of total interests in partnership capital and profit ("block transfers");

(7) transfers under redemption or repurchase agreements that are exercisable only upon (a) death, disability, or mental incompetence of the partner, or (b) retirement or termination of service of a person actively involved in managing the partnership or in providing full time services to the partnership;

(8) transfers of an interest in a closed end partnership pursuant to a redemption agreement if the partnership does not issue any interest after the initial offering (and substantially identical investments are not available through the general partner or a person related in certain ways to the general partner under IRC Section 267(b) and IRC Section 707(b)(1));

(9) transfers of at least 50 percent of the total interests in partnership capital and profits in one transaction or a series of related transactions; and

(10) transfers not recognized by the partnership.

Redemption and Repurchase Agreements Safe Harbor. Transfers involving redemption and repurchase agreements (other than those described in (7) and (8) of "Private Transfers Safe Harbor," see above) are disregarded in determining whether interests in the partnership are readily tradable

1. Treas. Regs. §§1.7704-1(k)(2) to 1.7704-1(k)(4).
2. Treas. Reg. §1.7704-1(e).

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on a secondary market or the substantial equivalent thereof only if certain requirements are met: (1) the agreement provides that the partner must give written notice to the partnership at least 60 days prior to the redemption or repurchase date; (2) either (a) the agreement provides that the redemption or repurchase price not be established until at least 60 days after such notification, or (b) the redemption or repurchase price is not established more than four times during the partnership's taxable year; and (3) no more than 10 percent of partnership interests are traded during a taxable year (disregarding only private transfers, see above).[1]

Qualified Matching Services Safe Harbor. Transfers involving matching services are disregarded in determining whether partnership interests are readily tradable on a secondary market or the substantial equivalent thereof if the following requirements are met: (1) the matching service consists of a computerized or printed listing system of customers' bid/ask quotes and matching occurs by matching the list of buyers and sellers or through appropriate bidding procedure; (2) the selling partner cannot enter into an agreement to sell the interest until the 15th day after the date information regarding the sale is made available to potential buyers and there is written evidence of this time period; (3) the closing of a sale (treated as occurring at the earlier of the passage of title or the payment of the purchase price or when funds are made available for the purchase) involving a matching service does not occur within 45 days after information of the sale is made available; (4) the matching service displays only nonfirm price quotes or nonbinding indications of interest and does not display firm quotes; (5) the selling partner's information is removed from the matching service within 120 days after information of the sale is made available; (6) once such information is removed from the matching service (other than by reason of sale), the selling partner does not enter an offer to sell a partnership interest in the matching service during the next 60 days; and (7) no more than 10 percent of partnership interests are traded during a taxable year (disregarding only private transfers, see above).[2]

Private Placement Safe Harbor. Interests in a partnership will not be treated as publicly traded if: (1) all interests in such partnership were issued in transactions that were not required to be registered under the Securities Act of 1933, and (2) the partnership does not have more than 100 partners at any time during the taxable year. Each person indirectly owning an interest in the partnership through a partnership, S corporation, or grantor trust is treated as a partner if (1) substantially all of the value of the owner's interest in the entity is attributable to its interest in the partnership; and (2) a principal purpose of the tiered arrangement is to satisfy the 100 partner limitation.[3]

Two Percent Safe Harbor. Interests are not tradable on a secondary market or the substantial equivalent thereof if less than 2 percent of the percentage interests in partnership capital or profits are transferred during the taxable year (disregarding certain transfers involving private transfers, those involving qualified matching services, and certain redemption and repurchase agreements).[4]

1. Treas. Reg. §1.7704-1(f).
2. Treas. Reg. §1.7704-1(g).
3. Treas. Reg. §1.7704-1(h).
4. Treas. Reg. §1.7704-1(j).

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7703. How do limited partners report partnership income, gains, losses, deductions, and credits?

The federal income tax laws recognize a partnership as an entity having its own taxable year (within limits) and having its own income and losses. It computes its income much as an individual does. However, once its income for its tax year is determined, the partnership does not, in general, pay taxes.[1] Certain publicly traded partnerships and electing 1987 partnerships are nonetheless subject to tax at the entity level. See Q 7699. An electing 1987 partnership is also subject to the "flow through" rules described below. The "flow-through" rules for electing large partnerships (see Q 7704) are somewhat different from those described here. Also, a partnership may be required to make an accelerated tax payment on behalf of the partners, if the partnership elects not to use a required taxable year.[2] See Q 7735 regarding the partnership anti-abuse rule.

The partnership reports its income on an information return (Form 1065). It also reports to each individual partner his or her share of items of partnership income, gains, losses, deductions, and credits (on Schedule K-1, Form 1065). Schedule K-1 identifies separately the partner's share of combined net short-term capital gains and losses, combined net long-term capital gains and losses, combined net gains and losses from sales or exchanges of "IRC Section 1231 property" (see Q 7772), miscellaneous itemized deductions (see Q 631), each class of charitable contribution, taxes subject to the foreign tax credit, and certain other items required by regulation to be stated separately (including: intangible drilling and development costs; any item subject to special allocation that differs from allocation of taxable partnership income or loss generally; and the partner's share of any partnership items "which if separately taken into account by any partner would result in an income tax liability for that partner different from that which would result if the partner did not take the item into account separately"). Finally, the schedule reports the partner's share of the partnership taxable income or loss exclusive of separately stated items.[3]

A multi-tiered partnership may not be used to avoid the separately stated requirement. Items that might affect the tax liability of a partner owning his interest indirectly through a multi-tiered partnership arrangement retain their character while flowing through an intermediate partnership. Consequently, such items must be separately stated by each of the different tier partnerships.[4]

A limited partner then reports on his or her individual income tax return, subject to any applicable limitations, the partner's distributive share of the partnership's taxable income or loss, and separately stated items of partnership income, gain, loss, deductions, and credits. For example, the partner includes the share of partnership long-term and short-term capital gains and losses and "IRC Section 1231" gains and losses with his or her own.[5] A partner's share

1. IRC Secs. 701, 703.
2. IRC Sec. 7519.
3. IRC Sec. 702(a); Treas. Reg. §1.702-1(a).
4. Rev. Rul. 86-138, 1986-2 CB 84.
5. IRC Sec. 702(a); Treas. Reg. §1.702-1(a).

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of partnership miscellaneous itemized deductions is combined with the partner's individual miscellaneous deductions for purposes of the 2 percent floor on such deductions.[1] A partner's share of the partnership's investment interest expense is combined with individual investment interest expense to determine the amount deductible as investment interest (explained in Q 7941).[2] A partner's distributive shares of income, losses, and credits that are passive to the partner enter into the calculation of the partner's passive income and losses, and tax attributable to passive activities, to determine whether passive credits may be taken and passive losses deducted (see Q 7918 to Q 7929).

As a consequence of this "flow through" system of taxability, distributions the partner may have received during the year are not the measure of a partner's share of partnership income for a year. A partner may have taxable income without having received a distribution. The existence of conditions upon actual or constructive receipt is irrelevant for this purpose.[3] Similarly, the partner may have a deductible loss even though he or she received a distribution.

As a general rule, the character of items for tax purposes is determined at the partnership level and they retain that character for a partner's tax computations.[4] Whether or not an activity is passive with regard to a partner is determined at the partner level. See Q 7918 to Q 7929.

Partnership income is computed using a cash or accrual method of accounting, whichever the partnership uses, regardless of the accounting method used by the individual partners in reporting their own income.[5] However, in some cases a partnership may not use the cash method. In general, a partnership that has average gross receipts in excess of $5,000,000 and has a C corporation (other than a personal service corporation) as a partner may not use the cash method.[6] Also, a partnership that is a "tax shelter" may not use the cash method.[7] A limited partnership is a "tax shelter" within this rule if (1) at any time interests in it have been offered for sale in any offering required to be registered with any federal or state agency having the authority to regulate the offering of securities for sale, (2) more than 35 percent of the losses during the taxable year are allocable to limited partners, and (3) a significant purpose of the partnership is the avoidance or evasion of federal income tax.[8]

Especially because items of partnership loss, deductions, and credits are "passed through" and treated as items of the individual partners, the partnership was historically the most popular form for tax shelter syndications. (These syndications have largely disappeared, however, after enactment of the passive activity loss rules.) The limited partnership was particularly popular because it offers limited liability to limited partners.

1. Temp. Treas. Reg. §1.67-2T(b).
2. Rev. Rul. 84-131, 1984-2 CB 37.
3. *Stonehill v. Comm.*, TC Memo 1987-405.
4. IRC Sec. 702(b); Treas. Reg. §1.702-1(b); *Brannen v. Comm.*, 84-1 USTC ¶9144 (11th Cir. 1984); *Podell v. Comm.*, 55 TC 429 (1970).
5. *Truman v. U.S.*, 4 F.Supp. 447 (N.D. Ill. 1933).
6. IRC Secs. 448(a)(2), 448(b)(3).
7. IRC Sec. 448(a)(3).
8. IRC Sec. 448(d)(3).

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7704. What is an electing large partnership?

Certain partnerships may elect to be treated as electing large partnerships. An electing large partnership generally has fewer separately stated items of income, gain, loss, deduction, and credit than partnerships that are not electing large partnerships. See Q 7703 generally.[1] The electing large partnership provisions were enacted in part to ease the reporting requirements of limited partners.[2] An electing large partnership is subject to the regular partnership rules (see Q 7703 to Q 7735) except to the extent that the regular rules are inconsistent with the electing large partnership rules.[3] A publicly traded partnership could not be an electing large partnership unless it is an electing 1987 partnership. See Q 7699.

An electing large partnership is a partnership that had at least 100 partners in the previous taxable year and that elects to be treated as an electing large partnership. To the extent provided in regulations, a partnership shall cease to be treated as an electing large partnership if the number of partners falls below 100 during a taxable year. The election to be treated as an electing large partnership applies to the taxable year for which it is made and all subsequent years. The election may be revoked with the consent of the IRS.

For purposes of determining the number of partners, those partners performing substantial services for the partnership, or individuals who performed services in the past at the time they were partners, will not be counted toward the 100 partners needed to elect. Also, an election to be treated as an electing large partnership will not be effective with respect to a partnership if substantially all the partners are performing substantial services for the partnership or are personal service corporations (the owner-employees of which perform such substantial services), are retired partners who performed substantial services in the past, or are spouses of partners who are or were performing substantial services for the partnership. A partnership the principal activity of which is the buying and selling of commodities, or options, futures, or forwards with respect to commodities, may not elect large partnership status.[4]

7705. How is an electing large partnership treated for tax purposes?

Simplified Flow-Through

The following items are separately stated by an electing large partnership: (1) taxable income or loss from passive loss limitation activities (see Q 7919); (2) taxable income or loss from other activities; (3) net capital gain or loss allocable to passive loss limitation activities (see Q 7919, Q 608); (4) net capital gain or loss allocable to other activities (see Q 608); (5) tax-exempt interest; (6) a net alternative minimum tax (AMT) adjustment for passive loss limitation activities (see Q 7919, Q 653); (7) a net AMT adjustment for other activities (see Q 653); (8) general credits; (9) low income housing credit (see Q 7754); (10) rehabilitation credit (see Q 7761); (11) foreign income taxes; and (12) other items that the IRS determines should be separately

1. IRC Secs. 771-777.
2. General Explanation of Tax Legislation Enacted in 1997, p. 354 (the 1997 Blue Book).
3. IRC Sec. 771.
4. IRC Sec. 775.

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stated.[1] If the electing large partnership has income from the discharge of indebtedness, it is also separately stated.[2]

In the case of a limited partnership interest, a partner's share of taxable income or loss from passive loss limitation activities is considered to be income or loss from the conduct of a trade or business which is a single passive activity. A similar rule applies to net capital gain or loss allocable to passive loss limitation activities and to the AMT adjustment for passive loss limitation activities. However, in the case of a general partnership interest, that partner's distributive share of partnership items allocable to passive loss limitation activities is taken into account separately as necessary to comply with the rules under IRC Section 469. A passive loss limitation activity is any activity that involves the conduct of a trade or business, any rental activity, and any activity involving property held for the production of income. See Q 7918 to Q 7929 regarding the passive loss rule.

A partner's distributive share of income or loss from other activities (item (2) above) is treated as an item of income or expense with respect to property held for investment (see Q 7948), except that any deduction due to such a loss is not treated as a miscellaneous itemized deduction for purposes of the 2 percent floor on such deductions. See Q 631. A partner's distributive share of net capital gain or loss (from both passive loss limitation activities and other activities) is treated as a long-term capital gain or loss. A partner's distributive share of general credits is taken into account as a current year business credit. See Q 643. General credits are any credit except the low-income housing credit (see Q 7754), the rehabilitation credit (see Q 7761), and the foreign tax credit. The credit for producing fuel from a nonconventional source is not a general credit in tax years ending before 2006. Tax-exempt interest is interest on state and local bonds that is excludable from gross income. See Q 7642.

The net AMT adjustment is determined with the adjustments applicable to individuals or corporations, depending on whether the partner is an individual or corporation. It is calculated by determining what adjustments would occur to income from passive or other activities (as the case may be) if these items were determined using the AMT adjustments and preferences. See Q 653.[3]

Partnership Level Computations

In determining the taxable income of an electing large partnership, miscellaneous itemized deductions are taken at the partnership level, but instead of the 2 percent floor (see Q 631), 70 percent of these deductions are disallowed. Charitable contributions are deducted at the partnership level but this deduction generally may not exceed 10 percent of the partnership's taxable income. Elections affecting the computation of the taxable income or any credit of the electing large partnership are made by the partnership (except for elections relating to income from the discharge of indebtedness and the foreign tax credit). Most limitations and provisions affecting the computation of the taxable income or any credit of the electing large partnership are applied at the partnership level. However, provisions relating to the overall limitation on

1. IRC Sec. 772(a).
2. IRC Sec. 773(c).
3. IRC Sec. 772.

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itemized deductions (see Q 629), the at risk limitations, the limitations on passive activity losses and credits, and any other provision specified in regulations are applied at the partner level.[1]

Computations at the partnership level are made without regard to (1) the optional adjustment to basis of partnership property (see Q 7734) and (2) the reduction of certain tax attributes when certain discharges of indebtedness are excluded from gross income. However, items of a partner's distributive share are adjusted (as appropriate) to take into account these rules.

Credit recapture is taken into account at the partnership level and is determined as if the credit with respect to which the recapture is made had been fully utilized to reduce tax. The partnership takes into account credit recapture by reducing the amount of the appropriate current year credit. If the recapture amount exceeds the current year credit, the partnership is liable to pay such excess. Credit recapture means any increase in tax due to low income housing credit recapture (see Q 7754) and investment credit recapture. See Q 7824.

No credit recapture is required due to a transfer of a partnership interest. Also, an electing large partnership is not considered terminated due to the sale or exchange of 50 percent or more of partnership interests within a 12-month period.

The interest surcharge rules for certain installment obligations (see Q 586) are applied at the partnership level, and in determining the amount of interest payable under these rules, the partnership is treated as subject to the highest tax rate under IRC Sections 1 or 11 (39.6 percent in 2014).[2]

7706. What special rules apply to electing large partnerships with oil and gas properties?

Electing large partnerships with oil and gas properties are subject to special rules. The allowance for depletion (see Q 7802) is computed at the partnership level, except in the case of a disqualified person. Such depletion is determined without regard to the limits of production for which percentage depletion is allowable (see Q 7806), and without regard to the limit of percentage depletion to 65 percent of taxable income (see Q 7810). Also, a partner's basis in the partnership interest is not reduced by any depletion allowance computed at the partnership level (see Q 7815). Such depletion would generally be treated as from a passive loss limitation activity (see Q 7705).

If any partner is a disqualified person, that partner's distributive share of income, gain, loss, deduction, or credit attributable to a partnership oil or gas property is determined without regard to the electing large partnership rules. In addition, that partner's distributive share attributable to oil or gas property is excluded for purposes of the simplified flow-through and partnership level computations. A disqualified person is a retailer or refiner of crude oil or natural gas (see Q 7806) or any other person whose average daily production of domestic crude oil and natural gas exceeds 500 barrels. In determining a person's average daily production, all production

1. IRC Sec. 773.
2. IRC Sec. 774.

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of domestic crude oil and natural gas is taken into account, including the person's share of any production by the partnership.[1]

7707. In what year does an individual include partnership income and loss on a tax return?

A partner includes on a return the distributive share of partnership items of income, gain, loss, deductions, and credits for the partnership year that ends in or at the same time as his or her own taxable year. Since most individuals report on a calendar year basis, an individual partner generally includes partnership income for the same calendar year as a partnership that reports on the calendar year basis. If the partnership uses a non-calendar fiscal year, the calendar year partner includes partnership income, gains, losses, deductions, and credits for the partnership year that *ends* in the partner's calendar year.[2]

The amounts included in the year a partnership interest is acquired, or in which a partner sells, liquidates, or gives away his or her partnership interest or the year a partner dies, are explained in Q 7714, Q 7721, Q 7727, and Q 7731.

7708. What is a limited partner's adjusted basis in a partnership interest?

A partner's "basis" is an account of the partner's interest in the partnership for tax purposes—for example, to determine tax on cash distributions (see Q 7719), gain or loss on sale (see Q 7723), or the limit on loss deduction (see Q 7718). Initially, the basis is the amount of money and the adjusted basis of any property the partner has contributed to the partnership; it undergoes a series of adjustments thereafter.[3] The basis is increased by any further contributions and by the partner's distributive share of taxable income, tax-exempt income, and the excess of the deductions for depletion over the basis of the property subject to depletion.[4] The basis is decreased (but not below zero) by current distributions to him by the partnership; by the partner's distributive share of losses and nondeductible expenditures not properly chargeable to capital; and by the amount of the partner's deduction for depletion with respect to oil and gas wells.[5]

A partner's basis also includes his or her share of partnership liabilities. See Q 7709. Basis goes up by any increase in the share of partnership liabilities as if he or she had made cash contribution.[6] A partner is deemed to receive a cash distribution to the extent the partner's share of partnership liabilities decreases; thus, basis goes down if the share of partnership liabilities decreases.[7]

Contribution of a limited partner's personal note to the partnership does not increase the basis of the partnership interest, because it is a contribution of property in which he

1. IRC Sec. 776.
2. IRC Sec. 706(a); Treas. Reg. §1.706-1(a).
3. IRC Secs. 722, 705.
4. IRC Sec. 705(a)(1), Treas. Reg. §1.705-1(a)(1).
5. IRC Secs. 705(a)(2), 705(a)(3).
6. IRC Secs. 752(a), 705(a).
7. IRC Secs. 752(b), 705(a)(2).

has no basis.[1] When the note is paid, the amount is an additional contribution that is added to basis.

If the interest was acquired by purchase, see Q 7725; by gift, see Q 7730; on death, see Q 7733.

7709. What liabilities are included in a partner's adjusted basis in a partnership interest?

Liabilities Incurred or Assumed by Partnership After January 29, 1989, and Partner Loans and Guarantees After February 29, 1984

A partner's basis includes the partner's share of *partnership* liabilities.[2] Regulations provide an economic risk of loss analysis that is used to determine which liabilities are included in a partner's adjusted basis. A partnership liability is treated as a *recourse* liability to the extent that any partner bears the economic risk of loss for that liability.[3] A partner bears the economic risk of loss for a partnership liability to the extent that the partner (or certain related parties) would be obligated to make a payment to any person or a contribution to the partnership with respect to a partnership liability (and would not be entitled to reimbursement by another partner, certain parties related to another partner, or the partnership) if the partnership were to undergo a "constructive liquidation." A "constructive liquidation" would treat (1) all of the partnership's liabilities as due and payable in full; (2) all of the partnership assets (including money), except those contributed to secure a partnership liability, as worthless; (3) all of the partnership assets as disposed of in a fully taxable transaction for no consideration (other than relief from certain liabilities); (4) all items of partnership income, gain, loss, and deduction for the year as allocated among the partners; and (5) the partner's interests in the enterprise as liquidated.[4] See Q 7735 regarding the partnership anti-abuse rule.

If one or more partners or related persons guarantee the payment of more than 25 percent of the interest that will accrue on a partnership nonrecourse liability over its remaining term and it is reasonable to expect that the guarantor will be required to pay substantially all of the guaranteed interest if the partnership fails to do so, the loan will be deemed to be recourse with respect to the guarantor to the extent of the present value of the future interest payments.[5] An obligation will be considered recourse with respect to a partner to the extent of the value of any property that the partner (or related party in the case of a direct pledge) directly or indirectly pledges as security for the partnership liability.[6] An obligation will be considered recourse to a partner to the extent that the partner or a related party makes (or acquires an interest in) a nonrecourse loan to the partnership and the economic risk of loss for the liability is not borne by another partner.[7]

1. *Oden v. Comm.*, TC Memo 1981-184; Rev. Rul. 80-235, 1980-2 CB 229.
2. IRC Secs. 752, 705(a).
3. Treas. Reg. §1.752-1(a)(1).
4. Treas. Reg. §1.752-2(b)(1).
5. Treas. Reg. §1.752-2(e).
6. Treas. Reg. §1.752-2(h).
7. Treas. Reg. §1.752-2(c).

A recourse liability allocated to a partner under the above rules is included in the partner's basis in the partnership. A limited partner generally will not bear the economic risk of loss for any partnership recourse liability because limited partners are not typically obligated to make additional contributions and do not typically guarantee interest, pledge property, or make loans to the partnership. Otherwise, a limited partner can include a share of a partnership liability in his basis only if it is nonrecourse liability (see below).

A partnership liability is treated as a *nonrecourse* liability if no partner bears the economic risk of loss (see above) for that liability. Generally, partners share nonrecourse liability in the same proportion as they share profits. See Q 7710. However, nonrecourse liabilities are first allocated among partners to reflect each partner's share of (1) any partnership minimum gain or (2) IRC Section 704(c) minimum gain. Partnership minimum gain is the amount of gain that would be realized if the partnership were to sell all of its property that is subject to nonrecourse liabilities in full satisfaction of such liabilities and for no other consideration. IRC Section 704(c) minimum gain is the amount of gain that would be allocated under IRC Section 704(c) to a partner who contributed property to the partnership if the partnership were to sell all of its property that is subject to nonrecourse liabilities in full satisfaction of such liabilities and for no other consideration.[1]

These regulations apply to any liability incurred or assumed on or after December 28, 1991, other than those incurred or assumed pursuant to a written binding contract in effect before that date and at all times thereafter. A partnership may elect to apply the provisions of the regulations to liabilities incurred or assumed prior to December 28, 1991, as of the beginning of the first taxable year ending on or after that date.[2]

Substantially similar temporary regulations apply to liabilities incurred or assumed by a partnership after January 29, 1989, and before December 28, 1991, unless the liability was incurred or assumed by the partnership pursuant to a written binding contract in effect prior to December 29, 1988, and at all times thereafter.[3] They also apply to partner loans and to guarantees of partnership liabilities that were incurred or assumed by a partnership after February 29, 1984, and before December 28, 1991, beginning on the later of March 1, 1984, or the first date on which the partner bore the economic risk of loss with respect to a liability because of his status as a creditor or guarantor of such liability.[4] A partnership could elect to extend application of the temporary regulations to all of its liabilities as of the beginning of its first taxable year ending after December 29, 1988, and before December 28, 1991, subject to certain consistency rules.[5]

Liabilities Incurred or Assumed by Partnership Before January 30, 1989, and Partner Loans and Guarantees Before March 1, 1984

For an election to extend application of the final or the temporary regulations discussed above to all of a partnership's liabilities, see above.

1. Treas. Regs. §§1.752-3(a), 1.704-2(d).
2. Treas. Reg. §1.752-5.
3. Temp. Treas. Reg. §1.752-4T(a), prior to removal by TD 8380.
4. Temp. Treas. Reg. §1.752-4T(b), prior to removal by TD 8380.
5. Temp. Treas. Reg. §1.752-4T(c), prior to removal by TD 8380.

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A partner's basis includes the partner's share of *partnership* liabilities.[1] However, accrued but unpaid expenses and accounts payable of a cash basis partnership are not treated as partnership liabilities for this purpose.[2] Where none of the partners has any personal liability with respect to a partnership liability (*nonrecourse* debt), all partners (including limited partners) share the liability in the same proportion as they share profits. Prior regulations gave as an example of such a liability a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage. Partnership *recourse* liabilities are shared by the partners in the same ratio that they share losses, but a limited partner's share of partnership recourse liability may not exceed the difference between the limited partner's actual contribution and the total contribution to the partnership that he or she is obligated to make under the partnership agreement.[3]

Because limited partners who are not obligated to make additional contributions can include in basis a share of a partnership liability only if it is nonrecourse (no partner has personal liability with respect to the obligation), the question has come up whether a partner who guarantees an otherwise nonrecourse partnership loan has "personal liability" within the meaning of the regulations. The IRS takes the position that a general partner's guarantee makes the partner personally liable to the extent the value of the property securing the loan is insufficient to cover the amount due and, as a consequence, the guaranteed loan is one for which a partner is personally liable. Therefore, limited partners not committed to make future contributions are not able to include a share of such an obligation in their bases.[4]

Guaranteeing a partnership recourse obligation does not increase a limited partner's obligation to make additional contributions "under the partnership agreement." Therefore, a limited partner may not increase his or her share of partnership recourse liability by making such a guarantee.[5] Similarly, a limited partner's agreement to indemnify a general partner for certain recourse liabilities does not increase the limited partner's basis in the partnership interest by a share of partnership recourse liabilities because it does not increase the limited partner's obligation "to the partnership."[6] Where a partnership obligation is partly nonrecourse and partly recourse, a limited partner may include in basis the limited partner's share of the portion that is nonrecourse. (For example, a note provides that to the extent property securing a loan of $350X is inadequate, the general partner is liable up to $150X; a limited partner may share the $200X nonrecourse liability in the same proportion he or she shares profits.)[7]

If the likelihood the limited partner will have to make additional contributions is contingent or indefinite, he or she cannot share partnership recourse liabilities. The IRS determined that the obligation to make additional contributions represented by letters of credit contributed by

1. IRC Secs. 752, 705(a).
2. Rev. Rul. 88-77, 1988-2 CB 128.
3. Treas. Reg. §1.752-1(e), prior to removal by TD 8237; Rev. Rul. 69-223, 1969-1 CB 184.
4. Rev. Rul. 83-151, 1983-2 CB 105; *Raphan v. U.S.*, 759 F.2d 879, 85-1 USTC ¶9297 (Fed. Cir. 1985). See also P.L. 98-369 (TRA '84), Sec. 79.
5. *Brown v. Comm.*, TC Memo 1980-267; *Block v. Comm.*, TC Memo 1980-554.
6. Rev. Rul. 69-223, 1969-1 CB 184.
7. Rev. Rul. 84-118, 1984-2 CB 120.

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limited partners was too contingent and indefinite where the principal on a partnership loan, which was assumed by limited partners and secured by the letters of credit, was not due for four years. The Service noted that the partnership could have generated sufficient income to pay the loan through income from operations or sale of assets prior to the due date and that the likelihood of a default in the tax year which would cause the loan to be immediately payable was remote since interest payments were not due until the next taxable year.[1]

To increase basis, the loan must be a bona fide loan. Such an increase has been denied where the "loan" was determined to be an investment or capital contribution to the venture. A nonrecourse loan from a general partner to limited partners or to the partnership is a contribution to the capital of the partnership by the general partner, not a loan; therefore, the amount increases the basis of the partnership interest of the general partner, but not of the limited partners.[2] A nonrecourse loan by an unrelated third party to a partnership engaged in exploring for oil and gas, secured by property of limited value but convertible into an interest in partnership profits, was ruled not a bona fide loan, but capital at risk in the venture.[3]

Increase in basis has been denied where the obligation was so speculative as to be considered a contingent obligation. For example, the IRS ruled that a partnership nonrecourse note payable only out of partnership cash flow was not includable in basis because payment was so speculative that the liability was a contingent liability. The partnership business involved a commercially untested new process and no realistic predictions could be made about the partnership's net cash flow.[4]

A nonrecourse note to be paid only if there was production from oil wells was too uncertain and indefinite an obligation to be treated as a partnership liability.[5]

The Service will not recognize a sham liability entered into for the purpose of increasing the basis of property and, as a result, the allowable depreciation, or enlarging a partner's basis against which the partner may deduct partnership losses. A nonrecourse note did not represent genuine indebtedness because the principal amount of the note greatly exceeded the value of the property purchased by it and securing it.[6]

7710. How are partnership income, gains, losses, deductions, and credits allocated among partners?

The partnership agreement can dictate the allocation of separately stated items of partnership income, gain, loss, deductions, credits, and other bottom line income and loss, even if the allocation is disproportionate to the capital contributions of the partners (a so-called "special allocation"). However, if the method of allocation lacks "substantial economic effect" (or if no

1. TAM 8404012.
2. Rev. Rul. 72-135, 1972-1 CB 200.
3. Rev. Rul. 72-350, 1972-2 CB 394.
4. Rev. Rul. 80-235, 1980-2 CB 229.
5. *Brountas v. Comm.*, 692 F.2d 152, 82-2 USTC ¶9626 (1st Cir. 1982); *Gibson Products Co.–Kell Blvd. v. U.S.*, 460 F. Supp. 1109, 78-2 USTC ¶9836 (N.D. Tex. 1978), aff'd,637 F.2d 1041, 81-1 USTC ¶9213 (5th Cir. 1981).
6. *Hager v. Comm.*, 76 TC 759 (1981); *Wildman v. Comm.*, 78 TC 943 (1982); *Narver v. Comm.*, 75 TC 53 (1980), aff'd per curiam, 670 F.2d 855, 82-1 USTC ¶9265 (9th Cir. 1982).

allocation is specified in the partnership agreement), the distributive shares will be determined in accordance with the partner's interest in the partnership, based on all the facts and circumstances.[1] See Q 7735 regarding the partnership anti-abuse rule.

The purpose of the substantial economic effect test is to "prevent use of special allocations for tax avoidance purposes, while allowing their use for bona fide business purposes."[2] Regulations provide that generally an allocation will not have economic effect unless the partners' capital accounts are maintained properly, liquidation proceeds are required to be distributed in accordance with the partners' capital account balances and, following distribution of such proceeds, partners are required to restore any deficits in their capital accounts to the partnership. The economic effect will generally not be considered substantial unless the allocation has a reasonable possibility of affecting substantially the dollar amounts received by partners, independent of tax consequences. Allocations are insubstantial if they merely shift tax consequences within a partnership tax year or are likely to be offset by other allocations in subsequent tax years.[3]

7711. What are the rules for allocation of partnership losses and deductions attributable to nonrecourse obligations?

Regulations finalized in 1991 modified the rules relating to the allocation of losses and deductions attributable to nonrecourse obligations. In addition, if there is no substantial modification to the partnership agreement, various transitional rules permit the use of the earlier regulations under certain circumstances.[4]

Taxable Years Beginning After December 27, 1991

An allocation of a loss or deduction attributable to the nonrecourse liabilities (see Q 7709) of a partnership ("nonrecourse deductions") cannot have economic effect with respect to a partner because the nonrecourse lender and not the partner bears the ultimate risk of economic loss with respect to the deductions.[5] The amount of nonrecourse deductions for a partnership year is equal to the excess, if any, of the net increase in "partnership minimum gain" for the year over the amount of any distributions of proceeds of nonrecourse liabilities allocable to an increase in "partnership minimum gain."[6] Partnership minimum gain is the amount of gain which would be realized in the aggregate if the partnership were to sell each of its properties which is subject to a nonrecourse liability for an amount equal to the nonrecourse liability.[7]

Generally, for taxable years beginning after December 27, 1991, nonrecourse deductions will be considered to have been allocated in accordance with the partners' interests in

1. IRC Secs. 704(a), 704(b).
2. Sen. Fin. Comm. Report No. 938, 94th Cong., 2d Sess. 100 (1976).
3. Treas. Reg. §1.704-1(b)(2).
4. See Treas. Reg. §1.704-2(l).
5. Treas. Reg. §1.704-2(b)(1).
6. Treas. Reg. §1.704-2(c).
7. Treas. Reg. §1.704-2(d).

the partnership (and the allocation will therefore be honored), if the following requirements are met:

(1) Allocation of nonrecourse deductions is provided for in a manner that is consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse financing.

(2) All other material allocations and basis adjustments either have economic effect or are allocated in accordance with the partners' interests in the partnership.

(3) The partners' capital accounts are maintained properly.

(4) Liquidation proceeds are required to be distributed in accordance with the partners' capital account balances.

(5) Following distribution of liquidation proceeds, partners are required to either (a) restore any deficits in their capital accounts to the partnership or (b) allocate income or gain sufficient to eliminate any deficit.

(6) If there is a net decrease in partnership minimum gain (see above) during a year, each partner must be allocated items of partnership income and gain ("minimum gain chargeback") for that year equal to that partner's share of the net decrease in partnership minimum gain. (This requirement does not apply to the extent that a partner's share of the net decrease in minimum gain is caused by a guarantee, refinancing, or other change in the debt instrument causing it to become partially or wholly recourse debt or partner nonrecourse debt, and the partner bears the risk of economic loss for the liability. Nor does it apply to the extent that a partner contributes capital to the partnership to repay the nonrecourse liability and the partner's share of net decrease in minimum gain results from the repayment.)[1]

A distinction must be made between nonrecourse debt and nonrecourse liabilities. Nonrecourse debt refers to the traditional concept of nonrecourse, for example, where a creditor's right to repayment is limited to one or more assets of the partnership. Nonrecourse liability, on the other hand, means partnership liability with respect to which no partner bears the economic risk of loss (as described in Q 7709). If a partner bears the economic risk of loss with respect to nonrecourse debt, deductions and losses allocable to such nonrecourse debt must be allocated to such partner.[2]

Taxable Years Beginning After December 29, 1988, and Before December 28, 1991

For those partnerships which qualified under the 1989-1991 rules and which choose to remain grandfathered under such rules, former Temporary Treasury Regulation Section 1.704-1T(b)(4)(iv) generally provides that nonrecourse debt be treated under the rules

1. Treas. Regs. §§1.704-2(b)(1); 1.704-2(e); 1.704-2(f).
2. Treas. Reg. §1.704-2(i).

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described above. Nonrecourse deductions will be deemed to be allocated in accordance with the partners' interests in the partnership if the first four and part (a) of the fifth of the current requirements, above, are met, and if the partnership agreement contains a clause complying with the minimum gain chargeback requirements contained in former Temporary Treasury Regulation Section 1.704-1T(b)(4)(iv). Those requirements provide that if there is a net decrease in partnership minimum gain during a year, each partner must be allocated a minimum gain chargeback equal to the greater of (1) the partner's share of the net decrease in minimum gain attributable to a disposition of property securing nonrecourse liabilities, or (2) the partner's deficit capital account, as specially defined in the former temporary regulations.

Taxable Years Beginning Before December 30, 1988

For those partnerships which qualified under the pre-December 30, 1988, rules and choose to remain grandfathered under such rules, former Treasury Regulation Section 1.704-1(b)(4)(iv) generally provides that nonrecourse debt be treated under the rules described in former Temporary Treasury Regulation Section 1.704-1T(b)(4)(iv) above, except that:

(1) The amount of nonrecourse deductions for a partnership year is equal to the net increase in partnership minimum gain for the year. There is no reduction for certain distributions as there was under the former temporary regulations.

(2) Nonrecourse deductions need not be allocated in accordance with the partners' interests in the partnership if current requirements (1) through (4) are met and either: (1) following distribution of liquidation proceeds, partners are required to restore any deficits in their capital accounts to the partnership; or (2) if there is a net decrease in partnership minimum gain during a year, each partner must be allocated items of partnership income and gain for that year equal to that partner's share of the net decrease in partnership minimum gain.

7712. What are the rules for allocation of a partnership's income, gains, losses, deductions, and credits if a partner contributes property to the partnership?

If a partner contributes property to a partnership, allocations of income, gain, loss, and deduction must generally be made to the partner to reflect any variation between the basis of the property to the partnership and its fair market value at the time of contribution.[1] When contributed property is distributed to a partner other than the contributing partner, the contributing partner will recognize gain or loss upon such distribution if it occurs within seven years of the contribution.[2] However, a contributing partner is treated as receiving property which he or she contributed (and no gain or loss will therefore be recognized on the distribution) if the property contributed is distributed to another partner and like-kind property is distributed to the contributing partner within the earlier of (1) 180 days after the distribution to the other

1. IRC Sec. 704(c (1)(A).
2. IRC Sec. 704(c)(1)(B).

partner, or (2) the partner's tax return due date (including extensions) for the year in which the distribution to the other partner occurs.[1]

For contributions of property made after October 22, 2004, if the property has a built-in loss, the loss is considered only in determining the items allocated to the contributing partner. Also, when determining items allocated to other partners, the basis of the property is considered its fair market value when it was contributed to the partnership.[2]

7713. Can the IRS reallocate partnership income and deductions to prevent distortion of income?

Yes. The Service may reallocate income and deductions attributable to distributions of property from a partnership to an individual and the individual's controlled corporation to prevent distortions of income.[3] (See also Q 7735.)

7714. Can a limited partner who enters a partnership late in the year receive a "retroactive" allocation of partnership losses that occurred before entering the partnership?

Partnership income or loss may not be retroactively allocated to a partner acquiring an interest during the year. The partner's allocable share may be determined according to the portion of the year the partnership was held or by an interim closing of the books.[4] Proposed regulations on these issues were published in April 2009.[5]

Thus, a partner admitted during the year cannot deduct a full year's depreciation. Losses not shown to have occurred after an individual became a partner are prorated and a deduction allowed only for the part of the partnership year that the individual was a partner.[6] However, where an interim closing of the books had been made, and it accurately reflected the losses incurred by the partnership after the new partner entered the partnership, the result was that a year-end total loss could not be prorated according to the portion of the year the new partner was a partner.[7] Losses accrued by an accrual basis partnership prior to cash basis partners' becoming partners were not deductible by the cash basis partners.[8] However, new partners have been permitted to deduct losses incurred by a cash basis partnership prior to their entry where an interim closing of the books established the losses were paid by the partnership after their entry and the interim closing of the books method reflected economic reality because the contributions of the new partners were needed to pay the expenses.[9]

The IRC provides for special allocation rules with respect to certain amounts attributable to periods after March 31, 1984, in cash basis partnerships, and with respect to amounts paid

1. IRC Sec. 704(c)(2).
2. IRC Sec. 704(c).(1)(C).
3. IRC Sec. 482; *Dolese v. Comm.*,811 F.2d 543, 87-1 USTC ¶9175 (10th Cir. 1987).
4. *Richardson v. Comm.*, 76 TC 512 (1981), *aff'd*, 693 F. 2d 1189, 83-1 USTC ¶9109 (5th Cir. 1982); Sen. Fin. Comm. Rep. No. 938, 94th Cong. 2d Sess. 100 (1976); Treas. Reg. §1.706-1(c)(2)(ii).
5. See Prop. Treas. Reg. §1.706-4.
6. *Hawkins v. Comm.*, 713 F. 2d 347, 83-2 USTC ¶9475 (8th Cir. 1983).
7. *Lipke v. Comm.*, 81 TC 689 (1983).
8. *Williams v. U.S.*, 680 F. 2d 382, 82-2 USTC ¶9467 (5th Cir. 1982).
9. *Richardson v. Comm.*, above.

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or accrued by a lower tiered partnership after March 31, 1984, to prevent avoidance of the retroactive allocation prohibition.[1]

In the case of a cash method partnership, interest, taxes, payments for services or for the use of property, and other items prescribed by regulations (none have yet been issued)—"allocable cash basis items"—are to be assigned to each day in the period to which it is economically attributable (i.e., to the day or days in such period to which the item would accrue if the partnership were on the accrual method) and allocated among the partners in proportion to their interests in the partnership at the close of each day.[2] If, using this method, any portion of such an item is economically attributable to periods before the beginning of the taxable year, that portion will be assigned to the first day of the year and allocated to the persons who were partners on that day, in proportion to their varying interests in the partnership. (Similarly, any portion economically attributable to periods after the end of the taxable year will be assigned to the last day of the year.).This determination will require allocation of such items in the manner in which the partners would have borne the corresponding economic cost even though the cost is actually borne by another partner (typically, a later-admitted partner) in connection with a change in the partners' interests in the partnership. If persons to whom all or part of such items are allocable are not partners in the partnership on the first day of the partnership taxable year in which the item is taken into account, then their portions must be capitalized by the partnership and allocated to the basis of partnership assets.[3]

In the case of tiered partnerships, if a partnership is a partner (an upper-tier partnership), its share of any item of income, gain, loss, deduction, or credit of the lower-tier partnership will, except as otherwise provided in regulations, be allocated among the partners of the upper-tier partnership (1) by assigning the appropriate portion of each item to the appropriate day in the upper-tier partnership's taxable year on which the upper-tier partnership is a partner in the lower-tier partnership, and (2) by allocating the portion assigned to a day among the partners in proportion to their interests in the upper-tier partnership as of the close of the day (determined in a manner consistent with IRC Section 704). For this purpose, items allocable to periods before or after the upper-tier partnership's taxable year will be assigned to the first or last day of that year, respectively. If the persons to whom items are properly allocated are no longer partners in the upper-tier partnership on the first day of the upper-tier partnership taxable year in which the item is taken into account, then such persons' portions of such items are capitalized and allocated to the basis of partnership assets.[4]

7715. What are the tax consequences of a change ("flip-flop") in allocation of profits and losses in a limited partnership after a specified time?

Limited partnerships frequently provide for allocations that give to the limited partners a large share of income, expenses, and losses until their contribution is recovered. For example, the partnership agreement might allocate 95 percent to limited partners and 5 percent to

1. IRC Sec. 706(d).
2. IRC Sec. 706(d)(2).
3. IRC Sec. 706(d)(2)(D).
4. IRC Sec. 706(d)(3).

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general partners. Then after a period of time, or after the limited partners have recovered their contributions, the allocation changes ("flip-flops") so that, for example, 60 percent is allocated to the limited partners and 40 percent to the general partners. (Such an allocation was upheld as reflecting economic reality, where limited partners had contributed 95 percent of the partnership's capital and the general partners had contributed 5 percent.)[1]

A flip-flop can have unexpected tax results. Under general principles, when a partner's interest in partnership profits changes, his or her share of partnership liabilities changes. See Q 7709. The IRC provides that any decrease in a partner's share of the liabilities of a partnership is considered a distribution of money to the partner.[2] As a result, commentators have concluded, there can be a taxable gain to the partner if the amount of the reduction in the partner's share of partnership liabilities (that is, the distribution of money) exceeds the adjusted basis in the partnership interest immediately before the flip. (Taxation of a cash distribution in excess of basis is discussed in Q 7719.) Furthermore, a change in a partner's share of liabilities affects the partner's basis in the partnership interest. When the change occurs, each limited partner experiences a decrease in the amount of his or her share of nonrecourse liabilities and consequently a decrease in adjusted basis in the partnership interest against which the limited partner may deduct partnership losses or offset future distributions.

7716. Can limited partners deduct the expenses of partnership organization?

A partnership may deduct up to $5,000 of organizational expenses in the year the partnership begins business. The $5,000 amount is reduced (but not below zero) by the amount of organization expenses that exceed $50,000. Remaining organizational expenses may be deducted over a 180-month period beginning with the month that the partnership begins business.[3] These expenses include legal fees for services incident to organization, accounting fees for establishment of the partnership accounting system, and necessary filing fees.[4]

The determination of the date the partnership begins business is a question of fact, but ordinarily it begins when the partnership starts the business operations for which it was organized. For example, the acquisition of operating assets that are necessary to the type of business contemplated may constitute beginning business. The mere signing of a partnership agreement is not sufficient to show the beginning of business.[5]

7717. Can limited partners deduct the expenses of selling interests in the partnership and other expenses of syndication?

No. Expenses to promote the sale of (or to sell) an interest in the partnership cannot be deducted and cannot be amortized.[6] They must be capitalized.[7]

1. *Hamilton v. U.S.*, 687 F.2d 408, 82-2 USTC ¶9546 (Ct. Cl. 1982). See also Treas. Reg. §1.704-1(b)(5) Ex. 3, Ex. 5.
2. IRC Sec. 752(b).
3. IRC Sec. 709(b).
4. Treas. Reg. §1.709-2(a).
5. Treas. Reg. §1.709-2(c).
6. IRC Sec. 709(a); Rev. Rul. 81-153, 1981-1 CB 387.
7. Treas. Reg. §1.709-2(b); Rev. Rul. 85-32, 1985-1 CB 186.

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Syndication expenses are those connected with issuing and marketing partnership interests. For example, according to the regulations, syndication expenses include brokerage fees, registration fees, legal fees for securities advice and advice pertaining to tax disclosures in the prospectus or placement memorandum, and the costs of printing the prospectus, placement memorandum, and other selling and promotional material.[1]

7718. Is there a limit on the deduction of a limited partner's share of partnership losses?

Yes.

Partnership basis. A partner may not deduct his or her share of partnership losses in excess of the partner's basis in the partnership interest determined as of the end of the partnership year in which the loss occurred (before reduction for the loss). Any excess loss may be deducted in succeeding years, but only to the extent of basis at the end of the particular partnership year.[2]

In order to apply the limit properly, the partner's basis is first increased, as explained in Q 7708. Then it is decreased, as explained in Q 7708, by any current distributions and nondeductible expenditures not chargeable to capital, but not by losses for the year (and not by any losses previously disallowed and carried over). If the partner's losses exceed basis, the partner must allocate his basis among the loss items in order to determine how much of each item may be deducted. The partner allocates the basis to each loss in the same proportion as that loss bears to the total loss. (In determining this fraction, the total loss must include the partner's share of losses for the current year and any disallowed losses carried over from prior years.)[3]

> *Example*: A partner was allocated the following distributive share of partnership items: long-term capital loss of $5,000; short-term capital gain of $1,000; IRC Section 1231 loss of $3,000; and "bottom line" income of $3,000. Prior to adjustment for any of these items, his adjusted basis in his partnership interest was $2,000. His basis is increased by the short-term gain of $1,000 and bottom line income of $3,000 to $6,000. His total loss is $8,000. His $6,000 basis is allocated 5/8 ($3,750) to long-term capital loss and 3/8 ($2,250) to IRC Section 1231 loss. Thus, he may deduct $3,750 of long-term capital loss and $2,250 of IRC Section 1231 loss. He may carry over a long-term capital loss of $1,250 and an IRC Section 1231 loss of $750.[4]

At risk limitation. A partner may not deduct in a year a loss from any activity to the extent the loss exceeds the amount the partner has "at risk" in the activity.[5] Thus, a limited partner may generally deduct losses of a limited partnership to the extent of basis, but the limited partner may not deduct losses in excess of the amount he or she has "at risk" in the venture if that is less than the basis in his partnership interest. See Q 7911 to Q 7917 on the "at risk" limitation.

Passive loss limitation. Income, losses, and credits from a limited partnership interest will generally be passive. Such items are aggregated with the limited partner's income, losses, and credits from other passive activities. In general, passive losses are deductible only against passive

1. Treas. Reg. §1.709-2(b).
2. IRC Sec. 704(d); Treas. Reg. §1.704-1(d)(1).
3. Treas. Reg. §1.704-1(d)(2).
4. See Treas. Reg. §1.704-1(d)(4) Ex.3.
5. IRC Sec. 465.

income; passive credits may be used only against tax liability attributable to passive activities.[1] See Q 7918 to Q 7929 on the "passive loss" rules.

See also Q 7941 on the limitation on deduction of investment interest expense, and Q 7943 on the deduction of interest expense if the partner owns tax-exempt obligations.

7719. Is a limited partner taxed on a current cash distribution?

Current cash distributions (i.e., not in liquidation of a partner's interest) that are not in excess of the partner's adjusted basis in the partnership interest immediately before the distribution are a nontaxable return of capital.[2] The partner's adjusted basis in the partnership interest is reduced by the amount of such cash distributions.[3] See Q 7708.

To the extent that a cash distribution to a partner exceeds the partner's basis in the partnership interest immediately before the distribution, the partner realizes a gain that is taxed as if there were a sale of a partnership interest.[4] See Q 7723. This is true of a current cash distribution or a cash distribution in liquidation of a partner's interest.[5]

A decrease in a partner's share of nonrecourse liabilities is considered, for tax purposes, a cash distribution.[6] See Q 7708. Such a decrease can occur when a mortgage is satisfied, a liability is discharged through foreclosure, or the partnership sells property subject to a mortgage. To the extent that such a deemed distribution exceeds the partner's adjusted basis in the partnership interest, the partner has a taxable gain.[7]

Loss is not recognized on a distribution other than a liquidating distribution.[8]

7720. Is a limited partner's distributive share of partnership income subject to the self-employment tax?

Generally, no. A limited partner's distributive share of partnership trade or business income is not treated as earnings from self-employment subject to Social Security tax on self-employment income. However, guaranteed payments to limited partners for services actually rendered to or on behalf of the partnership are treated as self-employment income.[9]

7721. What is a partner's distributive share of partnership income and loss in the year he or she sells, exchanges, or liquidates an entire partnership interest?

A partner includes the distributive share of partnership items up to the time of sale, exchange, or liquidation. The taxable year of the partnership closes with respect to the partner when the partner sells or exchanges his or her entire interest in the partnership, or if the interest

1. IRC Sec. 469.
2. IRC Sec. 731(a).
3. IRC Sec. 733.
4. IRC Sec. 731(a).
5. Treas. Reg. §1.731-1(a)(1)(i).
6. IRC Sec. 752(b).
7. IRC Sec. 731(a).
8. IRC Sec. 731(a)(2).
9. IRC Sec. 1402(a)(13).

is liquidated, but does not close with respect to any other partner[1] (unless the sale causes the partnership to terminate).[2] Thus, the distributive share of income or loss for the short partnership year resulting from the disposition is included in the tax year in which the sale is made, because that is the year in which the short partnership year ends as to the partner leaving the partnership. See Q 7707. If the partnership and partner have different years (i.e., the partnership is on a fiscal year and the individual uses a calendar tax year), it is possible that both a regular full partnership year and the short partnership year will end in the same year of the individual. Consequently, there can be a bunching of more than one year's partnership income (or loss) in one year's return of the individual.

The partner's distributive share of partnership income for the part of the partnership year that ends when he or she sells, exchanges, or liquidates the interest may be determined under the method used to determine a new partner's share, as discussed in Q 7714.

The partnership year does not end as to a partner who disposes of less than his or her entire interest[3] (again assuming the disposition does not cause a termination of the partnership). A liquidation is a termination of a partner's interest by a distribution or a series of distributions to the partner from the partnership. The entire interest of a partner is not liquidated until the final distribution of a series is made. Thus, the partnership year does not close with respect to a liquidating partner until the final distribution.[4]

7722. What amount does a limited partner realize on sale of a partnership interest?

In addition to any money and the value of property received, a limited partner is considered to have received an amount equal to the limited partner's share (see Q 7709) of any partnership liabilities, both recourse and nonrecourse, of which he or she has been relieved.[5] This includes the limited partner's share of the nonrecourse debt even if it exceeds the value of the property securing the debt.[6]

If the sale or exchange of an interest in an upper-tier partnership results in a termination of the upper-tier partnership, the upper-tier partnership is treated as exchanging its entire interest in the lower-tier partnership (with additional amounts realized with respect to the lower-tier partnership).[7]

7723. How does a limited partner treat the amount realized on a sale of a partnership interest?

If the amount the partner realizes (see Q 7722) exceeds the partner's adjusted basis in the partnership interest, the gain is capital gain *except* that if part of the *amount realized*

1. IRC Sec. 706(c).
2. IRC Sec. 708(b)(1)(B) (providing for termination if, within a 12-month period, 50 percent or more of the total interest in partnership capital and profits has been sold or exchanged).
3. IRC Sec. 706(c)(2)(B).
4. Treas. Reg. §1.706-1(c).
5. IRC Sec. 752(d); Treas. Reg. §1.752-1(c). See *Crane v. Comm.*, 331 U.S. 1 (1947).
6. *Comm. v. Tufts*, 83-1 USTC ¶9328 (U.S. 1983).
7. Treas. Reg. §1.708-1(b)(2).

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(whether it is more or less than the basis) is attributable to a share of certain ordinary income property (i.e., partnership assets which, if sold, would result in ordinary gain), part of the amount realized (not just part of the gain) will generally have to be treated as ordinary income.[1] The IRC uses the terms "unrealized receivables" and "inventory items of the partnership" to identify the kinds of ordinary income property.[2] These items are also often called "hot assets" or "IRC Section 751 property."

In effect, a sale of a partnership interest is treated as two transactions, a sale of "IRC Section 751 property" and a sale of other property. (In fact, although this situation is not common, the transaction may have to be further broken up, into as many as four transactions, to the extent the partnership's assets, if sold, would generate collectibles gain (taxed at a maximum 28 percent rate) and unrecaptured section 1250 gain (taxed at a maximum 25 percent rate), as well as the more traditional capital gain and ordinary income).[3] In order to determine the gain or loss on each sale, the total amount realized by the partner on sale of the interest and the partner's adjusted basis in the interest must each be allocated between the share of the partnership's IRC Section 751 property and the share of other property.[4]

IRC Section 751 property includes much more than the term "unrealized receivables," on its face, suggests. In order to prevent the conversion of ordinary income on certain items of partnership property to capital gain, Congress has frequently used the term "unrealized receivables" as a catch-all for various items generating ordinary income. Thus, for example, the term includes potential depreciation recapture computed as if the property had been sold by the partnership at its fair market value at the time the partnership interest is sold, and amounts that would be treated as ordinary income attributable to market discount if the partnership had sold market discount bonds (issued after July 18, 1984) or short term obligations it held.[5] (See Q 7630 regarding market discount bonds, Q 7613 and Q 7615 address short term obligations). The term "inventory items" includes property held primarily for sale to customers and other property that would not be considered a capital asset or "IRC Section 1231" property.[6]

The amount realized by a partner upon the sale or exchange of an interest in IRC Section 751 property is the amount of income or loss from IRC Section 751 property that would have been allocated to the partner if the partnership had sold all of its property in a taxable transaction in an amount equal to the fair market value of the property immediately before the partner's transfer of the interest in the partnership. Any gain or loss recognized that is attributable to IRC Section 751 property is ordinary gain or loss. The difference between the amount of capital gain or loss that the partner would realize in the absence of these rules and the amount of ordinary income or loss determined under these rules is the partner's capital gain or loss on the sale of the partnership interest.[7] It is possible to have ordinary income attributable to the sale of the

1. IRC Sec. 741.
2. IRC Sec. 751.
3. See Treas. Reg. Sec. 1.1(h)-(1).
4. IRC Secs. 741, 751.
5. IRC Sec. 751(c).
6. IRC Sec. 751(d).
7. Treas. Reg. §1.751-1(a)(2).

interest in IRC Section 751 property and a capital loss attributable to the sale of the interest in the other property.

Example: Partner B sells a one-half interest in partnership AB, when the balance sheet is:

	Assets			Liabilities and Capital	
	basis	market value		book value	market value
Cash	$3,000	$3,000	Liabilities	$2,000	$2,000
Capital			Capital		
Assets	17,000	15,000	A	9,000	15,000
Unrealized					
receivables	0	14,000	B	9,000	15,000
	$20,000	$32,000		$20,000	$32,000

B receives $16,000 for his one-half interest ($15,000 in cash and $1,000 in reduction of partnership liabilities). B's interest in partnership property includes his one-half interest in unrealized receivables worth $7,000. Thus, $7,000 of the $16,000 realized is considered received in exchange for his interest in unrealized receivables and is therefore ordinary income. B's basis for his partnership interest is $10,000. The difference between the amount of capital gain or loss that the partner would realize in the absence of IRC Section 751 ($16,000 - $10,000 = $6,000) and the amount of ordinary income or loss determined above ($7,000) is B's capital gain or loss on the sale of its partnership interest. In this case, B will recognize a $1,000 capital loss.[1]

On sale of an interest in an upper tier partnership, a proportionate share of the lower tier partnership's "unrealized receivables" and "inventory items" will be deemed sold.[2]

Regulations require a statement relating to the sale.[3]

The partner's distributive shares of partnership gains and losses are included in the return for the year of sale, and are not part of the sale proceeds (See Q 7721). Any such income increases basis. If the partner fails to consider this when selling the partnership interest, the partner may realize ordinary income from operations instead of gain on the sale.

Gain or loss from sale of a partnership interest is generally treated as passive for purposes of the "passive loss" rules (See Q 7918 through Q 7929) if the activity is passive with respect to the partner (See Q 7919).

Partnership interests in different partnerships are not eligible for non-recognition treatment under the like-kind exchange rules.[4] (See Q 614 regarding the like-kind exchange rules generally, and Q 7776 to Q 7777 regarding like-kind exchanges of real estate).

The installment sales rules (see Q 586) are applied to the sale of a partnership interest in the same manner that the rules would be applied to a direct sale of the underlying assets. Thus, for example, the installment method cannot be used to report income from the sale of a partnership interest to the extent that the sales proceeds represent income attributable to the partnership's

1. Treas. Reg. §1.751-1(g)(Ex. 1).
2. Madorin v. Comm., 84 TC 667 (1985); IRC Sec. 751(f).
3. Treas. Reg. §1.751-1(a)(3).
4. IRC Sec. 1031(a)(2)(D).

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inventory items, which would not qualify for installment treatment if sold directly.[1] Similarly, the installment method cannot be used to report gain on the sale of a partnership interest attributable to depreciation recapture, which is an unrealized receivable for these purposes,[2] and it is generally assumed that the same rule applies to gain attributable to any other unrealized receivable as well. The underlying principle is that the installment method can be used to defer recognition of capital gain, but not of ordinary income.

7724. What is the transferee's distributive share of partnership income in the year he or she purchases a partnership interest?

Any partner who is a transferee of a partnership interest includes in taxable income, as the partner's distributive share of partnership items with respect to the transferred interest, the pro rata part of the amount of such items that would have been included had he or she been a partner from the beginning of the partnership's taxable year. The pro rata share may be determined based on the portion of the year that the interest was held, or by any other reasonable method, but must be determined by the same method used to determine the transferor's share.[3] See Q 7721. While the regulations use the word "partner," they would apparently apply to an assignee of an interest who is not formally made a partner through agreement by the general partner.[4]

7725. What is an individual's basis in a partnership interest that is purchased from a limited partner?

The initial basis of a purchased interest is its cost basis and thereafter it is adjusted, as explained in Q 7708.[5]

7726. How is a partner taxed if the partnership liquidates his or her interest in cash?

Cash payments (including the partner's share of partnership liabilities of which he or she is relieved–see Q 7719) in liquidation of a partnership interest may represent several items.[6] Part may represent the fair market value of the partner's interest in partnership assets, part may be attributable to the partner's interest in "unrealized receivables," and part may be attributable to goodwill.

In general, the cash liquidation of a partnership interest is treated like a sale. Thus, the difference between the amount of payment allocated to inventory items and the amount of basis allocated to such inventory is ordinary gain or loss. Presumably, the amount of payment allocated to "unrealized receivables" is fully taxable as ordinary income. Also, the difference between the amount of payment allocated to the balance of the partnership property (presumably including

1. IRC Sec. 453(b)(2)(B); Rev. Rul. 89-108, 1989-2 CB 100.
2. IRC Secs. 751(c), 453(i).
3. Treas. Reg. §1.706-1(c)(2)(ii).
4. See Rev. Rul. 77-137, 1977-1 CB 178 (assignee of partner's interest treated for tax purposes as substitute limited partner although other partners had not consented to his admission as a partner), and Rev. Rul. 77-332, 1977-2 CB 484 ("principal" who could not be a partner in a CPA firm because he was not a CPA was nonetheless treated as a partner for tax purposes).
5. Treas. Reg. §1.742-1.
6. Treas. Reg. §1.736-1(a).

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goodwill) and the amount of basis allocated to such property is capital gain or loss.[1] See Q 7723. The gain or loss is includable in the individual's income for the tax year in which the payment is received without regard to the partnership year in which it is received.[2]

However, with respect to a general partner in a partnership in which capital is not a material income-producing factor, the portion of the payment attributable to the partner's share of "unrealized receivables" (e.g., potential depreciation recapture) (see Q 7723) or goodwill (in the absence of an agreement to the contrary) will be treated as a distributive share (if determined with reference to the partnership's profits) or a guaranteed payment (if not) and taxed as ordinary income.[3] It is includable in the individual's tax year in which or with which the partnership year ends.[4] A transition rule provides that the rules in this paragraph also apply to any partner (without regard to whether the partner is a general partner or whether capital is a material income-producing factor for the partnership) who retires after January 4, 1993, if a written contract to purchase such partner's interest was binding on January 4, 1993, and at all times thereafter.[5]

Example: Assume the ABC partnership's balance sheet is as follows:

	Assets			**Capital**	
	basis	market value		basis	value
cash	$13,000	$13,000	Liabilities	$3,000	$3,000
unrealized			Capital		
receivables	0	30,000	A	10,000	21,000
			B	10,000	21,000
capital					
assets	20,000	23,000	C	10,000	21,000
	$33,000	$66,000		$33,000	$66,000

A, a limited partner, withdraws from the partnership and receives $22,000 ($21,000 in cash and $1,000 in liabilities assumed by the partnership). A's one-third interest in partnership assets other than unrealized receivables is $12,000 (one-third of ($13,000 + $23,000 fair market value of capital assets)). The basis of A's partnership interest is $11,000 ($10,000 + $1,000 partnership liabilities). A's gain is $1,000. It is capital gain because there are no inventory items involved. The remaining $10,000 A realized ($22,000 - $12,000) represents A's share of unrealized receivables and is ordinary income.[6]

7727. Does a limited partner report partnership income and losses in the year he or she makes a gift of a limited partnership interest?

A partner includes the distributive share of partnership items up to the time of the gift of the interest. The taxable year of the partnership closes with respect to the partner when the partner gives away his or her entire interest in the partnership, but does not close with respect

1. IRC Sec. 736(b); Treas. Reg. §1.736-1(a)(2).
2. Treas. Reg. §1.736-1(a)(5).
3. IRC Sec. 736; Treas. Reg. §1.736-1(a)(3).
4. Treas. Reg. §1.736-1(a)(5).
5. OBRA '93 Sec. 13262(c)(2).
6. See Treas. Reg. §1.736-1(b)(7)(Ex. 1).

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to any other partner.[1] Thus, the distributive share of income or loss for the short partnership year resulting from the gift is included in the tax year in which the gift is made, because that is the year in which the short partnership year ends as to the donor partner. See Q 7707. If the partnership and partner have different years (i.e., the partnership is on a fiscal year and the individual uses a calendar tax year), it is possible that both a regular full partnership year and the short partnership year will end in the same year of the individual. Consequently, there can be a bunching of more than one year's partnership income (or loss) in one year's return of the individual. The partnership year does not end as to a partner who terminates less than the entire interest.[2]

7728. Will an individual who gives away an interest in a limited partnership realize taxable gain?

As a general rule, there is no gain or loss to the donor on the gift of property. However, where the gift is of an interest in a partnership that has liabilities, there may be taxable gain to the donor. The IRS takes the position that if the amount of an individual's proportionate share of partnership liabilities exceeds the adjusted basis in the partnership interest, the donor is considered to have received gain and the transfer is deemed, in part, a sale.[3] The Service has found support for this position in court.[4] (The Service takes the same position with regard to a gift to charity. See Q 8001.) The treatment of the amount received on a sale and allocation of basis is explained in Q 7723. Thus, there may be ordinary gain to the extent the partner making the gift has "IRC Section 751 property" (e.g., potential depreciation recapture) and long-term or short-term capital gain.

If the share of liabilities is less than the adjusted basis, there is no deductible loss.[5]

To the extent the fair market value of the donor's partnership interest exceeds the liability (the amount realized on the sale), there is a gift.[6] If the value exceeds the liability by more than $14,000 in 2014, ($28,000 in the case of a split gift by husband and wife), there may be a gift tax. See Q 753.

7729. Does the grantor of a grantor trust that owns a partnership interest realize gain when the grantor renounces retained powers and the trust ceases to be treated as a grantor trust?

The IRS and the Tax Court take the position that there is gain. They reason that where a grantor of a trust retains certain powers, and as a result is treated as owner of the trust for tax purposes, the grantor is considered, for tax purposes, owner of a partnership interest purchased by the trust. As owner, the grantor reports the distributive share of partnership income, gains, losses, deductions, and credits allocable to the trust. When the grantor renounces the retained

1. IRC Sec. 706(c).
2. IRC Sec. 706(c)(2)(B).
3. Treas. Reg. §1.1011-2(a); Rev. Rul. 75-194, 1975-1 CB 80.
4. *Guest v. Comm.*, 77 TC 9 (1981); *Est. of Levine v. Comm.*, 72 TC 780 (1979), aff'd, 634 F.2d 12, 80-2 USTC ¶9549 (2d Cir. 1980).
5. Treas. Reg. §1.1001-1(e).
6. *Johnson v. Comm.*, 59 TC 791 (1973), aff'd, 495 F.2d 1079,74-1 USTC ¶9355 (6th Cir. 1974), cert. den., 419 U.S. 1040 (1974).

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powers that resulted in the trust's being classified as a grantor trust, the grantor is no longer considered owner of the trust's assets. In effect, the grantor has transferred ownership of the partnership interest to the trust. On the transfer, the grantor is deemed to receive a share of partnership liabilities.[1] The amount realized is taxable as proceeds of a sale, as discussed in Q 7723. The fair market value of the interest in excess of the liability is a gift to the trust. See Q 7728.

7730. What is the basis of the donee of a limited partnership interest?

The donee's unadjusted basis for determining gain is the greater of the amount of the donee partner's share of liabilities (see Q 7709) or the transferor's adjusted basis (see Q 7708) at the time of the transfer. If the fair market value of the interest is greater than the donor's adjusted basis, the donee's unadjusted basis is increased by the amount of the gift tax paid that is attributable to the appreciation in value, but not increased in excess of the fair market value of the gift. The donee's unadjusted basis for determining loss is the lesser of the unadjusted basis as used in determining gain or the fair market value of the interest at the time of the transfer.[2] Thereafter, the donee's basis is adjusted in the same manner as any other partner. See Q 7708.[3]

7731. Is partnership income and loss included in a deceased partner's final return? In the return of his successor in interest?

The taxable year of a partnership will close with respect to a limited partner whose entire interest in the partnership terminates for any reason, including the death of the limited partner.[4] A decedent's own tax year also ends on the date of death and is ordinarily a short year.[5] Thus, since the partnership tax year and the decedent's tax year will end on the same day, partnership income or loss will be included in the decedent's final return.

If the successor sells or exchanges its entire interest, or its interest is liquidated, the partnership year will end as to the selling successor at the date of sale. See Q 7721.

7732. Does a limited partner realize gain or loss on his partnership interest at death?

No. The transfer of assets to an estate on the death of a taxpayer is not considered a taxable sale or exchange.

7733. What is the basis of the estate or other successor in interest in a limited partnership?

The estate or other successor in interest has a basis in the partnership interest "stepped up" (or down) to the fair market value of the interest on the date of death, or alternative valuation date used for estate tax purposes, increased by the estate's (or successor's) share of partnership liabilities on that date, and reduced to the extent the value is attributable to items of income in

1. *Madorin v. Comm.*, 84 TC 667 (1985); Treas. Reg. §1.1001-2(c)(Ex. 5); Rev. Rul. 77-402, 1977-2 CB 222.
2. IRC Secs. 742, 1015; Treas. Reg. §1.1015-4.
3. Treas. Reg. §1.742-1.
4. IRC Sec. 706(c)(2)(A).
5. Treas. Reg. §1.443-1(a)(2).

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respect of a decedent.[1] A modified carryover basis may replace stepped up basis for property acquired from a decedent dying in 2010. See Q 598, Q 636. For partnership tax years beginning after 1997, the partnership tax year ends with respect to a partner who dies (see Q 7731). For partnership tax years beginning before 1998, the distributive share attributable to the period ending with the date of death which was taxable to the estate or successor was income in respect of a decedent, not part of the basis.[2]

7734. What is the effect of a partnership's not electing to adjust the basis of partnership property on the sale or exchange of a partnership interest or on the death of a limited partner?

Large syndicated limited partnerships generally state that they will not elect to adjust the partnership basis in property on the sale or exchange of an interest or on the death of a partner. Failure to make the election can have unfavorable tax consequences for an individual who purchases or succeeds to an interest.

Generally, a partner's adjusted basis in a partnership interest reflects the partner's proportionate share of the partnership's basis in its property. However, this is not necessarily true of a person who buys or succeeds to a partnership interest from another partner. See Q 7725, Q 7733.

Example: A, B, and C are partners in a partnership having $3,000 in cash, and real property with an adjusted basis of $24,000. Each partner's adjusted basis in his partnership interest is $9,000. C sells his 1/3 interest in the partnership to D for $15,000, at a time when the fair market value of the land is $42,000. The balance sheet of the partnership at the date of sale shows the following:

	Assets			**Capital**	
Assets	adjusted basis	market value		adjusted basis	market value
cash	$3,000	$3,000	A	$9,000	$15,000
land	24,000	42,000	B	9,000	15,000
	$27,000	$45,000	C	9,000	15,000

Following the sale, the partnership's adjusted basis in its property remains at $27,000 and each partner's share of partnership basis remains at $9,000, but D's basis in his partnership interest is $15,000, its cost to D.

If the land is sold in 2014 for $42,000, its fair market value, the partnership will realize a capital gain of $18,000. Each partner must report a capital gain of $6,000 as the partner's distributive share of the partnership gain. In effect, D is now realizing gain and paying tax on $6,000 of appreciation that was already included in the purchase price paid to C (and that was taxed to C at that time).

Assume the partnership terminates in 2015, distributing $15,000 to each partner in liquidation of his or her 1/3 interest. D has an adjusted basis of $21,000 in the partnership interest ($15,000 purchase price plus $6,000 distributive share of capital gain) and so will have a $6,000 capital loss in 2015 on the liquidation of the interest. However, D's capital loss in 2015 will not make D whole for the capital gain in 2014. D's $6,000 loss may be of limited use in 2015, and D will have lost use of the amount paid in taxes in 2014.

In acknowledgement of the unfair results (of course, if these would be the results, D should probably not have paid $15,000 for the interest in the first place), the IRC permits the partnership to elect to adjust

1. Treas. Reg. §1.742-1.
2. Treas. Regs. §§1.753-1(b), 1.706-1(c)(3)(v).

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the partnership's basis in partnership property with respect to a partner to whom an interest in a partnership is transferred by sale or exchange or on the death of a partner. (Adjustment is not made in the case of a gift.) Furthermore, for transfers after October 22, 2004, a basis adjustment is *required* if the partnership has a built-in loss of more than $250,000 immediately after the transfer.

The adjustment decreases or increases the partnership's basis in partnership assets by the amount by which the purchasing or succeeding partner's basis in the interest exceeds or is less than the partner's proportionate share of the adjusted basis of partnership property. The effect of the adjustment is limited to the particular partner.[1] If a partnership is terminated by a sale of an interest in the partnership, an election under IRC Section 743 that is in effect for the year the sale occurs applies to the incoming partner. The bases of property are adjusted before their deemed contribution to the new partnership.[2]

Example: Under the facts in the above example, if the election had been in effect with respect to C's transfer to D, A's share of partnership basis would have continued to be $9,000, B's share of partnership basis would have continued to be $9,000 and D's share would have been adjusted to $15,000. Thus on sale of the property in 2014, D's account would not reflect a share of the gain:

	Partnership	A's share	B's share	D's share
Sale price of land	$42,000	$14,000	$14,000	$14,000
Less adjusted basis				
common basis	24,000	8,000	8,000	8,000
adjustment to partnership basis for D	6,000	0	0	6,000
Total adjusted basis	$30,000	$8,000	$8,000	$14,000
Taxable gain from sale	$12,000	$6,000	$6,000	$0

If, instead of selling the interest, C dies in 2014 and D succeeds to C's interest, D's basis would be stepped up to the fair market value on date of death.[3] See Q 7731. Therefore, D would have a problem similar to that of the purchaser of an interest, if the partnership does not make the election.

An incoming partner of an upper-tier partnership (UTP) is entitled to an adjustment in his or her share of the lower-tier partnership's (LTP) adjusted basis in the LTP's partnership property, if and only if, the election has been made by both the UTP and the LTP.[4]

Regulations require that the election be filed with the partnership return for the taxable year during which the transfer occurs.[5]

In the case of an electing large partnership, see Q 7704.

7735. What is the Subchapter K (partnership) anti-abuse rule?

Subchapter K provides for the formation of partnerships to conduct business transactions without incurring an entity-level tax. The partnership must be bona fide and transactions entered into for a substantial business purpose. The transactions must be respected under substance over form principles, and the tax consequences of the transactions must accurately reflect the partners'

1. IRC Sec. 743.
2. Treas. Reg. §1.708-1(b)(5).
3. IRC Sec. 1014(a).
4. Rev. Rul. 87-115, 1987-2 CB 163.
5. Treas. Reg. §1.754-1(b)(1).

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economic agreement and clearly reflect the partner's income.[1] The anti-abuse rule provides that if a partnership is involved in a transaction with a principal purpose of substantially reducing the present value of the partners' aggregate tax liability in a manner that is inconsistent with the intent of subchapter K, the IRS can recast the transaction for federal tax purposes to achieve tax results that are consistent with subchapter K.[2] The anti-abuse rule applies only to income taxes, which are governed under IRC subtitle A. It does not apply to transfer taxes, such as estate and gift taxes, which are governed under IRC subtitle B.[3]

The determination as to whether a partnership has violated the anti-abuse rule will be based on an analysis of all of the facts and circumstances, including a comparison of the purported business purpose of the transaction and the claimed tax benefits resulting therefrom. Factors to be considered include whether: (1) the present value of the partners' aggregate federal tax liability is substantially less than (a) if the assets were owned and business conducted directly, or (b) if separate transactions were integrated and treated as a single transaction; (2) necessary partners either have a nominal interest in the partnership, are substantially protected from any risk of loss from the partnership's activities, or have little or no participation in the profits from the partnership's activities other than a preferred return; (3) substantially all of the partners are related to one another, either directly or indirectly; (4) partnership items are allocated in compliance with Treasury Regulation Sections 1.704-1 and 1.704-2, but the results are inconsistent with the purpose of IRC Section 704(b) and these regulations (see Q 7710); (5) the benefits and burdens of ownership of partnership property are either substantially retained by the contributing partner or substantially shifted to a distributee partner.[4] These Regulations generally apply to transactions occurring after May 11, 1994.[5]

Further, the Regulations allow the IRS to treat a partnership as an aggregate of its partners, unless IRC provisions prescribe the treatment of a partnership as an entity and that treatment and resulting tax implications are clearly contemplated by those IRC provisions.[6] This provision is effective for transactions occurring after December 28, 1994.[7]

1. Treas. Reg. §1.701-2(a).
2. Treas. Reg. §1.701-2(b).
3. Treas. Reg. §1.701-2(h).
4. Treas. Reg. §1.701-2(c).
5. Treas. Reg. §1.701-2(g).
6. Treas. Reg. §1.701-2(e).
7. Treas. Reg. §1.701-2(g).

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