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Partnership/LLC Taxation Guide with Problem Set & Solutions

ACE Seminars

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As an accounting graduate of La Salle University in Philadelphia, Prof. Connors went on for his law degree at the University of Notre Dame, graduating in 1980. After serving as an instructor in the School of Business Administration, he obtained his Masters of Law in Taxation at the University of Miami Law School in Coral Gables, Florida. He then served on the graduate tax faculty at the University of Wisconsin's School of Business in Milwaukee, WI.

His professional background includes experience in income and estate tax planning, as well as individual, partnership and corporate tax return preparation and research as a senior tax consultant for Price Waterhouse in the Philadelphia and South Bend offices. Prof. Connors also worked on expatriate and corporate tax matters as an international tax consultant for the Chrysler Corporation in London, England.

Prof. Connors currently conducts a national consulting practice designed especially for tax professionals based out of Milwaukee, WI. He also publishes a tax newsletter devoted exclusively to practitioners entitled the ***Monthly Tax Update***. He has been the outside editor for CCH's Federal Tax Course, and has spoken at numerous tax institutes, workshops and conferences around the country. And, his ***"Complete Guide to Depreciation, Amortization & Transfers of Property - Issues, Strategies & Answers"*** is sold to tax practitioners throughout the U.S., along with a brand new publication entitled ***"LLCs Taxed as Partnerships."***

As a nationally known speaker on a variety of tax topics, Prof. Connors has consistently earned average overall ratings in excess of 4.7 (i.e., on a 5.0 scale) for his knowledge and presentation skills, as well as the quality of his materials. He was chosen as a Distinguished Discussion Leader for the New York Society of CPAs Foundation for Accounting Education. And, in 2013, he received the AICPA prestigious ***Sidney Kess Award for "Excellence in Continuing Education."***

Advanced Partnership and LLC Issues

CHAPTER I: INTRODUCTION - DRAMATIC INCREASE IN USE OF PARTNERSHIP/LLCs

Comment: Increasingly, we are seeing LLCs being used for trades or businesses. They are no longer simply being used to hold real estate or develop real estate. With regard to rental properties, the main benefit is limiting the possible liability exposure for the owners who would have otherwise been holding the property as tenants-in-common (unless a limited partnership was used). But, since the title is recorded in the name of a separate legal entity, it will now be necessary to file a **Form 1065, U.S. Return of Partnership Income** (unless a single-member LLC was involved, in which case it would be ignored for tax purposes and only a **Schedule E, Supplemental Income and Loss** would have to be file).

Comment: One of the other most important recent developments is the **Sec. 199A** 20% deduction for "qualified business income." But, with a business that is highly-automated with little or no wages being paid to rank-and-file employees, or most work being done by the owners, there can be a problem since the final regs have confirmed that "guaranteed payments" cannot be used as additional "wages" should the 50% or 20% "wage limitations" have to be applied as a cap on this deduction. If that turns out to be the case, there might be a real incentive to switch over to S corp status (where wages paid to owner/employees are counted for these **Sec. 199A** "wage limitations").

Comment: Probably the most controversial issues with the new Sec. 199A deduction is due to the approach taken by the reg writers that rental activities meet a "Sec. 162 trade or business standard" in order that net rental income be included in the definition of "qualified business income" (QBI). When Congress decided at the last minute to include rental income as an additional source of QBI, they realized that since "wages" tend *not* to be found on a rental schedule, they devised an alternative test (i.e., 2.5% x UBIA) to support the "QBI component" (i.e., the initial 20% Sec. 199A deduction). More importantly, the final Conference Agreement for the TCJA makes no mention of rental income having to meet this aforementioned standard. So, practitioners are left in a state of flux when attempting to make such a subjective determination as to whether or not a rental activity satisfies this "T/B standard."

Comment: Detailed discussion of the **Sec. 199A** deduction is included in **Chapter XVII** below.

☞**Number of Partnership Returns Continues to Grow (IRS Statistics of Income Bulletin)**

The number of partnerships and partners in the United States continued to increase for according to some recent IRS statistics. Partnerships filed more than 3 million returns for the 2015 tax year, representing more than 27 million partners. The real estate and leasing sector contained nearly half of all partnerships (49.8 percent) and just over a quarter of all partners (27.7 percent).

Types of Partnerships and Relevant Statistics: The IRS bulletin revealed the following facts:

- Limited liability companies (LLCs) made up the majority of all partnerships (66%), surpassing all other entity types for the 12th consecutive year. Between 2012 and 2013, partners associated with LLCs increased 5.4% (from 9.2 million to 9.7 million), and LLC profits decreased slightly (from $242.5 billion to $241.9 billion). Also, LLCs represented 31.5% of the overall profits for all partnerships for 2013, an increase from 31.2% in 2012.

- In contrast to LLCs, limited partnerships represented only 12% of all partnerships with total net income decreasing by $10.9 billion between 2012 and 2013.

- Net rental real estate income increased 25.9% (to $42.9 billion) between 2012 and 2013. This was the fourth year of reported gains, following two years of deficits for 2008 and 2009. The majority of this increase came from increases in gross rents (up $20.7 billion) outpacing rises in real estate rental expenses (up $14.9 billion).

- The real estate and rental and leasing sector reported the largest changes in net rental real estate income, increasing $8.5 billion to $43.6 billion for 2013. Within this sector, the lessors of nonresidential buildings industry (except mini-warehouses) reported $53.9 billion for net rental real estate income, which was the largest amount for an individual industry. Meanwhile, lessors of residential buildings and dwellings reported losses of $10 billion, and other activities related to real estate reported losses of $6.4 billion. **(Misc.; Form 1065)**

☞**Flowthrough Entities & Proprietorships (SMLLCs) Continue to Dominate (Tax Fact—Flow-Through Business Income as a Share of AGI)**

A study from the Washington, D.C.-based Tax Policy Center looks at the share of total AGI reported on individual income tax returns by businesses organized as flowthrough K-1 entities and sole proprietorships. "Flowthrough entities" are described in the report as businesses that do *not* pay the regular corporate income tax, but instead pass profits through to owners who pay tax on their individual income tax returns. More than 90% of businesses, representing more than one-third of all business activity, in the U.S. are structured as flowthrough entities, according to the paper. The importance of pass-through businesses, particularly partnerships and S corporations, "has grown dramatically," the paper said. In 2012, net income from sole proprietorships, partnerships and S corporations totaled nearly $840 billion and accounted for more than 9% of total AGI reported on individual income tax returns. Also in 2012, partnership and S corporation income rose to reach 5.9% of total AGI, with 8.3 million returns reporting in the neighborhood of $535 billion in net income. **(Misc.; Flowthrough Entities)**

Comment: Since the top marginal tax rate for regular C corporations has dropped from 35% to 21%, while 90% (or, more) of all entities are structured as flowthrough entities (with the top individual marginal tax rate at 37%), taxpayers are increasingly weighing the choice-of-entity decision. In certain instances, S corps might be motivated to revoke their elections, while LLCs would "check the box" (on **Form 8832**) to be treated as C corps. In response, Congress enacted Sec. 199A to provide for a 20% deduction with regard to "qualified business income." Yet, this only serves to lower the effective top marginal rate from 37% down to 29.6%. But, in fairness, the prospect of "double taxation" serves to counter this discrepancy when comparing the use of a C corporation v. a flowthrough entity such as an S corp or a partnership. Especially with appreciating assets such as real estate, it might *not* make much sense to expose any gains to double taxation upon their sale (or, distribution), or upon the ultimate termination of the C corporation.

☞**SOI - Partnership Tax Return Statistics**

Twenty-two tables containing Tax Year 2014 statistics (i.e., the latest available) for partnerships, including statistics on the types of partnerships and specific industrial sectors, are available on **Tax Stats**. These statistics cover balance sheets, trade or business income and deductions, portfolio income, rental income (including rental real estate income), and total net income. Data are classified by industry and size of total assets. **(Misc.; Partnership Statistics)**

A. Selecting form of doing business

1. Consideration in making selection

a. Choice depends on underlying issues:

1) Business law

2) Taxation

3) Personal preferences

Comment: Tax reasons are *not* the sole criteria. But, after the passage of the TCJA and the new Sec. 199A deduction, the "choice-of-entity" decision will be impacted. Proprietors, or LLCs operating as a partnership, might want to consider making an S corporation election. For example, if the taxpayer was above the "applicable threshold" (i.e., $160,700, or $321,400 for MFJ filers in 2019), there would be a need for "wages" in order to support a possible QBI deduction, which would *not* be available to a proprietor.

Example: Lisa is a Schedule C proprietor of a service-based business which has no investment in equipment, etc. (i.e., no UBIA) and no rank-and-file employees. If her taxable income before any Sec. 199A deduction was *below* the applicable threshold, there would be no issue with claiming this 20% deduction. But, should her taxable income be above, she would have no "support factors" (i.e., wages or UBIA) to claim the Sec. 199A deduction. In the "phaseout range" (i.e., $50,000, or $100,000 for MFJ filers), she might still get a partial deduction. Over the end of the phaseout range, however, the deduction would be completely loss (i.e., there is no carryover of QBI to a future tax year).

Comment: In the **Example** above, it might be advisable to consider making an S election where Lisa could pay some of the business profits to herself as wages (of course, it would be at the "cost" of employment taxes v. a distribution but she would have had to pay self-employment tax anyway, if she had continued to operate her business as a proprietorship). Given she had no employees in her business, she would have to pay 28.3% of the new S corp's profits out to herself as "wages" to maximize a possible 20% QBI deduction. But, keep in mind that if Lisa's business was a SSTB, and her taxable income before any Sec. 199A deduction was beyond the end of the $50,000 or $100,000 phaseout range, it would *not* matter since the 20% deduction would have been completely eliminated.

Comment: Again, had Lisa's business been owned with another partner (and, was therefore operation as a Form 1065 partnership entity instead), then it too might want to consider possibly making an S election, given each owner had taxable income, before any Sec. 199A deduction, above the "applicable threshold" and there was little or no "wages" otherwise being paid to rank-and-file employees by the business.

b. Personal liability

1) General partnerships

a) *All* partners jointly and severally liable for debts and obligation of entity

Comment: Examples of larger accounting firms found guilty of fraud or malfeasance exist and their malpractice insurance policies refuse to cover such behavior.

2) Limited partnerships

a) Limited partners shielded from personal liability to creditors, unless their day-to-day activity with partnership operations beyond that of a typical investor

Comment: Be wary of limited partners (or, LLC "investor" members) who wish to avoid **Code §469** passive loss rules by insisting that they meet one of the seven "material participation" tests. The result would be that they effectively become *general* partners (or, LLC "managing" members) with unlimited personal liability.

Comment: Technically, under **Code §1256(e)(3)(B)** if a flowthrough entity such as a partnership or S corporation is a "tax syndicate" which is defined as having > 35% of its losses in a given tax year "allocable to limited partners or limited entrepreneurs." Although Congress should act to correct this unintended result with a "technical correction" to the TCJA, it means that the "small business exceptions" (i.e., meant for businesses with < $25,000,000 of average gross receipts) might not be available.

Comment: Cf. **ULPA §§179.23, .24 & .25** for more information on this issue.

3) Incorporated businesses

a) All investors protected from personal liability *regardless* of any management activity

Comment: Especially with *closely-held* businesses, where personal co-signing of loans or checks is required, this might negate liability somewhat. Consider adequate insurance coverage as an option. Also, be aware of "thin capitalization" and "piercing of the corporate veil." As far as the latter warning, consider the ***Rochlani*** case discussed below, as well as the **"Comments"** that follow.

☞**JCT Publishes Summary on Choice of Entity for Businesses (JCX-66-12)**
The Joint Committee on Taxation (JCT) has published a document covering selected issues relating to the choice of a business entity. In 2009, there were more than 22.6 million non-farm sole proprietorships out of 33.6 million total business returns. There were approximately 1.7 million C corporations, 1.9 million farms, 3.1 million partnerships, and 4.1 million S corporations. The number of passthrough entities surpassed the number of C corporations in '87 (coincidentally, when the repeal of the ***General Utilities*** doctrine occurred) and has nearly *tripled* since then, led by growth in small S corporations and limited liability companies taxed as partnerships. This summary contains four sections: (1) data on passthrough entities and C corporations; (2) descriptions of present law related to C corporations, passthrough entities, and certain other entities, as well as rules relating to social insurance taxes; (3) historical background with respect to both business entity classification issues and certain legislative changes to the taxation of different entities since '86; and (4) an analysis of selected issues related to the choice of a business entity. The issues discussed in the last section of the document include the following: (1) the effect on entity choice of the corporate tax rate, individual tax rate, and tax on dividends and gains; (2) distinguishing entities taxable as C corporations or partnerships; and (3) a hypothetical uniform passthrough regime. **(Misc.; Choice of Entity)**

Comment: Take special note of the above statistic where 22.6 out 33.6 million (i.e., 67%) businesses were non-farm proprietorships, and add 1.9 million Schedule F farm proprietorships, along with 7.2 million K-1 entities (3.1 million partnerships and 4.1 million S corporations) for a total of 42.7 million businesses (out of 44.4 million total businesses, or 96%) effectively taxed at individual marginal rates which will approach 40.8% when added to the 3.8% Medicare tax on unearned (or, passive) income.

Comment: How can we have a tax system where upwards of 51% of all "taxpayers" pay no *income* tax (though they may be paying employment, sales and real estate taxes), 5% of those individuals actually paying taxes cover 67% of the total tax revenues collected annually, and now, C corporations getting a flat rate of 21% (which would give these entities a tax rate which is now below the *average* 25% that of other developed countries in an emerging global economy)? How can 96% of all businesses pay marginal rates approaching

41%, while 4% of the other businesses (i.e., C corporations) pay a flat rate of just 21%? (Note: It is estimated that the Fortune 500 companies actually pay an average tax rate of just 12.46%, with 30 of them paying no tax at all, such as Amazon). And, with multi-national corporations, how can they only be taxed on profits which they choose to *repatriate back to the U.S.* (i.e., and, *not* on worldwide income in the same fashion as individuals who might derive a good deal of their income from flowthrough entity businesses, or sole proprietorships, and whether or not such profits are plowed back into those businesses)?

Comment: A more recent study had 60 of the largest businesses in the U.S. generating over $79 billion of income and yet paying no tax. Of course, this could be partially due to write-offs of reinvestment in equipment and other assets which are otherwise eligible for 100% bonus depreciation.

Comment: With the TCJA passage of **Code §965**, multi-national corporations are now being forced to "repatriate" their accumulated earnings (whether they are actually brought back into the U.S. or not because of the "deemed repatriation" rule).

☞**Corporate Form Could Not Be Ignored (*Rochlani*, T.C. Memo 2015-174 (9/8/2015))**

The taxpayer and her late husband owned a sporting and concert ticket sales company. Their son, without permission, incorporated the business using an online legal service, but the parents did nothing to stop or unwind the incorporation process upon learning of it. Personal credit cards were then used to make business purchases, and corporate books or accounts were *not* maintained. The business expenses were claimed on the couple's Form 1040 for the years at issue. The IRS issued a notice of deficiency to remove the business deductions from the taxpayer's Schedule C, asserting that the company should instead be treated as a corporation. The Tax Court agreed, holding that the late husband ratified and adopted the corporate form merely by filing annual reports. Therefore, the company's business expenses could *not* be deducted on the taxpayer's personal return and Form 1120 had to be filed for the business. **(Code §351; Corporate Formation)**

Comment: Could this case be cited in other situations, especially with the proliferation of S corps with only one shareholder/employee, where corporate formalities are *not* being adhered to and the IRS was attempting to "pierce the corporate veil?" Could the taxpayer argue that at least the annual report was being filed each year and the corporate charter renewed? Also, consider doing an Type F re-org to convert the means by which a closely-held S corp is obtaining its limited liability (i.e., by having a corporate charter and being designated by the "Inc." suffix after its name) into an LLC which would then have the *same* limited liability protection, but without the need for the various corporate formalities.

c. Fringe benefits

1) No longer any major differences in pension area (however, self-employed individuals are contributing *all* of the funds to their plans whereas corporate employee can have an employer *match* within limits). One exception would be where a self-employed individual sets up a "**Solo 401(k) plan**."

2) Both can have "death benefit" under **Code §101**

3) Medical reimbursement plans (i.e., HRAs) for *corporate* employees only (**Code §§104** & **105**)

4) Group-term life insurance for *corporate* employees only (i.e., $50,000 cap under **Code §79** with any excess coverage being taxed pursuant to the **P.S. 58 table**)

5) Flexible spending accounts for *corporate* employees only (i.e., **Code §125**)

6) Pre-employment and pre-income tax accident and health insurance for both C and S corporate owner/employees (Cf. **Rev. Rul. 91-26**), with partners/LLC members and proprietors getting only pre-income tax treatment (but, after S/E tax)

Comment: With the introduction of the new Sec. 199A deduction, "guaranteed payments" in general should be avoided since they do not count as "wages" and they only serve to reduce QBI. Instead, "special allocations" of partnership profits pursuant to **Code §704(b)(2)** should be used. Nevertheless, if the partnership is paying for a partner's health insurance (e.g., $2,000/month for family coverage), this $24,000 in annual premiums has to be shown as a "guaranteed payment."

7) "De minimis" fringe benefits for *corporate* employees only (**Code §132**)

8) Tax rates max out at 37% (plus 3.8% Medicare surtax) for passive K-1 investors (except S

corp owner/employees can utilize distributions v. W-2 salaries to avoid the surtax)

a) Prior to 2018, PSCs paid a flat rate of 35% though most tried to "comp down taxable income to zero" (now, PSCs are treated no differently then any other regular C corporation and receive the flat 21% rate as well)

b) Prior to 2018, regular C corps paid up to 39% on taxable income between $100,000 and $335,000 (but, effectively, 22.25% on first $100,000 of taxable income with the graduated tax rates). Starting in 2018, there is a flat rate of 21% for all C corporations on their total taxable income.

c) C corporations get **Code §243** dividend received deduction as well (though, after 2017, it has dropped from 70% to 50%)

d. Flowthrough entities

1) Permit character of each item of income, gain, loss, deduction or credit of the partnership/LLC to retain same trait when reported on partner's tax return

2) Effectively can avoid "double taxation" unlike C corporations (unless a "**personal goodwill**" argument can be successfully asserted)

Comment: With closely-held corporations, shareholder/employees can use compensation, rents on property leased to the entity, etc. to avoid one layer of tax (and, save employment tax with the rents). But, with self-rental income, this is recharacterized as nonpassive income to the owners that materially participate. And, this includes rents paid by C & S corps, as well as partnerships/LLCs.

3) Allows immediate write-off of losses, given **Code §704** basis, **Code §465** at-risk and **Code §469** passive loss rules are all satisfied (and, the "new" post-2017 NOL limits are *not* exceeded)

Comment: Keep in mind that we now have a fourth "barrier" to taking K-1 losses in 2021 with the reinstatement of **Code §461(l)** and the "excess business loss" limitation (i.e., $250,000/500,000). The $3,000 annual limit on excess

4) Flowthough K-1 entity might *not* be desirable where all profits are going to be retained by business yet owners required to pay associated taxes with little or no cash flow

Comment: This is especially true now that C corporations receive a flat tax rate of just 21%. Consider a flowthrough entity which intends to retain substantial earnings to fund such future cash flow needs including: (1) redemption of retiring/exiting owner; (2) buyout of other competing businesses; or (3) purchase of additional equipment. **Would you want to pay 21% on this accumulations of earnings at the entity level over several years time, or a possible top marginal tax rate of 37% for flowthrough entity owners?**

☞Alternatives for Handling C Corp Profits

Example: "Paying Out Nondeductible Dividend"
On $100 of C corporation profits, $21 would be paid in federal income taxes. Then, of the $79 remaining to pay a nondeductible dividend, 20%[1] or about $16 would be subject to tax at the shareholder level. As a result, this $100 of corporate profit would face a combined effective tax rate of 37%, which is also the top marginal tax rate on ordinary income for individuals starting in 2018.

Example: "Corporate Profits Paid Out as Deductible Wages"
If this $100 of C corporation profits **had been paid out as wages**, there would have been a **corresponding deduction to the corporation**, with the owner/employee picking up this ordinary wage income **at marginal rates of up to 37%**. In addition, even if the FICA cap (i.e., $132,900 in 2019) is exceeded, there would still be the 2.9% in employments taxes to be considered (1.45% for the employer and employee each). Finally, the .9 Medicare surtax would also have to be considered if the taxpayer's AGI exceeded the $200,000/250,000 thresholds (depending on filing status).

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[1] This, of course, ignores the possible imposition of the **Code §1411** 3.8% Medicare surtax.

Choice of Entity: As far as the "choice-of-entity" question, had this $100 of profit instead flowed through on an owner's K-1 from an S corporation or a partnership, it could have possibly received a 20% deduction (given that the partner/S corp shareholders taxable income did *not* exceed for 2018 $315,000 on a MFJ return ($157,5000 for an unmarried taxpayer). And, even if it did exceed these aforementioned "threshold amounts," then given that it was *not* a "serviced-based business," the 20% deduction would be allowed as long as it did *not* exceed 50% of any wages paid by the company (or, an alternative formula of 2.5% x UBIA for capital intensive businesses). The bottom line is, given that the 20% deduction was allowed, this would leave $80 (of the original $100 of profit) which could be taxed at a marginal rate of up to 37%, resulting in a effective tax rate of 29.6%.[2]

- Another option would be to just accumulate this $100 of profit as additional working capital which could be invested in a mutual fund, for instance, yielding a dividend each month. First of all, the C corporation would have $79 (of the original $100 of profit) to invest. And, **Code §243** would permit 50%[3] of this dividend to be excluded from the C corporation's taxable income when received.

Example: "Retaining C Corp Profits as Invested Working Capital"
If a C corp had a $100 of profit, should it be paid out as additional wages, which would face a top marginal tax rate of 37%, along with at least 2.9% of employment taxes (and, possibly, the .9% Medicare surtax shown on **Form 8959**)? Or, should the C corp instead accumulate this working capital and invest it in a mutual fund paying 7%? The C corp shareholder would only have, if in the top marginal bracket of 37% and over the end of the 2019 FICA cap of $132,900), about $60 to invest after federal income and employment taxes on wages, and would then face up to a 20% tax rate on any dividends or LTCGs, leaving $80 after-tax per $100. On the other hand, the C corporation would have $79 to invest after-tax, and would only pay an effective tax rate of 10.5% of each $100 of return on investment (($100 x 50% DRD) x 21%). Of course, the C corporation would have to watch out for both the AET tax penalty under **Code §53l** (where up to $150,000 or $250,000 of accumulated earnings could be retained without question), as well as the **Code §541** personal holding company penalty.

Comment: Even if C corporation profits were simply being retained for anticipated future business needs such as the acquisition of new assets, acquiring or expanding a business, redeeming a shareholder's stock, etc., it would make more sense to leave these needed monies in the C corporation where they are **taxed at 21% at the federal level v. having the owners put monies into the corporation later on as additional paid-in capital (especially if these were previously taxed wages at up to 40.8% - (37% + 2.9% + .7%)).**

Comment: In a narrow set of circumstances, it might even make sense for an S corporation anticipating significant business expenditures over several years to revoke their S election and accumulate and expend these funds as a regular C corporation.

Example: Dr. Scott and Dr. Smith are orthopedic surgeons who own an S corporation with profits in excess of $2 million/year (which are paid out in a combination of wages and S corp distributions). They inform you that over the next 4 to 5 years their company will be acquiring the practices of several retiring physicians, as well as making significant equipment purchases. And, at their respective levels of income, there is likely no chance they would qualify for the 20% Sec. 199A deduction on this source of income. As a result, would it make sense to revoke their S election and thus have their business be taxed as a C corporation where such retention of profits over the next several years would be taxed at a flat rate of 21% v. a likely marginal rate of 37% (and, this is assuming that the S corporation profits were not instead paid out as wages facing an effective marginal rate of 40.8% - 37% + 3.8% in Medicare taxes)? Furthermore, at the end of 5 years they would be eligible to make an S election once again (or, simply argue "personal goodwill" should they liquidate the C corporation in the interim).

Comment: For most of the PSCs which faced a flat tax rate of 35% for tax years before 2018, this will need to be a "new" consideration instead of "comping out taxable income with bonuses to zero." In other words, now with a federal income tax rate of only 21%, consideration should be give to leaving some monies within the C corporation for anticipated future business needs.

Example: "C Corp Profits Used to Make Retirement Plan Pay-In"
A final option might be for the C corporation to contribute the $100 profit into a qualified retirement plan. There

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[2] Of course, separately-stated dividends, LTCGs or Sec. 1231 gains would receive an even lower rate versus a C corporation which would face a flat 21% tax rate regardless of the source of income.

[3] The dividend received deduction had been 70%, but will be reduced to just 50% under the TCJA starting in 2018.

would be no income taxes due on this amount, although employment taxes of at least 2.9% would be owed.

2. Comparison to S corporations

a) **Subchapter S Revision Act of 1982** made S corps much closer in tax characteristics to partnerships although **TRA '86** with **Code §1374** built-in gains provision can create "double taxation" on conversion of regular C corporation to S corp status

b) Taxation of distributions can vary with presence or absence of former C corp E&P

c) With fringe benefits, > 2% S corp shareholders treated *same* as partners (meaning that most fringe benefits will be taxable to owner/employees)

3. Ease of getting owners and/or property into, or out of, partnership on tax-deferred basis

a) **Code §311(b)** major impediment to getting appreciated property out of either C or S corp without taxation while built-in losses are denied on *nonliquidating* distributions

b) Gain or loss on partnership distributions limited to "disproportionate distributions" of **Code §751** "hot assets"

c) Might be easier, though, to do merger of two corporations v. two partnerships from a business law, as well as, tax standpoint

4. Mere co-ownership of property or joint ventures *not* treated as partnership

a) Typical example involving tenants-in-common owning real property or professionals sharing office space and a conference room but otherwise maintain separate books and records.

b) **Reg. §1.761-2(a)(1)** requires that members of such arrangements be able to compute their income *without* need to compute "partnership taxable income"

c) But, degree of "activity," and *not* necessarily legal title as co-tenants, controls possible classification as "partnership" for tax purposes

d) With rental of real property, for example, activities involving "significant personal services" could result in co-ownership being characterized as "partnership" trade or business (i.e., **page 1 of Form 1065**)

1) Apartment building v. hotel, motel, bed & breakfast, etc. (Cf. **Rev. Rul. 75-374**)

e) Ability to "elect out" of partnership status, especially where mere co-ownership of investment assets are involved (i.e., by the individuals v. an LLC), under **Code §761(a)** given certain conditions are met

1) "Tests" to elect out under **Code §761(a)** are "conjunctive" and the election out statement must be filed with **Form 1065** within required time limits per **Reg. §1.6031-1(e)** with unanimous consent of all owners

Comment: How many co-owners in such situations actually take the trouble to file at least the one **Form 1065** return to make this "election out" of potential partnership treatment? Most "investment clubs" simply open a brokerage account and have it owned "for the benefit of" (FBO) it members.

5. Advantages of "co-ownership" v. "partnership" arrangement

a) One partner "dealer" does *not* taint character of income on sale of property for others

b) One co-tenant can sell interest in property for cash while other owner can utilize **Code §1031** like-kind exchange rules (i.e., this could *not* be done with a "partnership interest")

Comment: This is commonly known as a "drop-and-swap" transaction.

c) With casualty/condemnation losses, one co-tenant can keep cash while other used **Code §1033** casualty provisions

6. Partner acting in capacity as other than partner

a) Partner as employee

1) Entitled to a "salary" which takes form of "guaranteed payment" (i.e., **Box 4 on K-1** subject to self-employment tax) and has priority over non-partner creditors of the partnership

b) Partner as creditor

1) Has liquidation rights *after* non-partner creditors

B. Complexity of Partnership Tax Law: Even though S corporation returns (**Form 1120S**) continue to be the returns most prevalently filed, as discussed above, there has been a significant surge in the use of **Form 1065**. This is in spite of the fact that partnership tax law (Subchapter K) continues to be one of the most complex areas of tax to comply with.

Comment: Over the past decade and a half, tax filings by partnerships have seen a dramatic increase. For calendar year 2004, about 2.5 million partnerships filed **Form 1065**; by calendar year 2017, that number had risen to more than 4 million, an increase of 59 percent. The rise in filings by partnerships was dramatically greater than the rise in filing by C-corporations and S-corporations, combined, which rose about 14 percent over the same time frame.

C. LLCs as Estate Planning Tool: In the estate planning area, the use of family limited partnerships (FLPs) is slowly being replaced with family limited liability companies (FLLCs). FLLCs enable parents, who would have been general partners in an FLP, to have limited liability protection, and remain managing members of the LLC. More importantly, the use of this type of entity allows the investor member interests to be transferred to other family members at a sizable discount for transfer tax purposes.

D. Adopted in All 50 States: All states and the District of Columbia have enacted limited liability company (LLC) legislation. And, unless an election is made to treat them as associations taxed as corporations (i.e., discussed more fully below by filing **Form 8832**), they are taxed as partnerships for federal income tax purposes.

E. Basic Features of LLC: An LLC is an unincorporated association formed under state laws among one or more members. An LLC owner, whether by contribution of capital or performances of services is called a **member**, whereas a partnership owner is a partner and a corporation owner is a shareholder. **LLCs have two principal features:**

1. Pass-through taxation, like a partnership, and

2. Limited liability, like a shareholder in a corporation.

F. Effective Date of LLC's Existence: A business must be aware of the date that the LLC existence as a separate legal becomes effective. This date can vary by state. While some states recognize the LLC on the date the articles of organization are filed, others do *not* recognize the LLC until the articles are accepted. Still, others allow the members to insert an effective date into the articles. This is important because any actions of the members prior to the effective date are **not** protected by the LLC.

G. Terminology of LLCs: Throughout this text, the words **member** and **partner** are often used interchangeably. But, although there are some similarities to limited partnerships, LLCs are distinct and separate legal entities when it comes to the limited liability protection of their owners.

H. Benefits of an LLC: Were it not for the liability protection that an LLC provides, many businesses would probably *not* choose to operate as an LLC. Instead, they might choose to be an S corporation. Some benefits an LLC provides as compared to an S corporation are:

• LLCs are **not** restricted in the **number or type of allowed members**.

• **Membership is not restricted** to corporations, partnerships, pension plans, or other entities (or, nonresident alien investors, as would be the case with S corps)

• LLCs have **wide latitude in defining preferred interests and creative allocations** of earnings and losses among members according to the terms of the operating agreement (unlike an S corp where income and deductions have to be allocated on a strict stock ownership basis).

• Similar to S corporation shareholders, all members of an LLC (unless they have agreed to serve as a guarantor of the LLC's debts) **enjoy limited liability for debts of and claims against the LLC** unlike the joint and several liability faced by a general partner in a limited partnership.

• Unlike S corporations, appreciated property can potentially be transferred out of the LLC without it being treated as a deemed sale (as is the case with either C or S corporations under **Code §311(b)**).

Day-to-day management of the LLC business is usually done by its **managing members** in a fashion similar to that employed by the **general partners** of a partnership. Furthermore, LLCs are generally **not** subject to **disclosure, record keeping, and reporting requirements** that are as strict as those of general and limited partnerships. LLCs also allow contributions to capital by members in the form of cash, property, and services rendered, and recognize binding obligations to make such contributions.

I. LLC Entity Classification Election: An LLC is often characterized as a **hybrid entity**. It may be taxed as a partnership while providing limited liability protection for all its members. This is unlike a limited partnership, in which at least one general partner is necessary. Under the federal check-the-box rules,[4] **LLCs having at least two members are treated as a partnership for federal income tax purposes unless the LLC elects to be taxed as a corporation.** The corporate election is made by filing **Form 8832, Entity Classification Election**. The election becomes effective on the date indicated on the election, but cannot be retroactive more than 75 days prior to the date of filing (i.e., similar to the rules for S corporations which state "within 15 days of the third month" for *retroactive* elections).

Comment: Pursuant to **Rev. Proc. 2004-48**, if an entity timely files the S corporation election on **Form 2553** but fails to file **Form 8832**, **Temp. Reg. §301.7701-3T(c)(1)(v)(C)** applies and the entity is **deemed to have filed Form 8832.** However, **Temp. Reg. §301.7701-3T(c)(1)(v)(C)** does **not** apply to an entity that **also fails to timely file Form 2553.** In this situation, the entity must request relief through the letter ruling procedures. However, the new guidelines contained in this revenue procedure provide **simplified procedures** for requesting relief in this situation. Specifically, an entity seeking to use the "simplified method" provided by the revenue procedure must file Form 2553 **within six months** after the due date of the tax return for the **first year** of the intended S corporation election, excluding extensions. The form must state at the top that it is **"FILED PURSUANT TO REV. PROC. 2004-48"** and include a statement explaining the entity's failure to timely file the S corporation **and entity classification elections**; among the eligibility requirements is **"reasonable cause"** for that failure. An entity that obtains relief under the revenue procedure is **treated as having made an election to be classified as an association taxable as a corporation** under **Reg. §301.7701-3(c)** as of the effective date of the S corporation election.

Comment: **Rev. Proc. 2013-30** further "facilitates the grant of relief to taxpayers that request relief previously provided in numerous other revenue procedures by consolidating the provisions of those revenue procedures into one revenue procedure and extending relief in certain circumstances." This revenue procedure also *modifies and supersedes* **Rev. Proc. 2003-43**; **Rev. Proc. 2004-48**; and **Rev. Proc. 2007-62**, for taxpayers to make late S corporation elections, Electing Small Business Trust (ESBT) elections, Qualified Subchapter S Trust (QSST) elections, Qualified Subchapter S Subsidiary (QSub) elections, and late corporate classification elections which the taxpayer intended to take effect on the same date that the taxpayer intended that an S corporation election for the entity should take effect.

J. Passthrough Taxation: Unless the LLC elects to be taxed as a regular C corporation for federal tax purposes, the income and expenses of an LLC pass through the business entity and are taxed at the member level

[4] Treas. Reg. §301.7701-1 to -3

with the specifics of each item being spelled out on the Schedule K-1 per the partnership/LLC agreement.

K. Type of Interest: A member's ownership in an LLC consists of an ownership of LLC capital (i.e., "capital" interest) and a share of current operating results (i.e., "profits" interest).

1. The **capital** interest represents the LLC member's contribution plus a cumulative share of undistributed LLC profits. Another way of looking at it would be that it represents a member's share of liquidation proceeds of the LLC.

2. The **profits** interest represents the LLC member's share of current and future income earned by the LLC.

Comment: Since an LLC operating agreement can be amended at any time up until the unextended (i.e., original) due date of the Form 1065 to reflect a change in which the current results are allocated to the various members, the profits and capital interests may *not* always be equal, and the profits interest may also *not* be the same over time. In fact, a profits interest may vary for different types of income, deduction, etc. during a single tax year (so long as they have "substantial economic effect" pursuant to **Code §704(b)(2)**). More information on this issue is contained in the section below on "LLC Agreements."

Comment: Compare this to an S corporation where there can be only one class of stock and there is no such thing as a "profits" v. "capital" interest. In addition, all distributions must be pro rata based on each shareholder's percent of ownership v. "draws" in a partnership (i.e., since only common stock can be issued for an S corporation).

☞**"Wage Limitation" Test Does Not Include Guaranteed Payments**

If a taxpayer's taxable income *before* any Sec. 199A deduction is expected to exceed their applicable threshold (i.e., for 2018, $157,500 or $315,000; $164,925 or $329,850 for 2021), then either the "wage" or "capital investment" test must be met to support the initial "QBI component." But, the final regs repeat the stance taken in the proposed regs by insisting that **guaranteed payment to owners of partnerships for services performed do *not* equate to wages paid to an S corporation owner/employee**. As a result, **guaranteed payments serve no useful purpose when calculating the potential Sec. 199A deduction**. Consideration should **instead be given to making a "special allocation" under Code §704(b)(2)** to compensate a specific partner for services performed. That way, **overall QBI will *not* be reduced (i.e., by "guaranteed payments" that are otherwise shown in Box 4 of the K-1) while the recipient partner's T/B income on Schedule K-1, Box 1 (i.e., QBI) will be *correspondingly increased*.**

Comment: Another **alternative approach**, if the entity is *not* in a position to make an S election, is to **have the partner form a SMLLC and file an S election on Form 2553**. Then, transfer the partnership/LLC interest to this newly-formed S corp with any "wages" being paid out of it (and, the remainder of the net profit on **Form 1120S** being treated as QBI).

Comment: A partnership has **65 days after yearend (i.e., by the unextended due date of Form 1065) to modify its current agreement** to make a **Code §704(b)(2)** "special allocation." And, **what is done one year does *not* necessarily lock the entity into making the same election in a subsequent tax year**.

Comment: Obviously, if the taxpayer's taxable income before any Sec. 199A deduction is expected to **be below their applicable threshold**, then a **partnership (or, proprietorship) may be the preferred type of entity** since there would *not* be the need to pay any "wages" to an owner that would otherwise reduce QBI (as would be the case of an S corporation which must pay "reasonable compensation" to its owner/employees, while also being liable for employment taxes).

L. LLC Agreements: The LLC agreement includes the original agreement and any subsequent modifications. However, any modifications must be agreed to by *all* of the members (current members, as well as those who were owners for any part of the applicable tax year). But, the agreement or modifications may be oral or written. However, if the LLC agreement or any modification is silent on any matter, the provisions of local law will be treated as part of the LLC agreement.

Comment: Modifications to the partnership agreement can be made up until the unextended due date of the Form 1065 tax return (i.e., March 15th for partnerships on the calendar tax year). (Cf. **Reg. §1.761-1(c)**)

Comment: Modifications after the end of the tax year can be useful in allocating gains/losses to those partners who need them the most (though, the tests for "special allocations" under **Code §702(b)(2)** must be satisfied).

But, *retroactive* allocations to *new* partners are *not* permitted.

1. The term "LLC agreement" is very broad and refers to any agreement which has an impact on the economic sharing arrangement among the members, or between one or more members and the LLC. (**Reg. §1.704-1(b)(2)(ii)(h)**). Although the LLC agreement may be oral or written, any document or oral agreement which bears on the underlying economic arrangement of the members is considered to be part of the LLC agreement. Examples of such documents might include:

● Loan and credit agreements

● Assumption agreements

● Indemnification agreements

● Subordination agreements

● Correspondence with a lender concerning terms of a loan

● Loan guarantees

Comment: In other words, the LLC agreement can encompass more than just an formal "agreement document."

M. Entity vs. Aggregate Theory: These two competing theories govern the taxation of partnerships (and, therefore, LLCs)

Comment: The **"entity"** theory, derived from European civil law, treats each partner as having only an interest in the *partnership entity separate and apart* from its assets and operations, in which *no* partner has a *direct* interest (i.e., similar to a corporation).

1. Under the **entity** theory, an LLC is considered to be an independent entity and, therefore, separate and apart from the collection or aggregation of its members. Examples of this approach can be found in the following:

● The LLC is free to make most of its tax accounting elections. (**Code §703**)

● Prior to 2018, the LLC was treated as "technically terminated" for federal income tax purposes as a result of a member's death or the sale, exchange or gift of an interest (i.e., given it's greater than 50% in a 12-month period). (**Code §708**)

Comment: After 2017, "technical terminations" have been eliminated in partnership tax law. As a result, you can have dramatic (i.e., > 50%) changes in ownership in a given tax year and the entity is still considered to remain in place for tax purposes.

● A member can engage in transactions with the LLC in a capacity other than as an owner. (**Code §707(c)**)

● Partnership has its own tax bases in its assets (e.g., real estate can be acquired in the partnership's name and when so acquired, it can only be conveyed in the entity's name)

● Partners can sell their interests in the partnership much like shares of stock in a corporation (although they may face **Code §751** "hot asset" treatment which precludes capital gain treatment otherwise accorded by **Code §741**)

● Partnership is a separate entity when audited by IRS (especially with the new "centralized audit" rules commencing in 2018 and thereafter, unless the entity has ≤ 100 owners and elects out annually on **Schedule B-2** on **Form 1065**).

Comment: The **"aggregate"** theory, derived from English common law, treats a partnership as a "transparent aggregation" of individual owners, each of whom is considered to possess a *direct undivided* interest in the partnership's assets and operations.

2. Other the other hand, under the **aggregate** (or, conduit) theory, an LLC is a "common pool" to which

each member contributes capital or services in the pursuit of profit. Consequently, it is a "channel" through which income, deductions, gains, losses and credits flow to each respective member. Examples of this approach can be found in the following:

● LLCs generally are *not* subject to federal *income* taxation (although it may have to pay the employer's share of any employment taxes). (**Code §701**)

● Once an LLC has determined its ordinary income or loss and calculated all other items of gain, loss, credits, etc., its existence can be disregarded, since the members would now separately report and pay tax on their share of these items. (**Code §702**)

● The basis of contributed property to the partnership entity is a "carryover basis" from the contributing member under **Code §723** (with the contributing member taking a "substituted basis" pursuant to **Code §722**). However, if the contributing member recognizes any gain under **Code §721** (i.e., due to the receipt of boot on the otherwise tax-deferred exchange), the carryover basis of the property to the LLC is increased by this gain (i.e., given an election under **Code §754** election is in effect).

● Obtaining credit and loans today typically means that some, if not all, partners remain personally liable for repayment of the debt due to guarantees being required by lenders. (Cf. **UPA §178.12**)

Comment: Compare this treatment to that accorded corporations in a tax-deferred exchange pursuant to **Code §351**. There, if a transferor recognizes any gain due to the receipt of boot, the transferee corporation automatically increases the carryover basis by this gain pursuant to **Code §354** (i.e., there is no equivalent to having to make a "**Code §754** election" at the corporate level).

3. State law and federal law *combine* these two theories (i.e., aggregate v. entity) with respect to specific statutory provisions.

Comment: The problem (and, complexity) arises because of the *lack of predictability* as to which theory will sometimes be applied to a given set of circumstances.

4. Examples of accounting and tax elections made at the entity level:

- Method of accounting (can vary from that used by the individual partners)
- Depreciation methods (including Sec. 179 immediate expensing and bonus depreciation)
- Use of the "de minimis" ($2,500 or $5,000) safe harbor
- Inventory method
- Election to defer casualty gain under **Code §1033**
- Election for defer COD income on **Form 982** under **Code §108**
- Election of tax year
- Election to use installment method under **Code §453**
- Election to step up inside bases of assets under **Code §754**

Comment: Partnership elections reinforce the "entity" theory while elections made by the individual partners, such as whether to deduct or take a credit for foreign taxes paid by the partnership, are indicative of the "aggregate" theory.

N. LLC Member Definition: An LLC, which is treated for tax purposes as a partnership, is defined under common law as a "contractual relationship between two or more persons who join together to carry on a trade or business, each contributing money, property, labor or skill and all with the expectation of sharing in the profits and losses of the underlying business.

Comment: The Code provides a much broader definition of a partnership. Under **Code §§761(a)** and **7701(a)(2)**, the definition of a "partnership" is expanded to include a syndicate, group, pool, joint venture or other unincorporated organization.

O. Single-Member LLCs: All states permit the formation of "single-member LLCs." The IRS classifies a single-member LLC as a disregarded entity.[5] Therefore, it is taxed as a sole proprietorship and all income and expenses are reported on the single member's **Form 1040** – **Schedule C** or **Schedule F** (or, **Schedule E**, if a rental property is involved). However, a disregarded entity is treated as a separate entity for some purposes:

• Federal tax liabilities of the entity for any taxable period for which the entity was **not** disregarded[6]

• Federal tax liabilities of any entity for which the entity is liable[7]

• Federal tax refunds or credits[8]

• Federal and state payroll tax liabilities

Comment: The above rules did **not** apply to disregarded entities prior to April 1, 2004. Furthermore, a SMLLC may nevertheless still be treated as a *separate* entity apart from its owner in some states.

Comment: SMLLCs are excellent entities for providing limited liability protection while still offering a great deal of simplicity from an income tax standpoint. Besides offering a proprietorship format to individuals who utilized them, S corps can also employ them instead of having to meet the technical requirements of Subchapter S subsidiaries (QSUBs) or qualified small business trusts (QSBTs). And, C corporations can use SMLLCs instead of having convoluted consolidated corporate/subsidiary structures. Finally, partnerships can take advantage of SMLLCs and avoid complex multi-tiered partnership arrangements.

☞**IRS Offers Guidance on Issues for Partnership That Became SMLLC (CCA 201351018)**

In this guidance from the Chief Counsel Office, the IRS has resolved a number of issues that arose after a two-person partnership became a disregarded entity (i.e., a SMLLC when one partner bought out the other owner) and then proceeded to hired him on as an employee. These issues covered in this CCA involved employment tax, reporting of income, and procedural matters, as summarized below.

Comment: When examining the underlying issues when a multi-member LLC converts to a SMLLC, one should reference **Rev. Rul. 99-6** (and, **Rev. Rul. 99-5** when the opposite is true).

Facts: The partnership consisted of two partners who instituted a phased buyout plan whereby one partner bought out the other with the latter partner becoming an employee of the SMLLC. The former partnership also had other employees during the years at issue. The result was that the partnership terminated when the second partner sold out his interest and became an employee.

Despite the termination of the partnership under state law, the remaining partner continued to file employment tax returns under the former partnership's name and EIN. Also, pursuant to the terms of the buyout contract, the former partner continued to receive K-1s, *not* W-2s, until the buyout was completed (i.e., over the course of several years).

IRS Ruling: The IRS's Examination Division (Exam) put forth five specific questions to the Office of Chief Counsel, which resolved them as follows:

- Employment tax issue: Exam wanted to know whether the former partnership's employment tax returns were correctly filed under the former partnership's "old" EIN. The CCA observed that the partnership became a disregarded entity (i.e., a SMLLC) when its membership was reduced to just one member, at which time the partnership ceased to exist. But, the CCA noted that **Rev. Rul. 2001-61** provides that, when a partnership becomes a disregarded entity, and the disregarded entity chooses to calculate, report, and pay its employment tax obligations under its own name and EIN pursuant to **Notice 99-6**, the disregarded entity "must retain the *same* EIN for employment tax purposes it used as a partnership." Though **Notice 99-6** was obsoleted by **T.D. 9356**, **Reg. §301.7701-2(c)(2)(iv)(B)**, issued under **T.D. 9356**, also provides that the disregarded entity reports its employment tax obligations, *not* the owner. As a result, because the employment tax returns were filed under the former partnership's "old" EIN, they were proper.

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[5] Treas. Reg. §301.7701-2(c)(2)(i)

[6] Treas. Reg. §301.7701-2(c)(2)(iii)(A)(1)

[7] Treas. Reg. §301.7701-2(c)(2)(iii)(A)(2)

[8] Treas. Reg. §301.7701-2(c)(2)(iii)(A)(3)

- Treatment of business activity after change in status: Exam wanted to know whether it should treat all business activity *after* the former partnership became a disregarded entity (i.e., SMLLC) as that of now remaining owner's Schedule C sole proprietorship. The CCA said that it should, except with respect to employment tax, as addressed in the preceding issue. However, the CCA noted that if remaining owner passed through any self-employment income on a K-1, the government still would *not* have received any less employment tax than what was otherwise due.

Comment: Although a bit confusing, what they apparently are trying to say is that if the former owner was still getting **Code §736(b)** payments (i.e., until his partnership interest was fully liquidated), then a partnership return with K-1s coming out to both of them would be appropriate. But, once there was only one owner of this LLC, then all reporting would be done solely on a Schedule C.

- Treatment of returns: Exam wanted to know whether it should treat returns filed under the former partnership's name and EIN as filed under the sole proprietorship's owner's social security number (SSN) for statute of limitation purposes. The CCA said that the former partnership's employment tax returns should have been filed under the former partnership's old EIN, *not* the remaining owner's SSN. Because the employment tax returns were valid, the CCA stated that Exam will need to obtain statute extensions.

- Mechanics of statute extensions: Exam questioned who should sign the statute extensions, and in what capacity. The CCA instructed that remaining owner should sign any statute extension consent in his capacity as the owner of the disregarded entity (i.e., SMLLC).

- Notices: Exam wanted to know to whom notices should be issued. The CCA advised that notices should be issued to the owner of the now SMLLC disregarded entity because the partnership ceased to exist when its membership was reduced to one member. **(Code §7701; SMLLCs)**

Comment: There are a couple of other issues that should be mentioned when a multi-member LLC becomes a SMLLC (i.e., because one member buys out all of the interests of the other members, or the entity itself makes liquidating distributions to all but one of the LLC members). First, pursuant to **Code §732**, the one owner of this SMLLC can make the equivalent of a **Code §754** election and step up the inside basis of the now Schedule C proprietorship's assets (at least for the share of the assets deemed purchased from the other exiting members) to the FMV of what was paid on the outside for their interests (and, for which, bonus depreciation can be claimed). Second, as to any depreciable assets (or, amortizable, in the case of goodwill), the "old" **Form 4562** inside bases carry over to the extent of the share of assets that continue to be owned by this one remaining member on his now Schedule C (i.e., SMLLC) business. But, as to the bases of any other tangible or intangible assets deemed purchased from the exiting members, this would require a "fresh start" approach as to MACRS lives and holding periods (with a step-up in their bases, if this was elected by the continuing owner of the business).

Example: An LLC owned equally by A, B and C holds title to unencumbered property which it had purchased for $600,000 and which now has an adjusted basis of $300,000. Its current FMV is $900,000. A proceeds to buy out B and C's interests for $600,000. The entity is now classified as a SMLLC, solely owned by A. As far as **Form 4562**, A would continue to have a $100,000 basis for his share of the asset, and a stepped-up cost basis of $600,000 for the portion of the asset acquired by purchase (which would have "fresh-start depreciation" as to its life and method).

Comment: It goes without saying, that if this had been an LLC merely holding real estate (i.e., that was being reported on the **Form 8825** as part of the **Form 1065** partnership return), then the SMLLC would now be a **Schedule E** instead of a **Schedule C** (or, a **Schedule F** in the case of an agricultural or horticultural business previously reported on **page 1** of **Form 1065**). But, the issues discussed above would still be handled in the same fashion.

P. Miscellaneous Developments:

Note: The developments listed below are in chronological order with the latest items first.

☞**Guidance for Brokers on Withholding for Transfers of PTP Interests (Notice 2023-8)**

The IRS is providing additional guidance for brokers to comply with final regulations under **Code §1446(f)** related to withholding on the transfer of an interest in a Publicly Traded Partnership (PTP). The IRS has determined that "the burden on brokers to determine whether a foreign entity that trades on a foreign market is a PTP would likely be disproportionate to the amount of gain subject to **Code §864(c)(8)** on the transfer of such interests." The IRS intends to issue proposed regulations amending the final regulations to allow a broker that executes a sale of an interest in a foreign-traded entity "to presume that the entity is *not* a PTP for U.S. tax purposes unless the broker has actual knowledge otherwise." Additionally, the IRS will allow brokers to rely on late certifications for withholding purposes and will provide an exception to withholding on a PTP short sale, subject to certain limitations. **(Code §1446; PTPs)**

☞IRS Offers Alternative to Filing AAR (Rev. Proc. 2021-29)
The Service has now offered an alternative which will allow an eligible partnership to file an amended **Form 1065, U.S. Return of Partnership Income**, while also furnishing a corresponding **Schedule K-1, Partner's Share of Income, Deductions, Credits, etc.**, to each of its partners as an alternative option to filing an "administrative adjustment request (AAR)." However, the option to file amended returns only applies to partnerships that have *not* elected out of the centralized audit rules (i.e., **Bipartisan Budget Act of 2015** or "BBA partnerships"). BBA partnerships that filed a **Form 1065** and furnished all required **Schedules K-1** for the taxable years beginning in 2018, 2019, or 2020 and did so *prior to* the issuance of this revenue procedure may file amended partnership returns and furnish corresponding Schedules K-1 *on or before* October 15, 2021. **(Code §6031; Form 1065)**

> **Comment:** In this revenue procedure, the IRS is explaining how a partnership can change its recovery period for "certain residential rental property" (i.e., where the LLC has made a election to be a "real estate trade or business) to 30 years under the alternative depreciation system (ADS) by filing an amended **Form 1065, U.S. Return of Partnership Income**, rather than filing an administrative adjustment request (AAR). In other words, it would *not* have to file **Form 3115** to request a "change in accounting methods." However, this amended tax return does *not* change the fact that the partnership will still be subject to the centralized audit rules (i.e., it remains a "BBA partnership").

☞IRS Launches Centralized Partnership Audit Website (IR 2020-199)
The IRS has launched its **Bipartisan Budget Act (BBA) Centralized Partnership Audit Regime** website. Under the BBA, which is generally effective for tax years beginning on or after January 2018, the IRS generally assesses and collects any understatement of tax at the *partnership* (v. individual partner) level. The new website is intended to be a "one-stop location" for anything BBA-related, including regulations and other guidance and instructions related to the Partnership Representative (PR), electing out of the centralized audit regime, Administrative Adjustment Requests (AARs), and what to expect during a BBA administrative proceeding. The IRS hopes that taxpayers "will visit the website often" for information, including electronic submission instructions of forms related to a BBA examination (when those instructions are available).

The Service has also developed a flowchart in its efforts to explain this program. It provides a reminder that a partnership can opt to push out the adjustment with the associated tax to the partners on record for the audited tax year by issuing adjusted Forms K-1 to them. The partners would then take the changes into account on their own tax returns. Partnerships with 100 or fewer partners can opt out of these audit rules. IRS Pub. 5388 provides a "one-page road map" on the process, time frames and more. **(Misc.; IRS Audits)**

☞**New Guidance Issued for Centralized Partnership Audit Regime (Memorandum AP-08-1019-0013)**
The IRS has issued a memo that provides interim guidance for IRS Appeals employees on new case procedures for different phases of the centralized partnership audit regime enacted by the **Bipartisan Budget Act of 2015 (BBA)**. The new partnership audit regime generally provides that adjustment, assessment, and collection of tax due to audit adjustments will occur at the partnership (i.e., enity) level. Previously, adjustments were passed through to partners with ensuing tax, penalty and interest adjustments. The guidance is effective October 18, 2019, and will be incorporated into the **Internal Revenue Manual (IRM) Part 8.19 (Appeals Pass-Through Entity Handbook)** and addresses several phases, including (1) early election into **BBA**, (2) **Administrative Adjustment Request (AAR)**, (3) **Notice of Proposed Partnership Adjustment (NOPPA)**, (4) modification disputes, and (5) **Notice of Final Partnership Adjustment (FPA)**. **(Misc.; IRS Audits)**

☞**Draft of New Partnership Audit Liability Form and Schedule Released (Form 8978, Partner's Audit Liability Under Section 6226)**
The IRS has released a draft of new **Form 8978, Partner's Audit Liability Under Section 6226**, and **Schedule A, Partner's Imputed Underpayment (Supplemental)**, which will be used by partnerships making a "push-out election" under **Code §6226(a)(1)** to notify partners and the IRS of each partner's share of the partnership's audit adjustments.

Background: Generally, a partnership is required to account for IRS audit adjustments at the partnership (i.e., entity) level. (**Code §6225(a)(1)**) As a result, the partnership (and, *not* each individual partner) is subject to tax on any underpayment resulting from an audit. (**Code §6225(a)(1)**) However, **Code §6226(a)(1)**, which was added by the **2015 Bipartisan Budget Act**, provides an alternative to this general rule.

Under **Code §6226(a)(1)**, a partnership may elect to "push out" any audit adjustments made by the IRS to the persons who were its partners during the reviewed year. When a partnership makes this election, the partners, *not* the partnership, must account for any adjustments made by the IRS and pay any tax due resulting from those adjustments. The term "reviewed year" means the partnership tax year to which the item being adjusted relates. (**Code §6225(d)(1)**) A partnership making an election under **Code §6226(a)(1)** must also furnish a statement of each partner's share of any adjustment to income, gain, loss, deduction, or credit as determined in the **Final Partnership Administrative**

Adjustment (FPAA), to each person who was a partner of the partnership during the reviewed year and to the IRS. (**Code §6226(a)(1)**)

New Form 8978 and Schedule A: The IRS has released a draft of new **Form 8978**. Partnerships making a "push-out election" under **Code §6226(a)(1)** will use **Form 8978** to provide the statement of audit adjustments required by **Code §6226(a)** to the persons who were its partners during the reviewed year and to the IRS. The IRS has also released a draft of **Schedule A (Form 8978)**. Partnerships will use **Schedule A** to report each partner's name, tax identification number, and share of the partnership's adjustments, to the IRS. **(Code §6226; Partnership Audits)**

☞**IRS Issues Partnership Audit "Push-Out" Election Forms**

Under the "centralized partnership audit regime" enacted by the **Bipartisan Budget Act of 2015**, a partnership may elect to "push out" final audit adjustments determined at the partnership level within 45 days of the date the Notice of Final Partnership Adjustment (FPA) is mailed by the IRS. If elected, the tax attributable to the adjustments made at the partnership entity level is instead assessed and collected from the individual partners. The IRS has released **Form 8988, Election for Alternative to Payment of the Imputed Underpayment** (i.e., pursuant to **Code §6226**), for making the election. Among the requirements, the partnership must indicate whether it is making the election "for a general or a specific imputed underpayment," and it must furnish statements to partners (and, file an IRS copy) within 60 days of the adjustments in the FPA becoming finally determined. The IRS has also issued **Form 8989 , Request to Revoke the Election for Alternative to Payment of the Imputed Underpayment** to request IRS consent to revoke the election. **(Misc.; Centralized Partnership Audit Rules)**

Comment: The decision to *not* have the new "centralized partnership audit rules" apply needs to be made before filing **Form 1065** for the 2018 tax year (and, each year thereafter). The "elect out" decision is made on **Schedule B-2**. Any partnership agreements should also be modified accordingly. However, if the partnership otherwise issues a K-1 to either: (1) another partnership; (2) a disregarded entity; (3) a trust; or (4) "certain other partners" it is *not* eligible for this election. There is still some debate as to whether a partnership with a "revocable living trust" can make the election out. But since this entity is ignored for income tax purposes until it "springs into being" upon the death of the grantor, it should arguably *not* be a problem.

Comment: If an S corp is a partner in a partnership, then each K-1 issued to the owners of the S corp are counted for purposes of the "100-partner opt-out election."

Comment: For "smaller" partnerships (i.e., < 100 partners), language should perhaps be added to any partnership agreement that help maintain the ability to opt out of these new audit rules. For example, restrictions should be placed on the ability to transfer a partner's interest if it would result in the loss of this "opt-out election" (e.g., transfer to an "ineligible partner" such as another partnership).

Comment: If the new centralized audit rules will instead be in play, partnerships will need to select a representative to deal with IRS-related matters and list this person on the partnership tax return. They would be similar to a "tax-matters partner" but with more authority.

Comment: Consideration should be made as to adding restrictions as to the powers of the representative, such as specifying when they can "push out" additional taxes due to the individual partners, or whether they should be required to consult with the entity's leaders before hiring outside experts, initiating litigation, or making other binding decisions.

☞**Filing Relief for Certain Partnerships Affected by "Centralized Audit Regs" (Rev. Proc. 2019-32)**

Under **Code §6031(b)**, partnerships subject to the "centralized partnership audit regime" (i.e., **Bipartisan Budget Act of 2015 (BBA)** partnerships) are prohibited from amending the information required to be furnished to their partners *after* the tax return's due date. But, recognizing that some BBA partnerships made errors on their already-filed 2018 returns, the IRS is providing relief from **Code §6031(b)**. Specifically, the IRS will treat the timely filing of **Form 1065** by certain BBA partnerships as a "timely and appropriately filed request" for a six-month extension of the filing deadline. BBA partnerships that timely filed a **Form 1065** and timely furnished all required Schedules K-1 may file a *superseding* **Form 1065** and furnish corresponding Schedules K-1 *before* the expiration of the extended deadline. To take advantage of this relief, partnerships should write **"Superseding Form 1065 Pursuant to Revenue Procedure 2019-32"** on the top of their superseding **Form 1065**. **(Code §6031; Partnership Audit Rules)**

☞**Final Regulations on New Partnership Audit Regime Released (TD 9839)**

The Treasury has released final regulations on the new partnership audit regime (enacted under **Section 1101** of the **2015 Bipartisan Budget Act**). The regulations modify proposed regulations issued last year regarding the designation and authority of the partnership representative. For example, under the new rules, a disregarded entity can be a "partnership representative" if it (and, the individual designated to act on its behalf) "has a substantial presence in the U.S." In addition, the final regulations adopt, without substantive modifications, temporary regulations issued in 2016 on the election to apply the new partnership audit rules to partnership tax years beginning *after* 11/2/15 and *before* 1/1/18. **(Misc.; Partnership Audits)**

> **Comment:** The final regulations are effective on 8/9/18 and affect partnership tax years beginning *after* 12/31/17 (unless early adoption is elected). Also, **Schedule B-2** for Form 1065 has now been released and must be filed *annually* in order for "smaller" partnerships to elect out of these audit rules.

☞**New Partnership Audit Rules Apply to Tax Years Beginning after Dec. 31, 2017**

For tax years beginning after Dec. 31, 2017, the new "centralized partnership audit rules" will apply. The "unified partnership audit and litigation rules" currently in effect were enacted as part of **TEFRA** in 1982 and are commonly referred to as the "TEFRA partnership procedures." Then, the **Bipartisan Budget Act of 2015** repealed the TEFRA partnership procedures and the existing rules applicable to "electing large partnerships," replacing them with the new rules summarized below.

> **Comment:** The IRS has issued final regs (which basically follow the proposed regs that were originally issued in June 2017) regarding the election out of the centralized partnership audit regime rules. **(T.D. 9829)**

Generally, under **Code §6221**, any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership tax year (and, any partner's distributive share thereof) will be determined, and any tax attributable thereto will be assessed and collected, at the partnership (i.e., entity v. owner) level. The applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to any such item or share will also be determined at the partnership level.

Nevertheless, **Code §6221(b)** will allow partnerships that are required to furnish *100 or fewer* Schedules K-1, to elect out of this new regime. Generally, a partnership will be able to elect out only if each of its partners is an individual, corporation (including certain types of foreign entities), or estate (and, arguably, grantor trusts).

> **Comment:** This election, however, **must be made annually**. Moreover, with a significant change in ownership, current day partners could be paying interest, tax and penalties for an IRS adjustment pertaining to a prior tax year that they had no involvement in.

Partnerships were allowed to elect to have most of the new partnership audit regime apply to returns of the partnership filed for partnership tax years beginning *after* Nov. 2, 2015 (i.e., the BBA's enactment date) and *before* Jan. 1, 2018. However, effective for tax years beginning *after* Dec. 31, 2017, the centralized partnership audit rules become *mandatory*, rather than elective, except for partnerships that meet the above 100-or-fewer exception. **(Code §6221; Partnership Audit Rules)**

☞**IRS Issues Additional Proposed Partnership Audit Regulations (REG-118067-17)**

In June 2017, the IRS issued proposed regulations on the centralized partnership audit regime that addressed electing out of the regime, filing administrative adjustment requests, and determining amounts owed by the partnership or its partners. Additional regulations were later proposed on international provisions under the regime and procedures for tiered partnerships to push out audit adjustments. In an effort "to fill in the gaps in areas reserved by these regulations," the IRS has now issued additional proposed rules that provide guidance on how partnerships and their partners adjust tax attributes to take into account partnership adjustments under the new regime. Specifically, the proposed regulations provide rules on (1) adjusting partnership asset basis and book value; (2) creating "notional" items; and (3) allocating such notional items under **Code §704(b)**. **(Prop. Reg. §§1.704-1, 1.705-1 , 1.706-4 , 301.6225-3 , 301.6225-4 , and 301.6226-4; Partnership Audits)**

> **Comment:** The new audit regime applies to partnership tax years beginning after 12/31/17, but partnerships can elect to apply it for partnership tax years beginning after 11/2/15.

☞**Partnership Audit Provisions Modified in New Bipartisan Budget Act of 2015 (H.R. 1314)**

The **Bipartisan Budget Act of 2015**, which has been passed by the House and Senate and is expected to be signed by the President, contains important provisions dealing with partnerships audit rules. With respect to partnership tax years beginning after 2017 (or, earlier if elected), the Act replaces the current "TEFRA uniform partnership audit and electing large partnerships rules" with a streamlined single set of rules for auditing partnerships and their partners at the partnership level. Under the new "streamlined audit approach," any adjustment to partnership income, gain, loss, deduction, or credit (and, any partner's distributive share of such adjustment) is determined at the partnership level. Similarly, any tax attributable to such adjustment is assessed and collected, and the applicability of any penalty, addition to tax, or additional amount relating to the adjustment, is determined at the partnership level. **(Code §§6221 to 6241; IRS Audits)**

> **Comment:** The bottom line on these changes is that the Service is going to have an easier time auditing large partnerships. Last year, it examined less than 1% of partnerships with over 100 partners, in part due to the demand that any adjustments be computed at the partner level. And, with some larger partnerships having up

to thousands of partners, this proved to be a difficult task for the IRS. The examination process will now be streamlined because of the budget deal. Under the new approach, the Service will audit the partnership's tax return and collect any additional taxes due from the partnership (and, *not* the partners individually). Alternatively, a partnership will have the option of issuing adjusted K-1 forms to the partners, who would then take the changes into account on their own tax returns. Smaller partnerships (i.e., those with 100 or fewer partners) would still be able to opt out, so that the agency would have to make adjustments to each partner's return.

☞**IRS Reissues Proposed Partnership Audit Regs (REG-136118-15)**
Earlier this year, the IRS released proposed regulations on the new partnership audit regime enacted under **Section 1101** of the **2015 Bipartisan Budget Act**. However, these regulations were withdrawn in accordance with a "regulatory freeze" instituted by the Trump administration. The IRS has now reissued the proposed rules, which are "virtually identical to the withdrawn regulations." The proposed regulations provide procedures for electing out of the "centralized partnership audit regime, filing administrative adjustment requests, and determining amounts owed by the partnership or its partners for adjustments arising from a partnership examination." **(Misc.; Partnership IRS Audits)**

Comment: The new audit regime applies to partnership tax years beginning after 12/31/17, but partnerships can elect to apply it for partnership tax years beginning after 11/2/15.

☞**IRS Releases Temporary Regs on Electing into Partnership Audit Rules (TD 9780)**
The IRS has released temporary regulations regarding the election to apply the new partnership audit regime, which takes effect in 2018, to tax years beginning *after* 11/2/15 and *before* 1/1/18. The regulations specify the time, form, and manner for making this election. In general, the election must be made within 30 days of receiving a notice from the IRS that a return has been selected for examination. Once made, the election cannot be revoked without IRS consent. **(Code §7805; Partnership Audits)**

Comment: Basically, the IRS is streamlining its approach in auditing partnerships. The agency will audit the partnership's tax return and collect any additional tax due directly from the partnership and *not* the partners. Alternatively, a firm will have the option to instead issue adjusted K-1 forms to the partners, who will account for the changes on their own tax returns. Partnerships with 100 or fewer partners can elect out of these audit rules, however, so that the Service in that case would have to make adjustments to each partner's return.

Comment: The regulations are effective 8/5/16 and will expire on 8/5/19. These rules are also found in proposed regulations (**REG-105005-16**) and are subject to a 60-day comment period.

☞**Service Pledges More Audits of Flowthrough Entities**
There is no question that audits of partnership entities by the IRS have been deplorable in recent years. Currently, the Service audits less than 2 partnership returns out of every 1,000 Form 1065s filed (i.e., less than 0.2%). Even then, about 50% of exams result in no change to taxes at the partner level. As a result, the IRS has pledge to improve these figures and bring in additional tax revenues by dramatically increasing its enforcement efforts.

The Service has announced that it will be hiring more revenue agents, tax law specialists and attorneys with experience in pass-through entity taxation to work on audits involving large partnerships and LLCs. It has also made changes to the **Form 1065** and is updating its models for selecting partnership returns to audit. Targeted compliance campaigns will focus on some of the more complex issues relating to partnerships and their owners. One of the key issues that IRS auditors will take an in-dept look at involve large losses claimed by partners on their 1040s.

Comment: Right now, **Form 7203** is required as an attachment to Schedule E, page 2 whenever an S corporation share hold claims a K-1 loss, receives a distribution, disposes of their stock or receives a repayment of a loan made to the S corporation. Nevertheless, there is currently no similar form for partners.

The Service is concerned that partners claiming flow-through K-1 losses from partnerships on their individual returns might not have sufficient adjusted basis in their partnership interests to do so (or, the at-risk and passive loss rules have not been properly taken into account). Another key issue is whether partners who sell their partnership interests are properly determining not only the amount of the gain or loss, but also the character of such gain or loss (i.e., pursuant to **Code §741** and **751**.

Centralized Audit Regime: The IRS was hoping that its new "centralized partnership audit regime" would result in a significant increase in the audit of more partnerships, as well as making it easier to collect any additional taxes owed. Many larger partnerships have multiple levels of ownership, with hundreds or thousands of partners. Previously, when the Revenue Service examined one of these huge partnerships and proposed changes, it had to track down each and every partner and make the adjustments to their respective returns. That required more personnel and resources than the agency otherwise had available.

This new regime applies to partnership returns filed for tax years beginning after 2017 and allows the IRS to audit the partnership's tax return and collect any tax due solely from the partnership entity and not each individual partner. The partnership can then elect to push out the tax to the partners on record for the audited tax year by issuing adjusted **Forms K-1** to them with the partners then taking the changes into account on their own tax returns.

Partnerships with 100 or fewer partners can elect out of these centralized audit rules. **IRS Pub. 5388** for a one-page road map on the process, time frames and other pertinent information. Nevertheless, this new audit program has failed to make a dent in IRS's "no-change rate." As a matter of fact, it is even worse now. In 2019, the IRS began auditing selected 2018 **Form 1065s** under the new regime and closed 78% of those exams with no change to taxes, Treasury inspectors stated in a recent report. The Service agrees with the GAO that the no-change rate is too high, but it continues to insist that "it is too early to reach any definite conclusion about that finding." **(Misc.; IRS Audits)**

☞**IRS Audits of Partnerships Slated to Increase**

While the explosive growth of partnerships "does *not* automatically suggest that IRS must increase its audits of large partnerships, it can be expected that the agency will exercise more flexibility in deploying its depleted auditing resources and not just concentrate on large C corporations," according to IRS officials speaking at a District of Columbia Bar Taxation Section meeting. When it comes to partnerships, the IRS is focusing on the "right returns," said Rosemary Sereti, acting deputy commissioner for services and enforcement. "Streamlining the audit process for large partnerships is the wave of the future," said William Heard, senior counsel in the Office of Associate Chief Counsel (Procedure and Administration). A possible way to accomplish this is "to forget about tiers and assess the first passthrough to the top partners," he said. At that point, it is the partners who have to handle the tax liability with indirect partners, Heard continued. Basically, the IRS "no longer has the resources to assess thousands of partners," he added. **(Misc.; IRS Audits)**

☞**IRS Not Effectively Using K-1 Information for Audit Purposes (Audit Report No. 2019-30-078)**

A recently released TIGTA audit determined that with "better use" of **Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc.** details by the IRS, it could "aid the agency in dealing with taxpayer noncompliance." According to TIGTA, it "initiated [the audit] to determine whether the IRS uses Schedule K-1 data effectively to identify taxpayers *not* submitting tax returns or taxpayers underreporting tax while also minimizing unnecessary notices to taxpayers." As stated in the audit report, "Schedules K-1 are used by flow-through entities to report recipients' allocated share of income, deductions, credits, and other amounts." The first key finding of the audit stated that the IRS "annually accepts flow-through returns with approximately 3 million ... Schedules K-1." **The audit also found that the IRS "did *not* identify approximately 4,000 nonfilers who received $25,000 or more of Schedule K-1 income**, and could improve identification of underreporter noncompliance." **(Misc.; K-1 Matching Program)**

> **Comment:** TIGTA made 11 recommendations of which the IRS rejected only one.

☞**Partnership Avoids Imposition of IRS Fraud Penalty (*Genecure*, TC Memo. 2022-52 (5/23/2022))**

A partnership was able to avoid a fraud penalty that the IRS first imposed in its **Notice of Final Partnership Administrative Adjustment** issued to the firm on April 9, 2015. The Service maintained that prior written supervisory approval for the penalty was obtained prior to this date. Nevertheless, it was uncovered that the approval related to the penalties asserted against the majority partner in his *individual* capacity, and *not* the partnership entity. **(Misc.; Partnership Audits)**

☞**More Partnership Audits Result in No Changes (TIGTA 2012-30-060)**

According to the **Fall 2011 Statistics of Income Bulletin**, since 2000, the **number of partnerships has increased at an average annual rate of 5.1%**, with the majority of this growth coming from partnerships classified as LLCs. And, given this dramatic growth as the entity of choice, one would perhaps expect that the IRS would have been honing its partnership examination skills. However, this Treasury Inspector General for Tax Administration report indicates otherwise. **While the IRS closed nearly 25% more partnership exams in fiscal year (FY) 2011 than in FY 2007, 50% of the returns selected for audit by the "tried-and-true Discriminant Index Function" (i.e., DIF score) were closed as a "no-change."** Furthermore, no "significant quality problems" were identified that would suggest how the items selected and audited on the returns could substantially improve this no-change rate. **(Misc.; Tax Audits)**

> **Comment:** One of the main issues that has come up during these audits is that the partners have had to prove their basis in their respective ownership interests so as to demonstrate their ability to take any K-1 losses flowing out to them. Along these lines, they also are having to prove their "material participation" in the partnership's day-to-day activities. Otherwise, the IRS is insisting that such passive losses (absent other sufficient passive income sources to cover them) be suspended on Form 8582.

☞**Individuals' SOL Extension Also Extended Assessment Date for Their Partnership Income (*Inman Partners*,**

TC Memo 2018-114 (7/23/2018))

The Tax Court confirmed that, where several individuals who were partners in a partnership each agreed to extend the statute of limitations (SOL) on assessment for any income tax on any return made by or for them "for the period ended Dec. 31, 2000," the extension also applied to partnership items from the partnership whose tax year ended Dec. 19, 2000. **(Code §6501; Statute of Limitations)**

☞**Individuals Considered Owners of Property Held Through Mexican Land Trusts (Rev. Rul. 2013-14)**

Although the Mexican Federal Constitution prohibits non-Mexican persons from directly owning residential real property in certain areas of Mexico ("restricted zones"), non-Mexican persons are permitted hold residential real property located in the restricted zones through a Mexican Land Trust (MLT) with a Mexican bank after obtaining a permit from the Mexican Ministry of Foreign Affairs. This new revenue ruling examines three separate fact patterns and concludes that the MLT is *not* a trust for U.S. income tax purposes in all three scenarios under **Reg. §301.7701-4(a)**. In Situation 1, the bank's only duties are to hold and transfer legal title at the direction of an SMLLC (i.e., which is a disregarded entity for U.S. income tax purposes), which has the right to manage, control, collect rent, and the obligation to pay taxes and other expenses. Since the SMLLC is treated as a disregarded entity, the U.S. individual is instead treated as the owner of the property for tax purposes. The analysis is the same in Situation 2, since the entity (which is a corporation instead of a disregarded LLC) is treated as the owner. In Situation 3, the rights and obligations are held directly by the individual, who is treated as the owner of the real property. **(Code §7701; Mexican Land Trusts)**

Comment: There continue to be more U.S. individuals investing in second or retirement homes in Mexico and this IRS ruling is a good review of the tax issues involved. Remember, however, that most purchases of "time shares" in Mexico should be distinguished since they do *not* involve any direct ownership of the underlying real estate at all.

☞**Tax Treatment of Series LLCs Clarified (PLR 200803004)**

A "**series limited liability company**" (SLLC) is an entity that provides limited liability protection to the owners of each entity in the series. However, the federal tax status of an SLLC and each of its series has been somewhat uncertain. But, this recent private letter ruling provides some guidance concerning the federal tax treatment of an SLLC by concluding that each series will be viewed as one *separate* tax entity. Furthermore, based upon its characteristics and elections, it will have its own tax status independent of each other series.

Background: Several states have enacted SLLC statutes. In '96, Delaware enacted the first SLLC statute, and it continues to be one of the more developed statutes. Illinois also has a well-developed SLLC statute. Iowa, Nevada, Oklahoma, Tennessee, and Utah have also enacted SLLC statutes. The basic concept of an SLLC is that its single operating agreement establishes separate series similar to separate LLCs, each with its own objectives, voting rights, management, and liability. One reason for the use of a series is to reduce administrative costs incurred by organizing separate entities. Several examples include holding one manager and member meeting for all of the entities in the series; filing one registration document for entities required to register with the Securities and Exchange Commission; and reducing formation and maintenance costs by allowing the creation of additional series simply by using the provisions of the operating agreement without requiring the filing of separate organization documents with the state.

Comment: Although SLLCs can provide businesses with cost and administrative benefits, it appears that few businesses have utilized the SLLC structure, possibly due to the fact that there is little statutory or case law, or administrative guidance, on the treatment of SLLCs and until now the federal tax status of an SLLC has been uncertain.

Possible Tax Treatment of SLLC: Prior to **PLR 200803004**, neither Congress, the courts, nor the IRS had provided any guidance on the federal tax classification of an SLLC. The regs establish mandatory classification for federal tax purposes for some entities and a procedure for electing a tax classification for other entities. If an entity meets the requirements of **Reg. §301.7701-2**, **Reg. §301.7701-3**, and **Reg. §301.7701-4**, it is *not* subject to mandatory tax classification and it has the option to choose to be classified as either: (1) a disregarded entity if it has only one owner or a partnership if it has more than one owner or (2) a corporation. However, the entity must be: (1) separate from its owners; (2) a business entity; and (3) an eligible entity (i.e., *not* a "per se corporation").

Comment: A "per se corporation" is any one of seven categories of business entities described in the regs that is subject to the corporate income taxation rules of the Code and is *not* entitled to elect its tax classification. A business entity that is *not* a "per se" corporation is an eligible entity, such as an LLC.

The threshold question to determine the tax classification of an SLLC is whether each series is treated as a separate entity. Prior to **PLR 200803004**, it appeared that SLLCs could be classified in different ways, including: (1) Each series of an SLLC could be treated as a separate entity; or (2) The SLLC could be treated as a parent company that is the sole owner of each of its series that is taxed as a disregarded entity, in which case the SLLC and all of its series could be treated in the aggregate as a single entity. Assuming that each series could be taxed separately, there was further uncertainty before **PLR 200803004** as to whether all of the series must have the *same* tax classification.

IRS Ruling: PLR 200803004 appears to be the first ruling on the taxation of an SLLC. It holds that each series of an SLLC is a separate entity for federal tax purposes. The IRS issued the private letter ruling to a group of insurance company taxpayers that were reorganizing their mutual fund operations as a Delaware SLLC. Therein, the IRS implicitly ruled that each series of the SLLC is a separate entity for federal income tax purposes and each series is entitled to choose its own entity classification independent of the classification of other entities in the series.

> **Comment:** Although the facts of the letter ruling involved particular types of taxpayers (i.e., mutual funds used to fund variable annuity and life insurance contracts), its analysis and holdings should be broadly applicable to SLLCs conducting other types of activities.

Organizing an SLLC: Technically, **PLR 200803004** reflects the IRS's holding on only the transactions described therein and another taxpayer may *not* rely on the letter ruling. Nevertheless, the Delaware statute, IRS's prior rulings on series trusts, and **PLR 200803004** provide a blueprint for organizing an SLLC with increased certainty that the IRS will treat each series as a separate entity. But, because the SLLC is a relatively new type of state law entity and few states have established SLLC statutes, it is recommended that an SLLC be organized in one of the states that have passed an SLLC statute, such as Delaware. The Delaware Limited Liability Company Act includes a provision that deals specifically with SLLCs. Although other SLLC statutes may also be used, the Delaware statute has this distinct advantage, namely, the IRS ruled in **PLR 200803004** that each series of a Delaware SLLC is a separate entity.

SLLC Operating Agreement: Each series of a Delaware SLLC having the characteristics of a separate entity pursuant to the terms of its operating agreement and under Delaware law should be treated as a separate entity for federal income tax purposes. But, to assure greater certainty that the IRS will treat each series as a separate entity, it is recommended that the operating agreement of an SLLC include the following provisions (which are permitted under the Delaware Statute):

- **Separation:** Each series will consist of a separate pool of assets, liabilities, and stream of earnings.

- **Ownership:** The members of each series may share in the income only of that series, and the ownership interest of the members in a series will be limited to the assets of that series upon redemption, liquidation, or termination of such series.

- **Liabilities:** The payment of the expenses, charges, and liabilities of a series is limited to that series' assets and the creditors of each series are limited to the assets of that series for recovery of expenses, charges, and liabilities.

- **Separate Business:** Each series may have a separate business purpose or investment objective.

- **Voting:** Votes of the various members may be conducted by each series separately with respect to matters that affect only that particular series. **(Code §7701; Series LLCs)**

☞**Final Regs Shorten Automatic Filing Extension Period for Certain Passthrough Entities (T.D. 9407)**

The IRS has finalized temporary regs issued in 2005 which dealt with "simplified automatic extension procedures" for a wide array of taxpayers. It also issued temporary (as well as corresponding proposed) regs **shortening from six to five months** the automatic extension period for certain passthrough entities.

> **Comment:** With the due date for Form 1065 partnership returns now being March 15th (at least for calendar year entities), the extension for such returns is **back to 6 months** so that the extended due date is now September 15th.

Automatic Extension Rules: In general, the new regs finalize the automatic extension rules and procedures issued in 2005 temporary regs (which were effective for applications for an automatic extension of time to file returns filed after 2005).Here is a summary of the key provisions contained in the final regs:

- Permit an individual to obtain an automatic six-month extension to file an income tax return by submitting a timely, completed application for extension on **Form 4868**.Taxpayers must make a proper estimate of any tax due and failure to pay any tax as of the original due date of the return may subject the taxpayer to penalties and interest. (**Reg. §1.6081-4**)

- The rules on filing extensions for corporate income tax returns (i.e., automatic six-month extension of time to file their income tax returns on **Form 7004**) have *not* been changed but the title has been altered to "Application for

Automatic 6-Month Extension of Time to File Certain Business Income Tax, Information, and Other Returns" and now permit certain other types of entities to also use Form 7004 to request an automatic six-month extension of time to file. (**Reg. §1.6081-2, Reg. §1.6081-3, Reg. §1.6081-6**)

- Administrators and sponsors of employee benefit plans subject to the Employee Retirement Income Security Act of 1974 (ERISA) will now be allowed to report information concerning the plans and direct filing entities to use a special version of **Form 5558**, Application for Extension of Time To File Certain Employee Plan Returns, for an automatic 2½ month extension of time to file. (**Reg. §1.6081-11**)

- Donors who do *not* request an extension of time to file an income tax return under **Code §6075(b)(2)** will now be able to request an automatic six-month extension of time to file **Form 709**, United States Gift (and Generation-Skipping Transfer) Tax Return, by filing a **Form 8892**, Payment of Gift/GST Tax and/or Application for Extension of Time to File Form 709. (**Reg. §25.6081-1**)

Consolidated Returns: The final regs retain the requirement that extensions for affiliated groups of corporations filing a consolidated return include a statement listing the name and address of each member of the affiliated group. They also explicitly provide that the attached list will grant an extension for each member's separate return in the event that the member does *not* file as part of the consolidated group. (**Reg. §1.6081-3(a)(4)**)

Shorter Automatic Extension Period for Passthrough Entities: The temporary regs issued in 2005 provided for a six-month automatic filing extension for partnerships, estates or trusts required to file an income tax return, and real estate mortgage investment conduits (REMICs). These new temporary regs changed the automatic filing extension period to *five* months, with no additional extension for certain pass-through entities, for partnerships filing **Form 1065** or **Form 8804** (Annual Return for Partnership Withholding Tax), and estates and trusts filing **Form 1041**. (**Reg. §1.6081-2T(a)(1), Reg. §1.6081-6T(a)(1)**)

Comment: The 6-month extension period continues to apply to certain electing large partnerships, certain specialized entities such as those required to file an income tax return for qualified funeral trusts, and to REMICs. However, this new five-month extension period will hopefully mean that individual owners will now have a better chance to get their extended Form 1040s in on time a month later (i.e., Oct. 15th). Even the IRS stated that the extension period "was abbreviated out of concern that an individual or corporate partner may *not* receive a K-1 information return from a partnership that got an automatic 6-month extension period before the individual's or corporation's extended due date, forcing the partner to file using estimates of income and then file an amended return after it receives the K-1."

Comment: The IRS says it believes that a five-month automatic extension period "strikes a reasonable balance and reduces the overall burden on taxpayers." The five-month extension period "allows pass-through entities, including complex and tiered entities, an adequate time to prepare the required pass-through return" and also "ensures the timely and accurate dissemination of information to a large number of taxpayers who require that information for completion of their own income tax returns." However, the IRS recognizes that some corporations with ownership interests in pass-through entities may continue to experience delayed receipt of the information needed to complete their own corporate returns and some pass-through entities may find it difficult to complete their returns. As a result, the IRS is requesting comments on whether the five-month automatic extension of time to file for these pass-through entities increases or reduces overall taxpayer burden.

Effective Date: The new regs generally are effective for applications for extension of time to file returns after July 1, 2008. However, the temporary regs allowing certain pass-through entities to obtain an automatic five-month extension apply to applications by those entities for an automatic extension of time to file affected returns due on or after Jan. 1, 2009. These entities may obtain an automatic six-month extension of time to file applicable returns which are required to be filed before Jan. 1, 2009. **(Code §6081; Return Extensions)**

Note: The following articles highlight the changes made over the years with regard to Form 1065 and provide a sense of how the form has evolved to its present version.

☞IRS Unveils Proposed Redesigned Partnership Form for 2021 (IR 2020-155)

The IRS has released a proposed redesigned partnership form for tax year 2021 (i.e., for the 2022 filing season). The new form "is intended to provide guidance on how to report international tax information to partners in a standardized format." The new **Schedule K-2 (Partners' Distributive Share Items-International)** replaces portions of the existing **Form 1065, Lines 16(a)** through **16(r)**. The new **Schedule K-3 (Partner's Share of Income, Deductions, Credits, etc.- International)** replaces portions of **Schedule K-1, Part III, Boxes 16** and **20**. According to the IRS, the redesigned form would be used "only if the partnership has items of international tax relevance" (i.e., generally foreign activities or foreign partners). The proposed changes would *not* affect domestic partnerships with no international tax items to report. **(Misc.; Form 1065)**

☞Partner Capital Accounts Not Only Change to 2020 Form 1065

The IRS has issued 2020 draft **Form 1065, U.S. Return of Partnership Income**, along with **instructions**. A great deal of attention has been paid to the revised instructions for partnerships required to report capital accounts to partners on their K-1s. Nevertheless, there are several other notable changes.

Background: With the release of **IR 2020-240** the IRS announced the publication of the 2020 draft **Form 1065 instructions** while also discussing the revised instructions for partnerships required to report capital accounts to partners on **Schedule K-1 (Form 1065)**.

Additional Changes to Form 1065 and Instructions: Below is a list of some of the other significant changes in the draft **Form 1065** and its instructions.

- Page 1- Form 1065:

1) Changes to reflect provisions of COVID-related legislation: The instructions for **Line 7, Other income**, require that the amount of payroll tax credit taken by the partnership for "qualified sick leave and/or family leave" be shown on **Line 7** as an addition to income, in order that "double tax benefit" is *not* created. The same applies to the amount of "self-employment tax credit" taken by self-employed individuals for "qualified sick leave equivalent and/or qualified family leave equivalent."

2) Instructions for Line 15, Interest Deduction: These instructions have been changed to reflect the COVID-related legislative changes to the business interest deduction under **Code §163(j)**.

Comment: Keep in mind that the **CARES Act** made several changes to this limitation such as *retroactively* increasing the "adjusted taxable income" (ATI) threshold from 30% to 50%, while also allowing the use of the ATI for 2019 on the 2020 tax return of the business.

- Page 3 - Form 1065:

1) Schedule B, question 27: The instruction to this question, about foreign partners being subject to **Code §864(c)(8)** as a result of their transfers of their partnership interest or receiving distributions, has been updated to reflect **TD 9919**.

- Schedule B, Question 29: New **Question 29** has been added to **Schedule B**, regarding a foreign corporation's direct or indirect acquisition of substantially all of the properties constituting a trade or business of the partnership.

- Schedule K - Partners' Distributive Share Items:

1) Charitable Contributions, Line 13a: These instructions have been amended to reflect COVID-related legislation (e.g., the ability to deduct certain cash contributions in amounts up to 100% of AGI).

2) Other credits, Line 15f: The employee retention credit and the employer credit for paid family and medical leave were *not* mentioned in the original version of the 2019 instructions but were added in the revised version of those instructions which were issued in the spring of 2020. They are again mentioned in the 2020 instructions as credits to be listed on **Line 15f**.

3) Codes for Schedules K and K-1: Complete descriptions of codes for **Schedules K** and **K-1** are provided in the **Form 1065** instructions at **"Specific Instructions (Schedules K and K-1, Part III, Except as Noted)."** As a result, the codes are no longer listed on **page 2** of **Schedule K-1**.

Comment: Especially with the "codes" relating to Sec. 199A information, these continue to be "condensed" into just one **"Code Z."** Nevertheless, we still need to give K-1 recipients the necessary information to properly determined this 20% deduction on their personal tax returns such as: (1) Whether the entity is an SSTB or a non-SSTB, or a "hybrid entity" (e.g., optometrist who does both exams and sells eye-ware); (2) Are the rents in **Box 2** coming from an SSTB that the landlord/lessor controls, or from a non-SSTB, or other unrelated third-parties (whether or not these third-parties are SSTBs or non-SSTBs, and regardless of type of entity); (3) The owner's share of QBIA and/or wages; and (4) the owner's share of REIT dividends and/or PTP gains or losses.

- Schedule L - Balance Sheets per Books: There is no longer a requirement to reconcile **Schedule L** to **Schedule M-2**, unless **Schedule L** is reported on a "tax basis."

- Additions to the Instructions, that do *not* apply to a single line on Form 1065: The instructions contain the following additions that do *not* specifically refer to a particular line on the form:

1) Related-party payments to certain hybrid entities;

2) Disregarded entity and **Code §743(b)** Reporting (i.e., **Sec. 754** adjustments);

3) Revocation of a **Code §754** election using new **Form 15254**;

4) Technical terminations and **Code §708** relating to the continuation of a partnership;

Comment: "Technical terminations" (i.e., where > 50% of the ownership of a partnership shifted within a 12-month period) were eliminated by the **TCJA** for post-2017 tax years.

5) Substantial built-in loss rules for **Code §743** (i.e., where the Sec. 754 downward adjustment is mandatory since the decrease in the FMV partnership's asset(s) was > $250,000 when compared to the total adjusted bases of the entity's assets;

6) Additional instructions with respect to partnership audit procedures (e.g., electing out of the "centralized audit partnership rules on an *annual* basis) and administrative adjustment requests under the **Bipartisan Budget Act of 2015**. **(Misc.; Form 1065)**

☞**IRS Issues Revised Instructions for 2020 Form 1065 and Schedule K-1 (Rev. 1/14/2021)**
The IRS has issued a revised draft of the 2020 instructions for **Form 1065, U.S. Return of Partnership Income**. The draft instructions also include some new instructions regarding **Schedule K-1**.

Background: Form 1065 is an information return used to report the income, gains, losses, deductions, credits, and other information from the operation of a partnership. It is also used to report to the IRS each partner's share of the partnership's income, deductions, credits, etc. In October 2020, the IRS issued draft instructions for the 2020 **Form 1065** and **Schedule K-1** that included revised instructions for partnerships required to report capital accounts to partners on **Schedule K-1**.

Revised Instructions: The latest draft instructions note the following changes:

- Business interest expense: Reg §1.163(j)-6(h) created a *new* **Code §704(d)** loss class for business interest expense effective for tax years beginning *after* November 12, 2020. As a result, all partnerships must report business interest expense to partners on **Schedule K-1** in **Box 20 (Other Information)** using **Code N**.

- Code §448(c)(2) gross receipts: In order to qualify as a "small business" under the TCJA and therefore to be permitted to use the cash method of accounting, partnerships and partners must determine their "average gross receipts." In addition, such "smaller businesses" will also avoid the **Code §163(j)** business interest expense deduction limitation.

- Gross receipts reporting: For tax years ending *after* December 30, 2020, partnerships with current year gross receipts greater than $5 million are required to report their current year gross receipts to partners. And, for tax years ending *after* December 30, 2021, a partnership that has current year gross receipts greater than $5 million will also be required to report gross receipts to partners for the *three immediately preceding* tax years as well as gross receipts for the current year. This will be reported in **Box 20** of **Schedule K-1** using **Code AG**.

- Other changes: Clarifications have been made to the instructions for **Line 11 (Repairs and Maintenance)** of **Form 1065** and for determining a partnership's "qualified trades or businesses." Information regarding a partnership's qualified trades or businesses is reported on **Schedule K-1** so that a partner can determine their **Code §199A** qualified business income (QBI) deduction. **(Misc.; Form 1065 Instructions)**

☞**IRS Releases Draft 2019 Forms 1065, 1120-S, and Schedules K-1 (IR-2019-160)**
The IRS issued has issued a draft of the tax year 2019 **Form 1065, U.S. Return of Partnership Income (PDF)**, and its **Schedule K-1, Partner's Share of Income, Deductions, Credits, etc (PDF)**. The changes to the form and schedule are intended "to improve the quality of the information reported by partnerships both to the IRS and the partners of such entities." For example, among the changes is the addition of a checkbox that allows a taxpayer to indicate if "certain grouping or aggregation elections" have been made. The changes also "reflect updates consistent with changes resulting from the **Tax Cuts and Jobs Act**." The additional information requested in the draft **Form 1065** and **Schedule K-1** is intended to "aid the IRS in assessing compliance risk and identifying potential noncompliance while ensuring that compliant taxpayers are less likely to be examined." The IRS believes these changes to **Form**

1065 and **Schedule K-1** “will improve tax administration in the partnership arena, an area of critical importance to the IRS.” In addition, certain similar changes can be found in the draft of the tax year 2019 **Form 1120-S, U.S. Income Tax Return for an S Corporation (PDF)**, and its **Schedule K-1, Shareholder's Share of Income, Deductions, Credits, etc., (PDF)**.

Over the past 15 years, tax filings by partnerships have seen a dramatic increase. For calendar year 2004, about 2.5 million partnerships filed **Form 1065**; by calendar year 2017, that number had risen to more than 4 million, an increase of 59 percent. The rise in filings by partnerships was dramatically greater than the rise in filing by C-corporations and S-corporations, combined, which rose about 14 percent over the same timeframe. This increase in filings “reinforces the IRS's need to improve the data available for its compliance selection processes.” **(Misc.; 2019 Tax Forms)**

> **Comment:** The draft 2019 **Form 1065 and Schedule K-1**, as well as the draft Form 1120-S and its Schedule K-1, are “near-final forms.” The drafts “are intended to give tax practitioners a preview of the changes and software providers the information they need to update systems” before the final version of the updated forms and schedules are released in December.

☞**Draft Instructions for 2019 Form 1065 and Schedule K-1 Released**

The IRS has now released draft **instructions** for the 2019 **Form 1065** **(U.S. Return of Partnership Income)**. The draft instructions also include instructions for **Schedule K-1** **(Partner's Share of Income, Deductions, Credits, Etc.)**.

Background: Form 1065 is an information return used to report the income, gains, losses, deductions, credits, and other information from the operation of a partnership. Meanwhile, **Schedule K-1** is used to report income, deductions, and credits allocated to partners and S corporation shareholders. The IRS *previously released* a draft of **Form 1065** and **Schedule K-1** for 2019. However, the *new* instructions include the following changes:

Changes to Schedule B of Form 1065:

- New **Question 27** has been added to enter the number of foreign partners that transferred all or part of their interests or received a distribution subject to **Code §864(c)(8)**.

- New **Question 28** has been added regarding disclosures for “disguised sales.”

Changes to Schedule K of Form 1065:

- **Schedule K** and **Schedule K-1**, **Line 4**, **Guaranteed Payments**, now has three lines: a) Guaranteed payments for services, b) Guaranteed payments for capital, and c) Total.

> **Comment:** Keep in mind the guaranteed payments only reduce QBI, but do *not* count as “wages” for the 50% test under **Code §199A**. Instead, **Code §704(b)(2)** “special allocations” should be made to allocate profits to a particular partner (though, fringe benefits paid for by the partnership such items as health insurance premiums would still be listed as GPs).

- **Schedule K, Lines 16(d)** and **(k)**, are “Reserved for Future Use” because **Code §951A** categories are no longer reported on **Schedules K** and **K-1**.

Changes to Schedule K-1:

- **Item E:** A parenthetical note has been added to caution against using the TIN of a disregarded entity (i.e., SMLLC)

- **Item H:** Has been revised to request the name and TIN of a disregarded entity, if applicable.

- **Item J:** A *new* checkbox has been added to indicate the sale of a partnership interest.

- **Item K:** A *new* checkbox has been added to indicate whether the liabilities shown in that box include liabilities from lower-tier partnerships.

- **Item L:** Partner's capital accounts are now reported only on the *tax basis* method, and checkboxes to indicate other methods have been removed.

- **Item N:** A new item has been added for partner's share of unrecognized (i.e., pre-contribution **Code §704(c)**) gain or (loss) at the beginning and the end of the year.

- **Box 11: Code F** will no longer be used for **Code §951A** income. Instead, it will now be used for any “net positive income effect” from **Code §743(b)** adjustments.

- Box 13: *New* **Code V** has been added for any “negative income effect” from **Code §743(b)** adjustments.

- Box 20: Codes Z through **AD** that were previously used to report **Code §199A** information have been changed. Only **Code Z** will be used to report **Code §199A** information.

Comment: Even though there is only the “Code Z” now, you would still have to let the K-1 recipient know if there is any SSTB income (or, a “blended business” with both SSTB and non-SSTB income/loss), along with the share of wages, QBIA, and any REIT dividends or PTP income.

- Box 20: Code AA is used for the net income/loss effect for all **Code §704(c)** adjustments.

- Box 20: Code AB is used for **Code §751** gain or loss from the sale of a partnership interest.

- Box 20: Code AC is used for any deemed gain or loss from **Code §1(h)(5)** collectibles from the sale of a partnership interest.

- Box 20: Code AD is used for any deemed gain under **Code §1250** (i.e., depreciation recapture) from the sale of a partnership interest.

- Box 20: Code AH, Other, includes net **Code §743(b)** adjustment for partners with basis adjustments.

- Lines 21 and 22: These *new* lines have checkboxes to indicate that there are attachments to the **Schedule K-1** related to the partnership having *more than one* activity for **Code §465** at-risk purposes (i.e., as shown on **Form 6198**), or *more than one activity* for **Code §469** passive activity purposes, or both. **(Misc.; Form 1065)**

Comment: The draft instructions point out that at the time the instructions went to print, several credits and deductions available to partnerships expired prior to 2019. The instructions tell taxpayers who wish to find out if legislation extended the credits and deductions and made them available for 2019, to go to **IRS.gov/Extenders**.

☞**IRS Issues Final 2018 Form 1065 and Draft Instructions (Form 1065 and Instructions)**

The IRS has issued the *final* version of 2018 **Form 1065** and draft instructions for the form. The form and instructions contain numerous changes, most of which derive from either the new “centralized partnership audit rules” or changes made by the Tax Cuts and Jobs Act.

Form 1065: The following are among the changes to Form 1065 and its instructions:

- Address change for filing returns: The filing address for partnerships located in some states has changed. See "Where To File" in the Form 1065 instructions.

- Line removed - Page 1, Item G. Technical terminations: On page 1, in **Item G**, the check box for “technical terminations” has been removed because technical terminations do *not* apply for partnership tax years beginning *after* 2017.

- Lines 23-30 - Tax, payments, and refunds: These lines comprise an “entirely new section” of the form.

1) Line 23 - Interest due under the “look-back method” for completed long-term contracts: Partnerships that are *not* “closely-held” should attach **Form 8697** and a check or money order for the full amount due. They should write the partnership's employer identification number (EIN), daytime phone number, and **"Form 8697 Interest"** on the check or money order.

2) Line 24 - Interest due under the “look-back method” for property depreciated under the “income forecast method:” Partnerships that are *not* “closely-held” should attach **Form 8866** and a check or money order for the full amount due. They should write the partnership's employer identification number (EIN), daytime phone number, and **"Form 8866 Interest"** on the check or money order.

3) Line 25 - BBA AAR imputed underpayment: BBA stands for the **Bipartisan Budget Act of 2015** (i.e., the law that created the centralized partnership audit rules), and AAR stands for “administrative adjustment request.” Partnerships should use this line if they are filing an AAR electronically and choose to pay the imputed underpayment. For instructions on how to figure the imputed underpayment, see the instructions for **Form 8082**. Write the name of the partnership, tax identification number, tax year, **"Form 1065,"** and **"BBA AAR Imputed Underpayment"** on the payment. Payments can be made by check or electronically.

4) Line 26 - Other taxes: In a few instances, payments other than those listed above may have to be made with Form 1065. Partnerships wishing to make those payments should enter the amount on this line and attach a statement identifying the purpose of the payment.

5) Line 28 - Payment: Partnerships should enter any prepayments related to **lines 23-26** above.

- Schedule B questions: Both in 2018 and historically, Schedule B is entitled **"Other Information"** and provides a series of questions that the taxpayer must answer.

Removed questions: The questions relating to the **Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)** have been removed from Schedule B because TEFRA has been *repealed and replaced* by the BBA. The removed questions are **2017 Questions 2 and 5**.

Question 21: New question 21 asks if the partnership is a "**Code §721(c)** partnership" defined in **Reg. §1.721(c)-1T(b)(14)**.

> **Comment:** A partnership (domestic or foreign) is a "section 721(c) partnership" if there is a contribution of section 721(c) property (i.e., property which has built-in gain) to the partnership and, after the contribution and all transactions related to the contribution: (A) A related foreign person with respect to the U.S. transferor is a direct or indirect partner in the partnership; and (B) The U.S. transferor and related persons own 80 percent or more of the interests in partnership capital, profits, deductions, or losses.

Question 22: New question 22 was added for **Code §267A**. That Code section provides that a deduction for certain interest or royalties paid or accrued by or to a related party pursuant to a "hybrid transaction" (or, by or to a "hybrid entity"), may be disallowed to the extent the related party does *not* include the amount in income or is allowed a deduction with respect to the amount paid. **Question 22** also asks the partnership to indicate the disallowed deduction amount.

Questions 23 and 24: New question 23 and question 24 are added for **Code §163(j)**. For tax years beginning in 2018, *every* taxpayer who deducts business interest is required to file **Form 8990, Limitation on Business Interest Expense Under Code Sec. 163(j)**, "unless an exception for filing is met" (i.e., a "small taxpayer" with average gross receipts under $25 million is claiming the interest expense). Both of the new questions ask about those exceptions. **Line 24** requires the partnership to file **Form 8990** even if no exception applies.

Question 25: New question 25 is added for the "centralized partnership audit regime elect out provision" under **Code §6221(b)**.

Question 26: New question 26 asks if the partnership is certifying as "qualified opportunity fund."

- Page 3, Designation of partnership representative: On page 3, the "tax matters partner signature block" has been replaced with the "designation of partnership representative (PR)," and includes the identity of the designated individual for the PR if the PR is an entity.

- Changes to Schedule K: Schedule K is used to provide information regarding partners' distributive share items.

Line 6c - Dividend equivalents: Partnerships should use this new line to enter the amount of "dividend equivalents" as defined in **Code §871(m)**, for persons that are *not* U.S. persons, who generally are required to treat dividend equivalents as U.S. source dividends, and domestic partnerships with partners who may need this information.

Line 11 - Other income (loss): This line is used to list "other income," with each type of other income having its own code. The 2018 instructions add the following codes: a) **Code §951A** income (code F) - Partnerships must provide the information partners need to figure the **Code §951A** income (i.e., global intangible now-taxed income (GILTI)); b) **Code §965** inclusion (code G) - Partnerships must enter the **Code §965(a)** inclusion amount from **Form 965, line 3**, on **Schedule K, line 11**. They must also complete and attach **Form 965, Inclusion of Deferred Foreign Income Upon Transition to Participation Exemption System**, and applicable schedules; c) Subpart F income (other than **Code §951A** and **Code §965** inclusions) (code H) - Partnerships must provide the information the partners need to figure the subpart F income other than **Code §951A** and **Code §965**.

Line 13d - Other deductions: The IRS has removed from this line codes T-V which pertained to the now-repealed **Code §199** "domestic production activities deduction." It has also added code K, "excess business interest expense," and code X, **Code §965(c)** deduction.

Line 16 - Foreign transactions: Historically, this section of Schedule K has required partnerships to assign to categories their foreign gross income sourced at the partnership level and their deductions allocated and apportioned at the partnership level to foreign source income. For 2018, the IRS has added two categories for this purpose (i.e., a **Code §951A** category and a "foreign branch" category).

Line 20c - Other items and amounts: For 2018, the following new items must be listed here:

> **Comment:** These "codes" are extremely important in conveying the necessary information to the partner so that the new Sec. 199A deduction can be calculated. If omitted, the amounts for Sec. 199A purposes are deemed to be zero.

a. Codes Z through AD: Various items of information regarding the "qualified business income" (QBI) deduction in **Code §199A**;

b. Codes AE and AF: Items with respect to the **Code §163(j)** limitation on business interest expense;

c. Code AH:

i) Transfer of a partnership interest by a foreign partner;

ii) If the partnership is a "**Code §721(c)** partnership," line 20c must include the amounts relating to any remedial items made under the "remedial allocation method" (i.e., as described in **Reg. §1.704-3(d)** and **Reg. §1.704-3T(d)(5)(iii)**) with respect to "**Code §721(c)** property;" or

iii) Partnership is a patron of an agricultural or horticultural cooperative.

Partnerships should also attach a statement to Schedule K-1 showing the partner's distributive share of the "qualified business income" allocable to qualified payments received from the cooperative so the partner may compute the "patron reduction" under **Code §199A(b)(7)**.

- Listing of new rules of which Form 1065 preparers should be aware: The Form 1065 instructions list the following new rules for 2018 of which Form 1065 preparers should be aware:

a. QBI deduction under **Code §199A**;

b. Eligibility to use the cash method of accounting by additional small businesses;

c. Treatment of deferred foreign income upon transition to participation exemption system under **Code §965**;

d. Inclusion of GILTI under **Code §951A**;

e. Foreign-derived intangible income (FDII) under **Code §250**;

f. The repeal of the "domestic production activities deduction" under former **Code §199**;

g. Treatment of gain or loss from sale or exchange of interests in partnerships engaged in U.S. trade or business under **Code §864(c)(8)**;

h. Special rules for eligible gains invested in qualified opportunity funds under **Code §1400Z-2**; and

i. 3-year holding period requirement for "applicable partnership interests" under **Code §1061**. **(Misc.; 2018 Form 1065)**

☞**Revisions to 2017 Form 1065 Partnership Return**

The IRS has issued final versions of 2017 **Form 1065, U.S. Return of Partnership Income**, and the instructions to the form. Even though Form 1065 itself remains unchanged when compared to the 2016 form, there are several changes to the instructions, including the following:

- Page 1, Box A. Principal business activity: The Principal Business Activity Codes, located at the end of the Form 1065 instructions, have been updated and revised to reflect updates to the North American Industry Classification System (NAICS).

- Page 1, Signature: The partnership return must be signed by a partner. Beginning in 2017, any partner of a partnership or any member of a limited liability company may sign the return.

- Page 1, Line 16. Depreciation: The **Tax Cuts and Jobs Act (TCJA)** provides that 100% bonus depreciation applies to certain depreciable property acquired and placed in service *after* Sept. 27, 2017. For such property, the TCJA also eliminates the requirement that the "original use" of the property start with the taxpayer. The TCJA also expands the definition of "qualified property" to include qualified film, television, and live theatrical productions released, etc. after Sept. 27, 2017.

> **Comment:** Property eligible for Sec. 179 immediate expensing has also been expanded to include certain types of "qualified improvement property" in the definition of "qualified real property" (which used to only include "qualified leasehold improvements," "qualified restaurant property," and "qualified retail improvements"). These new types of property include HVAC assets, fire alarm and security systems, as well as roofs (i.e., *not* just merely "roof coverings" which can be currently expensed as a "repair").

- Address change for filing returns: The filing address for partnerships located in some states has changed. A complete list of filing addresses is on page 5 of the Form 1065 instructions.

- New attachment to Form 1065: Certain U.S. persons that are the "ultimate parent entity" of a U.S. multinational enterprise group with annual revenue for the preceding reporting period of $850 million or more are required to file **Form 8975**. **Form 8975** and its **Schedule A (Form 8975)** must be filed with the income tax return of the ultimate parent entity of a U.S. multinational enterprise group for the tax year in or within which the reporting period covered by **Form 8975** ends. These rules apply beginning with the 12-month reporting period that begins *on or after* the first day of a tax year of the ultimate parent entity that begins on or after June 30, 2016.

- Form 1065, Schedule K-1: A new item was added to **Code G ("Contributions (100%)") of Schedule K-1 (Form 1065), box 13**, to report qualified cash contributions for relief efforts in certain disaster areas. Partnerships should use this new item to show each partner's distributive share of "qualified cash contributions" made for relief efforts in certain disaster areas that were paid *after* Aug. 22, 2017, and *before* Jan. 1, 2018. Partners can elect to use a 100% AGI limitation for these contributions.

- Fiscal year partnerships-TCJA rule changes: The TCJA contains numerous provisions that change rules with respect to transactions that take place *after* Dec. 31, 2017 and thus may affect fiscal year 2017 returns.

> **Comment:** Some of those provisions are unique to partnerships. For example, for transfers of partnership interests *after* Dec. 31, 2017 (i.e., to reflect the fact that "technical terminations" of partnerships has now been eliminated). Also, the definition of "substantial built-in loss" in **Code §743(d)**, under the rules that require the adjustment of the basis of partnership property following the transfer of a partnership interest, has been revised.

- Other provisions apply to businesses generally: For example, no deduction is allowed for most entertainment expenses, as well as the continued nondeductibility of membership dues, and facilities used in connection with entertainment activities for amounts incurred or paid after Dec. 31, 2017.

- Other recent changes to keep in mind when filing Form 1065: The following significant changes first affected 2016 returns and continue to apply to 2017 returns.

- Due date for Form 1065: The due date for a domestic partnership to file its **Form 1065** has changed to the 15th day of the 3rd month following the date its tax year ended.

- Information reporting by specified domestic entities: For tax years beginning *after* Dec. 31, 2015, domestic partnerships that are formed or availed of to hold specified foreign financial assets (i.e., "specified domestic entities") must file **Form 8938** with their Form 1065 for the tax year. **Form 8938** must be filed each year the value of the partnership's specified foreign financial assets meets or exceeds the reporting threshold. Furthermore, a domestic partnership required to file **Form 8938** with its Form 1065 for the tax year should check "Yes" to **question 22 of Schedule B, Form 1065**. **(Misc.; Form 1065)**

☞**2014 Partnership Return Unchanged, But Instructions Reflect Modified Reporting Rules**

The IRS recently issued draft instructions for the 2014 partnership income tax return. While the form itself is *identical* to 2013 Form 1065, the instructions reflect several changes, including a change in the way some partnerships complete **Form 1065, Schedule M-3, Net Income (Loss) Reconciliation for Certain Partnerships**. Here is a summary of the major changes contained in the draft 2014 Instructions for **Form 1065, U.S. Return of Partnership Income**:

- Form 1065, Schedule M-3: Previously, any entity that filed Form 1065 had to file **Schedule M-3 (Net Income (Loss) Reconciliation for Certain Partnerships)** instead of **Schedule M-1 (Reconciliation of Income Return)** if either: a) the amount of total assets at the end of the tax year reported on **Schedule L (Balance Sheet)**, line 14, column (d) was $10 million or more; b) the amount of adjusted total assets for the tax year was $10 million or more; c) the amount of total receipts for the tax year was $35 million or more; or d) an entity that was a reportable entity partner with respect to the partnership owned or was deemed to own, directly or indirectly, an interest of 50% or more in the partnership's capital, profit, or loss, on any day during the tax year of the partnership. Furthermore, a U.S. partnership filing Form 1065 that was *not* otherwise required to file Schedule M-3 could nevertheless *voluntarily* file Schedule M-3 in place of Schedule M-1.

Now, for tax years ending Dec. 31, 2014 and later, Form 1065 filers that (a) are required to file Schedule M-3 and have less than $50 million total assets at the end of the tax year, or (b) are *not* required to file Schedule M-3 and *voluntarily* file Schedule M-3, must either complete Schedule M-3 entirely, or complete Form 1065, Schedule M-1 instead of completing Parts II and III of Schedule M-3. These filers are *not* required to file Form 1065, **Schedule C (Additional Information for Schedule M-3 Filers)** or **Form 8916-A (Supplemental Attachment to Schedule M-3)**. If these filers choose to complete Form 1065, Schedule M-1 instead of completing Parts II and III of Schedule M-3, line 1 of Form 1065, Schedule M-1 *must equal* line 11 of Part I of Schedule M-3.

- Payments due with return: The draft instructions add a section covering the instances in which a payment must be made with the return. They note two such instances and instruct that the relevant payment amounts should be identified in the bottom margin on page 1 of Form 1065.

Partnerships that are *not* "closely held" but that are liable for interest due under the "look-back method" for completed long-term contracts should complete **Form 8697** and write "From Form 8697" and the relevant dollar amount in the bottom margin.

Partnerships that are *not* "closely held" and that are liable for interest due under the "look-back method" for property depreciated under the income forecast method should complete **Form 8866** and write "From Form 8866" and the relevant dollar amount in the bottom margin.

Partnerships that cannot pay the full amount of tax due may apply for an installment agreement online if it meets each of the following criteria: a) it cannot pay the full amount shown on the bottom margin on page 1 of Form 1065; b) the total amount it owes is $25,000 or less; and c) it can pay the liability in full in 24 months.

- Election with respect to Sec. 1411: Taxpayers may elect under **Reg. §1.1411-10(g)** to include **Code §951** inclusions (i.e., from a controlled foreign corporation (CFC)) and **Code §1293** inclusions (i.e., from a qualified electing fund (QEF)) in net investment income for purposes of the **Code §1411** 3.8% surtax. If a **Reg. §1.1411-10(g)** election is in effect with respect to a taxpayer's stock in a CFC or QEF, then the amounts included in income for regular tax purposes under **Code §951** and **Code §1293** from the stock of the CFC or QEF are included in net investment income, and distributions from the stock of the CFC or QEF described in **Code §959(d)** or **Code §1293(c)** are *excluded* from net investment income. **(Misc.; Form 1065)**

> **Comment:** The Form 1065 instructions note that this election is made at the partnership level in a statement that is filed with the partnership's original (or, amended return) for the tax year in which the election is made. The election must be made no later than the *first* tax year beginning after 2013 during which the partnership: (i) includes an amount in gross income under **Code §951(a)** or **Code §1293(a)** for the CFC or QEF, and (ii) has a direct or indirect owner that is subject to tax under **Code §1411** (or, would have been if the election were made).

☞**Recent Changes on 2011 Form 1065**

The IRS has released a final version of the **Form 1065** which reflects both numerous tax and non-tax changes. The draft **instructions** to Form 1065 list the following new items:

- Merchant card and third-party payments: For the 2011 tax year, the IRS has deferred the requirement to *separately* report on Form 1065 the amount of merchant card and third-party network payments from **Form 1099-K, Merchant Card and Third-Party Network Payments**. Instead, partnerships are directed to report gross receipts or sales from all business operations as indicated on the instructions for lines 1a through 1d. Line 1a is entitled Merchant Card and third-party payments including amounts reported on Form(s) 1099(k). But, because of the deferral of the separate reporting requirement, partnerships are directed to enter "zero" on line 1a. Line 1b is entitled gross receipts *not* reported on line 1a. Partnerships are directed to report on line 1b gross receipts or sales from *all* business operations (including gross receipts or sales included in any amounts reported to the partnership on Form(s) 1099-K), except for amounts that must be reported on line 4 through 7.

Comment: Recent versions of Form 1065 continue this deferral of having to report credit card sales separately as part of the entity's overall gross receipts, as well as the other items in this summary.

- **Cost of goods sold:** The IRS has deleted **Schedule A (Cost of Goods Sold)** from Form 1065. Cost of Goods Sold is now reported on *new* **Form 1125-A**, which has *not* yet been finalized but is available in draft form on IRS's website.

- **Foreign government partners:** On **Schedule B, Other Information**, line 3a, the IRS added "any foreign government" to the list of partners the partnership may need to disclose.

- **Form(s) 1099:** On **Schedule B**, the IRS added *new* line 18a and *new* line 18b regarding Form(s) 1099. Line 18a asks whether the partnership made any payments during the tax year that would require it to file Form(s) 1099. If the answer is "yes," the partnership must respond on line 18b whether it did or will file all required Form(s) 1099.

- **Form(s) 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations:** On Schedule B, the IRS added a *new* line 19 for **Form(s) 5471** filed.

Comment: **Form 5471** is used by certain U.S. citizens and residents who are officers, directors, or shareholders in certain foreign corporations. The form and schedules are used to satisfy the reporting requirements of **Code §6038** and **Code §6046**, as well as the related regs.

- **Loans to/from partners:** On **Schedule L, Balance Sheet per Books**, the IRS added *new* line 7a, Loans to partners (or persons related to partners), and a *new* line 19a, Loans from partners (or persons related to partners).

Comment: The new line regarding "Loans from partners" will, among other things, remind entities of the need to respect these loans, including the payment of interest, even if it means the imposition of the imputed interest rules under **Code §7872**.

- **Form(s) 8621, Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund:** The draft Form 1065 instructions note that certain partnerships may have to file **Form 8621**.

- **Form 8938, Specified Foreign Financial Assets:** The draft Form 1065 instructions note that certain partnerships may be required to file **Form 8938** in future years. **(Misc.; Form 1065)**

Comment: At the present time, the IRS instructions state that it "anticipates issuing regulations that will require a domestic entity to file Form 8938 if the entity is formed or availed of to hold specified foreign financial assets and the value of those assets exceeds the appropriate reporting threshold." But, until the IRS actually issues such regulations, only individuals must file Form 8938.

☞**Partnership Changes Reflected on 2009 Form 1065**

Form 1065 has several changes unique for the reporting requirements for partnerships. One of the most prominent ones is that the automatic extension period for filing Form 1065 due after January 1, 2009, has been changed to five months, rather than six months. For example, in the case of a calendar-year partnership, Form 1065 will need to be filed by September 15, rather than October 15.

Comment: This change should enable individual taxpayers to obtain the Schedule K-1 information necessary to complete their returns by their October 15 six-month extended due date.

Other Changes to Form 1065:

- The partnership's reporting requirements in **Schedule B (Other Information)** have been modified and expanded greatly.

- Partnerships filing **Schedule M-3**, **Net Income (Loss) Reconciliation for Certain Partnerships**, must also now file a new **Schedule C, Additional Information for Schedule M-3 Filers**.

- A *new* checkbox for **Item G** of **Form 1065** has been added for partnerships to report their technical terminations.

- A *new* Code W has been added to box 20 of the **Form 1065 Schedule K-1** for reporting pre-contribution gain or loss on distributions of **Code §704(b)** property to non-contributing partners within seven years of the date of contribution. **(Misc.; Form 1065)**

☞**IRS Addresses FAQs Regarding Changes to 2008 Form 1065**

The IRS has made numerous changes to the 2008 version of Form 1065. And, to help practitioners understand them, the IRS has posted to its website nine frequently asked questions (FAQs) on these changes. This summary provides an overview of the changes, as well as the FAQs meant to address them.

Changes to Form 1065: The first page of the instructions for the 2008 Form 1065 list these new items:

(1) Many of the questions on Schedule B have been modified and additional questions have been added. Partnerships filing Schedule M-3 must also complete the questions on the new **Schedule C, Additional Information for Schedule M-3 Filers**.

(2) On Form 1065, page 1, **Item G, checkbox (6)** has been added. It is used to indicate a technical termination, and is checked in conjunction with checkbox (1) or checkbox (2).

(3) The automatic extension period for Form 1065 returns that are due to be filed on or after Jan. 1, 2009, has been changed to just 5 months.

(4) The **"Where To File"** instructions have been revised for certain partnerships whose principal business, office, or agency is located in Tennessee or Georgia.

(5) For business start-up and organizational costs paid or incurred after Sept. 8, 2008, a partnership is *deemed* to have made an election to deduct a certain amount of its start-up and organizational costs under **Code §195(b)** and **Code §709(b)**. Therefore, it is no longer necessary to attach a statement to the return to make this election. Nevertheless, a partnership can elect to forgo this deemed election and amortize all such costs (i.e., over 180 months).

(6) Various credits are new for 2008, as detailed on page 1 of the Form 1065 instructions.

(7) A **new code G** has been added for **box 13 of Schedule K-1** (Form 1065) to report certain charitable contributions for which the adjusted gross income limitation has been suspended.

(8) The AMT on the low-income housing credit have been repealed for credits attributable to buildings placed in service *after* Dec. 31, 2007. As a result, two new codes have been added to separately report the post-2007 low-income housing credits on Schedule K-1 that are *not* subject to the alternative minimum tax limitations.

(9) The codes used to report the welfare-to-work credit and the new markets credit on Schedule K-1 have changed. These credits are now reported using **code P in box 15**.

(10) One new code has been added for **box 19 of Schedule K-1** (Form 1065). Code C is used to report distributions of **Code §737** property.

(11) **Recapture of low-income housing credit.** For the disposal of a building or an interest therein occurring after July 30, 2008, a partnership is *not* required to establish a bond or pledge eligible U.S. Treasury Securities to avoid recapture of the low-income housing credit if it is reasonably expected that the building will continue to be operated as a qualified low-income building for the remainder of the building's compliance period.

(12) One new code has been added to **box 20 of Schedule K-1** (Form 1065). **Code W** is used to report pre-contribution gain or loss.

FAQs on changes to Form 1065: The FAQs relate to new information that must be entered on the revised Form 1065, *not* new law changes. The summary below lists the questions and provides abbreviated answers to some of them.

Comment: The IRS website provides more detailed responses to these FAQs.

(1) How may the partners' shares of profit, loss, and capital be reported in cases where the partnership agreement does *not* express such items as percentages? The IRS provides the answer to this question in the form of an example of a reasonable method of calculating partners' percentage shares of profit, loss, and capital for purposes of completing **Form 1065 Schedule B questions 3 and 4**, and for purposes of completing **Schedule K-1 item J**, for tax years ending on or after Dec. 31, 2008. The method shown by the IRS includes a fairly detailed fact pattern involving a two-person partnership governed by a partnership agreement that requires capital accounts to be maintained in accordance with **Code §704(b)** but that does *not* express the partners' shares of profit, loss, and capital as fixed percentages. Under **Code §704(b)**, a partner's distributive share of income, gain, loss, deduction, or credit is determined in accordance with his interest in the partnership if the partnership agreement does *not* specify the partner's distributive share of these items, or the allocation to a partner of these items under the agreement does *not* have "substantial economic effect."

Comment: A partnership can also compute the partners' end-of-tax-year percentages of capital by dividing each partner's *positive* capital account balance on the last day of the tax year by the total positive capital account balance on that day, and expressing the result as a percentage. A *negative* capital account balance is reported as zero percent. Likewise profit percentages are determined by computing each partner's share of items that increased partnership capital (other than capital contributions). Loss percentages are determined by computing each partner's share of items that decreased partnership capital (other than distributions).

(2) What is the percentage interest in the partnership that should be reported on Form 1065 Schedule B question 3b in three distinct cases? In **Situation 1**, spouses H and W each owns a 50% interest in the partnership profit, loss, and capital. **Answer:** Report H and W each as owning, directly or indirectly, 100% (i.e., each owns 50% directly and 50% by family attribution). In **Situation 2**, Parent and Child each owns a 50% interest in the partnership profit, loss, and capital. **Answer:** Report each as owning, directly or indirectly, 100% (50% directly and 50% by attribution). In **Situation 3**, four siblings each owns a 25% interest in the partnership profit, loss, and capital. **Answer:** Report each as owning, directly or indirectly, 100% (25% directly and 75% by family attribution).

Comment: Keep in mind that in **Situation 1**, the H and W might be able to instead elect to file *two* separate Schedule Cs instead of Form 1065 to report the results of this jointly-owned trade or business (i.e., vs. the co-ownership of a partnership which holds rental properties reported on **Form 8825**).

(3) In this instance, a partnership consists of three partners who own differing percentages of the three items named (profit, loss, capital). Form 1065, Schedule B, Question 3b, asks for the maximum percentage owned by any partner owning more than 50 percent of any of those three items. A partner whose interests in profits, loss, and capital are 60, 20 and 50 percent, respectively, would answer Question 3b by reporting 60 percent (the maximum of the three percentages given).

(4) The fourth question pertains to each partner's percentage of ownership reported on Form 1065, Schedule K-1, Item J. In this example, the partners' interests are *not* set forth as percentages, but are calculated using a complex formula taking into account activity thresholds and targets, which causes profit allocations to vary. For example, three partners end the tax year with capital account balances of $75, $50, and a deficit of $25. The end-of-year capital account reported by the partnership is $100 ($125 in the positive account balances minus the $25 negative account balance). The first partner divides his $75 positive ending capital by the total positive ending capital of $125, for a share of 60 percent. The second partner divides her $50 positive ending capital by $125, for a share of 40 percent. The third partner would receive no net distribution of capital if the partnership were to liquidate at the end of the year, but would instead have to contribute capital to the partnership. Therefore, for purposes of computing the percentage amounts on **Schedule K-1, Item J**, this partner's ending positive capital account percentage would be zero. The IRS considers this to be a "reasonable method" of calculating these amounts.

(5) What percentage interests in partnership X are individual partners A and B and entities W, Y, Z, and T considered to own for purposes of answering questions 3a and 3b of Form 1065, Schedule B for tax year 2008? The IRS provides an answer to this question involving complicated facts.

(6) For purposes of the requirement in the **Form 1065 Schedule K-1, Item J**, instruction at page 24, first paragraph, last sentence referring to "multiple changes in the profit and loss sharing percentage during the year" should the phrase "change" be interpreted as applying only to changes in ownership resulting from sale, purchase, transfer, contribution, or distribution as distinguished from changes which occur because of fluctuations in profit allocations during the year due to formula methods specified in the partnership agreement? The IRS says that the answer to this question is yes, and the phrase "change" for this purpose does *not* apply to changes that occur because of fluctuations in profit allocations during the year due to formula methods specified in the partnership agreement.

(7) Partnership A wishes to report ownership percentages on tax year 2009 Form 1065 Schedules K-1, Item J, using a different reasonable method from the reasonable method used for tax year 2008. Must Partnership A disclose the change on the 2009 Form 1065? The partnership agreement does *not* express the partners' percentage interests as fixed percentages. Therefore, the IRS answers this question in the *affirmative*.

(8) Partnership A has over 100 partners. The partnership agreement does *not* express the partners' percentage interests as fixed percentages. The partnership wants to send tax year 2008 Form 1065 Schedules K-1 to partners in March 2009 with a blank Item J. The partnership proposes that it will adopt a reasonable method for reporting ownership percentages on Item J before the extended due date of the return and include percentages on Item J of the Schedules K-1 included with the Form 1065 that will be filed with the IRS prior to the extended due date. **Is it permissible for Partnership A to send 2008 Schedules K-1 to partners with a blank Item J? The answer is no.** The tax year 2008 Form 1065 Schedules K-1 sent to partners in 2009 must include a completed Item J and must be consistent with those filed with the Form 1065.

(9) For purposes of answering Schedule B questions 3a and 3b what percentage interest does the Partnership report as being owned by individual partners A and B and revocable grantor trusts T1 and T2 under specified facts? The IRS provides an answer to this questions involving somewhat complicated facts. **(Misc.; Partnership FAQs)**

☞**2008 Form 1065 for Carries New "Schedule C" (IR 2008-92)**

The IRS has released for comment a draft Form 1065, as well as certain related schedules, including new **Schedule C, Form 1065**. The Service stated that changes on the drafts "are designed to increase transparency about the ownership and relationships between entities that make up complex enterprise business structures." But, one important change to Form 1065 "will allow more small partnerships to file a streamlined return."

Form 1065: For small partnerships, the asset threshold for filing Schedules L (Balance Sheet per Books), M-1 (Reconciliation of Income (Loss) per Books With Income (Loss) per Return), and M-2 (Analysis of Partners' Capital Accounts) has been increased from $600,000 to $1,000,000. But, Form 1065 filers that do in fact file Schedule M-3 (Net Income (Loss) Reconciliation for Certain Partnerships) will have to complete *new* Schedule C (Additional Information for Schedule M-3 Filers) to report related party transactions, allocations, transfers of interest, cost sharing arrangements and changes in methods of accounting. **(Misc.; Form 1065)**

☞**Changes to 2008 Partnership and Corporation Tax Forms (IR 2007-138)**

The IRS has announced that it is seeking comments on these newly-released draft revisions to **Form 1065, U.S. Return of Partnership Income**, and **Form 1120, U.S. Corporation Income Tax Return**. The forms and related schedules are slated for use for tax years ending on or after Dec. 31, 2008.

Proposed Revisions: The IRS is seeking with these new forms "to improve compliance while lessening a taxpayer's filing burden." In addition, the IRS expects the revisions "to increase transparency, providing it with a more accurate understanding of the entities and their ownership structures, and thus allowing it to focus its compliance efforts on returns and issues that deserve examination." In this regard, the IRS says that "it has taken care to ask only for information that in most cases will be readily available." The redesign of the Forms 1065 and 1120 is based on two guiding principles: 1) Promoting compliance by accurately reflecting the entity's ownership structure so that the IRS may efficiently assess the risk of noncompliance; and 2) Minimizing the filing burden on most taxpayers by requiring this information only from complex entities. While some small partnerships will have a reduction in burden (i.e., since the asset threshold for filing certain schedules with Form 1065 has been increased from $600,000 to $1,000,000) partnerships with complicated ownership structures, related party transactions, contributions and distributions of built-in gain or loss property, special allocation issues and optional basis adjustments may spend more time providing information.

Revised Partnership Form: The major changes to the Form 1065 involve ownership issues. The revisions add new questions to the existing Schedule B, which includes reporting requirements for partnerships having complex ownership structures. These partnerships are required to identify entities having direct and indirect (i.e., through attribution) ownership interests of 10% or more in the partnership and to identify entities in which the partnership owns interests of 10% or more. The revised Schedule B also asks for information about cancelled debt, and like-kind exchanges that the partnership may have participated in at any time during the tax year. For Form 1065 filers required to file Schedule M-3, Net Income (Loss) Reconciliation for Certain Partnerships, there is a *new* Schedule C requiring the partnership to provide additional information on related party transactions. The new Schedule C also asks for the identity of individuals or entities owning 50% or more of the partnership and of other entities required to file U.S. income tax returns. There are also minor revisions to Schedule K-1 which require the partnership to identify contributions and distributions of built-in gain or loss property and to identify the maximum percentage of a partner's share of profit, loss and capital in cases where those amounts change during the year.

Revised Corporation Form: The major change to Form 1120 also involves ownership. In particular, a corporation will be required to identify entities which own 10% or more of the corporation and individuals who own 50% or more of the corporation. A corporation will also be required to identify any foreign or domestic corporation in which it owns 10% or more of the total stock voting power, any disregarded entity that it owns and any foreign or domestic partnership or trust in which it owns an interest of 10% or more. A new Schedule B has been added for Form 1120 filers required to file Schedule M-3, Net Income (Loss) Reconciliation for Corporations with Total Assets of $10 Million or More. In addition, a new Schedule B asks questions concerning ownership, allocations, transfers of interest, cost sharing arrangements and changes in methods of accounting. Small corporations, those having less than $10 million in assets, will not be required to file the new Schedule B. **(Misc.; Draft Forms)**

Notes:

CHAPTER II: IRS DEFINITION OF PARTNERSHIP

A. Background: For tax purposes, a partnership includes a syndicate, group, pool, joint venture or other unincorporated organization through which any business, financial operation or venture is carried on and which is *not* a corporation, estate or trust for income tax purposes.[9] The general definition of a partnership is "an association of two or more persons to carry on a business for profit as co-owners." The courts determine whether there is a partnership or simply co-ownership of property by focusing on the intent of the members, joint sharing of profits and losses, joint control and joint ownership of the business.

Comment: No written agreement is required for a partnership to exist except for *limited* partnerships where specific terms must be spelled out in writing.

Comment: The **Uniform Partnership Act (UPA)** and **Uniform Limited Partnership Act (ULPA)** govern the general conduct of LLCs in all states except Louisiana. All fifty states have adopted the **Revised Uniform Limited Partnership Act**. A new act, **Uniform Limited Partnership Act (2001)**, drafted by the National Conference of Commissioners on Uniform State Laws was approved by the American Bar Association on February 4, 2002.

B. Key Ingredients for Partnership Existence - Cases & Rulings:

• A partnership must consist of at least two partners. A partner may be a natural person, an estate, or a C or S corporation.

Comment: If a corporation is a partner, though, it might result in the loss of the cash method of accounting, even where average gross receipts are below $26 million (i.e., otherwise meeting definition of a "qualified small business").

• A partnership may have a formal or informal agreement. The agreement may be a written or oral agreement.

Co-ownership of property does *not* necessarily mean a partnership exists. Factors to consider include:

• The services and contributions each party made in the venture,

• Their relationship,

• Who controls the income, and

• How the income is used or distributed[10]

Example 1: John and Mary (brother and sister) inherit an apartment building from their mother. They hold the property as tenants-in-common. They hire a management company to deal with all tenant and maintenance issues. Each receives their share of the income and pays their share of the expenses. They are *not* required to file a partnership tax return.

Example 2: John and Mary become concerned about liability issues. They transfer the apartment building to an LLC in which they are equal members. They are now required to file **Form 1065**, even if the only transactions are reported on **Form 8825, Rental Real Estate Income and Expenses of a Partnership or an S Corporation**.

Example 3: Don and Rhonda, a married couple filing a joint return, establish a bed and breakfast. They each materially participate in its operation. As explained below, they have the option to file **Form 1065** to report this jointly owned business on page 1. Or, they can instead elect to file two separate Schedule C's to report their respective shares of the business' income and expenses (i.e., as a "qualified joint venture (QJV) where *both* spouses participate in the day-to-day business activities).

Comment: In the case of rental property, there is sometimes a question of whether a "trade or business" is

[9] Code §761(a)

[10] Under the UPA §178.15, partners share partnership profits and losses *equally*. For instance, A and B form a partnership whereby A contributes 99% of the capital while B only contributes 1%. But, the partnership agreement is *silient* as to the sharing of profits and losses. Presumption is that each will be shared equally.

being conducted (i.e., which should be reported on **page 1** of **Form 1065**) because "significant personal services" are being offered. Or, is it simply a rental activity to be reported on **Form 8825**? Examples of this may be where a trailer park offers spaces with customary services such as electrical, sewerage and water hook-ups with leases normally running month-to-month, if not longer. On the other hand, consider a summer campground where other services such as a general store, swimming pool and other recreational amenities, etc. are also being offered and, as a result, a "trade or business" is being conducted.

C. Aggregate vs. Entity Theory: As discussed above, two general theories of a partnership have evolved, namely the "aggregate theory" and the "entity theory." Both theories are derived from the partnership provisions of the Code and from the **Uniform Partnership Act**.

1. AGGREGATE THEORY: Under the "aggregate theory," a partnership is treated as "a transparent aggregation of its owners," with no existence distinct from its members. The aggregate theory is seen in the requirement of the Code that a partner include his share of specified gains, losses, deductions and credits of the partnership in his personal income since the partnership itself is **not** a separate taxable entity. In the **UPA**, the aggregate theory is also seen in provisions making each general partner *jointly and severally liable* for partnership debts.

Comment: One of the ways to test this theory is that you should *not* get a different answer, at least from a tax standpoint, where a transaction occurs at an individual owner level vs. the LLC. In other words, if the LLC member disposes of his or her interest in the entity, they should get the *same* tax result as if they had individually sold their respective share of each and every asset that they are deemed to indirectly own in the LLC.

2. ENTITY THEORY: According to the "entity theory," a partnership is treated as an entity *separate and distinct* from its partners. The entity theory is again seen in various provisions of the Code. This permits a partner to be treated as if he was an outsider conducting business with the partnership, and that the general elections affecting the computation of taxable income (e.g., accounting method, Sec. 179 election, etc.) are made by the partnership and **not** the individual partners. The entity theory can be seen in the provisions of the **UPA** which permit a partnership to hold title to property in its own name without being subject to the personal debts of the partners or the rights of their spouses or heirs.

Comment: In an LLC, the "entity theory" predominates in areas other than taxation.

☞LLC Not Terminated for Tax Purposes When Converted to Limited Partnership (PLR 201745005)

The IRS has concluded that a conversion of a limited liability company (LLC) classified as a partnership for federal tax purposes, to a limited partnership, was *not* a partnership termination and did *not* cause the entity to be treated as an association taxable as a corporation. The key in this instance was that LP agreement would be *substantially identical* to the LLC agreement, and that each partner's capital account, share of liabilities, and interest in profits, losses, and capital would remain the *same*.

Background: Under **Code §708(b)**, a partnership is considered as terminated only if: (1) No part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership; or (2) Within a 12-month period, there is a sale or exchange of 50% or more of the total interest in partnership capital and profits (i.e., a "technical termination"). **Reg. §1.708-1(b)(2)** provides that a contribution of property to a partnership does *not* constitute a "sale or exchange" for purposes of **Code §708(b)(1)(B)**.

Comment: Under the **Tax Cuts & Jobs Act**, the "technical termination" provision will be repealed for tax years after 2017.

Rev. Rul. 84-52: This ruling addressed the federal income tax consequences of a conversion of a general partnership interest into a limited partnership interest in the same partnership. In **Rev. Rul. 84-52**, X was formed as a general partnership with equal partners A, B, C, and D. The partners proposed to convert the general partnership into a limited partnership, with A and B as limited partners, and C and D as both general partners and limited partners. But, a key factor was that each partner's total percentage interest in the partnership's profits, losses, and capital would remain the same after the conversion, and the general partnership's business would continue. **Rev. Rul. 84-52** held that even though A, B, C, and D were exchanging their interests in a general partnership for interests in a limited partnership, no gain or loss would be recognized.

Rev. Rul. 95-37: This ruling examined the conversion of a domestic partnership into a domestic LLC classified as a partnership for federal tax purposes. **Rev. Rul. 95-37** held that such a conversion is treated as a partnership-to-partnership conversion that is subject to the principles of **Rev. Rul. 84-52**. **Rev. Rul. 95-37** also stated that the same holdings would apply if the conversion had been of an interest in a domestic LLC that is classified as a partnership for federal tax purposes into an interest in a domestic partnership.

IRS Letter Ruling: The IRS concluded that this conversion will *not* cause a termination of X, and that neither X nor its members will recognize taxable income, gain, or loss upon the conversion of an LLC into a limited partnership. It also concluded that the conversion will *not* cause X to be treated as an association taxable as a corporation. **(Code §7701; Partnership Termination)**

☞**Accountant Mistakenly Treated as Independent Contractor (*Thoma*, TC Memo. 2020-67 5/27/2020))**

The Tax Court confirmed that an accountant's compensation should have been treated as W-2 wages and *not* as a share of the firm's profit since he was *not* a partner. He received his compensation bi-weekly based on the hours that he actually worked, as well as his billable rate. Nevertheless, he insisted that he was a co-owner of this accounting firm even though the entity did *not* file a **Form 1065** partnership tax return. But, it also failed to send him a W-2 and did *not* withhold any taxes or provide any paid leave or vacation time. The accountant treated the funds received as self-employment income and filed a **Schedule C**. The IRS countered that the funds should have been instead treated as "wages." After reviewing all the facts, the Tax Court decided that there was no partnership for federal tax purposes, and agreed with IRS's characterization of the payments as wages. **(Code §3121(d)(2); Independent Contractors)**

Comment: Since the accounting firm was in fact his employer, they would normally be liable for their share of employment taxes. But, they can claim as a credit half of the self-employment taxes that he had already paid which would ensure that this share was *not* being paid twice (i.e., he paid 15.3% v. the 7.65% share that he should have paid as an employee).

☞**Business Arrangement Not a Partnership for Tax Purposes (*Marc and Kelly White*, TC Memo 2018-102 (7/3/2018))**

The taxpayers, husband and wife, entered into a business arrangement with another couple. The business had two separate components of mortgage lending and real estate transactions. The question arose as to whether the business constituted a partnership for tax purposes, so the taxpayers would be taxable only on their distributive shares of the partnership's income. In making this determination, the Court considered the eight factors provided in the ***Luna*** case. After analyzing the ***Luna*** factors, the Court found that seven of the factors did *not* support that a partnership existed, and only one factor supported the taxpayers' argument. The Court concluded that the record indicated that "there was some sort of relationship between the parties, but the business was *not* properly classified as a partnership for tax purposes." **(Code §7701; Partnership Status)**

☞**Management Partnership for Family-Owned Investments Treated as Business for Tax Purposes (*Lender Management, LLC*, TC Memo 2017-246 (12/13/2017))**

An investment management LLC/partnership was entitled to "ordinary and necessary trade or business deductions" under **Code §162** that the IRS had initially determined should instead be "investment expenses" under **Code §212**, that allows a deduction for ordinary and necessary expenses paid in connection with the production or collection of income, and which are otherwise treated as miscellaneous deductions (i.e., subject to a 2% of AGI threshold and AMT addback). The key factors were that the employees of the management LLC were employed full-time and provided services comparable to professional hedge fund managers. Their services were also "tailored to their individual related clients' needs and went beyond those of an investor." The management LLC was also entitled to compensation for services separate from investor returns. While there was a "family relationship, the clients could withdraw their investments if dissatisfied." **(Code §162; T/B Expenses)**

☞**Informal Business Arrangement Treated as Partnership for Tax Purposes (*Chinweike Nwabasili*, TC Memo 2016-220 (12/5/16))**

The taxpayer was an employed engineer who operated two side businesses with his brother. Although the brothers had no formal partnership agreement, they agreed to share the income and expenses, while dividing the various tasks involved with the businesses. The taxpayer reported the receipts ($6,350) and expenses ($56,252) from these businesses on his Form 1040. Upon audit, the IRS disallowed the expenses. The Tax Court agreed, concluding that the expenses should have been claimed on a Form 1065 partnership return "because the brothers showed intent to conduct the businesses as a partnership." Furthermore, the taxpayer failed to show that he had sufficient adjusted basis in his partnership interest at the end of the tax year at issue and there was no evidence of his contributions to or distributions from the partnership. **(Code §7701; Partnership Status)**

Comment: Realize that with a sole proprietorship, there would normally *not* be any prerequisite that the proprietor have sufficient "basis" (or, that it be "at-risk" on a **Form 6198**) in order to claim otherwise ordinary and necessary business expenses as would be the case with a K-1 business loss from a partnership (or, an S corporation for that matter).

☞**Partnership Existed Where Profits From Joint Venture Shared (*Stewart*, H-10-294 (D.C., Tex., 8/20/2015))**

Because a partnership was found to have existed, profit from managing oil and gas wells were permitted to be treated as capital gain. When a firm acquired a portfolio of wells, it asked five individuals who had been with the former owner to manage them. If they would stay on with the company under its new ownership and help run the operation, they were to receive 20% of the profits upon a later sale of the properties. These five individuals then set up a partnership to manage the wells and agreed to forgo taking salaries (i.e., guaranteed payments) from it. Over a year later, the wells were sold for a large profit. The IRS claimed that the managers' share was in reality compensation for services (i.e., ordinary income v. capital gain), but the court disagreed because "they had an ownership stake in the entire venture and rendered the services that increased the value of the wells." **(Code §7701; Joint Venture)**

☞**Taxpayer's Investments in Various Oil and Gas Ventures Resulted in Partnership Treatment and S/E Income (*Methvin*, TC 2015-81 (4/27/2015))**

An individual who acquired "small working interests" in several oil and gas ventures was found to be a partner in a partnership for tax purposes. This was despite his lack of active involvement in the operation of the wells, as well as making an election-out of the partnership rules (i.e., pursuant to **Code §761(a)**). In fact, for tax purposes, the working interest owners and well operator had created a pool or joint venture for the operation of the wells. But, based on the facts here, the taxpayer's income from the working interests had to be treated as income from a partnership, Furthermore, he was also liable for self-employment tax on the net income received from his "working interests" (i.e., even though he himself was not active in the day-to-day operations of any of these ventures). **(Code §7701; Working Oil & Gas Interests)**

> **Comment:** Keep in mind that "working interests" which do *not* limit an investor's liability exposure are *not* impacted (or, are other subject to) the **Code §469** passive loss rules.

☞**Father-Son Farm Treated as Partnership Since Each Had Equal Interest in Its Expenses (*Holdner*, TC Memo. 2010-175 (8/4/2010))**

The Tax Court confirmed that a farming activity operated by a father and son should be treated as a partnership (i.e., to be reported on Form 1065 instead of two separate Schedules F) for federal income tax purposes. Furthermore, in the absence of substantial proof rebutting the presumption of equality (i.e., oral or written partnership agreement stating differently), each had *equal* interests in the partnership income, expenses, and other partnership items (i.e., all items of income, loss or deduction were to be shared on a 50/50 basis).

> **Comment:** What is, perhaps, more alarming is that the necessary Form 1065 was never filed for the years in question which could result in a penalty for failure to file (i.e., $85 per owner per month in '08, $89 in '09 and $195 in '10 and thereafter). Thus far, the IRS has been lenient in regard to this penalty, so long as it was the *first* time that Form 10665 was required and the taxpayers failed to report the activity as such. However, in the process, it appears that the Service is ignoring the **Rev. Proc. 84-35** exception (i.e., businesses with 10 or fewer owners, all of whom are individuals and residents of the U.S. and who are otherwise reporting their allocable shares of the activity's income or loss on their respective Form 1040s). But, in some of the waiver letters that the IRS have sent out thus far, they are insisting that they are waiving the applicable penalty only because this was the *initial* request. Nevertheless, even though this revenue procedure exception is *not* available for S corporations that fail to file Form 1120S, this is no apparent limit on many times it could be requested for a partnership that failed to file Form 1065, as long as it met the conditions set forth in the procedure.

Background: For federal income tax purposes, a "partnership" is defined to include a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is *not*, within the meaning of the Code, a corporation, trust or estate. (**Code §761(a)**, **Code §7701(a)(2)**) In ***Luna v. Commr.*, 42 TC 1067 (1964)**), the Tax Court identified eight factors that were relevant in determining whether an enterprise was a partnership for Federal income tax purposes:

(1) The agreement of the parties and their conduct in executing its terms;

(2) The contributions, if any, which each party has made to the venture;

(3) The parties' control over income and capital and the right of each to make withdrawals;

(4) Whether each party was a principal and co-proprietor, sharing a mutual obligation to share losses;

(5) Whether business was conducted in the joint names of the parties;

(6) Whether the parties filed Federal partnership returns or otherwise represented to the IRS or to persons with whom they dealt that they were joint venturers;

(7) Whether separate books of account were maintained for the venture; and

(8) Whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.

Facts: William and Randal Holdner, father and son, ran a farming operation (Holdner Farms) since '77. Although there was no written agreement, they agreed that Randal would be entitled to one-half of Holdner Farms' gross proceeds from cattle sales and that he would have an equity interest in Holdner Farms (though the precise nature of that interest was unclear, Randal expected to inherit jointly owned properties on his father's death). Together they purchased additional property which they held jointly as tenants-in-common (i.e., legal title to the property was never held in the name of an LLC). Holdner Farms grew into a profitable cattle farming and logging operation. Throughout 2004-2006 Randal managed Holdner Farms' day-to-day operations, often working 16-18 hour days, while William (a practicing accountant) was primarily responsible for its finances and accounting. At some point before 2004, they agreed to share equally in Holdner Farms' gross rental income and gross income from timber sales, and divided these sources of income equally. Each was an authorized signatory on the Holdner Farms bank account and could sign checks and withdraw funds. They purchased an insurance policy for Holdner Farms which describes the form of business insured as a "partnership." Furthermore, in 2003, they registered Holdner Farms as a "partnership" with the State of Oregon, renewing the registration in 2004 and 2006.

William and Randal each reported one-half of Holdner Farms' gross income for 2004, 2005, and 2006 on their respective Schedules F and also (where appropriate) on Schedules D, of their personal returns for those years. Form 1065 was never used. However, they did *not* split the expenses equally. Instead, William Holdner deducted most of the expenses on his own Schedules F. Upon audit, the IRS issued separate notices of deficiency issued to the Holdners. The IRS determined that (1) Holdner Farms was a partnership (or, a joint venture taxed as a partnership) for 2004-2006; (2) the Holdners were *equal* partners in the partnership; and (3) William Holdner was liable for the **Code §6621** accuracy-related penalty for 2004-2006.

> **Comment:** To protect against whipsaw, the IRS allocated 100% of Holdner Farms' income to each and disallowed all expenses, even though the Service acknowledged that each should actually be allocated only one-half of Holdner Farms' gross income and that each should be allowed to deduct one-half of Holdner Farms' expenses.

Taxpayer Arguments: The Holdners' position apparently was that their enterprise was a joint venture between two individual proprietorships (i.e., between William's individual proprietorship and Randal's individual proprietorship). At trial, William asserted that the allocation of expenses was related to his and Randal's respective investments in Holdner Farms and to their agreements regarding specific Holdner Farms expenses.

Tax Court Decision: The Tax Court agreed with the IRS that the Holdners' activity was a partnership for Federal income tax purposes in 2004-2006. In addition, the Court concluded that in the absence of substantial proof rebutting the presumption of equality, William and Randal had equal interests in partnership income, expenses, and other partnership items. The Court felt that William had "arbitrarily and unilaterally allocated farm expenses between himself and his son primarily to shelter William's other income in an allocation that was made on an annual basis without any apparent input from Randal."

Both William and Randal contributed capital and labor to Holdner Farms which conducted a business activity for profit since '77 when it was formed. While the Holdners' correctly noted that "mere co-ownership of property or a joint undertaking to share expenses" alone was *not* sufficient to satisfy the business activity requirement for a partnership, the Tax Court concluded that the Holdner Farms enterprise clearly was more than a "mere co-ownership of property" or a "means to share expenses."

> **Comment:** In the eyes of the Tax Court, the record "overwhelmingly demonstrated that Holdner Farms was a business activity for profit that was jointly owned by the two Holdners."

> **Comment:** Even if Holdner Farms were a joint venture rather than a partnership, the joint venture would still create a separate entity for federal income tax purposes because the petitioners here were carrying on a farming business. (**Reg. §301.7701-1(a)(2)**) And, as a domestic separate entity with at least two members, it would be treated as a partnership for federal income tax purposes under the check-the-box regs' system of classifying entities for tax purposes since the Holdners failed to elect for the enterprise to be taxed as a corporation. (**Reg. §301.7701-3(b)(1)(i)**)

The Court concluded that seven of the eight ***Luna*** factors supported a conclusion that William and Randal formed a partnership in the Holdner Farms enterprise:

(1) They agreed to split the farm's gross income from cattle sales, timber sales, and leasing activity, and actually followed this agreement;

(2) They both contributed capital and services to the farm;

(3) They had equal access to and control over the farm's account, and each had unlimited power to make withdrawals;

(4) They shared a mutual proprietary interest in the farm;

(5) The name Holdner Farms, while ambiguous, suggested an enterprise that was *not* limited to one particular member of the Holdner family;

(6) Although they did *not* file a Form 1065, they represented to their insurer and to the State of Oregon that the farm was a partnership;

(7) They maintained a separate bank account for the farms, and kept meticulous records for the enterprise; and

(8) They exercised mutual control over and responsibility for the farm. **(Code §301.7701; Partnerships)**

Comment: The Court also decided to impose the **Code §6662** accuracy-related penalty for 2004-2006 on William. The Court stated that, as "a practicing accountant with decades of experience," he knew that a disproportionate allocation of the Holdner Farms expenses to him would allow him to shelter hundreds of thousands of dollars in unrelated income.

D. Electing Out of Partnership Treatment: Certain partnerships can elect to be excluded from reporting as a partnership when its purpose is for:

- Investment only, and *not* for the active conduct of a business.

- Joint production, extraction, or use of property, but *not* for the purpose of selling services or property produced or extracted.

Comment: It is important to realize that once real estate or a rental property is re-titled in the name of a LLC, a partnership tax return will normally have to be filed. In other words, it is no longer an option to "elect out" of partnership tax treatment (i.e., such as filing a separate **Schedule E** for each member's share of the net rental income or loss). The only exception would be where a SMLLC was set up to hold the real property (i.e., which is ignored for federal income tax purposes).

Comment: In **common law** states, when a husband and wife own an LLC, one would have to look at state law as to whether they would be considered a "single member" so that a partnership tax return would *not* have to be filed. If instead the business was located in a **community property** state, the IRS has previously stated that a partnership return would **not** have to be filed.[11]

Comment: Under the "qualified joint venture" rules, if the couple was instead involved in operating a trade or business (as opposed to the mere holding of real estate) in which they **both** materially participated (and the business was **not** set up as a separate legal entity under state law, such as an LLC), they would have a choice to either file a **Form 1065** or *two separate* **Schedule Cs**. If instead an LLC was used, they would **not** have this option according to the IRS (as discussed in the article below).

Comment: If multiple tenants-in-common wanted to benefit from limited liability protection yet did *not* want to have the responsibility of filing **Form 1065**, they could instead have SMLLCs hold their tenant-in-common interests, and still file **Schedule E** on their personal returns.

The election out of subchapter K is made by filing a statement with a timely filed **Form 1065** for the *first* tax year of the partnership.[12] However, in order to qualify for the above exception, the property may *not* be titled in the name of the LLC. Also, the co-owners may *not* conduct business under a common name or otherwise hold themselves out as a partnership or other form of business entity.[13]

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[11] **Rev. Proc. 2002-69** technically dealt with a trade or business, but it should also apply to rental real estate titled in the name of an LLC.

[12] Treas. Reg. §1.761-2(b)(2)

[13] Rev. Proc. 2002-22, 2002-1 C.B. 733

Comment: Four investors hold investments through a brokerage firm now worth $20 million. They would like to simply matters by dissolving the account and distributing the investments evenly so that these individuals can now open their own separate accounts. Would it matter if they had set up an LLC to hold the investments, or just had an account that was labeled as "For the benefit of (four investors named)?

Other arrangements of two or more persons could potentially be treated as partnerships if the responsibilities of the parties involved are *not* clearly specified. Expense sharing arrangements, such as a group of contractors (or, farmers) purchasing equipment for shared use would *not* be a partnership. However, use of the equipment for custom work for other parties puts it in the category of a "trade or business activity," and therefore requires subchapter K reporting as a partnership. However, the mere co-ownership of property (e.g., as tenants-in-common) without the provision of "significant personal services" does *not* rise to the level of being a partnership. Therefore, a formal election out of partnership tax treatment is *not* necessary.

E. Form 1065 Requirements: Form 1065 is used to report partnership income and expenses. If an organization is found to be a partnership for tax purposes, but fails to file **Form 1065**, the IRS is permitted to assess a fine of $195 per partner per month for a maximum of 12 months. But, under **Rev. Proc. 84-35**, a partnership that fails to file a required **Form 1065** may nonetheless avoid the imposition of the penalty if it meets all of these requirements:[14]

1. The partnership is a domestic entity,

2. The partnership has 10 or fewer partners who are all individuals or estates,

3. Each partner's share of capital, profits and losses is pro rata,

4. The partnership is *not* a member of a "tiered arrangement," and

5. The partners each fully report their respective shares of partnership items on their timely-filed income tax returns.

Comment: The utilization of this exception to the penalty may be especially useful where real estate, for instance, is titled in the name of an LLC yet the members choose to simply put their share of the property's rental income and deductions on their respective **Schedule Es.** In other words, they fail to file a **Form 1065** with the rental activity being properly reported on **Form 8825**. But, this exception covers only the failure to file a partnership return and does **not** speak to the omission of an S corp return. In this latter instance, the only "avenue of relief" would be to request a "first-time abatement" from the IRS.

Comment: It remains to be seen as to whether the IRS will invoke this penalty. But, it could amount to a $2,340 (12 x $195) (or, more after 2015 as this $195 amount is annually adjusted for inflation and in 2021 is set at $205) penalty for *each* owner if an exception did *not* otherwise apply.

☞**IRS Provides Penalty Relief for Late-Filed Partnership Returns (Notice 2017-47)**

The **Surface Transportation Act of 2015** changed the due date for filing calendar-year partnership tax returns or extension requests from April 15 to March 15. The new due date applies to returns for tax years beginning *after* 12/31/15. Nevertheless, the IRS has discovered "that many partnerships filed their tax returns or extension requests for the 2016 tax year by the *old* April deadline." As a result, the IRS has decided to grant penalty relief for partnerships that failed to file their tax returns or extension requests by the *new* March 15 deadline if, (1) the partnership filed the returns with the IRS and furnished copies to partners (as appropriate) by the date that would have been timely *before* amendment by the Surface Transportation Act (i.e., 4/18/2017), or (2) the partnership filed **Form 7004** to request an extension of time to file by the date that would have been timely *before* amendment (i.e., by 4/18/2017).

Comment: Special note should also be taken of the fact that the statutory basis for relief from the failure-to-file penalty pursuant to **Rev. Proc. 84-35** was provided under **TEFRA**, which has now been repealed for tax years beginning *after* 12/31/2017. As a result, the "first-time abatement procedure" takes on more importance. But, of course, given that it applies only once, it fails to provide relief for those small partnerships that simply do *not* file returns (i.e., the way that **Rev. Proc. 84-35** could). Perhaps, the IRS will recognize this change and provide new relief in such instances.

Comment: The IRS has now also extended the relief in **Notice 2017-47** to Real Estate Mortgage Investment

[14] **Rev. Proc. 84-35**

Conduits (REMICs). This is because REMICs are treated as partnerships for purposes of subtitle F of the Code (i.e., dealing with procedure and administration). **(Code §§6698 & 6651; Failure-to-file Penalty)**

☞**Relief for Partnerships That Missed New 2017 Return Filing Deadlines Also Applies to Fiscal Year Filers (Notice 2017-71)**
The IRS has re-issued a Notice that it initially issued on November 30, and which expanded previous relief to partnerships and certain other entities that failed to take certain timely actions under the new deadlines in effect for the first tax year beginning after Dec. 31, 2015. The re-issued Notice provides that the expanded relief applies to for *fiscal-year* as well as calendar year entities. **(Code §6072; Tax Penalties)**

☞**Partnerships Must Still File Returns Despite Limited Exemption from Failure-to-File Penalty (CCA 201733013)**
Normally, partnerships that fail to timely file a partnership return are subject to a failure-to-file penalty under **Code §6698** unless "reasonable cause" is shown. **Rev. Proc. 84-35** provides a limited exception to this rule for domestic partnerships with 10 or fewer individual partners if all partners report their proportionate shares of income and deductions on timely-filed returns. In this recent Chief Counsel Advice, the IRS concluded that **Rev. Proc. 84-35** does *not* provide an automatic exemption to partnerships from the actual requirement of filing **Form 1065**. The justification is that the IRS does *not* know how many partners are in the partnership or whether all of the partners timely filed their income tax returns unless and until the partnership (or, one of its partners) is selected for audit. **(Code §6698; Failure-to-File Penalty)**

> **Comment:** Speaking of tax penalties, the IRS is imposing more estimated tax penalties on individuals. Over the past five years, there has been a 42% increase in the number of these fines. On the other hand, the number of "accuracy penalties" assessed is dropping. They are down 18% from 2012 to 2016 for individual taxpayers. Accuracy fines imposed by examiners on businesses have decreased even more with a 59% drop over the same five-year time frame.

☞**Faxed Form 1065 Satisfied IRS Filing Requirement (*Seaview Trading, LLC*, No. 20-72416 (9th Cir., 5/11/2022))**
Faxing a copy of a late partnership return to an IRS agent was treating as filing a return, according to the 9th Circuit Court of Appeals. This decision *reversed* the Tax Court which held that the firm never filed its 2001 return because it failed to send the document directly to the IRS service center. In this instance, an IRS agent notified the firm in 2005 that the Service had never received the **Form 1065** for the 2001 tax year. The partnership then faxed a copy of it to the agent, who began an audit of the return. In 2010, the agent sent the firm a notice of adjustment. The firm claimed the notice was invalid because it was issued *over three years after* the company filed its return with the agent. The 9th Circuit concluded that a delinquent partnership return should be treated as filed "when an IRS official asks for it, the partnership delivers it and the official receives it." **(Code §6229; SOL)**

☞**Partnership Has Burden of Proof When Contesting IRS Penalties (*Dynamo Holdings, LP*, 150 TC No. 10 (5/7/2018))**
The Tax Court confirmed that a partnership has the burden of proof in refuting penalties imposed by the IRS. After a lengthy partnership audit, an IRS auditor concluded that the firm was liable for the 20% negligence penalty. In response, the partnership argued that the IRS should bear the burden of proving the penalty was properly determined. The firm also claimed that the agent who applied the penalties in the audit did *not* get the requisite prior written approval from their immediate supervisor. But, according to the Tax Court, the burden of proof is put on the IRS only when penalties are asserted against individuals. In this instance, the fine was imposed in a partnership-level proceeding. **(Code §6662; IRS Penalties)**

☞**Guidance Issued on Unincorporated Businesses Jointly Owned by Married Couples (CCA 201402004)**
This Chief Counsel Advice outlines whether a Schedule C can be jointly operated by a married couple and, if so, under what conditions. While an unincorporated business jointly owned by a married couple is generally classified as a partnership for federal tax purposes, a "qualified joint venture" (QJV) whose only members are a husband and a wife filing a joint return, can elect *not* to be treated as a partnership. Spouses make the QJV election on a jointly filed Form 1040 by dividing all items of income, gain, loss, deduction, and credit between themselves according to each one's interest in the joint venture, and each spouse filing a separate Schedule C with the Form 1040. Furthermore, the only way they would owe FICA would be if one spouse is the employee of the other spouse, and then only the spouse's wages would be subject to FICA. **(Code §7701; Qualified Joint Venture)**

> **Comment:** If one of the spouses can be legitimately treated as an employee's on the other spouse's Schedule C (including a SMLLC), then this make much more sense, at least from a prospective of the tax treatment of the fringe benefits which can now be paid income- and employment-tax-free to that employee spouse. Outfits such as **Total Administrative Services Corp** are well-versed in helping clients set up these employment arrangements (know as **BizPlanNOW** for **Schedule C** and **AgPlanNOW** for **Schedule F**).

> **Comment:** This CCA is a "very informal response" to a request by an IRS field auditor. What it fails to mention,

however, is that this option to file two **Schedule Cs** instead of a **Form 1065** partnership tax return is that the business cannot be formed as a "limited liability entity" such as an LLC or a limited partnership. If that were the case, then a **Form 1065** would have to be filed even though the sole owners were a husband and wife who both were active (i.e., "materially participating") in the business on a day-to-day basis. And, remember, if the couple instead jointly owns an LLC which holds title to real estate (i.e., as shown on **Form 8825**) instead of a page-one **Form 1065** trade or business, then a partnership return (v. a **Schedule E**) must always be filed.

☞**Husband-Wife LLC Not Allowed to Claim SMLLC Status (*Argosy Technologies LLC*, TC Memo 2018-35 (3/22/2018))**

The Tax Court has ruled against husband/wife members of a limited liability company (LLC), who appealed a determination made at a collection due process (CDP) hearing regarding a levy with respect to the penalty for failure to file a partnership return. The taxpayers had argued that they should *not* be held liable for the penalty because their entity should instead be treated as a single-member LLC. **(Code §6698; IRS Penalties)**

Comment: The petitioner was an LLC wholly-owned by a husband and wife. Its 2010 and 2011 tax returns (**Form 1065**), which were filed late, stated that the election to be covered under TEFRA unified audit procedures "was still in existence and in force." In 2014, the IRS attempted to collect unpaid income tax liabilities and late filing penalties by sending a **CP-90, Final Notice of Intent to Levy and Notice of Your Right to a Hearing**. The LLC timely submitted a **Form 12153 (Request for a Collection Due Process or Equivalent Hearing)**, claiming that it was a disregarded single-member LLC, *not* a partnership. The Tax Court disagreed, holding that an LLC may *not* file a partnership tax return and then disclaim its validity by adopting another entity type. Also, there was no evidence of a "qualified joint venture election" under **Code §761(f)**. Therefore, the LLC was liable for the late filing penalties.

Comment: In reading over the Tax Court's decision, no mention is made with regard to **Rev. Proc. 84-35** which can be used to avoid the failure-to-file penalty with regard to **Form 1065**. Furthermore, only in the case of a "qualified joint venture" (QJV) can a husband-wife business choose to instead file two separate **Schedule C's** instead of a **Form 1065** partnership return.

☞**Husband and Wife Sole Proprietors Have Filing Choice - Partnership Return or Two Schedule C's**

Before the passage of the **Small Business and Work Opportunity Tax Act**, if a husband and wife operated a business jointly and share in the profits and losses, they were treated as having formed a partnership for tax purposes. As explained below, the law now gives a choice to such couples to either file **Form 1065** as a partnership or instead file two separate **Schedule C's** or **F's** (i.e., depending on the type of the underlying business).

Comment: Obviously, if the couple would like to receive tax-free fringe benefits, it would be advisable to instead have one of the spouses be hire as an employee in a business being conducted as a sole proprietorship by the other spouse.

Background: The new law generally permits a "qualified joint venture" whose only members are a husband and wife filing a joint return *not* to be treated as a partnership for federal tax purposes. For purposes of this provision, a qualified joint venture is a joint venture involving the conduct of a trade or business, if: 1) the only members of the joint venture are a husband and wife; 2) *both* spouses materially participate in the trade or business; and 3) both spouses elect to have the provision apply. Given these requirements are met, a qualified joint venture conducted by a husband and wife who file a joint return is *not* treated as a partnership for federal tax purposes. Instead, all items of income, gain, loss, deduction and credit are divided between the spouses in accordance with their respective interests in the venture. Each spouse takes into account his or her respective share of these items as a sole proprietor and reports this on either a **Schedule C** or **F**. **(Code §7701; Spousal Partnerships)**

Comment: The Service has stated that this provision is *not* intended to change the determination under present law of whether an entity is a partnership for federal tax purposes (without regard to the election provided by the provision). And, each spouse would still pay any S/E tax otherwise due on their respective share of the business' earnings.

Comment: There is some concern, though, that if the couple were to file two **Schedule Cs**, would they in any way jeopardize their limited liability status (i.e., by *not* filing as a jointly-held, multi-member LLC). Some experts have commented that if this is how you are registered with the state (i.e., as a protected, limited liability entity) and this is how you are representing yourselves to the public, should you *not* file the appropriate form for income tax purposes? It is somewhat analogous to the "piercing the corporate veil" argument with corporations where, especially with closely-held businesses, the owners do *not* follow certain procedures (e.g., holding an annual meeting with minutes being kept) and the IRS finds that the company is merely an "alter ego" of the owner (i.e., a Schedule C or F).

Comment: The IRS has now made it clear (as discussed in the article below) that QJV status is *not* available (with the right to file two separate Schedule Cs (or, Fs) if the business is set up as a "limited liability" entity.

Effective Date: This option became effective for tax years beginning after 2006.

☞**Election Out of Partnership Treatment for Spousal Businesses Limited in Scope**

An unincorporated business jointly owned by a married couple is normally classified as a partnership for federal income tax purposes (and should, therefore, be filing a Form 1065). But, under a recent law change made by the Small Business and Work Opportunity Act of 2007 (Small Business Act), if an individual and his spouse both *materially participate* as the *only* members of a jointly-owned and operated business, and they file a joint return for the tax year, they can make a joint election to be taxed as a qualified joint venture instead of as a partnership (i.e., file two separate Schedule Cs with their Form 1040). While the IRS has yet to issue formal guidance on this change, information on its web site indicates that the change is limited in scope. Most importantly, it does *not* apply to spouses who operate in the name of a state law entity (i.e., an LLC). In other words, the election can be made only for a business operated by spouses as co-owners that is or should otherwise be taxed informally as a partnership.

Comment: Before the latest information was even published, tax experts were warning that if the couple was holding themselves out to the public (e.g., checking account, letterhead, invoices, etc.) as operating an LLC for their jointly-owned business for liability purposes would their liability shield be compromised if they instead filed "inconsistently" as two **Schedule C** proprietors. **Therefore, only for those business where the husband and wife are operating as *general* partners and also where they are *both* materially participating in its underlying day-to-day operations will this exception apply.**

Comment: Keep in mind that this exception *never* applied (and therefore a **Form 8825** had to be filed along with the **Form 1065**) where real property was owned (and therefore titled) in the name of an LLC for liability purposes in **common law** states (unless the LLC was treated as being owned by a *single* member, namely the husband and wife being treated as just one owner). And, indeed, this is what the IRS confirmed on their website. Furthermore, the Service stated that "mere joint ownership of property is *not* a trade or business." Therefore, it does *not* qualify for the election. Finally, where the operation of a trade or business is involved, the spouses must share the items of income, gain, loss, deduction, and credit in accordance with each spouse's interest in that business.

Comment: The main concern is that the increased penalty for failure to file a partnership return ($195 per month per owner for up to 12 months; $205 in 2021) would be imposed (although **Rev. Proc. 84-35** might apply to eliminate this penalty). Nevertheless, there is no question that if a multi-member LLC was involved (unless all of the members were SMLLCs) and it did in fact hold title to rental real estate, for instance, there would be a requirement that **Form 1065** (with **Form 8825** to report the rental activity) be completed.

How the Election Works: The **Small Business Act** provision generally permits a "qualified joint venture" whose only members are a husband and wife filing a joint return *not* to be treated as a partnership for Federal tax purposes. (**Code §761(f)**) A "qualified joint venture" is a joint venture involving the conduct of a trade or business, if:

1) the only members of the joint venture are a husband and wife,

2) *both* spouses *materially participate* (i.e., for purposes of the passive loss rules) in the trade or business , and

3) both spouses elect to have the provision apply. (**Code §761(f)(2)**)

Where the election is made, all items of income, gain, loss, deduction, and credit are divided between the spouses according to their respective interests in the venture (i.e., *not* necessarily 50/50), and each spouse takes into account his or her respective share of these items as if they were attributable to a trade or business conducted by the spouse as a sole proprietor. Each spouse must file a separate **Schedule C** (or **Schedule F**) to report profits and losses and, if otherwise required, a *separate* **Schedule SE** to report self-employment tax for each spouse (which is also the case if they were to instead receive two separate K-1s from the partnership).

Comment: This generally does *not* increase the total tax (i.e., income and self-employment) on the return, but it does give each spouse credit for social security earnings on which retirement benefits are based. However, this may *not* be true if either spouse exceeds the social security tax limitation (i.e., FICA cap).

Reasons for Making the Election: Because a business jointly owned and operated by a married couple is normally treated as a partnership for federal income tax purposes, the spouses were supposed to comply with filing and recordkeeping requirements imposed on partnerships and their partners (i.e., Subchapter K of the Code). And, married co-owners failing to file properly as a partnership may have been reporting on a **Schedule C** in the name of just *one* spouse, so that only that particular spouse received credit for social security and Medicare coverage purposes. This election would now permit certain married co-owners to avoid filing partnership returns, if each spouse reports their respective share of all of the businesses' items of income, gain, loss, deduction, and credit. Furthermore, under the election, *both* spouses will receive credit for social security and Medicare coverage purposes.

Scope of Provision Limited: Initially, this qualified joint venture provision appeared to allow *any* business jointly owned by spouses to avoid partnership treatment. However, although there has been no formal pronouncement, the IRS has stated on its website that **a qualified joint venture "includes only businesses that are owned and operated by spouses as co-owners, and *not* in the name of a state law entity (including a general or limited partnership or limited liability company.)"**

Comment: This may present a trap for taxpayers who might have assumed that this "qualified joint venture provision" only covered businesses operated as LLCs or state law partnerships. The IRS has *not* provided a justification for its position. Nevertheless, as long as the IRS continues to follow this position, taxpayers should be wary of maintaining that an entity owned by a husband and wife is a "qualified joint venture" that can elect out of partnership treatment if is it formed as an LLC, FLP or other partnership entity.[15] **But, as stated above, you might *not* want to elect out of partnership status if this would somehow jeopardize your limited liability status.**

How to Make the Election: Spouses make the election on a jointly filed **Form 1040** by dividing all items of income, gain, loss, deduction, and credit between them in accordance with each spouse's respective interest in the joint venture, and each spouse filing with the **Form 1040** a separate **Schedule C** or **Schedule F**. In addition, and if otherwise required (i.e., net earnings from self-employment exceed $400), a separate **Schedule SE** is required for each spouse.

Comment: For example, to make the election, a married couple should jointly file their **Form 1040**, with the required schedules. And, if the couple had been previously filing a **Form 1065** for their jointly owned business, the partnership would be deemed terminated at the end of the tax year *immediately preceding* the year the election takes effect. One question that might arise though is whether the IRS would be confused insomuch as they would have never received a **Form 1065** marked "final" and yet there would be no more partnership returns being filed. And, if the former partnership had any employees, the **Schedule C** or **F** of the spouse who would continue reported these wages would have to submit an **SS-4** for a new EIN (as discussed below).

Reporting Issues: Normally, spouses do *not* need an Employer Identification Number (EIN) for the "qualified joint venture" since an EIN is only required for a sole proprietorship where it has to file excise, employment, alcohol, tobacco, or firearms returns. But, if an EIN is required, the filing spouse should complete a **Form SS-4** and request an EIN as a *sole proprietor*. If the spouses already have an EIN for the partnership (i.e., given that is the way that they have been filing in the past), one spouse *cannot* continue to use that EIN for the qualified joint venture. Instead, the EIN must remain with the partnership (and be used by the partnership for any year in which the requirements of a "qualified joint venture" are *not* met). If the business has employees, *either* of the sole proprietor spouses may report and pay the employment taxes due on wages paid to the employees, using the EIN of that spouse's sole proprietorship. If the business already filed **Forms 941** or deposited or paid taxes for part of the year under the partnership's EIN, the spouse may be considered the "successor employer" of the employee for purposes of determining whether the wages have reached the social security and Federal unemployment wage base limits (but the proprietorship would still need to have its own *separate* EIN). **(Misc.; Partnership Election)**

Comment: If a couple wanted to make a "qualified joint venture" election for a "rental real estate *business*," IRS **Pub. #553, Highlights of 2007 Tax Law Changes**, emphasizes that they must each report their share of the income and deductions on **Schedule C** instead of **Schedule E**. Of course, what constitutes a "trade or business" for tax purposes is a matter of interpretation. But, in the real estate area, the key is whether "significant personal services" are being provided for the tenants. Therefore, a motel/hotel or bed and breakfast operation would clearly meet this standard. However, simply providing the tenants of a commercial building, for instance, maintenance of the common areas and perhaps security at the front entrance would *not* be enough to take this situation off a **Schedule E** (or, **Form 8825**, if a partnership return was instead being filed). Also, certain "personal property rentals" (PPRs) are *not* considered to be "trades or businesses" and are instead reported as **"Other Income"** on **Line 21** of page of **Form 1040**. (**IRS Pub. 925, p. 15, col. 2**)

Comment: Pay special attention as to what normally (i.e., based on case law to-date) caused the rental

[15] And, the IRS needs to clarify the impact of **Rev. Proc. 2002-9** as it applies to couples operating businesses in community property states.

of real estate to potentially be treated as a "trade or business." The key was the providing of "significant personal services" such as that typically seen with a hotel, motel, or bed and breakfast business (i.e., as opposed to traditionally longer rental terms of greater than 30 days as would be the case of a "transient dweller"). Now, with the introduction of the Sec. 199A deduction, the reg writers have decided to add a "Sec. 162 trade or business" requirement in order for any net rental income being treated as "qualified business income." And, they are asking for any landlord to be involved on a "regular, continuous and substantial basis" (i.e., similar to a business owner) even though Congress mentioned none of this when they passed the TCJA and included rental income as an additional source of QBI (and, the "tough 2.5% x UBIA test" to support the deduction where the taxpayer's taxable income exceeded certain thresholds). But, even if the rental activity is treated as a "trade or business" for Sec. 199A purposes, any net rental income is *not* subject to S/E tax.

☞**Income From Rental Real Estate Held by Husband/Wife as "Qualified Joint Venture" Not Subject to Self-Employment Tax (CCA 200816030)**

The IRS has concluded that the "qualified joint venture election" under **Code §761(f)** does *not* cause self-employment tax to be imposed on income from a rental real estate business that would otherwise be excluded. Dividends and capital gains also received from such ventures are similarly excluded. The qualified joint venture election, which wasadded by the **Small Business and Work Opportunity Act of 2007** (i.e., Small Business Act), allows eligible married co-owners to avoid filing partnership returns and both spouses to receive credit for social security and Medicare coverage purposes.

Qualified Joint Venture: The **Small Business Act** provision generally allows a "qualified joint venture" whose only members are a husband and wife filing a joint return *not* to be treated as a partnership for federal income tax purposes. (**Code §761(f)**) A "qualified joint venture" is a joint venture involving the conduct of a trade or business, if: 1) the only members of the joint venture are a husband and wife; 2) both spouses materially participate in the trade or business, and 3) both spouses elect to have the provision apply. (**Code §761(f)(2)**) The meaning of "material participation" is the *same* as under the passive activity loss rules in **Code §469(h)** and its regs. Where the election is made, all items of income, gain, loss, deduction, and credit are divided between the spouses according to their respective interests in the venture, and each spouse takes into account his or her respective share of these items as if they were attributable to a trade or business conducted by the spouse as a sole proprietor.

Comment: As reported previously, this election is *not* available if the business is owned and conducted through an LLC (or, any entity that is accorded limited liability status).

Self-Employment Tax: A tax is generally imposed on an individual's self-employment income (i.e., on his net earnings from self-employment) with certain adjustments. (**Code §1401**, **Code §1402(b)**) Net earnings from self-employment generally includes an individual's gross income from a "trade or business," plus his distributive share of income or loss from a partnership in which he is a member. An exception provides that rental income from real estate is excluded from net earnings from self-employment, unless the rental income is received in the course of a trade or business "as a real estate dealer." (**Code §1402(a)(1)**) Similarly, dividend income and gain or loss from sale or exchange of a capital asset are excluded from net earnings from self-employment. (**Code §1402(a)(2), Code §1402(a)(3)**)

Comment: The Code mentions in the course of a trade or business "as a real estate dealer." Basically, that would involve the operation of a hotel, motel or bed and breakfast. Or, any real estate venture where "significant personal services" are provided in addition to the rental of the underlying realty. **But not if you meet the "Sec. 162 trade or business"standard asked for by the reg writers under Sec. 199A**.

Code §1402(a)(17), added by the **Small Business Act**, provides that "notwithstanding the preceding provisions of this subsection," (i.e., notwithstanding other self-employment rules) each spouse's share of income or loss from a "qualified joint venture" is taken into account under the **Code §761(f)** in determining the spouse's net earnings from self-employment. The IRS has indicated that an electing husband and wife must each file with their joint income tax return a *separate* **Schedule C** or **Schedule F**, along with a separate **Schedule SE** for each spouse.

Incorrect IRS Instructions: While the general instructions for the 2007 **Form 1040** did *not* address the issue, the instructions for the 2007 **Schedule E** informed electing spouses that for a "rental real estate business" each spouse had to report his or her share of this income on their respective **Schedules C** and *not* on **Schedules E**. In addition, IRS examiners have questioned whether the spouses' "qualified joint venture election" for a "rental real estate business" does *not* serve to convert income derived from this type of business into net earnings from self-employment.

Chief Counsel Advice: The CCA concludes that in the case of a husband and wife who make the qualified joint venture election for a "rental real estate business," each spouse has a share of the qualified joint venture income, and each spouse may exclude his or her respective share of the qualified joint venture income from net earnings from self-employment under the **Code §1402(a)(1)** exclusion. In other words, an individual who has income from a "rental real estate business" will *not* be subject to self-employment tax on the income because it is excluded from net earnings from self-employment under **Code §1402(a)(1)**. Instead, the income would be reported on **Schedule E** and then carried over to his individual return, but *not* include the amounts on **Schedule SE** in calculating self-employment tax.

> **Comment:** The wording in the advice is a bit misleading in that a "real estate trade or business" would simply pertain to the holding of rental real estate otherwise reported on **Form 8825** (i.e., as opposed to **page 1** of **Form 1065**). For example, if a married couple decided to transfer ownership of rental real estate to an LLC for liability protection reasons, it would *not* change the fact that it was still a rental *not* subject to S/E tax (i.e., no different than if the ownership of the rental property had never been transferred to the LLC). On the other hand, it would *not* make any difference (as to whether this election was made) if a married couple operated a hotel/motel through a **Schedule C** or an LLC. In either case, it would constitute a "trade or business" whose net profits are subject to S/E tax.

The CCA states that the legislative history of **Code §761(f)** suggests that any income earned by a "qualified joint venture" is reported for all federal tax purposes using the *same* forms "as if each spouse were a sole proprietor" who earns that income. The phrase "not withstanding the preceding provisions of this subsection," in **Code §1402(a)(17)** taken together with the rest of **Code §1402** and **Code §761(f)'s** legislative history directs that none of the preceding subsections in **Code §1402** are to alter that allocation between spouses. To read this phrase as nullifying the application of all the exclusions from net earnings from the definition of self-employment would trigger dramatic changes in the application of the self-employment tax to spouses electing qualified joint venture treatment. This was clearly *not* intended. The purpose of **Code §761(f)** was *not* to convert income that would otherwise be excluded from net earnings from self-employment altogether into income that is subject to self-employment tax. **(Code §761; Qualified Joint Venture)**

> **Comment:** The CCA goes on to state that its reasoning also applies to dividends and capital gains earned by a "qualified joint venture." That is, this income is also excluded from self-employment tax for a "qualified joint venture" (i.e., just as it would be if the same portfolio income was earned directly by the couple).

F. Other Forms of Partnerships:

1. Limited Partnership: A limited partnership (LP) is a partnership with special features. It must have at least one general partner who has unlimited personal liability. It must also have at least one partner who is only liable for his investment in the partnership. At one time, liability protection for the general partner was created by making the general partner a corporation. However, this is no longer necessary since the business can form an LLC instead. In exchange for the limitation of liability, the ULPA requires the limited partners to sacrifice some of the traditional privileges of the general partner. Therefore, the limited partner is restricted from participating in the control of the business. Section 10 of the ULPA sets forth the rights of a limited partner. As such, his distributive share of income, other than guaranteed payments for services actually rendered, is *not* self-employment income.[16]

2. Family Partnerships:[17] A person is a partner if he owns a capital interest in the partnership. Whether the capital interest is achieved by gift, purchase or contribution of property is irrelevant. Family partnerships are typically used to split income among family members. Frequently, some family members are minors and do **not** contribute any services to the partnership. When capital is a **material income-producing factor**, and the allocation of income between return to capital and return to services is reasonable, family partnerships are upheld.[18] However, it is extremely important that any family members performing significant services for the partnership receive an adequate guaranteed payment in return. These rules are not a problem for families in which all partners participate in the business. Family partnerships are discussed in more detail later in this chapter.

3. Family Limited Partnership: In recent years, limited partnerships are being formed for estate planning purposes. In these situations, a parent is a general partner. Consequently, he controls the partnership with gifts or other transfers of limited partnership interests. Both for gift and estate transfer purposes, discounts in value have been obtained by the limited partners for both lack of control and marketability of their interests. The IRS and

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[16] Code §707(c) defines guaranteed payments as those determined without regard to the income of the partnership

[17] Code §704(e)

[18] *Leo A. Woodbury, et al. v. Commr.*, 49 TC 180 (1967); A. 1969-2 C.B. XXV; *William H. Gross v. Commr.*, 7 TC 837 (1946); A. 1946-2 C.B. 2.

Congress are starting to limit the discounts, especially for investment-type partnerships in which the parents continue to benefit from most, if not all, of the income generated by the LLC's assets. This is especially the case when the parents leave little, if any, assets outside the LLC to sustain their normal budgetary needs. Nevertheless, the IRS has been allowing modest discounts when other individuals own a part of the limited partnership. However, they continue to make strong attacks regarding whether the gift of a partnership interest constitutes a "completed gift." For instance, one recent case upheld the family limited partnership, but included the entire value of the partnership in the federal estate of the original assets owner. In this case, the contributor retained management control of the partnership assets, and did **not** distribute any cash or property to the limited partners.[19] The courts uphold the family limited partnership in other cases in which things were "done right." Property needs to be transferred for adequate consideration and the partners need to share in their percentage of the partnership income.[20] In a 2006 case, the court upheld a 60% discount for lack of control based on the difficulties associated with valuing the property, relationships among partners, and the use of the property.[21]

4. Limited Liability Company: A limited liability company must file articles of organization as an LLC under the laws of the state. Members of an LLC are **not** personally liable for any debt of the LLC. The conversion of a partnership into an LLC, classified as a partnership for federal tax purposes, does **not** terminate the partnership. An LLC that is incorporated under state law is treated as a corporation (i.e., regardless of whether the LLC makes a "check-the-box" election on **Form 8832**).

5. Limited Liability Limited Partnership: A limited liability limited partnership (LLLP) is a partnership that registers under state law so the general partner has limited liability protection similar to limited partners. It may be an alternative to an LLC in states that allow foreclosure of an owner's business interests and forced liquidation of the business by the owner's personal creditors. However, LLLPs are **not** allowed in all states.

6. Professional Limited Liability Corporation: A professional limited liability company (PLLC) is an LLC formed to provide professional services. Typically, it is used in a business when the state requires a license to provide such services.

G. Key Terms:

1. Member: An LLC member is an owner. This is comparable to a partner in a partnership, except the member is offered liability protection under state law.

2. Managing Member: A managing member is the same as the general partner. However, unlike a general partner, the managing member has liability protection (except to the extent that they may have guaranteed any of the LLCs debts).

3. General Partner: A partner who is personally liable for partnership liabilities is considered a general partner. A partner is **not** considered an employee of the partnership and must pay self-employment tax on his share of the partnership's business income. This person is equivalent to the managing member in an LLC. Self-employment taxes are discussed more fully later in this chapter.

Comment: The point needs to be emphasized that the owners of a partnership or an LLC are **not** "employees" of the entity. Therefore, they do **not** receive a W-2 (instead they are paid "guaranteed payments" which are reported in **Box 4** of their **K-1**) and, except in limited circumstances, cannot partake of the tax-free fringe benefits that rank-and-file employees otherwise enjoy.

4. Limited Partner: A limited partner is one whose personal liability is limited to the amount of money or other property he contributed (or, will contribute) to the partnership. It is important to know if a partner is a limited partner because the tax treatment of some of his allocated partnership items is different from a general partner. A limited partner may be limited on the reported losses he may deduct, and he is generally **not** subject to S/E tax on his share of partnership income.

Comment: This exclusion from S/E tax does **not** apply to guaranteed payments made to a limited partner for

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[19] *Theodore R. Thompson v. Commr.*, 84 TCM 374, (2002); aff'd 382 F.3d 367 (3rd Cir. 2004).

[20] *Estate of Eugene E. Stone III v Commr.*, 86 TCM 551 (2003); *Estate of Albert Strangi v. Commr.*, 115 TC 478, (2000); *Estate of Ruth Kimbell v. U.S.*, 371 F.3d 257 (5th Cir. 2004).

[21] *Estate of Charlotte Dean Temple* v. U.S., 423 F.Supp.2d 605 (E. D. Tex. 2006).

services actually rendered to or on behalf of a partnership engaged in a trade or business.

Comment: Generally, they are "passive investors" who are willing to let the general partner (or, "managing member" in an LLC) run the day-to-day affairs of the entity. They may contribute cash and/or property, but *not* services, to the entity. But, if a limited partner (or, "investor member of an LLC) starts to take an active role in the management of the entity, they could be recharacterized as a general partner (or, "managing member" in an LLC).

5. Nonrecourse Loans: A nonrecourse loan is one for which no member or related person would ultimately bear an economic risk of loss (i.e., any personal responsibility for its repayment if the entity should fail to repay it in full). Therefore, the only means by which a creditor in such instances can look to be repaid is by LLC profits. And, thus, the creditor is the only one that would bear the economic risk of loss and could thereby lose money upon default of the loan. A member's share of nonrecourse deductions is normally determined by his interest in the LLC (unless he or she has personally guaranteed that particular debt). However, as discussed below, the "minimum chargeback" rules can come into play in making this determination.

Under former **Reg. §1.752-1(e)**, a partner's share of nonrecourse debt was based solely on the partner's *profit* sharing ratio since the only way that the debt could be repaid was through partnership profits. But, the regs were then revised to describe *three* different categories or layers of debt allocation that must be used in allocating the partnership's nonrecourse debt to each owner.

Final **Reg. §1.752-3** (which was effective 10/31/2000), along with **Rev. Rul. 92-97** and **Rev. Rul. 95-41**, outline the three layers that must be applied in order to allocate the nonrecourse debt to basis properly. There three layers are as follows:

- LLC member's share of **Code §704(b)** minimum gain
- LLC member's share of **Code §704(c)** minimum gain
- LLC member's share of "excess nonrecourse debt"

Under this *last* "allocation layer," the member is allocated any "excess nonrecourse liabilities" *not* allocated to layers 1 and 2 under one of several methods that the LLC is free to choose. For instance, the LLC may choose to allocate these nonrecourse liabilities in accordance with the member's share of LLC profits per the operating agreement or based on "certain reasonably expected deductions." In addition, base on the final regs, the LLC may first allocate an "excess nonrecourse liability" to a particular member up to the amount of the "built-in gain" that is otherwise allocable to that member based on any **Code §704(c)** property (or, property for which "reverse" **Code §704(c)** applies), where such property is subject to the nonrecourse liability to the extent that such built-in gain exceeds the gain described in layer 2 with respect to such property. However, this additional method does *not* apply for purposes of **Reg. §1.707-5(a)(2)(ii)** and does *not* apply to any liability incurred or assumed by an LLC *prior to* October 31, 2000. Furthermore, to the extent that an LLC uses this additional method and the *entire* amount of the excess nonrecourse liability is *not* allocated to the contributing member, the LLC must allocate the remaining amount of the excess nonrecourse liability under one of the other methods described in the regs for the *third* layer.

Comment: Final **Reg. §1.752-3(c), Example 3** describes in detail how this method applies.

a. **Sec. 704(b) "Minimum Gain:"** This is the amount of gain that would be recognized if the LLC disposed of the property in full satisfaction of the nonrecourse liability and for no other consideration.[22]

b. **Sec. 704(c) "Minimum Gain:"** This is the amount of gain that would be recognized if the LLC disposed of **Code §704(c)** appreciated property in full satisfaction of the debt and for no other consideration (i.e., where the nonrecourse liability on the contributed property exceeds the adjusted basis on that particular piece of property).[23]

c. **"Excess Nonrecourse Liabilities:"** These would be all of the nonrecourse liabilities *not* accounted for in either layer 1 or 2. These allocations are determined in accordance with the member's share of LLC profits that may be allocated differently per the operating agreement

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[22] Reg. §1.752-3, Example 1.

[23] Ibid.

with regard to layer 3. This occurs because there may be special allocations for nonrecourse deductions (e.g., depreciation) that are allocated to one particular member. As a result, the corresponding nonrecourse liability must be allocated to that member to allow their outside basis to take into account this deduction. If these types of allocations are made, they must have "substantial economic effect" (i.e., pursuant to **Code §704(b)(2)**). If they do not, then the nonrecourse liabilities should be allocated by the profits interest in effect for other items per the operating agreement or allocated up to the amount of the built-in gain that is allocable to the member of the **Code §704(c)** property (or reverse **Code §704(c)** allocation that exceed layer 2 gain).[24]

Comment: The allocation of "excess nonrecourse liabilities" can change every year, so IRS auditors may need to request a copy of the actual LLC operating agreement, as well as any amendments. If the operating agreement is silent in this area, then the profits interest ratios should be used in preparation of the members' K-1s.

- If any member (or, members) personally guarantees the underlying loan, this will then override the nonrecourse liability scenario discussed above and this debt will instead be now considered a *recourse* liability for which this particular member will bear the economic risk of loss. As a result, this debt will be allocated to that one member (or, members).[25]

- If any member (or related person[26]) directly loans the LLC money, and the loan is nonrecourse (i.e., no other member is responsible for its repayment should the entity fail to repay it), than that member will be considered to bear the economic risk of loss. As a result, the debt is entirely allocated back to that member for basis (and, at-risk) purposes.[27] However, there can be no right of subrogation from any other member.[28]

Comment: If the debt is "qualified nonrecourse financing" (generally, nonrecourse loans secured by only the underlying real estate), then each member will be considered at-risk and losses will be allowed (unless the passive loss rules otherwise apply to prevent the deduction).

H. Classification Issues: The IRS first attempted to write revenue rulings for each state law to indicate whether an LLC enacted under such legislation would automatically meet requirements to be taxed as a partnership.

The former Treas. **Reg. §301.7701(3)** listed six characteristics attributable to a corporation. These are:

1. Associates
2. Objectives to carry on a business for profit
3. Continuity of life
4. Transferability of interests
5. Centralized management
6. Limited liability of owners

Partnerships, corporations and LLCs **all possess the first two characteristics**. As a result, if the entity possessed **three or more** of the remaining characteristics, it was taxed as a **corporation**.

I. Check-the-Box Election: Effective January 1, 1997, **Reg. §§301.7701-1** to **-3** greatly simplify the task of

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[24] Reg. §1.752-3(c), Examples 2 and 3.

[25] Reg. §1.752-2(f), Example 5.

[26] Cf. Reg. §1.752-4(b) for the definition of a "related party."

[27] Reg. §1.752-2c.

[28] Reg. §1.752-2(b)(5).

classifying an entity as either an association (i.e., taxed as a corporation) or as a partnership. These regulations are commonly referred to as the "check-the-box" rules. For federal income tax purposes, the result is that domestic unincorporated entities may be treated as partnerships without the necessity of meeting the "four-factor test" of the former regulations. The end result is that a multi-member LLC is treated as a partnership unless it elects to be taxed as a corporation. An LLC taxed as a partnership is therefore a passthrough entity. Tax consequences follow the operating agreement among the members.

There are two aspects of an LLC which may make taxation of LLC members different from partners in a partnership. These are:

• The lack of a fully liable owner (e.g.; a general partner of a limited partnership), and

• The ability of all members to participate in management without the risk of personal liability for the actions of other members.

When the above issues come into play, some partnership regulations can be ambiguous. This is true since LLCs were **not** contemplated at the time these regulations were written. The application of many rules for partnership taxation depends upon the concept of general and limited partners in the following areas:

1. Basis calculation
2. At-risk rules
3. Passive loss rules
4. Method of accounting
5. Selection of the tax matters partner
6. Self-employment tax

J. Accounting Methods: An LLC must use **accrual** accounting if it has a **C corporation** among its members, or if it is a tax shelter.[29] However, relief from the accrual accounting requirement is available to LLCs that qualify as a farming business, or whose average gross receipts are $5 million or less for the past three years (or, the LLC's period existence, if less than three years).[30] An exception is also available if more than 65% of the losses are allocated to members who actively participate in management. In that case, the LLC is **not** considered a "tax shelter."[31] Therefore, until this problem is resolved, if cash accounting is desired, LLCs should **not** be used unless members are sure net income will be positive, or at least 65% of any losses will be allocated to members who are considered active in management.

Comment: LLCs with S corporation members are eligible to use the **cash** method of accounting regardless of gross receipts. Otherwise, LLCs are allowed to use the **cash** method and fall under the **same** rules as other entities.

☞**Change Treated as Accounting Method Change Despite Increase in Partnership Property Basis (CCA 201521012)**

The IRS has concluded that, where an adjustment would otherwise constitute an "accounting method change," the fact that the adjustment permanently increases a partnership's basis in its property by changing the adjustment required by **Code §734(b)** does *not* create a change in "lifetime taxable income." As a result, the adjustment is still an "accounting method change."

Background - Accounting Method Changes: **Code §446(b)** provides that, if a taxpayer's accounting method "does *not* clearly reflect income," the computation of taxable income is to be made under a method that the IRS decides does in fact clearly reflect income. Furthermore, the IRS has "broad discretion" in determining whether a taxpayer's accounting method clearly reflects income, and the IRS's determination must be upheld unless it is "clearly

[29] Code §448(a)

[30] Code §448(b); but, TCJA changed this to $25 million or less of average gross receipts for 2018 onward.

[31] Code §464(c)

unlawful." (***Thor Power Tool Co.*, 43 AFTR 2d 79-362 (S Ct, 1979)**)

A "change in accounting method includes a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any material item used in such overall plan." A '"material item" includes '"any item that involves the proper time for the inclusion of the item in income or the taking of a deduction." (**Reg. §1.446-1(e)(2)(ii)(a)**) In determining whether timing is involved, generally the pertinent inquiry is whether the accounting practice "permanently affects the taxpayer's lifetime taxable income or merely changes the tax year in which taxable income is reported." (**Rev. Proc. 2002-18, §2.01**) If the accounting practice does *not* permanently affect the taxpayer's lifetime taxable income, but does or could change the tax year in which taxable income is reported, it involves timing and is therefore considered to be an "accounting method."

For purposes of **Code §446**, "lifetime taxable income" is analyzed with respect to the item(s) at issue solely at the partnership level (**Reg. §1.481-2(c)(5)(i)**). And, when a taxpayer changes its accounting method, **Code §481(a)** adjustments must be made to prevent items from being duplicated or omitted. (**Reg. §1.446-1(e)(3)(I)**)

Background - Adjustment to Basis of Partnership Property After Partnership Distribution to Partner: **Code §731(a)(1)** provides that, in the case of a distribution by a partnership to a partner, gain must be recognized by the partner to the extent that any money (or, FMV of marketable securities) distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution. And, unless the partnership increases the basis of its assets to reflect the **Code §731(a)(1)** gain, if any, recognized by the withdrawing partner, there may be a "temporary distortion" in the income recognized by the remaining partners, who may be taxed on the built-in gain economically attributable to the redeemed partner.

To eliminate this type of timing distortion, **Code §734(b)(1)** provides that, if the partnership otherwise has an election under **Code §754** in effect, the partnership increases the adjusted basis of partnership property by the amount of any gain recognized to the distributee partner under **Code §731(a)(1)**. The partnership then takes any **Code §734(b)** adjustments into account when subsequently calculating its gain or loss upon the ultimate sale or disposition of property subject to an **Code §734(b)** adjustment.

Code Sec. 754 Election: **Code §754** provides an election under which partnerships may adjust the bases of their assets upon the happening of *either* a distribution of partnership property to a partner or a transfer of a partnership interest. And, because **Code §705** provides that each partner's basis in his partnership interest is increased by his distributive share of income from the partnership, an increase in partnership property basis will, at some point, reduce partnership income, but will also reduce each partner's basis in his partnership interest by that same amount. As a result, an election under **Code §754** does *not* affect the total income recognized by all the partners over the life of the partnership. **(Code §754; Basis Adjustment)**

> **Comment:** If a Sec. 754 adjustment is *not* made when a departing partner recognizes a gain due to a **Code §731** distribution, then this increased gain recognition will be reflected, in turn, when the partnership ultimately disposes of its remaining property resulting in an corresponding increase in each partner's outside basis in their partnership interest. And, then this will usually result in a corresponding capital loss when the partner sells or exchanges their individual ownership interest in the entity (or, the partnership itself is liquidated).

K. Tax Matters Partner: Partnerships who have **more than 10 partners**, have a nonresident alien as a partner, or have a partner other than a natural person are generally subject to **comprehensive unified audit proceedings**. These proceedings are designed to facilitate audits by determining adjustments at the **partnership level** rather than forcing the IRS to audit **each individual partner**. Every partnership or LLC subject to these provisions must have a tax matters partner (TMP). The statute defines tax matters partner as the general partner, or the partner with the **largest profits interest** if there is no designated general partner. In an LLC with a member-manager, the **member-manager** is treated as a general partner and is considered the TMP. In cases in which there is no member-manager, **any** member can be considered a member-manager and can be designated by the members to serve as the TMP.

L. Partnership to LLC Conversion: The IRS has long recognized that general and limited partnerships can convert from one form to the other without causing a termination (or, immediate taxation) if, after the conversion, the old partnership's business is continued and each partner's percentage interest in profits, losses and capital remains the **same**. Private letter rulings indicated that conversion to an LLC or limited liability partnership (LLP) receives the same treatment. The conversion from a **general partnership** to an LLC does **not** close the tax year for any partners and the new LLC does **not** need to obtain a new taxpayer identification number.[32]

Rev. Rul. 99-5 addresses situations in which a **single-member LLC** sells a one-half interest to a new member. This is an issue because single-member LLCs are **disregarded entities**. The transaction is treated like a sale of a partnership interest. **Rev. Rul. 99-6** describes the reverse process in which the members of a multi-owner LLC sell their interests to a single owner. In each case, the continuing member has a nontaxable conversion for his share of ownership in the transaction.

M. Sale of an Interest: Under **Code §741**, a member who sells or exchanges an interest in an LLC generally recognizes a capital gain or loss in the same manner as with the sale or exchange of a partnership interest. However, under **Code §751**, ordinary gain or loss results to the extent of the member's disposition of his share of unrealized receivables and substantially appreciated inventory (and other "hot assets" such as depreciation recapture and unrecaptured Sec. 1250 gain).

An additional complication in a sale, exchange, or other transfer of an LLC interest is the recognition of the member's relief from their share of liabilities as an additional part of the amount realized. This may force a major recognition of gain in the year of transfer.

If the LLC makes an **Code §754** election (or, otherwise already has one in effect), the acquiring members receives an immediate step-up in basis for their share of the LLC's assets. This may provide the new member with a significant tax benefit for depreciation and amortization, as well as inventory deductions. This is especially true when a member is buying into a service-type LLC.

N. Estate Planning: Since the outside basis of a member's interest is stepped up on the death of that member (except for 2010 when we had the option of "modified carryover basis"), an interest transfer made at death may provide significant tax savings over the transfer of corporate stock.[33] If the LLC makes the Sec. 754 election to allow for the adjustment of inside basis, the estate's share of the LLC's assets are also stepped up to reduce the amount of gain recognized on the disposition of the asset by the LLC and/or to increase depreciation or other deductions.

O. Other Developments:

1. Letter Rulings 9350013 AND 9412030: No gain or loss was recognized under **Code §721** by any party when a partnership converted to an LLC. The LLC was treated as a continuation of the partnership, so the partnership did **not** terminate under **Code §708** by reason of the conversion. The LLC was *not* prohibited from using the cash method of accounting since the LLC:

- Was classified as a partnership,
- Did *not* have a corporation as a member, and
- Was *not* a tax shelter.

Comment: The only difference between these two rulings is that **PLR 9350013** deals with a law firm and **PLR 9412030** deals with an accounting firm.

2. Letter Ruling 9416028: An LLC was classified as a partnership for tax purposes. No gain or loss was recognized by any party when the LLC's predecessor limited partnership converted to an LLC. The LLC was treated as a continuation of the partnership. Therefore, there was no termination of the partnership equity by reason of the conversion.

3. Letter Ruling 9420028: A general partnership's conversion to a limited liability partnership under state law did **not** result in a termination of the general partnership under **Code §708**. The general partnership's business continued in the LLP, and the partner's interests in capital, profits and losses remained the same after the conversion. The LLP was required to use the same method of accounting and accounting period as the general

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[32] Rev. Rul. 84-52, 1984-1C B 157; Rev. Rul. 86-101, 1986-2 CB 94

[33] A "Code Sec. 338(h)(1) election" to treat a corporate stock purchase as instead being a deemed asset purchase could effectively be viewed as an equivalent to a Sec. 754 election for a partnership.

partnership unless the IRS granted permission for a change.

4. Letter Ruling 9636007: An S corporation that converted to an LLC was permitted to continue to be taxed as an S corporation after the transfer of the corporation's assets and liabilities to the LLC in a **Type F reorganization**.

5. Proposed Regs. §§1.707-5(a)(8), 1.707-7 AND 1.707-8(c): Proposed regulations were released on November 26, 2004 further restricting transactions between a partner and a partnership. The prior regulations presumed a contribution of property by a partner and a subsequent distribution of cash within two years was a disguised sale. The proposed regulations changed this to a **7-year presumption**.[34]

A transfer of property or other consideration (including the assumption of a liability) by a partner (purchasing partner) to a partnership and a transfer of property or other consideration to another partner (selling partner) is treated as a sale of the selling partner's interest in the partnership to the purchasing partner. The facts and circumstances of the transaction are used to determine if a deemed sale occurred. Transfers **after two years** are **not** presumed to be a sale.[35]

Liabilities incurred on property which is transferred to a partnership **within two years** is presumed to be incurred in anticipation of the transfer unless facts and circumstances establish otherwise. The proposed regulations add a **7-year rule** requiring disclosure if a partner transfers property to a partnership and the partnership assumes a liability of the partner within a 7-year period.[36]

> **<u>Comment</u>:** While these transactions may **not** create a taxable event, they are required to be disclosed by attaching a statement or Form 8275 (Disclosure Statement) to the tax return.

☞**<u>Indirect LKE Between Related Partnerships Allowed</u> (<u>PLR 200810016</u>)**
The IRS has confirmed that indirect like-kind exchanges between related parties can defer tax. In this instance, it approved a swap involving related partnerships where one of them acquired realty from the other through an intermediary. The partnership that disposed of the realty then acquired qualified replacement property from an unrelated party. The tax on the exchange will be deferred as long as *both* partnerships keep the realty they acquired for two years. However, if either partnership sells during that time frame, *both* will owe tax on their gain. **(<u>Code §1031</u>; LKEs)**

> **<u>Comment</u>:** This strategy might provide a good way to get excess liquidity out of one related entity and into another to be used to acquire additional assets without giving up ownership of the original parcel. But, remember that under the **TCJA**, like-kind exchanges after 2017 will **only be permitted for real estate assets**.

☞**<u>LKE Treatment Allowed for Acquisition of Partnership Interest in Limited Circumstance</u> (<u>PLR 200807005</u>)**
Normally, the acquisition of a partnership interest is *not* considered to be "qualified replacement property" in a like-kind exchange. Instead, the law requires that **actual title in the underlying property** be obtained. However, in this ruling the IRS agree that where the monies being held by a qualified intermediary in an escrow account were used to acquire all of the partners' interests in a partnership that held nothing but a parcel of real estate, it could be treated as the acquisition of "qualified replacement property." **Because the taxpayer got the whole partnership, it was treated for tax purposes as if it got all of the partnership's underlying assets**. **(<u>Code §1031</u>; LKEs)**

> **<u>Comment</u>:** This might be the first time that we have seen the acquisition of a partnership interest as being "qualified replacement property." But, it makes senses from the standpoint that this partnership could have been dissolved by passing out its real estate to the respective partners (who would then own the property as tenants-in-common). Then, if they transferred the property to the taxpayer pursuant to the like-kind exchange, it would have put the taxpayer in the *same* place (i.e., in complete ownership of the property as the sole owner of all of the partnership interests).

<u>Notes</u>:

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[34] Prop. Treas. Reg. §1.707-3(c)(2)

[35] Prop. Treas. Reg. §1.707-7

[36] Prop. Treas. Reg. §1.707-5(a)(8)

CHAPTER III: LLC FORMATION

A. Formation Decisions

1. Articles of Organization: An LLC is a separate legal entity like a corporation, distinct from its owners, having full powers to conduct business in its own name. Creation of the LLC is accomplished by filing articles of organization with the Secretary of State or the appropriate office in the jurisdiction under whose laws the LLC is chartered. The articles must be signed by one or more persons, including third parties such as the attorney. Unlike a partnership, an LLC may be formed having **only one member** (i.e., a SMLLC). However, to make an election to be taxed as a partnership, there must be **two or more** member-owners.

> **Comment:** This comes across as being more complicated than it really is. In WI, for instance, you simply go to the Department of Financial Institutions **website** and fill out an "Articles of Organization" form and submit a payment of $130 for an on-line application. The form asks for the LLC name and its registered agent. After you receive back an approval letter, you will also need to file an **SS-4** to obtain an employer identification number. Take the information to the bank to open a checking account for the LLC. An annual registration fee of $25 is also charged by the state.

Articles of organization for an LLC are similar to articles of incorporation for a corporation. Typically, articles of organization contain:

- Company name,
- Purpose(s) for forming the company,
- Company and the initial resident agent mailing address,
- A statement indicating whether the company will be managed by a manager rather than members, and
- Duration of existence for the company; such as perpetual or for a pre-determined period of time.

2. Operating Agreement: The formality of developing a written partnership agreement, or operating agreement can be very important for small businesses and LLCs. For instance, operating agreements force discussion and decision making on many issues at formation. Unfortunately, problems arise because issues are frequently deferred or glossed over. It may even be difficult to ascertain whether the members are actually owners of an LLC or to determine who owns what property. If an LLC is intended, the individuals should make it look and perform like an

LLC.[37] If it is determined that the entity is **not** an LLC, it could lose the liability protection provided by an LLC.

An **LLC should have an operating agreement** between its members since it serves to provide the LLC operating rules and procedures. The operating agreement has the same purpose as the partnership agreement among partners or corporate by-laws in a corporation insomuch as **operating agreement regulates the business activity and the relationship among the members**.

Nevertheless, like a partnership, an operating agreement is **not** required for the LLC to be valid. Most states have LLC statutes that contain default provisions that apply if no agreement is in place. However, members should create an operating agreement since it is the document used to settle any member disagreements.

Key decisions at the time of organization include:

- What property and debts to contribute,
- Which property is owned by the members and which is leased to the LLC,
- Any special allocations on contributed property,
- The selection of tax year and accounting method, and
- The election to amortize organizational and start-up expenses (for such costs incurred *before* 9/9/08).

The LLC is managed by its members or by one or more managers. The manager selection method should be described in the operating agreement. The manager is normally elected by the members, similar to the election of directors by corporate shareholders.

Members should consider the following provisions and include them in the operating agreement as appropriate.

1. LLC formation and registered agent
    a. Name
    b. Registered agent and office
    c. Continuance of LLC
    d. Business purpose
    e. Principal place of business
    f. Identification of members
    g. Admission provisions for new members
2. Capital contributions
    a. Initial contribution
    b. Additional contributions
3. Profits, losses and distributions
    a. Allocation of profits and losses
    b. Distributions to members
4. Management

[37] *Leo A. Woodbury,et al. v. Commr.*, 49 TC 180 (1967). The Tax Court found a father and minor son farm partnership to be a partnership for tax purposes because of the way the business was operated. See also, *Manuel v. Commr.*, 45 TCM 981 (1983). In that case, the farm business was *not* a partnership between a parent and child.

a. Name and address of manager

b. Liability of nonmember managers

c. Powers of managers

d. Chief executive manager

e. Nominee

f. Company information

g. Exculpation

h. Indemnification

i. Records

5. Compensation

a. Management fee (either done with guaranteed payment or special allocation)

b. Reimbursement arrangements (especially for member expenses)

6. Accounting

a. Books

b. Members capital accounts

c. Financial reports

7. Transfers of member interest

a. Assignment

B. Organization and Start-Up Expenses

1. Incurred After 10/22/04: Organization and start-up expenses incurred after October 22, 2004 as a direct result of the LLC's creation may be eligible for an immediate deduction.[38] These expenditures are categorized into three areas:

- Investigatory,
- Business start-up, and
- Anticipatory activities.

Such costs can only be amortized if they meet all of the following tests:

- They are specifically incurred for the creation of the LLC and *not* for the starting or operating of the entity's trade or business;[39]
- They are otherwise chargeable to a capital account;
- They could be amortized over the life of the LLC if the entity otherwise had a fixed life; and
- They are incurred by the due date of the LLC return (excluding extensions) for the first tax year in which the entity actually conducts business activities.

Comment: As to this last requirement, an LLC using the cash method of accounting is *not* permitted to deduct an organizational cost unless it is actually paid by the end of the tax year. However, any cost the LLC could have deducted as an organizational cost in an earlier year (i.e., if it had been paid that year) can be deducted in the year actually paid.

Organizational costs include the following fees:

- Legal fees for services incident to the organization of the LLC, such as the negotiation and preparation of the LLC operating agreement
- Accounting fees for services incident to the organization of the LLC
- Filing fees (such as recording the LLC name and filing the operating agreement)

Nonqualifying costs would include:

- The cost of acquiring assets for the LLC or transferring assets to the partnership (e.g., surveys and preparation and filing of deeds). They must be capitalized in a fashion similar to the purchase cost of land or added to the property's basis.
- The cost of admitting or removing members, other than at the time that the LLC is first organized
- The cost of making a contract concerning the operation of the LLC's trade or business (including a contract between a particular member and the LLC)
- The costs for issuing and marketing ownership interests in the LLC (e.g., brokerage and registration fees, along with legal fees and printing costs). These "syndication fees" are considered capital expenses that cannot be amortized.

Comment: Organizational costs generally involve the type of item which could normally be expected to benefit the LLC throughout its entire life. And, as mentioned above, if the LLC uses the cash method of accounting, organization expenses **cannot** be amortized until paid and the business has **actually commenced** for tax purposes.

Organizational or Start-Up Costs Incurred Before 10/23/04: *All* such costs were written off over a **60-month period**, given a proper election under the appropriate Code section was made with the entity's first tax return.

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[38] Code §§248 and 195

[39] These latter costs would instead be **Code §162** ordinary and necessary expenses that are being incurred once the business is up and running and would, therefore, be taken on its first tax return.

Organizational or Start-Up Costs Incurred After 10/22/04: Taxpayers could elect to currently deduct up to $5,000 of start-up expenses in the year the business begins. Any excess expenses were amortized over 180 months. But, if start-up expenses exceeded $50,000 in either category, the $5,000 deduction amount is reduced on a dollar-for-dollar basis (i.e., and would, therefore, be eliminated at $55,000 or more of such costs).

Organizational or Start-Up Costs Incurred After 9/6/04: The election to amortize either organization expenses or start-up costs (above the $5,000 threshold for immediate expensing) was formerly made by attaching a statement to the LLC's return for the taxable year in which the LLC began business. However, for such costs incurred after 9/6/08, final regs have been adopted whereby the election is now deemed to be *automatic* unless the taxpayer formally elects out of **Code §195** (i.e., start-up costs), **Code §248** (i.e., for non-partnership organizational costs) or **Code §709** (i.e., for partnership organizational costs).[40]

> **Comment:** Taxpayers were permitted to apply all the provisions of the new regs to expenses paid or incurred after Oct. 22, 2004, provided the period of limitations on assessment of tax had *not* expired for the year the election under **Code §195**, **Code §248**, or **Code §709** is deemed made. In other words, if a taxpayer failed to make the election and was therefore technically forced to capitalize such costs, they could now go back and deduct up to $5,000 of such costs and amortize the rest over the 180-month period otherwise allowed (if the statute of limitations on amending the return had *not* yet passed).

A taxpayer may irrevocably choose to forgo the deemed election by clearly electing on **Form 4562** to instead capitalize its start-up or organizational expenses on a timely-filed federal income tax return (including extensions) for the tax year in which the active trade or business begins (**Code §195**), the tax year in which the corporation begins business (**Code §248**), or the tax year in which the partnership begins business (**Code §709**). (**Reg. §1.195-1T(b), Reg. §1.248-1(c), Reg. §1.248-1T(b)**) The temporary regs also contain examples illustrating how the election is made, how to calculate the amount of the deduction that is allowed in the year in which the election is made, and how to effect subsequent re-determinations in the characterization of an item or the year in which the trade or business begins.

To determine when the LLC began business is a matter of facts and circumstances. The mere signing of the LLC agreement is **not** sufficient to show the LLC began business. If the LLC has "advanced to the extent necessary to establish the nature of the business," it is deemed to have begun business for tax purposes. The purchase of assets and placing them in a state of readiness also establishes the LLC began business.[41] The election should include the LLC's name and address and the fact that it is being filed pursuant to **Code §709(b)**. The statement should also include a description of each incurred organization expense with the amount, the day and month the LLC began business, and the number of months (not less than 180) over which the expenses will be amortized.[42]

> **Example 1:** MJ Accounting, LLC incurred and paid the following organization expenses upon its formation in 20x1: legal fees to draft an agreement of $1,500, accounting fees of $600 for advice on formation, and various filing fees of $500. Since these organizational costs did *not* exceed $5,000, all of them can be immediately deducted in 20x1.
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> **Comment:** Prior to October 23, 2004, an election statement would have been included to amortize such costs over **not** less than 60 months. This is **no longer necessary** since the first $5,000 of such expense can be **immediately expensed**. However, when the post-10/22/04 rules first came out, if either type of cost (organizational or start-up) exceeds $5,000, then an election statement had to be included, but it should state "180 months" instead of "60 months." Under the tax law in effect now for such costs, an election no longer need to be included unless the taxpayer wanted to elect out of the immediate deduction for the first $5,000 of these costs.
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> **Example 2:** TFIG Restaurant, an ever-expanding chain of carry-out restaurants, incurred $15,000 of start-up costs in preparing to open another location. Under the rules stated above, the first $5,000 of such costs can be elected as an immediate expense, and the remaining $10,000 amortized over **not** less than 180 months.

Syndication costs for "tax loss partnerships" must be capitalized, and are **nondeductible and nondepreciable**.[43]

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[40] T.D. 9411.

[41] Treas. Reg. §1.709-2(c)

[42] Code §195(b)

[43] Rev. Rul. 85-32, 1985 C.B. 186.

If the LLC liquidates before all expenses are amortized, the unamortized amount is **deducted in the final taxable year**. However, there is no LLC deduction for **capitalized syndication** expenses.[44]

C. Tax Years Allowed

1. Required Tax Year: Under **Code §706(b)(1)**, the tax year of an LLC must be determined by systematic reference to certain tax years of the members. As a result, a new LLC must elect the **same** taxable year as that of its **majority member** (i.e., member with a more than 50% aggregate profit and capital interest). If all the members are **individuals**, then the **calendar year** is used. However, if a **fiscal-year corporation** is the majority member, then its tax year must be used.

If there is no majority member, than the tax year of all **principal members** (i.e., all members with a 5% or greater profit and capital interest having the *same* yearend) must be used.

If a required tax year cannot be determined under either of these first two approaches, then the LLC's tax year must be determined under the **least aggregate deferral method**. In other words, the tax year that results in the least aggregate deferral of income to the members will control. The steps used in this process are as follows:

Step 1: Figure the number of months of deferral for each member using one particular member's tax year. Then, count the months from the end of that tax year forward to the end of each other member's tax year.

Step 2: Multiply each member's months of deferral figured in Step 1 by that member's interest in the LLC's profits for the year used in Step 1.

Step 3: Add the results in Step 2 to arrive at the total deferral for the tax year used in Step 1.

Step 4: Repeat Steps 1 and 2 for each member's tax year that is different from the other members' tax years.

The member's tax year that results in the lowest total number in Step 3 is the required tax year of the LLC. If the calculation results in more than one year qualifying as the tax year that has the least aggregate deferral, the LLC is permitted to use any one of those tax years as its tax year. However, if one of the years that qualifies is the LLC's existing tax year, the LLC must retain that tax year.

Example 3: CJ Auto Repair, LLC is comprised of all **individual** members. It uses the **calendar year** as its required tax year.

Example 4: An LLC is formed with a C corporation owning 51%, which has a fiscal year end of June 30. The other member is an individual. Given the majority member has a fiscal year end, June 30 is the required year end of the LLC.

2. Business Purpose Exception: An LLC can establish a "business purpose" for a fiscal year end. For example, a seasonal business such as a ski slope operation could elect a June 30 year end since this would be a much slower time of the year rather than December 31 (i.e., where is was otherwise owned by all individual members).

3. Natural Business Year: If an LLC establishes that more than 25% of its gross receipts consistently come within a 2-month period over three consecutive years, then a fiscal year end can be elected to coincide with the end of this 2-month period. An example might be a tax practice which consistently receives at least 25% of its gross receipts during April and May each year.

Comment: In most cases, members and the LLC may **not** have **different** taxable years without the consent of the Commissioner.[45] Furthermore, a **new** LLC must file a letter with its **first** return indicating its election of a taxable year.[46]

4. Sec. 444 Election and Required Payments: Section 10206 of the **Omnibus Budget Reconciliation Act**

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[44] Treas. Reg. §1.709-1(b)(2)

[45] Code §706(b). For procedures to adopt other taxable years, see Rev. Proc. 87-32, 1987-2 C.B. 396. For guidelines to determine whether a "natural business year" exists, see Rev. Proc. 2002-39, 2002-1 C.B. 1046.

[46] Code §706(b)(5)(ii)(b)

of 1987 allowed a partnership, an S corporation, or a personal service corporation to elect to retain as its tax year the last tax year beginning in 1986. Alternatively, for its first tax year beginning after 1986, it could instead elect to adopt or change to a tax year with a deferral period that is **not** longer than the **shorter of three months** or the deferral period of the year that is being changed.[47] If the election was made to adopt a tax year other than the tax year required under the 1986 Tax Reform Act, then a **required payment** had to be made. This was intended to maintain a deferred payment balance for the taxes that were deferred by the partners or shareholders due to the election of a tax year other than a calendar year.[48]

a. A partnership makes a Sec. 444 election for a fiscal yearend by filing **Form 8716, Election to Have a Tax Year Other Than a Required Tax Year**.[49] The election is filed with the IRS Center where the partnership files its return and receives *automatic* consent. The election form must be filed by the **earlier** of:

• The fifteenth day of the sixth month of the tax year for which the election will be effective; or

• The due date (**not** including extensions) of the income tax return for the tax year resulting from the Section 444 election.

Under this election, an LLC must maintain a tax deposit account based on the deferred portion of LLC income. The deposit is based on the highest individual tax rate, plus 1% (36% for 2008). As a result, the cost of this election could prove to be prohibitive.

Comment: An LLC using a taxable year that corresponds to its "required tax year" generally must obtain the approval of the IRS to retain this tax year is its "required tax year" changes because of a change in ownership.

Comment: An LLC that is required to change its taxable year because of a *minor* percentage change in ownership can often retain its "old" tax year for one more year.

D. Contribution of Assets to LLC

1. Tax-Deferred Transaction: Pursuant to **Code §721**, there is normally **no gain or loss recognized** upon the transfer of property to a partnership unless boot (i.e. either cash or other property) is received by the transferor. However, this rule does **not** apply to the contribution of property to a **partnership investment company**.

Comment: This tax-deferred treatment under **Code §721** differs dramatically from the "control requirement" under **Code §351** where *not* only the presence of boot, but also the lack of 80% control by the transferee(s) will result in a taxable exchange of assets to the corporation.

a. **Contribution of Member's Promissory Note:** Unlike the decisions reached by the 2nd and 9th Circuits with regard to tax-deferred transfers to corporations pursuant to **Code §351**, the contribution of a member's personal note may raise significant tax issues. This is because it does *not* increase the member's tax basis in their interest and the LLC also acquires no tax basis in the note as of the time of the original contribution. However, any payments made the member on the note will serve to increase their basis for the amount actually paid.[50]

Comment: Under the**TCJA**, **Code §118 would effectively be repealed**. As a result, ***all* contributions to capital by a non-owner (e.g., governmental entity) made after the date of enactment (12/22/17) would be taxable.** And, it would *not* matter whether these contributions were made to a corporate or non-corporate entity (e.g., partnerships, SMLLCs).[51]

Example: "Capital Contributions by Non-Owner"

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[47] IRC §444(b)

[48] IRC §7519

[49] Code Sec. 444(d)(1); Temp. Reg. §1.444-3T(b)(1).

[50] Rev. Rul. 80-235.

[51] This change would have a significant impact on businesses that receive incentives and concessions from state or local governments. Code Sec. 118, as amended by Act Sec. 13312

In order to have a company locate their new location within a certain municipality, both the state and local government has extended significant enticements including free land, along with tax rebates. If these enticements are made after 12/22/2017, the FMV of each must now be included in the gross income of the company.

Comment: There is, however, an exception for "prior approvals." As a result, the new provision does *not* apply to any contribution made **after the date of enactment (i.e., 12/22/17)** by a governmental entity "pursuant to a master development plan that had been approved **prior to such date** by a governmental entity."

☞IRS Insists That Capital Contributions By Nonmembers To Noncorporate Entities Are Taxable Income (LMSB4-1008-051)

The IRS's Large and Mid-Size Business (LMSB) division has concluded in a coordinated issue paper (CIP) effective November 18, 2008 that capital contributions to a partnership or other noncorporate entity by a nonmember are taxable income to the entity. LMSB determined that neither **Code §118(a)**, contributions to the capital of a corporation, or any common law doctrine would exclude amounts received from a non-owner from income.

Comment: A major exception to this doctrine has been carved out by Congress with regard to any forgiven PPP loan amounts. The entities receiving such monies due to the pandemic have basically been used as "conduits" whereby to have the PPP loan forgiven they need to "pass along" the monies for an allowable expense such as payroll, mortgage interest, rents or utility costs. So, even though one might argue that these forgiven PPP loan monies are essentially a "capital contribution" by the federal government to these businesses, they do not have to be included in the entity's gross income (yet the businesses still receive a deduction for these expenses paid with this tax-exempt income, while also receiving an increase to the owner's basis in a flowthrough entity).

Comment: A CIP is *not* a statement of law but does reflect the IRS's current thinking on a particular issue. And, they are particularly "useful for IRS examiners," according to the IRS website. **But, for tax years after 2017, with the passage of the TCJA, it would not matter whether a corporate or noncorporate entity was involved. Such capital contributions by non-owners are now taxable in all cases.** But, in the past, if an entity was to received such "outside money," we made sure that even if it was set up as an LLC, it would have made an S corp election on **Form 2553** to be treated as a corporation for tax purposes.

Comment: With the current state of the economy, local state and municipal governments may be more inclined to offer incentives such as money and/or property to businesses operating as LLCs to locate their companies in a particular area. And, according to this directive, such amounts would constitute taxable income to the LLC (whereas, there would be no tax effect, **at least before 2018**) had the same incentive been made available to a C or S corporation).

Background: LMSB indicated that state law partnerships and LLCs classified as partnerships have claimed that contributions to capital by persons without an interest in the partnership are *not* taxable income to the partnership. They have made this argument for grants, government subsidies and other payments.

Comment: Contributions to a partnership **by a partner** in exchange for a partnership interest continue to be nontaxable under **Code §721**.

Congressional Mandate: In the 1954 Tax Code, Congress codified existing law in **Code §118**, providing for an exclusion from income for capital contributions to a corporation. However, Congress in **Code §362(c)** **required a zero basis for property acquired with nonshareholder contributions**. This *reversed* existing case law and Tax Code provisions on depreciation deductions, which had provided a "double benefit" by excluding the contributions from income while allowing basis for taking depreciation deductions.

IRS Position: In the CIP, LMSB concluded that these provisions "effectively preempted the issue of excluding contributions to the capital of partnerships from gross income." LMSB cited legislative history that Congress limited the provision to *corporations*, because that is what case law had addressed. None of the pre-existing cases had addressed capital contributions to partnerships or other noncorporate entities.

Comment: As LMSB points out, Congress was concerned about a double benefit to a corporation from providing basis to the corporation where there was no income recognition. It does *not* necessarily follow that Congress intended to preempt the treatment of capital contributions to partnerships.

Because since there was no statutory exclusion for third-party payments (i.e., capital contributions) to a *noncorporate* entity, LMSB concluded that the payments are includible in income under the broad sweep of **Code §61**. Whether or not a *noncorporate* entity would receive basis in the assets contributed is *not* determinative of the income issue, LMSB advised. LMSB also cited ***MAS One Limited Partnership v. U.S.*, 271 F.Supp.2d 1061 (S.D. Ohio 2003), *aff'd* 390 F.3d 427 (6th Cir., 2004)**. In that case, the payment was made by a departing partner as part of an agreement to help the partnership pay off a loan to a third-party. The government argued that the payment was either business income or discharge of indebtedness income under **Code §61**. The court agreed that the payment was *not* a contribution to capital. **(Code §61; Contributions to Partnerships)**

2. Substituted Basis for Member's Interest: Pursuant to **Code §722**, a partner's initial basis in a partnership interest acquired by a contribution of property, including money, is the amount of money and the adjusted basis of the property to the contributing partner at the time of the contribution.

a. Basis - Interest Acquired by Other than Contribution of Cash and/or Property[52]

1) Inherited interest: FMV of deceased partner's interest as of date of death

2) Gifted interest: Carryover basis (plus gift tax paid, if any), increased by suspended **Code §469** passive losses, if any

3) Property settlement in divorce: Carryover basis, increased by suspended **Code §469** passive losses, if any

4) Acquired in connection with performance of services: Cost of interest, if any, to the partner, plus amount of taxable income realized in connection with the receipt of the interest

5) Acquired by purchase: Initial basis is cost paid under **Code §1012**, plus liabilities assumed, if any

Comment: If a partner lends money to the partnership, the adjusted basis of his partnership interest is increased under **Code §752(a)** only to the extent of that partner's increased share of partnership liabilities.

Example: A lends $30,000 to equal ABC partnership. The debt, along with all of the other liabilities of the partnership, are guaranteed by the three partners. A's basis is only increased by $10,000 and *not* $30,000 (i.e., under **Code §752(a)**, only his one-third share of the partnership's $30,000 liability). Under **Code §707(a)**, A is considered to be acting in a capacity of other than as a partner (i.e., a creditor). Furthermore, a contribution of a negotiable promissory note would have no basis until principal payments were made.

Comment: In the example above, had none of the partners guarantee this particular debt, then A's basis in his partnership interest would have been increased by the *entire* $30,000 amount of the loan made to the entity.

☞**No Basis for Property Not Actually Contributed to the LLC (*Coastal Heart Medical Group Inc. et al.*, TC Memo 2015-84 (5/4/2015))**

A physician who conducted his medical practice through a corporation had his company lease a CT scanner from an outside third party. The lease, which could *not* be assigned, was signed by the physician on behalf of his corporation. The physician and two other individuals then formed an LLC to manage the rental and use of the CT scanner by the corporation. During the tax year in question, the physician fully deducted his distributive share of the LLC's large tax loss on his personal return. However, the IRS asserted that he had insufficient basis to do so. The physician countered that he had sufficient basis in the LLC because he personally guaranteed the lease that his corporation had entered into. Nevertheless, for property subject to a liability to be considered a liability of the partnership/LLC, the property needs to actually be contributed to the LLC. Here, the Tax Court determined, based on the substance of the transaction, that neither the CT scanner nor the liability was transferred to the LLC, thus, the liability did *not* increase the member's basis in the LLC (the LLC was merely formed to "manage" the use of the CT scanner within the medical corporation of the doctors). Therefore, the Tax Court disallowed the physician's K-1 loss deduction which flowed through from the LLC. **(Code §752; Partnership Liabilities)**

Comment: With the passage of the TCJA, NOLs incurred after 2017 are limited to $250,000/year ($500,000 for a MFJ return), even if a partner, for instance, had sufficient at-risk basis and was not otherwise subject to the passive loss limitations.

[52] IRC §742

3. Carryover Basis to LLC: The partnership's basis for contributed property is the adjusted basis of such property to the contributing partner at the time of contribution.[53] As discussed below, depreciable property is then set up on the partnership depreciation schedule with the recovery period, adjusted basis and recovery method unchanged (i.e., "shoes depreciation").[54] Property acquired prior to 1981 is subject to the anti-churning rules in the case of sales between related parties which are then contributed to a partnership.

Example 5: Rhonda and Don form an equal LLC by merging their accounting practices. Each contributes property with an FMV of $50,000. The following table provides details on their contributions.

	Rhonda		**Don**		**LLC**	
Property Contributed	**Adjusted Basis**	**FMV**	**Adjusted Basis**	**FMV**	**Adjusted Basis**	**FMV**
F&F/Computers	$15,000[55]	$30,000	$35,000[56]	$40,000	$50,000	$ 70,000
Accounts Receivable	-0-	5,000	-0-	2,500	-0-	7,500
Goodwill	-0-	15,000	-0-	7,500	-0-	22,500
Total	$15,000	$50,000	$35,000	$50,000	$50,000	$100,000

The adjusted basis of Rhonda's contribution is $15,000, since accounts receivable and goodwill have a zero adjusted basis in her hands. Therefore, the adjusted basis Rhonda's LLC interest is $15,000.

Don contributed property with an FMV of $50,000 and an adjusted basis in his hands of $35,000. Therefore, the adjusted basis of Don's LLC interest is $35,000.

The LLC's adjusted basis of its $100,000 FMV of assets is $50,000. This is all allocated to the depreciable furniture and fixtures, along with the computers. The FMV of each member's equity is $50,000. However, the total of the capital accounts on the LLC **Schedule L** balance sheet is $50,000 ($15,000 allocated to Rhonda and $35,000 to Don).

Comment: **Example 5** above assumes that a **tax method** balance sheet is being used. If the capital accounts were being reflected on a **book basis** instead, they would each have a $50,000 capital account (i.e., equal to the FMV of the respective assets that they contributed to the LLC).

Comment: Unrealized receivables, inventory and capital loss property retain their character and are treated as ordinary income or capital losses if disposed of by the partnership **within seven years** of their contribution.[57]

4. Holding Period: The holding period of property contributed to an LLC by a member **includes the period during which the property was held by the contributing member**. This is because the property has the **same** basis in the LLC's hands as in the hands of the contributing member.[58] In turn, the member takes a **substituted holding period** for their ownership interest equal to the holding period of the property contributed.

Comment: If *both* cash and long-term holding period property were contributed by an LLC member, then there would be a "split holding period" should this member sell their interest within one year of the initial contribution date (i.e., there would be the potential for both short- and long-term treatment as to any capital gain). On the other hand, it would *not* matter as to holding period for gain due to any "Sec. 751 hot assets."

5. Depreciation of Contributed Property: When property is contributed to an LLC by a member in

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[53] IRC §723

[54] IRC §168(i)(7)

[55] $35,000 of the original cost was immediately expensed under Sec. 179.

[56] $25,000 of the original cost was immediately expensed under Sec. 179.

[57] IRC §724

[58] Treas. Reg. §1.723-1

a nonrecognition transaction, the LLC must depreciate the property using the **same** depreciation method and class life used by the contributing member (i.e., "shoes depreciation").[59] Therefore, the LLC's depreciation deductions are in the **same** amount they would be if the contributing member had retained ownership of the property. In other words, the LLC is **not** permitted to depreciate the property using the recovery period and depreciation method (if different) in effect at the time of the contribution.

> **Example 6:** Chris purchased heavy construction equipment in 20x1 for $40,000. It had a 7-year recovery period. Chris depreciated the bulldozer for three years. In 20x4, Chris contributes the bulldozer to an LLC for an ownership interest. The adjusted basis of the bulldozer upon contribution is $22,046.

$40,000 – (4,286 + 7,654 + 6,014) = $22,046

In other words, the LLC takes the donor's basis as its initial basis, and then depreciates it **over the remaining years** of the equipment's cost-recovery period, continuing to use the MACRS method (and the half-year convention for the last year).

> **Comment:** Now with the significant sums that can be written off immediately under **Code §179**, along with 100% bonus depreciation, it will be common to see assets being transferred into an entity (e.g., partnership or corporation) with little, or no, adjusted basis as of the time of the transfer.

> **Comment:** If, by chance, there was some gain recognized (e.g., due to "boot" being received by the contributing LLC member), then this would be an additional step-up to the "carryover basis" normally assumed by the entity. Furthermore, it would be eligible for either Sec. 179 immediate expensing or bonus depreciation.

If the asset is contributed during the taxable year of the member and the LLC, the depreciation **deduction is prorated**

[59] IRC §168(i)(7) and Prop. Treas. Reg. §1.168-5(b)

between the member and the LLC **on a monthly ownership basis.**[60] However, if a basis increase occurs as a result of the contribution, such as a gain resulting from a **taxable liability assumption or boot being received** by the transferor member, the added basis is **separately depreciated** using current cost-recovery methods and lives as if placed in service by the transferee ("fresh-start" depreciation).[61] Personal-use property is deemed to be placed in service when the property is converted to business use. Therefore, it is depreciated under cost-recovery methods and lives applicable at the time of conversion, using the **lower of** the FMV or adjusted basis at the time of conversion.

6. Trade or Business Interest Incurred to Purchase an Ownership Interest or Make Capital Contribution to LLC: The tax treatment of interest expense incurred to either purchase an ownership interest in a flowthrough entity (i.e., partnership/LLC or S corporation) or to make a capital contribution to such an entity is governed by IRS **Notice 89-35** which sets out the following statement:

TREATMENT OF DEBT OF OWNERS OF PASSTHROUGH ENTITIES ALLOCATED TO EXPENDITURES FOR CONTRIBUTIONS TO OR PURCHASES OF INTERESTS IN SUCH ENTITIES (DEBT-FINANCED ACQUISITIONS)
Allocation Rules - *In the case of debt proceeds allocated under* ***Code §1.163-8T*** *to the purchase of an interest in a passthrough entity (other than by way of a contribution to the capital of the entity), the debt proceeds and the associated interest expense shall be allocated among all the assets of the entity* ***using any reasonable method****. Reasonable methods of allocating debt among the assets of a passthrough entity ordinarily include a pro-rata allocation based on the fair market value, book value, or adjusted basis of the assets, reduced by any debt of the passthrough entity or the owner allocated to such assets.*

Interest expense on debt proceeds allocated under section ***Code §1.163-8T*** *to a contribution to the capital of a passthrough entity shall be allocated* ***using any reasonable method****. Reasonable methods for this purpose ordinarily include allocating the debt among all the assets of the entity or tracing the debt proceeds to the expenditures of the entity under the rules of* ***Code §1.163-8T*** *as if the contributed debt proceeds were the proceeds of a debt incurred by the entity. For purposes of this notice, a purchase of an interest in a passthrough entity shall be treated as a contribution to the capital of the entity if and to the extent that the entity receives proceeds from the purchase.*

For purposes of this notice, the determination of whether a particular method of allocating debt proceeds used to purchase an interest in or to make a capital contribution to a passthrough entity is reasonable ***depends on the facts and circumstances*** *including, without limitation, whether the taxpayer* ***consistently applies the method from year to year****. In general, to the extent that debt proceeds are allocated under this section IV among the assets of a passthrough entity, such proceeds shall be reallocated among the assets of the entity as the assets of such entity, or the use of such assets, changes. In general, to the extent that debt proceeds are allocated under this section IV by tracing the debt proceeds to the expenditures of the entity under the rules of* ***Code §1.163-8T****, the debt proceeds shall be reallocated, when necessary, under the rules of* ***Code §1.163-8T****.*

Reporting Rules - *Individuals should report allowable interest expense paid or incurred in connection with debt-financed acquisitions* ***on either Schedule E or Schedule A*** *of* ***Form 1040****, depending on the type of expenditure to which the interest expense is allocated. Subject to any applicable changes in the underlying forms and schedules (or their instructions), specific instructions contained in* ***Notice 88-37*** *should be followed for (a) interest expense allocated to trade or business expenditures, (b) interest expense allocated to passive activity expenditures, (c) interest expense allocated to investment expenditures, and (d) interest expense allocated to personal expenditures. Taxpayers other than individuals should report interest expense on debt-financed acquisitions on the line for interest expense on their returns, in accordance with section IV.B. of Notice 88-37.*[62]

In many cases, the LLC is an operating entity and all of its assets are used in the trade or business. However, if the LLC has assets which produce portfolio income (e.g., from an investment of its excess working capital), an allocation must be made and the interest deduction for that portion of the interest is reported on **Schedule A** (i.e., as investment interest expense flowing from **Form 4952**) rather than on **Schedule E**, page 2 (where the K-1 information is otherwise reported). Or, if the LLC held significant rental properties (and there are a lot of LLCs out there simply formed to hold title to rental real estate or equipment), interest incurred to buy into or make capital contributions would have to be allocated to the carrying of a passive activity and treated accordingly (i.e., it would still be reported on **Schedule E, page 2**, but might be subject to the passive loss rules).

☞**Inherited Partnership Interests Not Subject to Investment Interest Limit** (***Lipnick*** **, 153 TC No. 1 (8/28/2019)**)

[60] Treas. Reg. §1.168-5(b)(4)(i)

[61] Treas. Reg. §1.168-5(b)(7)

[62] Notice 89-35, 1989-1 C.B. 675.

The taxpayer acquired interests in four partnerships by gift or bequest from his father. Prior to the transfers, the father received debt-financed distributions from the partnerships. After receiving the interests, the taxpayer treated his distributive shares of partnership interest expense as fully deductible against his allocations of partnership income. The IRS argued that the taxpayer should have "stepped into the shoes" of his father and reported the expense on **Form 4952** as "investment interest" subject to the **Code §163(d)** limit. The Tax Court disagreed, holding that the taxpayer made a "debt-financed acquisition of the partnership interests" (i.e., governed by IRS **Notice 89-35**) he received from his father. Because the taxpayer did *not* actually receive the proceeds of the partnerships' debts, interest expense passed through to him was *not* "investment interest" under **Code §163(d)**.

Background - Investment Interest: In the case of a taxpayer other than a corporation, the amount allowed as a deduction for investment interest for any taxable year cannot exceed the "net investment income" (i.e., for **Form 4952** purposes as opposed to NIIT which is used for **Form 8960** purposes with the 3.8% Medicare surtax) of the taxpayer for the taxable year. (**Code §163(d)(1)**). "Investment interest" is defined as interest that is "paid or accrued on indebtedness properly allocable to property held for investment." (**Code §163(d)(3)(A)**)

Background - Interest Expense "Tracing Rules:" Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures. (**Reg. §1.163-8T(a)(3)**) For example, if a taxpayer uses debt proceeds to make a personal expenditure, such as taking a vacation, the interest is treated as nondeductible personal interest. (**Reg. §1.163-8T(a)(4)(ii), Example (1)**)

These regs, however, do *not* specify how these tracing rules apply to partnerships and their partners. But the IRS has published guidance in **Notice 89-35**. That Notice states that, if a partnership uses debt proceeds to fund a distribution to partners (i.e., to make debt-financed distributions), it is each partner's actual use of the proceeds to determine whether the interest passed through to them constitutes investment interest. As a result, if a partner uses the proceeds of a debt-financed distribution to acquire property that he holds for investment, the corresponding interest expense incurred by the partnership and passed on to them will be treated as investment interest.

On the other hand, **Reg. §1.163-8T(c)(3)(ii)** explains how debt should be allocated where *no proceeds are actually disbursed* to the taxpayer. It states that if a taxpayer incurs or assumes a debt in consideration for the sale or use of property or takes property subject to a debt, and no debt proceeds are disbursed to the taxpayer, the debt is treated as if the taxpayer used an amount of the debt proceeds equal to the balance of the debt outstanding at such time to make an expenditure for such property.

Notice 89-35 in **Part IV.** refers to the scenario described in **Reg. §1.163-8T(c)(3)(ii)** as a "debt-financed acquisition," as opposed to a "debt-financed distribution," and it explains how the reg applies to partnerships and their partners: "In the case of debt proceeds allocated under **Reg. §1.163-8T** to the purchase of an interest in a passthrough entity (other than by way of a contribution to the capital of the entity), the debt proceeds and the associated interest expense shall be allocated among all the assets of the entity using any reasonable method."

Facts: The taxpayer's father had owned interests in partnerships that made "debt-financed distributions" to the partners and he had used the proceeds of those distributions to purchase assets that he held for investment. As a result, he treated the interest paid by the partnerships on those debts and passed through to him as "investment interest" (i.e., on **Form 4952**) subject to the limitation on deductibility imposed by **Code §163(d)**. But, the taxpayer in this instance who inherited (or, was gifted) these partnership interests was *not* personally liable for any of the partnership loans. And, the partnerships continued to incur interest expense on the debts, which was passed through to the taxpayer as a *new* partner which he treated as allocable to the partnerships' real estate assets and reported the interest expense (i.e., on **Schedule E, page 2**) as regular business interest that offset the passed-through partnership real estate income.

Tax Court Decision: The Court characterized the IRS's argument as essentially being that the taxpayer "stepped into his father's shoes," with the result that the interest should be reported as "investment interest," and would remained as such so long as the loans remain on the partnerships' books. The Court, however, found that there was no support for this theory in the statute, the regs, or the decided cases, especially since the taxpayer *did not receive, directly or indirectly, any portion of the debt-financed distributions* that the partnerships made to his father. Nor did the taxpayer use distributions from those partnerships to make investment expenditures.

Instead, the Court concluded that, whereas the father received a "debt-financed distribution," his son (i.e., the taxpayer in this case) should be treated as having made a "debt-financed acquisition" of the partnership interests he acquired from his father by way of gift or inheritance. Therefore, for **Code §163(d)** purposes, the debt proceeds should be allocated among all of the partnerships' real estate assets using a reasonable method, and the interest paid on the debt is allocated to those assets in the same way. (**Reg. §1.163-8T(c)(1)**) In this instance, the partnerships' real estate assets were actively managed operating assets. Even the IRS agreed that those assets did *not* constitute "property held for investment."

The IRS countered that under **Reg. §1.163-8T(c)(3)(ii)**, the taxpayer, when acquiring the partnership interests from his father, did *not* "assume a debt" or "take property subject to a debt." Instead, these loans "were bona fide liabilities of the partnerships." As a result, the taxpayer had no personal liability on those loans, which were nonrecourse, and that the liens held by the lenders ran against the partnerships' real estate assets, *not* against the taxpayer's partnership interests.

The Court disagreed stating that the taxpayer acquired his interests in the partnerships subject to the partnership debts, even though he did *not* personally assume those debts, which remained nonrecourse with respect to the partners individually. In the converse situation, where a partner sells a partnership interest, the regs provide that the partner's "amount realized" includes his share of the partnership liabilities of which he is relieved, even if the liabilities are nonrecourse. (**Reg. §1.752-1, Reg. §1.1001-2(a)(4)(v)**) For purposes of subchapter K partnership rules generally, any increase or decrease in a partner's share of partnership liabilities is treated as a deemed contribution or distribution, regardless of whether the debt is recourse or nonrecourse. (**Code §752; Reg. §1.752-1**). And, the fact that a partner is *not* personally liable for a partnership's debt does *not* mean that his partnership interest is *not* "subject to a debt" for purposes of Subchapter K. The Court then concluded that **Reg. §1.163-8T(c)(3)(ii)**, in conjunction with **Notice 89-35**, dictates that the interest expense passed through to the taxpayer from the partnerships was *not* "investment interest" under **Code §163(d)**. **(Code §163; Investment Interest)**

☞**Service Clarifies Treatment of Investment Interest Expense Flowing Through to Partners of Entities Actively Trading Securities (Rev. Rul. 2008-38; Ann. 2008-65)**

In **Rev. Rul. 2008-12**, the IRS originally ruled that a *nonmaterially* participating partner's share of the interest expense of a partnership that trades securities is subject to the **Code §163(d)(1)** investment interest limitation (i.e., allowed as an itemized deduction to the extent of net investment income on **Form 4952**), assuming that the partner is an individual. This new revenue ruling now clarifies that interest paid or accrued on debt allocable to property held for investment is a "trade or business expense" that is deductible (after the application of **Code §163(d)(1)**) in determining the taxpayer's AGI. Thus, according to a related announcement, the limited partner should include the allowable amount of his or her distributive share of the trading partnership's interest expense in computing ordinary business income or loss on **page 2** of **Schedule E**. **(Code §163(d)(1); Investment Interest Expense)**

> **Comment:** This is good news from the IRS insomuch as these investors will *not* need to itemize their deductions in order to be able to deduct their share of the partnership's interest expense. Therefore, the write-off can be taken for determining AGI (i.e., on Schedule E, *not* Schedule A), as some taxpayers had thought. Nevertheless, the limited partners' share of the interest paid is still treated as "investment interest." So, the deduction is limited to the extent of "net investment income" as normally determined for purposes of **Form 4952**.

7. Loans Made by LLC Member for LLC Purposes

a. Tracing Rules: If a member borrows money and **loans it to the LLC** (i.e., otherwise shown as a "credit" in the liability section of the partnership's balance sheet), the interest the member pays is automatically treated as **investment interest**. The member therefore reports the interest he pays on **Form 4952 Investment Interest Expense**. As opposed to the situation above where the member borrows money and contributes it to the LLC as a **capital contribution**, there is no need to resort to the tracing rules which depend on how the LLC uses the money.[63] This is true since if this was a "company loan" by the LLC member to the entity, it would result in **portfolio income** being paid to the loaning member (i.e., interest income reportable on **Schedule B** of the owner's personal return, even if the imputed interest rules[64] have to be employed).

8. Exceptions to Nonrecognition Rules

a. Disguised Sales: A determination must sometimes be made as to whether a partnership interest is being sold in exchange for property,[65] or whether it is merely being received because of a tax-deferred contribution of property by a new or existing partner.[66]

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[63] Temp. Treas. Reg. §1.163-8T

[64] IRC §7872

[65] IRC §707 treats such "sales" as a transaction occurring between a partnership and a partner *not* acting in his capacity as a partner. In other words, it is viewed the same as if an unrelated third party was making a sale of the property to the entity.

[66] Treated as a tax-deferred exchange under IRC §721

Comment: New **Question 28** has been added regarding disclosures for "disguised sales" on the 2019 **Form 1065, Schedule B**.

If, at the time of formation or later (**within seven years**), property is contributed to an LLC, and money or other property is received from the LLC by the contributing member, the disguised sales rules may apply. These rules state that if:

- A member transfers money or other property either directly or indirectly to the LLC, or
- There is a related direct or indirect transfer by the LLC to the member or another member, or
- When viewed together, the transfers are properly characterized as a sale or exchange of property,

then, the transaction is presumed to be a sale or exchange unless facts and circumstances indicate otherwise.[67]

A transaction within this provision is treated for income tax purposes as either a sale between the members, or as a partial sale and partial contribution of property to the LLC.

Example 7: "Property Contribution and Immediate Cash Distribution"

Mary contributes appreciated real estate to an LLC in which she is a 25% owner. The LLC holds several properties and immediately after this contribution, refinances one of its properties with all proceeds going to Mary. These two steps would probably be viewed as a disguised sale. Therefore, Mary is considered to have sold part of her ownership in the contributed building (i.e., up to the FMV of the consideration received), and the remaining portion of the transfer is treated as a tax-deferred contribution governed by the normal **Code §721** rules.

For example, suppose Mary has a $250,000 basis in the building that she contributed and its FMV is $500,000. The cash immediately distributed to Mary is $200,000. Because the disguised sales rules apply, 40% of the building ($200,000 cash distributed divided by the $500,000 FMV of the building) is considered sold. Because 40% of the building's basis is $100,000, Mary has a taxable gain of $100,000 ($200,000 cash less $100,000 of allocated basis). Some of this gain is taxed at up to a maximum rate of 25% (i.e., as "unrecaptured Sec. 1250 gain") to the extent of any S/L depreciation taken by Mary before the transfer, with the remainder being treated as Sec. 1231 gain (with both types of gain being reported on **Form 4797**). The remainder of the transfer ($300,000 of the building's FMV) is governed by **Code §721**. Therefore, Mary receives a **substituted basis** in her LLC interest equal to $150,000 ($250,000 less $100,000). The basis of the building to the LLC is the $150,000 carryover basis plus $200,000 for the portion of the building deemed purchased by the LLC.

Comment: For depreciation purposes, the "carryover basis" portion of the building (i.e., $150,000) is depreciated using the same recovery period and method as Mary had been using before the transfer of the property to the partnership. As to the $200,000 "stepped-up basis" portion (i.e., equal to the FMV of the consideration paid for the purchase of the remaining portion of the building), the partnership would use a "fresh-start" approach for depreciation.

If property previously contributed to the partnership is subsequently distributed, either directly or indirectly, by the partnership to **other than the contributing partner within seven years** of the contribution, the **contributing partner** is treated as recognizing gain or loss equal to the **pre-contribution difference** between the property's basis and book value. The result is as if the property was sold in a deemed sale at its FMV **on the date of the original contribution to the entity.**[68]

The character of the gain or loss from this deemed sale is determined by reference to the character of the gain or loss which would result if such property were sold by the partnership to the distributee.

Appropriate adjustments are made to the adjusted tax basis of the contributing partner's interest in the partnership, because of the deemed gain or loss recognized due to these rules, as well as to the distributed property's adjusted tax basis.

Example 8: "Distribution of Pre-Contribution Gain Property within Seven Years"

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[67] IRC §707(a)(2)(B)

[68] IRC §704(c)(1)(B)

Tony transferred land to a partnership solely for a partnership interest. The land had a basis of $50,000 and an FMV of $250,000. The land is distributed to Kurt within seven years. Kurt is unrelated to Tony.

This distribution is treated as a deemed sale with the pre-contribution gain of $200,000 being **allocated solely to Tony**. Additionally, since Tony is required to recognize this deemed gain, Kurt **receives a corresponding step-up in basis**. Therefore, Kurt's property now has a basis of $250,000 ($50,000 basis from the partnership which would carry over to Kurt, plus the $200,000 step-up gain required to be recognized by Tony due to the distribution within seven years). He would also take a long-term holding period for the stepped-up basis portion of the property ($200,000), as well as for the substituted basis portion ($50,000), given that he has held his partnership interest for more than one year.

☞**IRS Issues Final Regs on Partnership Disguised Sales (TD 9787)**

The IRS has issued final regulations on partnership disguised sales under **Code §§707** and **752**. The final rules largely adopt proposed regulations issued in 2014, with certain modifications. Among other things, the final regs adopt a "property-by-property rule." Nevertheless, limited aggregation of property is permitted in cases "where separate accounting would be burdensome." In addition, the final rules limit the methods available to determine a partner's share of "excess nonrecourse liabilities" for disguised sale purposes. The final regs generally apply to transactions and partnership liabilities that occur *on or after* 10/5/16, unless liabilities are assumed pursuant to a written binding contract in effect prior to that date. **(Code §707; Disguised Sales)**

☞**Sale of Partnership Interest Treated as Disguised Sale of Underlying Assets**

In an attempt to avoid transfer tax on the sale of real property, the following steps were proposed. LLC A which owned some valuable warehouse rental real estate would transfer title to the property to a newly-formed LLC B which would be owned 99% by LLC A and just 1% by the potential purchaser. In return, LLC A would receive no cash or other boot, but solely a partnership interest in LLC B. As a result, **Code §721** would control and there would be no gain recognized with LLC A taking a substituted basis and a long-term holding period in the LLC B partnership interest received, with the latter taking a carryover basis and holding period.

LLC A would then sell its 99% interest in LLC B to the aforementioned purchaser recognizing a Sec. 1231 gain except for the unrecaptured Sec. 1250 gain (i.e., to the extent of the S/L depreciation taken which would be taxed at a maximum marginal rate of 25%). However, the local taxing jurisdiction would *not* impose a transfer tax on the mere exchange of a partnership interest as opposed to the actual sale of the real estate.

However, none of the above would apply because in all likelihood this is a disguised sale of the underlying assets by LLC A and the "substance" of the transaction would control, *not* the "form." Even though the parties involved would like to avoid transfer tax, for tax purposes, you would get the same result as if LLC A had simply sold the assets directly to the third party. Namely, the gain would be reported on **Form 4797** with unrecaptured Sec. 1250 gain to the extent of any S/L depreciation taken. And, the purchaser would take a new holding period in this acquired property with its basis being equal to the FMV of the consideration paid. **(Code §721; Disguised Sale)**

☞**Partnership's Special Allocation of State Tax Credits Recharacterized as Disguised Sale (*SWF Real Estate LLC, et al.*, TC Memo 2015-63 (4/2/2015))**

The Tax Court held that the **Code §707** "disguised sale rules" applied to a transaction involving a taxpayer's contribution of cash to a partnership in exchange for an allocation of state tax credits. The Court concluded that the taxpayer would *not* have transferred money to the partnership but for the corresponding Virginia tax credits. Although the IRS recently issued **Rev. Proc. 2014-12**, saying it will *not* challenge partnership allocations of **Code §47** rehabilitation income tax credits by a partnership to its partners, it specifically provides that the safe harbor is *not* available to situations under which a transfer of state credits by a partnership may be treated as a disguised sale under **Code §707(a)(2)(B)**. **(Code §707; Disguised Sales)**

☞**Transfer of State Tax Credits to Partner Treated as Disguised Sale (*Route 231, LLC*, 117 AFTR 2d 2016-XXXX)**

This LLC (which was treated as a partnership for tax purposes) admitted a new member/partner which paid $3.816 million ($500 plus an additional sum equal to the product of $0.53 for each $1.00 of the tax credits allocated to it) in exchange for a 1% membership interest and the majority of the Virginia historic rehabilitation tax credits earned by the LLC. The LLC, in turn, recorded the $3.816 million as a nontaxable "capital contribution." However, the Tax Court agreed with the IRS' position and ruled that the credits were "property" for purposes of the **Code §707** "disguised sale rules." As a result, the proceeds of this sale had to be included in the taxable income of the partnership rather than be treated as a nontaxable capital contribution followed by an special allocation of the LLC's assets (i.e., pursuant to **Code §704(b)(2)**) to this new member. **(Code §707; Disguised Sales)**

Comment: The LLC appealed this decision and the 4th Circuit reiterated that the transaction was a disguised sale and that income had to be recognized.

9. Receipt of a Member Interest in Exchange for Services: The LLC interest received by a member who contributes services is **deemed ordinary income** to the extent of the FMV of the interest received.[69] However, this characterization can be avoided if the interest has a "substantial risk of forfeiture." Meanwhile, the other members surrendering a portion of their capital interests are allowed a deduction for the value of the services (i.e., assuming it was paid to an employee, it would be a deduction for "wages" with employment tax owed by both the LLC and the employee) included in the gross income of the service-performing member.[70] The value of the transferred interest is considered a guaranteed payment and is either capitalized or deducted, based upon the nature of the services rendered.

Valuing the transferred interest may be difficult. But, if any capital interests were sold near the time of the transfer, they may be used to establish a comparable value.

Example 9: In 20x1, architect Gary, a cash method taxpayer, draws the plans for a new office building at a cost of $60,000. In 20x2, the building owners, an LLC, give Gary a $60,000 capital interest in the LLC. Gary reports $60,000 income in 20x2 (i.e., as reported on **Form 1099** to this independent contractor).

Initially, it was thought that granting of only a **profits interest** would **not** generate immediate taxable income to the service-providing partner prior to the ***Campbell*** decision.[71] However, this case created a great deal of controversy over its implications, especially for investment-type partnerships when the organizers generally take only a profits interest. Upon appeal, the IRS changed its argument that the profits interest was received **from the employer rather than the partnership**.

On appeal, the 8th Circuit ruled the profits interest did in fact come from the partnership (i.e., under these circumstances where an **outside contractor** as opposed to an employee of the partnership) was receiving compensation for services performed for the partnership). And, since it was **not** possible to place a value on the profits interest at the time it was received, they overruled the Tax Court. Their opinion did **not** settle the issue however since the 8th Circuit only held that it was **not possible to ascertain a value** when issued.[72] Other courts ruled that the profits interest is taxable income if the interest is **sold shortly after being issued**. As a result of these decisions, the IRS issued **Rev. Proc. 93-27** which states that a person receiving only a **profits interest for providing services** to a partnership or in anticipation of being a partner will **not** treat the receiving of the interest as a taxable event. There are three exceptions to this rule:

- If the profits interest relates to a "substantially certain and predictable stream of income" from partnership assets;

- If within **two years** of receipt, the partner disposes of the profits interest; or

- If the profits interest is a limited partnership interest in a "publicly traded partnership."

Example 10: Inventor Bob develops a new type of hair dryer. He then contributes the patent to an LLC for a 40% profit interest. As a result, Bob does *not* receive any money unless the LLC reports a profit. Bob does **not** report any taxable income until such time as the LLC shows a profit (and, they flow through to him on his K-1).

On the other hand, the courts have consistently ruled that the contribution of services for a **capital interest** causes the recognition of ordinary income. The IRS has also issued **Rev. Proc. 2004-34** which allows taxpayers to report income from **advance payments** in the year in which it is earned. However, the income recognition **cannot** be deferred past the **succeeding year**.

☞**Value of Services Does Not Create Basis until Actually Taxed** (***Hastings,* TC Memo 2016-61 (4/5/2016)**)
The taxpayer, along with four other individuals, formed an LLC treated as a partnership for tax purposes. But, the taxpayer did *not* contribute any capital to the business, while agreeing to forego a "salary" (i.e., guaranteed payment) until such time that the LLC had sufficient cash flow. The business failed the following year, and the taxpayer was never paid for his services. Nevertheless, on his tax return, the taxpayer deducted his share of the LLC's losses

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[69] IRC §83(a)

[70] Treas. Reg. §1.83(h)

[71] W.G. Campbell v. Comm'r, 59 TCM 236 (1990).

[72] W.G. Campbell v. Comm'r, 943 F.2d. 815 (8th Cir. 1991).

(approximately $39,000). Upon audit, the IRS disallowed the loss, arguing that the taxpayer lacked sufficient tax basis. The Tax Court agreed, holding that tax basis does *not* include the value of services unless such services have been subject to tax. **(Code §704; Tax Basis)**

Comment: Had this service partner guaranteed some of the LLC debt, **Code §752(a)** would have given him at-risk basis to that extent. Conversely, had the other partners financed these losses (or, solely guaranteed the debt that was used to finance them), the entity could have arguably made a special allocation to just these other partners.

☞**Proposed Regs Issued on Disguised Payment for Services (REG-115452-14)**
The IRS has issued proposed regs which establish a test, based on **Code §707(a)(2)(A)** legislative history, to determine when a partnership distribution or allocation arrangement will be treated as a "disguised payment for services." The test includes six factors, of which, significant "entrepreneurial risk" as to the amount and fact of payment is the primary factor given the most weight. **(Code §707; Partnership Distributions)**

Comment: The proposed regs are effective when published as final and would apply to any arrangement entered into or modified on or after that date.

10. Transfers to Investment Partnerships: The nonrecognition rules of **Code §721(a)** do **not** apply to gains realized upon the transfer of property to a partnership or LLC that is classified as an "investment company." An **investment company** is any corporation or partnership in which **more than 80%** of the value of the assets consists of:[73]

- Money,
- Stocks and other equity interests in a corporation,
- Evidence of indebtedness,
- Options,
- Forward or futures contracts,
- Notional principal contracts and derivatives,
- Foreign currency,
- Interests in precious metals,
- Interests in a regulated investment company or real estate investment trust,
- Common trust funds,
- Publicly-traded partnerships, or
- Interests in noncorporate entities that are convertible into, or exchangeable for, any of the previously listed assets.

Example 11: "Transfer of Investments to Investment Partnership"
Frank and Jane want to reduce their individual investment risks and decide to contribute their investments to an LLC in which each receives a 50% interest. Frank contributes 1,000 shares of Hi Tech Corp. which is valued at $80 per share and cost $10 per share. Jane contributes a debenture which is valued at $80,000 and cost $60,000.

Both members must report taxable income when the LLC is formed since the LLC meets the definition of an **investment partnership**. Frank reports income of $70,000 ($80,000 – $10,000) and Jane reports income of $20,000 ($80,000 – $60,000).

Comment: Probably unlikely that most clients would do this but it would be quite a surprise should a client make such a transfer without first consulting with their tax practitioner.

[73] IRC §351(e)(1)

11. Contributions of Encumbered Property: The outside basis of an LLC interest acquired by a contribution of property is the sum of the money contributed:

- **Plus** — the adjusted basis of the contributed property,
- **Plus** — the share of LLC liabilities assumed by a member,
- **Less** — the sum of the member's liabilities assumed by the LLC.[74]

The assumption of liabilities **by the LLC** is treated as a **distribution of money** to the member, and the assumption of liabilities **by the member** is treated as a **contribution of money** to the LLC. For an individual member, these two transactions are deemed to have occurred simultaneously.

Example 12: "Contribution of Encumbered Property to Partnership - Chattel Mortgages"
Jessica and Chris form a service LLC. Jessica contributes 1/3 of the assets, and Chris contributes 2/3 of the assets. The assets are encumbered with chattel mortgages. Information about their contributions follows:

	Jessica		Chris		LLC	
Property Contributed	**Adjusted Basis**	**FMV**	**Adjusted Basis**	**FMV**	**Adjusted Basis**	**FMV**
F&F/Computers	$60,000	$100,000	$40,000	$120,000	$100,000	$220,000
Accounts Receivable	-0-	40,000	-0-	40,000	-0-	80,000
Total Assets	$60,000	$140,000	$40,000	$160,000	$100,000	$300,000
Liabilities	$60,000	$ 60,000	-0-	-0-	$ 60,000	$ 60,000
Capital Accounts	-0-	80,000	40,000	160,000	40,000	240,000
Total Liabilities & Capital	$60,000	$140,000	$40,000	$160,000	$100,000	$300,000

The basis of Jessica's and Chris' LLC interests are calculated as follows:

Jessica:	Adjusted basis of assets contributed	$60,000
	Jessica's liabilities assumed by LLC	(60,000)
	Jessica's share of LLC liabilities (1/3 of $60,000)	20,000
	Basis of Jessica's LLC interest	$20,000
Chris:	Adjusted basis of assets contributed	$40,000
	Chris' liabilities assumed	-0-
	Chris' share of LLC liabilities (2/3 of $60,000)	40,000
	Basis of Chris' LLC interest	$80,000

Comment: Careful planning is necessary when establishing the initial contributions of assets and liabilities to an LLC. A contribution of liabilities **exceeding** the adjusted basis of assets contributed plus liabilities assumed is a **taxable transaction**. As discussed more fully below, one way to avoid this possible issue is to keep the **primary responsibility** for the payment of the liability with the LLC member (i.e., do *not* have the liability transfer with the asset) even though the asset might still serve as collateral for repayment of the debt. In this regard, careful consultation with an attorney familiar with state or local law is required to assure that the liability is **not** considered to have been transferred with the property.

Comment: Since real estate transferred to an LLC will often be encumbered with a mortgage, it is especially important that this calculation be made *before* the transfer occurs so as to avoid any unintended gain due to excess liabilities over the basis of the property transferred (i.e., considering the proportional ownership percentages of the LLC members).

Example 13: "Contribution of Encumbered Property to Partnership - Real Estate Mortgages"
Use the same facts as **Example 12** except, Chris contributes $120,000 of liabilities and the equity interests

[74] Treas. Reg. §1.722-1

in the LLC are **reversed**. That is, Chris is now a 1/3 member. The basis of Chris' LLC interest is:

Adjusted basis of assets contributed	$ 40,000
Chris' liabilities assumed by the LLC	(120,000)
Chris' share of LLC liabilities (1/3 of $180,000)	60,000
Basis of B's LLC interest	($ 20,000)

Chris potentially has a **negative basis** of $20,000 which must be returned to zero by recognizing a gain of $20,000. The gain is ¼ ordinary income representing Chris' contribution in accounts receivable and ¾ **Code §1231** gain representing his contribution of F&F/computers. In addition, a portion of the gain is subject to the **Code §1245** depreciation recapture rules (i.e., to the extent of any depreciation claimed by Chris prior to the transfer of this property to the partnership).

Comment: As mentioned above, initial LLC contributions of assets and liabilities should be structured to avoid this taxation.[75]

With regard to Jessica's basis in **Example 12**, her basis would be calculated as follows:

Adjusted basis of assets contributed	$ 60,000
Jessica's liabilities assumed by the LLC	(60,000)
Jessica's share of LLC liabilities (2/3 of $180,000)	120,000
Basis of A's LLC interest	$120,000

Comment: The gain reported in the above transaction does **not** automatically increase the basis of Chris' LLC interest, nor does the LLC increase its adjusted basis in the contributed property.[76] However, if the LLC makes the **Code §754** election, it can increase the inside adjusted basis of this contributed property.

Comment: By way of comparison, in the case of a transfer of encumbered property to either a C or S corporation, **Code §357(c)** simple states if the liabilities transferred exceed the aggregate of the bases of the property being transferred at the same time, the excess will normally be a **taxable event**. This is true even if the shareholder remains a guarantor on the debt.[77] An exception is created when the payment of the liability would give rise to a tax deduction such as would be the case with most accounts payable.

Taxable gain created by an excess liability situation could be prevented by:

• Increasing the basis of Chris' LLC contribution,

• Reducing the liabilities he contributes, or

• In the case of an established LLC, increasing his LLC basis by having the LLC borrow enough money to increase his basis up to or in excess of the gain on contribution.

Chris could also increase his LLC contribution basis by:

• Selecting other property with a **higher basis** to contribute,

• Contributing cash,

• Adding improvements to the property being contributed, or

• Adding additional property to his LLC contribution.

The latter two alternatives change his FMV contribution. Chris could also reduce the existing liability by:

• Paying down the loan prior to contribution, or

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[75] Treas. Reg. §1.722-1

[76] Rev. Rul. 84-15, 1984-1 C.B. 158 discusses the partnership basis adjustments not made as a result of this gain.

[77] *Seggerman Farms, Inc. v. Commr.*, 308 F.3d 803 (7th Cir., 10/24/2002), aff'g, T.C. Memo. 2001-99

• Restructuring his loan and transferring part of it to other property as security which is *not* being contributed to the LLC, so a smaller loan is contributed with the secured property contribution.

The shift in security is important since a liability attached to property contributed to an LLC is considered a liability assumed by the LLC.[78] A liability attached to property is treated as a liability of the contributing member only to the degree of the property's FMV.

In a 2000 letter ruling, the IRS stated no gain is recognized on a member's contribution of mortgaged property to his LLC because he **remained responsible** for the recourse liability. Even though the LLC signed a debt assumption agreement that made it primarily liable for the mortgage, the member also executed a guarantee. The key, however, was that the guarantee allowed the lender to **proceed directly** against the member without attempting to collect from the LLC. The member also agreed to indemnify the LLC if it had to satisfy the mortgage.[79]

Effective January 29, 1989, temporary regulations under **Code §752** provide an "economic risk of loss analysis" to determine whether partnership liabilities are recourse or nonrecourse.[80] A partnership liability is a **recourse** liability to the extent that a partner bears an economic risk of loss.[81] On the other hand, a partnership liability is **nonrecourse** if a partner does **not** bear an economic risk of loss.[82] If one or more partners bears the economic risk of loss as to part, but not all of a partnership liability represented by a single contractual obligation, that liability is treated as two or more separate liabilities for purposes of **Code §752**. The portion of the liability for which one or more partners bear the economic risk of loss is a **recourse** liability and any remaining liability is a **nonrecourse** liability.[83]

In an LLC, no member has economic risk beyond his contribution. Therefore, all LLC liabilities are usually treated as **nonrecourse** liabilities. There are four exceptions:

• A member has **guaranteed** the loan or **made the loan directly** to the LLC,

• State law imposes the debt on the member,

• The debt falls under the interest guarantee rule or property pledged rule,[84] or

• The debt is covered by the anti-abuse rules.[85]

Taxpayers have **attempted to add basis** when they contribute assets to a partnership or a corporation to avoid the excess liability problem. One tactic is to **contribute a personal loan** to the entity. For example, if a member is contributing assets with a basis of $300,000 and liabilities of $350,000, he might contribute a note receivable for $50,000 to the LLC. In most cases, the IRS does **not** recognize the personal loan. The argument is that there is no requirement that the loan be repaid.

However, one taxpayer challenged this issue. And, when he won in the lower court, the IRS appealed the case.[86] In ***Lessinger***, a sole proprietor contributed all his proprietorship assets and liabilities for 100% of the corporation's stock. The only reason the taxpayer formed the corporation was because a creditor refused to continue loaning money to the proprietorship since state law set a **lower usury rate** on loans to **individuals** than it did to **corporations**. After the corporation was formed, the excess liabilities problem was discovered. A promissory note between the taxpayer

[78] Treas. Reg. §1.752-1(e)

[79] PLR 200050032

[80] Temp. Treas. Reg. §1.752-1T

[81] Treas. Reg. §1.752-1(a)(1)

[82] Treas. Reg. §1.752-1(a)(2)

[83] Treas. Reg. §1.752-1(i)

[84] Treas. Reg. §1.752-2(h)

[85] Treas. Reg. §1.752-2(j)

[86] *Sol Lessinger and Edith Lessinger v Comm'r*, 872 F.2d. 519 (2nd Cir. 1989).

and the corporation was signed at that time. No shares were issued when the taxpayer contributed the note to the corporation (i.e., since the issuance of shares was **not** necessary to qualify for nonrecognition of gain). Only one payment was made on the note before the corporation filed for bankruptcy protection. However, the court upheld the legitimacy of the note, ruling the liability was **real, continuing and indirectly enforceable by the corporation's creditors**.

Peracchi is another case concerning liabilities in excess of basis. There, the taxpayer convinced the appellate court that a promissory note to his corporation did in fact constitute basis.[87] This situation resulted from the corporation's need to comply with state minimum premium-to-asset regulations for insurance companies. The sole shareholder of the insurance company contributed two parcels of real estate to the corporation to meet the state requirement. He also contributed the liabilities on the land which exceeded the basis in the land by more than $500,000. To avoid recognition of gain on the transfer, he also contributed a $1 million promissory note. Both the IRS and the Tax Court refused to recognize the promissory note as having a basis. But, in an interesting written opinion, the 9th Circuit judge agreed with the shareholder that the note added basis. The key was that if the corporation were to file bankruptcy, the note would become available to the corporate creditors for collection. Therefore, the shareholder had **not** protected his personal assets from the creditors. Without the note, the corporate creditors would **not** be able to go after the personal assets. Another judge wrote a dissenting opinion.

> **Comment:** The 9th Circuit's decision in ***Peracchi*** is easy to read and understand. It details all the factors involved in determining the basis issue and how to avoid an excess liability situation and should be read if a need arises to argue for basis in an audit arises.

Unfortunately, the IRS has **not** acquiesced in either the ***Peracchi*** and ***Lessinger*** decisions. As a result, it continues to rule that a promissory note from a contributing owner does **not** add basis. The IRS argues that there is **no requirement to ever repay** the loan in the closely-held corporation (even though the contributing shareholder remained a 100% guarantor on the underlying debt) and some courts are in agreement with the IRS.[88]

☞**Unsecured Notes Contributed to Partnership Provided No Basis to Contributing Partners (*VisionMonitor Software, LLC*, TC Memo 2014-182 (9/3/2014))**

Under **Code §723**, the basis of property contributed to a partnership by a partner is the partner's adjusted basis in the property at the time contributed (i.e., carryover basis). Over the years, it has consistently been held that the contribution of a partner's own note to his partnership is *not* considered to be the equivalent of a cash contribution. As a result, it does *not* serve to increase that partner's basis in his partnership interest. In this instance, the partners insisted that their contribution of promissory notes increased their outside bases by amounts equal to the face value of the notes, citing ***Gefen,* 87 TC 1471 (1986)**. Nevertheless, the Court turned aside this argument since, in addition to executing a limited guaranty as a condition of investment in the limited partnership, the partner in ***Gefen*** assumed personal liability to the partnership's existing creditor for her pro rata share of the partnership's recourse indebtedness. But, here, there was no evidence that the partners were personally obligated to contribute a fixed amount for a specific, pre-existing partnership liability. Thus, the court concluded that the partners have no adjusted basis in the notes. Instead, until they are actually paid, the notes "are only a contractual obligation to their partnership." **(Code §723; Contributed Notes)**

12. Effect of Liabilities on LLC's Basis in Contributed Property: The existence of encumbering liabilities has no effect on the basis of contributed property to the LLC. However, if a **Code §754** election was made to adjust the basis of LLC property because of gain recognized by a contributing member, the basis is adjusted by the gain recognized.

13. Special Allocations: Members are taxed according to their distributive share of LLC income, gain, loss, deduction and credit.[89] Each member's distributive share is allocated according to the general profit-sharing ratio. If this is **not** specified in the agreement, it is the **same** as the capital interest.[90] However, the LLC agreement can

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[87] Donald Peracchi and Judith Peracchi v. Comm'r, 143 F.3d. 487 (9th Cir. 1998).

[88] *Segerman Farms, Inc. v. Commr.*, 81 TCM 1543 (2001), aff'd 308 F.3d. 803 (7th Cir. 2002); *Coltec Industries, Inc. v. U.S.*, 454 F.3d. 1340 (Fed. Cir. 2006).

[89] IRC §702

[90] Treas. Reg. §1.704(b)

allocate specific items as desired as long as there is **substantial economic effect** to the allocation.[91] Furthermore, the primary purpose of the allocation cannot be to **avoid taxes** or **distort allocations** for tax purposes.

> **Comment: Special allocations are discussed more fully later on in the text. But, in light of the changes made by the TCJA, especially with regard to the new Sec. 199A deduction and the need, in certain instances where the taxpayer's taxable income exceeds the applicable "threshold," for "wages" to support the QBI component, it makes little sense to continue the use of "guaranteed payments." Instead, "special allocations" can be made to earmark a set amount of profits to a particular partner. That way, QBI is unaffected while that partner still receives an appropriate share of the entity's income (i.e., equivalent to what they would have received through a guaranteed payment).**

☞**Lacking "Substantial Economic Effect" Partnership's Allocation of Losses to Equity Partners Limited to Capital Accounts (CCA 201741018)**

The IRS has determined that a joint venture's method of allocating its partnership losses to the partners "lacked economic effect" under **Reg. §1.704-1(b)(2)(ii)**. As a result, the losses had to be reallocated in accordance with the partners' interests in the partnership. Specifically, the equity partners to which the losses were allocated did *not* bear the "economic burden for the loss allocations" because they would have no obligation to restore any shortfall in the event that the joint venture liquidated (and, the entire balance of any outstanding debt had *not* been fully repaid). Thus, the allocation of losses to them was limited to the amount of their *positive* capital account balances (i.e., their "at-risk basis" otherwise shown on **Form 6198**).

Background: Under **Code §707(c)**, guaranteed payments (i.e., those made without regard to the income of the partnership) to a partner for services or the use of capital are treated as if being made to someone who is *not* a member of the partnership for the purposes of inclusion in gross income under **Code §61(a)**. Therefore, subject to the **Code §263** rules for capital expenditures, they are characterized as "ordinary and necessary business expense deductions" under **Code §162**. In other words, a partner is treated as receiving gross income and *not* a distributive share, from a guaranteed payment for the use of capital under **Code §707(c)**, with the partnership gets a corresponding deduction under **Code §162**. As a result, the income from the guaranteed payment does *not* affect the recipient's basis in their partnership interest or their capital account. (**Reg. §1.704-1(b)(2)(iv)(o)**) But, the partnership's deduction for the guaranteed payment will serve to reduce the partnership's income (or, increases the partnership's loss) to be allocated among its partners.

A partner's distributive share of income, gain, loss deduction, or credit is determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if:

1. The partnership agreement does *not* specifically provide as to the partner's distributive share of income, gain, loss, deduction, or credit; or

2. The allocation to a partner under the agreement of income, gain, loss, deduction or credit does *not* have "substantial economic effect". (**Code §704(b)(2)**)

Reg. §1.704-1(b)(2) sets out the 2-part analysis of the "substantial economic effect" test:

i. The allocation must have "economic effect" (i.e., within the meaning of **Reg. §1.704-1(b)(2)(ii)**, below); and

ii. The economic effect of the allocation must be "substantial" (i.e., within the meaning of **Reg. §1.704-1(b)(2)(iii)**).

An allocation of income, gain, loss, or deduction to a partner will have "economic effect" if, throughout the full term of the partnership, the partnership agreement provides that:

1. The partnership will maintain a capital account for each partner under the rules of **Reg. §1.704-1(b)(2)(iv)**;

2. The partnership will liquidate according to *positive* capital account balances; and

3. The partners are unconditionally obligated to restore any deficit balances in their capital accounts following the liquidation of the partnership or of the partner's interest in the partnership (i.e., a "deficit restoration order"). (**Reg. §1.704-1(b)(2)(ii)(B)**)

The bottom line is that If an allocation lacks "substantial economic effect," then the item must be allocated in accordance with the partners' interest in the partnership. (**Reg. §1.704-1(b)(3)(i)**) And, the determination of a partner's

[91] See Treas. Reg. §1.704-1(b) for a discussion of partnership allocations and examples.

interest in a partnership is made "by taking into account all facts and circumstances relating to the economic arrangement of the partners." **(Code §704(b)(2); Special Allocations)**

☞Special Allocations v. STCL for Loans Made to Partnerships

What is the proper tax treatment for a loss resulting from monies loaned to an entity (here, a partnership)? Normally, it is a *nonbusiness* bad debt which then results in a STCL deduction. But, if instead, an employee position was being protected by making the loan, then arguably an ordinary loss could be taken. Nevertheless, it would still have to be taken on **Form 2106** subject to 2% of AGI (i.e., as a miscellaneous deduction), phase-out rules and an AMT addback (Cf. ***Kenneth Graves*, T.C. Memo 2004-140 (6/15/2004), affirmed by the 9th Circuit in 2007**). The basis for this position can be found in **Code §166(d)(2)(A)** which recharacterizes this as a *business* bad debt. The same argument would exist for a partner who, for example, had derived a great deal of their income through guaranteed payments for services rendered to the entity. But, a partner who, on the other hand, is just a mere investor would have a difficult time claiming a business debt for such a loan. Instead, as discussed below, a "special allocation" of the partnership's ordinary business losses should instead be made.

> **Comment: This issue has become moot after 2017 with the passage of the TCJA and the elimination of 2% miscellaneous itemized deductions and Form 2106 for unreimbursed employee expenses (which would include a deduction being claimed to "protect one's employment status"). And, if the taxpayer was in an AMT position, it also would not matter since all 2% miscellaneous deductions had to be added back anyway on Form 6251.**

In light of the recent recession in our country's economy, many small businesses especially are having a difficult time maintaining adequate lines-of-credit. As a result, they are forced to turn to their owners for loans and/or capital infusions. With a partnership (v. an S corp), however, **Code §704(b)(2)** can be used to make a special allocation of Box 1 "trade or business" losses on a K-1 in a *non-pro rata* fashion where it otherwise makes "substantial economic" sense. Specifically, where a business has no retained earnings and no sources of outside third-party lending, and it has to turn to its owner for its continued existence, then such an allocation would be justifiable. **(Code §166; Bad Debts)**

> **Example:** A, B and C each contribute $10,000 in cash to form an LLC trade or business. Needing more capital to operate initially, the LLC borrows $100,000 with A being the sole guarantor. After the first year of operations, the LLC incurred a $130,000 loss. If split 1/3 each (i.e., $4333,334 to each member's K-1), B and C would have an excess loss carryover of $33,334 each due to the lack of basis. Instead, the first $110,000 of loss should be specially allocated to A, with the remaining $20,000 being allocated $10,000 each to B and C. Since this entity could not have even operated for that first year without the line-of-credit, there is a "substantial economic effect" for allocating the $110,000 portion of the $130,000 overall loss to A as the sole guarantor.

> **Comment:** There is no such thing as a "special allocation" for S corporations since there is only *one* class of common stock allowed and all allocations of income or losses must be made on a *pro rata* basis.

☞Special Allocations - Partnership K-1 Items

There are three specific requirements under **Code §704(b)(2)** for partnerships intending to make special allocations of K-1 items in a particular tax year. The most important one is that there be "substantial economic effect" for the allocation (as opposed to it only being done strictly for a more favorable tax result to a particular partner). In a client's situation where the banks had refused to lend any more monies to the business, and with the losses that it had incurred to-date, there was no source of funds to finance continued operations. Therefore, an individual partner decided to contribute (v. lend) an additional $250,000 to the entity which allowed the business to stay afloat, at least for the most current tax year when it incurred over $350,000 in losses.

The other two remaining requirements under the Code for special allocations would be that capital accounts were maintained and that, if there was a deficit in this particular partner's capital account, he would be required to make a sufficient contribution to restore that balance back up to zero before exiting the partnership (i.e., a "deficit restoration order" or DRO).

A fair allocation in this instance, which should be committed to writing as an addendum to their partnership agreement (although, no special statement need to be included with either the Form 1065 or the partner's personal tax return), is that the first $250,000 of the current tax year loss (which was financed by his capital contribution) would be specifically allocated to his K-1, with the remainder of the $350,000 overall loss being allocated based on their respective ownership percentages. **(Code §704(b)(2); Special Allocations)**

> **Comment:** Partnerships have until the unextended due date of Form 1065 to amend their agreement to make a special allocation.

☞**De Minimis Rule Dropped for Partnership Allocations (T.D. 9607)**

Partnership allocations must have either "substantial economic effect" or "be in accordance with the partners' interests in the partnership." The determination of whether an allocation of income, gain, loss, or deduction has "substantial economic effect" involves a two-part analysis under **Reg. §1.704-1(b)(2)** . When determining substantiality, the "de minimis rule" specified that the tax attributes of partners who owned less than 10% of the capital and profits of a partnership and were allocated less than 10% of each partnership item did *not* have to be taken into account. Now, these final regulations removed the "de minimis partner rule" under **Reg. §1.704-1(b)(2)(iii)(e)** because "it was too broad and easily abused." As a result, this exception is now eliminated for all partnership tax years beginning *after* 12/27/12, regardless of when the allocation became part of the partnership agreement. **(Code §704; Partnership Allocations)**

14. Property Distributions Made Within Seven Years of Contribution

a. Deemed Sale: If property is distributed, either directly or indirectly, by the partnership to other than the contributing partner **within seven years** of the contribution, the **contributing partner** is treated as recognizing gain or loss equal to the pre-contribution difference between the property's basis and book value. The result is treated as if the property was sold in a deemed sale at its FMV on the date of the original contribution to the entity.[92]

The character of the gain or loss from this deemed sale is determined by reference to the character of the gain or loss which would have resulted if such property had been sold by the **partnership to the distributee**.

Appropriate adjustments are made to the adjusted tax basis of the contributing partner's interest in the partnership, because of the deemed gain or loss recognized due to these rules, as well as to the distributed property's adjusted tax basis.

Example 14: "Distribution of Pre-contribution Gain Property within Seven Years"

Alex transferred land to a partnership solely for a partnership interest. The land had a basis of $50,000 and an FMV of $250,000. The land is then distributed to Carl **within seven years**. Carl is unrelated to Alex.

This distribution is treated as a **deemed sale** with the pre-contribution gain of $200,000 being allocated solely to Alex. Additionally, since Alex is required to recognize this deemed gain, Carl receives a **corresponding step-up in basis**. Carl's property now has a basis of $250,000 ($50,000 basis from the partnership which would carry over to Carl, plus the $200,000 step-up gain required to be recognized by Alex due to the distribution within seven years).

15. Transfers Between Related Members or LLCs: Frequently sales are made between family members in order to acquire assets for contributing to a new LLC when it is formed.[93] There are also several Code sections and treasury regulations which address transactions between individual members and the LLC, and between family members or related parties.

Capital gain is disallowed for sales of depreciable property between husband and wife or in cases in which the seller owns a **more then 50% interest** either directly or indirectly in a purchasing corporation, LLC or partnership.[94] However, these rules do allow **capital gain** treatment on sales between parents and children (i.e., a "controlled entity" is **not** involved), or the sale otherwise involves property which is nondepreciable in the hands of the controlled entity to which it is transferred. Nevertheless, if nondepreciable property, such as land, is sold to an LLC (as opposed to a corporation) which is controlled (i.e., more than 50%) either directly or indirectly by the selling party, then all the gain is recharacterized as **ordinary** unless the land is held as a **capital asset** (i.e., as defined in **Code §1221**) in the hands of the LLC.[95]

Comment: Note, the asset must be a "capital asset" in the hands of the LLC. If, instead, it is a **Code §1231**

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[92] IRC §704(c)(1)(B)

[93] IRC §1239(A)

[94] IRC §1239(c)(1)(b)

[95] IRC §707(b)(2)(A)

asset (i.e., one used in a trade or business, held long-term, for which a depreciation deduction is allowed, or land used in a trade or business), then this condition would **not** be satisfied and ordinary income would still result on the transfer to the controlled LLC.

Example 15: Andy held a parcel of land as an investment for 15 years. In order to secure the capital gain on the appreciated portion of the land, he forms an LLC with Rob who will be the developer on the property. An arm's length sale price is established based on a recent appraisal. If Rob owns 50% or more of the development LLC, the gain realized by Andy will be **long-term capital gain**. However, if Andy insists on controlling the property's development by owning a **majority** of the LLC to which the property is sold, all the gain would be treated as **ordinary income**.

Comment: If Andy had sold the land to a newly-formed **S corporation**, which would then manage the development work, it would **not** matter whether he had control of this entity. Since the land would **not** be depreciable property in the hands of the transferee (the S corporation), all of the gain would be capital under **Code §1239**.

This strategy of "locking in" capital gain with regard to undeveloped land has been confirmed by several cases. However, appraisals should be carried out to support the underlying appreciation in value as of the time of the sale. Also, if the sale is made with an **installment note**, care should be taken to abide by its terms as to both principal and interest payments with otherwise due or the IRS might have a good argument that a **capital contribution** had instead been made. Furthermore, make sure the formation and capitalization of the S corporation and the sale of the land to the S corporation are **completely separate and distinct events**. Therefore, do **not** allow the S corporation to issue any stock to the client at the **same time** the land sale is made.[96]

In the case of land sales to an individual's family member of up to $500,000 after June 30, 1985, an imputed rate of the lessor of 6% compounded semi-annually or the AFR applies, if the minimum simple interest rate in the contract is less than 6%.[97]

Transactions between a member and the LLC, conducted other than in the capacity as a member, are treated the same as between unrelated parties.[98] However, there are **two limitations**.

- If there is a sale or exchange between an LLC and a member owning, either directly or indirectly, more than 50% of profits or capital, then **no loss is allowed.**[99] Likewise, if the sale or exchange is between two LLCs in which the same persons own more than 50% of the profits or capital, then no loss is allowed.

- Any payments to a member in his capacity as a member are **guaranteed payments** if they are determined without reference to LLC income.[100] Generally, guaranteed payments are taxable as **ordinary income** and are considered **self-employment income**.

E. Discussion Questions

Partnership Tax Year:

1. The ABC partnership uses a fiscal year ending January 31st. Partner A uses the calendar year. For FYE 1/31/x6, the partnership information return on Schedule K-1 shows that A's distributive share of profits for the year is $12,000. When must A report his share of profits in income? Has tax deferral been achieved in this situation? If a partnership's FYE is instead June 30th, must a calendar year partner make a 1st and 2nd quarter estimated tax payment?

2. A, B and C agree to form an equal partnership for the practice of medicine. They each use the calendar year

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96 *Bradshaw, Jolana S. v. U.S.*, 50 AFTR 2d 82-5238, 683 F2d 365, 82-2 USTC 9454 (Ct Cl, 1982).

97 Treas. Reg. §1.483-3(b)(2)

98 IRC §707(a)(1)

99 IRC §707(b)

100 IRC §707(c)

for their individual returns. Can the partnership adopt a fiscal tax year? (Cf. **Code §706(b)(1)**)

3. Under what circumstances can a partnership have a different taxa year from that of its majority or principal partner(s)? What is the "business purpose" exception? What is the "natural business year" exception?

4. What would a partnership have to do from a procedural standpoint with the IRS if it had to switch, for instance, from a fiscal yearend to a calendar yearend? (Cf. **Form 3115 Instructions**)

Contributions of Property:

5. A is engaged in a business as a sole proprietor and uses the cash method of accounting. He is contemplating an expansion of his business but needs additional capital. His employee, B, is willing to contribute the necessary capital in return for a proprietary interest in the business.

A's only asset consists of a machine purchased on 1/1/x4 for $12,000. The machine is presently worth $10,000 and has an adjusted basis of $7,000. A would contribute the machine to the new business venture with B. B, in turn, would contribute $10,000 in cash for an equal interest.

Determine the tax consequences in each of the following:

(a) While in business for himself, A exchanges $1,000 in cash and his old machine for a new machine of like-kind worth $11,000. Is **Code §1031** elective?[101]

(b) A and B agree to form a corporation. A exchanges the machine for half of the outstanding stock. B receives the other half of the stockin return for his cash contribution of $10,000. Does it matter if A is not in control of the new corporation? (Cf. **Code §351(a)**; **Code §368(c)**)

(c) On 1/1/x6, A and B agree to form a partnership. A contributes the machine and B contributes the cash.

(i) What is A's basis and holding period for his partnership interest?

(ii) What is the partnership's basis and holding period for the machine? What if A held the machine for only 4 months prior to the contribution? What if A contributed a capital asset held for only 4 months prior to the contribution? (Cf. **Reg. §1.1223-1(a)**) What if A contributed inventory held for 2 years?

(iii) Suppose on 7/1/x6, C becomes an equal partner with A and B by contributing a machine, FMV $10,000, adjusted basis $8,000, to the partnership? Does the nonrecognition and carryover basis treatment still apply? (Cf. **Reg. §1.721-1(a)**)

(iv) Suppose the partnership sells the machine it received from A on 2/1/x7 for $10,500. What are the tax consequences of the sale? (Cf. **Code §47(a) and (b); Reg. §1.47-3(f); Code §704(c) and Code §724**)

Other Code/Reg cites:	**§§1.1245-4(c)(1)**	**1.1245-2(c)(2)**	**1.1245-4(c)(4), Ex. #2**
	§§1.1250-3(c)(1)	**1.1250-3(c)(2(vi)**	**1.1250-3(c)(3)**

6. On 1/1/x6, D contributes his *personal* truck to a partnership in return for an interest in the business. D originally purchased the truck on 1/1/x5 for $8,000. Its value when converted to business use was $6,000. Determine D's basis and holding period in his partnership interest and the partnership's basis and holding period in the truck. (Cf. **Reg. §1.167(g)-1; Code §1223(2); Reg. §1.1223-1(a)**) What depreciation method and recovery period would the partnership use? (Cf. **Code §168(i)(7)**)

7. A and B form an equal partnership on 1/1/x6. A contributes $10,000 in cash. B contriubtes a machine worth $10,000, originally purchased on 1/1/x5. A short time later the business needs additional capital. On 4/1/x6, A contributes $5,000 cash and B contributes a second machine worth $5,000, originally purchased on 1/1/x4. What are A and B's holding periods for their partnership interests? What would be the result if B had purchased the $5,0000 machine on 1/1/x6? What would B's holding period be if he contributed both machines at the same time?

8. A contributes cash to an existing partnership in return for a partnership interest on 1/1/x6. On 2/1/x6, the

[101] With the passage of the TCJA, like-kind exchange treatment is now only available for real estate.

partnership sells a capital asset held for more than one year at a gain. Can A report his distributive share of the parthership gain as LTCG even though he was only a partner for one month? (Cf. **Rev. Rul. 68-79**) Does he even report any of the gain under the dictates of **Code §704(c)**?

9. Although A is a partner is an existing partnership, he is *not* willing to invest any more capital. However, A is willing to lend the necessary funds to the partnership. How may the IRS view such a loan? (Cf. **Rev. Rul. 72-135; Rev. Rul. 72-350**) Suppose the fact indicate that the advance was a bona fide loan. If A later cancels the loan, must the partnership report the amount of the loan as cancellation of debt (COD) income? (Cf. **Reg. §1.61-12(a)**)

10. A, a cash basis sole proprietor, contributes his accounts receivable to a partnership. Determine A's basis in his partnership interest and the partnership's basis in the receivables. Does it matter if the partnership uses the accrual basis of accounting? Does the assignment of income doctrine have any applicability here?

11. S entered into a binding agreement with a bank to provide 100% financing for a proposed building project. S then proceeds to contribute this contract to a partnership in return for a partnership interest worth $40,000. Since the contract is "property," can S qualify for the nonrecognition treatment afforded by **Code §721**? (Cf. **Reg. §1.721-1(b)(1); *Stafford* and Rev. Rul. 84-15**)

Contribution of Property Subject to Liabilities:

12. A and B form the AB partnership. A contributes $5,000 cash for a one-third interest. B contributes a machine for a two-thirds interest, FMV $13,000, adjusted basis $5,000, subject to a chattel mortgage of $3,000. The partnership assumes liability for the chattel mortgage. Determine the tax consequences to A, B, and the partnership upon the contribution of this property. (Cf. **Reg. §1.722-1, Ex. 1**)

13. A and B form the AB partnership. A contributes a capital asset, FMV $25,000, adjusted basis $6,000, subject to a $15,000 mortgage with a holding period of 18 months in return for a one-third interest. The partnership assumes the liability. B contributes $20,000 cash for a two-thirds interest. What are the tax consequences to A, B and the partnership? How can the recognition of gain upon contribution be reconciled with **Code §721**? How migh recognition be avoided in this situation? (Cf. **Reg. §§1.722-1, Ex. 2; 1.752-1(c); Rev. Rul. 84-15 and Code §723**)

14. What would be the character of the gain, if in #9. above, the property contributed by A was a machine, a **Code §1231** asset, with an original cost of $20,000? (Cf. **Reg. §1.1245-4(c)(4), Ex. 3**)

15. What problems may be anticipated if a cash basis individual contributes his sole proprietorship to a partnership and that business has substantial accounts payable?

Contribution of Services for a Partnership Capital Interest:

16. A renders services to the B corporation, his employer. Instead of paying A in cash, B Co. gives A an inventory item worth $100. The inventory item originally cost the company $65. What are the tax consequences to A and B Co.? (Cf. **Code §83(h); Reg. §1.83-6(b); Code §311(d) and Code §162**)

17. Suppose in #16. above, A instead received stock in B Co. in satisfaction of his right to receive wages? (Cf. **Code §351(a)**)

18. A and B agree to form the AB partnership. A contributes $1,000 cash for a 50% interest in capital and profits. B is to run the day-to-day operations of the partnership and receives the other 50% capital and profits interest in return for this promise to render future services. What are the consequences to A, B and the partnership? Does the nonrecognition provision of **Code §721** apply? (Cf. **Reg. §§1.721-1(b)(1); 1.722-1 and *Frazell***)

(a) Suppose A is entitled to receive a return of his capital investment before any cash can be distributed to B. If the facts indicate that B was a partner from the outset, what would be the tax consequences?

19. A and B own some land as tenants-in-common, FMV $10,000, adjusted basis $7,500. C agrees to manage the property for them in return for a one-third interest in the capital and profits. As a result, the ABC partnership is formed with A and B contributing the property. What are the tax consequences to A, B and C, if C's interest in vested immediately upon formation of the partnership?

<u>Contribution of Services for Partnership Profits Interest</u>:

20. What is a "profits interest?" (Cf. **Reg. §1.704-1(e)(1)(v)**)

21. Assume that the sole asset of the AB partnership is a corporate bond with a basis and FMV of $100,000, maturing in 5 years and bearing interest at a rate of 8% per year. The partnership conveys a 50% unrestricted interest in its future *profits* to C in return for *past* investment services. The present value of an income stream of $4,000 per year for 5 years is $14,000. Has C received a profits interest? Who is entitled to the principal upon maturity? What would a third party be willing to pay C for his interest in the year C received it? How will C treat the receipt of the $4,000 each year? Does C have income in the current year? Is this the ***Sol Diamond*** case? How could the result in the ***Diamond*** been avoided? (Cf. ***Stafford***)

22. D is hired to manage an office b uilding for the ABD partnership. Determine the tax consequences to T and his employer in each of the following situations:

(a) Payment for D's services is to be 10% of the building's net operating profits.

(b) D is to receive 10% of the building's net operating profits, plus cash equal to 20% of the building's appreciation in value at the end of 5 years. Is this the ***Frazell*** case? (Cf. ***McDougal***)

<u>Contribution of Services for Restricted Partnership Interests</u>:

23. A is a sole proprietor engaged in the retail clothing business. B and C are his employees. The parties intend to form a partnership on the following terms and conditions:

<u>Interest in Profits</u>	<u>Share of Losses</u>	<u>Interest in Capital</u>
A. 51%	A. 100%	A. 80%
B. 24½%	B. -0-	B. 10%
C. 24½%	C. -0-	C. 10%

A agrees to contribute to the partnership all of his business assets presently owned and operated under the sole proprietorship. B and C will contribute *future services only*. B and C will not be entitled to withdraw their capital for 5 years unless the partnership is terminated by the death of any partner. If otherwise terminated, the capital interests of B and C will revert to A. In addition, B and C may not sell their interests in the partnership without prior approval of A until 5 years have passed. Finally, if either B or C fail to perform the future services for the next 5 years called for in the partnership agreement, their rights to their capital and profits interest are forfeited to A.

Assume that at formation of the partnership a 10% capital interwst is worth $8,000 and at the end of 5 years it is worth $30,000. (Cf. **Code §83(a), (b), (c)(1) and (h); Reg. §1.83-3(c)(1); Reg. §1.721-1(b)(1)**) What are the tax consequences upon the formation of this partnership and at the end of 5 years?

(a) How would you value the profits interest? Is this feasible?

(b) Would the Tax Court in ***Diamond*** have currently included in the service partners' income a profits interest received for future services? Would the 7th Circuit in ***Diamond*** have taxed the receipt of a profits interest if it was *not* readily susceptible of valuation when received?

(c) Is an election under **<u>Code §83(b)</u>** advisable? When would you want to make it?

24. What was the purpose behind the amendment of **<u>Code §704(c)</u>**? Did it effectively close the loophole?

<u>Special Allocations of Contributed Property</u>

25. X and Y form the XY partnership. X contributes $20,000 and Y contributes land with an adjusted basis of $5,000 and a FMV of $20,000. Under the partnership agreement, X and Y are to share equally in the profits and losses of the partnership.

(a) If XY sells the land for $19,000, what would be the tax consequences to X and Y? (Cf. **<u>Code §704(c)(2)</u>**)

(b) Same as (a), except the land is sold for $22,000.

(c) What is the character in (a) and (b) if Y was a real estate dealer? (Cf. **Code §724(b)**)

Notes:

CHAPTER IV: PRE-CONTRIBUTION GAIN ON CONTRIBUTED ASSETS

A. Pre-Contribution Gain & Code §704(c):

Code §704(c)(1)(A) provides in part:

*Under regulations prescribed by the Secretary, income, gain, loss and deduction with respect to property contributed to the partnership by a partner shall be shared among partners **so as to take account of the variation between the basis of the property to the partnership and its FMV at the time of contribution**.*[102]

The House Committee Report made it relatively clear that Congress wanted to prevent an **artificial shifting** of tax consequences between partners who are in **different** tax brackets. For instance, in **Example 2** below, gain is allocated to a partner in a **lower** tax bracket (the son) by sharing depreciation deductions on contributed property with the **higher** taxed partner.

Consider the tax effect of any **pre-contribution gain** to the respective members.

Example 1: Angela in A & B Equal LLC contributed equipment with an adjusted basis of $10,000, with an original cost of $25,000 and FMV of $20,000. If the equipment is sold for its FMV by the LLC, all the gain is Code §1245 ordinary income and would normally be allocated equally between Angela and Barry. However, Angela received the tax benefit from the pre-contribution depreciation taken, and economically should report the full $10,000 in her income.

Example 2: In a 50-50 father-son LLC, the son purchased $50,000 of equipment from the father prior to the LLC's formation. The purchased equipment then became the son's contribution to the new LLC, and the depreciation is shared equally between father and son barring any special allocation (i.e., since with the $50,000 cost basis of this equipment, there is no pre-contribution gain or loss).

Comment: There is no equivalent of **Code §704(c)** in Subchapter S of the IRC for S corporations. As a result, attempts at shifting gain on appreciated assets might be employed, but remember an imputed gift transfer argument might be asserted by the IRS which would then examine and detect similar exchanges with S corps.

The **Tax Reform Act of 1984**, in an attempt to prevent the shifting of income, required an allocation of gain or loss **back to the contributing member** for contributions made after May 1, 1986 under **Code §704(c)** regulations.[103] Other means of taking into account pre-contribution gain, loss or depreciation are:

1. Sale to the LLC,

2. Sale to other members,

3. Lease to the LLC, and

4. Reduction in contribution value to reflect pre-contribution tax consequences. In other words, depreciated equipment is contributed at adjusted book value.

These rules were set forth in **Treas. Reg. §1.704-3(e)(1)(i)** and **(ii)** and state that if a partner contributes one or more items of property to a partnership **within a single taxable year** of the partnership, and the disparity between the book value of the property and the contributing partner's adjusted tax basis in the property is a **"small disparity,"** the partnership may:

• Use a **reasonable Code §704(c)** method,

• **Disregard** the application of **Code §704(c)** to the property, or

• Defer the application of **Code §704(c)** to the property until the **disposition** of the property (i.e., any depreciation or amortization would be shared pro rata until the property was sold).

A disparity between book value and adjusted tax basis is considered to be a "small disparity" if the book value of all

[102] Deficit Reduction Act, §71(a)

[103] Tax Reform Act of 1984, §71 and Committee Report

properties contributed by one partner during the tax year does ***not*** differ from the adjusted tax basis by **more than 15%** of the adjusted tax basis, **and** the total gross disparity does ***not*** exceed $20,000.

As a result, if the taxpayer chose to ignore the "small" pre-contribution gain for instance, depreciation deductions can be shared equally among partners in the interim, and **not** solely allocated to the **noncontributing partner(s)**. Furthermore, any gain on a taxable disposition of the property can also be **shared pro rata** among the partners.

> **Comment:** The **Code §704(c)** rules would most probably arise in situations where real property was being contributed to an LLC. This could also occur where a like-kind exchange of real estate had previously occurred and the qualified replacement property was subsequently being transferred in exchange for an LLC interest (i.e., where the previously deferred gain was reflected in the use of a substituted basis for the LLC interest received in the exchange).

Accrued, but unpaid, items of income or deduction of a cash method partner that are contributed to, or assumed by, the partnership are treated the same as any other **Code §704(c)** property.[104] In effect, these rules require that when partner-contributed accounts payable are paid, the expense is **not** deducted by the partnership, but is instead allocated to the **contributing partner**. Similarly, when partner-contributed accounts receivable are received, the taxable income is **not** included in partnership taxable income, but is specifically allocated to the **contributing partner**.

> **Comment:** With the combination of service-type businesses, keep in mind that each contributing partner would remain liable for the tax due on those accounts receivable still outstanding but which were subsequently collected by the newly-combined firm. On the other hand, it is common for each partner who is now combining their practice to simply keep track of, and *not* contribute over to the new entity, their prior accounts receivable. Then, they would merely include these in the income of their former practice and pay the corresponding tax.

Final and proposed regulations concerning **Code §704(c)** were issued December 21, 1993 and describe three methods of making **Code §704(c)** allocations. These are:

- Traditional method,
- Traditional method with curative allocations, and
- Remedial allocation method.

"Code §704(c) property" is defined as property, which at the time of contribution, has an FMV **that differs from the contributing partner's adjusted tax basis**.

Generally, regulations require an allocation to correct differences on a property-by-property basis. However, an aggregation of properties contributed by one partner in a tax year is allowed.[105] Therefore, depreciable items in the same general asset account, zero basis property, and inventory may be aggregated for the purposes of determining **Code §704(c)** allocations.

When making allocations, different methods may be used for different items or aggregation of items.

> **Comment:** The regulations state that a specific selected method is *not* unreasonable just because another method would result in a greater overall tax liability.

> **Example 3:** Frank and Mark form an equal partnership. Frank contributes a depreciable asset with an adjusted tax basis of $100,000 and book value (i.e., FMV) of $200,000. Mark contributes $200,000 of cash. If the depreciable asset is ever sold by the partnership, the pre-contribution gain of $100,000 is allocated to Frank to the extent that no special allocation of depreciation was allocated to Mark.

If the property has depreciation (or, amortization) deductions, they may be allocated in one of three ways.

1. Traditional Method: When a partnership or LLC taxed as a partnership has income, gain, loss, or deduction, the traditional method requires the partnership to **make appropriate allocations to the partners to avoid shifting the tax consequences of the built-in gain or loss**. For example, if the partnership sells an item of **Code §704(c)** property and recognizes gain or loss, the built-in gain or loss on the property is allocated to the **contributing**

[104] Treas. Reg. §1.704-3(a)(4)

[105] Treas. Reg. §1.704-3(e)(2)

partner. Likewise, a cost-recovery deduction, such as depreciation, must take into account the built-in gain or loss on the property. Therefore, tax allocations are assigned to **non-contributing partners** up to their book allocations and any remaining tax allocations are assigned to the contributing partner up to the total book allocations. Any excess deductions over FMV are allocated according to their profit-sharing ratio. These allocations are subject to the "ceiling rule," which states total tax allocations cannot exceed the partnership's tax allocations. Therefore, in some circumstances, the tax allocations to non-contributing partners may *not* equal their book allocations.[106] The ceiling rule could also be stated as book depreciation for the non-contributing partners can exceed the total tax depreciation.

Example 4: Use the facts from **Example 3**. The contributed asset is depreciated over 10 years using the straight-line method. The yearly tax depreciation is $10,000, while the book depreciation is $20,000. Because the asset has a built-in gain of $100,000 at the time of contribution, the depreciation is allocated to Mark (i.e., who contributed **cash**) in order to bring the adjusted tax basis of his capital account in line with Frank (i.e., who contributed the **appreciated property**). The entire tax depreciation of $10,000 is allocated solely to Mark due to the ceiling rule. The book depreciation is split between the two partners. Frank's built-in gain is now reduced to $90,000 after the first year.

Example 5: Use the same facts as **Example 4**. The annual depreciation deduction on the asset is equal to $10,000 per year. If the partnership sells the depreciable asset at the beginning of the second year for $180,000, it recognizes a gain of $90,000. The entire gain must be allocated to Frank since he still has this amount of built-in gain. If the property sold for $200,000, the partnership recognizes a gain of $110,000. Frank is allocated his built-in gain of $90,000, plus 50% of the additional $20,000 gain, or $10,000. Mark is allocated $10,000.[107]

Comment: In addition to any pre-contribution gain allocated to the partner who originally contributed the property, the character of that gain might also be subject to the depreciation recapture rules. If the property sold in **Example 5** was a building, and straight-line (S/L) depreciation was claimed, Frank would have a portion of the $90,000 pre-contribution gain recharacterized as "unrecaptured **Code §1250** gain." This would be taxed at a maximum 25% marginal rate, along with the remainder of the gain being treated as a **Code §1231** gain. Both amounts would flow to **Form 4797** and then to **Form 8949** and then to **Schedule D**, assuming that there were no other **Code §1231** losses to be netted against these gains.

2. Traditional Method with Curative Allocations: To correct distortions created by the "ceiling rule," a partnership may make reasonable "curative allocations" so that equal allocations of book and tax items may be made to the non-contributing partners. To be "reasonable," these allocations must be expected to have *substantially the same effect* on each partner's tax liability as the tax item limited by the ceiling rule. For example, a depreciation shortfall for a non-contributing partner could be corrected by an allocation of depreciation from the contributing partner's share, or an allocation of ordinary income from the non-contributing partner to the contributing partner to offset the shortfall.[108] The LLC may limit its curative allocations to allocations of one or more particular tax items even if the allocation of those available items does *not* fully offset the effect of the ceiling rule.

3. Remedial Allocation Method: The remedial allocation method[109] carries the traditional method with curative allocations a step further to eliminate distortions caused by the "ceiling rule." The procedure creates remedial items and makes tax allocations between the partners to correct the differences between book and tax allocations even when the contributed property no longer has any tax allocations to be made.[110] Presumably, adoption of this method ultimately corrects all differences between the partners in their proportionate share of the partnership tax basis and book value.

Example 6: "Like-Kind Exchange Money Reinvested in Real Estate"

A number of investors involved in a like-kind exchange (LKE) were searching for suitable qualified replacement property during the 45-day identification period. They were approached by Don, a long-time real estate developer. Don located a sizable parcel of land upon which an X-Mart Super Center already was located. The

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[106] Treas. Reg. §1.704-3(b)(1)

[107] Treas. Reg. §1.704-3(b)

[108] Treas. Reg. §1.704-3(c)

[109] Treas. Reg. §1.704-3(d)(2)

[110] Treas. Reg. §1.704-3(d)(1)

store wished to sell both the land and building and then lease it back so as to improve their cash flow. Sensing this was a good deal, the investors used their LKE escrow monies toward the purchase of the property and building. However, Don needed additional investors to raise the necessary capital. Therefore, he located 10 other investors who had *not* previously been involved in any LKE, but who had the cash to make an investment into the property. As a result of the pooling of these investment dollars (i.e., with the monies already sitting in the qualified intermediary's escrow account), the land and building were purchased. The respective basis must be determined for each of the investors related to their tenant-in-common interest in the underlying real property. For the investors who simply reinvested monies held in a LKE escrow account, they have a **carryover basis** equal to that of the real estate disposed of in the LKE. For the investors contributing cash, their basis is equal to the **actual amount invested**.

Example 7: Using the *same* facts as **Example 6**, the investors subsequently deeded their ownership interests in the land and building to a newly-formed LLC in return for a membership interest equal to the contributed property's FMV. No other boot is received. There is **pre-contribution gain** related to the LLC's holding of the real estate. This is due to the **carryover bases** that the investors had from the LKE. As a result of the **Code §704(c)** rules, the future depreciation deductions relating to the building will flow solely to the cash-only investors under the rules discussed above.

B. Miscellaneous Developments:

☞**Proposed Regs Cover Variety of Partnership Transactions**

The IRS has issued proposed regs that cover several partnership subjects including contributions of built-in loss property, **Code §743** basis adjustment rules, **Code §734** basis adjustment rules, and **Code §755** rules for allocation of basis (i.e., when a **Code §754** election is made to step-up the inside bases of partnership assets).

Note: The discussion below would apply for contributed assets with built-in losses before 2018. With the passage of the TCJA, the rule has been modified for tax years beginning after 2017 as explained by the IRS FAQs:

Purpose of Substantial Built-in Loss Rules

Q1. What's the purpose of the substantial built-in loss rules?

A1. The purpose of the substantial built-in loss rules is to prevent a double benefit of built-in losses that may result from the transfer of a partnership interest. The transferor partner recognized the built-in loss in the partnership property upon the sale or exchange of their interest. If the partnership doesn't adjust partnership property with respect to the transferee partner, the transferee will benefit from the built-in loss associated with the partnership property such as through depreciation or loss on the sale of the property.

Substantial Built-in Loss Defined (Prior Law)

Q2. What is a "substantial built-in loss" under prior law (through December 31, 2017)?

A2. In general, a partnership doesn't adjust the basis of partnership property following the transfer of a partnership interest unless it has a valid IRC Section 754 election to make basis adjustments or a substantial built-in loss immediately after the transfer. Under prior law, a substantial built-in loss exists if the partnership's adjusted basis in its property exceeds by more than $250,000 the fair market value of the partnership property.

If the partnership has made an IRC Section 754 election, **or** has a "substantial built-in loss" immediately after the transfer, the partnership adjusts its bases in its partnership property with respect to the transferee partner.

These adjustments account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee's basis in its partnership interest. The adjustments approximate the result of a direct purchase of the partnership property by the transferee partner.

Q3. How was a substantial built-in loss determined under prior law?

A3. The substantial built-in loss rules used an "aggregate approach." The partnership compared the fair market value (FMV) of *all* assets to its *total* adjusted tax bases. A "substantial built-in loss" existed if the adjusted basis of partnership assets exceeded the FMV of partnership assets by more than $250,000.

Changes to Substantial Built-in Loss Rules under the TCJA

Q4. What changes did TCJA make to IRC Section 743(d)?

A4. The TCJA changed the rules relating to the substantial built-in loss computation. The new provision adds another definition for purposes of determining whether there is a "substantial built-in loss" at the time of the transfer of a partnership interest. Now, the partnership has a "substantial built-in loss" when:

(1) The partnership's adjusted basis in partnership property exceeds the fair market value of such property by more than $250,000, **or**

(2) The transferee would be allocated a loss of more than $250,000 if the partnership sold assets for cash equal to their fair market value immediately after such transfer.

Q5. Example – Loss Allocated Exceeds $250,000

A5. Partnership ABC has three partners (partners A, B, and C) and has *not* made an election under **Code §754**. The partnership has two assets. Asset G has a built-in gain (BIG) of $2 million. Asset L has a built-in loss (BIL) of $1.8 million.

Under the terms of the partnership agreement, any gain on sale or exchange of Asset G is specially allocated to partner A.

Partners A, B and C share equally in all other partnership items, including the built-in loss in Asset L. Partners A, B and C's share of the net built-in loss is $600,000 (one-third of the loss attributable to Asset L) allocable to their respective partnership interest.

Under prior law, the partnership would have a net built-in gain of $200,000 ($2 million gain in Asset G netted with the BIL of Asset L of $1.8 million). Because of no BIL, former law would have required no adjustment.

Under the TCJA, if Partner C sells his partnership interest to D after January 1, 2018, for $66,666 (one third of the net $200,000 FMV of the partnership), the partnership would have a "substantial built-in loss."

The test for a "substantial built-in loss" applies at *both* the partnership level and at the transferee partner level. Immediately after the transfer, the assets are treated as sold for cash equal to their fair market value. The partnership computes gain or loss on an asset-by-asset basis. **Even with no overall loss, it's possible that on an individual basis, some assets, if sold, would result in a loss**. If the transferee partner under the partnership agreement would be allocated a loss of more than $250,000 from the sale of such assets, the partnership must adjust the basis of its assets to the transferee partner. The partnership must adjust the basis of the assets giving rise to the substantial built-in loss with respect to the transferee partner.

In this example, the partnership must adjust the basis of Asset L to partner D (or by $600,000).

> **Comment:** This provision prevents a "double deduction" of losses associated with BIL partnership property. In this example, the BIL partnership property would have reduced the FMV paid to Partner C (effectively reducing their gain or increasing their loss). If not for this provision, transferee partner D would have been able to benefit from the BIL associated with Asset L.

"Substantial Built-in Loss Property Contributed to Partnerships Prior to 2018:"

Contributions of Built-in-Loss Property Prior to 2018: Code §704(c)(1)(C)(i) provides that if property contributed to a partnership has a "built-in loss" (i.e., **Code §704(c)(1)(C)** property), such built-in loss is to be taken into account only in determining the amount of items allocated to the contributing partner (i.e., **Code §704(c)(1)(C)** partner). **Code §704(c)(1)(C)(ii)** further provides that, except as provided by regs, in determining the amount of items allocated to the other partners, the basis of the contributed property in the hands of the partnership is equal to its FMV at the time of the contribution.

For purposes of **Code §704(c)(1)(C)**, the term "built-in loss" means the *excess* of the adjusted basis of the **Code §704(c)(1)(C)** property (determined without regard to **Code §704(c)(1)(C)(ii)**) over its FMV at the time of contribution. Property contributed to a partnership by a partner is "**Code §704(c)** property" if, at the time of contribution, the property has a "built-in gain" or "built-in loss" (i.e., a basis which is **either above or below its current FMV** as of the time of the contribution).

Proposed Regs: These proposed regs provide additional guidance with respect to the application of **Code §704(c)(1)(C)** in the following areas: (1) the scope of **Code §704(c)(1)(C)**; (2) the effect of the built-in loss; (3) distributions by partnerships holding **Code §704(c)(1)(C)** property; (4) transfers of a **Code §704(c)(1)(C)** partner's partnership interest; (5) transfers of **Code §704(c)(1)(C)** property; and (6) reporting requirements.

Code §704(c)(1)(C) Property: The proposed regs define "**Code §704(c)(1)(C)** property" as **Code §704(c)** property with a "built-in loss" at the time of contribution. As a result, in addition to the rules in the proposed regs, **Code §704(c)(1)(C)** property is subject to the existing rules and regs applicable to **Code §704(c)** property generally. However, **Code §704(c)(1)(C)** property does *not* include a "**Reg. §1.752-7** liability" (generally, any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of Code) or property for which differences between book value and adjusted tax basis are created when a partnership revalues property pursuant to **Reg. §1.704-1(b)(2)(iv)(f)**. (**Prop. Reg. § 1.704-3(f)(2)(i)**)

Code §704(c)(1)(C) Basis Adjustment: The proposed regs also create the concept of a "**Code §704(c)(1)(C)** basis adjustment." The **Code §704(c)(1)(C)** basis adjustment is initially equal to the built-in loss associated with the **Code §704(c)(1)(C)** property at the time of the original contribution and then is adjusted in accordance with the proposed regs.

> **Example:** If A contributes property with a FMV of $6,000 and an adjusted basis of $11,000 to a partnership, the partnership's basis in the property is $6,000, A's outside basis in its partnership interest is $11,000, and A has a **Code §704(c)(1)(C)** "basis adjustment" of $5,000.

Similar to basis adjustments under **Code §743(b)**, a **Code §704(c)(1)(C)** basis adjustment is unique to the **Code §704(c)(1)(C)** partner and does *not* affect the basis of partnership property or the partnership's computation of any item under **Code §703**.

The rules regarding the effect of the **Code §704(c)(1)(C)** basis adjustment are similar to the rules for **Code §743(b)** adjustments in **Reg. §1.743-1(j)(1)** through **(3)**, including: (1) the effect of the **Code §704(c)(1)(C)** basis adjustment on the basis of partnership property; (2) the computation and allocation of the partnership's items of income, deduction, gain, or loss; (3) adjustments to the partners' capital accounts; (4) adjustments to the **Code §704(c)(1)(C)** partner's distributive share; and (5) the determination of a **Code §704(c)(1)(C)** partner's income, gain, or loss from the sale or exchange of **Code §704(c)(1)(C)** property.

Basis Adjustments - Cost Recovery: For property eligible for cost recovery, the proposed regs provide that, regarding the effect of the basis adjustment in determining items of deduction, if **Code §704(c)(1)(C)** property is subject to amortization under **Code §197**, depreciation under **Code §168**, or other cost recovery in the hands of the **Code §704(c)(1)(C)** partner, the **Code §704(c)(1)(C)** "basis adjustment" associated with the property is recovered in accordance with **Code §197(f)(2)**, **Code §168(i)(7)** (i.e., "shoes depreciation/amortization"), or other applicable Code sections. Similar to **Code §743** (as discussed below), the proposed regs further provide that the amount of any **Code §704(c)(1)(C)** basis adjustment that is recovered by the **Code §704(c)(1)(C)** partner in any year is added to the **Code §704(c)(1)(C)** partner's distributive share of the partnership's depreciation or amortization deductions for the year.

Distributions of Code §704(c)(1)(C) Property: The proposed regs also provide guidance on current distributions of **Code §704(c)(1)(C)** property to the **Code §704(c)(1)(C)** partner; distributions of **Code §704(c)(1)(C)** property to another partner; and liquidating distributions to a **Code §704(c)(1)(C)** partner. The rules are similar to those for **Code §743(b)** adjustments.

Under **Code §722**, a **Code §704(c)(1)(C)** partner's basis in its partnership interest "fully reflects the built-in loss portion of the basis of the contributed property," and the built-in loss generally is taken into account by the **Code §704(c)(1)(C)** partner upon disposition of the partnership interest. Nevertheless, the proposed regs provide that the transferee of a **Code §704(c)(1)(C)** partner's partnership interest generally does *not* succeed to the **Code §704(c)(1)(C)** partner's **Code §704(c)(1)(C)** "basis adjustment." Instead, the share of the **Code §704(c)(1)(C)** basis adjustment attributable to the interest transferred is simply eliminated.

> **Example:** If a **Code §704(c)(1)(C)** partner sells 20% of its interest in a partnership, the partner recognizes its outside loss with respect to that 20%. But, 20% of the partner's **Code §704(c)(1)(C)** "basis adjustment" for each **Code §704(c)(1)(C)** property contributed by the partner is eliminated. The transferor, however, remains a "**Code §704(c)(1)(C)** partner" with respect to any *remaining* **Code §704(c)(1)(C)** basis adjustments.

> **Comment:** The proposed regs do, however, provide exceptions to this general rule for nonrecognition transactions.

Reporting Requirements: The proposed regs prescribe certain reporting requirements for **Code §704(c)(1)(C)** "basis adjustments" that are similar to the requirements for **Code §743** adjustments. Specifically, the proposed regs provide that a partnership that owns property for which there is a **Code §704(c)(1)(C)** basis adjustment must attach a statement to the partnership return for the year of the contribution of the **Code §704(c)(1)(C)** property, in which it sets forth the name and taxpayer identification number of the **Code §704(c)(1)(C)** partner as well as the **Code §704(c)(1)(C)** basis adjustment and the **Code §704(c)(1)(C)** property to which the adjustment relates.

Code §743 Basis Adjustment Provisions: Code §743(a) and **Code §743(b)** require a partnership to adjust the basis of partnership property upon a sale or exchange of an interest in the partnership or upon the death of a partner if there is a **Code §754** election in effect, or, for transfers *after* Oct. 22, 2004, if the partnership has a "substantial built-in loss" immediately after the transfer (**regardless of whether the partnership has a Code §754 election in effect**).

> **Comment: Code §743(d)(1)** provides that, for purposes of **Code §743**, a partnership has a "substantial built-in loss" if the partnership's adjusted bases in *all* of its partnership property exceeds the FMV of the property by more than $250,000. With the recent downturn in certain sectors of the real estate market it would be advisable to keep track of any decreases in the FMV of properties held by LLCs.

Code §743(d)(2) provides that the IRS must prescribe such regs "as may be appropriate to carry out the purposes of **Code §743(d)(1)**, including regs aggregating related partnerships and disregarding property acquired by the partnership in an attempt to avoid such purposes."

Electing Investment Partnerships: The Code provides an exception to these rules for "electing investment partnerships" (EIPs). Namely, this option would apply for partnerships that meet the requirements of an EIP in **Code §743(e)(6)** and that elect to apply the provisions of **Code §743(e)**. **Code §743(e)(1)** provides that for purposes of **Code §743**, an EIP is *not* to be treated as having a "substantial built-in loss" with respect to any transfer occurring while the EIP election is in effect. Instead, **Code §743(e)(2)** provides that, in the case of a transfer of an interest in an EIP, the transferee's distributive share of losses (without regard to gains) from the sale or exchange of partnership property is generally *not* allowed.

Comment: Notice 2005-32 provides interim procedures and reporting requirements for EIPs.

Other Proposed Reg Rules: The proposed regs contain a number of **Code §743** rules, including:

- **"Substantial built-in losses:** Rules that provide that, in determining whether there is a "substantial built-in loss," **Code §743(b)** adjustments and **Code §704(c)(1)(C)** basis adjustments (except the transferee's **Code §743(b)** adjustments and **Code §704(c)(1)(C)** basis adjustments, if any) are disregarded.

- **Rules with respect to tiered partnerships:** a) for determining FMV of property; b) for partnership property basis adjustments where a partner transfers an interest in an upper-tier partnership that holds a direct or indirect interest in a lower-tier partnership; c) for partnership property basis adjustments in general; and d) that provide that there are no special tiered partnership EIP rules.

- **"Anti-abuse rules" to further a chief purpose of Code §743:** These rules are meant to prevent a partner that purchases an interest in a partnership with an *existing* built-in loss and *no election* under **Code §754** in effect from being allocated a share of the loss when the partnership ultimately disposes of the property, or takes cost recovery deductions with respect to the property. The proposed regs provide that if a "principal purpose" of a transaction is to avoid the application of the "substantial built-in loss" rules with respect to a transfer, the IRS can recast the transaction for federal income tax purposes "as appropriate to achieve tax results that are consistent with the purpose of the provisions."

- **Several rules with respect to the EIP exception apply:** The proposed regs generally adopt the statutory language in **Code §743(e)** and the provisions in **Notice 2005-32**, but they do contain several new rules. For example, **Code §743(e)(6)(C)** requires that to be an EIP, a taxpayer can never have been engaged in a trade or business. The proposed regs provide a safe harbor provision with respect to that requirement.

Code §734 Basis Adjustment Provisions: Code §734(a) and **Code §734(b)** require a partnership to adjust the basis of partnership property upon a distribution of partnership property to a partner if there is a **Code §754** election in effect or, for distributions occurring *after* Oct. 22, 2004, if there is a "substantial basis reduction" with respect to the distribution. **Code §734(d)(1)** provides that for purposes of **Code §734**, there is a "substantial basis reduction" with respect to a distribution if the sum of the amounts described in **Code §734(b)(2)(A)** and **Code §734(b)(2)(B)** exceeds $250,000.

The amount described in **Code §734(b)(2)(A)** is the amount of loss recognized to the distributee partner with respect to the distribution under **Code §731(a)(2)**. The amount described in **Code §734(b)(2)(B)** is, in the case of distributed property to which **Code §734(a)** applies, the excess of the basis of the distributed property to the distributee, as determined under **Code §732(b)**, over the adjusted basis of the distributed property to the partnership immediately before the distribution (as adjusted by **Code §732(d)**).

Comment: Code §734(d)(2) provides regulatory authority for the IRS to carry out the purposes of **Code §734(d)** by cross reference to **Code §743(d)(2)** (as discussed above).

The proposed regs generally follow the statutory provisions regarding "substantial basis reductions." Among the new rules they contain are:

- The $250,000 threshold in **Code §734(d)(1)** applies *separately* with respect to each distributee.

- If there is a "substantial basis reduction," the partnership is treated as having an election under **Code §754** in effect for the tax year in which the distribution occurs, but solely for the distribution to which the substantial basis reduction relates (unless another transaction is subject to the "mandatory basis adjustment" provisions of **Code §734** or **Code §743**).

- Rules similar to the proposed regs' **Code §743** rules for "tiered partnerships."

Code §755 Rules for Allocation of Basis: Code §755(a) generally provides that **any increase or decrease** in the adjusted basis of partnership property under **Code §734(b)** must be allocated in a manner that: (1) reduces the difference between the FMV and the adjusted basis of partnership properties, or (2) in any other manner permitted by regs. Generally, **Code §755(b)** requires a partnership to allocate increases or decreases in the adjusted basis of partnership property arising from the distribution of property to property "of a like character" to the property distributed (i.e., either to (1) capital assets and property described in **Code §1231(b)**, or (2) any other property).

Code §755(c) provides that in making an allocation under **Code §755(a)** of **any decrease** in the adjusted basis of partnership property under **Code §734(b)**, no allocation may be made to stock owned by the partnership in a corporation (or, any person related (within the meaning of **Code §267(b)** and **Code §707(b)(1)**) to such corporation) that is a partner in the partnership.

Reg. §1.755-1(b)(5) provides guidance on how to allocate basis adjustments under **Code §743(b)** that result from "substituted basis transactions," which are defined as: a) exchanges in which the transferee's basis in the partnership interest is determined in whole or in part by reference to the transferor's basis in that interest; or b) exchanges in which the transferee's basis in the partnership interest is determined by reference to other property held at any time by the transferee.

Comment: The preamble to the proposed regs notes that the IRS believes "it is it is appropriate to interpret **Code §755(c)** to apply broadly" to related persons under either **Code §707(b)(1)** or **Code §267(b)**. In fact, it states that if **Code §755(c)** "only applied to persons treated as 'related' within the meaning of *both* **Code §707(b)(1)** and **Code §267(b)**, then the provision would apply 'in very limited circumstances," significantly restricting the scope of **Code §755(c)**."

With regard to the "substituted basis transactions rules," the IRS states in the preamble to the proposed regs that it is aware that "the current rules can result in unintended consequences," particularly with regard to the "net gain" and "net loss" requirement in **Reg. §1.755-1(b)(5)(ii)**. The net gain or net loss requirement in **Reg. §1.755-1(b)(5)(ii)** may, in certain situations, cause a partnership "to be unable to properly adjust the basis of partnership property with respect to a transferee partner." The proposed regs contain several new rules here, including those involving allocations between classes of property, allocation within classes of property and transferees succeeding to the transferor's basis adjustment.

Other Provisions of Proposed Regs: The proposed regs also contain rules on:

- The interaction of the built-in gain, built-in loss rules on contributions to partnerships under **Code §704(c)** ("forward 704(c) gain or loss") and the comparable allocation rules with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues property pursuant to **Reg. §1.704-1(b)(2)(iv)(f)** ("reverse 704(c) allocations"). (**Prop. Reg. § 1.704-3(a)(6)**)

- The **Code §704(c)(1)(B)** rule that addresses the treatment of "built-in gain property" and "built-in loss property" that is distributed to partners *within seven years* of its contribution to the partnership. (**Prop. Reg. §1.704-4(a)(4)**)

Effective Date: The regs are generally proposed to apply to partnership contributions and transactions occurring *on or after* the date final regs are published in the Federal Register. However, the proposed regs under **Prop. Reg. §1.755-1(b)(5)** will apply to transfers of partnership interests occurring *on or after* Jan. 16, 2014. (**Prop. Reg. §1.755-1(f)(2)**) But, the regs state that "no inference is intended as to the tax consequences of transactions occurring *before* the effective date of these regs." **(Misc.; Partnership Transfers)**

☞**Form 1065 Rules for Reporting of Contributions with Built-in Gain or Loss Relaxed**

When the IRS released the original version of the 2009 **Form 1065**, it included a number of tax and non-tax changes. One change concerned a new requirement to report contributions of all property with built-in gain or loss "since the formation of the partnership." The IRS has now changed the instructions (as least for the on-line version of **Form 1065**) "to narrow the scope of this requirement and to ease it for contributions of more than 10 properties by the *same* partner." More importantly, only such contributions made during current tax year need to be reported (i.e., *not* all prior tax years).

Comment: Part II of **Schedule K-1** still contains the question under **"Item M"** which asks **"Did the partner contribute property with a built-in gain or loss?"** And, if "Yes," a statement must be attached as outlined in the **Instructions** to **Form 1065** which requires:

• A description of each property the partner contributed.

• The date the property was contributed.

• The amount of the property's built-in gain or loss.

Background: If the basis of property contributed to a partnership by a partner deviates from the property's fair market value (FMV) at the time of contribution (i.e., there is built-in gain or loss), and the following rules then apply:

- If the partnership distributes contributed property to a partner or partners *other than the contributing partner within seven years* of the contribution, then the distributed property is treated as if it had been sold by the partnership for its FMV *at the time of the distribution*. The contributing partner is then forced to recognize any gain or loss from this constructive sale in an amount equal to the amount of gain or loss that would have been allocated to him if the property had actually been sold. (**Code §704(c)(1)(B)**)

- Where property is instead distributed to the partner who originally contributed it, gain is recognized to the extent of the *lesser* of: (a) the excess of the FMV of the property over the adjusted basis of the partner's interest in the partnership immediately before the distribution (reduced, but *not* below zero, by any money and marketable securities received), or (b) the partner's net pre-contribution gain under **Code §737(b)**. In other words, the amount in (b) is the gain that would have been recognized by the distributee partner under the rules discussed above if all property held by the partnership immediately before the distribution that had been contributed to it by the distributee partner *within seven years* of the distribution, was distributed to another partner. (**Code §737(a)**)

Change to Form Instructions: When IRS first released the 2009 version of Form 1065, it was *not* clear whether the reporting requirement applied only to contributions made during the *current* tax year or whether it reached contributions made in prior years. Now, the IRS has recently changed the **instructions** (but *not* the form itself) to make it clear that the "Yes" or "No" box must only be checked to indicate whether the partner contributed property with a built-in gain or loss **during the *current* tax year**.

Comment: So, the end result is that the scope of the new reporting requirement is *not* as broad as some practitioners had feared.

Multiple Property Contributions: In addition, the IRS has changed the instructions to add an exception for a partner who contributes more than 10 properties with *either* a built-in gain or built-in loss on any date during the tax year. In such instances, the partnership is *not* required to provide the required information *separately* for each property contributed for that date. Instead, the partnership is allowed to report: (a) the number of properties contributed on that date, (b) the total amount of built-in gain, and (c) the total amount of built-in loss. Nevertheless, the partnership is instructed *not* to net the built-in gains against any built-in losses. But, in any case, it should still show the total built-in gain and total built-in loss for all properties contributed on that date. **(Code §704(c); Sec. 704(c) Gains)**

☞**LIFO Methodology Allowed for Calculating Section 704(c) Gain (PLR 200829023)**

The IRS has approved a partnership's proposed methodology for allocating excess **Code §704(c)** tax gain resulting from a like-kind exchange.

Facts: In this instance, a real estate trust, which elected to be treated as a partnership, owned property which was contributed to it by several partners at a time when the property's FMV exceeded its tax basis. At the time of the ruling request, the Section 704(c) pre-contribution gain had *not* been entirely eliminated (i.e., by means of special allocations to the other partners who had *not* contributed such property). In the meanwhile, the property had continued to appreciated significantly. Due to revaluations and the fact that the property was booked at its FMV when contributed, the Section 704(c) property was being carried on the partnership's books at a basis that had been adjusted to reflect *both* the pre-contribution and post-contribution gain. The partnership then disposed of this property in a transaction that was intended to partially qualify as a **Code §1031** like-kind exchange. That is, in addition to the like-kind property being received without recognition of gain in exchange for the relinquished Section 704(c) property, the partnership will also receive boot in the form of cash. And, the amount of taxable gain was expected to be greater than the aggregate amount of book gain recognized, but less than the sum of the total book gain recognized in the exchange and the amount of book gain reflected in prior upward revaluations of the property since contribution of the relinquished Section 704(c) property to the partnership.

LIFO Methodology: The partnership proposed a methodology for allocating the taxable gain that would involve the following steps: (1) the partnership will calculate the **Code §1031** recognized gain (limited to the *lesser* of the gain realized or the boot received) separately for book capital account purposes and tax capital account purposes; (2) to the extent the recognized tax gain equals the book gain recognized in the exchange, the tax gain will be allocated in the same manner as such book gain is allocated under **Code §704(b)**; (3) the partnership will allocate, under **Code §704(c)** principles, the remaining excess tax gain on a "last-in, first-out" basis; and (4) while the partnership does *not* anticipate any excess gain will remain unallocated after step (3), if it does, the remaining excess tax gain will be allocated under **Code §704(c)** to the Section 704(c) partner in the same manner as the pre-contribution gain was credited to the partners' capital accounts.

IRS Ruling: In **PLR 200829023**, the partnership represented that the amount by which the FMV of the replacement property exceeded its adjusted tax basis (substituted from the relinquished Section 704(c) property) was in fact *greater* than the entire remaining pre-contribution gain attributable to the relinquished Section 704(c) property. As a result, the Section 704(c) consequences that are preserved in that the replacement property can be treated as Section 704(c) property with the *same* amount of remaining pre-contribution gain as the relinquished Section 704(c) property. And, under **Reg. §1.704-3(a)(8)**, if a partnership disposes of Section 704(c) property in a nonrecognition transaction, the substituted basis property is treated as Section 704(c) property with the *same* amount of built-in gain or loss as the Section 704(c) property disposed of by the partnership. But, if gain or loss is recognized in such a transaction, appropriate adjustments must be made. The IRS ruled that, based solely on the facts in **PLR 200829023**, the use of the LIFO methodology by the partnership would result "in an appropriate adjustment under **Reg. §1.704-3(a)(8)**. **(Code §704(c); Sec. 704(c) Gain)**

> **Comment:** The IRS noted that no inference should be drawn that there may *not* be "other appropriate methodologies" resulting in an appropriate adjustment under **Reg. §1.704-3(a)(8)**.

☞**Service Offers Guidance on Partnership's Allocation of Low-Income Housing Tax Credits (CCM 200812023)** A partnership's low-income housing tax credits must be allocated **in the *same* proportion as the actual allocations of the related depreciation deductions giving rise to the credit for the year**.

> **Comment:** With no question, partnership taxation is probably the toughest area of tax law that we deal with on a day-to-day basis. And, with more LLCs being elected as the preferred means of forming and operating an entity, the preparation of **Form 1065s** is only going to increase more and more. So, decisions like these are vital to improving our understanding of partnership law by carefully reading and building upon the principles contained therein to strengthen our knowledge base.

Facts: An LLC was formed by a managing member and a non-managing member to own and operate housing that qualifies for the low-income housing credit. The LLC is treated as a partnership for federal tax purposes. The LLC's operating agreement provides for specified percentages of its taxable income or loss to be allocated to the managing member and the non-managing member. Before the allocation of taxable income or loss, however, the agreement requires that certain special allocations be made. The special allocations require that if losses otherwise allocable to the non-managing member would cause the non-managing member to have a deficit capital account, the losses are instead allocated to the managing member. During the LLC's second and third years of operation, the allocation of losses to the non-managing member in accordance with the general allocation in the operating agreement would have caused the non-managing member to have a deficit capital account. This then triggered the provision relating to special allocations, causing a lesser amount of the LLC's non-recourse deductions to be allocated to the non-managing member in those years. For its second and third years of operation, the LLC sought to allocate its low-income housing credits in accordance with the general allocation of operating agreement. However, because of the special provision, the depreciation deductions related to the property giving rise to the credits were actually allocated between the LLC's members in different percentages than the general allocations in the operating agreement. Under these circumstances, the Office of Chief Counsel was asked whether the low-income housing tax credits must be allocated in proportion to allocations of related depreciation deductions for the years giving rise to the credit where the special allocations in the partnership agreement result in the actual allocation of depreciation being *different* from the general allocations provided in the agreement.

Background: A partner's distributive share of income, gain, loss, deduction, or credit is determined in accordance with the partner's interest in the partnership if the allocation to a partner under the partnership agreement of income, gain, loss, deduction, or credit lacks "substantial economic effect." **Reg. §1.704-1(b)(4)(ii)** provides that allocations of tax credits are *not* reflected by adjustments to the partners' capital accounts. As a result, such allocations *cannot* have economic effect and any tax credits must be allocated in accordance with the partner's interest in the partnership as of the time the credit arises. If a partnership expenditure that gives rise to a tax credit in a partnership tax year also gives rise to valid allocations of partnership loss or deduction for the year, the partners' interests in the partnership regarding the credit are in the *same* proportion as the partners' respective distributive shares of the loss or deduction.

Chief Counsel Advice: The Office of Chief Counsel advised that because the partnership expenditure that gave rise to the credit for the partnership tax year also gave rise to valid allocations of partnership loss or deduction for the year, the partners' interests regarding the credit **are in the *same* proportion as the partners' respective distributive shares of the loss or deduction**. As a result, the credits must be allocated in the *same* proportion as the actual allocations of the related depreciation deductions giving rise to the credit for the year. **(Code §704; Special Allocations)**

Notes:

CHAPTER V: BASIS CALCULATIONS - INSIDE VS. OUTSIDE BASIS

A. Background: An LLC member has two types of basis in his LLC interest. He has both an **inside** basis and an **outside** basis. The "outside basis" is his basis in his LLC interest. The "inside basis" is his aggregate share of the basis of the assets held by the LLC. Oftentimes, the two basis amounts are equal. However, if a member purchases an LLC interest from someone, he is likely to pay a different amount than the aggregate inside bases of the LLC assets.

Example 1: "Partnership Interest Acquired by Purchase"
Bob is an original LLC member. His inside and outside basis are both $75,000. He sells his interest to Charlie for $100,000 since the LLC's assets have appreciated in value. As a result, Charlie comes into the LLC with an *inside* basis of $75,000, and an *outside* basis of $100,000.

Comment: Obviously, if a Sec. 754 election is in effect, Charlie would be allowed to step up the inside basis of his share of any assets to equal the $100,000 outside purchase price that he had paid to acquire an indirect interest in them.

B. Importance of Basis: Determination of an LLC member's basis is important because a:

• Members can **withdraw cash distributions** from the LLC without tax to the extent of their outside basis.

• Members may **deduct losses** on their personal returns only to the extent of their outside basis.

• Members may receive **tax-deferred property distributions** equal to the LLC's adjusted basis in the property, even if the basis of the property exceeds the member's outside basis (i.e., by using substituted basis rules).

• On the **sale or exchange** of a member's interest, the outside basis is used to determine the gain or loss on the sale.

• A member's estate receives a step-up in basis to its FMV upon death.

Comment: Under **Code §731**, the member would only recognize gain if **cash plus the value of any marketable securities** received exceeded his **outside** basis. With regard to **nonliquidating** distributions of property, the member simply assumes the LLC's **inside** basis unless this is **greater than his outside basis**. With **liquidating** distributions, if the latter situation occurred, the LLC could make a **Code §754** election to re-allocate this "disappearing basis" to its remaining assets.

Comment: Compare the partnership treatment regarding the distribution of property (especially appreciated property) to a corporation (i.e., C or S corp) distributing appreciated property to a shareholder in a nonliquidating distribution. Gain, but *not* loss, is recognized by the corporation under **Code §311(b)**. In other words, simply re-titling an appreciated corporate asset in the name of a distributee shareholder results in a taxable transaction. That is why is much better to hold assets, especially those that tend to appreciate such as real estate, in a partnership due to the flexibility to "get owners and/or property into, or out of, a partnership" without immediate taxation.

The starting point for the determination of a member's basis is the cash paid and/or adjusted basis of any property contributed in exchange for the LLC interest. But, a member's initial basis is affected by the manner in which a member acquires his interest (i.e., by means of a gift, inheritance, or purchase).

• If the member acquired his interest through a **gift**, he uses the carryover basis from the donor, and increases this basis by any suspended passive losses of the donor that existed for that interest at the time of the transfer allocable to the gifted interest.

Comment: This "gift rule" also applies to a partnership interest acquired in a property settlement pursuant to the divorce.

• If the member acquired his interest through an **inheritance**, his basis normally is the decedent's share of the FMV of the LLC assets as of the date of the deceased member's death.

• If the LLC interest was acquired by **purchase** from another member, the initial basis is the price paid for the interest.

Example 2: "Basis of LLC Acquired by Gift"

Becky's father decides to gift her a portion of an LLC interest he currently holds. At the time of the gift, the father's basis in this portion of his interest is $20,000. Because he is a passive investor in this LLC and could **not** utilize all the flow-through losses (i.e., even though he had sufficient at-risk basis), he also has $4,000 of **suspended passive losses** allocable to this portion of his interest. In this instance, Becky has a carryover basis of $20,000, increased by the $4,000 in suspended passive losses, for an overall basis of $24,000.

Comment: In the example above, if the donor instead had losses allocable to this gifted interest that are suspended by his overall **lack of basis** or the **at-risk limitations** instead of the passive loss rules, they do **not** flow to Becky. Therefore, they would have **no effect** on the initial determination of her basis in the LLC interest received. Instead, these tax attributes **remain personal to the donor** and stay suspended until such time Becky's father has sufficient basis to deduct them (and, even then, he might still face the passive loss rules as a final barrier before he could deduct them). And, if he should sell his entire interest in the meantime (i.e., before he got sufficient basis to deduct them), they would be wasted (i.e., they would simply disappear without any tax benefit being derived from them).

Comment: If this partnership interest was transferred pursuant to the terms of a **divorce decree** to the non-partner ex-spouse, **the rules above for gifts would also apply here**. Therefore, the ex-spouse would take a **carryover basis** in the interest, increased by any suspended passive losses (i.e., the same $24,000 basis as mentioned in **Example 2** above). This is true even if the purchasing ex-spouse has just paid for the FMV of the partnership interest in cash since property settlements in a divorce are treated as tax-deferred transaction (although any interest paid pursuant to an installment note to make this buy-out would be currently deductible as it was paid).

Example 3: "Basis of LLC Interest Acquired by Inheritance"

Use the same facts as **Example 2**, except Becky inherits her father's interest upon his death. As of his date of death, the LLC interest is valued at $25,000. Her father's basis immediately before death was only $20,000. Therefore, the interest receives a $5,000 step-up in basis. At the time of death, $4,000 in suspended passive losses was attributable to the interest. However, since the step-up of $5,000 is **greater than** the $4,000 in suspended passive activity losses, these go to the grave with the father. If the step-up to FMV was only $1,000 (the FMV was $21,000 at the time of death), then $3,000 (of the overall $4,000) in suspended passive losses could be used on the father's final return (i.e., unlike a gift situation, they do *not* serve to increase the donor's carryover basis).

Comment: For the FMV date-of-death value that the beneficiary takes for inherited property, the entity must have a Sec. 754 election in place in order for any increase in **outside** basis to affect her **inside** bases of the LLC's assets.

Notes:

CHAPTER VI: OPERATIONS OF THE LLC

A. Measuring and Reporting LLC Income/Losses - A Two-Step Approach

1. Ordinary Income or Loss: First, all items of income, gain, deduction, loss or credit which are required to be *separately stated* pursuant to **Code §§702(a)(1)** through **(a)(7)** and **704(c)**, or which must be allocated under a special allocation agreement, are removed from the calculation. The remainder is considered to be the LLC's **ordinary income or loss** (i.e., reported on **Line 1** of the K-1).

2. Separately Stated Items: Each "separately-stated item" is separately reported on the LLC's **Schedule K (Form 1065)**, and each member's allocable share is then reported on Schedule K-1.

a. **Code §702(a)(1)** to **(7)** require that a number of specific items be segregated by the partnership and included as separate items on the Schedule K-1 that each partner receives.

b. Separately-stated items include:

- STCG/L
- LTCG/L
- Sec. 1231 G/L
- Charitable contributions
- Dividends
- Investment interest expense
- Foreign taxes paid by the partnership
- Any other item that might have a different impact on one partner v. another partner (Cf. **Reg. §1.702-1(a)(8)**)

Comment: For purposes of the Sec. 199A deduction, all items of deduction, even if separately stated, must be taken into account in determining "qualified business income" (or, loss). For example, interest allocated to the individual partners incurred in connection with a "debt-financed distribution" must be considered, along with charitable contributions made by the entity.

c. Capital gains and losses are netted at the partnership level, where appropriate, and passed through as a single item on the partner's K-1 who then combines them with any other items that he might have on Schedule D

Example 1: "Treatment of Separately-stated Capital Gains/Losses"
Assume that a partnership and one of its partners had the following capital items:

Partnership:	LTCG	$14,000	Partnership level - net only items with the same character - G/L
	STCG	500	
	LTCL	(2,000)	Net LTCG: $14,000 - 2,000 = $12,000*
	STCL	(2,000)	Net STCL: $500 - 2,000 = ($1,500)*

*Note: Divide each type of CG/L pro rata to each partner

Partner A:	LTCL	($2,000)	Sources other than partnership
1/3 Interest	LTCG	4,000	Partnership K-1
	STCL	(500)	Partnership K-1
	Net CG	$1,500	Reported on Schedule D

d. Net partnership Sec. 1231 gains and losses passed through separately on partner's K-1 so that they can be factored in on **Form 4797** with any other Sec. 1231 G/Ls that the partner might have (including "recapture" of net Sec. 1231 losses for the prior 5 years and "unrecaptured Sec. 1250 gain"). Depreciation or amortization recapture would simply be picked up as "ordinary income" on page one of Form 1065.

e. Charitable contributions made by the partnership as passed through and combined with a partner's contributions, if any, to determine the overall 60%[111] and/or 30% of AGI limitations.

Comment: Separately-stated partnership items have the **same character** as if realized directly from the sources from which realized by the partnership, or incurred in the same manner as incurred by the partnership. As a result, the character of an item is determined at the partnership level.

Comment: This last observation reinforces the principle that "you shouldn't get a different answer just because an asset held by, or an activity is conducted by, a partnership" v. what the tax impact would have been had the situation involved direct ownership such as on an individual partner's Schedule C/E/F.

3. Passive Activity vs. Investment Related Items: The passive activity provisions of **Code §469** and the investment interest expense provisions of **Code §163(d)** necessitate that portfolio income or loss and related deductions, interest income, dividend income, royalty income, and interest expense on debt incurred to acquire investment income property be excluded from an LLC's ordinary income computation and be separately stated on **Schedules K** and **K-1**.

4. AMT Items: Tax preferences and adjustments must be determined at the LLC level and then allocated to each member.

5. Miscellaneous Form 1065 Reporting Requirements:

☞**Revised Draft Form 1065 Schedules K-2 and K-3 Instructions**

The IRS has revised the draft **Schedule K-2 (Partners' Distributive Share Items—International)** and **K-3 (Partner's Share of Income, Deductions, Credits, etc.—International)** instructions for **Form 1065**. The revised instructions made changes to the "domestic filing exception" that provides an exception to filing **Schedules K-2** and **K-3**. The key changes made to the domestic filing exception in the new draft instructions include: (1) the notice to partners no longer must be issued by 1/15/23 (i.e., the notice can be furnished with the K-1); (2) the 1-month date (i.e., for when a particular can request a copy of the **Schedule K-3**) will now be as late as one month before the **Form 1065** is actually filed, as late as 8/15/23, for extended calendar year returns; and (3) the list of U.S. citizen or resident alien partners is now expanded to include S corporations with a single shareholder and single member LLCs whose owner is listed as an eligible U.S. citizen or resident alien partner. **(Misc.; Schedules K-2/K-3)**

☞**Draft Instructions for Schedule K-1 Released**

Draft **instructions** for **Schedule K-1** were released on 12/9/22. Changes to the form include: (1) international transactions new notice requirement, (2) additional information required for IRA partners with respect to "unrelated business taxable income," and (3) **Schedule K-1** no longer has page 2 with the list of codes. The list of codes and descriptions are now provided at the end of the partner's instructions. Related to the international transactions new notice requirement, if **Box 16** is *not* checked, partners should receive notification from the partnership that they will *not* be receiving a **Schedule K-3** unless they request one. **(Misc.; Schedule K-1)**

☞**IRS Releases Domestic Filing Exception to Schedules K-2 and K-3**

The IRS is offering a *new* "filing exception for purely domestic partnerships" in the draft version of the **2022 Partnership Instructions** for **Schedules K-2 and K-3 (Form 1065)**. A "domestic partnership" (as defined under **Code §7701(a)(2)** and **(4)**) will *not* need to complete and file with the IRS the **Schedules K-2** and **K-3** or furnish to a partner the **Schedule K-3** except where requested by a partner at least one month before the due date (without extension) of **Form 1065** (i.e., the "one-month date") if each of the following four criteria are met with respect to the partnership's tax year 2022: (1) No or limited foreign activity, (2) Only U.S. citizen/resident alien partners, (3) Partner notification, and (4) No 2022 **Schedule K-3** requests by the one-month date.

Comment: Further guidance and examples concerning the need for reporting by partnerships with domestic activity and with partners who are U.S. persons are available on the IRS **website**.

Comment: Keep in mind that these are "draft instructions," so there might be further instructions (or, clarifications) in the final copy of these instructions. Furthermore, draft instructions for **Form 1120S, Schedule K-2 and K-3** have *not* yet been released for 2022.

Form 1116: Individuals with sources of foreign income (or, who have otherwise paid foreign taxes directly, or through a flowthrough entity) are usually required to file **Form 1116** in order to claim the foreign tax credit on their personal tax return.

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[111] Starting in 2018, the TCJA increased the 50% limitation on cash donations to 60% of AGI.

Schedules K-2 and K-3: A partnership or S corporation having foreign sourced income, expenses, assets or tax the entity is otherwise required to fill out the 19-page **Schedule K-2** for the entity, each owner in turn receives the 20-page **Schedule K-3** reflecting their respective share of the entity's foreign activity items.

Waiver for 2021 Tax Year: For the 2021 tax year the IRS waived the filing requirement in **Notice 2021-39** for most "small partnership and S corporations" if the entity met a few basic requirements. A similar waiver is also applicable to returns filed for the 2022 tax year (i.e., "**Form 1116 Exemption**" discussed more fully below). Nevertheless, the penalty for failure to file these schedules was $280 for each **K-2** or **K-3** *not* filed where otherwise required, or where they were incorrect or incomplete.

Payments to Foreign Related Parties of Domestic Partnerships: Even with a partnership with no foreign source income, no assets generating foreign source income, no foreign partners, and no foreign taxes paid or accrued may still need to report information on **Schedules K-2** and **K-3**. For example, if a partner claims a credit for foreign taxes paid or accrued by that partner, that partner may need certain information from the partnership to complete **Form 1116** or **1118**. In addition, a partnership that has only domestic partners may still be required to complete **Part IX** when the partnership makes certain deductible payments to foreign related parties of its domestic partners.

New Waiver for 2022 Tax Year: These new **draft instructions** waive the requirement for a partnership to file **Schedule K-2** and furnish partners with a copy of **Schedule K-3** if it is a domestic partnership and otherwise meets the following four rules:

1. The partnership has no foreign activity, or only passive foreign income (e.g., dividends or interest) that has less than $300 of foreign tax paid or withheld thereon and which is otherwise reported to the entity;

2. All 2022 owners are US citizens/US estates/US grantor trusts/regular trusts with only US citizen beneficiaries, or resident aliens;

3. The partnership notifies its partners by 1/15/23 (electronically or via mail, which is two months before the due date without extension) that no **Schedule K-3** will be prepared unless the partner notifies the entity of the need for the **Schedule K-3**; and

4. The partnership does *not* receive a notification from any partner of their need for a **Schedule K-3** by 2/15/23 (i.e., one month before the unextended due date of the entity's tax return).

Comment: Keep in mind that any partnership with an S Corporation, C Corporation or another partnership owner does *not* meet this "domestic filing exemption" but might still satisfy the "**Form 1116 exemption**" discussed below.

Late Schedule K-3 Requests: If a partnership receives a request from a partner for the **Schedule K-3** information *after* the "1-month date deadline" (i.e., after 2/15/23) and has *not* received a request from any other partner for **Schedule K-3** information on or before 2/15/23 (i.e., the 1-month date), the "domestic filing exception" is still deemed as being satisfied. As a result, the partnership is *not* required to file the **Schedules K-2** and **K-3** with the IRS or furnish the **Schedule K-3** to any of the *non-requesting* partners. However, the partnership is still required to provide the **Schedule K-3**, completed with the requested information, to the *requesting* partner on the *later* of the date on which the partnership actually files the **Form 1065** or one month from the date on which the partnership originally received the request from the partner.

Form 1116 FTC Exemption: If a partnership does *not* meet the "domestic filing exception," it may still meet the **Form 1116 Exemption** to filing the **Schedules K-2** and **K-3**. In other words, the partnership has no direct or indirect partners that would be able to claim a foreign tax credit (or, who is otherwise exempt from filing **Form 1116** or **1118**). This **Form 1116 exemption** applies in situations such as when foreign taxes are all on passive income *and* amount to less than $600 MFJ/$300 for others in total FTC amount being claimed. Nevertheless, the partnership would still need a statement (or, a **W-8** or **W-9**) from every partner in this type of situation no later than 2/15/2023 (i.e., one month before the unextended **Form 1065** due date) as was the case for the 2021 tax year. **(Misc.; Schedules K-2/K-3)**

☞IRS Issues Additional FAQs for Schedule K-2 and K-3

The IRS has added new **FAQs** related to various **Schedules K-2** and **Schedules K-3**. These additional FAQs are intended to clarify that affected partnerships and S corporations "need complete only the forms' relevant portions," while also addressing an array of special circumstances. The **FAQs** relate to *both* **Form 1065** and **Form 1120S** and include the following:

- **FAQ 19:** The partnership or S corporation does *not* qualify for any exceptions otherwise provided for in previous

FAQs. Is the partnership or S corporation required to complete *all* parts of Schedules K-2 and K-3?

> **Comment:** New **FAQ 19** builds on a crucial earlier one, **FAQ 15**, in which the IRS outlined the scope of an exception for tax year 2021 to filing the schedules for certain entities. Entities that do *not* qualify for that exception may nevertheless *not* have to fill out the schedules in their entirety. It refers to the forms' instructions stating that entities "need only complete the relevant portions" of Schedules K-2 and K-3. Other new questions as outlined below concern which parts of the forms must be completed by affected entities of several types and in several unique circumstances.

- FAQ 20: A filer otherwise required to file **Forms 5471**, **8865**, and/or **8858** may qualify for an exception from filing those forms based on the Internal Revenue Code, IRS guidance, and/or instructions to those respective forms (e.g., the "multiple filer exception"). If the filer qualifies for such exception, do the Instructions to the **Schedules K-2** and **K-3** nevertheless require a filer to complete **Forms 5471**, **8865**, and/or **8858**?

- FAQ 21: In **Part II, Section 1 (Description)** and **Part III, Section 4, Lines 1** and **3** of **Schedules K-2 and K-3**, is it possible to enter the code "RIC"?

- FAQ 22: When must a filer complete **Section 1** of **Part III, Schedules K-2** and **K-3**?

- FAQ 23: If a foreign partnership has passive foreign investment companies (PFICs) for which a mark-to-market (MTM) election described in **Reg. §1.1291-1(c)(4)** has been made (e.g., under **Code §475**), does the filer need to report the PFICs on **Part VII** of **Schedules K-2** and **K-3 (Form 1065)**?

- FAQ 24: Are **Part VIII (Form 1065)** and **Part VII (Form 1120S)** of **Schedules K-2** and **K-3** required to be completed for dormant foreign corporations (i.e., as defined in **Rev. Proc. 92-70, Sec. 3**)?

- FAQ 25: How should a partnership report its accrued original issue discount (OID) and OID income taxable on a gross basis to a foreign partner on **Section 1** of **Part X** of **Schedules K-2** and **K-3 (Form 1065)**?

- FAQ 26: Could you clarify the reporting on **Section 3, Lines 2b, 3a**, and **3b, of Part X, Schedules K-2 and K-3 (Form 1065)**? **(Misc.; Schedules K-2 and K-3)**

☞**New 2021 Filing Requirement for Schedules K-2 and K-3**

There has been a quite deal of consternation regarding these new schedules (19- and 20-pages, respectively) which might be required when filing either **Form 1065** or **Form 1120S** for the 2021 tax year. And, although the IRS has come out with some additional clarification and possible relief (as discussed below in **Notice 2021-39**), practitioners are still trying to cope with these new rules.

> **Comment:** The IRS is still stating that it will be until March 20th before its electronic filing system will be able to accept these schedules. And, for S corporations, the anticipated date will be sometime around mid-June. Absent filing an overall extension for the return, preparers will have to attach these schedules as a .PDF file to their e-filed **Form 1065** and **Form 1120S**.

In this ever-emerging global economy, it is reasonable for the IRS to be provided the information re:

1. Does the entity have any foreign owners (much like the various states needing a composite return to be aware of, and to have back-up withholding for, out-of-state owners to ensure that taxes are being paid)?

2. Does the entity have any foreign source items (income, losses, deductions, etc.)?

3. Does the entity have any foreign taxes paid that might be passed through to the owners in the possible calculation of their FTC on **Form 1116**?

The IRS has now released additional **Instructions** to provide clarification and guidance for **Schedules K-2** and **K-3**. The changes relate to the section entitled **"Who Must File"** and address the requirement for **Schedule K-2** and **K-3** completion for partners who may need certain information from the partnership to complete **Form 1116** **(Foreign Tax Credit)**. Also, a partnership with only *domestic* partners may still be required to complete **Part IX, Partners' Information for Base Erosion and Anti-Abuse Tax**, when the partnership makes certain deductible payments to foreign related parties of the domestic partners. The additional instructions address each part of the schedules with new or amended instructions.

> **Comment:** This same approach also applies to S corporations and the need to file **Schedule K-2** and **K-3**.

According to the IRS, the new **Schedules K-2** and **K-3** "improve reporting by standardizing international tax information to partners and flow-through investors, making it easier for them to report these items on their tax returns." In addition, the changes are intended to "ease flow-through return preparation compliance by clarifying obligations and standardizing the format for reporting."

Notice 2021-39 provides penalty relief for "good-faith efforts to adopt the new schedules." This transition relief takes the form of new frequently asked questions (**FAQs**) on **Schedules K-2** and **K-3**, allows an additional exception for tax year 2021 filing requirements by certain domestic partnerships and S corporations. To qualify for this exception, the following conditions must be met:

1. In **tax year 2021**, the direct partners in the domestic partnership are *not* foreign partnerships, foreign corporations, foreign individuals, foreign estates or foreign trusts.

2. In **tax year 2021**, the domestic partnership or S corporation has no foreign activity, including foreign taxes paid or accrued or ownership of assets that generate, have generated or may reasonably expected to generate foreign source income.

3. In **tax year 2020**, the domestic partnership or S corporation did *not* provide to its partners or shareholders nor did the partners or shareholders request the information regarding (on the form or attachments thereto):

- **Line 16, Form 1065, Schedules K and K-1 "Foreign Transactions"** (**Line 14 for Form 1120-S**), and

- **Line 20c, Form 1065, Schedules K and K-1 "Other Information"** (e.g., Controlled Foreign Corporations, Passive Foreign Investment Companies, 1120-F, section 250, section 864(c)(8), section 721(c) partnerships, and section 7874) (**Line 17d for Form 1120-S**).

> **Comment:** Additional detailed information regarding the changes made to the requirements for each schedule can be found at on the IRS website (i.e., **Form 1065** and **Form 1120S**).

4. The domestic partnership or S corporation "has no knowledge that the partners or shareholders are requesting such information for tax year 2021."

If a partnership or S corporation qualifies for this exception, the domestic partnership or S corporation does *not* need to file **Schedules K-2** and **K-3** with the IRS or with its partners or shareholders. However, if the partnership or S corporation is subsequently notified by a partner or shareholder that all or part of the information contained on **Schedule K-3** is needed to complete their tax return, then the partnership or S corporation must provide the information to the partner or shareholder.

If a partner or shareholder notifies the partnership or S corporation *before* the partnership or S corporation files its return, the conditions for the exception are treated as *not* having been met and the partnership or S corporation must provide the **Schedule K-3** to the partner or shareholder and file the **Schedules K-2** and **K-3** with the IRS.

> **Comment:** **IR 2022-38** has also been released by the IRS along with some **FAQs** on this issue but it essentially restates what was contained in **IR 2021-39**, while failing to add any significantly new insights.

☞**IRS Issues Corrections to 2018 Form 1065 Instructions**

The IRS has posted to its **website** the following updates and corrections to 2018 **Form 1065**:

- **Failure-to-file penalty:** The Code penalizes taxpayers for late or incomplete filing of **Form 1065**. **Page 6** of the **Form 1065** **instructions** indicates that the penalty is $210 for each month or part of a month (up to a maximum of 12 months) the failure continues, multiplied by the total number of persons who were partners in the partnership during any part of the partnership's tax year for which the return is due.

> **Comment:** The above $210 amount should instead be $200 (but it now is $210 for the 2018 and 2019 tax years).

- **Taxpayer identification numbers (TINs) of partnership representatives and designated individuals:** The instructions under the **Taxpayer Identification Numbers** "sidehead" on **page 27** of the **Form 1065 instructions** are **not** valid. Instead, on Form 1065, under **Designation of Partnership Representative**, taxpayers may enter all 0s (examples: 00-0000000 or 000-00-0000) for the TIN of the partnership representative (PR) or designated individual (DI). However, a preparer tax identification number (PTIN) or centralized authorization file (CAF) number may *not* be used as a TIN to designate a PR or DI.

- Partner's capital account analysis: On **page 30** of the **Form 1065 instructions**, under **Item L, Partner's Capital Account Analysis**, the partnership is instructed that, if it reports other than "tax basis capital accounts" to its partners on **Schedule K-1** in **Item L**, and tax basis capital, if reported on any partner's **Schedule K-1** at the beginning or end of the tax year would be *negative*, the partnership must report on **line 20** of **Schedule K-1**, using **Code AH**, each partner's beginning and ending shares of tax basis capital, and this is in addition to the required reporting in **Item L** of **Schedule K-1**. **(Misc.; Form 1065)**

Comment: As discussed above, in **Notice 2019-20**, IRS announced that it has become aware that certain persons and partnerships may be unable to comply timely with this new requirement and provided penalty relief for those persons and partnerships.

☞**New Forms for Partnership Modifications to Imputed Underpayments**

Under the "centralized partnership audit regime," adjustments to partnership-related items are determined at the partnership level. The tax attributable to those adjustments is assessed in the form of an "imputed underpayment." According to **Code §6225(c)**, an imputed underpayment may be modified in certain situations. The IRS has now released four new forms to facilitate the modification process. **Form 8980** is used by a partnership to request modification of an imputed underpayment. **Form 8982** is attached to **Form 8980** by the partnership representative to affirm that a relevant partner has either filed amended returns or met alternative requirements. **Form 8983** certifies that a "relevant partner" is either a domestic tax-exempt entity or a foreign partner exempt from tax under **Code §501(a)**. Lastly, **Form 15028** is used by a publicly traded partnership to request a modification under **Code §6225(c)(5)**. **(Misc.; Centralized Partnership Audits)**

☞**Partners Entitled to Receive Partnership Administrative File Records**

The IRS's **Privacy, Governmental Liaison and Disclosure** division issued **guidance** that says that partner(s) (or, a partnership representative) are entitled to request and receive administrative file record(s) containing partnership returns and return information. This memo also states that **Code §6103(e)(10)** (i.e., limitation on certain disclosures to persons having a material interest) does *not* apply to such a request.

Background - Return Disclosure: The Code provides that, in the case of a partnership return, the return of a partnership must, upon written request, be open to inspection by, or disclosure to, *any* person who was a member of such partnership during *any* part of the period covered by the return. (**Code §6103(e)(1)(C)**) But the disclosure of partnership returns is also limited by the provisions of **Code §6103(e)(10)** which provides that, in the case of an inspection or disclosure under **Code §6103(e)** (i.e., relating to the return of a partnership, S corporation, trust, or an estate), the information inspected or disclosed may *not* include any supporting schedule, attachment, or list which includes the taxpayer identity information of a person other than the entity making the return or the person conducting the inspection or to whom the disclosure is made.

Disclosures of returns and return information subject to **Code §6103(e)** (i.e., disclosure to persons having a "material interest") can also be made under the **Freedom of Information Act (FOIA)**, as well as pursuant to **Reg. §301.9000-1** through **Reg. §301.9000-7** (i.e., "other disclosure methods").

An "IRS administrative file" is a return and/or other documents such as work papers, schedules, audit reports, etc., that are related to a taxpayer's account regardless of whether the documents are physically with the return or maintained separately by IRS. (**IRM 3.5.61.1.8(1)**)

Background - Partnership Audits: The **Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)** created procedures which require that an examination of any partnership items be handled in one partnership-level proceeding and *not* at the partner level. This "TEFRA process" generally applies to tax years *prior* to 2018. TEFRA also created the Tax Matters Partner (TMP) who is the primary contact during a TEFRA examination.

Sec. 1101 of the **Bipartisan Budget Act of 2015 (BBA)** repealed the TEFRA partnership procedures. BBA is generally effective for tax years *after* December 31, 2017. After that date, partnerships are required to designate a "partnership representative." The partnership representative has the sole authority to act on behalf of the partnership. The partnership representative does *not* have to be a partner. Nevertheless, their actions will serve to bind the partnership and all partners of such partnership in dealings with the IRS.

IRS Guidance Regarding Disclosure Rules: This IRS memo notes that **Code §6103(e)(10)** applies to a request made for a partnership return. But it does *not* apply to a request made (i.e., by any partner or partnership representative) under the other disclosure methods discussed above (such as a FOIA request) for access to IRS administrative file record(s), pertaining to a partnership. As a result, partner(s) or a partnership representative are entitled to request and receive administrative file record(s) containing partnership returns and return information. **Code §6103(e)(10)** does *not* apply to these requests.

☞**Partnership's Payments Treated as Deductible Interest Expense** (***Deitch*, TC Memo 2022-86 (8/25/2022)**)

A partnership financed a commercial building. The terms of the lending agreement included fixed rate interest payments, 50% Net Cash Flow (NCF) interest payments, and a payment of 50% appreciation in the value of the property if sold or the loan was terminated. The building sold and in accordance with the loan agreement, the partnership paid the lender the 50% appreciated interest and deducted the payment as interest expense. The IRS asserted that the lender and the partnership were in a joint venture and the "50% appreciated interest payment" was made toward the lender's equity interest and disallowed the interest deduction. The Tax Court held that the partnership and the lender were *not* engaged in a joint venture and the 50% appreciation payment to the lender was correctly recorded by the partnership as an interest payment deductible under **Code §163(j)**. **(Code §163; Interest Expense)**

☞**Farm Partnership Allowed to Use Cash Method** (***Burnett Ranches*, No. 13-10403 (5th Cir., 5/22/2014)**)

The Appeals Court confirmed that a farm partnership should be allowed to use the cash method of accounting, despite the IRS' objection that this constituted a "farm tax shelter" under **Code §464**. Normally, a farm that is operated as a partnership or S corporation must use the accrual method unless "active participants" own 65% or more of the business. In addition, those owners generally must have actively participated in farm management for at least five years. In this instance, a majority owner in a ranching partnership had run the operations for decades. But, she held her interest in the farm partnership indirectly through an S corporation in which she was the sole owner. Nevertheless, the Court agreed that she was still an "active owner" and the farm partnership was entitled to use the cash method. **(Code §446; Farm Tax Shelters)**

☞**Taxpayers Never Abandoned Intent to Develop Property, Thus Gain from Sale Resulted in Ordinary Income (*Fargo and King*, TC Memo 2015-96 (5/26/2015))**

A partnership was found to have been holding real property for development purposes and *not* for investment. As a result, gain from the sale of the property, which flowed through to the partners, was *not* entitled to capital gain treatment and was instead taxed as ordinary income.

Background: **Code §1201(a)** provides for preferential treatment with respect to gain realized on the sale of a capital asset. Meanwhile, **Code §1221(a)(1)** defines a capital asset as "property held by the taxpayer...but does *not* include...property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." The Tax Court analyzes a number of factors, including the following, in evaluating whether a taxpayer held certain properties primarily for sale to customers in the ordinary course of their business:

1. The purpose for which the property was initially acquired;

2. The purpose for which the property was subsequently held;

3. The extent to which improvements, if any, were made to the property by the taxpayer;

4. The frequency, number, and continuity of sales;

5. The extent and nature of the transactions involved;

6. The ordinary business of the taxpayer;

7. The extent of advertising, promotion, or other active efforts used in soliciting buyers for the sale of the property;

8. The listing of property with brokers; and

9. The purpose for which the property was held at the time of sale. (***Maddux Constr. Co.*, 54 TC 1278 (1970)**)

Tax Court Decision: The Court agreed with the IRS that the gain on the sale of the property should be treated as generating ordinary income after analyzing the relevant factors listed above to decide whether the taxpayer held the land for development v. investment purposes. The key determinations were as follows:

1. Initial purpose for acquiring property: The initial purchase for which the property was acquired was development. **(This factor favors the IRS)**

2. Subsequent purpose for holding property: Although the taxpayer held the property in part to wait for the market to recover (i.e., which indicates investment), this was *not* its primary purpose, as shown by its continued efforts to obtain financing and further its development plan. **(This factor favors the IRS)**

3. Improvements made: The taxpayer made only minor improvements to the property. **(This factor favors the taxpayer)**

4. Frequent and substantial sales: The taxpayer had never sold real estate before the sale of the property. **(This factor favors** the **IRS)**

5. Extent and nature of transactions: The sale of the property was the only sale associated with this transaction, and the sale was to an unrelated entity with the plan for the taxpayer to develop the property and to share in the resulting profit (i.e., from the property's development). **(This factor favors the IRS)**

6. Extent of advertising, etc.: The offer to purchase was unsolicited, and the taxpayer had *not* performed any substantial marketing or advertising. **(This factor favors the taxpayer)**

7. Listing with brokers: The property was listed with an outside third party serving as the broker, and it was paid a fee based on the sale price. **(This factor favors the taxpayer)**

8. Purpose for holding property at time of sale: The taxpayer had continued its efforts to plan and develop the property up until the purchase date. **(This factor favors the IRS)**

The bottom line is that the Tax Court concluded that the property was **held for development purposes** and that it therefore was "sold in the ordinary course of the taxpayer's trade or business" under **Code §1221(a)(1)**. The property "was purchased for development, and this intent was never abandoned." Even though the property was temporarily used as rental property, the Court found that such use was *not* the taxpayer's **primary purpose of holding it**. Instead, "it was just making the best use of the property as office and rental space while never abandoning its primary intent to sell it." **(Code §1221; Real Estate Development)**

Comment: If lay investors simply apply for zoning to determine where and what type of development might be done on a given plot of land, this does not, in and of itself, cause the property to become "inventory" (i.e., with ordinary gain when sold). They can even go so far as to have the land platted into lots.

☞**Short-Term Capital Gains Resulted From Sale of State Income Tax Credits (*McNeil*, TC Memo 2011-109 (5/23/2011))**

Once again, the Tax Court has determined that transferable (i.e., in this instance, Colorado) conservation easement income tax credits that a partnership received as a result of its charitable contribution donation and then sold were capital (v. ordinary) assets. As a result, the partners recognized short-term capital gains on the proceeds of the sale.

Comment: Although short-term capital gains are taxed at the *same* marginal rate as any other source of gross income, their characterization as such meant that capital losses could be used to shelter them.

Comment: As in ***Tempel*, 136 TC No. 15 (4/5/2011)**, the Court rejected the taxpayers' contention that their holding periods in their land and State tax credits were one and the same because they "were both part of the bundle of their real property rights." It reasoned that a Colorado taxpayer had no "property rights" in a conservation easement contribution State tax credit until the donation was complete and the credits were granted. In fact, the credits never were, nor did they become, part of the taxpayers' real property rights. **(Code §1221; Conservation Credits)**

☞**Partner Taxed on Distributive Share Regardless of Being Constructively Received (*Dodd*, TC Memo 2021-118 (10/5/2021))**

The Tax Court agreed with the IRS that a partner was liable for tax on her distributive share of income from the partnership, regardless of whether she constructively received that allocable share of income or not.

Background: **Code §702(a)** provides that, "[i]n determining his income tax, each partner shall take into account separately his distributive share" of the partnership's items of income and loss. Specifically, each partner must include their distributive share of the partnership's "gains and losses from sales or exchanges of property described in section 1231." (**Code §702(a)(3)**) This rule applies regardless of whether the partner receives the income currently, via distribution or otherwise. (***Basye*, 31 410 U.S. 441 (S Ct, 12/271973)**)

Facts: In 2013, a partnership in which the taxpayer was a partner sold a building. The partnership then sent her a K-1 allocating $1 million as a net section 1231 gain for the year. Also in 2013, the partnership paid back a loan it had taken out in 2011 (i.e., repayment of principal on a loan does *not* give rise to a tax deduction). The taxpayer was a co-borrower on the loan. The amount of the share of Dodd's loan liability that was paid back was more than $1 million. The taxpayer did *not* pay income tax on the 1231 gain, arguing that she never received the money because it was used to pay back the loan. In other words, she did *not* constructively receive the funds under **Reg §1.451-2**.

Tax Court Decision: The Tax Court disagreed with the taxpayer and concluded that for Federal tax purposes the question is *not* whether she constructively received the funds. Under **Code §702(a)**, the Court agreed that she is taxable on her distributive share of the section 1231 gain whether or not it was actually distributed. **(Code §702; Distributive Share)**

Comment: Here, the monies derived from the sale of the real estate were used to make a distribution to the majority partner (i.e., who controlled the "purse strings" of the entity). So, the taxpayer here had to pay tax on the $1 million Sec. 1231 gain allocated to her despite not have any cashflow from the partnership to do so. The "moral of the story" is that if you are going to be a minority owner in a flowthrough entity (i.e., S corp or partnership/LLC), make sure that there is a written clause in your ownership agreement that distributions sufficient to pay all federal, state and local taxes will be made each year to you.

☞**Partnership Income Taxable Despite Partner Being Unaware (*Nik Lamas-Richie*, TC Memo 2016-63 (4/11/2016))**

The taxpayer was approached by an investor who recommended the formation of a partnership which would publish a periodical. The taxpayer agreed, receiving a 41% limited partnership interest. He continued functioning as the editor and received wages from a related entity. Although he timely filed his tax return for the year at issue, he did *not* include his share of partnership income from the LLC. Furthermore, he never received distributions or a Schedule K-1 from the partnership. Nevertheless, the IRS assessed a tax deficiency and an accuracy-related penalty. The Tax Court agreed that the taxpayer was taxable on his distributive share of the partnership income, regardless of whether he was aware of it. However, the Court declined to impose accuracy-related penalties because the taxpayer showed that he acted in good faith. **(Misc.; K-1 Income)**

☞**Members Remained Taxable On LLC Income After Supposed Liquidation of Entity (*Brennan*, TC Memo. 2012-209 (7/23/2012))**

Individuals were found to have remained partners of an LLC it was supposedly liquidated. As a result, they were taxable on their distributive shares of the LLC's capital gains income received in the two years *after* the restructuring.

Comment: A partner that retires nevertheless remains a partner for tax purposes until *all* of their ownership interest has been *completely* liquidated. And, a retiring partner's interest in a partnership is treated as being "completely liquidated" when the *entire* partnership interest is terminated through one or more distributions to the partner from the partnership. It is not until the final distribution that the partner's status as such is terminated. Consequently, "any financial connection" between the partnership and a retiring partner is sufficient to maintain the partner's status as a current partner.

Background: Individuals A and B were members of an LLC. In 2002, the LLC restructured and sold a customer list to an outside party, determining that the income was long-term capital gains. Under the restructuring, the LLC agreed to pay 45 percent of the net proceeds of the sale to each of A and B. But, under the "restructuring agreement," individual A remained a member (or partner) of the LLC, while individual B's interest was converted to merely being an "economic interest" which granted B the right to receive a liquidating share of the LLC's income, gains, losses, deductions and credits, as collateral for the LLC's obligation to B. The purchaser of the customer list made payments to the LLC in 2003 and 2004. Accordingly, the LLC reported long-term capital gains on its 2003 and 2004 returns. But, the LLC did *not* distribute any cash or property to B in those years with the LLC eventually filing for bankruptcy protection.

Individual A reported capital gain income for 2003, but Individual B did *not* report any gains for 2003. Then, neither A nor B reported any capital gains for 2004.

Tax Court Decision: Individual B claimed he was no longer a partner after 2002 and should therefore *not* be taxable on any of the capital gain income. The Tax Court disagreed, finding that Individual B remained a partner until he received a *final* distribution from the partnership. And, since the partnership did *not* make any "liquidating distributions" to B, he remained a partner in 2003 and 2004. Thus, individual B had to include in his gross income his distributive share of the partnership's capital gain income (as well as any other partnership items) from those years.

Comment: Individual A did *not* dispute that she remained a partner during 2003 and 2004 and should have reported her 45 percent share of the capital gains received by the partnership in both of those years.

As a result, the Tax Court upheld the following penalties and additions to tax on individual A: the late-filing addition to tax under **Code §6651(a)(1)**, for 2000, and the accuracy-related penalty under **Code §6662(a)** for 2003 and 2004. Individual A failed to file her return on time for 2000, and substantially understated her taxes for 2003 and 2004. In doing so, the Court agreed that the IRS met its burden of production for both items. Individual A failed to establish "reasonable cause" for the violations, rather than "willful neglect." Nevertheless, the IRS chose *not* to apply any penalties and additions to tax to individual B. **(Code §731; Liquidating Distributions)**

☞**Owners Always Taxed on Partnership Profits Whether Distributed Or Not (*Jose Martignon*, TC Summ. Op. 2012-18 (3/1/2012))**

In an issue that has been decided a number of times before, for both partnerships and S corps, the Tax Court has confirmed that the profits of these flowthrough entities are taxed to their owners, whether distributed or not. Here, the taxpayer owned a 40% partnership interest in a restaurant which he had opened with a business partner. But their relationship subsequently deteriorated and eventually his involvement in the business completely ceased. In all prior years, the business had reported losses, but for the tax year in question, he received a Schedule K-1 reporting a profit. Nevertheless, the taxpayer failed to report any of the passthrough income on his individual return because he never received distributions from the partnership. Citing the Supreme Court in ***U.S. v. Basye*** **(31 AFTR 2d 73-802)**, the Tax Court noted that "few principles of partnership taxation are more firmly established than that no matter the reason for nondistibution, each partner must pay taxes on his distributive share." **(Code §761; K-1 Profits)**

> **Comment:** Here, it is useful to understand just how drastic the situation was to understand why the taxpayer felt that he should *not* have to pick up any of the restaurant's profits on his personal tax return. The two men set up a partnership to operate a restaurant, with the taxpayer owning a 40% stake in the entity and was in charge of day-to-day operations such as cooking and serving, while his partner owned 60% and handled the finances. A few years later, when the two partners had a falling-out and the 60% owner shut the 40% partner out of the business, he also changed the locks, refused to talk and ignored several requests for any of the business records. Nevertheless, the 40% owner got a K-1 from the business reporting 40% of the profits, but he felt that he should *not* have to include any of these "paper profits" on his 1040 because he never actually got any money. But, as the IRS insisted, despite the lockout, he is still treated as a co-owner and owes tax on his share of the restaurant's profits. Not until his interest in the partnership is formally and completely liquidated by the entity, or otherwise bought out by the other partner (or, some third party), he must continue to report his share of any and all profits (or, losses).

☞**Supreme Court Refuses Certiori Where Partner Owed Tax on Disputed Distributive Share While Funds Held in Escrow (*Burke*, 99 AFTR 2d 2007-941 (1st Cir., 5/4/2007) cert denied 2/19/2008)**

The Supreme Court has declined to review a decision of the U.S. Court of Appeals for the 1st Circuit that an individual who was a partner in a partnership had to pay tax on his distributive share of the partnership's income, notwithstanding that the partnership's receipts had been placed in escrow pending the outcome of a suit by the individual against the other partner.

> **Comment:** This is not a surprising result in that one will normally owe tax on their distributive share of a flowthrough entity's profits based on their ownership percentage as of yearend. Of course, special allocations can be made in a partnership (unlike an S corporations) after yearend up until the due date of the tax return. But, absent that occurring, the K-1 information is based on ownership percentages otherwise existing at that point in time, even where one of the partners has actually stolen money from the entity. (Cf. ***Sweeney v. Commr.*****, T.C. Summary 2006-169** for a similar case dealing with S corporation owners or ***Hightower v . Commr.*****, No. 06-73838 (9th Cir., 2/7/2008)** where an S corp owner was suing over the purchase price paid for his shares under a buyback agreement and just let the proceeds sit in an escrow account in the interim; for Tax Court opinion cf. ***Hightower v. Commr.*****, T.C. Memo 2005-274 (11/28/2005)**)

Facts: In '93, Timothy J. Burke formed a partnership with Jeffrey Cohen named "Cohen & Burke," agreeing to split the proceeds of the enterprise *evenly* after allocating a 10% origination fee to the partner who generated new business. In '98, a dispute arose between the two partners when Cohen allegedly refused to comply with a superseding partnership agreement that linked the distribution of the partnership's proceeds more tightly to each partner's individual efforts and stole money received by the partnership. As a result of the dispute, Burke filed suit against Cohen in state court on Oct. 4, '99, alleging breach of fiduciary duty, breach of contract, deceit, and conversion, and requesting an accounting. Cohen and Burke agreed to keep the partnership receipts in an escrow account pending the outcome of the litigation. Meanwhile, Cohen filed the partnership tax return for '98 reporting $242,000 in ordinary income, with $121,000 as each partner's distributive share. Burke reported zero as his distributive share of partnership income and filed a notice of inconsistent determination stating that Cohen's partnership tax filing was factually and legally inaccurate.

IRS Response: The IRS issued Burke a notice of deficiency alleging that he had improperly failed to report his distributive share of partnership income on his individual return. Burke timely petitioned the Tax Court for redetermination of the deficiency, claiming that his distribution of partnership income from '98 should *not* have been taxed that year because the money was being held in escrow and he therefore did *not* have access to it. The IRS then filed a motion for summary judgment arguing that, as a matter of law, a partner's distribution of partnership income was taxable in the year the partnership received the income, regardless of whether the partner actually received a distribution of these profits. Burke countered that there were material facts in dispute precluding summary judgment in favor of the IRS and moved for partial summary judgment on the issue of whether he had to report his distributive share of the '98 partnership income. The Tax Court granted summary judgment to the IRS, holding that Burke had to include his distributive share of partnership income for the '98 tax year even though he had *not* yet received that distribution.

Court of Appeals Decision: In making his appeal to the 1st Circuit, Burke cited numerous cases (but none dealing with partnerships) holding that individuals must only include income to which they have "a claim of right." Citing the language of **Code §703** that "[t]he taxable income of a partnership shall be computed in the *same* manner as in the case of an individual," Burke argued that the partnership did *not* "earn taxable income" in '98 because "the restriction of funds...defers the recognition of income at the partnership level, as it does for individuals, until the restriction is removed." The 1st Circuit rejected this argument. It said that **Code §703** "didn't help Burke because a 'self-imposed restriction' on the availability of income *cannot* legally defer recognition of that income." The Court stressed that the partnership "received the money free and clear in '98." It was Burke and Cohen, who chose to place the funds in escrow and *not* the partnership's clients or other persons owing the partnership money. The Appeals Court also "pointed to the well-settled rule that partners' distributions are taxed in the year the partnership receives its earnings, regardless of whether the partners actually receive their share of partnership earnings." The Court also rejected an argument that there were facts in dispute which should have operated to prevent the IRS from obtaining a summary judgment. Specifically, Burke claimed that the Tax Court incorrectly assumed Burke's taxable income for '98 was about $151,000, but that this number was incorrect because it included money that Cohen had stolen from the partnership. The Appeals Court rejected this claim because the record showed that the Tax Court properly found that the IRS used Burke's own calculation of the partnership's gross receipts for '98, subtracting from that number his calculations of the allegedly stolen funds, in arriving at his taxable income for '98. Accordingly, it affirmed the Tax Court.

> **Comment:** It's a bit curious why Burke disputed these issues with the IRS in the first place when the law is fairly clear in this area. It might have been because he lacked the funds to pay the tax. In the end, he did ultimately prevail in the underlying dispute with Cohen and received his fair share of the funds, but he did have to pay the tax on these monies in the interim while the dispute was being settled.

☞**Payouts to Exiting Partner Treated as Guaranteed Payments (*Wallis*, TC Memo 2009 -243 (10/27/2009))**
In this instance, partnership payments to a departing partner had to be treated as guaranteed payments (i.e., taxable as *ordinary* income) instead of payments for his underlying interest in the partnership (i.e., taxable as *capital* gain) since the payments "were in the nature of retirement payments." The departing partner, who was a tax lawyer, was also assessed an accuracy related penalty for *not* having included the payments on his return. However, he did *not* owe any tax on the capital account payments from the partnership because the IRS failed to prove that the payments he received were in excess of his basis in his partnership interest.

Background: Under **Code §736**, payments made by a partnership in liquidation of the interest of a retired partner fall into one of three categories: (1) those representing the recipient's distributive share of partnership income; (2) those that are guaranteed payments; and (3) payments in exchange for the partner's interest in partnership property. Payments in the first two categories are taxed to the recipient as *ordinary* income. However, as to any payments in the third category, the amount received in excess of the adjusted basis of the withdrawing partner's partnership interest, is taxed as *capital* gain.

Facts: Donald Wallis, a tax lawyer, was a member of Holland & Knight LLP, a limited partnership that practiced law. For a time, Wallis was a "Class B" capital partner of the firm. As such he made required capital contributions to the firm and also was entitled to receive "Schedule C units." These units were granted to each Class B capital partner per capita, without regard to the firm's profits (i.e., they were a guaranteed payment). However, the dollar value of the units was *not* reserved or set aside by the firm and generally were forfeited by any partner who voluntarily left the firm. And, when a partner retired at age 68, the value of the Class units was to be paid out over a period of years. In January of 2003, Wallis ceased to be a Class B capital partner of the firm and on Mar. 19, 2003, he withdrew as a partner entirely and stopped performing services for the law firm. Holland & Knight sent him a schedule of the amounts he was due for his capital interest and his Schedule C withdrawal payments. Both were distributed to him over a period of years. For 2005, Wallis received $80,000 for his Schedule C units and $32,721 as a capital account payment. Since the Schedule C units were forfeitable, Holland & Knight did *not* treat the Schedule C Units as income in the year they were awarded. Instead, it treated the Schedule C amounts as additional compensation to the recipient partner in the year that the amount was actually paid. In 2005, Holland & Knight sent Wallis (and the IRS) a Form 1099-MISC (Miscellaneous Income), reporting $80,000 as "nonemployee compensation" for the amount it considered as payment for Wallis's Schedule C units. Holland & Knight then deducted this amount as nonemployee compensation (i.e., guaranteed payment) in 2005. Conversely, Holland & Knight did *not* deduct the 2005 capital account payment as nonemployee compensation in 2005. But, Wallis failed to include either the Schedule C or capital account payments on his 2005 tax return. He later conceded that he should have reported the $80,000 Schedule C payment in his income but claimed that it should be taxed as *capital* gain. Furthermore, he claimed that all of the capital account payment was a return of basis and therefore nontaxable.

Tax Court Decision: The Court agreed with the IRS that the payments for Wallis's Schedule C Units were guaranteed payments taxable as *ordinary* income. It pointed to the fact that each partner received the same number of Schedule C units each year for services rendered to the law firm regardless of the size of the partner's partnership interest in Holland & Knight and *without regard to the firm's income*. The Schedule C Units were *not* treated as part of the partners' respective shares of partnership income or partnership property and were *not* reflected in the partners' respective capital accounts. In addition, the law firm did *not* establish a reserve or any other account to reflect the value of the Schedule C units. Finally, the Tax Court noted that the partnership agreement stated that a partner would receive the value of his Schedule C units within 3 months after the first day of the fiscal year following his 68th birthday. It appeared to the Court that Holland & Knight's creation of the Schedule C Units program "was a means by which the law firm provided retirement benefits to its equity partners, since after '91, the law firm had no retirement plan as such." In other words, the value of the Schedule C units provided the measurement for the retirement amounts to be paid to each of the law firm's equity partners, and the source of payment of those amounts was the future revenues of the law firm. The Tax Court also noted that it had previously held that retirement payments paid to a withdrawing partner as part of the liquidation of his partnership interest under **Code §736** are to be treated as guaranteed payments. But, with regard to the capital account payments, the Tax Court held on the facts that there "was no preponderance of evidence to support IRS's position." Therefore, it failed to carry the burden of establishing that the payments in liquidation of Wallis's partnership property exceeded his basis. As a result, the Tax Court ruled for Wallis on this issue.

Imposition of Accuracy Related Penalty: The Tax Court also imposed a **Code §6662(a)** accuracy related penalty on Wallis for his failure to report the $80,000 of Schedule C payments. Wallis claimed his failure to report the payments was reasonable because Holland & Knight incorrectly reported these payments as "nonemployee compensation" on **Form 1099-MISC** instead of reporting it as a distribution on Schedule K-1 and that he "could not possibly report the receipt of the payments both correctly and also in a manner that was consistent with the reporting" by Holland & Knight. The Tax Court was *not* persuaded by Wallis's "circular argument," and pointed out that under **Code §6222(b)(1)(B)** and **Reg. §301.6222(b)-1(a)**, "there exists a mechanism that a partner can use to report an item of income inconsistently with the way in which the partnership reports the item on its own return, as long as the partner provides a statement reporting that inconsistent treatment to the IRS" (namely, **Form 8082**, Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)). Furthermore, a partner is subject to the **Code §6662(a)** accuracy related penalty if he fails to comply with this requirement. The Court stated that "as a tax attorney of long standing, Wallis should have been familiar with this mechanism. To simply *not* report the income was *not* reasonable and did *not* show good faith." **(Code §736; Sec. 736 Payments)**

☞Partnership Taxed on Property Transfer to Partner in Satisfaction of Guaranteed Payment (Rev. Rul. 2007-40)

The Service has ruled that a transfer of partnership property to a partner in satisfaction of a guaranteed payment under **Code §707(c)** is a taxable sale or exchange to the partnership under **Code §1001** and *not* a tax-free distribution under **Code §731**.

Background: Under **Code §731(b)**, no gain or loss is recognized to a partnership on a distribution to a partner of property, including money. To the extent determined without regard to the income of the partnership, payments to a partner for services or for the use of capital are considered as made to one who is *not* a member of the partnership. (**Code §707(c)**) Gross income includes gains derived from dealings in property. (**Code §61(a)(3)**) Gain from the sale or other disposition of property is the excess of the amount realized over the property's adjusted basis, and loss is the excess of the adjusted basis over the amount realized. (**Code §1001(a)**) The amount realized from the sale or other disposition of property is the sum of any money received plus the fair market value of the property (other than money) received. (**Code §1001(b)**) Pursuant to a number of court decisions, a taxpayer that conveys appreciated or depreciated property in satisfaction of an obligation, or in exchange for the performance of services, recognizes gain or loss equal to the difference between the basis in the distributed property and the property's fair market value.

Facts: A partnership purchased Blackacre for $500,000. Arthur, a partner in the partnership, is entitled to a guaranteed payment under **Code §707(c)** of $800,000. When it's worth $800,000, the partnership transfers Blackacre to Arthur in satisfaction of his guaranteed payment. At that time, the partnership's adjusted basis in Blackacre was $500,000.

IRS Ruling: The ruling concluded that a transfer of partnership property in satisfaction of a partnership's obligation to make a guaranteed payment under **Code §707(c)** should be treated as a sale or exchange under **Code §1001**. Also, since the transfer is a sale or exchange under **Code §1001**, it is *not* a distribution under **Code §731**. As a result, the **Code §731(b)** nonrecognition rule does *not* apply to the transfer (i.e., where gain is only recognized to the extent cash and/or marketable securities exceed the adjusted basis of a partner's interest). Thus, the partnership realizes a $300,000 gain on the transfer. **(Code §707(c); Guaranteed Payments)**

B. Discussion Questions

Accounting for Partnership Operations:

1. Does the aggregate or entity theory apply where the partnership is required to file an information return on **Schedule K-1**?

2. Why is a partnership *not* allowed a personal exemption deduction? (Cf. **Code §703(a)(2)**)

3. Although the partnership files a separate return, the "conduit concept" is preserved by **Code §702(a)** which requires that certain partnership items must be separately stated by the partnership and separately reported by the individual partners.

Why must each partner's share of capital gains and losses be separately stated and reported? (Cf. **Reg. 1.703-1(a)(2)(vii)**) Likewise, what is the rationale for separate accounting for **Code §1231** transactions? For charitable contributions? For dividends? For investment interest expense? For interest expense incurred by the partnership when it uses, for instance, a line of credit to make distributions to the its partners?

Why are items such as **"Trade or Business Income"** in **Box 1** of **Schedule K-1**, or **"Net Rental Income or Loss"** in **Box 2**, reported separately to each partner? (Cf. **Code §469**)

4. A is a real estate dealer/developer who holds land for sale to his customers. A forms a partnership with B, a doctor. Each contributes land to the newly-formed partnership. The partnership holds the land for over a year, but due to a recession in the economy, it never develops either parcel of land and ends up selling both parcels at a gain? How is the gain characterized to each partner? What other factors would influence your answer? What approach did the Supreme Court take in the ***Bayse*** decision? Would **Code §724(b)** have any impact on these transactions?

5. A, B and C, all calendar year, cash basis taxpayers, formed a cash basis partnership on May 1st, 20x6 to purchase and operate for rental a ski chalet with 30 units in Vermont. The partnership agreement provided that each would contribute an equal amount of money to the partnership for the purchase of the property. When the property was acquired, each partner would contribute one-third of the necessary capital to renovate and furnish it. All profits and losses were to be shared equally. The next day the partnership purchased an eighty acre farm with an old farmhouse for $125,000. Each partner provided only $15,000 in cash as the partnership was able to secure an $80,000 mortgage from a Vermont bank. They spent $6,000 on capitalizable renovations of the house and another $4,500 on new furnishings. Each partner advanced another $3,500 to cover these costs. Assume the $4,500 of furnishings had a 5-year MACRS recovery period. The house was then available for rental on 11/1/x6 and was managed by a local rental agency that took care of collecting rents and servicing the property, while charging a 6% commission on gross rents. A and B were both dentists with individual practices in Albany. C, on the other hand, was a real estate developer who specialized in renovating old town houses in the downtown area of Albany and then selling them for a profit. C then suggested that the partnership sell the land that it was not using since it only increased the partnership's overhead. So, 60 of the 80 acres were sold during the second year of the partnership.

During the 12-month period ended April 30, 20x6, the partnership's operations produced the following results:

Gross rents	$18,000	
Operating costs:		
Commissions	1,050	
Mortgage interest	6,000	*(total mortgage payments were $6,450)
Property taxes	3,000	
Maintenance & repairs	900	
Utilities	3,600	

Note: $34,000 of the purchase price is allocated to the building with the remainder allocable to the land. And, the partnership would like to depreciate all wasting assets at the maximum rates permissible under the Code. Also, the average rental period was 30 days or less for all of these "transient-type dwellers." (Cf. **Reg. §1.48-1(h)**)

(a) Will the partnership be able to elect a fiscal year ending April 30th? The snow usually melts during the month of April. (Cf. **Reg. §1.706-1(b)(4)(iii)**; **Rev. Proc. 74-33; Rev. Ruls. 87-32 & 87-57**)

(b) Assume hereafter that the partnership is allowed to use the April 30th fiscal year requested. What is each partner's basis in his partnership interest?

(c) Determine the amount of the depreciation deductions that the partnership is entitled to (including Sec. 179 immediate expensing and bonus depreciation).

(d) What is the amount of the partnership's taxable income for the first year of operations?

(e) How would the partners report the partnership operations on their individual returns? Discuss their distributive share of income, losses and deductions and whether any of the income is subject to self-employment tax.

(f) Are any of these activities "passive" to the partners?

(g) Determine each partner's basis in his partnership interest at the end of the first year of operations if each partner receives a distribution of $1,000 in cash.

(h) Suppose in the second year of operations the partnership sells its excess land for a $12,000 gain. What is the character of that gain to each partner? When will it be reported in the income of the partners if the sale was made on July, 1, 20x7? (Cf. **Rev. Rul. 67-188; *Powell***)

(i) What advice would you give A and B if it was discovered that after the excess land was sold, C disappeared with all of the proceeds? (Assume the proceeds were $72,000)

Special Allocations During Partnership Operations

6. During the year, the AB Company, an equal two-person partnership, incurs $30,000 in losses. The loss resulted from the sale of Sec. 1231 property for a $15,000 loss and a loss of $15,000 from normal operations. In his individual capacity, A sold Sec. 1231 property for a $20,000 gain. Partner B had no Sec. 1231 transactions as an individual. After the close of the partnership tax year, the partners timely modify the partnership agreement (Cf. **Reg. 1.761-1(c)**) so that A is allocated the entire $15,000 loss from the sale of the partnership's Sec. 1231 property, while B is allocated the entire $15,000 loss from operations. Why did the partners adopt this special allocation? How is the IRS likely to view this allocation upon audit? (Cf. **1.704-1(b)(2), Ex. 1**)

7. During the year, the AB Company is in need of cash but no outside lender will advance any monies. A agrees to lend $15,000 to the partnership on the condition that the first $15,000 of losses are specially allocated to him. Normally, all profits and losses are shared equally by A and B. But, the partnership does end up losing $15,000 from operations for the year and the partnership agreement is modified on a timely basis to allocate all of this loss solely to A on his K-1. What are the chances that the IRS would approve of this special allocation? Would it make any difference if A had made a capital contribution of $15,000 to the partnership instead of lending it the money?

8. C and O form an equal partnership, each contributing $10,000 in cash. The partnership then purchases a building for $100,000 paying $20,000 in cash and securing a mortgage of $80,000. During the first year, the depreciation deduction is $7,000. The operating revenues are $10,000 and the operating expenses are $11,000. O has substantial income on his personal tax return, while C has an NOL on his return for the year. A special allocation is adopted whereby all of the depreciation deductions are allocated to O. Must the depreciation deduction be a "specifically stated item" under **Code §702(a)(7)**? (Cf. **Reg. §1.702-1(a)(8)(I)**) What probably motivated this special allocation?

(a) Suppose the building is sold for $93,000, with O receiving $3,000 of the sales proceeds as a distribution and C receiving $10,000. Does the special allocation have "substantial economic effect?" (Cf. ***Leon A. Harris***)

(b) Suppose the sales proceeds were distributed equally to O and C. Does the special allocation now have "substantial economic effect?"

Notes:

CHAPTER VII: PARTNER'S BASIS AND EXCESS PARTNERSHIP LOSSES

A. Background: The partner's distributive share of the aggregate of items of loss from separately stated items (e.g., the sale or exchange of property, capital losses, investment interest expense, and nonseparately stated losses from **Form 1065, page 1, Box 1, "Trade or Business Loss"**) may exceed the basis of the partner's interest. If this occurs, the overall limitation on losses **must be allocated** to the partner's distributive share of each loss.[112] This allocation is made by taking the **proportion that each loss bears to the total of all losses**. However, for this purpose, the total losses for the taxable year are the **sum** of the partner's distributive share of losses for the **current** year, as well as his losses disallowed and carried forward from **prior** years.[113]

Comment: Keep in mind that any item which could have a "varying tax effect" from one partner to another must be **separately stated** on **Schedule K-1**. This includes any item which might receive special treatment or could be subject to separate limits at the owner's level, or might impact the owner's AMT calculation.

Example 1: "Allocation of Losses When Aggregate Sum Exceeds Partner's Basis"

At the beginning of the year, Alex has a $4,000 basis in his partnership interest. As of the end of the current partnership tax year, Alex has the distributive share of partnership items shown below:

Sec. 179	(5,000)
Sec. 1231 loss	(10,000)
Short-term capital loss	(5,000)
Nonseparately stated income	6,000

At the end of the year, Alex's basis is calculated as shown below:

Beginning basis	$ 4,000
Nonseparately stated income from Form 1065, Page 1	6,000
Total Basis	$10,000

Because Alex's share of the loss and deduction exceeds his basis ($20,000 exceeds his basis of $10,000), he must prorate the losses against the basis.

	Total	Allocation Calculation	Deductible	Loss Carryover
Sec. 179	$ 5,000	(5,000/20,000) x 10,000	$ 2,500	$ 2,500
Sec. 1231	10,000	(10,000/20,000) x 10,000	5,000	5,000
STCL	5,000	(5,000/20,000) x 10,000	2,500	2,500
Total losses	$20,000		$10,000	$10,000
Remaining basis			-0-	

Example 2: "Carryover When Loss Exceeds Partner's Basis"

As of the end of the current partnership tax year, Elena has a $1,000 basis in her partnership interest. Her distributive share of nonseparately stated trade or business loss is $2,000. Because of the overall basis limitation rules, Elena is only allowed to claim $1,000 ($1,000 basis – $2,000 loss) of the partnership's loss on her individual return. The remaining portion of the loss is suspended and carried over to the following tax year.

If Elena's basis in her partnership interest increases by $1,000 or more in the following tax year, all of the $1,000 suspended loss from the prior tax year would now be allowed. The increase could be due to her allocable share of the partnership's separately stated or nonseparately stated income items, a contribution to

[112] IRC §704(d)

[113] Treas. Reg. §1.704-1(d)(1)

capital that she made, or because her share of the partnership's liabilities increased (including her personally loaning the entity monies, or otherwise personally guaranteeing debt of the partnership).

Conversely, if Elena's basis the following tax year increases by less than $1,000, then only that portion of the suspended loss being carried over from the prior tax year can be deducted on **Schedule E, page 2**. For instance, if her basis only increases by $500 in the following tax year, then only $500 of the $1,000 suspended loss from the prior year can be claimed. The remaining $500 of the $1,000 continues to be suspended until the following year or until Elena has sufficient basis in her partnership interest for it to become deductible.

Comment: Nondeductible items such as the **50% disallowance of meals and 100% of entertainment expenses** serve to reduce an LLC member's outside basis dollar-for-dollar just as any other deduction or loss (i.e., negative item on the member's K-1). However, if these nondeductible items are in excess of the member's outside basis at yearend, they need **not** be carried over to succeeding tax years to be taken against any new basis as it becomes available. Furthermore, unlike S corporations, there is **no election available** LLCs so as to use any available basis in a given tax year solely against deductible items.

Comment: These excess carryover losses/deductions can be taken in a succeeding tax year to the extent of increased basis. But, if a distribution was also made that next year, any new basis would be absorbed by this distribution first, and then the carryover loss would be considered.

Notes:

CHAPTER VIII: ISSUES WITH PARTNER'S CAPITAL ACCOUNT

A. Impact of Disallowed K-1 Losses on Capital Account

1. A partner's capital account, just like the basis in her partnership interest, is adjusted upward or downward to reflect the partner's distributive share of partnership gain or loss.[114] However, for certain deductions, a question arises when some of the partner's distributive share is disallowed because of lack of at-risk tax basis (or, the impact of the **Code §469** passive loss rules).

Query: Should the partner's capital account be adjusted only for that portion of the loss actually allowed for tax purposes on the partner's tax return?

Answer: No. Her capital account reflects the **economic relationships** among the various partners. As a result, capital account adjustments do *not* necessarily track the tax information shown on **Schedule K-1**. Therefore, the disallowed portion of meals and entertainment or country club dues paid by the partnership still reduce a partner's capital account *in full*. Conversely, a partner's distributive share of tax-exempt income serves to increase her capital account in the same manner as distributive shares of taxable income, even though tax-exempt income is never included in gross income on the partners' individual tax returns.[115] These adjustments are appropriate because capital accounts are intended to correspond to the partners' agreement on how to allocate **economic** gain and loss.[116]

Comment: Furthermore, capital accounts are adjusted downward completely by the **entire** amount of flowthrough losses, regardless of whether the individual member is prevented from taking the loss in a given tax year (i.e., due to the lack of basis, at-risk limitations or the passive loss rules).

B. Relationship Between Partner's Basis and Capital Account

1. Partner's **capital account** must be distinguished from a partner's **tax basis** in his partnership interest

a. **Reg. §1.705-1(a)(1)** - Partner's adjusted basis in his partnership interest is calculated without reference to his capital account

b. But, in many instances, there is a useful relationship between a partner's tax basis in his interest and the balance in his capital account

Partner's Basis in Partnership Interest	**(less)**	Partner's Share of Partnership Liabilities	**=**	Partner's Capital Account
(ASSETS)		(LIABILITIES)		(OWNER'S EQUITY)

c. Unlike partner's basis in his **partnership interest**, partner's basis in his **capital account** can be less than zero

Amounts Distributed to Partner	**+**	Partner's Share of Partnership Losses	**>**	Partner's Capital Contribution	**+**	Partner's Share of Partnership's Income

d. Under the laws of some states, partner with **negative capital account** at the end of the tax year has an obligation to make an additional contribution to the partnership to bring their account balance up to zero. Also, there are not additional reporting responsibilities when filing **Form 1065**.

Comment: One of the key requirements (besides that it have "substantial economic effect" and not be done "solely for tax purposes") behind the ability of a partnership to make a "special allocation" under **Code §704(b)(2)** is that the partner receiving this allocation must be subject to a "deficit restoration order" which

[114] Treas. Reg. §1.704-1(b)(2)(iv)(b)

[115] Ibid

[116] Treas. Reg. §1.704-1(b)(2)(ii)(a)

means that, at least upon exiting the partnership, they will bring any negative balance in their capital account back up to zero.

C. Never Make S Election for Partnership When Partners Have Negative Capital Accounts

Even though partnership liabilities can serve to increase a partner's tax basis in their partnership interest, especially those debts that a partner guarantees, once an S election is made for an on-going partnership it results in "at-risk recapture" pursuant to **Code §465(e)** if that additional liability basis was used for at-risk purposes on **Form 6198**. Under **Code §731**, a deemed cash distribution is treated as being received by any partner with a negative capital balance (i.e., which brings the negative balance "back up to zero"). And, with a tax basis of zero, gain must be recognized to the extent of this deemed cash distribution. The key is to keep in mind that only "direct shareholder loans" serve to increase a shareholder's tax basis.

Example: An LLC with "qualified nonrecourse real property indebtedness" totaling $1.2 million was used as at-risk basis to take additional partnership K-1 losses. However, this resulted in "negative capital accounts" for each of the partners. Without consulting their tax advisor, these clients decided to make an S election on **Form 2553**. If effective, the partners would have to "recoup" this negative $1.2 million by including it their gross income due to this deemed excess cash distribution under **Code §731**. Fortunately, one of the partners failed to sign the S corp election, so in order to avoid this "surprise pick-up of income," they decided *not* to "fix" this invalid election on **Form 2553**.

☞**Penalty Relief Regarding Calculation of Partners' Beginning Capital Account Balances (Notice 2021-13)**
For tax years beginning in 2020, pursuant to **Code §6031**, the IRS is now requiring partnerships to calculate and report their partners' capital accounts using the "transactional approach" for the tax basis method. However, **Form 1065** instructions allow certain partnerships to determine beginning capital account balances using the (1) tax basis method, (2) modified outside basis method, (3) modified previously taxed capital method, or (4) Section 704(b) method. The IRS has now provided partnerships with relief from penalties under **Code §§6698**, **6721**, or **6722** for including incorrect information in reporting its partners' beginning capital account balances using one of the methods listed above if the partnership "took ordinary and prudent care." The IRS will also waive the accuracy-related penalty under **Code §6662** for the imputed underpayment that is attributable to a reported partners' capital account balance based on the 2020 **Form 1065** instructions. **(Code §705; Partnership Capital Accounts)**

☞**IRS Proposes Methods for Reporting Partner Capital Accounts (Notice 2020-43)**
The IRS is proposing two new methods for reporting partner capital accounts on **Form 1065**. The new methods are proposed to apply to partnership tax years that end *on or after* Dec. 31, 2020 and are intended to be the "exclusive methods" for such reporting.

Background: Partnerships report partner capital accounts in **Box L** on the **Schedule K-1 (Form 1065 (U.S. Return of Partnership Income))** as currently reflected on the 2019 forms (i.e., **Tax Capital Reporting Requirement**). On April 5, 2019, the IRS released **Form 1065 Frequently Asked Questions (FAQs)** explaining how a partnership should determine a partner's tax capital account and providing a "safe harbor approach" based on a partner's outside basis in its partnership interest. Thereafter, early releases of drafts of the 2019 **Form 1065** expanded partner tax capital reporting to require *all* partnerships to report partners' tax capital accounts using the "tax basis method." But, tax professionals objected that partnerships that failed to historically maintain partner tax accounts would *not* be able to comply with this requirement.

As a result, the IRS released **Notice 2019-66** which removed the requirement that partnerships filing **Form 1065, Schedule K-1** report partner capital accounts in **Item L** of the **2019 Form 1065, Schedule K-1**, using the "tax basis method" for 2019.

New IRS Proposed Methods: In this Notice, the IRS is proposing two new methods, the **Modified Outside Basis Method** and the **Modified Previously Taxed Capital Method**, for meeting the **Tax Capital Reporting Requirement** and anticipates that the two proposed methods will be the *only* methods that meet this requirement for partnership tax years ending *on or after* December 31, 2020. Furthermore, once selected, that method must be used consistently for all partners of a particular partnership.

For tax years *after* 2020, however, a partnership is permitted to change its **Tax Capital Reporting Requirement** method from the **Modified Outside Basis Method** to the **Modified Previously Taxed Capital Method**, or vice versa, by attaching a disclosure to *each* Schedule K-1 describing the change, if any, to the amount attributable to each partner's beginning and end of year balances, and the reason for the change.

Under another technique, which IRS calls the **Transactional Approach**, partnerships maintaining tax capital:

i. Increase a partner's tax capital account by the amount of money and the tax basis of property contributed by the partner to the partnership (less any liabilities assumed by the partnership or to which the property is subject) as well as allocations of income or gain made by the partnership to the partner, and

ii. Decrease a partner's tax capital account by the amount of money and the tax basis of property distributed by the partnership to the partner (less any liabilities assumed by the partner or to which the property is subject) as well as allocations of loss or deduction made by the partnership to the partner.

Nevertheless, the Service has now announced that capital account amounts based on the **Transactional Approach** will *not* satisfy the **Tax Capital Reporting Requirement** going forward.

Modified Outside Basis Method: Under this method, a partnership determines, or is provided by its partners, the partner's adjusted basis in their partnership interest, determined under the principles and provisions of subchapter K, and subtracting from that basis the partner's share of partnership liabilities under **Code §752**. If the partnership is satisfying the **Tax Capital Reporting Requirement** by using this method, a partner must notify its partnership, in writing, of any changes to the partner's basis in its partnership interest during each partnership tax year, other than:

a. Changes attributable to contributions to and distributions from the partnership, and

b. The partner's share of income, gain, loss, or deduction that are otherwise reflected on the partnership's schedule K-1.

The partner must provide this written notification of such changes to the partner's basis within thirty days or by the tax year-end of the partnership, whichever is *later*. For example, if a person purchases an interest in a partnership that has chosen to use the **Modified Outside Basis Method**, the purchasing partner must notify the partnership of its basis in the acquired partnership interest, regardless of whether the partnership has an election under **Code §754** in effect or has a "substantial built-in loss," as defined in **Code §743(d)**, at the time of such interest purchase. For purposes of the **Modified Outside Basis Method**, a partnership is entitled to rely on the partner basis information that the partnership is provided by its partners "unless the partnership has knowledge of facts indicating that the provided information is clearly erroneous."

Modified Previously Taxed Capital Method: Reg. §1.743-1(d)(1) generally provides that a partnership interest transferee's share of the adjusted basis of partnership property is equal to the sum of the transferee's interest as a partner in the partnership's "previously taxed capital, plus the transferee's share of partnership liabilities." The reg further provides that the transferee's "previously taxed capital" is equal to:

i. The amount of cash that the partner would receive on a liquidation of the partnership following a hypothetical transaction; increased by

ii. The amount of tax loss (including any "remedial allocations" under **Reg. §1.704-3(d)**) that would be allocated to the partner from the hypothetical transaction; and decreased by

iii. The amount of tax gain (including any "remedial allocations" under **Reg. §1.704-3(d)**) that would be allocated to the partner from the "hypothetical transaction." The hypothetical transaction is a disposition by the partnership of *all* of its assets in a *fully taxable* transaction for cash equal to the fair market value of the assets. (Cf. **Reg. §1.743-1(d)(2)**).

The **Modified Previously Taxed Capital Method**, however, modifies the calculation described in **Reg. §1.743-1(d)(2)** (for purposes of the **Tax Capital Reporting Requirement** only) as follows:

i. The cash a partner would receive on a partnership liquidation and calculations of gain and loss in the "hypothetical transaction" would be based on the assets' fair market value, if readily available. Otherwise, a partnership may determine its partnership "net liquidity value and gain or loss" by using such assets' bases as determined under **Code §704(b)**, GAAP, or the basis set forth in the partnership agreement for purposes of determining what each partner would receive if the partnership were to liquidate, as determined by partnership management; and

ii. All liabilities are treated as *nonrecourse* for purposes of parts (ii) and (iii) of the calculation referring to gain or loss, respectively. This is intended so as to "avoid the burden of having to characterize the underlying debt and to simplify the computation." **(Code §§704 & 743; Partnership Capital Reporting)**

☞**Draft Form 1065 Instructions on Partner Tax Basis Capital Reporting Released**

The IRS released today a draft of the **instructions** to the 2020 **Form 1065, U.S. Return of Partnership Income** that include revised instructions for partnerships required to report capital accounts to partners on **Schedule K-1 (Form 1065)**.

The revised instructions "are part of a larger effort by the Service to improve the quality of the information reported by partnerships to the IRS and furnished to partners to facilitate increased compliance." The revised instructions indicate that partnerships filing **Form 1065** for 2020 "are to calculate partner capital accounts using the transactional approach for the tax basis method." Under the tax basis method outlined in the instructions, partnerships report partner contributions, the partner's share of partnership net income or loss, withdrawals and distributions, and other increases or decreases "using tax basis principles as opposed to reporting using other methods such as GAAP."

According to IRS data, most partnerships already use the "tax basis method" although partnerships previously could report capital accounts determined under multiple methods. Partnerships that did *not* prepare **Schedules K-1** under the "tax capital method" for 2019 or otherwise maintain tax basis capital accounts in their books and records (e.g., for purposes of reporting negative capital accounts) may determine each partner's *beginning* tax basis capital account balance for 2020 using one of the following methods: the **Modified Outside Basis Method**, the **Modified Previously Taxed Capital Method**, or the **Section 704(b) Method**, as described in the instructions, including special rules for publicly-traded partnerships.

In anticipation of requesting "more consistent and useful tax information" from partnerships, the Department of the Treasury and the IRS released **Notice 2020-43** seeking public comment on other possible methods to report capital accounts to partners. The IRS and the Treasury Department received numerous comments from taxpayers requesting that the "tax basis method approach" be retained. At the same time, the IRS did *not* receive "practical alternative approaches" to partner capital account reporting. Reporting using only one method "assists the IRS in assessing compliance risk, and identifying potential noncompliance, while ensuring that compliant taxpayers' returns are less likely to be examined."

> **Comment:** Maintaining partner capital accounts using a tax basis approach will be handy when determining: (1) potential taxation of distributions; (2) ability to take K-1 losses; and (3) gain or loss upon a sale or exchange.

To promote compliance with using the tax basis method described in the revised instructions, the Treasury Department and the IRS intend to issue a notice "providing additional penalty relief for the transition in tax year 2020." The notice will provide that solely for tax year 2020 (for partnership returns due in 2021), the IRS will *not* assess a partnership a penalty for any errors in reporting its partners' *beginning* capital account balances on Schedules K-1 if the partnership "takes ordinary and prudent business care" in following the form instructions to calculate and report the beginning capital account balances. This penalty relief will be in addition to the "reasonable cause exception" to penalties for any incorrect reporting of a beginning capital account balance. **(Code §704; Partner Capital Accounts)**

> **Comment:** According to the IRS, the draft instructions are intended to give tax practitioners "a preview of the changes and software providers the information they need to update systems before the final version of the updated instructions is released in December."

☞**Tax Basis Reporting for Partnership Interests Delayed (Notice 2019-66)**

The IRS has announced that the requirement to report partners' shares of partnership capital on the tax basis method will *not* be effective until 2020. For 2019, capital accounts must be reported according to the 2018 **Form 1065** and its instructions, which allow tax basis, Section 704(b), GAAP, or any other method. However, "negative tax basis capital accounts" must be reported on a partner-by-partner basis on **Line 20** of **Schedule K-1**, using Code AH. In addition, the IRS has clarified the 2019 requirement for partnerships to report a partner's share of "net unrecognized Section 704(c) gain or loss" (i.e., where there is any pre-contribution gain or loss with regard to property transferred by a partner to the partnership). Publicly traded partnerships, however, are exempt from this requirement until further notice. The IRS also has delayed reporting requirements regarding *separate* Section 465 "at-risk activities" until 2020. Taxpayers who report their activities in accordance with this guidance will receive penalty relief. **(Misc.; Form 1065)**

☞**IRS Issues FAQ Guidance on "Negative Tax Basis Capital Account" Reporting**

The IRS has issued guidance in the form of a **FAQ** on the "negative tax basis capital account reporting requirement" added to the 2018 **Form 1065** instructions. The instructions require partnerships to report partners' "tax basis capital accounts" on **Line 20** of **Schedule K-1** if those amounts are negative at *either* the beginning or ending of the year. **Notice 2019-20** provides penalty relief for some partnerships that fail to report the amounts. The FAQ defines a partner's "tax basis capital account" and explains how it is calculated with examples, and provides a "safe harbor" that allows partnerships to calculate a partner's tax basis capital account by subtracting the partner's share of partnership liabilities under **Code §752** from the partner's outside basis. **(Code §722; Partner Capital Accounts)**

> **Comment:** A partner's "tax basis capital account" (sometimes referred to simply as "tax capital") represents its equity as calculated using tax principles, *not* based on GAAP, **Code §704(b)**, or other principles.

> **Comment:** A partner's "tax basis capital account" can be *negative* when its outside basis is otherwise zero or positive because outside basis is increased by the partner's share of partnership liabilities under **Code §752**

and the partner's tax basis capital account is *not*. A partner's tax basis capital account can also be *negative* if a partnership allocates tax losses or deductions or make distributions to the partner in excess of the partner's tax basis equity in the partnership, or when a partner contributes property subject to debt in excess of its adjusted tax basis to a partnership.

IRS Example: "Negative Capital Accounts"
On January 1, 2021, A and B each contribute $100 in cash to a newly formed partnership. On the same day, the partnership borrows $800 and purchases Asset X, "qualified property" for purposes of **Code §168(k)** (i.e., bonus depreciation), for $1,000. Assume that the partnership properly allocates the $800 liability equally to A and B under **Code §752**. Immediately after the partnership acquires Asset X, both A and B have tax basis capital accounts of $100 and outside bases of $500 ($100 cash contributed, plus $400 share of partnership liabilities under **Code §752**). In 2021, the partnership recognizes $1,000 of tax depreciation under **Code §168(k)** with respect to Asset X; the partnership allocates $500 of the tax depreciation to A and $500 of the tax depreciation to B. On December 31, 2021, A and B both have tax basis capital accounts of negative $400 ($100 cash contributed, less $500 share of tax depreciation) and outside bases of zero ($100 cash contributed, plus $400 share of partnership liabilities under **Code §168(k)**, and less $500 of share tax depreciation).

☞**Penalty Relief for Missing Negative Tax Basis Capital Account Information (Notice 2019-20)**
This IRS Notice provides a waiver of penalties under **Code §§6722** and **6698** to certain partnerships that file Schedules K-1 that fail to report information about partners' "negative tax basis capital accounts" for the partnerships' 2018 tax year. Nevertheless, this relief is conditioned on the partnerships providing the missing information in a separate schedule by March 15, 2020. **(Code §§6722 & 6698; Tax Penalties)**

Comment: "Negative basis" in a partner's capital account comes about when distributions from the partnership to the partner exceed their "hard basis" (i.e., the sum of cash and adjusted basis of property contributed to the entity, along with net increases due to positive income items flowing through on the Schedule K-1to-date). Instead, the partner is using "soft basis" (i.e., "other people's money," or OPM) to finance the distribution (such as the partnership's business line-of-credit). So, although a partner's tax basis in their partnership interest can never go below zero, the basis in their capital account can go "negative."

C. Calculation of Partner's Capital Account - Book Basis

1. Vital for keeping track of "economic relationship" for partner vis-a-vis other partners. Begin with partner's initial capital account (i.e., amount of cash or FMV of property contributed to partnership), and make the following adjustments:

a. Add partner's share of partnership profits

b. Add any additional capital contributions made by partner

c. Subtract partner's share of partnership losses

d. Subtract amount of cash or FMV of property distributed by the partnership to the partner

Comment: Partnership liabilities are ignored for purposes of calculating a partner's capital account.

D. Discussion Questions

1. A and B form the AB partnership. Profits and losses are to be shared equally. A contributes a machine worth $10,000 with an adjusted basis of $6,000. B contributes $10,000 in cash. What is the difference between each partner's basis in his partnership interest and his capital account? (Cf. **Reg. §1.705-1(a)(1)**) What would be the effect on both if the partnership earned $4,000 in profits during the year and none of the profits were distributed? Does the adjustment required by **Code §705** eliminate the potential for double taxation, when and if these profits are ever distributed?

2. In #1. above, suppose the $4,000 in profits was tax-exempt interest on a municipal bond? Why does **Code §705(a)(1)(B)** require an increase in the basis of the partners' interest?

3. The AB partnership (which is on the cash basis) purchases inventory on credit throughout the year. What effect do its normal trade accounts payable have on each partner's basis (assuming that the vendor had recourse against the individual partners should the entity not pay its bills)? (Cf. **Rev. Rul. 60-345**) What if trade payables were $6,000 in June and increased to $14,000 as of the end of the tax year? Are daily or monthly

adjustments necessary? (Cf. **Reg. §1.731-1(a)(1)(ii); Rev. Rul. 88-77**)

4. In a general partnership, how is the basis adjustment with respect to liabilities allocated for a **recourse loan** different than that for a **nonrecourse loan**? How would it differ if a limited partnership was involved? What is the impact, if any, if the partnership agreement was modified so as to change the profits or loss sharing ratio among the partners? Would the admission of a new partner affect the allocation of the partnership's liabilities? (Cf. **Reg. §1.752-1(e)**)

Notes:

CHAPTER IX: EFFECT OF LIABILITIES ON PARTNER'S BASIS

A. Background: Many companies, especially in their start-up phase, must depend on borrowing to provide for their day-to-day cash flow. The borrowed monies may also come directly from one or more of the individual partners. If this is the case, then the amount of debt **increases the tax basis of the partner who actually loaned the money to the entity.**[117]

Under **Code §752(a)**, an *increase* in a partner's share of partnership liabilities or assumption of a partnership liability by a partner (or, by personally guaranteeing one of more of the partnership's debts), is treated as a cash contribution by the partner to the partnership with the partner receiving an increase in the basis of his partnership interest. Likewise, under **Code §752(b)**, a corresponding *decrease* is treated as a deemed distribution of cash from the partnership to the partner.

Partnerships and LLCs taxed as partnerships treat personal loans made to the entity differently. For a **general** partnership, the contributing partner adds the amount of the loan to his partnership basis.[118] However, the other general partners are also liable for the loan repayment if the partnership is unable to repay. Therefore, the contributing partner's basis is **reduced** by the other partner's share of the loan.[119]

On the other hand, the individual members of an LLC are generally sheltered from the entity's liabilities. Therefore, the contributing member's personal loan only increases his basis and is **not** reduced because of **Code §752(b)**.

> **Comment:** This treatment of liabilities by a partnership and their potential impact on the basis of a partner's interest is one of the major differences when compared to S corporation where only "direct shareholder loans" can serve to increase a particular owner's stock basis. But, keep in mind that by doing a "**novation**" by yearend, an S corporation **can transform a shareholder's mere guarantee of an outside loan made to the company into a direct shareholder loan** (and, thus, result in an increase in their stock basis).

The following three examples are based on an LLC and the liabilities on its books:

Example 1: "Nonrecourse Debt and Effect on Outside Basis"

An LLC is formed and none of the members have guaranteed the debt. Therefore, the debt is considered **nonrecourse** due to the limited liability status of each of the members. As a result, they **all share equally** in the debt as an additional source of basis.

The LLC has three members. Each initially contributes $10,000, giving each member an initial basis of $10,000.

If the LLC borrows $60,000, without any personal guarantees, **each member's basis increases** by $20,000 ($60,000 ÷ 3). Each member has a $30,000 basis after the loan. However, as discussed later, **none** of this basis is considered at-risk (i.e., as determined on **Form 6198** unless it relates to "qualified real property indebtedness").

Example 2: "Member Loans Serve to Increase Basis in LLC Interest"

Arthur, Bob, and Chris form an LLC as equal owners. Each contributes $10,000 to capital, therefore each has a $10,000 initial membership interest basis. Being a new company, the LLC has trouble borrowing from local banks. Neither Arthur nor Bob can advance more money to the LLC. On the other hand, Chris agrees to lend $60,000 to the LLC in the form of a personal demand loan. This debt serves to increase Chris' basis from the initial $10,000 amount to $70,000.[120] However, this **has no effect** on the basis of either Arthur or Bob.

Example 3: "Member Guarantees and Effect on Outside Basis"

Use the same facts as **Example 2**, except Chris **guarantees** a $60,000 loan which is made by a local bank.

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[117] IRC §752(a)

[118] IRC §752(a)

[119] IRC §752(b)

[120] IRC §752(a)

Neither Arthur nor Bob agrees to guarantee the debt. Once again, only Chris benefits from the increase in basis due to the existence of the debt, since he is the only member who bears the economic risk of loss should the LLC fail to repay the loan.

Comment: Keep in mind that the mere addition of another partner to the partnership could alter the pro rata sharing of partnership liabilities and, therefore, the impact on a particular partner's basis.

There is a critical distinction between partnerships and S corporations as far as the effect of entity debt and whether it serves to increase one's outside basis. For S corporation owners, only **direct loans personally made** from the shareholder to the corporation increase basis. Therefore, a **mere guarantee** of S corporation debt **has no effect** on a particular shareholder's stock basis. The net result is that S corporations incurring losses in their start-up years are similar to regular C corporations. That is, the shareholders can only deduct Schedule K-1 losses to the extent of their basis, even though the entity might have significant debt on its books and one or more of the owners guarantee that debt.

Comment: In effect, there is no equivalent of **Code §752** in Subchapter S. Therefore, if a shareholder is going to be personally liable for the entity's debts as a guarantor, consideration should be given to restructuring the loans as coming directly from the individual shareholders.

B. Using Real Estate LLCs to Loan Monies to LLCs vs. S Corporations

It is very common for businesses to keep the real estate off of the company's balance sheet in order to shield these valuable assets from creditor claims as well as possible litigation. And, the entity of choice is often the LLC to hold title to such properties. Now, considering the discussion above with regard to the effect of liabilities on an owner's basis, consider the following scenario where an LLC business is in need of funds for its day-to-day operations. Furthermore, assume that the LLC holding the real estate is owned by the *same* individuals and in the *same* percentages as the LLC which is operating the trade or business.

The owners proceed to refinance the real estate and cause the monies received to be immediately loaned directly to their business. In other words, the monies were *not* first distributed out of the real estate LLC to the individual owners (who would have sufficient basis given the increase caused by this new mortgage as "qualified real property indebtedness" in the first place) who would then loan them to the business. Nevertheless, each member of the LLC operating the business would still have an increase to their respective bases due to the overall increase in the LLC's liabilities.

Now, consider the same scenario with an S corporation which is in need of additional funds for operations. The shareholders also own an LLC in the same percentages as the corporation and decide to refinance the real estate that it holds title to. The key here is that the monies **are lent directly from the real estate LLC to the S corporation**. Even if the LLC's debt mortgaged by the real estate is also **personally guaranteed** by the S corporation shareholders, they **will receive no step-up in basis** due to this new debt on the company's balance sheet (i.e., the loan that it now owes to the LLC). Instead, they should have first distributed the monies out of the LLC to themselves individually and then lent it to their S corporation as direct shareholder loan. Only in this way could the debt have increase their stock basis.

Comment: It's a shame that even though the S shareholders might be personally called upon to repay this debt, they will receive no corresponding basis increase in their stock until such time that this might actually occur. Merely by recasting this loan as coming directly from themselves would a more preferable result occur.

C. Refinancing Real Estate Held by LLC to Ease Admission of New Members

It was not unusual to see significant appreciation in real estate assets during the period before 2008 (and, also a bit more recently, especially on the two U.S. coasts). And, if the real estate is held as tenants-in-common, it might be for new owners (e.g., family members) to come into the picture. However, if the real estate is instead held by a separate entity such as an LLC, the admission of new owners might be facilitated by first refinancing the property and encumbering it with more debt thereby driving down the net fair market of the property. As a result, the purchase price might be more affordable for these potential new owners. Also, the **debt might be personally guaranteed by just these original owners** so any new purchaser would *not* become liable for its repayment. Nevertheless, consider the illustration below where the distinction between an LLC vs. an S corporation incurring more debt might backfire from a tax standpoint.

Example 4: "Refinancing Real Estate Eases Admission of New LLC Members"

An LLC with three equal members owns a commercial building valued at $600,000. There is no debt on the property and the members each have a basis in their LLC interest equal to $80,000.

Two additional individuals wish to buy into the LLC, but **cannot afford** the current admission price of $120,000 ($600,000 ÷ 5). Therefore, the LLC secures a mortgage in the form of a qualified nonrecourse debt on the property in the amount of $300,000. With the cash proceeds in hand, the LLC makes a current nonliquidating distribution of $100,000 to each of the original three members. The two new members are then able to purchase their LLC interests for just $60,000 (i.e., $300,000 FMV/5 LLC members).

The outside bases of each of the original three members increased from their current levels of $80,000 (before the new mortgage was obtained) to $180,000.[121] When the cash distributions are made to the three members, their bases return to their original level of $80,000 each. With the admission of the two new members, the debt is then shared in five equal portions. This reduces the original basis of each of the original three members to $40,000 (The $300,000 mortgage initially shared three ways is now shared five ways.) This results in a basis reduction of $40,000 (i.e., $100,000 down to just $60,000) for each to the three original members.[122]

For the original members, there is no tax effect when the decrease in the sharing of the liability (which is treated as a deemed cash distribution) caused by **Code §752(b)** occurs. This is because it lowers the bases of the three original members by $40,000. The original members have sufficient basis in their respective interests to absorb this decrease. Sharing the new liability allows the two new members to afford to buy a 20% interest in the LLC.

	Each Original Member's Basis
Beginning adjusted basis of capital interest	$ 80,000
Share of $300,000 mortgage	100,000
Cash distribution	(100,000)
Basis after admission of new partners	$ 80,000
Share of mortgage assumed by new partners	(40,000)
Basis after admission of new partners	$ 40,000

Comment: This example again illustrates one of the potential advantages of a partnership/LLC when it comes to the effect of liabilities on owner basis. In comparison, S corporation debt has no effect on a shareholder's basis unless it represents a direct loan from that particular shareholder to the entity (guarantees do *not* count until such time as that owner actually has to repay the debt of the entity). In **Example 4**, as an S corporation, refinancing the property for $300,000 and then making a distribution of $100,000 results in an immediate capital gain to each of the original owners equal to $20,000 ($80,000 basis – $100,000 distribution) since the debt does *not* serve to increase their respective bases, even if they are required to guarantee such debt (the lender requires this additional security along with the property serving as collateral).

D. Disguised Liabilities - Rev. Rul. 72-350:

1. An unrelated third-party made a "loan" to an otherwise unrelated limited partnership. The loan was secured by partnership assets which consisted of some expensive, but virtually unsalvageable oil and gas installations. None of the partners had any personal liability for repayment of the loan. The lender also had the right at any time to convert the "loan" and receive a 25% interest in partnership profits.

a. IRS concluded that the "loan" was *not* bona fide. Essentially, it was "capital placed at the risk of the venture." The funds really represented the lender's equity interest in the venture and was their basis in a partnership interest. Meanwhile, the ruling went on to state that "the bases of the other parties in their partnership interests were unaffected."

Comment: That last statement made by the IRS in their ruling is *not* necessarily true. If the concession that this third-party lender should actually be treated as an additional partner caused a shift in the sharing of any partnership liabilities under **Code §752(a)** and **(b)**, then the bases of the other partners' interests could very well be affected.

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[121] IRC §752(a)

[122] IRC §752(b)

E. Contingent Liabilities

1. A partner's basis cannot be increased by a liability that is too speculative (Cf. **Rev. Rul. 77-110**)

Example: A limited partnership bought the rights to a foreign film with $20,000 cash and a $480,000 note payable in 25 years with interest. The partners are *not* allowed to include the value of the note in the basis of their partnership interests because this nonrecourse obligation was "too speculative." Only the $20,000 initial investment could be considered for basis purposes.

F. Trade Accounts Payable

1. Considered to be a partnership liability for **Code §752** purposes (Cf. **Rev. Rul. 60-345**)

Comment: Advances of money (i.e., draws) against a partner's distributive share of income treated as a current distribution made on the last day of the tax year. (Cf. **Reg. §1.731-1(a)(1)(ii)**)

G. Indemnifications

1. Limited partner agrees to indemnify the general partners, outside of his original contribution, for payments made by the general partners, except for their pro rata share of partnership liabilities

2. Limited partner *not* allowed to increase his basis in his partnership interest. The agreement with the general partners is between them in their individual capacities and *not* an obligation by the limited partner to make a contribution to the partnership as outlined in **Reg. §1.752-1**. (Cf. **Rev. Rul. 69-223**)

3. Essentially, the limited partner potentially took on an additional liability but could *not* increase the basis in his partnership interest accordingly. The loan was still treated as recourse to the general partner.

Comment: Even though we do *not* see as many limited partnership situations anymore, this outcome could readily apply to LLC "investor" members who indemnify a "managing" member who has guaranteed some debts of the entity.

H. Miscellaneous Developments:

☞**Cash Infusions to Partnership Treated as Loans Not Equity (*Hohl*, TC Memo. 2021-5 (1/13/2021))**
The Tax Court in this instance agreed with the IRS that the partners had COD income from the discharge of the partnership's debt. The partnership had four individual partners with one of them regularly made loans to the firm. All of the partners treated these as loans on the books of the partnership. Nevertheless, several years later, when the partnership ceased operations and filed its final return, the partnership tried to reclassify those loans as capital contributions, with the result that the partners would now *not* be required to repay any of these amounts. The Court stated that it was clear that the cash infusions were loans and the partnership would *not* repay the debt. **(Code §108; COD Income)**

Comment: Keep in mind that the "exceptions"' listed in **Part I** of **Form 982** such as "insolvency" must be proven at the individual partner level to avoid having to pick up their respective share of COD income. In other words, it does *not* matter that the partnership entity itself is insolvent (i.e., it is an "owner-level test" and *not* an "entity-level" determination).

☞**IRS Issues Final Regulations on "Bottom Dollar Payment Obligations" (TD 9877)**
The IRS has released the final regs on how "bottom dollar payment obligations" are treated under **Code §752**. Similar to temporary regs issued in October 2016, the final regulations provide that bottom dollar payment obligations are ignored in determining whether a loan is recourse to a partner under **Code §752**. The final regulations also revise the definition of a bottom dollar payment obligation to specifically address "capital contribution obligations" and "deficit restoration orders." In addition, the final rules retain the requirement that taxpayers disclose bottom dollar payment obligations on **Form 8275**. When disclosing a payment obligation, taxpayers must state whether the obligation is a guarantee, a reimbursement, an indemnity, or a deficit restoration obligation. The final regs generally apply to liabilities incurred or assumed by a partnership, and payment obligations imposed or undertaken with respect to a partnership liability, *on or after* 10/5/16. **(Code §752; Recourse Debt)**

☞**Service Offers Guidance on Member's Guarantee of LLC's Qualified Nonrecourse Financing (CCA**

201606027)

This Chief Counsel Advice affirms that, for purposes of the basis and at-risk limitations applicable to a member's loss deductions attributable to an LLC taxed as a partnership, another member's guarantee of the LLC's qualified nonrecourse financing debt effectively transforms it into a recourse debt with regard to that particular member. This was because the guaranteeing partner had only limited remedies available to him, should the LLC default on repayment, which were *not* sufficient to render the non-guaranteeing members personally liable with respect to the guaranteed obligation. **(Code §752; Guaranteed Debt)**

> **Comment:** In this instance, an LLC taxed as a partnership acquired and renovated hotels had one of its members execute personal guarantees on the partnership's debt. However, the partnership agreement did provide that if the partner actually had to make a payment under the guarantee, he could then demand that the non-guaranteeing members make corresponding capital contributions. Despite this option, the IRS still concluded that the guaranteeing member's remedies against the non-guaranteeing members who fail to make required contributions generally were *not* enough to make non-guaranteeing members personally liable for the guaranteed debt under **Code §§752** and **465**. As a result, he remained the sole guarantor on the debt.

> **Comment:** This CCA offers an excellent review of the **Code §465** at-risk rules and how this guarantee of an otherwise nonrecourse debt effectively provides additional debt basis under **Code §752(a)**.

☞LLC Member's Obligation to Restore Deficit Failed to Satisfy At-Risk Rules (*Hubert Enterprises, Inc.*, TC Memo. 2008-46)

On remand from the 6th Circuit, the Tax Court has held that a deficit restoration obligation (DRO) added to the operating agreement of a limited liability company (LLC) did *not* permit its member to take into account its recourse debt. In other words, despite the DRO, the at-risk rules under **Code §465** barred a current deduction because the member was *not* personally liable for the repayment of that debt.

> **Comment:** Compare the situation with a DRO v. a partner actually guaranteeing a current debt on the partnership's books. Although the partner may never have to make good on the personal guarantee, it still gives him basis for taking losses in the interim.

Background: The "at-risk rules" limit the amount of losses that may be deducted by certain taxpayers engaged in covered activities. For such taxpayers, losses are limited to the amounts that they actually have at-risk within the activity (i.e., cash and the adjusted basis of property contributed to the activity as well as certain borrowed amounts). Losses that cannot be deducted under these rules are carried forward and may be available in future tax years. (**Code §465**) A taxpayer is considered to be at risk for an activity to the extent of: 1) the amount of money and the adjusted basis (cost) of other property contributed by the taxpayer to the activity, and 2) amounts borrowed with respect to the activity to the extent that the taxpayer is **personally liable** for the repayment or has pledged property, other than property used in the activity, as security for the borrowed amount. Thus, a taxpayer's at-risk amount does *not* include amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements or similar arrangements. (**Code §465(b)**)

Facts: Leasing Company (LC), an LLC, had two members, HBW, Inc. (HBW), a wholly owned subsidiary of Hubert Holding Co., and Hubert Commerce Center (HCC). HBW owned 99% of LC's 100 membership units, and HCC owned the remaining unit. LC bought equipment and partially financed its purchases using recourse debt. LC's two members amended LC's operating agreement to add a provision on deficit capital account restoration. Under the DRO, any LC member with a deficit capital account following the liquidation of its interest in LC had to contribute to LC by the end of the tax year, or if later within 90 days after the date of the liquidation, funds equal to the amount of the deficit for payment to LC's creditors or for distribution to the members of LC with positive capital accounts. And, based on the terms of the DRO, HBW took into account its proportionate share of LC's recourse debt in computing its at-risk amounts under **Code §465(b)(2)(A)**.

Tax Court Decision: The Tax Court held that the at-risk rules did *not* allow HBW to take into account LC's recourse debt because, despite the DRO, HBW was *not* personally liable for the repayment of that debt under **Code §465(b)(2)(A)**. In reaching its decision, the Court applied the "payor of last resort" test in ***Emershaw v. Commr.*, 68 AFTR 2d 91-5894 (6th Cir., 1991), *affg* TC Memo 1990-246** to determine whether the taxpayer was at-risk. Under that test, if a taxpayer has a fixed and definite obligation to use personal funds to pay a debt in a worst case scenario, such a "payor of last resort," is considered to be at risk under **Code §465(b)**. The Court concluded that HBW "did *not* make an unconditional promise to contribute additional capital to LC in the DRO." Furthermore, HBW was personally liable for the repayment of any of LC's recourse debt because its obligation to contribute additional funds to LC "was *not* unavoidable." In other words, HBW could avoid contributing capital under the DRO "simply by *not* liquidating." The operation of the DRO "hinged on a liquidation of a member's interest in LC." And, although HBW attempted to argued a contrary result under state law, the Court found that "a creditor of LC had no right to compel such a liquidation." HBW's personal liability for repayment of LC's recourse debt "was neither fixed nor definite but was generally contingent on HBW voluntarily causing a liquidation of its interest in LC." Even then, HBW's contribution of additional capital was required under the DRO only if HBW had a deficit capital account. In addition, the DRO did *not* require LC to pay the restored deficit to creditors. Instead, it allowed this amount to be distributed to members with positive capital account balances. Thus, the revised operating agreement for LC, by its own terms, "did *not* confer any rights on LC's creditors." The Tax Court found further support for its conclusion that HBW was *not* "a payor of last resort" for LC's recourse debt in the limited amount of capital contribution required under the DRO. Under the DRO, HBW's obligation was limited to restoring the amount of any deficit in its capital account, which "was *not* necessarily the same amount as HBW's proportionate share of LC's recourse debt." The Court also concluded that the **Code §465** at-risk rules "would have no purpose if a member of a LLC was automatically at risk for repayment of the company's recourse debt simply by inserting in the operating agreement a DRO, which is routinely inserted into a partnership agreement to meet the substantial economic effect requirements of **Code §704(b)**." **(Code §465; At-Risk Rules)**

☞**Determining Partnership's Recourse Debt for COD Income (CCA 201525010)**

The taxpayer, which was an LLC taxed as a partnership, treated its debt relief as cancellation of debt (COD) income based on its position that the debt was "recourse" under **Code §752**. And, as such, it wanted to exclude the income under the **Code §108** "insolvency exception" (i.e., which is elected on **Form 982**). On audit, the IRS agent questioned whether the LLC debt should instead be reclassified as "nonrecourse." Although this Chief Counsel Advice did *not* rule on whether the debt was recourse or nonrecourse, it stated that the **Code §752** regulations do *not* determine whether, upon foreclosure of the property, the partnership has COD income under **Code §61(a)(12)** or, instead, gains from dealings in property under **Code §61(a)(3)**. For this determination, the CCA stated that "the classification of the debt as nonrecourse or recourse requires a factual analysis of the operating and loan documents and any relevant state law." **(Code §752; Partnership Liabilities)**

Comment: The bottom line is that you cannot have COD income (which could possibly be excluded under one of the **Code §108** exceptions such as insolvency or "qualified real property indebtedness") if the loan was *not* "recourse" in the first place. Instead, if the debt is "nonrecourse," with the only security being the property that secures it, its FMV is deemed *not* to be less that the outstanding principal (plus any accrued interest) of the loan. So, when the property is exchange in satisfaction of the debt, any difference between its basis and deemed FMV will be treated as taxable gain (i.e., based on the difference between the property's adjusted basis and this deemed FMV).

☞**IRS Nonacquieses With Court Decisions Allowing Partner Exclusion of Partnership's COD Income (AOD 2015-001)**

The IRS has announced its nonacquiesence with four Tax Court decisions, each of which held that a partner who guaranteed the debt of a partnership and who was *not* in bankruptcy in his individual capacity, may exclude from gross income under **Code §108(a)**, partnership entity debt cancelled in a title 11 case.

Background: **Code §61(a)(12)** provides that gross income includes cancellation of debt income (COD income). But, **Code §108(a)(1)(A)** excludes from gross income any amount derived from "the discharge (in whole or in part) of indebtedness of the taxpayer" if the discharge occurs in a title 11 case. **Code §108(d)(2)** defines a "title 11 case" as "a case under title 11 of the United States Code (i.e., relating to bankruptcy), but only if the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court." However, **Code §108(d)(6)** provides that, in the case of a partnership (using the "aggregate v. entity" theory of taxation), **Code §108(a)** (and, certain other parts of **Code §108**) must instead be applied at the *partner* level. Finally, under the Bankruptcy Code, the term "debtor" means a person concerning which a case under title 11 has been commenced. (**11 USC 101(13)**)

Facts: Each of the four taxpayers was a general partner in a partnership and had personally guaranteed some of the partnership's debts. The partnership initiated this case under title 11 of the Bankruptcy Code. The partners reached a settlement agreement with the trustee of the bankruptcy estate, under which they would make payments to the partnership's bankruptcy estate in exchange for the release of claims or potential claims of creditors against them relating to the partnership. The bankruptcy court approved the agreement and discharged and released the partners from all liability related to the partnership, their status as general partners, and their personal guarantees of partnership debts. The same order provided that each partner "is subject to the jurisdiction of the Bankruptcy Court."

As a result of the bankruptcy court's discharge, none of these partners included the COD income allocated to him by the partnership (i.e., as a separately stated item on their respective K-1s) on his personal tax return for the year of the discharge. In the notice of deficiency, the IRS rejected the partner's claim to an exclusion of the partnership COD income.

Tax Court Decisions: The Tax Court held that each partner should be allowed to exclude his share of the partnership COD income from their individual gross income under **Code §108(a)(1)(A)** because the partnership debt was discharged "in a title 11 case" within the meaning of **Code §108(d)(2)**. The Tax Court noted that the bankruptcy court's order discharged and released the partners from liability in a title 11 case and explicitly asserted jurisdiction over them. (***Gracia*, TC Memo 2004-147 (6/22/2004)**; ***Mirarchi*, TC Memo 2004-148 (6/22/20)**; ***Price*, TC Memo**

2004-149 (6/22/2004); ***Estate of Martinez*, TC Memo 2004-150 (6/22/2004)**)

IRS Action on Decisions: The IRS disagreed with all of the Tax Court decisions. In nonacquiescing with the Tax Court holdings, the IRS noted the following:

- In ***Yamamoto*, TC Memo 1990-549, *aff'd without published opinion*, 958 F.2d 380 (9th Cir., 1992)**, the Tax Court observed that "the entire structure of **Code §108**, as well as the . . . legislative history [of **Code §108(a)(1)(A)**] (**S. Rept. 96-1035, pp. 8-14 (1980)**), makes it plain that the provision operates to provide tax relief to the debtor in bankruptcy," and *not* a non-debtor party in a bankruptcy proceeding.

- In discussing **Code §108(d)(6)**, Congress explained that discharge of a partnership debt is an item of income allocated *separately to each partner* pursuant to **Code §702(a)**. Congress indicated its intent to limit the scope of **Code §108(a)(1)(A)** to bankrupt or insolvent partners individually, and *not* to all partners of a bankrupt partnership. "The tax treatment of the amount of discharged partnership debt which is allocated as an income item to a particular partner depends on whether that particular partner is in a bankruptcy case, is insolvent (but, *not* in a bankruptcy case), or is solvent (and, *not* in a bankruptcy case). . . . [I]f the particular partner is bankrupt, the debt discharge amount is excluded from gross income pursuant to amended **Code §108**. . . " (**S. Rep. No. 96-1035, p. 21**)

- The legislative history further explains that the income tax treatment of debt discharge in bankruptcy is intended to preserve the debtor's "fresh start" after bankruptcy by excluding COD income from the debtor's income so that "the debtor coming out of bankruptcy . . . is *not* burdened with an immediate tax liability." (**S. Rep. No. 96-1035, p. 10**)

The bottom line was that the Tax Court's decisions "were inconsistent with the structure of **Code §108** and underlying Congressional intent." Here, the partners were *not* under the jurisdiction of the bankruptcy court in a title 11 case as debtors. Instead, it was the partnership entity, and *not* the partners in their individual capacity, which filed the petition in the bankruptcy court. Therefore, none of the partners met 11 USC 101(13)'s definition of a "debtor in bankruptcy" (i.e., a person concerning which a case under title 11 has been commenced). **Code §108(a)** applies at the *partner* level and *not* at the partnership entity level. As a result, the exclusion in **Code §108(a)(1)(A)** applies only to partners who are actually "debtors in bankruptcy" in their *individual* capacities and who need a "fresh start." In none of these cases was any of the partners in bankruptcy in their individual capacity and, therefore, did *not* need a "fresh start." Thus, according to the IRS, none of the partners was entitled to exclude his share of the partnership COD income under **Code §108(a)(1)(A)**. **(Code §108; COD Income)**

☞**Extension Granted for Filing of Form 982 to Exclude COD Income** (**PLRs 201316009** and **201316010**)
The IRS granted a taxpayer who was a 50% member in an LLC/ classified as a partnership, an extension for filing an election under **Code §108(c)(3)(C)** and **Reg. §1.108-5(b)**. This election would permit the taxpayer to exclude the COD income resulting from discharge of "qualified real property business indebtedness" and instead to reduce the basis of depreciable real property. The reason that the Service allowed this extension was because the LLC's Form 1065 and the Schedule K-1 issued to the taxpayer did *not* indicate that the discharge related to "qualified real property business indebtedness." A second firm then prepared the LLC member's Form 1040 and was unaware of the nature of the discharge until preparing tax projections in a later tax year. **(Code §108; COD Income)**

Comment: The election is made by filing **Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)**.

☞**Applying COD Insolvency Exception to Partnership Excess Nonrecourse Debt** (**Rev. Rul. 2012-14**)
This ruling explains how the amount by which a discharged partnership nonrecourse debt exceeds the FMV of the property securing the debt (i.e., "excess nonrecourse debt") is taken into account in measuring the partners' insolvency for purposes of the **Code §108(a)(1)(B)** "insolvency exception." To the extent discharged "excess nonrecourse debt" results in cancellation of indebtedness (COD) income that is allocated under **Code §704(b)** and its regs, each partner treats its part of the discharged excess nonrecourse debt related to the COD income as a liability in measuring insolvency under **Code §108(d)(3)**.

Background: Under **Code §61(a)(12)**, COD income is generally includible in gross income. However, under **Code §108(a)(1)(B)**, gross income does *not* include any amount which would otherwise be includible in gross income to the extent the taxpayer is insolvent when the discharge occurs. Under **Code §108(d)(1)**, the indebtedness of the taxpayer means any indebtedness for which the taxpayer is liable, or subject to which the taxpayer holds property. In the case of cancelled partnership debt, **Code §108(d)(6)** provides that the **Code §108(a)(1)(B)** "insolvency exception" applies at the partner level (i.e., *not* at the partnership or entity level). In **Rev. Rul. 92-53**, the IRS held that "excess nonrecourse debt" is treated as a liability in determining insolvency for purposes of **Code §108** to the extent that the excess nonrecourse debt is discharged. In **Rev. Rul. 2012-14**, the IRS has now *amplified* **Rev. Rul. 92-53**, to explain how partnership excess nonrecourse debt is taken into account in measuring the partners' insolvency for purposes of the insolvency exception.

Comment: With S corporations, the insolvency exception under **Code §108(a)(1)(B)** is instead applied at the entity level (i.e., v. the owner level as is the case with partnerships under the "aggregate" theory of taxation). Nevertheless, through the concept of "deemed NOL," the shareholders suspended S corp losses due to the lack of adequate *stock* basis (but, *not* debt basis and *not* due to the application of the **Code §469** passive loss rules) are correspondingly reduced by the amount of any COD income that was *not* recognized by the S corp due to this exception.

Facts: Partnership PRS has equal partners X (an investor other than a partnership) and H (a corporation). PRS's partnership agreement provides that income is to be allocated equally to X and H under **Code §704(b)** and its regs. In Year 1, PRS borrows $1 million which is secured by real estate valued in excess of $1 million that PRS acquired, in part with the proceeds of the note. The note is a *nonrecourse* liability under **Reg. §1.752-1(a)(2)** (i.e., neither PRS nor its partners are personally liable on the note). Then, in Year 2, when the value of the real estate is $800,000 and the outstanding principal on the note is $1 million, the bank agrees to modify the terms of the note by reducing the note's principal amount to $825,000. PRS's sole asset is the real estate subject to the note, and PRS's sole liability is the note. The modified note bears "adequate stated interest" under **Code §1274(c)(2)**. At the time of the modification of the note, X and H have no assets or liabilities other than their PRS partnership interests. PRS has no partnership "minimum gain" with respect to the note under **Reg. §1.704-2(d)(1)**. X and H share PRS nonrecourse liabilities equally under **Reg. §1.752-3**. Finally, the **Code §108(a)(1)(A)** "bankruptcy exception" does *not* apply.

IRS Ruling: In **Rev. Rul. 2012-14**, the IRS provides that for purposes of measuring a partner's insolvency under **Code §108(d)(3)**, each partner treats as a liability an amount of the partnership's "discharged excess nonrecourse debt" that is based upon the allocation of COD income to that partner under **Code §704(b)** and the regs. To properly apply **Rev. Rul. 92-53** in a partnership context, the partnership's discharged excess nonrecourse debt should be associated with the partner who, in the absence of the insolvency or other **Code §108** exclusion, would be required to pay the tax liability arising from the discharge of that debt. As a result, a partnership's "discharged excess nonrecourse debt" is treated as a liability of the partners for purposes of measuring the partners' insolvency under **Code §108(d)(3)** based on how the COD income with respect to that portion of the debt is allocated among the partners under **Code §704(b)** and its regs.

In the instance, the bank canceled $175,000 of PRS's $200,000 excess nonrecourse debt, resulting in $175,000 of COD income which is allocated equally between X and H under **Code §704(b)** and its regs. In measuring the partners' insolvency, PRS's discharged excess nonrecourse debt is treated as a liability of its partners based upon the COD income allocation: X treats $87,500 of PRS's debt as a liability of X, and H treats $87,500 of PRS's debt as a liability of H. Consequently, X and H treat their shares of the cancelled PRS excess nonrecourse debt as their own liabilities in determining whether, and to what extent, each is "insolvent" under **Code §108(d)(3)**.

X and H have no assets or liabilities other than their partnership interests in PRS. The value of X's and H's partnership interests in PRS is zero. Immediately before the bank discharges the indebtedness, X's liability exceeded the value of X's partnership interest by $87,500, and similarly H's liability exceeded the value of H's partnership interest by $87,500. X and H are each "insolvent" to the extent of $87,500 under **Code §108(d)(3)**. As a result, X and H may each exclude their $87,500 amount of COD income under **Code §108(a)(1)(B)**. **(Code §108; COD Income)**

Comment: It is a bit unusual that neither partner had any "assets or liabilities other than their partnership interests in PRS." Typically, an individual partner, when determining whether they are "insolvent" or not, will have a multitude of other assets that they owned, and this would include assets that we might not look to as being immediately available should we need the funds to pay this, or any other debts (e.g., IRA, qualified retirement plans, such as 401(k)s, 403(b)s, etc.).

☞COD Exceptions Apply at Owner Level for SMLLCs (REG–154159–09)

When a business entity, such as a C or S corporation, is forgiven an outstanding debt, the resulting COD income does *not* need to be included in gross income if one of the exceptions under **Code §108** is satisfied (e.g., insolvency, bankruptcy, etc.) This reflects the "entity theory" of taxation. On the other hand, when a partnership is involved, the entity's insolvency or bankruptcy is *not* considered at the entity level. Instead, the forgiven debt amount is passed through on the K-1s to the owners who must proved that one of the **Code §108** exceptions apply. Now, these regulations confirmed that businesses that are operated as SMLLCs (which are disregarded entities for tax purposes) must also passed along any COD income to its owner. And, it is the owner who must prove satisfy the insolvency (or, some other) exception in order to avoid having to pick up the forgiven debt in their income. **(Code §108; COD Income)**

Comment: According to **CCA 201116019**, the IRS is *not* permitted to levy an LLC's assets for taxes owed by its sole member. Even if a SMLLC is disregarded from its owner for federal tax purposes, that status does *not* apply for tax collection purposes because the member is deemed to have no direct ownership interest in the LLC's assets under state law (i.e., because of limited liability protection). However, the IRS might allow a levy for LLC payouts that are based on the owner's interest in the entity (e.g., if income from the LLC is the owner's source of support).

☞**Final Regs Issued on Partnership's Equity-for-Debt Exchange With Creditors (T.D. 9557)**

The IRS has issued final regs under **Code §108(e)(8)** on the determination of a partnership's cancellation of debt income on the transfer of a partnership interest to a creditor in satisfaction of the partnership's debt (i.e., a debt-for-equity exchange, similar to a Type E re-org, had a corporation instead been involved). In particular, the regs, which are effective for such exchanges *on or after* Nov. 17, 2011, provide a safe harbor under which the fair market value of the partnership interest in a debt-for-equity exchange will be treated as its liquidation value.

Comment: The bottom line is that the final regs treat the debt-for-equity exchange, with some exceptions, under the **Code §721** nonrecognition rule.

Background: Under **Code §108(e)(8)**, to determine income of a debtor from COD, if a debtor partnership transfers a capital or profits interest in the partnership to a creditor in satisfaction of its recourse or nonrecourse debt, the partnership is treated as having satisfied the debt with an amount of money equal to the FMV of the interest. And, if any COD income is still recognized as part of this exchange (i.e., because the equity interest received by the creditor is treated as being less than the principal amount of the debt outstanding immediately before the exchange), it is included in the distributive shares of its partners (i.e., which is normally the rule where the partnership entity otherwise has COD income).

Under **Code §721**, with some exceptions, no gain or loss is recognized to a partnership or any of its partners when property is contributed to the partnership in exchange for a partnership interest. Then, in October of 2008, the IRS issued proposed regs on a partnership's debt-for-equity exchanges. Now, the IRS has finalized those proposed regs, with some modifications.

Final Regs: The final regs provide a liquidation value safe harbor under **Code §108(e)(8)**, under which the FMV of a debt-for-equity interest will be the liquidation value of that debt-for-equity interest, if the following conditions are met:

- **Consistency requirement:** The creditor, debtor partnership, and its partners *must* treat the FMV of the debt as being equal to the liquidation value of the debt-for-equity interest for purposes of determining the tax consequences of the debt-for-equity exchange. (**Reg. §1.108-8(b)(2)(i)(A)**) In making this determination, a partnership *must* apply a "consistent valuation methodology" to *all* equity issued in any debt-for-equity exchange that is part of the *same* overall transaction; (Reg. §1.108-8(b)(2)(i)(B))

- **Arm's length requirement:** The debt-for-equity exchange has terms that are comparable to terms that would be agreed to by unrelated parties negotiating with adverse interests; (**Reg. §1.108-8(b)(2)(i)(C)**) and

- **Anti-abuse requirement:** Subsequent to the debt-for-equity exchange, the partnership does *not* redeem, and no person related under **Code §267(b)** or **Code §707(b)** to the partnership or its partners purchases, the debt-for-equity interest as part of a plan at the time of the debt-for-equity exchange which has as a principal purpose the avoidance of COD income by the partnership. (**Reg. §1.108-8(b)(2)(i)(D)**)

Comment: In addition, the final regs provide that for interests held in one or more lower-tier partnerships, the liquidation value of an interest in an upper-tier partnership is determined by taking into account the liquidation value of the lower-tier partnership interest. (**Reg. §1.108-8(b)(2)(ii)**)

The "liquidation value" equals the amount of cash that the creditor would receive for the debt-for-equity interest if, immediately after the transfer, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operations) for cash equal to the FMV of those assets, and then liquidated. (**Reg. §1.108-8(b)(2)(iii)**) If the FMV of the debt-for-equity interest does *not* equal the FMV of the indebtedness exchanged, then general tax law principles apply to account for the difference. (**Reg. §1.108-8(b)(1)**)

Final Code §721 Regs: In a debt-for-equity exchange, the **Code §721** nonrecognition rule generally applies to the creditor's contribution of partnership debt to the partnership solely in exchange for the partnership interest. (**Reg. §1.721-1(d)(1)**) Normally, **Code §721** does *not* apply to the transfer of a partnership interest to a creditor in satisfaction of a partnership's debt for unpaid rent, royalties, or interest on debt (including accrued original issue discount) that accrued on or after the beginning of the creditor's holding period for the indebtedness. Nevertheless, under the final regs, a debtor partnership will *not* recognize gain or loss upon the transfer of a partnership interest to a creditor in a debt-for-equity exchange for unpaid rent, royalties, or interest that accrued on or after the beginning of the creditor's holding period for the indebtedness. (**Reg. §1.721-1(d)(2)**)

Final Code §704 Regs: Current **Reg. §1.704-2(f)(6)** provides that any "minimum gain chargeback" required for a partnership taxable year consists first of certain gains recognized from the disposition of partnership property subject to one or more partnership nonrecourse liabilities and then, if necessary, of a pro rata portion of the partnership's other items of income and gain for that year. **Reg. §1.704-2(i)(4)** provides a similar for chargebacks of partner nonrecourse debt minimum gain. Under the final regs, COD income arising from a discharge of a partnership or partner nonrecourse indebtedness is now treated as a "first-tier item" for minimum gain chargeback purposes under **Reg. §1.704-2(f)(6)**, and under **Reg. §1.704-2(j)(2)(i)(A)** and **Reg. §1.704-2(j)(2)(ii)(A)** (i.e., dealing with ordering rules for allocations attributable to nonrecourse liabilities). (Reg. §1.704-2) **(Code §721; Debt-for-Equity Exchanges)**

Notes:

CHAPTER X: FACTORS OTHER THAN PARTNER'S BASIS

A. At-Risk and Passive Loss Rules: While a member's **outside basis** is an important factor to consider when determining the K-1 loss a taxpayer may deduct, or to determine whether a distribution is in excess of basis, there are **two other equally important factors**:

- At-risk limitations
- Passive loss limitations

Comment: Although delayed, the Code §461(l) "excess business deduction" limitation will now be effective beginning in the 2021 tax year and it represents the "4th barrier" in being able to take a K-1 loss/deduction (i.e., after the basis, at-risk rules and passive loss limitations are first applied).

Basis, at-risk limitations, and passive loss limitations **can all result in suspended losses**. A major difference is that **suspended basis losses cannot be used to reduce gain upon liquidation or disposition of the partnership interest**. That is, steps should be taken to **increase one's basis before disposition** so that these particular suspended losses can be utilized. Furthermore, these losses also **remain personal** to the selling partner so that they **cannot benefit** the new owner. But, at least suspended **at-risk** and **passive losses** can be used to **reduce gain** upon liquidation or disposition of the partnership interest. To avoid confusion, it is important to remember that the **tax basis** of a partnership interest is normally ***not*** the same as the **capital account**. One important difference is that an owner's capital account does **not** change when the total liabilities of the entity varies.

B. Code §465 - At-Risk Rules: Even if a partner has sufficient **basis** to initially absorb all the loss flowing through on his Schedule K-1, the **Code §465** at-risk limitations can still affect the limit on any deduction. The at-risk rules serve to limit a taxpayer's loss deduction to the amount he **could actually lose** from the activity.

The at-risk rules generally limit deductions to amounts for which the taxpayer has **a risk of economic loss**. Amounts disallowed under the at-risk rules retain their character and carry over indefinitely, and become allowable when the taxpayer has amounts at risk.

Comment: The at-risk rules apply *after* the initial basis limitations, and *before* the passive activities rules under **Code §469**. Computations are made on **Form 6198**. At-risk basis for an owner is generally determined as of the close of the taxpayer's year.

The at risk rules apply to individuals, estates, trusts and closely-held corporations, including PSCs and S corporations. With partnerships and LLCs, the at-risk rules apply to activities conducted by the entity, but at the partner or member level. As a result, it is possible for some partners to be at-risk while others are not.

Comment: The **Code §465** at-risk rules apply first at the corporate level and then to the shareholders in cases involving S corporations. And, if the corporation is *not* at risk, none of the shareholders are.

Generally speaking, the amounts at risk are listed **Code 465(b)** and include:

- Money and the basis of other property contributed for use in the activity;
- Debt for which the taxpayer is personally liable (i.e., as a guarantor);
- Qualified nonrecourse real property indebtedness (i.e., **Code §465(b)(6)**);
- The FMV (not basis) of property *not* used in the activity that the taxpayer has pledged as security for loans used in the activity; and
- Income from the activity that the taxpayer has *not* withdrawn.

Comment: At-risk amounts also include personal loans made by a partner (or, S corp shareholder) directly to the entity.

With regard to the loans of the entity, debt for which the taxpayer is personally liable generally is treated as an amount at risk. However, the taxpayer is *not* at risk with respect to amounts protected against loss (e.g., nonrecourse financing, guarantees, stop loss agreements, or similar arrangements). Nevertheless, for purposes of the at-risk rules, insurance coverage is *not* treated as protection against loss.

One of the major differences between a partnership v. an S corp has to do with how loan guarantees are treated for tax basis, as well as the at-risk rules. For S corporations, a loan guarantee generally does *not* increase the taxpayer's amount at risk, unless and until the taxpayer actually pays the debt and has no remaining legal rights against the primary obligor. However, a partner or member that guarantees the partnership's or LLC's debt generally is at risk except to the extent that the member has a right of recovery (i.e., subrogation rights) from other members.

Essentially, the at-risk rules affect that portion of a partner's basis which is derived from the **sharing of allocable partnership liabilities** if the particular partner is **not** at risk for that debt amount. For these purposes, the guarantee of a debt puts the guarantor partner at risk **since he bears the burden** of repaying the debt if the partnership defaults. However, for any other **nonrecourse** debt, except for "qualified real property indebtedness," this amount is then subtracted from the initial basis amount (i.e., since it is **not** considered to be at risk).

To reiterate, a partner's amount considered at risk includes all cash invested in the partnership, the adjusted tax basis of all property contributed, and most borrowed amounts for which the taxpayer personally bears the economic risk of loss for its repayment if the partnership defaults (i.e., "hard basis"). One can argue that a taxpayer's amount at risk in an investment is essentially equivalent to his adjusted tax basis in the property with one major difference. Generally, nonrecourse loans used to increase a partner's basis do *not* increase a taxpayer's amount considered at risk. However, amounts borrowed from any person having an interest in the activity (other than an interest as a creditor), i.e., a "prohibited continuing interest," are *not* considered to be at risk. (**Code §465(b)(3)**)

Under **Reg. § 1.465-8(b)(1)**, a person has a "prohibited continuing interest" under **Code §465(b)(3)** only if the person has either a capital interest in the activity or an interest in the net profits of the activity. A "capital interest" is defined as an interest in the assets of the activity which is distributable to the owner of the capital interest upon the liquidation of the activity. (**Reg. § 1.465-8(b)(2)**) A person may have an interest in the net profits of an activity even though he or she does *not* possess any incidents of ownership in the activity. (**Reg. §1.465-8(b)(3)**) **Code §465(b)(3)** focus on a "prohibited continuing interest" is most concerned with any "fixed and definite rights or interests that realistically may cause creditors to act contrary to how independent creditors would act with respect to their rights under the debt obligations in question."

The **Code §465** at-risk rules were introduced by the **1976 Tax Act** in response to the **rampant use of nonrecourse debt** in tax shelters. Significant tax basis was generated by such debts under **Code §752(a)**, thus permitting the deduction of K-1 losses **far in excess of any capital contributions** by the partners. Yet, there was little chance that any of these partners, especially limited partners, would ever be called upon to repay these debts.

> **Comment:** Since only **direct shareholder loans** serve to increase basis in an S corporation, and the particular shareholder that loaned the money is at-risk for these funds, the **Code §465** at-risk rules **rarely come into play** to decrease the initial debt basis calculation for a shareholder.

There is an exception for "qualified real property indebtedness." As mentioned above, taxpayers are **not** considered at risk for amounts protected against loss through nonrecourse financing, guarantees, stop-loss agreements, or other similar arrangements.[123] As a result, when there is no realistic possibility of personal economic loss by a particular owner, deductions are disallowed.[124]

This exception was lobbied for and eliminated from these at-risk rules in the **1984 Tax Act**. The banking and real estate lobbyists successfully argued that nonrecourse debt, secured solely by real estate and made by a qualified financial institution, as opposed to a marketer or promoter of the tax shelter is still considered at risk **even though it is unlikely** that any of the owners will ever be called upon to repay the debt.

Example 1: "At-Risk Rules and Nonrecourse Debt on Other-Than-Real Property Indebtedness"

The partnership borrows $100,000 from a local bank. The nonrecourse debt is only secured by the equipment purchased with the borrowed funds (i.e., a chattel mortgage). The individual partners' basis is initially increased by a corresponding amount.[125] However, under the **Code §465** at-risk rules, this basis is reduced by the same amount.

Example 2: "At-Risk Rules and Qualified Real Property Indebtedness"

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[123] IRC §465(b)(4)

[124] *Whitmire v. Commr.*, 109 TC 266 (1997), aff'd, 178 F.3d 1050 (9th Cir. 1999).

[125] IRC §752(a)

Use the same facts as **Example 1**, except the $100,000 is used as a down payment on the purchase of real estate, which is the sole source of security for the nonrecourse debt. Because of the exception created under **Code §465** related to "qualified real property indebtedness," the basis increase created by **Code §752(a)** is **not** reduced by the at-risk rules, even though this is a **nonrecourse** debt.

Losses disallowed under the at-risk rules remain suspended until the taxpayer's at-risk investment in the activity increases (e.g., he personally guarantees a debt or "qualified real property indebtedness" otherwise increases) or income from the activity (i.e., "positive" K-1 items) is includible in the partner's basis.[126] Normally, this occurs no later than when the taxpayer ultimately disposes of his partnership interest in a taxable transaction.

Under the "qualified real property indebtedness" exception, taxpayers are considered at risk for their proportionate share of qualified nonrecourse financing.[127]

Qualified nonrecourse financing is:

- Any debt incurred in connection with the activity of holding real property,
- Which is borrowed from or guaranteed by, any federal, state or local government, or which is borrowed from a qualified person who is actively and regularly engaged in the business of lending money;
- The real property in question must be the sole source of collateral for the debt, with none of the entity's members being personally liable for its repayment and
- The financing cannot be convertible from a debt obligation to an ownership interest.

A "qualified person" is:

- Regularly engaged in lending money;
- Not related to the taxpayer;
- Not receiving a fee in connection with the taxpayer's investment in the property; and
- Not the person from whom the taxpayer acquired the property.

Under final Treasury regulations issued in August 1998, the liability of the LLC for the indebtedness is ignored for purposes of the at-risk rules.[128] In other words, if the financing is deemed to be "qualified nonrecourse financing," the members or partners share it, and they are deemed to be at risk to the same extent that they share the liability under the normal rules of **Code §752**.

Code §465(e) - Recapture of amounts previously at-risk: If a combination of losses, withdrawals and/or conversion of at-risk amounts to amounts *not* at-risk would otherwise take a taxpayer's amount at risk below zero, the taxpayer has income equal to the *lesser* of: (1) What the negative at-risk amount would have been, or (2) Previously deducted net losses from the activity.

> **Comment:** One of the most common causes of recapture of at-risk amounts is when a particular debt that was recourse as to one or more owners now becomes nonrecourse, or a recourse debt is now shared differently than when a K-1 loss was taken in a prior tax year (i.e., with this specific owner now sharing in less, or none, of the debt that was converted). Or, simply the principal balance outstanding on the guaranteed debt is paid down.
>
> **Comment:** If a taxpayer has a negative at-risk amount, it carries over, and the taxpayer must become at risk in order to eliminate the negative amount *before* any subsequent loss passthroughs are allowed.

Code §465(e) - Recapture of previously recognized losses: In certain situations, the recapture of previously recognized losses may be required. Frequent reasons for recapture are a change in the character of partnership debt or a reduction in the amount of debt. If a recourse debt is converted to a nonrecourse debt, the conversion will affect

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126 IRC §465(a)(2)

127 IRC §465(b)(6)

128 Treas. Reg. §1.465.27

the at-risk basis calculation for the partners, both directly by the characterization shift (non-recourse debt does *not* provide at-risk basis) and indirectly by its effect on debt allocation. This can result in unwanted consequences. At-risk recapture can also occur when the partnership makes distributions to the partners, reducing their amount at risk (**Prop. Regs. §1.465-22**). It is important to note that if a partnership has had income in excess of deductions throughout its existence (and, therefore, has never had a **Code §465(d)** loss), there would be no recapture even if a partnership distribution reduces the at-risk basis below zero, because the taxpayer has no prior loss to recapture (**Code §465(e)(2)**).

> **Example: "At-risk Recapture Not Required for Profitable Partnership"**
> ABC Partnership began operation in 20x1, has reported income in excess of deductions for 20x1, 20x2, and 20x3, and at the end of 20x3 has nonrecourse debt secured by transportation equipment. At the end of 20x3, Partner B has an at-risk basis composed of a cash contribution of $50,000 and three years of his share of earnings totaling $10,000, for a total at-risk basis of $60,000, and a tax basis of $80,000 (including nonrecourse debt of $20,000). If the partnership distributes $70,000 to Partner B, the at-risk basis is reduced to ($10,000), while his tax basis is reduced to $10,000. Partner B has no Sec. 465(e) recapture because there have been no previously allocated losses.

☞**At-Risk Rules Not Avoided by Aggregating Business Activities of Multiple Entities (CCA 201805013)**
The IRS has determined that a taxpayer is *not* permitted to treat various business activities, conducted through three separate S corporations and a limited liability company (LLC) in which he was a minority owner, as a single activity for purposes of the at-risk rules under **Code §465**. As a result, the taxpayer, who had personally guaranteed a line of credit that had been utilized by only the LLC, could *not* deduct losses for all four entities on the basis of that one personal guaranty. **(Code §465; At-Risk Basis)**

☞**IRS Provides Guidance on At-Risk Amounts for LLC Member Guaranteeing LLC Debt (AM 2014-003)**
The IRS Associate Chief Counsel has issued a Legal Advice explaining how to determine the amount at risk when a member of a LLC guarantees entity debt, including how to determine the effect of that guarantee on the other members's amounts at risk. The IRS has noted that **Prop. Reg. §1.465-6(d)** does *not* apply when an LLC member guarantees LLC debt if: (1) the guaranteeing member has no right of contribution of reimbursement, (2) the guaranteeing member is *not* protected against the loss, and (3) the guarantee is bona fide and enforceable. Additionally, Qualified Nonrecourse Financing (QNF) when guaranteed by an LLC member is no longer considered QNF. Therefore, the guaranteeing member becomes personally liable (and at risk) for the debt which by definition is no longer QNF. And, the non-guaranteeing members, who previously included a portion of the QNF in the at-risk amount, are no longer able to do so. And, if the LLC is a single-member disregarded entity, the member's at-risk amount generally will *not* be affected by the guarantee. **(Code §752; At-Risk Liabilities)**

☞**Service Clarifies At-Risk Rules for Guarantors of LLC Debt (CCA 201308028)**
A guarantor of debt for an LLC that is treated as a partnership or a disregarded entity for federal tax purposes may still be considered "at-risk" under **Code §465** with respect to a guaranteed debt even if he does *not* completely waive his rights of subrogation and reimbursement from the LLC with respect to the guaranty. This would be the case as long as the guaranty is bona fide and enforceable by the creditor against the guarantor under local law and the guarantor is *not* otherwise protected against loss within the meaning of **Code §465(b)(4)**. On the other hand, when other persons co-guarantee LLC debt (regardless of whether or not those persons are also LLC members), a guarantor will *not* be considered "at-risk," except to the extent that he has no rights of contribution or reimbursement against those other guarantors for any amounts that may be paid by the guarantor on the guaranty (or, until those rights are exhausted under local law). **(Code §465; At-Risk Rules)**

☞**Partnership Distributions v. Guaranteed Payments Can Save Tax When Using Entity's Line-of-Credit**
With difficult economic times, many businesses had to resort to capital contributions or loans from their owners to stay afloat. Another option, if they're lucky enough to qualify, is to obtain a sufficient line-of-credit from a local bank (often with the owners needing to fully guarantee the debt).

> **Comment:** Keep in mind the recapture rules of **Code §465(e)** which state that if an at-risk liability is used to create basis (as shown on **Form 6198**) to take a K-1 loss and then the liability's status is changed to *not* be at-risk, the amount of the loss previously taken must be included in the partner's gross income in that later tax year.

> **Example 3:** Tom is a co-guarantor with John on a $100,000 line-of-credit for the partnership. He then properly uses $50,000 of this liability to increase his "hard" basis in order to take a K-1 loss on his personal tax return. Assume that during the next tax year when the partnership has a break-even year (i.e., no overall gain or loss), he is removed as a guarantor on this debt. Because of this, he has to now include in his gross income (on Schedule E, page 2) $50,000 of income (most likely taxed as ordinary income and it might also be subject to S/E tax).

Comment: A somewhat similar result would occur under **Code §752(b)** where, for instance, a debt is shared by two partners, and then, for example, two additional partners are admitted to the partnership at a time that the original partners' basis in their ownership interests is zero and these new partners also become co-guarantors of the outstanding debt.

Example 4: Assume again that Tom and John are guarantors of a $100,000 line-of-credit for the partnership. And, they have properly used this basis to cover a distribution, or take K-1 losses in prior tax year which has reduced the basis of their partnership basis to zero as of the time that the two new partners are admitted. These two new partners now become guarantors on this particular debt as well. Under **Code §752(b)** and **Code §731**, this deemed relief from debit is treated as a distribution of cash (i.e., $25,000 to each of them) which, given Tom and John's zero basis in their partnership interest, is taxable.

In this instance, a line-of-credit was in fact being used to keep the business alive and pay other creditors, as well as the employees' wages. But, with the owners needing to pay their own personal bills, they had to take some distributions out of the business as well (i.e., using this line-of-credit). However, the rub here was that the monies had been lent to the company by other family members who, for whatever reason, did *not* make the two sons (who were the partnership's owners) personally liable for repayment of the debt (i.e., guarantors). Therefore, they did *not* have at-risk basis for this liability (i.e., pursuant to **Code §465** and as shown on **Form 6198**). And, it was *not* "qualified real property indebtedness" (i.e., nonrecourse debt otherwise secured by real estate). As a result, the two partners received a basis increase for their ownership interest (pursuant to **Code §752(a)**) which would be sufficient to offset distributions from the partnership. But, this basis would not be considered "at-risk" and would therefore *not* count for purposes of taking any K-1 losses (which was what happened when they decided to treat the monies extracted from the company as "guaranteed payments").

In the process of preparing the partnership's extended 2011 Form 1065 tax return, it became obvious that if they insisted on treating the distributions taken throughout the tax year as "guaranteed payments," it would cause the K-1 loss flowing through to each of them to grow significantly. And, because they did *not* have sufficient at-risk basis, this loss would be suspended on their personal returns (they had no problem with the **Code §469** PAL rules since they both materially participated in the partnership's business). Nevertheless, they would still have to pay income tax on the "guaranteed payments" that would have been listed on Box 4 of their K-1s, as well as self-employment tax.

When appraised of this situation, it was decided that these "draws" (i.e., distributions) should be recharacterized as such (and, for which they would have sufficient basis to absorb due to the increase allowed under **Code §752(a)**) and *not* "guaranteed payments" would have produced suspended K-1 losses (at least until such time as the business became profitable, or they made sufficient capital contributions to create at-risk basis; they could have also simply guaranteed the debt). **(Code §465; At-Risk Basis)**

Comment: They could have also had the partnership "loan" them the monies with a legitimate repayment schedule, while also being charged a sufficient rate of interest (i.e., at least equal to the federal mid-term interest rate).

C. At-Risk Recapture - When Previous Sharing of Partnership Liabilities Shifts to Other Owners

1. It is entirely proper for a guarantor of a partnership debt to use their respective share as additional "soft basis" in order to take any losses allocated to them via their K-1

    a. But, if that share of the debt is shifted onto some of the other partners (or, to new partners) in a subsequent tax year, or that partner ceases being a guarantor, it could result in the recognition of income under the **Code §465(e)** "at-risk recapture rules."

Example 5: "Income Inclusion Due to At-Risk Recapture Rules"

An LLC has three equal members, A, B and C who each make a $10,000 contribution to capital for their partnership interest. The entity has a $100,000 line of credit, but only A agrees to guarantee the debt. During the first year, the entity has a $130,000 ordinary trade or business loss (i.e., as shown in Box 1 of their K-1s) which is initially allocated $10,000 to each of the members. The remaining $100,000 of the loss is then specially allocated[129] to A since he was the sole guarantor of the line-of-credit debt which was used to finance the majority of expenses incurred for that first tax year.

In year two, however, when the LLC otherwise had -0- income or loss from operations, the lender insisted (in

[129] Code §704(b)(2)

order to have more security on the line-of-credit debt) that B and C also join A as guarantors on this LLC liability. What impact, if any, would this have on A?

Under **Code §465(e)**, A would now only share in 1/3 of the $100,000 debt for at-risk basis purposes. As a result, A would now have to include as ordinary income (i.e., on page 2 of Schedule E, either as passive or nonpassive income, depending on whether he is materially participating in the LLC), $67,667.

Example 6: Same facts as in **Example 2** above, except A, B and C were all co-guarantors of the $100,000 line of credit in year one. As a result, each member was allocated 1/3 of the $130,000 loss (i.e., $10,000 due to their "hard basis" and $33,000 additionally due to their "soft basis" stemming from their respective guarantees).

In the second year, two new members (D & E) were admitted to the partnership so that the entity was now owned equally by these five members. In addition, these two new members also agreed to be co-guarantors on this $100,000 liability. Once again, the LLC had -0- income or loss from operations. What impact, if any, would the admission of D and E to the LLC, and their agreeing to be co-guarantors on the debt, have from a tax standpoint?

As in the case of **Example 2** above, **Code §465(e)** at-risk recapture rules would cause A, B and C to now include $13,334 (i.e., $33,334 - 20,000) of ordinary income on page 2 of Schedule E due to the decrease in the amount of the debt that they were now considered to be at-risk for.

Comment: Note that the income inclusion due to the at-risk recapture rules occurs even though there was -0- income or loss from operations in that second tax year.

Comment: Applying these examples to the real estate industry where "qualified nonrecourse real property indebtedness" is allowed to be included for at-risk purposes on **Form 6198**, there would be no change in the results mentioned where a subsequent event caused this debt to be shared in different proportion (due to factors such as those mentioned above) than that originally calculated in an earlier tax year. Or, if the principal amount of the mortgage was paid down (before other sources of at-risk basis were created).

D. At-Risk Recapture - When a Partnership With Deficits in Partners' Capital Accounts Makes S Election

1. When a partner has properly used "soft basis" (i.e., "OPM" or "other people's money") to create at-risk basis for taking K-1 losses to the extent that there is a deficit in their capital account (even though their tax basis in their partnership interest can never go below zero), and then the entity decides to make an S election, disastrous tax results can occur.

    a. The main reason for this is that guaranteed debt, including "qualified nonrecourse real property indebtedness," no longer counts for "at-risk basis" purposes in an S corporation setting

    b. "Direct shareholder loans" are the only type of liability found on an S corporation's balance sheet which can serve to create additional basis (i.e., "debt basis") beyond that resulting from capital contributions and previously-tax but undistributed income (i.e., "stock basis")

Example 7: A, B and C are equal members of a real estate development LLC. Due to large expenses in the early years of the development process, the entity has incurred significant losses thus far which were passed through to the members on their respective K-1s. Even though their "hard basis" (i.e., capital contributions the partners made in forming the partnership) has long since been used up in taking these losses on their personal returns, they were able to absorb even more of the losses due to the fact that they each served as co-guarantors of the LLC's outstanding debt. In fact, each of them showed a $100,000 deficit in their respective capital accounts.

Now, as the entity is about to earn significant profits from selling off their inventory of improved lots in an ever-improving real estate market, they file a **Form 2553** S corporation election effective as of the first day of the next tax year (which their tax advisor becomes aware of in late-March when finishing up their most recent **Form 1065** return). What impact, if any, would this have on each of the LLC members?

Since it is too late to retroactively revoke their S election, under the **Code §465(e)** "at-risk recapture rules" A, B and C would have to each pick up $100,000 of ordinary income (on Schedule E, page 2) due to the deficits in their respective capital accounts as this "qualified nonrecourse real property indebtedness" is no longer allowed for purposes of calculating either their stock or debt basis of the new S corporation.

Comment: Even if the partners decided to dissolve the partnership and distribute out the assets pro rata to each partner (who would now hold them as tenants-in-common), and then contribute them to a newly-formed S corporation pursuant to **Code §351** (i.e., receiving back only stock and no "boot"), **Code §357(c)** would still treat the excess of any liabilities over the adjusted bases of assets transferred into the corporation as "boot." And, this would be in spite of the fact that these new shareholders remained liable as guarantors on this debt.

E. Passive Loss Rules Limit Deduction of K-1 Losses: In addition to complying with the basis requirements and at-risk rules, a taxpayer may be limited in the use of a deduction, loss or credit from an business when he or she is otherwise subject to the passive loss rules. Under the passive loss rules, a loss or credit from a passive activity may only be used to the extent the taxpayer has income from that or other passive activities. The rules are applicable to individuals, estates, trusts, personal service corporations, and to a lesser extent, closely-held C corporations. Passive activities include all trades or businesses in which the taxpayer does *not* materially participate, as well as *automatically* for rental activities. Certain limited exceptions apply for "real estate professionals," and when a qualified grouping election is made.

If passive activity losses exceed a taxpayer's passive activity income, the losses are suspended until the taxpayer has sufficient income from the activity giving rise to the passive loss or from some other passive activity. The losses also cease to be suspended when the taxpayer disposes of the *entire* interest in the activity in a *fully taxable* transaction. Unlike the at-risk rules, with one exception, the passive loss rules do *not* depend on the **liability of the participants** of the organization. Instead, they are based on the taxpayer's **participation** in the activity. The statute provides that a limited partner is only considered to materially or actively participate to the extent provided in the regulations. However, the term "limited partner" is *not* defined in the statute. Therefore, it is necessary to determine what a limited partner is for purposes of the passive loss rules.

Temporary regulations issued in 1989 provided some additional guidance on this issue. Under these regulations, a limited partnership interest is an interest in a partnership which either:

- Is designated as a limited partnership interest in the certificate or limited partnership agreement, or

- Is an interest where the liability of such partner is limited to a fixed and determinable amount (such as contributions to capital or obligations to contribute to capital) under state law.

This definition appears to encompass all members of an LLC regardless of their degree of participation and differs from the definition used for classification purposes. But, if an LLC member is treated as a general partner, either as a result of being a manager or simply by participating in management as a member in a member-managed LLC, that member is **not** subject to the more restrictive rules applicable to limited partners. An individual LLC member is determined to **materially participate** in an activity during a taxable year if the member meets any **one** of the following tests:

1. The individual participates for **more than** *500 hours*.

2. The individual's participation in the activity **constitutes substantially all of the participation** in such activity by all of the participants (including nonmembers).

3. The individual participates in the activity for ***more than 100 hours*** and no other individual participates in the activity more than the individual.

4. The activity is a "significant participation activity" and the individual's aggregate participation in all significant participation activities **exceeds** *500 hours*.

5. The individual materially participated in the activity for **five of the preceding 10 taxable years**.

6. The activity is a ***service activity*** and the individual materially participated in **any three preceding years** (regardless of whether consecutive).

7. Based on the facts and circumstances, the individual participates on a **regular, continuous, and substantial basis**.

Comment: Limited partners have great difficulty materially participating. But LLC members, particularly member-managers probably should **not** automatically be considered limited partners. Even non-manager members should **not** be considered if they can meet the other tests of material participation, particularly the

500 hour test.[130]

☞Adverse Effect of Making PAL Grouping Elections

Careful thought should be given with regard to a real estate professional making a grouping election under the PAL rules so as to be able to materially participate in an underlying rental activity. Consider the case of a REP who also owns a number of rental properties, yet cannot prove that he meets at least one of the material participation tests on any one of the separate rental properties (e.g., 100 hours and *not* less than anyone else involved in the activity, let alone the 500-hour test). So, a grouping election is made to treat (on an "all-or-nothing basis") **all of these rental properties as just "one" activity** for purposes of the passive loss rules.

Furthermore, at the time that the election is made, assume that there are significant suspended losses as to some of the properties. In a subsequent tax year, and before these suspended losses are freed up (i.e., by having sufficient passive income to cover them), some of the "loss" properties are sold. And, in fact, given the current state of the economy, they are sold at a sizable loss. These losses would be reported on **Form 4797** as Sec. 1231 ordinary losses. But, since the taxpayer's "entire" interest in this passive activity (i.e., since it is comprised of **all of the rental properties** that the taxpayer owns) is *not* being sold in this transaction, the PAL "disposition" rule is *not* available and the suspended losses associated with the properties that were sold remain listed on the taxpayer's **Form 8582**.

Comment: The "moral of the story" is that, if a taxpayer foresees the disposition of some of the rental properties before sufficient passive income is available to free up any suspended passive losses associated with these properties, the grouping election should be delayed until after the sale (i.e., so the PAL "disposition rule" can be used to free up these losses, regardless if there is gain or loss on the sale).

Comment: A grouping election should also be delayed where, for instance, rental property is going to be sold at a gain, but a **Code §1031** LKE is going to be used. Then, any gain can avoided except to the extent that passive income is needed to free up current or suspended losses for the properties being sold, or for other suspended passive losses listed on **Form 8582**. And, if gain is needed to generate passive income, the exact amount can be generated simply by financing (to the extent needed) the purchase of the qualified replacement in the LKE instead of consuming all of the monies held in the qualified intermediary's escrow account.

Comment: Grouping elections for rental properties made by a real estate professional should maybe be avoided where there might be a minimal rental loss in the aggregate for such properties, but it is anticipated that significant rental income will be generated in the near future (and, it might as well be a passive source of income).

F. Issues Associated With Material Participation: As previously mentioned, it is very common for business owners to leave any real estate outside of the operating entity and rent the property back. Several issues arise from these scenarios.

1. To the extent that a particular owner materially participates in the underlying trade or business, any net rental income allocable to them (i.e., via the **Form 8825** and **Form 1065 K-1**) will be recharacterized as "nonpassive income" (even though any net rental loss is *automatically* passive under the normal rule with rental activities).

2. On the other hand, if a net rental loss is anticipated in a given year (e.g., due to a cost segregation study and the resulting catch-up depreciation), or on a continual basis (e.g., rental of airplanes where operating costs usually exceed any rental income), consideration should be given to making a **grouping election**. There, if the LLC which owns the rental real estate and the underlying entity to which the property is rented are own by the **same** individuals and in the **same** percentages (i.e., "identical ownership"), the rental activity can be grouped with the trade or business. The result is that just **one** activity (i.e., the trade or business) is considered to exist for tax purposes. And, it is one in which the owners are **materially participating**. Thus, it is **not** a passive activity. So, any net rental loss is **not** subject to the passive loss rules (i.e., without any need to look to the "real estate professional" exception). The bottom line is that this "grouping election" gives you the **same** result as if the rental property was instead listed on the company's balance sheet (thus eliminating the need to have any rental at all). And, since the owners are materially participating in the underlying trade or business, any deduction associated with the carrying of this property (along with any other operating deductions of the business) are deemed to be nonpassive.

3. Finally, assume an business owner (whether it involves a C or S corp, or an LLC) materially

[130] Gregg v. U.S., 186 F.Supp.2d 1123 (D. Or. 2001).

participates for a at least 5 years in the company's trade or businesses before finally retiring. Furthermore, assume that he also owns an interest in the LLC that holds title to the real property which has been leased to the business entity over the years. Therefore, he was subject to the passive loss "recharacterization rules." However, when he finally retires, he asks you whether any of his share of the net rental income from the LLC will ever be considered to be *passive* income. Well, given that he had materially participated for at least 5 of the years leading immediately up to his date of retirement, he would have to wait for 5 additional years (i.e., until the 6th year of his retirement) for the rents to be a source of passive income. And, if the trade or business had been a "service activity" in which he had materially participated (and that had occurred for at least any 3 years), the answer is that the rents would never be considered a source of passive income (including any gain on the ultimate sale of the rental property.

Example 8: "Effect of Guarantee on Member's Basis in a Passive Activity"

Allison contributes $10,000 cash in exchange for an LLC interest. At the end of the first tax year, the entity borrows $50,000 which is solely guaranteed by Allison. Under the basis rules, her initial basis is $60,000 ($10,000 cash contribution and $50,000 debt allocated under **Code §752(a)**). Therefore, the at-risk rules do *not* reduce this initial basis calculation since she is **personally at risk** for the repayment of the debt due to her guarantee. Nevertheless, if she is a mere investor and does **not** materially participate in the LLC's business operations, none of the initial losses, which might be incurred in the start-up years of the business, are deductible. Instead, she must wait until the LLC generates a business profit which flows through on her Schedule K-1 to offset any previously-denied partnership losses, or until she has sufficient passive income from other sources.

Comment: Any losses suspended under the passive loss rules are listed on **Form 8582**, **Passive Activity Loss Limitations**, until sufficient passive income exists to take them, or the partner has disposed of his **entire** partnership interest in a **fully-taxable** transaction.

☞Proposed Regs Will Focus on Participation Level to Determine If LLC Members Subject to PAL Rules (Prop. Reg. §1.469-5)

The IRS has issued proposed regs that would provide a new definition of a "limited partnership interest" for purposes of **Code §469(h)(2)**, which automatically treats "limited partnership interests" as passive interests for passive activity loss purposes except as regs provide otherwise. **(Code §469; PALs)**

Comment: The IRS has been insisting that an interest in a limited liability company (LLC) could be treated as a limited partnership interest for PAL purposes. While that is true, the final determination should hinge on whether the LLC member "materially participates" in the underlying activities of the LLC (unless the LLC only has rental activities which are normally treated *automatically* as passive activities, regardless of the level of owner participation). In other words, passive loss status cannot merely depend upon whether the LLC members otherwise have limited liability as to the entity's debts.

Comment: These regs merely respond to the string of cases where the IRS has unsuccessfully attempted to claim that LLC member interests were "limited partnership interests" for purposes of **Code §469(h)(2)**.

☞IRS Acquiesces in Result Only - LLC Member's Interest Not Automatically Passive (IRB 2010-14)

In an Action on Decision (AOD), the IRS has acquiesced, but in result only, with regard to the Court of Federal Claims' decision in ***Thompson v. U.S.*, 103 AFTR 2d ¶2009-5124 (Ct Fed Cl, 7/20/2009)**. **(Code §469; PALs)**

Comment: An acquiescence "in result only" means that the Service accepts the holding of the court in the case and that IRS will follow it in disposing of cases with the same controlling facts. Nevertheless, an acquiescence "in result only" indicates that the IRS disagrees with some or all of the reasoning in the original decision, but that it will *not* file an appeal in the case. The IRS also noted in the AOD that ***Thompson*** joined ***Garnett*, 132 TC No. 19 (6/302009)**, and ***Gregg v. U.S.*, 87 AFTR 2d 2001-337 (DC OR, 2000)**, as the *third* case to rule against the position that an interest in an LLC should *automatically* be treated the same as a limited partnership interest under **Reg. §1.469-5T(e)(3)(i)**.

Comment: The Service has actually lost on this issue in five separate court decisions. In addition to ***Thompson***, ***Garnett*** and ***Gregg***, the Tax Court also ruled against the IRS in ***Newell*, TC Memo 2010-23 (2/16/2010)** and in ***Hegarty*, TC Summary Opinion 2009-153 (10/6/2010)**.

☞Managing Member's LLC Interest Not Equivalent to "Limited Partnership Interest" for PAL Purposes (*Newell*, TC Memo 2010-23 (2/16/2010))

The Tax Court has once again rejected the IRS's position that a taxpayer's interest in a limited liability company (LLC) has to *automatically* be treated the same as a limited partnership interest for purposes of **Code §469(h)(2)** (i.e., which does generally treat *limited* partnership interests as passive interests for passive activity loss (PAL) purposes unless regs provide otherwise; that is, the limited partner actually meets one of the three cited tests for material participation). In this instance, the taxpayer, who acted as the day-to-day manager of the LLC's operations, "functioned just as a general partner would function in a limited partnership." As a result, the taxpayer's share of losses from the LLC was *not* subject to the PAL restrictions. **(Code §469; Passive Loss Rules)**

> **Comment:** It is a bit incredible that simply because an owner has limited liability protection, he should automatically be treated as passive (despite any examination as to whether he materially participates in the LLC's underlying trade or business activities). In fact, this is IRS's *fourth* straight defeat on this issue. In 2009, the Court of Federal Claims (***Thompson v. U.S.*, 103 AFTR 2d ¶2009-5124 (Ct Fed Cl, 7/20/2009)**), and the Tax Court (***Garnett*, 132 TC No. 19 (6/302009)**) both rejected the IRS's "expansive view of the limited partner restriction" in **Code §469(h)(2)**. The Tax Court also ruled against IRS in a TC Summary Opinion (i.e., which cannot be cited as precedent) (***Hegarty*, TC Summary Opinion 2009-153 (10/6/2009)**). One would think that this string of losses would lead the IRS to revise temporary regs that were issued in 1998 to address how the PAL rules apply to LLCs and their owners.

> **Comment:** When the IRS successfully labels someone as a "limited partner," these owners can only prove "material participation" for the PAL rules by meeting one of just *three* tests listed in **Temp. Reg. §1.469-5T(e)(2)** . However, in these various court decisions where the IRS stance was overturned, the taxpayer's LLC interest was found to be more akin to a "general partner" interest than a *limited* partner interest. As a result, the taxpayer was permitted to establish his "material participation" using any of the *seven* tests listed in **Temp. Reg. §1.469-5T(a)**.

☞**LLC Interest Not Automatically Equivalent to Limited Partnership Interest for Purposes of the Passive Loss Rules (*Thompson v. U.S.*, 103 AFTR 2d ¶2009-5124 (Ct Fed Cl, 7/20/2009))**

In a case of first impression for it, the Court of Federal Claims decisively rejected (i.e., turned aside a request for a summary judgment) the IRS's position that a taxpayer's ownership in a limited liability company (LLC) should automatically be treated as a limited partnership interest for purposes of the **Code §469** passive activity loss (PAL) rules. The Court concluded that the LLC was *not* technically a partnership under state law (even though this would be the default treatment for tax purposes under federal income tax law) and therefore could *not* be treated "as the equivalent of a limited partnership for PAL purposes." Moreover, it also indicated that the fact that is had the corporate characteristic of limited liability should *not* be "the determining factor" in deciding whether a taxpayer's interest in an activity is per se passive. Instead, the court felt that "Congress' primary concern was the level of involvement (i.e., whether there was material participation on the part of the taxpayer) in the activity."

> **Comment:** Coming immediately after a Tax Court decision earlier this month that interests in LLPs and LLCs "were *not* presumptively passive" under the PAL rules (***Garnett*, 132 TC No. 19 (6/302009)**), the new decision may lead the IRS to revise the temporary regulations that were issued in '98 to address how the PAL rules apply to LLCs.

> **Comment:** Although the Court of Federal Claims decision is a major victory for taxpayers, its applicability is somewhat limited in that it involved a taxpayer who was both a 99% direct owner in an LLC and its only manager. Nevertheless, the temporary regs only assert that a limited partner (i.e., in a limited partnership) is generally presumed to be passive for purposes of the **Code §469** rules.

> **Comment:** In certain states, it is *not* only the desire for limited liability protection that persuades the taxpayer to form an LLC to hold real estate. Sometimes, an LLC is more desirable from a state *income* tax prospective (e.g., PA). Moreover, a limited partnership (i.e., vs. an LLC) is sometimes formed with an SMLLC or S corporation (owned solely by the taxpayer) being the *general* partner, and the taxpayer also owning all of the limited partnership interests. And, the taxpayer is oftentimes the person who is running the business on a day-to-day basis. In such instances, it seems fairly clear that the taxpayer's limited partnership interest should *not* be automatically passive. In fact, given the level of involvement by the taxpayer in the business' underlying activities, the "material participation test" should be presumptively met in such circumstances.

Background: Under the **Code §469** passive activity rules, passive activity losses are *not* permitted to offset nonpassive activity income, such as wages, portfolio income, or profits from nonpassive activities. Passive activities include the conduct of trade or business activities in which the taxpayer does *not* "materially participate" and, generally, rental activities without regard to whether or not the taxpayer materially participates in them. (**Code §469(c), Reg. §1.469-1T(e)(1)**) Under **Code §469(h)(1)**, a taxpayer is considered to "materially participates" in an underlying trade or business activity only if he is involved in the activity's operations "on a regular, continuous, and substantial basis," which generally requires him to meet one of seven tests outlined in **Reg. §1.469-5T(a)** (e.g., the "500-hour" per year test). Meanwhile, under **Code §469(h)(2)**, a limited partner's interest in a limited partnership is *not* generally treated as an interest in an activity in which the taxpayer materially participates, "except to the extent provided in the regs." As a result, **Code §469(h)(2)** treats losses from an "interest in a limited partnership as a limited partner" as presumptively passive. Nevertheless, **Reg. §1.469-5T(e)(2)** provides that a limited partner can still be considered to "materially participate" in certain instances, but only if he meets one of three tests (i.e., instead of one the generally available seven tests). For these purposes, **Reg. §1.469-5T(e)(3)(i)** provides that a partnership interest is treated as a "limited partnership interest" if:

- the interest is designated a "limited partnership interest" in the limited partnership agreement or the certificate of limited partnership, without regard to whether the liability of the holder of the interest for obligations of the partnership is limited under the applicable state law; or

- the liability of the holder of the interest for obligations of the partnership is limited under the law of the state in which the partnership is organized to a fixed amount. For example, state law could limit the liability of the partner to the sum of the partner's capital contributions to the partnership and contractual obligations to make additional capital contributions to the partnership.

However, under **Reg. §1.469-5T(e)(3)(ii)**, a partnership interest will *not* be treated as a "limited partnership interest" for purposes of the passive loss rules if he is a *general* partner as well as a limited partner in the partnership during its tax year ending with or within the individual's tax year.

> **Comment:** In fact, this was the result in (***Garnett*, 132 TC No. 19 (6/302009)**) where the taxpayer was found to have *not* been holding their interests in limited liability partnerships (LLPs) and limited liability companies (LLCs) as "limited partners" for purposes of the special **Code §469(h)(2)** material participation provision under the PAL rules.

Facts: In 2002, James R. Thompson formed Mountain Air Charter, LLC under the laws of the State of Texas. He directly held a 99% member interest in Mountain Air and indirectly held the remaining 1% through JRT Holdings, Inc., an S corporation. Mountain Air's articles of organization designated Thompson as its only manager. Because Mountain Air did *not* elect to be treated as a corporation for federal tax purposes (i.e., on Form 8832 with a "check-the-box election"), it was treated by default as a partnership under **Reg. §301.7701-2(a)**. As a result, on both his 2002 and 2003 individual income tax returns, Thompson claimed Mountain Air's losses of $1,225,869 and $939,878, respectively. These losses exceeded his passive activity income. But, on audit, the IRS disallowed all of Thompson's claimed losses in 2002 and $783,878 of his claimed losses in 2003. Thompson paid the tax and interest but then filed for a refund, plus interest. Thompson and the IRS stipulated that if his LLC member interest in Mountain Air was deemed to be held as a *limited* partnership interest, then he could *not* demonstrate "material participation" in the LLC. On the other hand, if his interest was held *not* to be a *limited* partnership interest, then he can demonstrate "material participation" in the LLC (i.e., under any one of the seven material participation tests) and **Code §469** would therefore *not* limit his losses from being used against his active and portfolio income.

Federal Claims Decision: The Court of Federal Claims cited the following arguments in ruling for Thompson:

- **The LLC was *not* a partnership entity under state law:** This was in spite of the fact that the IRS contended that under **Reg. §1.469-5T(e)(3)(i)**, Thompson was a "limited partner" because he elected to have the LLC taxed as a partnership for *income* tax purposes and his liability was otherwise limited under state law. Instead, the Court countered that the reg applies, by its own terms, only if the ownership interest is in a business entity that is, in fact, a partnership entity under state law (i.e., *not* merely taxed as a partnership for *income* tax purposes under the Internal Revenue Code). Mountain Air was an LLC under Texas law, *not* a "limited partnership," so Thompson was a "member" of an LLC, *not* a "limited partner."

- **The taxpayer had dual roles as both a member and a manager:** The IRS had actually conceded to the Court that Thompson would be a *general* partner if Mountain Air were a "limited partnership." Nevertheless, the IRS "wanted to equate Thompson's interest in Mountain Air to that of a limited partner's interest in a limited partnership" for purposes of **Reg. §1.469-5T(e)(3)(i)**. Yet, at the same time, it also wanted to deny him the possible benefit of the "general partner exception" in **Reg. §1.469-5T(e)(3)(ii)**. As to this assertion, the Court rejected it as being "entirely self-serving and inconsistent."

- **Limited liability is *not* the determining feature of a limited partnership interest:** The IRS argued that when **Code §469** and **Reg. §1.469-5T** were promulgated, "there was universal agreement among the states that the sine qua non of a limited partnership interest was limited liability." However, the Court countered that when **Code §469** was enacted, "there was general agreement among state laws that a limited partner would lose his limited liability status if he participated in the control of the business." Put another way, "a limited partner's level of participation in the business dictated whether or not he enjoyed limited liability." But the court emphasized that the converse was *not* true. In fact, under the Uniform Limited Partnership Act (and its revisions), a limited partner who "takes part in the control of the business" becomes "liable as a general partner." As a result, the loss of limited liability under state law "likely deterred many limited partners from participating in the control of their businesses, but limited liability was *not* the sine qua non of a limited partnership interest." Furthermore, an analysis of the legislative history behind **Code §469** indicated that Congress "was primarily concerned with the taxpayer's involvement in the activity in question." The Court concluded that "had Congress wanted a test that turned on a taxpayer's level of liability, it would have so specified."

– Service's interpretation was contrary to the Code's direction: The IRS's interpretation of the Code "conflicted with its plain language." **Code §469(h)(2)** states that "except as provided in regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates." The purpose of Congress' grant of legislative reg authority "was to provide exceptions to (not expand upon) the Code's presumption that limited partners do *not* materially participate in their limited partnerships."

- An LLC is *not* substantially equivalent to a limited partnership: Unlike a limited partnership, an LLC allows all members to participate in the business while retaining limited liability. As a result, "it makes little sense to extend the Code's presumption about a limited partner's lack of participation in a limited partnership to Thompson and his LLC." Even if **Reg. §1.469-5T(e)(3)** could apply to Thompson and the Court had to categorize his membership interest as either a limited or a general partner's interest, "it would best be categorized it as a *general* partner's interest under **Reg. §1.469-5T(e)(3)(ii)**." Furthermore, "at best, the IRS identified an ambiguity in **Reg. §1.469-5T(e)(3)(ii)** as it applies to LLCs." However, the Court "should decide such ambiguities in favor of the taxpayer." **(Code §469; Passive Loss Rules)**

Comment: The bottom line was that Thompson was permitted to demonstrate his material participation in Mountain Air using any of the seven tests listed in **Reg. §1.469-5T(a)** (i.e., instead of just three of them). And, as a result, the Court decreed that **Code §469** did *not* limit Thompson's share of Mountain Air's losses, and directed the IRS to refund $781,241 to him for the 2002 and 2003 tax years, plus interest.

G. Sec. 461(l) "Excess Business Loss Rule" Starting in 2021: The **TCJA** added **Code §461(l)** that limits an individual to deducting no more than an inflation-adjusted $250,000 ($500,000 for MFJ filers) in net business losses in a year. Amounts in excess of that limit must be carried forward as NOLs. Originally the provision was scheduled to expire for years beginning *on or after* January 1, 2026. **ARPA** extends this rule for *one additional year*. So now it will cease to apply for years beginning *on or after* January 1, 2027.

- Review of Code §461(l) Now Applicable to 2021:

Modification of Limitation on "Excess Business Losses" for Noncorporate Taxpayers: Previously, **Code §461(l)(1)** disallowed the deduction of "excess business losses" by noncorporate taxpayers (i.e., an individual on Form 1040) for tax years beginning *after* Dec. 31, 2017 and ending *before* Jan. 1, 2026 (**now, 2027**). Generally, **Code §461(l)(3)(A)** provided that an "excess business loss" is the excess of the:

1. Taxpayer's aggregate trade or business *deductions* for the tax year over

2. The sum of the taxpayer's aggregate trade or business *gross income or gain* plus $250,000 (as adjusted for inflation), or $500,000 in the case of a joint return.

Example: "Sec. 461(l) Limit on Excess Business Deductions"
A single taxpayer has $300,000 of interest and dividends, $500,000 ordinary loss (e.g., K-1, Box 1 T/B loss) from a partnership and $100,000 of ordinary income (e.g., K-1, Box 1 T/B income) from an S corp with material participation in both business activities. Under *pre-TCJA* rules, this would result in a $100,000 taxable loss for the taxpayer ($300,000 - $500,000 + $100,000). But, under the *new* rules, the two "business interests" are first combined to get an overall loss of $400,000, which is then limited to $250,000 under the **Code §461(l)** EBL limitations which can be used to offset the $300,000 of nonbusiness (i.e., dividend and interest) income for a net positive income of $50,000. This calculation of the EBL would be included on the individual tax return **Form 461, Limitation on Business Losses**, which would be attached to the taxpayer's **Form 1040**. The disallowed $150,000 loss which is the excess of the $400,000 of business and other income over the new limitation $250,000 for a single taxpayer in this example is *not* permanently lost but is instead carried forward as a net operating loss (NOL).

- New law: The **CARES Act** temporarily modifies the loss limitation for noncorporate taxpayers so they can deduct "excess business losses" arising in 2018, 2019, and 2020. (**Code §461(l)(1)**) In essence, the **CARES Act** postpones the effective date for **Code §461(l)** excess business losses *retroactively* from tax years beginning *after* December 31, 2017, to tax years beginning *after* December 31, 2020.

Comment: For purposes of the Sec. 199A deduction, any "excess business deductions" (EBLs) remaining *after* application of **Code §461(l)** under the "old" law would have offset a taxpayer's "qualified business income" (QBI), if any, in the subsequent tax year. Now, at least for 2018, 2019 and 2020, this will *not* be the case. In fact, for any taxpayers impacted by the "excess loss limitation" for 2018 should now considered filing an amended tax return.

Example: Using the facts from the **Example** above (assuming it was the 2018 tax year), there would now be no "excess business deduction" carryover of $150,000 which would have reduced reduce QBI, if any, that the taxpayer had in 2019 or 2020 (but to the extent any NOL carryover remaining, it would reduce QBI starting in the 2021 tax year).

H. Capital Accounts: The procedures for maintaining the book accounts are similar to the adjustments made for tax basis accounts on **Schedules L, M-1** and **M-2** of **Form 1065**, except the FMV of assets is used. A partner's book capital account is **increased by**:

1. Any money contributed to the partnership;

2. The FMV of any property contributed to the partnership; and

3. Allocation of income and gain to the partnership, including tax-exempt income and gain, and certain adjustments to the capital account of the partnership, such as at the time of transfer of a partnership interest.

A partner's book capital account is **decreased by**:

1. Money distributed to the partner from the partnership accounts,

2. The FMV of any property distributed to the partner,

3. The allocation of expenditures not deductible from taxable income[131], and

4. Allocations of partnership loss and deductions.[132]

Similar to tax basis adjustments for liabilities for a partnership interest, liabilities assumed by a partner from the partnership are **treated the same as money contributed** to the partnership.

A key reason for requiring these FMV capital accounts is that if the partnership agreement does **not** provide for any special allocations of income, gain, loss, depreciation or other deductions, they are shared among the partners according to the **percentage share of their FMV capital accounts**. Likewise, in a liquidation of the partnership, the distributions are **required to be made according to the positive capital account balances** of the partners.

The regulations include 19 examples with numerous variations to illustrate the application of these provisions.[133]

For most small business partnerships, it may be significant to recognize that the regulations provide a refutable presumption that all partner's interests in the partnership are equal, determined on a per capita basis.[134] This may be the assumed sharing and capital interests understanding in the partnership arrangement anyway, therefore doing away with the necessity of worrying about the **Code §704(b)** regulations.

☞**Otherwise Reimbursable Expenses Not Deductible by Partner on Schedule E (*McLauchlan v. Commr.*, 113 AFTR 2d 2014-XXXX (5th Cir., 3/6/2014))**

The 5th Circuit confirmed that a law firm partner should *not* be permitted to deduct business expenses that were otherwise reimbursable by the firm. The partnership agreement specifically stated that expenses incurred for "business meals, automobiles, travel and entertainment, conventions, continuing legal education seminars and professional

131 IRC §705

132 Treas. Reg. §1.704-1(b)(2)(I)(b)

133 Treas. Reg. §1.704-1(b)(5)

134 Treas. Reg. §1.704-1(b)(3)(I)

organizations" would be borne by the partner unless reimbursement was approved by the managing partner. Additional expenses that taxpayer "chose to incur," such as for advertising, home office, or supplies, were *not* deductible as “partnership expenses.” Because all of the claimed expenses in this instance were potentially reimbursable by the partnership, or were *not* partnership expenses that taxpayer was required to incur, the 5th Circuit *affirmed* the Tax Court's disallowance. To conclude otherwise "would allow a taxpayer to convert an expense of the partnership into one of his own simply by failing to seek reimbursement." **(Code §162; Partnership Expenses)**

Notes:

CHAPTER XI: TAKING A K-1 LOSS ON PAGE TWO OF SCHEDULE E

A. The Critical "Four Steps:" To determine whether a Schedule K-1 loss is deductible on page two of Schedule E, these three steps must be applied in following order:

Step 1: Determine the member's **basis** in his ownership interest.

Step 2: Ascertain what amount, if any, of this initial basis amount is considered **at risk**.

Step 3: Determine whether the **passive loss rules** apply, and limit the loss to any passive income if the owner does **not** materially participate in the underlying trade or business of the LLC.

Step 4: Determine if "excess business loss deduction" limit under **Code §461(l)** applies

Comment: As previously mentioned, **"Step 2"** is an evaluation of the risk the owner might actually bear for his share of LLC liabilities allocated in **"Step 1"** (under **Code §752(a)**). **"Step 4"** is a new consideration for tax years beginning in 2021.

Comment: Certain exceptions, such as the "active rental real estate exception," or the "disposition rule" might allow excess passive losses to be deducted.

Example 1: "Keeping Track of Suspended Losses"

Ben contributes $10,000 cash to an LLC and receives a 50% interest in return. At the end of the first tax year, the LLC borrows $60,000 to purchase equipment without any of the members guaranteeing the debt. But, Ben lends $40,000 to the LLC personally (and, this debt is *not* guaranteed by any of the other partners), but does **not** otherwise materially participate in the business operations. The LLC incurs a loss for its first tax year. Ben's distributive share of the loss is $50,000.

Comment: Since the losses discussed below do not exceed the applicable $250,000/500,000 thresholds, the **Code §461(l)** "excess business loss deduction" rules do *not* come into play.

Question 1A - Step 1: What is Ben's basis, assuming no distributions are made during the year?

Answer 1A: Ben's initial basis of $80,000 is calculated as follows: $10,000 cash contributed + $40,000 personal loan to LLC + $30,000 allocable share of the LLC's nonrecourse debt.

Given the loss of $50,000 on the member's Schedule K-1, Ben's $80,000 basis is sufficient to deduct the entire loss, subject to at-risk and passive-loss limitations.

Question 1B - Step 2: What part of his basis is considered at risk?

Answer 1B: Of Ben's $80,000 basis (from **Step 1**), only $50,000 is considered at risk for purposes of **Step 2**. This is because Ben bears no economic risk of loss for his share of the LLC's nonrecourse debt of $30,000. In other words, if the LLC fails to pay this portion of the debt, Ben will never be personally liable for its repayment.

Comment: Ben's $40,000 personal loan to the LLC is considered at risk because he personally advanced these funds to the LLC. And, since $50,000 of Ben's initial basis of $80,000 is considered at risk, all of the $50,000 K-1 loss is deductible even after applying **Step 2**.

Question 1C - Step 3: How do the passive loss rules limit the deduction of this $50,000 loss on Ben's Schedule E, page 2 if he has no other sources of passive income?

Answer 1C: Since Ben does **not** have any passive income, none of the $50,000 loss can be deducted on Schedule E, page 2. Instead, this $50,000 is suspended and listed on the Form 8582 worksheet.

Example 2: "Keeping Track of Suspended Losses"

Use the same facts as **Example 1** except the LLC incurs a $200,000 loss for its first tax year, with Ben's distributive share of the loss being $100,000. Furthermore, assume that Ben has $30,000 of passive income from other sources.

Question 2A: What is Ben's basis assuming no distributions were made during the year?

Answer 2A: Ben's basis is $80,000 under **Step 1** (i.e., the *same* as in **Example 1**). Therefore, $20,000 of the total $100,000 K-1 loss is suspended due to the lack of basis.

Question 2B: What part of this basis is considered at risk?

Answer 2B: Ben's at-risk basis in **Step 2** is again $50,000. Therefore, $30,000 of the total $80,000 loss allowed in **Step 1** is suspended under the at-risk rules.

Question 2C: How do the passive loss rules limit the deduction of this $100,000 loss on Ben's Schedule E, page 2 given he has $30,000 of passive income from other sources?

Answer 2C: Since Ben has $30,000 of passive income, $30,000 of the total $50,000 loss allowed from **Step 2** (under the at-risk rules) is allowed and listed on Schedule E, page 2. The remaining $20,000 loss suspended due to the lack of passive income is listed on the **Form 8582** worksheet.

Example 3: "Taking Suspended Losses in Subsequent Tax Year"

From **Example 2**, $70,000 of the first year $100,000 loss is suspended (i.e., $20,000 due to the lack of basis, $30,000 under the at-risk rules and $20,000 due to the lack of passive income) with only $30,000 of the original $100,000 ultimately being allowed as a deduction on page 2 of Schedule E. In the second year of its operation, the LLC is successful and reports an allocable share of trade or business income on Ben's Schedule K-1 of $50,000. However, assume that Ben continues to hold this interest strictly as an investment and does **not** materially participate in the LLC business. He has no other sources of passive income in the second year and there was no change in the LLC debt, nor were there any distributions made.

Question 3A: What is the effect of this LLC income on Ben's basis?

Answer 3A: The three steps are applied as follows:

Step 1: Ben's basis of zero from Year 1 is now increased to $50,000.

Step 2: Since this source of basis was from Ben's share of LLC income, and **not** from his share of LLC debt, (i.e., under Code §752(a)) it need *not* be tested for purposes of the at-risk rules.

Comment: Sometimes this type of basis is referred to as **"hard basis."** The same is true of basis derived from capital contributions of either cash or property. On the other hand, basis derived from a share of LLC debt is referred to as **"soft basis"** and must always be tested under the at-risk rules.

Step 3: This $50,000 of K-1 income is also considered passive income.

Question 3B: Are any of the suspended losses from Year 1 freed up and now available to report on Ben's Schedule E, page 2 in this second tax year?

Answer 3B: Yes. Ben is now able to deduct $50,000 of suspended losses from Year 1, computed as follows:

Step 1: Since Ben now has $50,000 of basis in his LLC interest, the $20,000 of suspended loss from Year 1 (due to lack of basis) is allowed as follows:

Basis at beginning of Year 2	$ -0-
Share of Year 2 LLC income	50,000
Basis at end of Year 2	$50,000
Year 1 loss suspended due to lack of basis	(20,000)
Final Step 1 basis at end of Year 2	$30,000

Step 2: Since the $50,000 basis increase is due to Ben's allocable share of LLC income (and **not** due to a change in his share of LLC debt), all of this increase is considered at risk. Therefore, Ben's at-risk basis of zero at the beginning of Year 2 increases by $50,000. This results in **all** of the at-risk suspended loss of $30,000 from Year 1 being allowed as follows:

At-risk basis at beginning of Year 2	$ -0-
Increase to at-risk basis due to Ben's share of Year 2 LLC income	50,000
Basis at end of Year 2	$50,000
Year 1 loss suspended due to zero at-risk basis	(30,000)
Final Step 2 at-risk basis at end of Year 2	$20,000

Step 3: Even though Ben's share of LLC income is also considered passive, this $50,000 would **not** free up any of the $20,000 suspended passive loss from Year 1 since **all** the $50,000 income from Year 2 was already absorbed by the suspended *basis* loss of $20,000 and suspended **at-risk** loss of $30,000. Therefore, this remaining $20,000 suspended passive loss continues to be shown on the Form 8582 passive loss worksheets, as follows:

Suspended loss at end of Year 1 (on Form 8582)	$20,000
LLC income available from Year 2	-0-
Passive loss still suspended at end of Year 2	$20,000

To summarize, since Ben received an allocable share of LLC income in Year 2 equal to $50,000, he is now able to take $50,000 of the $70,000 loss suspended from Year 1. He shows this as a separate item on Schedule E, page 2, line 28 (i.e., he would list this year's income of $50,000 on line 28A. and, on the next line 28B., last year's carryover loss of ($50,000)). Also, Ben must also check "yes" for the box on line 27 since he is taking a loss suspended from a prior tax year. The remainder of the suspended $20,000 loss from Year 1 continues to be shown on the Form 8582 passive loss worksheets and is carried over to Year 3.

Example 4: "Effect of Distribution on Basis in Break Even Year"

Assume that Ben has $80,000 of basis, $50,000 of which is considered at-risk. However, he has no sources of passive income and does **not** materially participate in the LLC. His allocable share of the LLC's loss is $100,000. Once again, $20,000 of the loss is suspended due to the lack of **Step 1** basis ($100,000 – $80,000). Of the $80,000 loss allowed in **Step 1**, $30,000 is suspended due to the lack of sufficient **Step 2** at-risk basis ($80,000 – $50,000). None of the $50,000 is allowed under the **Step 3** passive loss rules because Ben has no other sources of passive income. But, of the $100,000 LLC loss shown on Ben's Schedule K-1, **none** of it is allowed on Schedule E, page 2. Nevertheless, Ben's **Step 1** basis is zero at the end of the first tax year. Now, in Year 2, when the LLC broke even, assume that he receives a $25,000 distribution.

Question 4A: Would the distribution be taxable if the LLC reports no income in Year 2?

Answer 4A: Even though none of the Year 1 $100,000 Schedule K-1 loss was allowed after applying the "three steps," Ben's original basis of $80,000 as of the beginning of Year 1 basis was fully reduced to zero. Therefore, the **entire** $25,000 distribution is taxed. This occurs because the Year 1 loss is considered to have absorbed Ben's entire $80,000 **Step 1** basis (which is the key when testing the taxation of a distribution). Furthermore, the LLC reported no income in Year 2 (which would have been added to Ben's basis first, had any profit occurred as seen in **Question 4B** below).

Question 4B: How does the answer change if the LLC is profitable for Year 2 and Ben's K-1 share is $10,000?

Answer 4B: Ben's zero basis from Year 1 is first increased to $10,000 due to his share of the LLC's income reported to him on his Schedule K-1.

As a result, only $15,000 of the total $25,000 distribution is taxed as follows:

Basis at end of Year 1	$ -0-
K-1 profit for Year 2	10,000
Available basis for distribution	$ 10,000
Less distribution	(25,000)
Excess distribution (taxable in Year 2)	($15,000)

Comment: The most critical point to understand and appreciate regarding the above example is that even through Ben received absolutely no tax benefit from the $100,000 Schedule K-1 loss in Year 1 (because the loss suspension rules limited any of the loss from being deducted currently), his basis going into Year 2 is still zero. And, it is the **Step 1** basis in a member's ownership interest that is used to measure possible taxation of a distribution made during the tax year.

Example 5: "Effect of Distributions on Basis in Profitable Years"

Use the **same** facts as **Example 4** with Ben's basis being zero at the end of the Year 1. Assume that he receives a $25,000 distribution during March of Year 2.

Question: How would the distribution be taxed if Ben's share of the LLC profit in Year 2 was $50,000?

Answer: Although Ben technically has a zero basis in March of Year 2 when he actually receives the cash distribution, he can anticipate the restoration of sufficient basis by the end of the tax year to cover this amount. This is due to his share of the anticipated LLC profit.

Consequently, his **Step 1** basis is first increased from zero to $50,000. Then, it is reduced by the $25,000 distribution taken earlier in the year.

The remaining $25,000 of this net **Step 1** basis increase in Year 2 is then available to use the $20,000 suspended loss carried over from Year 1 due to the lack of sufficient **Step 1** basis. And, given that the remaining $25,000 basis is due to K-1 profit, it is considered at-risk (i.e., it is "hard" basis). As a result, $5,000 of the total $30,000 suspended loss due to the lack of **Step 2** at-risk basis from Year 1 is available. Nevertheless, since all the $25,000 is absorbed by these first two steps, *none* of the $20,000 suspended passive loss from Year 1 is allowed. Consequently, it continues to be listed on Form 8582 and is carried over to Year 3.

Basis at end of Year 1	$ -0-
K-1 profit for Year 2	50,000
Available basis for distribution	$50,000
Distribution	(25,000)
Basis at end of Year 2	$25,000*
Taxable portion of distribution in Year 2	$ -0-

*Note: Used to absorb $25,000 of the suspended loss from Year 1.

Example 6: "Distributions Not Limited to At-Risk Basis"

Larry's basis is zero at the beginning of the tax year. During March, he takes a $50,000 cash distribution. At the end of that tax year, Larry's distributive share of partnership income is $25,000. The partnership also has a nonrecourse liability on its books (other than "qualified real property indebtedness") for which Larry is allocated $30,000 as an increase to his basis.

Question: Will any of the cash distribution made earlier in the year be taxable to Larry?

Answer: Larry's basis is first increased by his distributive share of partnership income for the tax year, in addition to his share of debt as permitted under **Code §752(a)**. Therefore, Larry's basis goes from zero to $55,000 ($25,000 + $30,000) as of December 31. This level of **Step 1** basis is then used to determine if sufficient basis exists to cover the $50,000 distributed earlier in the year.

With $55,000 of basis, there is enough to cover the partnership's $50,000 cash distribution to Larry. It is important to note that the test for possible taxation is **not** based on the partner's **Step 2 at-risk** basis (which is only $25,000). In other words, a partner's basis for purposes of determining the possible taxation of a distribution is determined *before* the application of the at-risk rules.

> **Comment:** The at-risk rules do **not** affect the tax basis of a partner's interest, or the amount of gain or loss realized if he sells his interest. Instead, these at-risk rules merely serve to limit the amount of K-1 loss that may be deducted by a partner in a particular tax year.

☞**New IRS Audit Effort Focuses on Partnership Loss Limitation Rules**

The IRS Large Business and International (LB&I) Division recently announced that it has added a new "**compliance campaign**" which addresses the tax basis limitations that apply to the amount of partnership losses (or, deductions such as Sec. 179 immediate expensing) that can be claimed by its partners. The **Code §704(d)** limitations which "are the main focus of this campaign" state that a partner's distributive share of partnership loss will be allowed only to the extent of the partner's adjusted basis in his partnership interest at the end of the partnership year in which the loss occurred. If the partner's share of losses exceeds this amount, the excess amount is suspended and may be carried over for use in another tax year in which the partner has basis available. The IRS has said that "partnership compliance is a priority and that the agency is stepping up enforcement." (**Code §704; K-1 Losses)**

Comment: Starting with the 2022 tax year, there are basically four distinct barriers to taking a flowthrough loss from a partnership return. They are applied in the following order: (1) Adjusted basis of the partner's interest; (2) How much of that adjusted basis is considered to be at-risk (i.e., pursuant to **Code §465** as shown on **Form 6198**); (3) Is the loss (or, deduction such as Sec. 179 immediate expensing) subject to the passive loss (PAL) rules under **Code §469**, and (4) Does the loss represent an "excess business deduction under **Code §461(l)** $250,000/500,000 limits. If a capital loss is being passed through on the K-1, then it might also be subject to the overall cap of $3,000 annually.

Comment: The S corporation equivalent of this increased focus by the IRS on properly claiming K-1 losses or deductions flowing through from a partnership, is the current requirement on page two of **Schedule E, Part II** where a separate "basis statement" (i.e., on **Form 7203**) needs to be provided if (1) a K-1 loss is being claimed; (2) the shareholder is receiving a distribution; (3) the shareholder is disposing of their stock; or (4) the shareholder is receiving a loan repayment from the S corporation. **(Code §704; Partnership Losses)**

☞Recent Case Highlights Inappropriate Claiming of Partnership Losses (*Kohout*, TC Memo. 2022-37 (4/18/2022))

An individual owned 1% of a partnership with the other 99% being owned by an S corporation, which was wholly owned by the same individual. The partnership incurred $132,000 in losses for the year, and this individual partner claimed that both he and the S corporation should be allowed to deduct their pro rata share of the partnership's losses. But because neither he nor the S corporation could prove their adjusted basis in their partnership interests, the Tax Court agreed with the IRS and disallowed the pass-through losses.

Partner's Adjusted Basis in Partnership Interest: Generally, under **Code §704(d)**, a partner is permitted to deduct their share of a partnership's loss for a taxable year only to the extent of the adjusted basis of their partnership interest calculated as of the end of the tax year. Under **Code §§705(a)(1)** and **722**, a partner's "outside basis" is *increased* in part by the partner's distributive share of income and the partner's contributions to the partnership. Meanwhile, under **Code §752(a)**, any increase in a partner's share of liabilities or assumption of partnership liabilities also increases the partner's outside basis. On the other hand, under **Code §§705(a)(2)** and **733**, a partner's basis is then *decreased* by the partner's distributive share of partnership losses, nondeductible expenses, and distributions.

Deducting K-1 Losses: If the partner cannot establish their adjusted basis in their partnership interest, then they are barred from currently deducting any partnership losses. (See **Code §704(d)**; ***Sennett v. Commr.*, 80 T.C. 825, 829–30 (1983), *aff'd*, 752 F.2d 428 (9th Cir., 1985)**. Furthermore, "proof of basis is a specific fact which the taxpayer has the burden of proving." (See ***O'Neill v. Commr.*, 271 F.2d 44, 50 (9th Cir. 1959), *aff'g* T.C. Memo. 1957-193**; see also ***Powers v. Commr.*, T.C. Memo. 2013-134**) **(Code §704(d); K-1 Losses)**

☞Partnerships Allowed to File Electronic Schedules K-1 (Rev. Proc. 2012-17)

Partnerships will now be able to provide **Schedule K-1, Partner's Share of Current Year Income, Deductions, Credits, and Other Items** electronically to partners. And, the IRS is providing this guidance, which is effective Mar. 5, 2012, which addresses how the required consent from the partners can also be provided electronically (including secure e-mail and through the partnership's internet page) and how partners are to be informed about changes in software. It also defines how the partnership is to provide instructions about accessing and printing electronic statements and the partnership's responsibility if the K-1 is electronically undeliverable.

Background: Partnerships generally must file Form 1065 to report their income and deductions. (**Code §6031(a), Code §6031(e), Reg. §1.6031(a)-1(a)**) And, every partnership required to file a return must furnish Schedule K-1, containing information from the return to every person who was a partner (or, who held a partnership interest as a nominee for another person) at *any* time during the partnership's tax year. The Schedule K-1 has to also indicate whether a partner contributed "built-in gain or loss property" during the tax year (i.e., as covered by **Code §704(c)(2)**). (**Code §6031(b), Reg. §1.6031(b)-1T(a)**)

Electronic K-1s: Rev. Proc. 2012-17, provides that a person required by **Code §6031(b)** to furnish a written statement on Schedule K-1 (i.e., furnisher) to the person to whom it is required to be furnished (i.e., recipient), may furnish the Schedule K-1 in an electronic format instead of paper. A furnisher who meets the requirements of **Rev. Proc. 2012-17, §4**, through **Rev. Proc. 2012-17, §10**, will be treated as furnishing the Schedule K-1 in a timely manner. However, a furnisher that fails to comply with the requirements of **Rev. Proc. 2012-17**, may be deemed to have failed to furnish the Schedule K-1 to the recipient, and **Code §6722** penalties for failure to furnish correct payee statements may apply. In general, the recipient must have *affirmatively consented* to receive the Schedule K-1 in an electronic format. The consent may be made electronically "in any manner that reasonably demonstrates that the recipient can access the Schedule K-1 in the electronic format in which it will be furnished to the recipient." Alternatively, the consent may be made in a paper document if the consent is confirmed electronically by the recipient and that consent reasonably demonstrates that the recipient can access the Schedule K-1 in the electronic format in which it will be furnished to the recipient.

Comment: A new consent is *not* required if a partnership undergoes a "technical termination" (i.e., there has been a sale or exchange of 50% or more of the partnership's interests within a 12-month period) under **Code §708(b)(1)(B)**.

On the other hand, **Rev. Proc. 2012-17** provides that the consent requirement will *not* be satisfied if the recipient withdraws the consent and the withdrawal takes effect *before* the statement is furnished. The furnisher may provide that a consent withdrawal takes effect either on the date it is received by the furnisher or on a subsequent date determined by the furnisher and communicated to the recipient "within a reasonable period of time after the furnisher receives the withdrawal."

Comment: The furnisher may also provide instead that a request for a *paper* statement will be treated as a withdrawal of consent.

If a change in hardware or software required to access the Schedule K-1 "creates a material risk" that the recipient will *not* be able to access the Schedule K-1, the furnisher must, before changing the hardware or software, provide the recipient with a notice. The notice must describe the revised hardware and software required to access the Schedule K-1 and inform the recipient that a new consent to receive the Schedule K-1 in the revised electronic format must be provided to the furnisher. And, after changing the revised hardware and software, the furnisher must obtain from the recipient, in the manner described in **Rev. Proc. 2012-17, §4.01**, a *new* consent or confirmation of consent to receive the Schedule K-1 electronically.

Disclosure Statements: Rev. Proc. 2012-17 provides that before or at the time of, a recipient's consent, the furnisher must provide to the recipient "a clear and conspicuous disclosure statement" containing specified disclosures described in **Rev. Proc. 2012-17, §5.02**, through **Rev. Proc. 2012-17, §5.08**. The statement may be electronic or on paper and must provide instructions on how to access and print the statement. In these statements, the furnisher must inform the recipient:

- That the Schedule K-1 will be furnished on paper if the recipient does *not* consent to receive it electronically;

- Of the scope and duration of the consent;

- Of any procedure for obtaining a paper copy of the recipient's statement after providing consent and whether a request for a paper statement will be treated as a withdrawal of consent;

- That the recipient may withdraw consent by writing (electronically or on paper) and how to do so;

- That the furnisher may provide that a withdrawal of consent takes effect either on the date it is received or a later date;

- That the furnisher will confirm the withdrawal and its effective date (either electronically or on paper);

- That a withdrawal of consent does *not* apply to a statement that was furnished electronically in the manner described in **Rev. Proc. 2012-17** before the date on which the withdrawal of consent takes effect;

- Of the conditions under which a furnisher will cease furnishing statements electronically to the recipient (e.g., the recipient's withdrawal from the partnership);

- Of the procedures for updating the information needed by the furnisher to contact the recipient;

- Of the hardware and software required to access, print, and retain the Schedule K-1, and

- The date when the Schedule K-1 will no longer be available on the website. **(Code §6301; Schedule K-1)**

Notes:

CHAPTER XII: DISTRIBUTIONS FROM AN LLC

A. Introduction: LLC distributions are classified as either **current** or **liquidating**. A distribution that does **not** liquidate a member's **entire** interest is a **current** distribution.[135] The liquidation of a member's **entire** interest means the termination of a member's LLC interest through a distribution or a series of distributions to the member by the LLC.[136]

B. Current Distributions: When only a few assets are distributed from an LLC and the members' respective ownership percentages are **not** altered by the distribution, few problems arise. Money and marketable securities can be withdrawn with no recognition of gain or loss to the extent that the money or FMV of the securities distributed **do not** exceed the member's adjusted basis in the LLC.[137] If any other assets (aside from cash or securities) are distributed, the member's adjusted basis in the LLC is reduced in an amount **equal to the adjusted basis of the asset to the LLC**. The basis of the assets distributed to the member is the adjusted basis of the assets in the LLC.[138] However, the basis may **not** exceed the adjusted basis of the asset in the LLC nor may it exceed the **outside basis** in the member interest **after the reduction for cash and marketable securities received**.

Example 1: "Current Distribution of Partnership Property"
Chris wants a piece of LLC equipment distributed to him. Its FMV is $4,000 and it has an adjusted basis of $800. Chris' tax basis in the LLC is $100,000 and his book (FMV) basis is $120,000. There is no gain or loss on the transaction. The adjusted basis of Chris' LLC interest after the distribution is $99,200 ($100,000 – $800) and his FMV capital account is reduced by $4,000.

Capital Account

	Inside Basis	FMV
Beginning balance:	$100,000	$120,000
Basis of equipment:	(800)	
FMV of equipment:		(4,000)
Ending balance:	$ 99,200	$116,000

Question 1A: What is the tax basis and capital account reduction if the equipment was **fully depreciated**?

Answer 1A: The FMV of the capital account is $116,000, but the tax basis remains at $100,000.

Question 1B: Chris, in **Example 1**, wants another piece of equipment distributed to him. It has an FMV of $15,000, with an original cost of $35,000. The tax basis to the LLC is $10,000. What are the tax implications to Chris and the LLC?

Answer 1B: Chris reduces the basis of his partnership interest in the LLC by $10,000, because he has at least $10,000 of basis. But, if his basis is less than $10,000, his basis after the distribution is $0. His basis in the distributed property is the **lesser** of its basis in the LLC, or his outside basis in the LLC.

If depreciable property is distributed to a member, the member continues the cost-recovery method and life as established on the LLC books (i.e., "shoes" depreciation), provided the adjusted basis is the **same** as on the LLC books.[139] When **Code §§1245** or **1250** recapture is associated with the depreciable asset, other members are taxed on their share of the depreciation recapture assumed by the member to which it was distributed.

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[135] Treas. Reg. §1.761-1(d)

[136] IRC §761(d)

[137] IRC §731(a)(1)

[138] IRC §732(a)(2)

[139] IRC §168(i)(7)

A contributing member generally is treated as recognizing gain or loss from the sale of property if the contributed property is distributed by the LLC to a member other than the contributing member within five years.[140] This is effective for property contributed to an LLC **after October 3, 1989**. The 5-year rule for contributed property also applies to any contributing member's successor. The 5-year rule was **extended to seven years** for property contributed **after June 8, 1997**.

Example 2: "Distribution of LLC Property to Other Than Contributing Member"
In 20x1, Member A contributed an asset to an LLC with a basis of $1,000 and an FMV of $1,500. In 20x2 (i.e., within 7 years of the original contribution), the LLC distributed the asset to Member B. Member A reports a $500 gain on his personal return, and has a $500 increase in basis of his LLC interest. Member B now has an asset with a FMV basis of $1,500 and a $1,500 reduction in the basis of his LLC interest. This rule is designed to prevent shifting of income from one member to another.

C. Liquidating Distributions

1. Proportionate Distribution of All Assets: If the LLC is terminated through a **proportionate distribution** of LLC assets, there is **no recognition of gain or loss** to the members as long as the distributed money or marketable securities do **not** exceed the members' outside bases in the LLC.[141] The members' bases is allocated to the assets received; first to cash and then to any unrealized receivables and inventory items (i.e., **Code §751** property).[142] These are often referred to as "hot assets." Any balance is prorated among any other properties received **in proportion to their inside bases** on the LLC books. Any depreciation recapture responsibilities then flow through to the respective member who is receiving the property.[143] For distributions after August 5, 1997, a more complex procedure was enacted to allocate any balance remaining after the allocation to money and **Code §751** property.[144]

Code §732(c) states:

IRC §732(c) ALLOCATION OF BASIS-

(1) IN GENERAL — The basis of distributed properties to which subsection (a)(2) or (b) is applicable shall be allocated —

(A) (i) first to any unrealized receivables (as defined in section 751 (c)) and inventory items (as defined in section 751(d)) in an amount equal to the adjusted basis of each such property to the partnership, and

(ii) if the basis to be allocated is less than the sum of the adjusted bases of such properties to the partnership, then, to the extent any decrease is required in order to have the adjusted bases of such properties equal the basis to be allocated, in the manner provided in paragraph (3), and

(B) to the extent of any basis remaining after the allocation under subparagraph (A), to other distributed properties —
(i) first by assigning to each such other property such other property's adjusted basis to the partnership, and

(ii) then, to the extent any increase or decrease in basis is required in order to have the adjusted bases of such other distributed properties equal such remaining basis, in the manner provided in paragraph (2) or

(3), whichever is appropriate.

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140 Treas. Reg. §1.704-1(c)(1)(B)

141 IRC §731(a)(1)

142 IRC §732(c)(1)

143 Treas. Reg. §1.1245-1(e)(2)(ii)(B)

144 IRC §732(c)

(2) METHOD OF ALLOCATING INCREASE — Any increase required under paragraph(1)(B) shall be allocated among the properties—

> *(A) first to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation before such increase (but only to the extent of each property's unrealized appreciation), and*
>
> *(B) then, to the extent such increase is not allocated under subparagraph (A) in proportion to their respective FMVs.*

(3) METHOD OF ALLOCATING DECREASE — Any decrease required under subparagraph (1)(A) or (1)(B) shall be allocated —

> *(A) first to properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation before such decrease (but only to the extent of each property's unrealized depreciation), and*
>
> *(B) then, to the extent such decrease is not allocated under subparagraph (A), in proportion to their respective adjusted bases (as adjusted under paragraph (A)).*

The principles of this Code section can be illustrated by **Examples 3** through **6**.

Example 3: "Dissolution of LLC - Inventory Assets"
A used car lot is operated as an LLC. It is owned equally by three members. They decide to dissolve the business through a distribution of property. This property consists of only three automobiles (i.e., inventory).

Inventory	Dealership Basis	FMV
'06 Pontiac	$11,500	$12,100
'04 Camero	13,300	14,200
'02 Lincoln	13,600	15,100
Total:	$38,400	$41,400

Since the FMVs are **not** equal, they decide to distribute ownership of each vehicle to each member. The members will own the cars as tenants-in-common after the dissolution of the LLC. After the business is dissolved, each member will purchase the vehicle he wants from the other members.

The members have the following outside bases in the LLC:

Member A	$13,000
Member B	14,900
Member C	10,500

Each member has a distinctly separate procedure for allocating his outside basis to his share of the vehicles received in the distribution.

Example 4: "Allocation When Outside Basis Exceeds Basis of Property Received"

Member A, in **Example 3**, has an outside basis of $13,000, which exceeds his share of the bases of assets he receives from the LLC. As illustrated below, his first allocation is $12,800 ($38,400 ÷ 3) to the three vehicles equal to his share of the LLC basis (**column 1**).

The remaining $200 of basis ($13,000 outside basis – $12,800) is allocated according to the share of **unrealized appreciation** (**columns 3 and 4**). His substitute basis is the **total** of columns 1 plus 5.

Outside basis	$13,000
Basis of property received	(12,800)
Excess basis	$ 200

Member A's Allocation

Vehicle	1 Share of Basis	2 Share of FMV	3 Unrealized Appreciation	4 Percent of Appreciation	5 Increase	6 Substitute Basis
Pontiac	$ 3,834	$ 4,034	$ 200	20%	$ 40	$ 3,874
Camero	4,433	4,733	300	30%	60	4,493
Lincoln	4,533	5,033	500	50%	100	4,633
Total:	$12,800	$13,800	$1,000	100%	$200	$13,000

Column 1 is 1/3 of the LLC's basis for each property.
Column 2 is 1/3 of the LLC's FMV for each property.
Column 3 is the difference between columns 2 and 1.
Column 4 is the percentage of each amount in column 3.
Column 5 is column 3 times column 4.
Column 6 is column 1 plus column 5.

Comment: Even though there are just a few assets being distributed in these Examples, the tax principals would equally apply to much more complex balance sheets with numerous assets.

Example 5: "Allocation When Outside Basis Exceeds Basis of Property Received and Exceeds the Unrealized Appreciation"

Member B, in **Example 3**, has a $14,900 outside basis, which exceeds his share of the bases of assets he receives from the LLC. Therefore, his first allocation is $12,800 to the three vehicles equal to his share of the inside bases of these assets to the LLC (**column 1**).

Of the remaining $2,100, $1,000 is equivalent to his share of the unrealized appreciation on his share of the assets and is allocated to each item according to its **unrealized appreciation** (**column 3**). The remaining balance of $1,100 is allocated **according to the FMV** of the vehicles (**columns 2, 4, and 5**).

Outside basis	$14,900
Basis of property received	(12,800)
Excess basis	$ 2,100
Unrealized appreciation	(1,000)
Amount for FMV allocation	$ 1,100

The total of the share of the original LLC basis (column 1)

Plus: Unrealized appreciation (column 3)
Plus: FMV allocation (column 5)

Equals: Member B's basis in his share of each vehicle after the distribution.

Member B's Allocation

Vehicle	1 Share of Basis	2 Share of FMV	3 Unrealized Appreciation	4 Percent of Appreciation	5 Increase	6 Substitute Basis
Pontiac	$ 3,834	$ 4,034	$ 200	29.2%	$ 322	$ 4,356
Camero	4,433	4,733	300	34.3%	377	5,110
Lincoln	4,533	5,033	500	36.5%	401	5,434
Total:	$12,800	$13,800	$1,000	100.0%	$1,100	$14,900

Column 1 is 1/3 of the LLC's basis for each property.
Column 2 is 1/3 of the LLC's FMV for each property.
Column 3 is the difference between columns 2 and 1.
Column 4 is the percentage of each amount in column 2.
Column 5 is the amount for FMV allocation times column 5.
Column 6 is column 2 plus column 5.

Example 6: "Allocation When Outside Basis is Less than Basis of Property Received"

Member C, in **Example 3**, has an outside basis which is less than his share of the basis of the vehicles on the LLC's books ($10,500 outside basis vs. $12,800 share of the inside basis).

Since none of the vehicles have an FMV less than the share of the LLC's basis, there is no allocation of unrealized depreciation and the total decrease of $2,300 ($12,800 inside basis – $10,500 outside basis) is allocated according to the **percentage of the share of the basis of each asset** on the LLC's books. Member C's basis is column 1 – column 3.

Outside basis	$10,500
Basis of property received	(12,800)
Decrease in basis	($ 2,300)

*Therefore allocation is based on outside basis.

Member C's Allocation

Vehicle	**1 Share of Basis**	**2 Percent of Basis**	**3 Decrease**	**4 Substitute Basis**
Pontiac	$ 3,834	30.0%	$ (689)	$ 3,145
Camero	4,433	34.6%	(797)	3,636
Lincoln	4,533	35.4%	(815)	3,718
Total:	$12,800	100.0%	($2,300)	$10,500

Column 1 is 1/3 of the LLC's basis for each property.
Column 2 is the percentage of each amount in column 1.
Column 3 is column 2 times decrease in basis.
Column 4 is column 1 minus column 2.

Comment: These **same** procedures are used to allocate basis to the **other property** in an LLC or partnership in which basis is first allocated to money, then to Code §751 property and the remaining basis to other property. However, the 1998 act modified this procedure to the extent that the FMV of assets with depreciation recapture potential is the adjusted bases of the assets, plus the excess (if any) of FMV above original basis. This change recognizes that potential depreciation recapture is considered a separate asset included in unrealized receivables.

2. Disproportionate Distributions of LLC Assets: A member may receive a distribution of property in exchange for all or a part of his interest in the LLC. However, any disproportionate distribution of unrealized receivables or substantially appreciated inventory is considered as a sale or exchange of the property between a member and the LLC.[145]

a. Unrealized Receivables: Unrealized receivables include, to the extent **not** previously included in income under the LLC's accounting method, any LLC right to payment for noncapital goods or for services rendered.[146] Unrealized receivables also include:

• Depreciation recapture on personal property,[147]

• Depreciation recapture on real property,[148]

• Soil and water conservation and land clearing recapture,[149]

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145 IRC §751(b)

146 IRC §751(c)

147 IRC §1245; this would include amortization on intangible assets as well.

148 IRC §1250

149 IRC §1252

• Oil, gas and geothermal property,[150]

• Stock in a Domestic International Sales Corporation,[151]

• Mining property,[152]

• Franchises, trademarks or trade names,[153]

• Stock in certain foreign corporations,[154]

• Market discount bonds, and

• Any short-term obligation as defined in **Code §1283** to the extent of the amount which would be ordinary income.

Example 7: "Unrealized Receivables"
The ABC Equal, LLC owns the property shown below. Member A's unrealized receivables are $1,167 (1/3 of $3,500).

LLC Property	Adjusted Basis	FMV	Depreciation Taken	Potential Gain	Potential Recapture
Cash	$ 10,000	$ 10,000	N/A	N/A	N/A
Raw Land	100,000	300,000	-0-	$200,000	-0-
Equipment	12,000	13,000	$5,000	1,000	$1,000
Truck	10,000	6,000	8,000	-0-	-0-
Trailer	500	3,000	3,500	2,500	2,500
					$3,500

b. Substantially Appreciated Inventory: "Inventory items" for purposes of **Code §751** "hot assets" include property primarily held for sale to customers in the ordinary course of business, trade accounts receivable, unrealized receivables, and any other property which, if sold or exchanged by the LLC, would **not** be considered either a capital asset or a **Code §1231** asset.

Comment: Note that this definition of "inventory" is quite broad. Most practitioners think it only includes actual inventory items, **not** everything except cash, capital or 1231 assets.

Comment: "Unrecaptured Sec. 1250 gain" is still treated as part of the overall Sec. 1231 gain and flows from **Form 4797** to **Form 8949** and eventually onto **Schedule D**. So, given the definition of "inventory" above, it arguably would *not* be included.

Inventory is considered **substantially appreciated** in value if the FMV of **all** inventory items taken together exceeds 120% of the basis of the inventory to the LLC.[155]

Example 8: "Substantially Appreciated Inventory"

LLC Property	Adjusted Basis	FMV	Percent Increase

[150] IRC §1254

[151] IRC §992(a)

[152] IRC §617(f)

[153] IRC §1253(a)

[154] IRC §1248

[155] IRC §751(b)(3)(A)

Cash	$ 5,000	$ 5,000	
Inventory	8,000	10,000	**125%***
Other assets (not Inventory)	55,000	95,000	
Total:	$68,000	$110,000	

$10,000 FMV ÷ $8,000 basis = 125% of basis

Therefore, it is **substantially appreciated**.

c. Code §751 or "Hot Assets" Unrealized receivables and substantially appreciated inventory are called **Code §751** property or "hot assets." They are always treated as **ordinary income** in situations involving a **non-proportionate** distribution, sale or exchange of an LLC interest or liquidation of an LLC interest.[156] And, for transactions after August 5, 1997, the **120% test no longer applies**. After that date, **any** inventory must be treated as ordinary income.[157]

Comment: In 1997, Congress **eliminated the requirement** that inventory be **substantially appreciated** for sales and exchanges of partnership interests. However, they did **not** eliminate the test in the context of partnership **distributions**.

When there is an sale or exchange of any interest in "**Code §751** property" (i.e., "hot assets"), the selling member must notify the LLC **within 30 days** of the exchange. The notification must include the names and addresses of the parties, their TINs and the exchange date (but there is a complete absence of any numerical information). The LLC is required to provide a **Form 8308, Report of a Sale or Exchange of Certain Partnership Interests**, to each of the members by January 31 of the following calendar year in which the exchange occurred and also include a copy attached to its return.[158] Failure to file **Form 8308** can result in penalties of $50 or $100 per failure.

Comment: Note that on **Form 8308**, the only information provided concerns the **identity of the buyer and seller** regarding a partnership interest. In other words, there is *not* one mention of any quantifying items such as basis or FMV of consideration exchanged, let alone the potential impact of the **Code §751** "hot asset" rules. Nevertheless, in some simpler situations, such as an LLC that only holds one parcel of rental property, it might be rather straightforward as to what a selling member's share of 25% "unrecaptured Sec. 1250 gain" would be.

Disproportionate distributions are very complex transactions. The regulations provide an example of a reduction in the proportion of capital ownership from 1/3 to 1/5 with a current distribution of cash and a disproportionate distribution of **Code §751** property.[159]

Example 9: "Disproportionate Distribution - Partnership Holding Sec. 751 "Hot Assets"
ABC, LLC has substantially appreciated inventory with a FMV of $30,000 with an income tax basis to the LLC of $6,000. It has capital assets with a FMV of $90,000 with an income tax basis to the LLC of $50,000. Member A wishes to reduce his LLC interest to 1/3 through a distribution of **only capital assets**. The LLC transfers $30,000 of capital assets to Member A and reduces his LLC capital account from $60,000 to $30,000 and his LLC interest from 1/2 to 1/3.

	FMV	**Adjusted Basis**
Inventory	$30,000	$ 6,000
Capital asset	90,000	50,000

LLC Total		**Member A**		**Change in**			
FMV Before	**FMV After**	**½ FMV Before**	**1/3 FMV After**	**Member A's Share**	**Member A Received**	**Excess Share**	**Relinquished**

[156] IRC §751(a)

[157] Ibid.

[158] Treas. Reg. §1.751-1(a)(3) and §149, Tax Reform Act of 1984

[159] Treas. Reg. §1.751-1(g), Example 5

Inventory	$30,000	$30,000	$ 15,000	$10,000	($ 5,000)	$ -0-	$ -0-	$5,000
Capital assets	90,000	60,000	45,000	20,000	(25,000)	30,000	5,000	-0-
Total:	$120,000	$90,000	$60,000	$30,000	($30,000)	$30,000	$5,000	$5,000

Member A's Inventory Basis

(Inventory relinquished ÷ total inventory) × inventory basis = ($5,000 ÷ $30,000) × $6,000 = $1,000

Member A's deemed gain

Deemed sale	$ 5,000
Basis	1,000
Deemed gain	$ 4,000

LLC inventory basis

Before transfer	$ 6,000
Basis transferred	(1,000)
Deemed sale	5,000
New basis	$10,000

LLC tax return

Deemed sale	$ 5,000
Basis: ($50,000 ÷ $90,000) × $5,000	2,778
LLC gain	$ 2,222

Increase to basis of LLC assets $ 2,222

Comment: The LLC received this step-up in basis on inventory due to the gain recognized by Member A. It was **not** due to a **Code §754** election. In fact, such an election does **not** need to be in place to receive this type of step-up.

Member A is **deemed to have sold** his $5,000 share of inventory relinquished to the LLC for $5,000.[160] His proportionate basis in the relinquished inventory is $1,000.

($5,000 ÷ $30,000) × $6,000 = $1,000

He has reportable **ordinary income** of $4,000 ($5,000 – $1,000 basis). The LLC has an increase in basis of inventory of $4,000 ($5,000 deemed paid – $1,000 basis on amount deemed sold). There is no adjustment to capital assets for Member A since the assets were distributed to Member A and removed from the LLC books.

The LLC is **deemed to have sold** $5,000 of capital assets to Member A. The LLC's basis in the assets sold is:

($50,000 ÷ $90,000) × $5,000 sale = 0.555 × $5,000 = $2,778

The LLC gain is $2,222 ($5,000 – $2,778). The gain is **added to the basis of the remaining LLC capital assets** and **reported as taxable gain by the remaining LLC members** (B and C).

3. Distributions to Deceased or Retired Partner

a. Payment for property or distributive share

1) The treatment of liquidating payments made to a retiring partner or a deceased partner's successor-in-interest depends on whether or not the payment is made for the partner's share of partnership property.

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[160] IRC §751(b)(1)

2) If the payment is made for a partner's share of partnership property, it is treated as a distribution (i.e., governed by **Code §731**). Otherwise, it is treated either as a distributive share of partnership income or as a guaranteed payment.

3) This characterization also determines when the partner has to include the amount in their gross income.

b. Continuity of partnership

1) The death or retirement of a partner generally does *not* terminate the entity, even in a two-person partnership

a) This is also true for an exiting partner, as long as they continue to receive liquidating payments for their partnership interest

b) **Prior to the passage of the TCJA**, when determining whether a partnership is "technically terminated" under **Code §708(b)(1)(B)** (i.e., 50% or more of the partnership interests are transferred within a 12-month period), liquidating distributions are *not* treated as transfers of partnership interests

2) Instead, the death of a partner causes the successor-in-interest to take a fair market value basis in the transferred partnership interest.

3) This, in turn, may result in a Sec. 754 basis adjustment to the inside basis of the partnership's assets so that they now equal the outside basis that this new partner has in their inherited interest.

c. Tax treatment of payments

1) **Code § 736** governs whether payments made to a retiring partner or a deceased partner's successor-in-interest are:

a) Distributions;

b) Part of the partner's distributive share; or

c) Guaranteed payments

2) **Code §§731** and **732** govern the effects of payments treated as distributions

3) Meanwhile, **Code §§702** and **706** govern the effects and timing of payments treated as a distributive share of partnership income

4) **Code §707(c)** governs payments treated as guaranteed payments

5) **Code §1014** determines a deceased partner's successor-in-interest's outside basis (normally, FMV as of the date of death)

d. Payments for partner's share of unrealized receivables or goodwill

1) Are *not* treated as distributions but instead as:

a) A distributive share of partnership income if the amount of the payment is determined by the partnership's income; or

b) Guaranteed payments if the amount is *not* determined by the partnership's income.

e. **Code §741** capital asset treatment

1) A partner recognizes capital gain on a distribution to the extent that the money distributed exceeds his outside basis and recognizes loss only when the distribution consists entirely of money, inventory items and/or unrealized receivables

2) A partner who receives a "Section 736 payment" treated as a distribution takes a basis in the distributed property equal to his outside basis, reduced by the amount of money distributed

3) Section 736 payments treated as a distributive share of partnership income reduce the income allocated to other partners, and the partnership can deduct Section 736 payments treated as guaranteed payments (i.e., as a deduction on page 1 of **Form 1065**)

4) However, payments treated as a distributive share or guaranteed payments are generally ordinary income to the payee partner

5) Gain recognized by a passive (v. active) partner on payments treated as distributions is included in calculating the partner's 3.8% Medicare surtax on "net investment income"

6) Payments treated as a distributive share of partnership income or as guaranteed payments to an active (v. passive) partner may instead be subject to the .9% Medicare surtax on earned income

f. Inclusion of distribution in partner's gross income

1) The relationship between a partnership's tax year as opposed to a partner's tax year determines when the partner takes into account his distributive share of partnership items and any payments treated as a distributive share of partnership income

2) A partner takes a payment treated as a guaranteed payment into income for the tax year in which the payment is deductible by the partnership

3) If a payment treated as a distribution is made in installments, "open transaction" treatment applies to determine the recipient partner's gain or loss (i.e., the exiting partner is allowed to recoup their basis first before the distribution becomes taxable)

g. Income in respect of a deceased partner

1) Income earned by a deceased person but received by another is known as "income in respect of a decedent" (IRD) and is subject to special rules.

2) Liquidating payments made to a deceased partner's successor-in-interest that are treated as a distributive share of partnership income or as guaranteed payments are IRD.

3) A partner who receives his partnership interest as a result of a partner's death takes a fair market value basis in the interest, but this basis is reduced to the extent that it is attributable to IRD.

4) A partnership may have to adjust the basis of its property if a partnership interest is transferred because of a partner's death, but no basis adjustment is made to property that is IRD as to the transferee partner.

D. Effect of LLC Liabilities on Distributed Assets:

1. Share of Liabilities Relinquished Treated as Receipt of Money: A member is treated as **receiving money** to the extent the **other members assume** all or part of his share of the liabilities.[161] Correspondingly, a member is regarded as **paying money** to the LLC to the extent **he assumes all or a share of liabilities** from other members.[162] These money transactions are presumed to occur **prior to the distribution** of property.

[161] IRC §752(b)

[162] IRC §752(a)

Comment: For a detailed discussion of the treatment of partnership liabilities on property distributed to partners see **Rev. Rul. 79-205**.See also **Rev. Rul. 87-120**. **Rev. Rul. 84-102** also discusses liabilities as well as **Code §751** property adjustments on admission of a new partner who contributes cash for his interest.

Example 10: "Property Distribution w/ Deemed Relief of Liabilities"
Member A receives a distribution of property with a basis and FMV of $10,000 to reduce his LLC interest from 1/3 to 1/5.

ABC, LLC

	Before Transfer		Member A's Share	
	Basis	FMV	Basis	FMV
Assets	$90,000	$90,000	$30,000	$30,000
Liabilities	30,000	30,000	10,000	10,000
Capital account - A	$20,000	$20,000	$20,000	$20,000
Capital account - B	20,000	20,000		
Capital account - C	20,000	20,000		
Member A's capital account		$20,000		
Share of LLC debt		10,000		
Original basis		$30,000		
Reduction in share of LLC debt		(4,000)		
Reduction in property distribution		(10,000)		
New basis - Member A		$16,000		

Member A is deemed to have **received a money distribution** of $4,000 to the extent his share of LLC debt was **reduced** from 1/3 of the total ($10,000) to 1/5 of the total ($6,000). Member A's **basis** of $30,000 ($20,000 capital account + $10,000 share of debt) was **reduced** first by the $4,000 reduction in share of debt and second by the $10,000 distribution of property to $16,000.

E. Distributions or Sale of Contributed Property

1. Contributed Property With Pre-Contribution Gain: The tax treatment of built-in gain must be addressed if contributed property with a built-in gain (i.e., **Code §704(c)** property) is distributed to any member other than the contributing member **within seven years** of its contribution, or is sold by the LLC **at any point in time**. In the case of an asset sale by the LLC, a special tax allocation of the built-in gain must be made to the contributing member.[163]

In the case of a **sale of an LLC interest**, the built-in gain or loss resulting from the contribution of assets by the selling member is **carried over to the transferee member** (i.e., given that a **Code §754** election is *not* made to step up the inside bases of assets deemed acquired by the new member). In the case of a partial sale, a proportionate part of the built-in gain is transferred.

Example 11: "Sale of Partnership Interest w/ Pre-contribution Gain Property"
Tony contributes land with a basis of $150,000 to an LLC in which he owns a 50% interest. At the time, the land's FMV was $200,000. Therefore, it has a **Code §704(c)** built-in gain of $50,000 ($200,000 – $150,000).

Subsequently, Tony sells his LLC interest to Rhonda when the FMV of the land is still $200,000. If the land is ever sold by the LLC at a price of $200,000 or more, Rhonda would be allocated the first $50,000 of built-in gain ($200,000 – 150,000). However, given that a **Code §754** election is in effect when Rhonda purchases her interest from Tony, this built-in gain will effectively disappear due to the step-up to Rhonda's share of the inside basis of the land in the LLC.

F. Distributions When Code §754 Election Not Made

1. Deemed Code §754 Election When Distribution Made Within Two Years: There are times when

[163] Treas. Reg. §1.704-3(b)(2)(iii) to the extent special allocations (such as depreciation or amortization have not been made in the interim to reduce this built-in gain amount.

a **Code §754** election is **not** in effect and property is distributed by an LLC. In this case, a transferee member may elect **Code §754** treatment for property, other than money, received from the LLC if it is **within two years** after the member's interest is acquired. The effect of this election is to treat the property as though the bases were adjusted under **Code §743(b)**, and a **Code §754** election was in effect.[164]

Example 12: "Deemed Sec. 754 Election to Transferee Under Sec. 732(d)"
Donald purchases a one-third interest in the ABC, LLC for $210,000 when no **Code §754** election is in effect and the FMV of the LLC's assets exceed 110% of their bases. At the time of the purchase, the LLC owns the following assets:

	Basis	FMV
Nondepreciable property (land):		
Parcel #1:	$ 10,000	$110,000
Parcel #2:	10,000	110,000
Parcel #3:	10,000	110,000
Depreciable property:		
Heavy construction equipment	300,000	300,000
Total:	**$330,000**	**$630,000**

Within two years, the LLC is terminated. Donald receives a liquidating distribution consisting of land Parcel #3 and one-third of the heavy construction equipment. Prior to this distribution, the LLC had taken $30,000 in depreciation deductions relating to the equipment, $10,000 of which had been allocated to Donald. These depreciation deductions have the effect of reducing Donald's share of the LLC's basis in the equipment to $90,000. Meanwhile, the outside basis of his LLC interest is reduced to $200,000.

If the LLC did **not** have a **Code §754** election in place, Donald's $200,000 basis in his LLC interest would be allocated among the distributed property based on their **relative inside adjusted bases** as follows:

$20,000 to land Parcel #3 ($200,000 x ($10,000 ÷ $100,000)); and

$180,000 to the depreciable equipment ($200,000 x ($90,000 ÷ $100,000))

Essentially, the distribution would have the effect of **shifting part of Donald's basis** in the LLC allocable to the appreciation in the **nondepreciable** land to the **depreciable** equipment he received.

However, if the mandatory special basis adjustment under **Code §732(d)** is applied, his basis in the land distributed from the LLC increases to $100,000 ($110,000 FMV – $10,000 of his share of the LLC's basis).

As a result, the bases of the LLC property distributed to Donald would be allocated as follows:

$110,000 to land Parcel #3 ($200,000 × ($110,000 ÷ $200,000)); and

$90,000 to the depreciable equipment ($200,000 × ($90,000 ÷ $200,000))

2. When Mandatory Code §754 Election Automatically Applies on Distributions: If a **Code §754** election is **not** in effect when property is distributed, the member receiving the property must apply a special basis rule.[165] Whether or not the distribution is made **within two years** after the transfer, this rule applies to the distribution at the time of the transferred interest if:

- The FMV of all LLC property, other than money, **exceeds 110% of its adjusted basis** to the LLC,
- An allocation of basis under **Code §732(c)** upon a liquidation of his interest immediately after the transfer of the interest results in a shift of basis from property **not** subject to an allowance for depreciation, or amortization to property subject to such an allowance, and

[164] IRC §732(d)

[165] Ibid.

• A special basis adjustment under **Code §743(b)** changes the basis to the transferee member of the property actually distributed.[166]

G. Exception to Code §751 "Hot Asset" Treatment on Distributions to Contributing Member

1. Property Distributed to Member Who Originally Contributed It to LLC: Code §751(b) "hot asset" treatment does **not** apply to distribution of property to an LLC member who originally contributed the property. Instead, the distribution of that property is governed by the usual rules for a property distribution outlined in **Code §§731** through **736** and illustrated above.

H. Abandonment of Partnership Assets

1. The abandonment (i.e., deemed taxable disposition) of a partnership asset by the partnership is treated as a taxable event. With realization of gain on the abandonment, partners must increase the basis in their partnership interest by the distributive share of the gain. And, conversely, with a loss, a decrease in their basis.

I. Miscellaneous Developments:

☞**Final Regs Issued on Calculating Partners' Distributive Shares When Interests Change During Year (T.D. 9728)**

The IRS has issued regulations modifying and finalizing the "varying interest rules" contained in the 2009 proposed regs. These varying interest regs come into play when a partner's interest changes during the course of the tax year. The final regs: (1) provide that, in all cases, partnership items must be allocated among the partners and no items can be duplicated regardless of the method or convention adopted by the partnership; (2) expand the service partnership safe harbor exception to apply to any partnership for which capital is *not* a "material income-producing factor;" and (3) allow partnerships to use either the "interim closing" or the "proration" (i.e., per share per day) methods to determine the distributive share of partnership items and to use different methods for different variations within the tax year. However, the partnership and all of its partners must use the *same* convention for all variations for which the partnership chooses to use the interim closing method. **(Code §706; Distributive Share)**

Comment: The regs are effective for partnership tax years beginning on or after 8/3/15.

Comment: These "varying interest" rules concerning the calculation of a partner's distributive share should *not* be confused with those covered under the **Reg. §1.1402** **self-employment regs** which allow for a managing member of an LLC to simultaneously own an "investor member" (or, "Class B") interest which would *not* be subject to S/E tax (at least for an LLC which does *not* provide services).

☞**Proposed Regs Issued on Treatment of Allocable Cash Basis Items (T.D. 9728)**

Proposed regulations were issued contemporaneously with final regs mentioned above which address the effect of "allocable cash basis items" (including items of deduction, loss, income or gain) under **Code §706(d)(2)**. The proposed regs would provide a "de minimis rule" for items less than 5% of the partnership's gross income or expenses and losses. Also, with respect to tiered partnerships, the proposed regs. would provide that the daily allocation method used for cash basis items applies to all items of the lower-tier partnership if there is a change in *any* partner's interest in the upper-tier partnership. They also add publicly-traded partnerships and transfers of a partnership interest in connection with the performance of services to the list of "extraordinary items." **(Code §706; Distributive Share)**

Comment: These regs apply the partnership tax years beginning on or after the date they are published as final.

☞**Release from Deficit Restoration Obligation Considered "Partnership Item" (*Bassing, III v. U.S.*, No. 06-712T (Fed. Cl. 3/18/08))**

A partner's release from his financial obligations to a partnership was determined to be a "partnership item" (i.e., vs. an individual item over which he would have control as to its reporting). Here, the taxpayer wanted to claim that this involved the forgiveness of debt which he would not have to pick up in his gross income since he was insolvent (i.e., as defined in **Code §108**). Instead, pursuant to **Code §§752(b)** and **731**, this relief from having to pay back his fair share of partnership liabilities used to previously cover deductions taken on his personal return (or, distributions made to the extent of the basis provided by the existence of these liabilities), was treated as a distribution of cash.

[166] Treas. Reg. §1.732-1(d)(4), see two examples.

Facts: Charles Bassing was a founding partner in a partnership established for the purpose of acquiring and owning a parcel of real property and for the development and construction of an office building on that property. Charles and another individual, Richard Cohen, were general partners. In addition, Charles and Richard, along with several other individuals and family limited partnerships (FLPs), were also limited partners. The partnership obtained a $5 million building loan from the First American Bank of Maryland (First American) to fund construction of the office building. The loan agreement required that Charles and Richard guaranty the loan. The partnership agreement required that in the event of the partnership's liquidation, any partner with a negative capital account was obligated to restore the deficiency to the partnership. When the First American loan matured, the partnership and its members were unable to satisfy their obligations. First American accepted title to the partnership's property and a lump sum payment from Richard in satisfaction of the partnership's loan obligations. The settlement agreement liquidated the partnership. The liquidation left Charles with a negative capital account balance of $882,871 that he was obligated to restore under the partnership agreement. Charles, however, was insolvent at this time. Consequently, in 1991, Richard and the remaining partners entered into an agreement releasing Charles from his obligations to the partnership. On his 1991 tax return, Charles treated the release from his deficit restoration obligation as a deemed sale of his interests in the partnership. He reported capital gain from the deemed sale, but did *not* pay the corresponding tax of $68,696. As a result, Charles was assessed tax, interest, and failure to pay penalties. In 2002, Charles paid $152,000 in full satisfaction of the liability, interest, and penalties he had accrued. A couple months later, Charles filed an amended return claiming that the underlying obligation was *not* income from the deemed sale of a partnership interest, but rather, income from the cancellation of debt that should have been excluded (i.e., pursuant to **Code §108**) from his 1991 income. The IRS denied his claim and Charles filed suit in the Court of Federal Claims, arguing that he overpaid his 1991 taxes by over $68,000. The IRS argued that **Code §7422(h)** bars refund actions attributable to partnership items. Charles countered that the release from his deficit restoration obligation was an "affected item" and *not* a "partnership item."

Federal Claims Decision: Since the partnership had FLP's as limited partners, it qualified as a TEFRA partnership, subject to **Code §§6221-6234**. Under TEFRA, items are delineated into three categories: (1) partnership items; (2) non-partnership items; and (3) affected items. The Court of Federal Claims agreed with the IRS and held that the 1991 agreement releasing Charles from his deficiency restoration obligation was a "partnership item." Citing **Code §6231(a)(3)** and the corresponding regulations, the court concluded that the signing of the 1991 agreement by eight partners demonstrated that the agreement contained decisions more appropriately determined at the partnership level than at the partner level. That agreement, the court said, "was a comprehensive document that defined the partners' obligations to each other after the First American settlement agreement and liquidation of the partnership." **(Code §6231; Partnership Item)**

☞Distribution of House to Redeemed Partner Not Covered by Partnership Tax Rules (ILM 200650014)
This internal legal memorandum (ILM) has concluded that the nonrecognition provision of **Code §731** and the substituted basis rule of **Code §732(b)** do *not* apply when a partnership acquires residential real estate that has no relation to its business activities, solely for purposes of immediately distributing it to a partner in liquidation. In addition, the ILM concluded that the partnership anti-abuse rules and judicial doctrines may be applied to attack and recharacterize the transaction. **(Code §731; Partnership Distributions)**

Comment: In a somewhat convoluted set of facts, a family partnership acquired a personal residence for the sole purpose of using it to make a liquidating distribution to a disgruntled member who wanted out. And, had he simply gotten cash instead, it would have exceeded his basis and gain would have resulted. So, the entity purchased the house first and then distributed it to this exiting partner who tried to use his substituted basis (i.e., of his partnership interest) as the basis of the distributed property, thus avoiding any immediate gain recognition. And, as to any "disappearing basis" (i.e., since the partnership had just paid FMV for the house), the entity could make an election to step up the bases of its remaining assets. In reaching its decision, the IRS correctly used a number of judicial doctrines, including the partnership anti-abuse rules (**Reg. §1.702-1**), step-transaction rules, and economic substance over form, to set aside the transaction.

☞Partnership Deemed Distribution of Notes Not Taxable to Partners (*Countryside Limited Partnership v. Commr.*, T.C. Memo. 2008-3 (1/2/08))
A partnership's distribution of third-party promissory notes in liquidation of its partners' interests had a business purpose. As a result, it was *not* recharacterized as a taxable distribution of cash for **Code §731** purposes under the economic substance doctrine.

Facts: Arthur Winn and Lawrence Curtis held partnership interests in the Countryside Limited Partnership, which owned and operated a 448-unit residential property (the Manchester property). Arthur had also set up two limited liability companies through two realty companies that he owned. WMC Realty Corp. formed CLP Promisee LLC (CLPP) and AMW Realty Corp. formed Manchester Promissee LLC (MP). Both were set up to engage in the business investing in and owning private bonds, notes, leases, debentures, and other non-marketable securities. WMC contributed cash for a 1 percent interest in CLPP and AMW contributed cash for a 1 percent interest in MP. In October 2000, Countryside borrowed $8.55 million from a bank and contributed the entire amount in cash to CLPP in exchange for a 99 percent interest in CLPP. CLPP then contributed $8.5 million in cash to MP in exchange for a 99 percent interest in MP. Thereafter, Countryside was a 99 percent shareholder in CLPP, and CLPP was a 99 percent shareholder in MP. MP then borrowed $3.4 million from a bank. Both the $8.55 million and $3.4 million loans were guaranteed by Arthur, and the loan to Countryside was secured by the Manchester property. MP used the $8.5 million received from CLPP and the $3.4 million borrowed from the bank to buy four privately issued notes from AIG Matched Funding Corp. (AIG). The AIG notes were neither listed nor traded on an established financial market. Countryside then distributed its 99-percent interest in CLPP to Arthur and Lawrence in complete liquidation of their respective partnership interests in Countryside. On the distribution to Arthur and Lawrence, each was relieved of his share of Countryside's liabilities. Arthur and Lawrence did *not* report any recognized gain on account of the distribution. The IRS argued that Countryside did *not* have a business purpose in purchasing the notes because the interest terms were unfavorable. It argued that the formation of CLPP and MP and the transactions involving them should be disregarded as without substance and should be recast as a cash distribution of over $11 million from Countryside to Arthur and Lawrence.

Tax Court Decision: The Tax Court agreed that the deemed distribution of the notes to Arthur and Lawrence resulted in nonrecognition of gain to them. The underlying business purpose of using the notes to redeem the partners' interests "was *not* negated by the fact that the means for accomplishing this were chosen, in part, for their favorable tax consequences." The court stressed that because the distribution of the notes to Arthur and Lawrence: 1) accomplished a legitimate business purpose (to enable them to convert their shares of Countryside's equity in the Manchester property into interest-bearing promissory notes); and 2) resulted in a change in their economic position, the transactions which enabled them to accomplish that result in a tax efficient manner may *not* be disregarded for lack of economic substance. In addition, the court said the notes were *not* publicly-traded on an established market and so were *not* themselves "marketable securities" that would be treated as cash under **Code §731(c)(2)(B)(ii)**. Furthermore, the court chose *not* to recast the transactions related to the liquidating distributions under the partnership anti-abuse rules since the partnership was bona fide and the transactions were entered into for a substantial business purpose. They did *not* violate substance over form principles. Finally, the court said the tax consequences that resulted from the transactions clearly reflected the partners' income, as contemplated by Subchapter K. **(Code §731; Partnership Distributions)**

☞**Service Asserts Tax Year Closed by SOL Still Open for Certain Purposes (CCA 200728001)**

The National Office of the IRS in this non-taxpayer specific Chief Counsel Advice stated that it is free to reopen a year closed by the statute of limitations in certain instances. In this case, a partner who sold his partnership interest wrongly deferred gain on the portion of the payments attributable to accounts receivable. They were "hot assets" which should have been picked up as ordinary income under **Code §751** in the year of sale. But, the IRS auditors discovered the error more than three years after the tax year in which the sale occurred. Nevertheless, the Chief Counsel's Office asserted that the seller's installment method of accounting for the sale can be retroactively changed, which allowed for immediate recapture of any wrongly claimed prior tax savings (i.e., these unrealized receivables were *not* eligible for the installment method of accounting).

Facts: A cash basis taxpayer sold a partnership interest to a corporation in exchange for promissory notes. The notes paid interest semi-annually for the first five years and the principal after five years. At the time of the sale, some of the partnership's assets included unrealized receivables. Part of the income realized by the taxpayer was attributable to those receivables (e.g., depreciation recapture or cash basis receivables) and, therefore, constituted ordinary income. Nevertheless, the taxpayer reported the *entire* sale of the partnership interest using the installment method of accounting (**Code §453(i)(2)**)and, therefore, recognized no income from the sale in the year of the sale. However, after an audit of the tax year following the sale, the IRS concluded that the portion of the sale attributable to the receivables could *not* be reported using the installment method. But, at the time of the audit, the tax year of the sale was closed under the statute of limitations. Nevertheless, the IRS proposed adjustments including a change to the taxpayer's accounting method from the installment method to the cash method with respect to the receivables, and a **Code §481** adjustment to be taken into account entirely in the year of change to prevent the omission of taxable income.

Background: A change in method of accounting includes a change in the overall plan of accounting for income or deductions, or a change in the treatment of any material item used in such overall plan. A "material item" includes *any* item that involves the proper time for the inclusion of the item in income. In determining whether timing is involved, generally the pertinent inquiry is whether the accounting practice permanently affects the taxpayer's lifetime income or merely changes the tax year in which taxable income is reported.

Chief Counsel Advice: The Office of Chief Counsel advised that a change in treatment of either the entire sale or the portion of the sale attributable to unrealized receivables, constitutes a change in method of accounting. Therefore, the IRS was permitted to impose this change in the year after the year of the sale. The treatment of a sale under either the installment method or the cash method is a "material item used in the taxpayer's overall plan of accounting" because such treatment involves the proper time for the inclusion of gain or loss from the sale in income. Furthermore, such treatment does *not* permanently affect the amount of taxpayer's lifetime taxable income. Instead, it merely affects the tax year in which income attributable to the sale is recognized. Also, in most instances, a method of accounting is *not* established for an item without "consistent treatment." Here, the taxpayer showed the requisite consistency by applying the installment method to the income from the sale of the unrealized receivables by filing returns reflecting such treatment for the *two successive tax years* after the sale. Because the twin requirements of timing and consistency are both satisfied, the change in treatment of the income from the sale of unrealized receivables satisfies the definition of a change in accounting method. Finally, as a result of the accounting method change, the taxpayer would have to take into account a **Code §481** adjustment to tax the gain on the receivables *entirely* in the year of change (i.e., no 4-year spread would be available even if the amount was over $25,000). **(Code §751; Hot Assets)**

☞**Installment Sale Treatment Not Available for Sale of Partnership Interest Relating to Hot Assets (CCM 200722027)**

The Chief Counsel Office of the IRS has concluded that, to the extent the sale of a partnership interest was due to unrealized receivables (i.e., "hot assets"), the taxpayer could *not* defer gain using the installment method.

Facts: A cash method taxpayer was a partner in a partnership that held **Code §751(c)(2)** unrealized receivables as payment for services rendered. A corporation purchased the taxpayer's interest in the partnership in exchange for a promissory note issued by the corporation. The stated principal amount of the note was greater than $250,000, which was payable on the five-year anniversary of the note's issue date. The note also provided for semi-annual cash payments of interest each year at a per annum interest rate equal to the semiannual mid-term applicable federal rate (AFR). The note generally could *not* be prepaid before its stated maturity date. However, the taxpayer had the right to convert all or any portion of the unpaid stated principal amount of the note into common stock of the corporation any time after the first anniversary of closing. Part of the income the taxpayer realized from the sale was attributable to the partnership's unrealized (i.e., cash basis) receivables for services rendered. The taxpayer did *not* realize any income attributable to a sale of inventory.

IRS Ruling: The IRS Office of Chief Counsel was asked to address two questions. First, whether a taxpayer may report income from the sale of the taxpayer's interest in a partnership under the installment method to the extent it represents income attributable to **Code §751(c)(2)** unrealized receivables for payment for services rendered. Second, assuming that the transaction between the taxpayer and the corporation is a sale or exchange of property, if the taxpayer may *not* report income under the installment method to the extent it represents income attributable to certain unrealized receivables, what is the taxpayer's amount realized from the note in the year of closing? Citing **Rev. Rul. 89-108**, the Office of Chief Counsel advised that, with respect to the first question, a taxpayer is *not* permitted to report income from the sale of the taxpayer's interest in a partnership under the installment method at least to the extent that it represents income attributable to **Code §751(c)(2)** unrealized receivables for payment for services rendered. However, the taxpayer is allowed to report the balance of the income realized from the sale of the partnership interest using the installment method of reporting. With respect to the second question, the Office of Chief Counsel concluded that the taxpayer's amount realized from the note in the year of closing is its stated principal amount. **(Code §751; Hot Assets)**

Comment: The Chief Counsel's Office did note that, while there are some reported cases that hold that the sale of the right to future income or profits is property that can be reported under the installment method, these cases do *not* involve income arising from compensation for services. However, the same acceleration rule (i.e., reporting of all of the ordinary income attributable to "hot assets" in the year of sale) would also apply to gain on inventory assets.

Comment: Compare this "aggregate" approach for partnerships/LLCs to that accorded installment notes received from the sale of assets in an S corporation. Suppose an S corp sold all of its assets in liquidation of the company, receiving a downpayment and distributing the underlying note to its shareholders in termination of their shares. Obviously, any gain attributable to the downpayment would flow through on Schedule K-1 to the shareholders (along with any other results from operations in this final year of business) and increase their stock basis accordingly. However, the remainder of any gain stemming from this sale of the company's assets would be deferred until such time as the installment payments were received over the term of the note. This includes any ordinary income, other than depreciation or amortization recapture which **Code §453(i)** denies installment sales treatment (i.e., it must be recognized in the year of sale regardless of the level of any downpayment). But, even though **Code §331** normally gives "sale or exchange" treatment (i.e., capital gain or loss) upon the termination of shareholder's stock pursuant to a liquidation governed by **Code §336**, this portion of the installment gain would retain its character as *ordinary* income. Essentially, **Code §453B(h)** puts the shareholders in the *same* tax position as the S corporation would have been in, had it been kept opened and it received the installment payments instead. And, of course, if an S corporation shareholder was to have simply sold their stock (i.e., instead of the company having a sale of assets), a pure "entity" approach would have been accorded such a sale with capital gain or loss treatment (except for any 28% gain on "collectibles").

☞**Installment Method Disallowed for Sale of "Hot Assets" (*Mingo*, TC Memo 2013-149 (6/12/2013))**

The Tax Court has consistently affirmed that an individual is *not* permitted to report the sale of their partnership interest on an installment sale basis for that portion of the proceeds attributable to the partnership's unrealized receivables (i.e., "hot assets"). But, the taxpayer was then allowed to reduce the amount of their long-term capital gain by the amount of ordinary income that had to be reported as a result of this holding.

Comment: This Tax Court decision has now been affirmed by the 5th Circuit (***Mingo*, 114 AFTR 2d ¶ 5518 (5th Cir., 12/09/14)**).

Facts: The taxpayer, who filed jointly with her husband for the years in issue, joined PricewaterhouseCoopers, LLP (PWC) sometime before tax year 2002. She was a partner in the management consulting and technology services business (consulting business) of PWC until tax year 2002, when PWC sold its consulting business to International Business Machines Corporation (IBM). As an initial step in the transaction, PwCC, L.P. (PwCC), a partnership, was formed earlier in 2002. PwCC was owned by certain subsidiaries of PWC. As part of the transaction, PWC transferred its consulting business to PwCC, including the consulting business' uncollected accounts receivable for services it had previously rendered (i.e., unrealized receivables). PWC then transferred to each of the 417 consulting partners an interest in PwCC and cash in exchange for the partner's interest in PWC. The taxpayer was one of these partners, and she received a partnership interest in PwCC and cash from PWC in exchange for her partnership interest in PWC. The value of her partnership interest in PwCC as of Oct. 1, 2002, was $832,090, of which $126,240 was attributable to her interest in partnership's unrealized receivables. On that date, PWC caused its subsidiaries to sell their respective interests in PwCC to IBM. At the same time, the consulting partners sold their respective interests in PwCC to IBM in exchange for convertible promissory notes. At the end of the transaction, IBM owned 100% of the consulting business. On Oct. 1, 2002, IBM gave the taxpayer a convertible promissory note (note) for $832,090 in exchange for her interest in PwCC. The $126,240 attributable to her interest in partnership unrealized receivables was included in that face value. The note had the following terms:

- The taxpayer had the right to convert all or any portion (in $1,000 increments) of the unpaid principal balance into IBM common stock at any time after the first anniversary of closing;

- IBM would pay interest on the unpaid principal balance semiannually; and

The outstanding principal amount of the note and any accrued and unpaid interest was due and payable on the fifth anniversary of the transaction's closing (i.e., Oct. 1, 2007).

On her 2002 joint return, the taxpayer reported the sale of her partnership interest on an installment sale basis. The selling price, gross profit, and contract price were listed as $832,090. The taxpayer did *not* recognize any income relating to the note other than interest income on her joint 2002 return. She did *not* convert any portion of the note during tax years 2002, 2003, 2004, 2005, and 2006. As a result, the taxpayer also did *not* report any income other than interest income from the note for any of those years.

During 2007, the taxpayer converted the entirety of the note in a series of transactions. On Feb. 26, 2007, she converted a portion of the note into shares of IBM stock worth $929,765. On Oct. 1, 2007, she converted the remainder of the note into shares of IBM stock worth $283,494. She then reported these amounts as long-term capital gain on the couple's 2007 joint return.

IRS Position: The IRS issued a notice of deficiency for 2003. It determined that the amount the taxpayer received in 2002 for her partnership interest in PwCC, to the extent it was attributable to partnership unrealized receivables (i.e., "hot assets" under **Code §751**), could *not* be reported under the installment method. This resulted in the immediate recognition of $126,240 in ordinary income for tax year 2003.

Background - Installment Method and Partnership Sales: **Code §453** provides that income from an installment sale can be reported over the term of the underlying note. An installment sale is a disposition of property where at least one payment is to be received after the close of the tax year in which the disposition occurs. (**Code §453(b)(1)**) If a partner sells or exchanges all or a part of his interest in the partnership after holding it for more than one year, he may recognize ordinary income, collectibles gain, section 1245 or 1250 gain, unrecaptured section 1250 25% gain or residual long-term capital gain or loss. (**Reg. §1.1(h)-1(a)**) Taxpayers will recognize ordinary income to the extent his gain is attributable to "hot assets" (i.e., unrealized receivables and appreciated inventory). (**Code §741, Code §751(a), Code §751(c)**) "Unrealized receivables" include, to the extent *not* previously includible in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for services rendered or to be rendered. (**Code §751(c)(2)**)

Tax Court Decision: The Tax Court noted that the purpose of **Code §751** is "to prevent the conversion of potential ordinary income into capital gain when a partnership interest is sold or exchanged." The effect of **Code §751** is to carve out certain income items which, if sold individually would have produced ordinary income, to effectuate this purpose. In other words, that portion of gain attributable to **Code §751** "hot assets" in the sale or exchange of a partnership interest are *not* allowed to be reported under the installment method since income that would have been realized on a *direct* sale of such property would have been denied this option as well.

In the context of a direct sale, the taxpayer here was essentially given a property interest (i.e., a portion of the note) in exchange for the right to collect unpaid amounts in satisfaction of services her partnership had previously rendered (i.e., the unrealized receivables). Standing alone, this transaction was a barter exchange, one in which a taxpayer would properly report the proceeds as ordinary income on her return for the year in which the exchange occurred. And, "nothing in **Code §453** or its legislative history suggests that Congress intended to allow taxpayers to escape the basic principles of revenue recognition by deferring compensation for services under the installment method." **(Code §453; Installment Method)**

Comment: And, of course, by having to pick up $126,240 of ordinary income in the year that the partnership interest was sold would mean that would be a corresponding decrease in the amount of capital gain to be picked up over the remaining term of the installment note.

Comment: Compare this "aggregate" approach for partnerships/LLCs to that accorded installment notes received from the sale of assets in an S corporation. Suppose an S corp sold all of its assets in liquidation of the company, receiving a downpayment and distributing the underlying note to its shareholders in termination of their shares. Obviously, any gain attributable to the downpayment would flow through on Schedule K-1 to the shareholders (along with any other results from operations in this final year of business) and increase their stock basis accordingly. However, the remainder of any gain stemming from this sale of the company's assets would be deferred until such time as the installment payments were received over the term of the note. This includes any ordinary income, other than depreciation or amortization recapture which **Code §453(i)** denies installment sales treatment (i.e., it must be recognized in the year of sale regardless of the level of any downpayment). But, even though **Code §331** normally gives "sale or exchange" treatment (i.e., capital gain or loss) upon the termination of shareholder's stock pursuant to a liquidation governed by **Code §336**, this portion of the installment gain would retain its character as *ordinary* income. Essentially, **Code §453B(h)** puts the shareholders in the *same* tax position as the S corporation would have been in, had it been kept opened and it received the installment payments instead. And, of course, if an S corporation shareholder was to have simply sold their stock (i.e., instead of the company having a sale of assets), a pure "entity" approach would have been accorded such a sale with capital gain or loss treatment (except for any 28% gain on "collectibles").

J. Discussion Questions

Limitations on Deductions:

1. All members of the ABC partnership share profits equally, but only B and C have a capital interests whereby they share equally as well. A is the service partner, contributing only his promise to render future services to the entity. B contributes property worth $10,000 with an adjusted basis of $2,000. C contributes $10,000 in cash. During the year the property B contributed is sold for $8,000 gain. How would this gain be taxed and to whom? Suppose the gain was $11,000. Would this change your answer? Suppose A got a capital and profits interest. Would this affect your answer?

2. A has a basis in his partnership interest at the beginning of the year of $1,000. His distributive shares are: $5,000 of net operating profits; $4,000 LTCL; and $2,000 STCL. In addition, A receives a $2,000 cash distribution from the partnership. What planning recommendations might you offer to benefit A? (Cf. **Rev. Rul. 66-94; Reg. §1.704-1(d)(4), Ex. 3**)

3. A is a partner in the equal ABC partnership. A has an adjusted basis in his partnership interest of $25,000 on 12/31/x6, before reflecting any share of partnership profit or loss for the year. $5,000 of A's basis in his interest is from a cash contribution to the partnership and the remainder is A's share of nonrecourse partnership liability of $60,000. A's distributive share of the partnership loss for the year is $10,000. How much of the loss can A utilize on his personal return? Assume that the liability is *not* "qualified nonrecourse indebtedness" but A does materially participate in the partnership's business.

4. In #3. above, what would happen to A's suspended losses due to the lack of adequate at-risk basis should he sell his partnership interest to D who will pay no cash but will assume A's share of partnership liabilities? How would your answer change if A only sold 32% of the overall 33% that he owns in the ABC partnership?

CHAPTER XIII: SALE OF MEMBER'S INTEREST IN LLC

A. Introduction

1. Deemed Indirect Ownership in Each LLC Asset: A member's capital interest in an LLC is deemed to be an indirect interest in each and every one of the LLC's assets, which are distributable to the capital interest owner upon his withdrawal from, or the liquidation of, the LLC.[167] In addition, a member interest may be sold, transferred, exchanged, gifted or bequeathed like any other intangible asset.

B. Determination of Gain or Loss on Sale or Exchange of LLC Interest

1. Initially Treated as Disposition of Capital Asset: In general, under **Code §741**, when a sale or exchange of an LLC interest occurs, any gain or loss must be recognized and treated as a **capital gain or loss,**[168] except to the extent of **Code §751** "hot assets" (i.e., unrealized receivables, including depreciation and amortization recapture, and substantially appreciated inventory). The amount of gain or loss realized by the selling member is equal to the difference between the amount realized and the selling member's adjusted basis in his member interest.[169]

The amount realized on the sale or exchange of a member interest is the sum of:

- The amount of money and the FMV of any property received by the selling member, **and**

- Any reduction in the member's share of LLC liabilities.[170]

Example 1: "Amount Realized and Gain Recognized on Sale of LLC Interest"
Mike has a basis in his LLC interest of $30,000, which includes his $20,000 share of LLC liabilities. Mike sells his **entire** member interest to Mary, an unrelated taxpayer, for $15,000. The amount realized on the sale is $35,000 (i.e., $15,000 cash + $20,000 assumption of liabilities). Mike's gain is $5,000.

$35,000 amount realized – $30,000 basis = $5,000 gain

If there are no **Code §751** "hot assets" on the balance sheet of the LLC, all of the gain is **capital** gain.

Comment: Mary under **Code §722** would take a "hard" outside basis of $15,000 for the cash that she paid, plus $20,000 "soft" basis for assuming Mike's share of partnership liabilities. So, her total basis of $35,000 would be available to absorb any distributions up to this amount, and she also have $35,000 of "at-risk basis" for deducting K-1 losses or deductions flowing through to her.

☞**Sale of Partnership Interest v. S Corp Stock**
Even though S corps are flowthrough entities like partnerships, they are taxed the same as C corporations when a shareholder sells their stock. In other words, unlike partnerships where you need to "look through" and ascertain each and every asset on the balance sheet that the partner owns indirectly, this is *not* required for S corp owners. Instead, they are entitled to capital gain (or, loss) treatment (which would also be eligible for **Code §453** installment sale treatment).

On the other hand, the tax treatment accorded a partner selling their interest is governed by **Code §741** which states:

> *"In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items)."*

So, initially, partners are also accorded capital gain (or, loss) treatment when they sell (or, exchange) their ownership interest. But **Code §751** "overrules" **Code §741** to the extent that, had the selling partner remained as an owner of

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[167] Treas. Reg. §1.704-1(e)(1)(v)

[168] IRC §741

[169] IRC §1001. See also Rev. Rul. 84-53, 1984-1 C.B. 159.

[170] IRC §752(d)

the entity, they would have received *ordinary* income (or, loss) treatment on the sale of those particular assets (e.g., collection/factoring of cash basis receivables, sale of inventory or depreciable/amortizable assets).

Code §751 states that *"The amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or a part of his interest in the partnership attributable to (1)unrealized receivables of the partnership, or (2)inventory items of the partnership, shall be considered as an amount realized from the sale or exchange of property other than a capital asset."*

> **Comment:** The term "unrealized receivables" in **Code §751** includes *not* only cash basis receivables but also depreciable or amortizable assets that would result in ordinary income if sold due to the "depreciation recapture" rules under **Code §1245**. And, "inventory items" no longer need to be "substantially appreciated" to come under the "hot asset" recharacterization provision of **Code §751**.

And since the sale of such assets would have resulted in ordinary income (or, loss), **Code §453(i)** installment sale treatment would *not* be available (although any gain deemed to be from other capital assets could be included in income pursuant to the terms of an installment note).

Example: "Sale of Partner's Interest in Accounting Firm"
Assume that an accounting firm had the following balance sheet and is owned by two equal partners and there are no outstanding liabilities:

Asset	Adjusted Basis	FMV
A/Rec	-0-	10,000
F&F*	-0-	2,000
Computers*	-0-	3,000
Goodwill**	-0-	85,000

*Note: The cost of these assets were immediately written off through **Code §179** or bonus depreciation.

**Note: The firm's current client base was generated through "practice development" efforts rather than the acquisition of any competing practices.

Had this partner remained and the firm was dissolved with the sale of all of its assets, the following tax consequences would result which would be shared equally by these two partners:

- Collection of cash basis receivables: 10,000
- Sale of F&F and computers: 5,000

Both of these gains would be treated as *ordinary* income whereas the sale of the firm's client base (i.e., goodwill) would be accorded *capital* gain treatment. So, the ordinary income be shared equally with $7,500 being listed as "Other Income" on each partner's K-1. The $42,500 of gain on the goodwill be listed as a capital asset gain on their K-1s.

> **Comment:** The capital gain from the sale of goodwill would *not* be a Sec. 1231 gain since even though it was a "trade or business asset" and held long-term, it was neither amortizable or depreciation (i.e., one of the three requirements under **Code §1231** in order for the gain to be reported on **Form 4797** as opposed to directly on **Schedule D**).

This example emphasizes that exactly the *same* tax result should occur if one of the partners were to instead sell their interest in the firm (i.e., instead of the firm being dissolved and sold) at a time that their basis in their partnership interest was zero. Assume that one partner sold their interest for $50,000 with $10,000 as a down payment and $10,000/year over the next four years. The first $7,500 of gain (i.e., allocable to the partner's share of ordinary income assets) would have to be included in income *immediately* (regardless of any down payment received). The remaining $40,000 of gain, however, would be recognized over the four-year installment period.

> **Comment:** The guiding principle in this summary is that "you shouldn't get a different result had you owned the assets in question directly (i.e., for example, in a **Schedule C** proprietorship), or instead sold their indirect interest in assets owned as a partner in a partnership." Comparing the two separate tax results really helps to see how the "hot asset" rules under **Code §751** should work.

Example: "Sale of Partner's Interest in LLC Holding Real Estate"
Assume an LLC owned by two equal partners owns a commercial building that had no outstanding debt on it (i.e., mortgage). It was purchased several years ago for $200,000, but due to S/L depreciation it now has an adjusted basis of $100,000. Its current FMV is $400,000 and is going to be sold in the current tax year.

Since it is a Sec. 1231 asset, the sale would be reported on **Form 4797**. The $300,000 gain is split between the $100,000 of "unrecaptured §1250 gain" with the remaining $200,000 (i.e., due to the underlying appreciation of the building from its original cost of $200,000 to its current FMV of $400,000) being treated as Sec. 1231 gain.

Both types of gain would initially be shown as separately stated items on the partners' K-1s and be reported on their **Form 4797** and then would flow over to the **Schedule D** worksheet (i.e., **Form 8949**) where the total $300,000 gain could be used to offset any capital losses. The net amount would finally be shown on **Schedule D**.

What would happen if instead one of the partners were to sell their interest? Assume that the building was used as collateral by the LLC for a loan with the $200,000 proceeds (i.e., one-half of the current FMV of $400,000) being used as a liquidating distribution (or, this partner could have easily sold their interest to an unrelated third-party). If the partner had a basis of $50,000 (i.e., one-half of the current adjusted basis of the building) in their partnership interest, the resulting gain would be $150,000. This gain would again be divided between the $50,000 of "unrecaptured §1250 gain" with the remaining $100,000 of §1231 gain.

Comment: As with the example above, both types of gain flow from the **Form 4797** over to **Form 8949** and finally to **Schedule D**. The curious thing here is that there is a distinction between the partner selling their interest to an unrelated third-party v. a liquidating distribution being made to extinguish their interest. The former option would result in the two types of gain, whereas the latter approach would yield *all* LTCG. In other words, with the liquidating distribution, the "unrecaptured §1250 gain" would stay with the building and would only be recognized when the building itself was ever sold by the LLC.

Comment: If the building was ever sold on an installment basis, both types of gain would qualify (i.e., since there would be no "ordinary income" portion attributable to the sale). But the "unrecaptured §1250 gain" would have to be included in income first, with the §1231 gain being picked up thereafter.

C. Calculation of Basis

1. Keeping Track of Member's Basis: The adjusted basis of an LLC member's interest is his initial basis in the LLC:[171]

Increased by the:[172]

• Amount of any additional monies contributed by the member,

• Adjusted basis (*not* FMV) of additional property contributed by the member,

• Member's distributive share for the current taxable year and all prior taxable years of LLC taxable income, exempt income (e.g., portion of forgiven PPP loan) and depletion deductions, and

Decreased by the:[173]

• Amount of any money distributed to the LLC member,

• Adjusted basis of property distributed to the LLC member,

• Member's distributive share of LLC losses, expenditures, which may *not* be deducted or capitalized, and

• Depletion deductions for oil and gas wells.[174]

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[171] IRC §722

[172] IRC §705(a)(1)

[173] IRC §705(a)(2) and (3)

[174] IRC §611

An **increase** in an LLC member's **share of liabilities** is treated as a **contribution of money** to the LLC, which increases the member's basis in his interest.[175] Conversely, a **decrease** in an LLC member's **share of liabilities** is treated as a **distribution of money**, which decreases the member's basis in his interest.

If the sale of a partner's interest involves **Code §751** "hot assets," the sale must be broken into two parts:

- The sale of the **Code §751** "hot assets," and
- The sale of other property (i.e., "cold assets") under **Code §741**.

Code §751 assets are treated as **ordinary income** based on the difference between the portion of the amount realized from these "hot assets" and the selling member's inside share of the bases of those assets.[176] The portion of the amount realized from "hot assets" can be allocated in an arm's length agreement between the seller and purchaser. But, if no allocation is made, the **relative FMV** of the LLC property is used.[177] The FMV of the recapture items is the amount of recapture that would be realized on a deemed sale of the recaptured property ("hot assets") by the LLC at FMV.

> **Comment:** Technically, any asset whose taxable sale or exchange would produce other than capital gain or loss, or Sec. 1231 gain or loss, has to be taken into account for purposes of the "hot asset" rule. For example, with an LLC holding real estate, a member who sells their interest cannot simply take capital gain or loss on the deemed disposition of their respective share in the underlying real estate if there is accumulated depreciation on the asset that would have produced "unrecaptured Sec. 1250 gain" taxed at 25% if it had otherwise been sold by the LLC directly (or, Sec. 1231 gain or loss, had it been disposed of).

> **Comment:** Perhaps the simplest way to understand the "hot asset" concept behind **Code §751** is to determine what the respective character of any gain or loss would have been had the partner/member held the assets directly (v. indirectly through a partnership) and disposed of them in a taxable sale or exchange.

The selling member's basis in the assets is an amount equal to what the selling member would have if he received his **proportionate share** of the properties in a current distribution immediately before the sale.[178] The basis also includes any special adjustments available to the selling member under **Code §§734(b)** or **743(b)**.

2. Prohibition Against "Negative Basis": The general policy of the tax law is to avoid dealing with the complexities of "negative basis." The specific Code sections prohibiting "negative basis" are as follows:

a. **Code §705(a)(2) and (3)**

b. **Code §704(d)** - Limits partner's deduction for partnership losses to his adjusted basis at the end of the partnership tax year in which the loss occurred

c. **Code §733** - Partner's basis in his partnership interest is reduced (but not below zero) by the amount of any money distributed, as well as the partnership's adjusted basis in any property distributed to him

d. **Code §732(a)(1)** - Partner receiving a current distribution of property (other than money), takes a carryover basis in such property equal to the partnership's adjusted basis in such property immediately before the distribution

e. **Code §732(a)(2)** - Limits the basis of any distributed property (other than money) to the distributee partner's basis in their partnership interest

f. **Code §731(a)(1)** - Requires that a distributee partner recognize gain to the extent that any money distributed to him exceeds his basis in his partnership interest. As a result, a partner with a zero adjusted basis in his interest, instead of reducing his basis any further upon the

[175] IRC §752(a)

[176] Treas. Reg. §1.751-1(a)(2), Rev. Rul. 75-323,1975-2 C.B. 346

[177] Ibid.

[178] Ibid.

distribution of money, is instead required to recognize gain to the extent of the money received, while taking a zero basis in any other non-money property received in the same distribution.

3. Holding Period: The selling member's holding period for determining whether the capital portion of the gain or loss recognized is long- or short-term is **determined without reference to the holding periods of the LLC's assets**. However, if the member acquired his interest in the LLC as a result of a contribution of property to the LLC, his holding period includes the holding period of the exchanged assets (i.e., a substituted basis and holding period is used).

4. Installment Sale: Under the installment sale method, the amount of reportable gain during the taxable year is that amount which bears the same proportion to the payments actually received during the year as the realized gross profit percentage on the sale bears to the total contract price.[179] **Payments** include all amounts actually or constructively received by the seller, plus the excess of the liabilities assumed by the buyer over the seller's adjusted basis in the property. **Total contract price** is defined as the amount realized by the seller, less any liabilities assumed by the buyer to the extent the liabilities do **not** exceed the seller's adjusted basis in the property.

A sale of a member interest is a sale of personal property. It qualifies as an installment sale if at least one payment is received after the close of the taxable year. For purposes of determining the "total contract price," the decrease in the selling member's share of LLC liabilities resulting from the sale is treated as an additional amount (i.e., consideration) realized on the sale.

When the LLC has **Code §751** "hot assets," the installment sale becomes more complicated. Any depreciation or amortization recapture income under either **Code §1245** or **Code §1250** that would have resulted had the partnership instead disposed of the asset at a gain must be reported in the year of sale and is deducted from the selling price to determine gross profit.[180] **Rev. Rul. 89-108** clearly concludes that all LLC **Code §751** property is **not** eligible for installment sale reporting, and therefore also must be reported in the year of sale (i.e., regardless of the amount of any down payment received).

If the entity theory holds, and the LLC has a **Code §754** election to step up the basis of LLC assets for a purchasing member in effect, this member receives an immediate step-up in his basis in the unrealized receivables and inventory items. Furthermore, he may deduct this basis against his share of the income when received by the LLC, even though installment payments by him to the selling member have **not** yet been made.[181]

5. Effect of Termination on Selling Member's Tax Year: For the selling member, the LLC tax year closes when a member sells or exchanges his **entire** LLC interest, and his distributive share of gain, loss, etc., is computed up to the date of the sale.[182] A pro rata allocation (i.e., per share, per day) is normally used, unless an election to have an interim closing of the LLC books is made and approved by all affected owners.[183]

A sale of only a portion of a member's interest does **not** close the LLC's tax year for the seller. Instead, his distributive share is computed taking into account varying interests during the taxable year.[184] Furthermore, the partnership year does **not** close for a partner who dies until the interest (held by the estate) is liquidated, sold, or exchanged.[185]

6. Effect of Sale on LLC: A transfer of an LLC interest has **no effect on the LLC property** unless the LLC is terminated. An **LLC is considered terminated** only if one of the following two events occurs:

• No part of any business, financial operation, or venture of the LLC continues to be carried on by any of its members.

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[179] IRC §453(c)

[180] IRC §453(i), as amended by TRA '86

[181] IRC §§754 and 743(b)

[182] IRC §706(c)(2)(A)(I)

[183] Treas. Reg. §1.706-1(c)(2)(ii)

[184] Treas. Reg. §1.706-11(c)(4)

[185] Treas. Reg. §1.706-1(c)(2)(i)

• **Within a 12-month period there is a sale or exchange of 50% or more of the total interest in LLC capital and profits.**[186] This means that there must be sales or exchanges of 50% or more of the total interest in LLC capital, and 50% or more of the total interest in LLC profits.

Comment: The TCJA eliminated the concept of "technical terminations" for tax years beginning after 2017.

Consequently, the sale of a 30% interest in LLC capital and a 60% interest in LLC profits is **not** the sale or exchange of 50% or more of the total interest in LLC capital and profits. However, when one member of an equal interest two-person LLC sells his entire interest to the other member, the LLC is **terminated**, unless the state recognizes a single-member LLC (SMLLC).

Example 2: "Pre-TCJA Technical Termination of LLC"
Members A, B, and C have equal interests in an LLC. On March 1, 20x1, Member A sells his interest in LLC profits and capital to a new Member D. Member B sells his interest in LLC profits and capital to a new Member E on February 2, 20x2. The LLC is deemed to have terminated on February 2, 20x2.

If Member B does **not** sell his interest, and Member D sells the interest he acquired from Member A, the LLC does **not** terminate. Only one interest was sold or exchanged within a 12-month period, even though it transferred twice.[187]

An LLC does **not** terminate for tax purposes on:

• Death of a member, even in a two-person LLC,

• Gift of a member interest,

• Liquidation of a member interest,

• Admission of a new member, or

• Sale of a member interest, unless the sale is 50% or more of the total interest in capital and profits within a 12-month period.[188]

Comment: "Technical terminations" were only for tax years beginning before 2018.

D. Tax Consequences of Technical Terminations Before 2018

- Technical Terminations of Partnerships

Comment: As discussed below, with a "technical termination" under **Code §708(b)(1)(B)**, a partnership is considered as terminated if, within any 12-month period, there is a sale or exchange of 50% or more of the total interest in partnership capital and profits. A technical termination gives rise to a deemed contribution of all the partnership's assets and liabilities to a new partnership in exchange for an interest in the new partnership, followed by a deemed distribution of interests in the new partnership to the purchasing partners and the other remaining partners.

Comment: Another key to understanding the tax ramifications as a result of a technical termination is that some of the tax attributes of the old partnership terminate. For instance, the partnership's tax year closes, partnership-level elections generally cease to apply and the partnership depreciation recovery periods restart.

Comment: Under the TCJA, for partnership tax years beginning after Dec. 31, 2017, the Code §708(b)(1)(B) rule providing for the technical termination of a partnership is repealed. But, this repeal

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[186] Treas. Reg. §1.708-1(b)(1)

[187] Treas. Reg. §1.708-1(b)(1)(ii)

[188] Treas. Reg. §1.708-1(b)(1)(ii); although, "technical terminations" were prospectively eliminated by the TCJA starting in 2018.

does *not* change the pre-Act law rule of **Code §708(b)(1)(A)** that a partnership is considered as terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.[189]

1. Background: If the LLC terminates as a result of a sale of **50% or more** of a capital and profits interest within a 12-month period, the LLC taxable year closes for **all** members on the LLC termination date.[190] In this situation, the following is deemed to occur:

• The LLC is deemed to have contributed **all** of its assets and liabilities to a **new** LLC in exchange for an interest in the new LLC, and

• Immediately thereafter, the terminated LLC distributes its interest in the new LLC to the purchasing member and the other remaining members in proportion to their interests in the terminated LLC, either for the continuation of the business by the new LLC or for its dissolution.[191]

• For depreciation purposes, the technical termination of a partnership results in a **"fresh start"** approach with regard to any carryover basis of assets deemed transferred from the terminated entity.

Comment: Dissolutions are distinguished from technical terminations to the extent that any depreciable property being distributed retains the **same** lives and recovery methods as that used by the predecessor entity. That is, any depreciable property received pursuant to the dissolution is entitled to **"shoes" depreciation**. This is because **Code §168(i)(7)(B)** specifically states that technical terminations under **Code §708(b)(1)(B)** are ***not*** entitled to "shoes" depreciation even to the extent of any carryover basis of depreciable property. Thus, they are treated as "newly-acquired" property (Note: Though a new depreciation method may be chosen, Sec. 179 is *not* available since this is considered a "purchase" from a related party. With regard to bonus depreciation, the IRS might argue that it is likewise *not* available since this "new" partnership is *not* considered the "original user" of the assets).

Comment: Since any property flowing over to the "new" partnership would be considered newly-acquired, an previous AMT adjustment might now be considered gone. For instance, suppose an LLC holds title to an apartment complex and it was placed in service before 1999, there would be an AMT adjustment for the difference between the S/L method over 40 years v. the 27.5-year MACRS recovery period used for regular income tax purposes. With a "fresh-start" approach now being required on any remaining basis, the new placed-in-service date would take it outside of this AMT adjustment requirement.

Example 3: Gary, Sue and John are equal members in the GSJ, LLC accounting firm. After a recent falling out, they decide to disband the firm and continue the business as separate single-member LLCs. There is an equal splitting of the clients, and all other depreciable and nondepreciable property. Therefore, **Code §751** (i.e., with regard to "hot assets") does *not* apply.

One of the distributed assets was the commercial building. This was titled in the LLC's name. It will now be held as tenants-in-common by the threesome. At the time of the dissolution on June 1 of the current tax year, the building had a depreciable basis of $500,000 and was in Year 9 of its 39-year MACRS recovery period. As a result of the distribution, the LLC takes 5½ months of depreciation (using the mid-month convention) and the three individual owners take the remaining 6½ months (each on their respective Schedules C). The new owners have a remaining recovery period of 30 years.

Example 4: Gary, Sue and John are members in the GSJ, LLC accounting firm. John decides to sell his interest. Gary and Sue each own 25% of the LLC. John owns 50%, which Gary and Sue purchase on June 1 of the current tax year. Since John owned 50% of the firm, this transaction results in a technical termination of the LLC. At the time of this deemed termination of the LLC, the commercial building had a depreciable basis of $500,000 and was in Year 9 of its 39-year MACRS recovery period. On the final tax return of the "old" firm (GSJ, LLC), 5½ months of depreciation for the building is reported on Form 4562. The remaining carryover

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[189] As a result, partnerships would not be required or permitted to make new tax elections following such a sale or exchange, but at least depreciation or amortization of assets would *not* have to begin anew on Form 4562. Code Sec. 708(b), as amended by Act Sec. 13504

[190] IRC §708(b)(1)(B)

[191] Reg. §1.708-1(b)(4)

basis is deemed transferred to the "new" firm (GS, LLC). However, it now has a "fresh start" recovery period of 39 years with a placed-in-service date as of the technical termination and 6½ months of depreciation being claimed for the remainder of the buyout year.

Comment: If John's LLC interest was instead terminated by receiving a liquidating distribution from the entity (i.e., v. having Gary and Sue purchase his interest outside of the LLC entity), then a technical termination would *not* have occurred and the "old" LLC with the continuation of the depreciation (or, amortization) of any of its assets on Form 4562 would have continued uninterrupted.

If a **Code §754** election is in effect, the basis adjustments for the new member are adjusted **prior** *to* their deemed distribution from the old to the new LLC.

This form of termination and reformation does **not**:

• Change the basis of any LLC assets, the book or capital accounts of the members, and

• Require a *new* taxpayer identification number (TIN) for the new LLC.

Comment: For terminations on or after May 9, 1997, this procedure effectively removes the negative tax consequences of terminations, in which the continuing members' accounts are affected by the deemed distribution of assets from the old LLC and re-contribution into the new LLC.

2. Impact of technical termination on LLC elections: Because any election currently in effect is nullified by a technical termination, a partnership undergoing a technical termination should review all the elections the "old" partnership made and decide whether the "new" partnership should either renew or forfeit any previously irrevocable elections.

a. The "new" partnership that is formed can decide whether to elect previously irrevocable elections such as the Sec. 754 election. The "new" partnership can also choose its own inventory method, accounting method, and tax year end. However, some aspects of the terminated partnership's elections carry over to the "new" partnership. Whether or not the "new" partnership decides to make a Sec. 754 election, existing Sec. 743 basis adjustments in property held by the old partnership that technically terminated retain their Sec. 743 basis adjustments in the "new" partnership (**Reg. §1.743-1(h)(1)**)

3. Reporting requirements due to a technical termination: Consideration should also be given to the various reporting requirements involved in preparing *two short-year tax returns* for a partnership undergoing a technical termination and the tax treatment of certain capitalized intangible assets upon partnership termination.

a. If a technical termination results in late filing of the partnership's tax return for the short year, the penalties that may apply can be costly (i.e., $195/month/partner (adjusted for inflation after 2015) for failure to file a partnership tax return).[192] There is also a $250 penalty for failure to furnish a payee statement for each Schedule K-1 that is not timely or properly filed, but the total penalty cannot exceed $3,000,000.[193]

b. As mentioned above, the partnership undergoing a technical termination has to file *two* short-year returns, and the date of the transaction involving a sale or exchange of partnership interest that triggers a technical termination becomes the close of the tax year for the old partnership.

1) A partnership tax return is due 3½ months following the end of the month during which a partnership terminates. But, a separate extension can be filed to extend the due date of each respective short-period return by an additional five months.

4. Reporting requirements for "old" Form 1065

a. The tax return of the "old" partnership should have the technical termination and final return boxes checked.

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[192] Under Code §6698, although Rev. Proc. 84-35 might be helpful in avoiding the imposition of this penalty. Furthermore, the accrual of the failure-to-file penalty is limited to a period of 12 months.

[193] Code §6722

b. Since, upon the technical termination of a partnership, it is deemed that the "old" partnership contributes all of its assets and liabilities to the new partnership, it is recommended that the ending balance sheet of the old partnership be zeroed out.

c. A statement should be attached to the tax return explaining the transaction(s) that triggered the technical termination and showing what the ending balance sheet was immediately prior to the partnership termination.

d. The K-1s of the partners of the "old" partnership should reflect zero ending capital accounts and should be marked final.

e. The K-1 instructions also state that once a partnership terminates, the ending percentages of each partner immediately before partnership termination should be reflected on Item J of each partner's Schedule K-1.

5. Reporting requirements for "new" Form 1065

a. Similar to the "old" partnership tax return, the "new" partnership tax return should have the technical termination and initial return boxes checked.

b. The beginning balance sheet should reflect the balance sheet of the "old" partnership immediately before termination.

c. Similarly, the beginning capital on Schedule M-2 of the "new" partnership tax return should reflect what the ending capital on Schedule M-2 of the old partnership was immediately before its termination.

d. The K-1s of the partners of the "new" partnership should have their beginning percentages in Item J be consistent with the ending percentages on the K-1 of the "old" partnership, and beginning capital on Item L of their respective K-1s should reflect their ending capital accounts immediately before the "old" partnership's termination.

Comment: It is also advisable that each Schedule K-1 of the old and new partnerships contain a statement that notifies the partners that a technical termination has occurred and that they will be receiving two short-year K-1s. Furthermore, it is important to include in an attached K-1 statement the continuing partner's proportionate share of any Sec. 754 adjusted basis property that will carry over to the new partnership from the terminating partnership.

6. Transactions not resulting in a technical termination: Normally, any sale or exchange outside of the partnership entity can impact whether a technical termination has occurred. However, a partnership interest that is disposed of by gift or devise is *not* counted as a transaction that determines whether a technical termination has occurred.[194] Partner contributions that result in a change of partnership ownership, unless they are part of disguised sales, were also *not* included in the determination of whether a technical termination has occurred. Additionally, a partnership interest that is sold to another partner and then resold to another party is only counted *once* toward the determination of whether a 50% or more change in partnership capital and profit has occurred.[195]

Example 5: Gary sells his entire 40% interest in partnership ABC to Sue and as a result increases Sue's interest in the partnership to 45%. If two months later Sue sells a 40% interest to John, this does *not* cause a technical termination since only *one* 40% interest was sold within a 12-month period.

Example 6: Assume the same facts as in **Example 5** except that one month later, a new fourth partner Lisa is admitted into the partnership with a 30% interest after she contributes $300,000, and two months later this new partner receives a distribution of $300,000. This disguised sale triggers a technical termination because a 70% change in partnership capital and profit has occurred.

E. Basis Adjustment for New Member

[194] Reg. §1.708-1(b)(2)

[195] Reg. §1.708-1(b)(2)

1. Using Sec. 754 to Equalize Inside Vs. Outside Basis: When a member purchases an LLC interest, he has a **cost basis** equal to what he paid for the interest, plus his share of LLC liabilities. When a member inherits an LLC interest, he has a basis equal to the interest's FMV as of the date of the former member's death, plus his share of LLC liabilities. In either case, the new member's basis for his LLC interest, referred to as "outside basis," may **differ substantially** from his share of the adjusted basis of LLC property on the books, referred to as "inside basis." When there is a substantial difference between a new member's initial inside and outside bases, the general rule of **not** adjusting the LLC property basis as a result of a transfer by sale or exchange or death may operate to the new member's disadvantage.

Comment: For acquisitions of "qualified property" placed into service after 9/27/17, bonus depreciation has been increased from 50% to 100%. More importantly, it applies for "used" property now, and *not* just "original use" property as had been the case previously. This would now include the step-up in partnership assets pursuant to a Code §754 election which otherwise meet the definition of "qualified property" (i.e., tangible real or personal property, new or use, which has a MACRS class life of 20 years or less).

Comment: But, only step-ups governed by Code §743 are eligible for bonus depreciation and not those resulting from the operation of Code §734.

Example 7: "Outside Basis Not Equal to LLC's Inside Bases"
Frank purchases John's one-third interest for $20,000. The LLC has two assets with a total FMV of $60,000 and no liabilities on its books as follows:

• $30,000 of receivables, with a basis of zero, and

• $30,000 FMV of equipment with an adjusted basis of $15,000.

Frank's adjusted basis for the purchase of his LLC interest is $20,000 (outside basis = to his purchase price paid). However, his share of the LLC's adjusted bases for its assets is only $5,000 (inside basis). In this case, Frank would recognize ordinary income of $10,000 upon the eventual collection of the receivables. This is the case even though he already purchased his share of the outstanding receivables at FMV. In addition, he would receive only $5,000 of the future depreciation deductions, even though he paid $10,000 for his share of the equipment.

1. Sec. 754 Election: To rectify the inequity described in **Example 5**, the law allows for a **Code §754** election. This permits the LLC to **increase or decrease** the **inside bases** of LLC's assets, but it is **solely for the new member's interest**. As a result, there is an adjustment for the new member **equal to the difference between his inside basis and outside basis**. These adjustments are made under **Code §§743(b)** and **(c)** and **Code §755**. They apply to depreciation, amortization, depletion, gain or loss and distributions of LLC property. However, when a member in a two-member LLC purchases the interest of the other member, he becomes the purchaser of the selling member's share of the assets.

Comment: For transfers after October 22, 2004, a **Code §743(b)** adjustment is required if the partner has a **substantial built-in loss** immediately after the transfer. Losses of **more than $250,000** are considered **"substantial**."

Example 8: "Using Sec. 754 Election to Equalize Inside v. Outside Basis"
Use the **same** facts as in **Example 5**. If the **Code §754** election is made, the "step-up adjustment" allows Frank to set up:

• A $10,000 basis in the receivables to be deducted from his LLC share of the gain when they are collected by the LLC, and

• A $5,000 addition to the equipment basis to be depreciated separately by Frank.

If the **Code §754** election is **not** made, Frank simply has a high basis in his LLC interest which does **not** benefit him until he either receives a current distribution from the LLC, or sells or liquidates his member interest (which might mean that in the interim he picks up ordinary income on the collection of the receivables only to realize additional capital loss when he sells his LLC interest).

Under the mechanics of Sec. 754 (i.e., as set out in the regulations under **Reg. §1.755**), the step-up adjustment is first allocated between **two distinct classes** of property:

• Capital assets, and

• Any other LLC property.

The portion of the adjustment allocable to each class of assets is equal to the difference between the new member's **outside basis** in his interest attributable to the value of a class of assets and his proportionate share of the LLC's **inside basis** for such class of assets. A **positive** adjustment is allocable to a class of assets only if the class has net **appreciation** in value. On the other hand, a **negative** adjustment is allocable to a class only if the class has net **depreciation** in value.

The portion of the adjustment allocated to each class of LLC assets is further allocated between individual assets within each class in a manner which **proportionately reduces** the difference between the FMV and the adjusted basis of each asset. **Positive** adjustments are allocated solely to **appreciated** assets. **Negative** adjustments are allocated solely to **depreciated** assets.

If the contributing member recognizes gain on the property contribution and the LLC makes a **Code §754** election, the LLC property's basis is **increased** by the amount of gain recognized. Furthermore, the amount of the gain is treated by the LLC as a **separate** asset.

Comment: As shown in **Example 9** below, this "new" Sec. 754 asset is broken out further depending on what MACRS classes it falls into, including a separate amortizable asset, if goodwill is deemed to be part of the purchase.

Example 9: "Mechanics of Sec. 754 Step-up"
The following balance sheet is used for Joe's adjustment when he purchases Mike's LLC share for $145,000 and the LLC has a **Code §754** election in effect.

LLC Assets

Assets	**Adjusted Basis**	**FMV**	**Difference**
Code §§1221 & 1231Property:			
Equipment	$ 40,000	$ 60,000	$ 20,000
Land	100,000	280,000	180,000
Buildings	95,000	65,000	(30,000)
	$235,000	$405,000	$170,000
Other Property:			
Cash	$ 10,000	$ 10,000	-0-
Accounts Receivable	-0-	20,000	20,000
Inventory	40,000	60,000	20,000
	$ 50,000	$ 90,000	$ 40,000
Total Assets:	$285,000	$495,000	$210,000
Liabilities & Capital:			
Liabilities	$ 60,000	$ 60,000	$ -0-
Capital - Mike	75,000	145,000	70,000
Capital B	75,000	145,000	70,000
Capital C	75,000	145,000	70,000
Total Liabilities & Capital:	$285,000	$495,000	$210,000

Mike sells his interest to Joe for $145,000. The **outside basis** of Joe's interest in the LLC equals his **cost plus his share of liabilities**.

$145,000 FMV + $20,000 (1/3 share of liabilities) = $165,000 outside basis

Meanwhile, Joe's deemed share of the inside bases in the LLC property is only $95,000 (1/3 × $285,000).

$75,000 of Member A's capital account + $20,000 (1/3 of the liabilities)

Consequently, pursuant to the Sec. 754 rules, Joe is permitted to adjust his share of the inside bases in the LLC's assets by $70,000. This is the difference between his **outside basis** in the LLC interest and his share of the adjusted **inside bases** of the LLC property. Although the adjustment election must be made by the LLC, only the transferee member's basis (i.e., Joe) is affected.

	Calculation of Allocation for Sec. 754 Purposes		
	Difference between FMV and LLC Basis	**Total Adjustment**	**Amount of Allocation**
Step 1: Allocating to the 2 Groups			
A. Capital assets & Sec. 1231 property	$170,000	$70,000 x (170/210)	$56,667
B. Other Property	40,000	70,000 x (40/210)	13,333
Total:	$210,000		$70,000
Step 2: Allocating to Individual Assets			
A. Equipment	$ 20,000	$56,667 x (20/200)	$ 5,667
B. Land	180,000	56,667 x (180/200)	51,000
Total:	$200,000		
C. Accounts Receivable	$ 20,000	$13,333 x (20/40)	$ 6,667
D. Inventory	20,000	13,333 x (20/40)	6,667
Total:	$ 40,000		$70,000

Joe would therefore **increase** his **inside bases** in the respective assets as follows:

- $5,667 in equipment,
- $51,000 in land,
- $6,667 in accounts receivable, and
- $6,666 in inventory.

There is nothing allocated to buildings since the FMV does **not** exceed the adjusted basis. For purposes of depreciation, gain or loss, and distributions, Joe has a special basis adjustment for those listed LLC properties. And, any special depreciation allocations are separately reported on Joe's Schedule K-1 as "supplemental information."

2. Making the Sec. 754 Election: To make the **Code §754** election, a **written** statement must be filed with a timely filed LLC return, including extensions, for the year in which the transfer occurs. Once the election is made, it is continuous and applies to **all transfers until revoked** or the LLC terminates. The statement must:

- Include the name and address of the LLC making the election,
- Be signed by any one of the members, and
- Contain a declaration that the LLC elects under **Code §754** to apply the provisions of **Code §734(b)** and **Code §743(b)**.[196]

Comment: The IRS has released a draft version of new Form 15254, **"Request for Section 754 Revocation."** Previously, before TCJA removed the provision for partnership "technical terminations" in the Code, there were numerous requests for such revocations. Although they will still be difficult to obtain, the

[196] IRC §734(b) applies to an unusual basis adjustment to partnership property when gain or loss was recognized on a distribution of property other than money to a partner

Service has set out in the related regs and form instructions those **instances** where such a request might be granted.

If an LLC interest is transferred and a **Code §754** election is made, the **Code §743** adjustment is made only for the **acquiring member**. That is, the only adjustments made on the LLC books are for the step-up in the **inside bases** with regard to the **acquiring member's interest**. And, as stated above, he is **specially allocated** any additional depreciation or amortization with regard to this increased basis, or any gain on a sale of assets, all of which flow through to this owner via the Schedule K-1.

If a **Code §754** election is **not** made, there may be a way to salvage the adjustment through a distribution of property, other than money, **within two years** of the date the member interest was originally acquired. The distributed property's adjusted LLC basis, upon the member's **Code §732(d)** election, is the adjusted basis it would have if the **Code §743(b)** adjustment was in effect.

If a **Code §754** election was made in a prior or current year and the LLC terminates due to a **technical termination (which was only in effect for pre-2018 tax years due to its repeal by the TCJA)**, the new member must make the basis adjustments for his share of the LLC assets prior to the distribution of the old LLC property. These special adjustments are utilized to distribute the basis of the new member's LLC interest to the assets distributed to him that are then deemed contributed back into a new LLC.

These adjustments are made as seen in **Example 7** above. In principle, this allows a new LLC member with an FMV interest in excess of basis to achieve a step-up in basis allocated to the FMV of the assets. Under **Code §704(c)**, these higher bases figures are specifically allocated to him. In turn, this will offset any income received from the receipt of unrealized receivables and sale of inventory, and increases any depreciation or amortization deductions to reflect the higher basis on depreciable assets.

When a **Code §754** election is **not** made and the LLC is terminated, the stepped-up basis is allocated prior to termination according to the basis on the LLC books. Depending on the difference between the FMV and basis, and the nature of the LLC assets, the new member may have very little allocation to ordinary income property and a much larger allocation to the depreciable and nondepreciable capital assets. When goodwill or going-concern value is present, special procedures for allocating the goodwill are outlined in **Temp. Reg. §1.755-2T**.

When a technical termination occurs, the resulting cost-recovery deductions for the old and new LLC depend on the year of acquisition and method of cost recovery used for the depreciable assets in the old LLC. For terminations after 1986 when property was depreciated under MACRS, the old LLC receives a half-year depreciation deduction for transferred Code §1245 property, and a monthly allocated deduction for Code §1250 property. The new LLC receives a first-year MACRS deduction and a new recovery period since the new LLC is treated as if all the property was purchased new (i.e., a "fresh start" approach). As a result, MACRS depreciation is computed using the carryover adjusted basis (i.e., as reported on Form 4562 for the terminated LLC's final return), with depreciation allowed on any tangible personal property using the half-year convention and a monthly allocation for any real property using the mid-month convention.

Comment: Amortizable property would simply split the 12-month period based on the number of respective months that each entity (i.e., the terminated LLC and the deemed "new" one which is created as a result) held the asset.

☞**IRS Issues Final Regs on Signature Removal for Sec. 754 Election** (**TD 9963**)

The IRS has issued final rules on how to make a valid election to adjust the basis of partnership property after the partnership makes a property distribution or a partnership interest is transferred. Under **Code §754**, after a partnership makes a distribution of partnership property, or an interest in the partnership is transferred, the partnership may make an election to adjust the basis of the remaining partnership property. Generally, a partnership makes a basis adjustment election in a written statement that's filed with the partnership's return for the year of the distribution or transfer. Proposed regulations (**REG-116256-17**) removed the partner signature requirement for a valid election under **Reg. §1.754-1(b)**. These final regulations adopted the October 2017 proposed regulations without change for tax years ending on or after 8/5/2022. **(Code §754; Sec. 754 Election)**

3. Mandatory "Negative" Sec. 754 Adjustment: A partnership is required to make downward basis adjustments to the basis of partnership assets under **Code §734** in the case of a distribution with respect to which there is a "substantial basis reduction," effective for distributions after October 22, 2004.

a. A "substantial basis reduction" means a downward adjustment of **more than $250,000** that would be made to the basis of partnership assets if a **Code §754** election were in effect.

b. The $250,000 threshold is determined by adding the following amounts (**Code §734(d)**):

1) the amount of any loss recognized to the distributee partner with respect to such distribution under **Code §731(a)(2)**, and

2) in the case of distributed property to which **Code §732(b)** applies, the excess of the basis of the distributed property to the distributee, as determined under **Code §732**, over the adjusted basis of the distributed property to the partnership immediately before such distribution (as adjusted by **Code §732(d)**).

Comment: There is no "percentage-of-assets alternative" to the definition of a "substantial basis reduction." In other words, the threshold is based on dollar amounts only. Furthermore, there is no built-in inflation adjustment related to the definition of a substantial basis reduction.

Example: A and B each contribute $500,000 and C contributes $1 million to a newly-formed partnership, which does *not* have an election under **Code §754** in effect. The partnership has no liabilities. It then purchases 2 parcels of real estate for $600,000 and $1,400,000, respectively. The value of each parcel subsequently declines to $200,000. The partnership distributes the parcels with an inside basis of $600,000 to C in complete liquidation of C's interest in the partnership. Under **Code §732(b)**, the basis of parcel in C's hands is $1 million (i.e., substituted basis of his ownership interest for this land received as a liquidating distribution) and C would recognize a loss of $800,000 if the parcel was then sold for its $200,000 value. In this situation, there is a "substantial basis reduction" within the meaning of **Code §734(d)**, because the $400,000 *increase* in the adjusted basis of the parcel (described in **Code §734(b)(2)(B)**) is greater than $250,000 (i.e., its *inside* basis to the partnership was $600,000, while the *outside* basis to C, using the substituted basis rule, would be $1 million). As a result, under **Code §734(b)**, the partnership is required to decrease the basis of its remaining parcel by $400,000 (the amount by which the basis of parcel was increased because C was permitted to substitute his $1 million basis as the basis for the parcel received in liquidation of his interest), leaving a basis of just $1 million remaining in the parcel (i.e., $1,400,000 - $400,000).

Comment: The partnership is required to attach a statement to the partnership return for the year of the distribution describing the basis reduction as if an election under **Code §754** were in effect at the time of the relevant distribution. (**Notice 2005-32**)

☞**IRS Provides Procedures for Revoking Sec. 754 Election**

The IRS has provided its employees with updated **procedures** to use when determining whether to approve or deny a partnership's request to revoke its **Code §754** election to adjust partnership property basis. Furthermore, this guidance applies to any partnership, whether subject to **TEFRA**, the **BBA**, or separate deficiency proceedings.

Sec. 754 Election: A partnership may elect to adjust the basis of its property after:

1. A distribution of partnership property, or

2. Certain transfers of a partnership interest.

To make the election, a partnership must attach a statement to the partnership's timely-filed return (including extensions) for the tax year in which a distribution or transfer occurs. The statement must include:

1. The name and address of the partnership, and

2. A declaration that the partnership is making a **Code §754 election**.

Once this election is made, it applies to *all* distributions and transfers made during the tax year for which the election is initially filed, and to *all* such transactions in any subsequent tax year unless the election is revoked. This election can only be revoked with permission of the IRS Commissioner. (**IRS.gov/Sec. 754 FAQs**)

Sec. 754 Revocations: A partnership that wants to revoke its **Code §754** election should file its revocation request using **Form 15254, Request for Section 754 Revocation**, no later than 30 days after the close of the partnership's tax year. **Form 15254** must state the reason(s) for requesting a revocation. The regulations provide examples of situations that may warrant the IRS approving a partnership's revocation application. (**Reg §1.754-1(c)**) These examples include:

1. A change in the nature of the partnership's business;

2. A "substantial increase" in the partnership's assets;

3. A "change in the character" of the partnership's assets, or

4. An "increased frequency" of retirements or shifts of partnership interests.

A revocation application will *not* be approved when the revocation's purpose is primarily to avoid a reduction in the basis of partnership assets upon a transfer or distribution of partnership property.

> **Comment:** Taxpayers used to employ a deliberate "technical termination" (i.e., more than 50% change in particular partner's interest within a 12-month period) to achieve the same result, namely the revocation of a Sec. 754 election previously made. But, with the passage of the **TCJA**, this was no longer possible since "technical terminations" have been eliminated in the tax law. Moreover, as stated above, the IRS will *not* approve such revocations in those situations where it would be most common (i.e., when the revocation's purpose is primarily to avoid a reduction in the basis of partnership assets upon a transfer or distribution of partnership property).

In addition, the IRS has updated procedures for reviewing revocation application requests on **Form 15254**. These procedures cover:

- Processing the **Form 15254**
- Making the determination to approve or reject the revocation request
- Getting managerial approval of the determination
- Sending the recommended determination to Chief Counsel for review
- Obtaining the proper signatures for the determination letter, and
- Document retention procedures. **(Code §754; Sec. 754 Elections)**

F. Abandonment of Partnership Interest

1. Background: When an LLC is in financial difficulty, some members may wish to abandon their LLC interest. Depending on the circumstances, abandonment may be considered a sale or exchange. If the member abandoning his interest has the remaining members assume his share of the liabilities, he is **deemed to sell his interest for his share of the liabilities**. This may result in either a capital gain or a loss. However, abandonment of an interest is **not** treated as a sale or exchange and can be accorded **ordinary** loss treatment provided that a distribution or other event creating sale or exchange treatment has **not** occurred.[197] The key is that absolutely nothing is either actually or constructively received so a "sale or exchange" of the LLC interest by the member has **not** occurred.

> **Example 8: "Abandonment of Partnership Interest"**
> Gary is a member of Gary and Sons, LLC. He owns 75% of the LLC. While Gary made the initial capital contribution to start the LLC, the sons have been performing all the work. The LLC has shown continual losses, eroding Gary's entire basis. In addition, the LLC has a $100,000 liability because of a bank loan. Gary is willing to give up his 75% ownership interest in order to avoid incurring additional losses. He is also released from any liability on the bank loan. Gary must report $75,000 ($100,000 × 75%) of income in the year of abandonment since he has no basis remaining in his ownership interest.

As mentioned above, a loss is considered **ordinary** only if there is neither an actual nor a deemed distribution to the member.[198] Therefore, in a limited partnership in which all the **recourse** liabilities are allocated to the general partners, and there are no **nonrecourse** liabilities, a limited partner can abandon his interest and have an **ordinary** loss rather than a **capital** loss. This is the case because giving up a recourse liability is treated as a deemed distribution. In an LLC setting, this would also arguably be the case where all of the liabilities are deemed to be nonrecourse, or the other members have guaranteed their repayment. However, if the LLC member has been able to use nonrecourse debt such as a mortgage on LLC real property to take K-1 losses (or distributions) in excess of "hard basis," then abandonment their interest might be at a point in time that they have a deficit capital account. And, if they fail to eliminate this deficit

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[197] *Citron v. Comm'r*, 97 TC 200 (1991).

[198] Rev. Rul. 93-80, 1993-2 C.B. 239

and are able to just walk away from the LLC without giving anything (as seen in the item listed below), the relief from this responsibility might be treated the same as if they had receive a cash distribution.

☞**Partnership Entitled to Worthless Debt Deduction** (***2590 Associates, LLC*, TC Memo 2019-3 (1/31/2019)**)
A real estate developer owned several business entities, two of which were involved in the construction of a mixed-use shopping center. In 2006, the entities obtained a $2 million bridge loan from an unrelated third-party (namely, Alabama's football coach Nick Saban). When it appeared the entities would default on the loan, however, the lender (i.e., Nick Saban) agreed to transfer the note to another entity owned by the developer in exchange for a 15% equity interest in the entity. On its 2011 partnership return, the entity then proceeded to claim a "worthless debt deduction" of $2.9 million for the note. The IRS disallowed the deduction, claiming that the transaction was instead a "capital contribution" because the note did *not* represent a bona fide debt. The Tax Court disagreed, finding "a genuine debtor-creditor relationship between the two entities." The Court noted that at the time of the note's transfer, the developer sincerely believed the project would succeed and the debt would therefore be repaid. As a result, the worthless debt deduction was justified. **(Code §166; Worthless Debts)**

☞**Disposal of Partnership Interests Generated Capital Losses** (***Watts*, TC Memo 2017-114 (6/14/2017)**)
The taxpayer owned a large chain of golf shops with his brother. To facilitate the sale of the business, the brothers formed a partnership and sold an 80.5% interest to a private equity firm. The private equity firm received preferred partnership interests, which offered certain preferred rights upon transfer of the business. Eventually, the entire partnership was sold to another private equity firm, with the brothers receiving no proceeds for the transaction. On his return, the taxpayer claimed that he "abandoned his partnership interest," which he claimed generated *ordinary* losses. But, upon audit, the IRS recharacterized the losses as *capital*. The Tax Court agreed with the IRS, finding that the taxpayer failed to show he was eligible for ordinary abandonment loss deductions. Therefore, disposal of the partnership interests gave rise to capital losses. **(Code §1221; Sale of Partnership Interest)**

☞**Abandonment of LLC Interest in Real Estate - Clients May Be Surprised by Gain Recognition Due to Relief of Debt**
When the members of an LLC that held only real estate had a falling out, one member simply abandoned her ownership interest and walked away receiving nothing. At least, that's what she thought. However, given that the building was heavily mortgaged, her ability to simply leave the partnership and be released from her share of the outstanding debt was treated under **Code §752(b)** and **Code §731** as if she had received a distribution of cash. And, when compared to the adjusted basis of her interest, it resulted in a taxable gain which, under **Code §751** (i.e., "hot assets") provisions, was taxed as 25% unrecaptured Sec. 1250 gain to the extent of her share of S/L depreciation taken over the years. The remainder of her gain was Sec. 1231 gain (and, along with the 25% gain) was reported on Form 4797 since this had been a building held long-term and used in a trade or business (i.e., even a mere rental would be considered a "trade or business" for purposes of Sec. 1231). **(Code §752(b); Distributions)**

> **Comment:** Given a **Code §754** election was in effect for the LLC, the remaining owners could step-up the inside basis of building to the extent of the total gain recognized by the exiting member. And, of course, this would represent a separate new piece of the building's basis which would be freshly depreciated on Form 4562 (i.e., using either 27.5 or 39 years and the S/L method depending on whether it was residential or commercial property).

G. Miscellaneous Developments:

☞**IRAs Investing in Master Limited Partnerships**
IRAs are permitted to invest in master limited partnerships. But there is a potential tax trap. MLPs tend to make large distributions. As a result, IRA owners favor them as good investments. However, MLPs issue Schedule K-1s to their owners (including retirement accounts), reporting the owner's share of ordinary business income or loss. For IRAs, though, this income is generally considered to be "unrelated business taxable income." Consequently, the IRA can owe tax. Furthermore, if UBTI from all of an IRA's investments exceeds $1,000, then the excess is taxed at a rate of up to 37% (i.e., as ordinary income). The IRA, and *not* the individual owner, uses **Form 990-T** to report and compute this UBIT tax. Most of the large IRA custodians will handle the preparation and filing of the **Form 990-T**, unless the IRA trust agreement between the IRA owner and custodian provides otherwise. Any taxes owed on an IRA's excess UBTI are paid from available assets within that IRA. **(Code §512; UBIT)**

☞**Proposed Regs Remove Signature Requirement for Partnership Sec. 754 Basis Election (Prop. Reg. § 1.754-1)**
In general, if a partnership files a **Code §754** election, the basis of its property is adjusted under either **Code §734** (i.e., for property distributions) or **Code §743** (i.e., for transfers of partnership interests). To ease the burden on partnerships making this election, and to eliminate the need for **Reg. §301.9100** relief (i.e., a procedural reg which allows for an *automatic* 12-month extension for make the election beyond the normal extended due date for the Form

1065), the IRS has released proposed reliance regulations that would remove the signature requirement in **Reg. §1.754-1(b)(1)**. The proposed rules would provide that a partnership making a Section 754 election must still file a statement with its return that: (1) sets forth the name and address of the partnership making the election, and (2) contains a declaration that the partnerships elects under **Code §754** to apply the provisions of **Code §§734(b)** and **743(b)**. **(Code §754; Sec. 754 Election)**

> **Comment:** The regulations are proposed to be effective when published in the Federal Register. However, taxpayers may rely on them for earlier periods.

☞**Proposed Reliance Regs Issued on Partner's Unrealized Receivables and Inventory Items (REG-151416-06)**
The IRS issued proposed regulations that prescribe how partners should calculate their respective interests in a partnership's unrealized receivables and inventory items (i.e., Sec. 751 "hot assets"), adopting a "hypothetical sale approach." They also provide guidance on the tax consequences of a distribution that causes a reduction in that interest. The proposed regulations reflect statutory changes that have been made since the rules under **Code §751(b)** were issued in 1956 and incorporate many of the principles described in **Notice 2006-14** that suggested alternative approaches to **Code §751(b)**. **(Code §751; Hot Assets)**

> **Comment:** The proposed regulations may be relied upon in determining a partner's interest in the partnership's Section 751 property *on or after* 12/3/14, if they are applied consistently for *all* partnership distributions and sale or exchanges, including a **Code §708(b)(1)(B)** "technical termination" of the partnership.

☞**Unamortized Expenditures Not Deductible on Technical Termination of Partnership (T.D. 9681)**
Final regs have now been issued which confirm that a new partnership formed on account of a technical termination (i.e., due to a sale or exchange of a ≥ 50% partnership interest) must continue amortizing any **Code §195** "start-up expenses," as well as any **Code §709** "organizational expenses," over the remaining portion of the amortization period adopted by the terminating partnership.

> **Effective Date: The regs apply to technical terminations that occur *on or after* Dec. 9, 2013, but before 2018 due to the elimination of "technical terminations" by the TCJA.**
>
> **Comment:** Under **Code §168(i)(7)(A)**, the assets of the former partnership are deemed distributed under **Code §731** to the remaining partners and then re-contributed to a newly-formed partnership (though, it keeps its same EIN#). Nevertheless, unlike the other specific tax-deferred transactions listed in **Code §168(i)(7)(B)**, you are *not* allowed to "maintain the tax status quo" by using "shoes depreciation/amortization" (i.e., the new entity/transferee continues to use the *same* recovery periods and methods to finish writing off the remaining adjusted bases of the assets transferred over). Instead, with a technical termination (unlike a dissolution of a partnership), "fresh-start depreciation/amortization" must be used (i.e., they are treated as if they have just been acquired and placed in service for the first time).
>
> **Comment:** In addition to technical terminations of partnerships, other tax-deferred transfers which are *not* specifically mentioned in this Code section (e.g., **Code §§1014, 1015, 1031, 1033, 1041, 338(h)(10)** elections and **Code §754** step-ups in basis) must employ "fresh-start depreciation." Although, there is a degree of flexibility with regard to any adjusted bases of assets transferred pursuant to the **Code §1031** LKE and **§1033** involuntary conversion rules can be recovered under *either* approach.

☞**"Fresh-Start" Depreciation Required on Technical Terminations But Not Dissolutions**
Under **Code §168(i)(7)(A)**, the assets of the former partnership which was "technically terminated" (i.e., under **Code §708(b)(1)(B)**) are deemed distributed under **Code §731** to the remaining partners and then re-contributed to a newly-formed partnership (though, it keeps its same EIN#). But, unlike the other specific tax-deferred transactions listed in **Code §168(i)(7)(B)**, you must use "fresh-start depreciation/amortization" (i.e., the new entity/transferee must treat adjusted bases of the assets transferred over as if they were just purchased. Therefore, they would all receive *new* recovery periods and methods. This is similar to "fresh-start depreciation/amortization" in the case of other tax-deferred transfers which are *not* specifically mentioned in **Code §168(i)(7)(A)** (e.g., **Code §§1014, 1015, 1031, 1033, 1041, 338(h)(10)** elections and **Code §754** step-ups in basis).

> **Comment:** Note that, technically, any adjusted bases of assets transferred pursuant to the **Code §1031** LKE and **§1033** involuntary conversion rules can be recovered under *either* approach. For instance, on the trade in of an asset such as a car or equipment, the taxpayer can use either "shoes" or "fresh-start" depreciation on the carryover basis portion ("fresh-start" depreciation is always used on any "boot" paid in the LKE).

For example, an LLC holds title to a building when 50% or more of its ownership changes hands thereby resulting in a technical termination. At that point in time, this commercial building with a MACRS recovery period of 39 years had been written off over 9 years thus far. But, due to the technical termination, the new partnership would now have to take whatever remained of the adjusted basis of the building over a "fresh" 39-year period (using the mid-month convention for the month in which the building is deemed transferred).

If, on the other hand, the old partnership is instead *dissolved* with the distribution of the entity's assets to its respective partners, **Code §708(b)(1)(A)** controls. More importantly, **Code §168(i)(7)(A)** would now specifically apply to this **Code §731** distribution with the remaining adjusted bases of the assets distributed receiving "shoes depreciation/amortization" whereby the *same* recovery period and method is retained. For example, if the 2-person accounting firm partnership decided to dissolve with the respective owners desiring to now operate as separate sole proprietors, the remaining adjusted bases of any depreciable or amortizable assets listed on Form 4562 would simply carryover to these individual owners who would then continue with the *same* lives and methods as the partnership had used up to that point in time in writing off the cost of the assets. **(Code §168; Tax-Deferred Transfers)**

☞**Related Party Rules Result in Disallowed Losses on Partnership Sale to Grantor Trusts (CCA 201343021)**
The IRS concluded in this Chief Counsel Advice that a short-term capital loss recognized on the sale of partnership property to grantor trusts may be disallowed under the **Code §267** and/or **Code §707(b)(1)(A)** "related party loss rules." In reaching this result, the Service had to examine complex facts involving many different entities, including several grantor trusts, and determine how the complicated constructive ownership rules applied to the various parties. More importantly, the ruling first concluded that grantor trusts should be disregarded as entities separate from their owners for all federal income tax purposes, included the related party loss rules. Therefore, if the grantor is considered "related" for tax purposes, the losses on the sales with the associated entity (here, a partnership) will be denied. **(Code §267(h); Related Party Losses)**

☞**LLC Permitted to Revoke Mistaken Election Out of Installment Reporting of Sale Caused by Failed LKE (PLR 200813019)**
This private ruling involved a failed like-kind exchange that instead had to be treated as a sale. Here, the IRS allowed an LLC to undo the inadvertent deemed election out of installment reporting it made by initially reporting the entire sales proceeds in the year the relinquished property was transferred. But, because of IRS's concession, the LLC was allowed to defer reporting gain on the sale until the following year that it actually received the sales proceeds.

Background: In general, no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of a like kind which is held either for productive use in a trade or business or for investment. (**Code §1031**) Qualified intermediaries (QIs) may be used to structure like-kind exchanges. (**Reg. §1.1031(k)-1(g)(4)**) Like-kind treatment is barred, however, under the so-called ***Starker*** exchange rules if the property to be received is *not* identified (e.g., by being specified in the contract) on or before 45 days after the transfer, or is *not* received within 180 days after the transfer or by the due date (with extensions) of the return for the year of transfer if earlier. (**Code §1031(a)(3)**) With regard to the installment sale rules, they must be used to report gain on the disposition of nondealer property where at least one payment is to be received *after* the close of the tax year in which the disposition occurs. (**Code §453(a)**, **Code §453(b)(1)**) Furthermore, the installment method may still be elected even though *no payments* are received in the year of sale. The amount of a payment that is includible as gross income to the taxpayer is that portion of the installment payments received in the year that the gross profit realized or to be realized bears to the total contract price (i.e., the gross profit ratio). (**Code §453(c); Reg. §15a.453-1(b)(2)(i)**) But, under **Code §453(d)**, a taxpayer may elect out of installment reporting. The election must be made on or before the due date (including extensions) of the return for the disposition year. A taxpayer that chooses to report the full sale proceeds in income in the year of sale is treated as having made the election out. (**Reg. §15a.453-1(d)(3)**) Supposedly, once the election out is made, it can only be revoked only if the IRS consents. But, a revocation will *not* be allowed if one of its purposes is to avoid federal income tax. (**Reg. §15a.453-1(d)(4)**)

Facts: During Year 1, LLC intended to enter into a **Code §1031** deferred like-kind exchange of its rental property. It entered into an exchange agreement with a professional QI which intended to facilitate the exchange in compliance with the **Code §1031** regs. On Date 1, under the exchange agreement, the QI sold LLC's rental property. The cash proceeds from the sale were retained by the QI pending LLC's identification and acquisition of replacement property. However, LLC was unable to locate suitable replacement property during the 180-day replacement period, and in Year 2, the QI gave the cash proceeds from the sale of the rental property to LLC. In Year 2, the accountant who prepared LLC's Year 1 partnership return failed to recognize that the Year 1 sale of rental property qualified for the installment method of reporting under **Code §453** and reported the *entire* gain from the sale on the Year 1 partnership return. LLC relied on its accountant to prepare its returns properly and to advise it regarding all necessary tax filings, including any provision that might benefit LLC. The accountant knew that the intended like-kind exchange had failed due to unavailability of suitable replacement property, and provided the taxpayer an affidavit indicating that the accountant's oversight was the reason the installment method was *not* used. Subsequently, other professionals advised LLC that the installment method should have been used in Year 1. Upon learning this, LLC immediately took action to request the IRS's consent to revoke its election *not* to use the installment method.

IRS Ruling: In granting the ruling request, the IRS noted that LLC provided the accountant with all the necessary information to prepare the Year 1 partnership return, including information on the sale of the rental property. The accountant failed to recognize that the Year 1 sale qualified for installment method treatment, and as soon as LLC became aware of this oversight, it filed a request for consent to revoke the election out of the installment method. The information submitted indicated that LLC's desire to revoke the election was due to the accountant's oversight rather than hindsight by LLC or a purpose of avoiding federal income taxes. As a result, the IRS granted permission for LLC to revoke its election out of the installment method for the Year 1 sale of rental property for the period that ends 75 days after the date of the private ruling. To revoke the election out of the installment method, the IRS stated that LLC must file an amended tax return for the tax year of the sale, so long as it is still open since under **Reg. §15a.453-1(d)(4)**, an election out *cannot* be revoked if the tax year in which any payment was received has closed. **(Code §453; Installment Sales)**

☞7th Circuit Decides Basis Overstatement Is Omission of Income for 6-Year Limitations Period (*Beard v. Commr.*, 107 AFTR 2d ¶ 2011-372 (7th Cir., 01/26/2011))

The 7th Circuit, *reversing* the Tax Court, has held that an overstatement of basis is an omission of gross income for purposes of the 6-year limitations period of **Code §6501(e)(1)(A)**.

Comment: Because of the split in the circuit courts (see ***Bakersfield*** below), the Supreme Court will ultimately have to decide this issue. It seems, though, that a taxpayer can understate income as easily by overstating the basis of an asset in a taxable sale or disposition as they would be simply not reporting all of the consideration generated by that same transaction.

Background: Code §6501(a) generally provides that a valid assessment of income tax liability may *not* be made more than 3 years after the *later* of the date the tax return was filed or the due date of the tax return. However, under **Code §6501(e)(1)(A)**, a 6-year period of limitations applies when a taxpayer omits from gross income an amount that's *greater than 25%* of the amount of gross income stated in the return. **Code §6501(e)(1)(B)(i)** provides that "in the case of a trade or business, the term "gross income" means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to the diminution by the cost of such sales or services."

In ***Bakersfield Energy Partners v. Commr.*, 103 AFTR 2d 2009-XXXX (9th Cir., 6/17/2009)**, the 9th Circuit, *affirming* the Tax Court, held that an overstatement of basis was *not* "an omission of gross income" for purposes of the 6-year limitations period of **Code §6501(e)(1)(A)**. The Court stressed that the taxpayer "did *not* omit any income receipt or accrual in its computation of gross income." Indeed, it had reported "the full amount of the receipts from the purchaser of the oil and gas properties." The Court of Appeals for the Federal Circuit, *reversing* the Court of Federal Claims, agreed with the 9th Circuit and the Tax Court that an overstatement of basis is *not* technically "an omission of gross income" for purposes of the extended limitations period. (***Salman Ranch Ltd. v. U.S.*, 100 AFTR 2d 2007-6654 (Ct Fed Cl, 11/9/2007)**) But other courts have agreed with the IRS that the 6-year limitations period can be triggered by a basis overstatement. **(*Brandon Ridge Partners v. U.S.*, 100 AFTR 2d 2007-5347 (DC FL, 7/30/2007))**.

Final Regs: In December of 2010, the IRS issued final regs under which an understated amount of gross income resulting from an overstatement of unrecovered cost or other basis constituted an omission of gross income for purposes of the 6-year period for assessing tax and the minimum period for assessment of tax attributable to partnership items. **(Code §6501; Statute of Limitations)**

Comment: The final regs adopt the position that the Service had held in temporary regs.

☞Despite Contrary Regs, Tax Court Maintains Basis Overstatement Does Not Trigger 6-year Limitations Period (*Intermountain Insurance Service of Vail, LLC, Thomas A. Davies, TMP*, 134 TC No. 11 (5/6/2010))

The Tax Court has denied IRS's motion to reconsider and vacate its previous decision that a basis overstatement should *not* be consider an omission of income for purposes of the 6-year limitations period. This is spite of the fact that the Service subsequently issued temporary regs holding to the contrary. Following its opinion in ***Bakersfield Energy Partners, LP, et al.*, 128 TC 207 (2007)**, the Tax Court had previously granted summary judgment to a taxpayer where the IRS made partnership item adjustments *after* the general 3-year period of limitations for assessing tax had expired (**Note:** the Tax Court's decision was affirmed by the 9th Circuit in (***Bakersfield Energy Partners v. Commr.*, 103 AFTR 2d 2009-XXXX (9th Cir., 6/17/2009)**). **(Code §6501; Statute of Limitations)**

Comment: Comment: The Court of Federal Claims agrees with the 9th Circuit and the Tax Court that, under ***Colony***, an overstatement of basis is *not* the same thing as an omission of gross income for purposes of the extended limitations period. (***Grapevine Imports Ltd. v. U.S.*, 100 AFTR 2d ¶2007-5065 (Ct Fed Cl, 7/17/2007)**) But, other courts have agreed with the IRS that the 6-year statute of limitations period can be triggered by a basis overstatement. (***Brandon Ridge Partners v. U.S.*, 100 AFTR 2d ¶2007-5107 (DC FL, 7/30/2007)**), and (***Salman Ranch Ltd. v. U.S.*, 100 AFTR 2d 2007-6654 (Ct Fed Cl, 11/9/2007)**).

Comment: More recently, the Tax Court reaffirmed that this is the correct result in ***Beard*, TC Memo 2009-184 (8/11/2009)**.

☞**Temp and Proposed Regs Define "Omission of Income" for Purposes of 6-Year Limitations Period (T.D. 9466)**
The IRS has now issued temporary and proposed regs defining what constitutes an "omission from gross income" for purposes of the six-year minimum period for assessment of tax attributable to partnership items and the six-year period for assessing tax. These regs resolve the on-going issue as to whether an overstatement of basis in a sold asset results in an omission from gross income. In response, the regs provide that the 6-year limitations period, instead of the 3-year period, applies if any partnership omits from the gross income stated in its return an amount properly includible in the return that is in excess of 25% of the amount of gross income stated in its return. **(Code §6501(e); Statute of Limitations)**

Comment: The regs apply to tax years with respect to which the applicable period for assessing tax did *not* expire before Sept. 28, 2009.

☞**6-Year Statute of Limitations Applied to Omission of Income Caused by Understated Basis (*Grapevine Imports Ltd. v. U.S.*, 107 AFTR 2d 2011-XXXX (Fed. Cir., 3/11/2011))**
The Appeals Court for the Federal Circuit has confirmed that a six-year (v. the normal 3-year) statute of limitations for assessment applies under **Code §6501(e)(1)** when a taxpayer omits more than 25% of the gross income reported on the return. Over the past year, several appellate courts have issued decisions on whether an overstatement of basis (which, in turn, results in an understatement of income on a taxable sale or exchange) is equivalent to an "omission from income" which should also trigger the six-year limitations period. On one hand is ***Colony Inc.*, 357 U.S. 28 (1958)**, where the Supreme Court held that an overstatement of basis in a business context (e.g., land sales), resulting in an understatement of income, is *not* an omission from income for limitations purposes. On the other hand is recently finalized **Reg. §301.6501(e)-1**, which states that understated gross income resulting from an overstatement of basis outside of a trade or business context constitutes an "omission from income" under the statute of limitations. In this instance, the Federal Circuit has concluded that an overstatement of basis from an alleged "Son of BOSS" tax shelter extended the statute of limitations to *six* years. In so holding, the Federal Circuit found that the regulations "were a reasonable interpretation of an ambiguous Code section and so were entitled to deference." **(Code §6501(e)(1); SOL)**

☞**SOL Bars IRS From Seeking Back Taxes on Underreported Gain Due to Misstated Asset Basis on Disposition (*Grapevine Imports*, Ct. of Fed. Cl. (7/17/07))**
In this instance, the Service was prevented from seeking back taxes on underreported gains since the extended six-year statute of limitations was *not* applicable. The case involved a partnership's profit on an asset sale where the gain that the partners included in their respective gross incomes was understated due to an inflated tax basis. The Service insisted that it had six years, not three, to audit the partners because they omitted more than 25% of their AGI. But, the Court stated that since the gain from the sale was reported, there was no omission. **(Code §6501(e)(1)(A); SOL)**

Comment: How would this affect a case were a taxpayer failed to take any depreciation on a Schedule E rental property and then proceeded to sell it, grossly underreporting (i.e., more than 25%) the amount of the gain on Form 4797 due to the depreciation that they failed to properly claim? Under the allowed or allowable principal, the correct basis should have been used to report the amount of the gain. However, if more than 3 years had passed, it would appear that the Service would be barred from re-opening that tax year (absent a showing of fraud).

Comment: If the normal 3-year SOL had *not* passed, **Rev. Proc. 2007-16** would permit the taxpayer to claim any catch-up depreciation with regard to the property (i.e., which could offset ordinary income up to a 35% marginal bracket) while the **Code §1231** gain would only be taxed at a maximum marginal rate of 25% (i.e., due to this additional S/L depreciation claimed on a **Form 3115**).

☞**Partnership Awarded Litigation Costs (*BASR Partnership*, 123 AFTR 2d 2019-XXXX (CA Fed. Cir.))**
The IRS issued a **Final Partnership Administrative Adjustment (FPAA)** under the TEFRA regime to a partnership. The partnership challenged the adjustment, claiming that the 3-year statute of limitations had passed. A trial court agreed and awarded the partnership over $300,000 in litigation costs. The IRS appealed, arguing that the partnership was *not* a "prevailing party" because only individual partners can be parties to a TEFRA proceeding. The Federal Circuit disagreed, finding that nothing in the statutory language disqualified the partnership from being "a party to the proceeding." The Court also held that the partnership (*not* the partners) was "the real-party-in-interest" because the partnership agreement and state law obligated it to pay all litigation costs. As a result, the trial court's award was affirmed. **(Code §7430; Litigation Awards)**

Comment: For tax years beginning after 2017, the TEFRA rules have been repealed and replaced by the “centralized partnership audit regime.”

Notes:

CHAPTER XIV: SELF-EMPLOYMENT TAXES

A. Background: Partners who **perform services** are generally treated as receiving income from self-employment (S/E) and are subject to social security tax on their distributive shares of income from a partnership. There are exceptions for certain types of distributions of rent, gain or loss from disposition of property (e.g., Sec. 1231 or capital gains or losses), and investment income (e.g., capital gains, dividends, interest or royalties).

> **Comment:** Partners subject to S/E tax would also be subject to the **Code §1411** Medicare surtax of .9%. Other partners who are merely passive investors would, instead, be subject to the 3.8% Medicare surtax on net K-1, Box T/B income each year. They would also pay the surtax on net gain generated upon the sale of their partnership interest.

Distributive shares of income or loss of limited partners, other than distributions that are guaranteed payments received as compensation for services, are excluded from earnings from self-employment. However, this is only to the extent that those payments are actually remuneration for those services.[199] A limited partner's distributive share of income from a partnership is **not** subject to SE taxes. Nevertheless, since an LLC member is neither a general partner nor a limited partner in the strictest sense, the IRS has had a difficult time determining an LLC member's status for SE tax purposes. In fact, the IRS issued three separate sets of proposed regulations regarding this issue. The first set of proposed regulations indicated that if a member:

- Lacked the authority to make management decisions to conduct company business, and
- The LLC could have been formed as a limited partnership in the same jurisdiction, and
- The member could have qualified as a limited partner under applicable law,

Then, the member's earnings would *not* be self-employment income. However, these initial regulations were never finalized. In January 1997, a second set of regulations were issued. **Prop. Reg. §1.1402(a)-2(h)(2)** would have subjected *any* LLC member's distributive share of earnings to self-employment tax if he:

1. Had authority to enter into contracts on behalf of the partnership;
2. Participated in the partnership's trade or business more than 500 hours per year, or
3. Had personal liability for the debts or obligations of the partnership by reason of being a partner/LLC member.

Furthermore, a special rule had provided that service partners in professional service partnerships are **never treated** as "limited partners" for S/E tax purposes. As a result, these "service" LLC members are subject to S/E tax whether they receive a guaranteed payment or K-1 distributive income. The third test caused the most controversy because the debt's size did *not* matter. For instance, when a lender required an LLC member to serve as a guarantor of the business' debt, this seemed to mean that S/E tax would be imposed. This was the case even when a guarantor was *not* involved with the day-to-day operations of the entity. However, since these regulations were merely proposed, many practitioners simply chose to ignore their guidance, especially for LLC members who only acted as guarantors.

> **Comment:** A close reading of the regs, however, seems to imply that guarantees by members who do **not** otherwise participate in the day-to-day operations of the business will only cause them to be subject to S/E tax where, by reason of the LLC membership agreement alone (and, *not* just due to the contractual arrangement with the lender), they will be held accountable for the repayment of this debt if the entity is unable to service it.

The negative reaction continued to such an extent that Congress finally imposed a moratorium on the implementation of these regulations. But, on January 27, 2005, the Joint Committee on Taxation (JCT) again proposed rules similar to the previously proposed regulations. They also suggested that only the partners' "reasonable compensation from the partnership" be treated as net earnings from self employment. This might mean that guaranteed payments would be subject to S/E tax, but the members' distributive share of business profits would be considered a return on equity exempt from S/E tax. However, members of professional service LLCs are specifically precluded from taking advantage of this exception. In fact, this latest set of rules (as incorporated in the proposed regs that we currently have) lays out an exception whereby "varying interests" may be held by the various LLC members and this would impact the imposition of SE tax as discussed below.

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[199] If the guaranteed payment represents a minimum level of return on capital, then SE tax is not imposed.

Service Issues Regs Regarding Partners Being Treated as Employees (T.D. 9766)

The IRS has issued temporary regulations intended to halt the practice some partnerships have adopted of treating partners as employees of a disregarded entity (i.e., SMLLC) owned by the partnership so they could be included in employee benefit plans and receive other benefits. However, the IRS is also asking for comments on when it might be appropriate to allow partners to also be employees of a partnership. Nevertheless, in order to give taxpayers time to implement the new rules, the IRS is allowing any plan sponsored by an entity that is disregarded as an entity separate from its owner to apply them on Aug. 1, 2016, or the first day of the latest-starting plan year following May 4, 2016, whichever is later.

Background: Under **Reg. §301.7701-2(c)(2)(iv)(B)**, a disregarded entity is treated as a *corporation* for *employment* (but, *not* income) tax purposes. And, as a separate legal entity, it is treated as the employer of the entity's employees (i.e., instead of the partnership entity which owns this SMLLC). However, this rule does *not* apply for self-employment tax purposes, so the owner of an entity that is treated as a sole proprietorship is subject to self-employment tax. The regs include an example in which the owner of the SMLLC is an individual who is subject to self-employment tax on the net earnings from the disregarded entity's activities. However, the regs do *not* provide an example in which the disregarded entity is owned by a *partnership*. As a result, some taxpayers have taken the position that where a partnership is the sole owner of a disregarded entity, partners in the partnership can be treated as employees of the disregarded entity because the regulations did *not* include a specific example applying the rule in the context of a partnership. Moreover, being able to treat the partners as employees of the disregarded entity allows them to participate in certain employee-benefit plans.

Rev. Rul. 69-184: In the preamble to Tuesday's temporary regs, the IRS reiterates that the holding of **Rev. Rul. 69-184** is still in effect. It states that (1) bona fide members of a partnership are *not* employees of the partnership for purposes of FICA, FUTA, and income tax withholding, and (2) a partner who devotes time and energy in conducting the partnership's trade or business, or who provides services to the partnership as an independent contractor, is considered self-employed and is *not* an employee. The preamble insists that the IRS did *not* intend to "create a distinction between a disregarded entity owned by an *individual* (i.e., a sole proprietorship) and a disregarded entity owned by a *partnership* in the application of the self-employment tax rule." It specifically states that "the rule that a disregarded entity is treated as a corporation for employment tax purposes does *not* apply to the self-employment tax treatment of any individuals who are partners in a partnership that owns a disregarded entity." The bottom line is that the general rule making the owner of an entity that is treated as a sole proprietorship subject to self-employment tax applies for *any* owner of a disregarded entity. There is no exception for partnerships.

Comment: The IRS is considering issuing rules that would permit "tiered partnerships," in some circumstances, to treat partners as employees of the partnership and is asking for comments on the impact on employee benefit plans (including qualified retirement plans, health and welfare plans, and fringe benefit plans) and on employment taxes if the IRS were to modify **Rev. Rul. 69-184** to permit partners to also be employees in certain circumstances and also what those circumstances might be.

Comment: There is an excellent article dealing this issue in ***The Tax Advisor*** **(Nov., 2013)**.[200]

B. "Varying Interests" in an LLC: The proposed regulations define an individual who is *not* a limited partner.[201] If a limited partner has day-to-day management responsibilities for the LLC's business operations, the regulations state this member may exclude from net earnings for SE tax purposes a portion of that individual's distributive share if he holds *more than one class* of interest in the partnership or LLC.[202] If an individual is *not* a limited partner solely because he participates in the entity's trade or business for more than 500 hours, he can still be treated as a "limited partner."[203] However, under either rule, such treatment is permitted only if the individual's distributive share is *identical* to the distributive shares of the partners who qualify as limited partners and who own "a substantial, continuing interest in the entity."[204] It might be more difficult under this approach to argue that earnings derived from an LLC that performs personal or professional services are *not* subject to SE tax. As a result, the proposed regulations state that if "substantially all" the activities of a partnership involve the performance of professional services, an

200 Brock, "Partners as Employees? Properly Reporting Partner Compensation."

201 Prop. Treas. Reg. §1.1402(a)-2(h)(2)

202 Prop. Treas. Reg. §1.1402(a)-2(h)(3)

203 Prop. Treas. Reg. §1.1402(a)-2(h)(4)

204 Prop. Treas. Reg. §1.1402(a)-2(h)(4)(i)

individual member who provides those services is *not* considered a limited partner.[205] For purposes of this exception, professional services include services performed in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.[206]

Example 1: "Using the Varying Interest Rule to Avoid SE Tax in Non-Service Partnership/LLC"

Agnes, Bonnie, and Cathy form an LLC to engage in a business that does *not* provide services. The LLC, classified as a partnership for federal tax purposes, allocates all items of income, deduction, and credit of the LLC to the three members in proportion to their ownership. Agnes and Cathy each contribute $1,000 for one LLC unit. Bonnie contributes $2,000 for two LLC units. Each LLC unit entitles its holder to receive 25% of the LLC's tax items, including profits. Agnes does *not* perform services for the LLC. Each year, Bonnie receives a guaranteed payment of $6,000 for 600 hours of services rendered to the LLC. Cathy receives a guaranteed payment of $10,000 for 1,000 hours of services rendered to the LLC. Cathy is the LLC's manager. Under the applicable state's law, only Cathy has the authority to contract on the LLC's behalf.

In this scenario, **Agnes** is treated as a limited partner in the LLC because she is *not* personally liable for debts of or claims against the LLC.[207] Agnes does *not* have authority to contract for the LLC under state law, and she does *not* participate in the LLC's trade or business for more than 500 hours during the taxable year. Therefore, Agnes's distributive share attributable to her LLC unit is excluded from net earnings from self-employment.[208]

Bonnie's treatment in this scenario is more complex. She must use the varying interest rule to avoid SE tax. Unless she takes advantage of this rule, Bonnie will *not* be treated as a limited partner. As a result Bonnie's guaranteed payment of $6,000 will be included in her net earnings from self-employment under §1402(a)(13).[209] Furthermore, Bonnie will *not* be treated as a limited partner with respect to other income flowing through to her on her K-1 because she participates in the LLC's trade or business for more than 500 hours during the taxable year.[210] As such, Bonnie's distributive share would also be included in her net earnings from self-employment. However, by using the varying interest rule, Bonnie could still treated as a limited partner (at least as to her distributive share). This is because Agnes, who is a limited partner under the regulations, owns a "substantial interest" with rights and obligations that are *identical* to Bonnie's rights and obligations.[211] In this example, Bonnie's distributive share could be deemed to be a "return on her investment" in the LLC and *not* as additional remuneration for any services she renders to the LLC. Therefore, Bonnie's distributive share attributable to her two LLC units are *not* treated as net earnings from self-employment under §1402(a)(13).

Finally, **Cathy's** guaranteed payment of $10,000 is included in her net earnings from self-employment.[212] In addition, her distributive share attributable to her LLC unit is considered net earnings from self-employment because she is *not* a limited partner. Cathy is *not* treated as a limited partner because she has the authority under state law to enter into a binding contract on behalf of the LLC, and because she participates in the LLC's trade or business for more than 500 hours during the taxable year.[213] Furthermore, Cathy is *not* treated as a limited partner because she does not hold more than one class of interest in the LLC.[214] Consequently, *both*

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[205] Prop. Treas. Reg. §1.1402(a)-2(h)(5)

[206] Prop. Treas. Reg. §1.1402(a)-2(h)(6)(iii)

[207] Prop. Treas. Reg. §1.1402(a)-2(h)(2)

[208] Prop. Treas. Reg. §1.1402(a)-2(i) Example(ii)

[209] Prop. Treas. Reg. §1.1402(a)-2(i) Example (iii)

[210] Prop. Treas. Reg. §1.1402(a)-2(h)(2)

[211] Prop. Treas. Reg. §1.1402(a)-2(h)(4)

[212] IRC §1402(a)

[213] Prop. Treas. Reg. §1.1402(a)-2(h)(2)

[214] Prop. Treas. Reg. §1.1402(a)-2(h)(3)

Cathy's guaranteed payment and distributive share are included in her net earnings from self-employment.

Comment: The approach taken by this latest set of proposed regulations is to exclude from an individual's SE tax those amounts that are demonstrably returns on capital invested in a partnership or LLC (much like the K-1 distributions to the owner of an S corporation, especially when "reasonable compensation" is *not* an issue).

Effective Dates: The proposed regulations were never adopted. In the 1997 Budget Reconciliation Act, the Senate expressed its displeasure with the proposed regulations defining limited partners. It stated that this task should be accomplished by the legislature. The conference committee directed the IRS *not* to issue any regulations on this matter before July 1, 1998.[215] There were two bills introduced in 2002 to modernized the code to explicitly deal with LLC members. However, neither of these was enacted. As of 2008, the IRS has *not* taken any further action on this matter.

Comment: LLC operating agreements should be reviewed and possibly modified to take advantage of the varying interest rule. In this regard, the example above should be carefully studied for possibly avoiding SE tax, especially for managing members of LLCs *not* providing service.

The following is from the Joint Committee on Taxation's Annual Report for 2000:

The Joint Committee staff recommends that references in the Code to "general partners" and "limited partners" should be modernized consistent with the purpose of the reference. In most cases, the reference to limited partners could be updated by substituting a reference to a person whose participation in the management or business activity of the entity is limited under applicable state law (or, in the case of general partners, not limited). In a few cases, the reference to limited partners could be retained because the provisions also refer to a person (other than a limited partner) who does not actively participate in the management of the enterprise, which can encompass limited liability company owners with interests similar to limited partnership interests. In one case, the reference to a general partner can be updated by referring to a person with income from the partnership from his personal services. The recommendation would provide simplification by modernizing these references to accommodate limited liability companies, whose owners generally are partners within the meaning of federal tax law, but are not either general partners or limited partners under state law.[216]

Comment: In the June 3, 1996 MSSP training guide for passive activity losses, IRS auditors are told to examine LLC agreements. If these agreements indicate certain members are essentially limited partners, it is an indicator that they are essentially limited partners for SE tax purposes. If this is *not* the case, an S corporation election might be considered.

Comment: The member of a single-member LLC is subject to SE tax in the *same* manner as a sole proprietorship. Therefore, in order to maintain limited liability status but perhaps avoid automatic application of the SE tax, an SMLLC member should consider making an S election (i.e., after making a "check-a-box election) and utilizing distributions while paying a reasonable salary commensurate to the services performed for the entity.[217]

Comment: Lawyers drafting operating agreements for LLCs have recently revised these documents to provide for "varying interests" in the entity. Some call them managing "member interests" versus "investor interests," while others use the terms "Class A" versus "Class B" interests. The attempt is to give the LLC members who manage the entity on a day-to-day basis a *small* percentage as Class A interest, and the remainder of their ownership as Class B interest. The intent is to tax guaranteed payments received for services, along with their Class A interest as SE income, while their Class B interest represents a return on investment in the LLC. This is similar to what occurred with limited partnerships in the past. In this case, a general partner could simultaneously hold his general partnership interest and receive guaranteed payments, both of which are subject to SE tax and a limited partnership interest which is excluded from SE income.

C. Planning Alternatives to Avoid Self-Employment Tax: Consideration should be given to the following

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[215] §734 of the Senate amendment to H.R. 2014

[216] JCX-27-01, April 25, 2001

[217] Rev. Proc. 2004-48 states that only a Form 2553 needs to be filed since a Form 8832 "check-a-box" election is considered redundant since it is clear that the taxpayer wishes to be treated as a corporation.

alternative methods may be employed to avoid SE tax issues:

1. Flow the Earnings through an S Corporation: A single-member LLC (SMLLC) is formed and a "check-the-box" election is made to be taxed as a corporation. The S election is made in order to avoid SE tax. The SMLLC can be used to hold the LLC interest in a service-type business with the K-1 income flowing through it first, and then earnings are treated only partially as "salary," with the rest as a distribution from the S corporation.

Comment: It is always possible that the IRS will attack such arrangements, especially if an unreasonably low salary is paid to the shareholder.[218] However, the Tax Court has upheld the validity of this arrangement due to a valid business purpose for the structure.[219]

2. Income Splitting among Family Members: Assuming a professional license is *not* required to be involved in the LLC's business activity, another alternative is to transfer a percentage of the LLC's ownership to a spouse, or a child who is *not* subject to the "kiddie tax." The spouse or child cannot be involved in the day-to-day operation of the LLC's business. The K-1 income flowing through to the spouse or child is *not* subject to SE tax. The key to this approach is that the LLC's other owners, who manage the business and perform the necessary services on its behalf, receive a reasonable guaranteed payment commensurate with the time they devote to the LLC's operations. If the spouse or child performs services for the LLC, the family partnership rules contained in §704(e) might apply. This requires recharacterization of some of the income flowing to the other family members as earnings that should be paid to the service-providing spouse or family member.

3. Payments re: Form 8825 (Rev. Rul. 64-220): Normally, a partner's share of rental income (i.e., as shown in Box 2 of Schedule K-1 is *not* subject to self-employment tax. Even if the partnership specially allocates a portion of the rents to one particular partner for services rendered with regard to the property, it normally would *not* be subject to S/E tax, unless that partner was performing service in other than his capacity as a partner. For example, suppose that partner own a property management company and provided services for many third-parties holding rental properties.

4. Carried Interest for Partners Performing Investment Services for Third-Parties

☞**IRS Guidance on Reporting Requirement for "Carried Interests"**

The IRS has released detailed reporting directions for certain passthrough entities and taxpayers reporting of partnership interests held in connection with the performance of services, often referred to as "carried interests", in the form of frequently asked questions (**FAQs**). The FAQs contain sample worksheets that certain passthrough entities and taxpayers may be required to use in reporting "carried interests," partnership interests held in connection with the performance of services for tax returns, filed *after* Dec. 31, 2021 in which a passthrough entity applies the final regulations.

In addition, the FAQs contain additional instructions for certain passthrough entities and taxpayers who though *not* required to file the sample worksheets must provide similar information and must nevertheless disclose whether the information was determined under the proposed regulations or another method for tax returns filed *after* Dec. 31, 2021 for a taxable year beginning *before* Jan. 19, 2021.

Comment: The **TCJA** recharacterized certain net long-term capital gains of a partnership that holds one or more "applicable partnership interest" (APIs) as short-term capital gains. The provision generally requires that a capital asset be held for *more than three years* for capital gains allocated with respect to any API to be treated as a long-term capital gain.

The purpose of the FAQs is to provide guidance relating to both passthrough entity filing and reporting requirements and owner taxpayer filing requirements in accordance with Department of the Treasury regulations revised in **TD 9945**. **(Code §1221; Carried Interests)**

Comment: This updated reporting guidance will also be added to the next revision of **IRS Pub. 541 - Partnerships**, which will be released in 2022.

☞**Proposed Regs Issued on Changes Made by TCJA to Holding Period Rules for "Carried Interest"**

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[218] *Grey Public Accountant, P.C. v. Comm'r*, 119 TC 121 (2002), aff'd 93 Fed.Appx. 473 (3rd Cir. 2004); *Nu-Look Design, Inc. v. Comm'r*, 85 TCM 927 (2003) aff'd 356 F.3d 290) (3rd Cir. 2004), Cert. denied, 125 S.Ct. 60 (2004).

[219] *Grigoraci v. Comm'r*, 84 TCM 186 (2002).

(**REG-107213-18**)

The **Tax Cuts and Jobs Act** added **Code §1061** which requires partnership interest derived from the performance of investment services (i.e., "carried interest") to be held for *more than three years* to be treated as long-term capital gains. The three-year holding period is required for sales of assets held (directly or indirectly) by the partnership, as well as for the sale of the partnership interest itself. Among other things, the proposed regulations clarify how to apply the holding period when a partner holds an API for less than three years, but the partnership sells an asset it held for more than three years. The proposed regulations also clarify that carried interests held by an S corporation are subject to the three-year holding period requirement. The regulations are proposed to apply to tax years beginning on or after the date they are adopted as final. However, for tax years beginning *after* 12/31/17, and *before* the regulations are adopted as final, taxpayers may generally rely on the proposed regulations provided they follow the rules in their entirety. **(Code §1061; Carried Interests)**

> **Comment:** For more information, see the **proposed regulations** and a **comparison** of changes to rules for carried interest under TCJA, on the application of **Code §1061**.

5. Partners Employed by SMLLCs Owned by Parent Partnership

☞**Final Regs Issued on S/E Tax for Partners in Partnership Owning SMLLCs (TD 9869)**

The IRS has issued final regs that provide that partners in a partnership that owns a disregarded entity are *not* employees of the disregarded entity for employment tax purposes and are, instead, subject to self-employment tax based on the their share of income from that partnership. **(Code §1402; S/E Tax)**

6. Guaranteed Payments to Partners

☞**LLC's Payments to Managing Member Treated as Guaranteed Payments (*Seismic Support Service*, LLC, TC Memo 2014-78 (5/5/2014))**

The taxpayer was seeking to avoid payroll taxes. Therefore, he requested that his employer treat him as an independent contractor. When his request was denied, he resigned and formed an LLC through which he provided design consultant services as a subcontractor. He owned a 95% interest in the LLC and received compensation for services provided on the LLC's behalf with the LLC's taking deductions for these payments as "management fees" on its Form 1065 for the years at issue. The IRS determined that the payments were instead "guaranteed payments" (i.e., to be shown in Box 4 on his K-1) under **Code §707(c)**, which, although fully deductible by the LLC, were subject to self-employment tax by the partner (and, now, possibly the new 3.8% Medicare surtax). The partner argued that the payments "were for the use of capital rather than services." However, the Tax Court disagreed, concluding that because the payments were for services performed on behalf of the LLC and made without regard to the LLC's income, they were guaranteed payments. **(Code §1402; Self-Employment Tax)**

> **Comment:** The LLC was also assessed accuracy-related penalties for negligence.

7. Reporting of S/E Income in Box 14 of Schedule K-1

☞**Taxpayer Bound by Reporting of S/E Income in Box 14 of K-1 (*Lauren Howell*, TC Memo 2012-303 (11/1/2012))**

A husband and wife formed an LLC with another partner for the purpose of providing software and hardware to hospitals. However, the wife lacked any background in computer technology. Nevertheless, she was given membership in the LLC, rather than her husband, because her credit rating was better and it needed to be used in order to obtain loans for the business. Meanwhile, her husband provided most of the day-to-day management services for the LLC. Initially, the LLC reported payments made to both of the taxpayers during the years in question as "guaranteed payments." But, on the couple's personal returns, the wife reported the amounts she received as "partnership distributions" that would *not* be subject to self-employment tax because of her limited involvement in the LLC's operations. The Tax Court held that the taxpayers "may *not* disavow the form of the transaction as reported on the LLC returns." This was based on the fact that the court found that "the wife provided marketing advice, signed documents, and entered into contracts that caused her to be more than merely a passive investor." **(Code §1402; Guaranteed Payments)**

8. Self-employment Income of LLP Members v. Limited Partners

☞**LLP Owners Not "Limited Partners" for S/E Purposes (*Renkemeyer, Campbell & Weaver, LLP*, 136 TC No. 7 (2/9/2011))**

Agreeing with the IRS, the Tax Court confirmed that a law firm's partners were liable for self-employment tax. The LLP members had attempted to claim that their interests in the limited liability partnership qualified as "limited partner interests" thereby exempting them from having to pay any S/E tax on their share of the firm's income. The Court disagreed, finding that the lawyers "were *not* mere investors in a partnership." Instead, they "actively participated in

the firm's business operations
by performing legal services." (**Code §1402; S/E Tax**)

Comment: The law firm was a Kansas limited liability partnership. Three partners were attorneys performing legal services while the fourth partner was an S corporation owned by a tax-exempt ESOP whose beneficiaries were the firm's three attorney partners. For tax year ended 4/30/04, the three attorneys each had a one-third capital interest and a 30% profits and loss interest in the firm, while the S corporation had a 10% profits and loss interest. Nevertheless, the firm allocated over 87% of its net business income to the S corporation. The Tax Court found that the special allocation "did *not* reflect economic reality" (i.e., resulting in a reallocation of the firm's business income to the partners). In reaching its decision, the Tax Court relied on the four factors listed in **Reg. §1.704-1(b)(3)(ii)**. The bottom line was that the attorneys were claiming that their distributive shares of the firm's net business income for the year should *not* be subject to self-employment tax.

Comment: Obviously, the law firm could file **Form 8832** and elect to be an S corporation with the entity making maximum use (i.e., given that "reasonable salaries" were being paid) of distributions to the lawyers.

9. Short-term Rentals & Self-employment Tax

☞**When Short-term Rental Income Is Subject to S/E Tax (CCA 202151005)**
This IRS Chief Counsel Advice outlines, in two examples, when income from short-term rentals is included in self-employment income.

Net Earnings from Self-employment: **Code §1401(a)** imposes a tax on an individual's net earnings self-employment (NESE). However, under **Code §1402(a)(1)**, "net rental income," generally is *not* included in NESE, unless:

1. The income is received by a "real estate dealer," or

2. The rent includes "substantial" (i.e., "significant personal") services provided to the occupant for the occupants' convenience.

Examples of rentals where "substantial services" are rendered for the occupants' convenience include hotels, motels, boarding houses, and BnB's. Sometimes, warehouses and storage garages might be included as well, depending on the circumstances. (**Reg. §1.1402(a)-4(c)(2)**)

Rental Activities: A rental activity is automatically *not* treated as a passive activity if the average period of customer use of the property is *seven days or less*. In addition, a rental activity (which is treated instead as a trade or business) would *not* be considered passive if the taxpayer "materially participates" in the activity. (**Code §469(a)(7)**)

Comment: But keep in mind that, under **Reg. §1.469-1T(d)(1)**, characterizing items of income or deduction as passive activity income or deductions only affects the treatment of those items for purposes of the passive activity loss rules.

Example #1: An individual, who is *not* a real estate dealer, has a business renting a fully furnished vacation property via an online rental marketplace (e.g., AirBnB or VRBO). The individual provides daily maid service, access to dedicated Wi-Fi, beach and recreational equipment for occupants' use during their stay and prepaid vouchers for ride-share services between the property and the nearest business district. For the year at issue, customers used the vacation property on average for seven days. As a result, the activity is *not* automatically considered a "rental activity" for purposes of the passive activity loss rules in **Code §469**. Instead, it is "elevated" to the same status as any other trade or business activity would be under the PAL rules.

In this example, Chief Counsel notes that the taxpayer provides services for occupants that:

1. Are *not* clearly required to maintain the space in a condition for occupancy, and

2. Are of such a "substantial nature" that the compensation for those services "constitutes a material portion" of the overall rent paid.

Therefore, the net rental income in this instance is included in NESE (and, must be reported on **Schedule C** as a business and subject to self-employment tax on Schedule S/E).

Example #2: An individual, who is *not* a real estate dealer, has a business renting a fully-furnished room and bathroom in their dwelling via an online rental marketplace. Renters only have access to the common areas of the home to enter and exit the room and bathroom, but they do *not* have no access to other common areas such as the kitchen and laundry room. The taxpayer cleans the room and bathroom in between each occupant's stay. For the year at issue, the average period of customer use of the vacation property is seven days and the taxpayer materially participates in the activity. Therefore, the activity is *not* automatically a passive activity for purposes of the passive activity loss rules. Moreover, in this situation, the taxpayer's net income from renting living quarters is excluded from NESE because only minimal services are rendered to the occupants. The taxpayer cleans and maintains the property so that it remains suitable for occupancy. Therefore, these services are *not* furnished primarily for the occupants' convenience. **(Code §1402; S/E Tax)**

Notes:

CHAPTER XV: BONUS DEPRECIATION & SEC. 179 IMMEDIATE EXPENSE DEDUCTION FOR LLCs

<u>Note</u>: Unless Congress acts, bonus depreciation will drop to 80% in 2023.

A. Background: Proposed amendments to existing final regulations were issued as a result of the 1986 and 1988 tax acts that apply to property placed in service in tax years ending after April 29, 1991. The annual dollar limitation and taxable income limitations come into play at *both* the LLC and member levels.[220] Therefore, an LLC may *not* pass through to its members **Code §179** expenses that exceed the LLC taxable income from its trades or businesses for that tax year (but, *not* from other non-T/B sources such as dividends, interest, Cgs, etc.). The LLC net income is the aggregate of the LLC pass-through items[221] other than credits and tax-free income. The regulations exclude guaranteed payments from the definition of net income. If the expense is taken, but the allocation *cannot* be made because of the income limitation, the deduction is suspended and carried over to future LLC tax years.

> **<u>Comment</u>: The Tax Cuts and Jobs Act raise the Sec. 179 cap to $1 million with a phaseout threshold starting at $2.5 million for tax years beginning in 2018 (and, adjusted for inflation thereafter). For 2023, the Sec. 179 cap is $1,160,000 and it begins to phase out at $2,890,000.**

> **<u>Comment</u>:** Keep in mind that with the *de minimis* safe harbor cap per item under the tangible property regs now at $2,500 even for those taxpayers without "applicable financial statements," this immediate write-off approach could be used instead of Sec. 179 immediate expensing. As a result, the overall annual cap and the phaseout starting point would *not* be impacted by this alternate approach. **Before 2018, even though Sec. 179 could *not* be used for tangible personal property (e.g., rugs, appliances, F&F, etc.) in residential rentals, the *de minimis* could be used instead to the extent that these items did *not* exceed the $2,500 or $5,000 caps per item. And, with the passage of the TCJA, Sec. 179 is now available for certain "high-efficiency HVAC units" placed in *commercial* (but, *not* residential) even though that are component systems of the real estate in which they are located. Finally, Sec. 179 is available for "qualified real property" for tax years before 2018, and for the expanded definition of "qualified improvement property" for tax years beginning after 2017.**

Each member must reduce the basis of his LLC interest by the full amount allocated to him, regardless of whether the member may currently deduct the entire amount (i.e., whether it be due to basis or at-risk limitations, or the passive loss rules).[222] If the member cannot deduct the entire Sec. 179 pass-through because of limitations on his personal return due to exceeding the Sec. 179 cap or the phaseout limits (but, *not* the "trade or business taxable income" limit), the excess deduction does *not* carry forward. Nevertheless, the member's basis in the LLC must be reduced by the *entire* amount in the meantime.

> **<u>Comment</u>:** If a flowthrough entity owner is not receiving a current tax benefit from the entity making a Sec. 179 immediate expensing election due to one of the reasons mentioned above, then their pro rata share of any "qualified business income" (QBI) is correspondingly *not* reduced until this carryover Sec. 179 separately-stated item can be used on the owner's personal tax return.

The **Code §179** deduction can be especially troublesome for LLC investors who do *not* actively participate in the business, or who do *not* have other independent sources of "trade or business income." Furthermore, the regulations take the position that the member must be active in **at least one** of the LLC's trades or businesses to be able to count the entities' "trade or business income" (i.e., as shown in **Box 1** of **Schedule K-1**, along with net Sec. 1231 gains) as his own in order to satisfy the "active trade or business taxable income" test on his personal tax returns. The bottom line is that the fact that the LLC engages in an active trade or business does *not* qualify the non-active investor.

> **Comment: With the passage of the TCJA, now that Sec. 179 immediate expensing is available for "assets used in connection with lodging" (and, *not* just businesses such as hotels, motels, or B&Bs shown on page 1 of Form 1065) but also those shown on Form 8825 where an LLC holds title to a rental property. As a result, the net rental income shown in Box 2 of Schedule K-1 will also count as "trade or business taxable income" for purposes of claiming the Sec. 179 deduction (so that it can be passed through to the Form 1065 owners).**

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[220] IRC §179(d)(8)

[221] IRC §702(a)

[222] Rev. Rul. 89-7, 1989-1 CB 178

B. Taxable Income Limits Apply at Both the Entity and Individual Owner Levels

1. **Definition: Code §179(b)(3)(A)** provides that the Sec. 179 deduction "shall *not* exceed the aggregate amount of taxable income of the taxpayer for such taxable year which is derived from the 'active conduct' by the taxpayer of *any* trade or business during such taxable year." For purposes of this limit, taxable income derived from the conduct of a trade or business shall be computed **without regard to the deduction** allowable under **Code §179**.

2. "From Any Trade or Business:" The taxable income limitation was added by the **Tax Reform Act of 1986**. While the Senate version of the taxable income limitation was limited to taxable income of the business in which property was used, **Code §179(b)(3)(A)**, as enacted, applies to taxable income from *any* "trade or business" of the taxpayer. As a result, a Sec. 179 deduction from a sole proprietorship operating at a loss may still be deducted on an individual tax return on which wages (or, self-employment income) in excess of the deduction are included. In other words (especially on a joint return), the "qualifying taxable income" limit can be satisfy by looking at *either* spouse's source of such monies from wages, **Schedule C** or **F** net profits, K-1 income from a partnership or S corporation, or *net* section 1231 gains.

a. **Form 1040 Adjustments:** In addition to be able to look to "any trade or business income" on a joint Form 1040, "taxable income" must be calculated *without regard* to any of the following:

- The section 179 deduction,
- The self-employment tax deduction,[223]
- Any net operating loss carryback or carryforward, and
- Any unreimbursed employee business expenses.

b. **Form 1065 Adjustments:** Net income or loss at the bottom of page 1 (i.e., the amount that will otherwise be shown on either line 1 or 2 of Schedule K) must be *increased* by adding back any "guaranteed payments" paid to the owners, along with being further adjusted (i.e., increased or decreased, as the case may be) by any *net* section 1231 gain or loss.

c. **Form 1120S Adjustments:** Taxable income from page one must be *increased* by an salaries or compensation paid to the officers or shareholders (i.e., line 7), along with being further adjusted (i.e., increased or decreased, as the case may be) by any *net* section 1231 gain or loss.

Comment: For purposes of the "active trade or business" income limit, the Service takes the position that the taxable income of a partner engaged in the active conduct of one or more of a partnership's trades or businesses includes his or her allocable share of taxable income derived from the partnership's active conduct of *any* trade or business. On the other hand, if a flowthrough entity owner is merely a *passive* investor in the underlying entity, then *none* of the flowthrough income from *any* of its trades or businesses can be used for meeting this limitation. As a result, that *passive* investor better have **other adequate sources of "trade or business taxable income"** on their personal tax return to cover the Sec. 179 deduction being passed through on their Schedule K-1, or the deduction must be carried forward (even though the **basis of their ownership interest is otherwise reduced in full for the tax year in question**).

3. **Taxable Income Requirement Applies at Both Entity & Owner Level:** In the case of a partnership, the taxable income applies to the partnership as well as each partner. A similar rule applies in the case of an S corporation and its shareholders (**Code §179(d)(8)**).

4. **Reg. §1.179-2(c)(2):** The IRS clarified the above rules in **Reg. §1.179-2(c)(2)**:

Application to partnerships and partners--(i) In general. The taxable income limitation of this paragraph (c) applies to the partnership as well as to each partner. Thus, the partnership may not allocate to its partners as a section 179 expense deduction for any taxable year more than the partnership's taxable income limitation for that taxable year, and a partner may not deduct as a section 179 expense deduction for any taxable year ***more than the partner's taxable income limitation for that taxable year****.*

Comment: This last part of the reg is a bit misleading though. If the partner otherwise had sufficient "trade or

[223] The 50% S/E tax deduction taken for AGI.

business taxable income" **from *another source* on their own tax return**, this could be used to make up the shortfall, thus allowing the full tax benefit of a passed through **Code §179** amount to be realized in a given tax year.

☞**Electing Sec. 179 With Rental Property Assets**

In today's litigious society and ever increasing employment tax environment, it is not only real estate that is kept off a company's balance sheet and put into a separate LLC (i.e., multi-member Form 1065, or single-member Schedule E). More and more, we are seeing, for instance, medical clinic assets such as MRIs, CAT scans and X-ray equipment put into LLCs and rented back to the operating entities. Likewise, in the trucking industry, tractor/trailer rigs are leased on a triple-net-lease basis back to commonly-controlled entities. It is an excellent way to get company profits out to the owners with employment tax, while protecting the assets in question from creditor claims, as well as potential judgments in a lawsuit.

Comment: For tax years beginning after 2017, assets "used in connection with lodging" (e.g., furniture, fixtures, appliances, rugs, etc.) will now eligible for Sec. 179 immediate expensing (let alone, remaining eligible for 100% bonus depreciation).

Background - Sec. 179: As far as "controlled groups" making the Sec. 179 election, this could be an issue where there was common control of multiple C corporations. If that was the case, the overall Sec. 179 cap of $500,000, along with the $2,010,000 million phaseout threshold (both amounts for 2016 and indexed for inflation annually after that), would have to be shared among the members of the group (i.e., in a similar fashion as would be the case with the lower corporate marginal tax rates). But, with S corporations, **INFO 2013-0016** has confirmed that such entities, even if commonly controlled (i.e., brother/sister corporation under **Reg. §1.1563**) cannot be "component members" of a controlled group. As a result, the amount of Sec. 179 assets taken into account by one S corp does *not* affect either the $500,000 cap or the $2,010,000 million phaseout threshold being used by another member of this commonly controlled group. Furthermore, the amounts that a taxpayer elects to immediate expense under Sec. 179, whether they are made by partnership/LLCs, or Schedule C, E or F proprietorships owned by the same taxpayer, are *not* aggregated for purposes of determining if the overall $2,010,000 million phaseout cap is being exceeded.

LLC Leasing Assets to Commonly Controlled Operating Entities: Based on the above analysis, where a taxpayer owns several LLCs (with other family members), as well as an S corp operating business, these entities are *not* combined as far as the total amounts of such assets that otherwise qualify for Sec. 179 with regard to the overall threshold for phaseout purposes. In other words, only when any one of these specific entities were to exceed the total cap on Sec. 179 assets in a given tax year would the threshold start to kick in (and, it would only be for that particular entity).

Reg. §1.179-2(b)(3) "Application to partnerships" states "the dollar limitation of this paragraph (b) applies to the partnership as well as to each partner. In applying the dollar limitation to a taxpayer that is a partner in one or more partnerships, the partner's share of section 179 expenses allocated to the partner from each partnership is aggregated with any nonpartnership section 179 expenses of the taxpayer for the taxable year. However, in determining the excess section 179 property placed in service by a partner in a taxable year, the cost of section 179 property placed in service by the partnership is *not* attributed to any partner.

Comment: Although the reg speaks about partnerships and their owners, it applies equally to S corps and their shareholders as well.

Sec. 179 & "Active Trade or Business Taxable Income:" Of course, when an owner of several passthrough entities receives his K-1s and there are Sec. 179 amounts on each one, these will be combined for purposes of the $500,000 limit (for 2016). And, they would need sufficient "trade or business income" to cover the Sec. 179 amount to be taken on their return. Otherwise, the basis in their ownership interest in the passthrough entity is reduced even while some or all of the Sec. 179 amount is suspended. But, as mentioned above, what each entity puts into service in a particular tax year as far as Sec. 179 property would have no impact on any other entity that the taxpayer owned, or his any Sec. 179 property that he may have put into service on his own Form 1040 (at least as far as the annual $2,010,000 million phaseout threshold).

For purposes of the "trade or business taxable income" requirement, an entity such as an LLC that solely rents property (i.e., only files Form 8825 and has no page one Form 1065 "trade or business), may nevertheless still count any net rental income as "trade or business taxable income" (which is then passed through to the owners of the LLC as Box 2, Net Rental Income) for purposes of the Sec. 179 requirement at the *entity* level. Now, whether the owners (i.e., LLC members) are allowed to count these amounts (i.e., Box 2, Net Rental Income) as "trade or business taxable income" is another matter. Basically, as pointed out in **Reg. §1.179-2(c)(6)**, each owner is tested as to whether they are "actively involved in a meaningful way" in the underlying trade or business of the partnership/LLC (even a Form 8825 rental activity).

Triple Net Leases: In a "triple net lease" situation it would be difficult to argue that the LLC (or, Schedule E) lessor was in fact "actively participating" in the underlying rental activity. For this purpose, we are *not* necessarily talking about a level of involvement that is on a *day-to-day* basis. But, merely receiving a check where the lessee performs all of the services related to the maintenance of the rented property (e.g., leasing of tractor/trailers to a trucking company), would *not* give rise to the level of involvement necessary for Sec. 179 purposes. Therefore, any Net Rental Income from Box 2 of the owner's K-1, at least in situations such as this, could *not* be used to meet this T/B taxable income requirement.

On the other hand, whether the rental property is held by an LLC/partnership (or, directly by the taxpayer on a Schedule E), if the LLC member makes decisions regarding the rental property such as arranging for needed repairs and other maintenance items, negotiates leases, signs checks and pays bills, any net rental income could then be used as "trade or business taxable income" (i.e., because here the owner is considered to be an "active participant" in the underlying rental activity).

Comment: This issue comes up again with the passage of the TCJA and the deduction now available for "qualified business income" under Code §199A and whether the net rental income is a source of QBI from a "trade or business" that meets the standards (at least according to the Sec. 199A reg writers) set out under Code §162.

Comment: Even if the owner/lessor was to "actively participate" in the rental of tangible personal property (e.g., trucks or equipment), and this rental could *not* be put on a **Schedule E** (i.e., since it did *not* involve the rental of real estate, or tangible personal property rented in connection with real estate), it does *not* necessarily go on a **Schedule C** (i.e., as a "trade or business" whose net profits would be subject to S/E tax). If this rental property was *not* offered **in the normal course of a trade or business to the general public**, and was titled in the name of a separate entity (such as a SMLLC) for limited liability purposes, it would *not* go on a **Schedule C**. Instead, any net profits (or, loss) would be reported **on page one of Form 1040** as **"Other Income/Loss"** on **Line 21** (and, obviously, *not* subject to S/E tax) with the **"PPR" (personal property rental)** acronym listed beside this amount (with a detailed statement of income and expenses attached).

Comment: With the revisions made to **Form 1040** starting with the 2018 tax year, **"Other Income/Loss"** now is reported on **Schedule 1, Line 21**.

Finally, even if the taxpayer fails to be an "active participant" (something that we used to check off on their K-1, but now just enter into the tax prep software), they are always free to look to their personal tax return for any other sources of W-2 or S/E income (i.e., either their own, or that of their spouse) which would readily count as "trade or business taxable income" for purposes of taking a Sec. 179 deduction. Remember too, that *net* Sec. 1231 gains (either separately stated on a K-1, or from property held directly by the taxpayer and reported on **Form 4797**) would also count as "trade or business taxable income," as well as net rental income from a **Schedule E** activity in which they were "actively involved."

Example: A taxpayer formed an LLC which held tangible personal property (e.g., tractor/trailers) which was then rented to his S corp trucking company pursuant to a "triple net lease." With regard to taking a Sec. 179 deduction on these rigs (*not* to exceed the overall cap for that particular tax year, with any excess being expensed using bonus depreciation and regular MACRS depreciation), there would be two major issues to contend with as follows:

1. The LLC (i.e., taxed as a **Form 1065** partnership) is definitely a "noncorporate lessor." Therefore, the "tests" under **Code §179(d)(5)** would have to be met (and, make sure that a *written* lease was in place so that there would be no question that the lease term did *not* exceed 50% of the MACRS classlife with regard to the assets being expensed).

2. With a triple net lease in place, it is fairly certain that any net rental income flowing from the **Form 8825** to **Box 2** of the LLC member's K-1s would *not* count as "trade or business taxable income." Therefore, it would be imperative that sufficient T/B income exist elsewhere on the LLC member's personal return in order to take any Sec. 179 deduction. **(Code §179; Immediate Expensing)**

Comment: With these "triple net lease" situations, consideration should be given to have the landlord (and, not the lessee) take over some of the responsibilities of handling the rental property, such as paying the real estate taxes, and maybe the insurance premiums as well. It is *not* that much additional trouble and, perhaps, it takes the property out of a "triple net lease" situation. Furthermore, with the introduction of the deduction under Sec. 199A, it would helped to make the net rents count as "qualified business income."

☞**Sec. 179 & "Active Trade or Business Income" Requirement for Flowthrough Entity Owners**

Facts: An LLC has 20 members, most of whom are retired, over 80 years old and who have no wages or earnings from other than investment income (e.g. interest & dividend) sources and social security benefits. The LLC is profitable and income is derived from manufacturing. For simplicity purposes, let's say that none of the members actually work at the LLC and only a few members (4) serve on the management committee which meets monthly/quarterly and does meaningful work affecting the day-to-day activities of the business. The LLC will soon acquire a $300,000 machine to be used in the manufacturing process.

Issue: Would the Sec. 179 requirement for sufficient "active trade or business taxable income" be met at the individual owner level so as to satisfy the amount (i.e., $300,000) which would be expensed at the LLC level and which would then be passed through to the shareholders on their K-1s?

Law: **Code §179 (b)(3)(A)** which discusses the "Limitation based on income from trade or business" states that "The amount allowed as a deduction .....shall *not* exceed the *aggregate* amount of taxable income of the taxpayer for such year which is derived from the *active conduct* by the taxpayer of *any* trade or business during such taxable year." Here, the concern is that the retired members might *not* have any taxable income derived from the "active conduct" by the taxpayer of any trade or business during such year. Clearly, should any LLC member here have wages (or, any other trade or business income such as self-employment income) from some other source (including that of a spouse), they would be able use the Sec. 179 benefit passed through on their respective K-1s from the LLC. However, most of the members have no wages or other "trade or business income," given their collective lack of active involvement in any of the underlying trades or businesses of the LLC. There is no question that the LLC can "take" Sec. 179 and put the amount on the Schedule K-1. So, the determination is ultimately at the member level as to whether Sec. 179 can be used to create a tax benefit on the owners' Form 1040s (or simply result in a carryover amount with no foreseeable utilization, yet there may have been a significant reduction of their bases in the meantime).

Holding: Many practitioners count on the Schedule K-1, Line 1 "trade or business income" for purposes of satisfying this test at the owner level. Pursuant to **Code §179(d)(8)**, each of the tests (i.e., overall $500,00 limit, $2,010,000 to $2,510,000 phaseout rules and "active T/B income") is apply at *both* the entity level as well as the owner level. This particular issue involves the *third* test which mandates that adequate "active trade or business income" also exist on the owners return to cover the **Code §179** immediate expense amount which is separately stated on the owner's Schedule K-1. At times, the owner might independently have sufficient "trade or business income" to cover the Sec. 179 amount being passed through because of their own W-2 income, or that of their spouse. Any source of self-employment income would also count as well. But, what if the investor is elderly, or a child, who has no other source of "active trade or business income?" **Reg. §1.179-2(c)(2)** and **(3)**, which is an "interpretative reg" (i.e., vs. a "legislative reg"), takes the position that the owner must be "active" in at least one of the trades or businesses of the flowthrough entity to be able to count the entity's trade or business income as his or her own for purposes of satisfying the "active trade or business income" test on their tax return. If the owner is "active," then *any* trade or business income of the flowthrough entity can be used for these purposes. However, if the owner does *not* participate in any way with the flowthrough entity's businesses, then it is the position of the Treasury in this reg that *none* of the Line 1, Schedule K-1 income can be used on the owner's return to satisfy this particular test. And, if the owner does *not* have an independent source of "active T/B income," the basis of his or her ownership interest is nevertheless reduced immediately, even if there is little prospect of having any such income in the near future. **(Code §179; Immediate Expensing)**

Comment: A number of practitioners seem to be unaware of this "interpretative reg" and count on the K-1 trade or business income shown on Schedule K-1 to satisfy the test. However, since this position technically goes against the Treasury's position, a **Form 8275-R** should be filed with the owner's tax return to disclose the deviation. And, according to a number of court decisions, there is a presumption that such a reg would be valid unless one could demonstrate that the statute was "ambiguous and did *not* represent a permissible construction of the statute."

Comment: This reg section was written back when the **Code §179** was significantly less than then the significant larger amounts now available. Still, until revised, it represents the Treasury's position with regard to this issue and could cause a problem for elderly investors with only portfolio income and/or social security benefits on their personal tax returns (or, minor children of the entity's owner who might also have been gifted interests in such businesses).

Comment: Of course, even "active trade or business income" (i.e., flowing through on one particular K-1) could still be eliminated (or, at least offset) if there was some other "negative" source of trade or business loss (e.g., other "negative" K-1s or net **Code §1231** losses from other flowthrough entities or net losses from Schedule C or F proprietorships of either the K-1 owner or his or her spouse on a joint return). But, guaranteed payments on the LLC's return actually electing the Sec. 179 amount get to be added back at least in determining the "trade or business taxable income" for the entity.

Comment: This "active" test imposed by the regs under **Code §179** was written *before* the "material participation" standards contained in passive loss rules under **Code §469**. However, it would seem that they would *not* be as onerous (e.g., 500 hours per year), for example, and they would also be mutually exclusive of each other.

☞Calculating the Taxable Income Limitation for Sec. 179 With a Flowthrough Entity

The taxpayer was an LLC member in which he "actively participated" (i.e., keep in mind this is an "old" standard contained in the Sec. 179 regs and has nothing to do with the passive loss rules: and, it was something that we used to have to check off on the Schedule K-1 and which most tax prep software packages still require us to answer on the input sheets). In addition to his LLC interest, he also owns and operates a Schedule F farm operation. His share of the LLC Sec. 179 deduction was $125,000 as to some farm equipment that it had purchased, but he was unsure as to the calculation of his taxable income limitation (assume that the LLC has sufficient "trade or business taxable income" to claim the entire $125,000). Here was the information (rounded for calculation purposes) from both his K-1 and Form 1040: 1) Guaranteed payment 43,500; 2) Sec. 1231gain 8,500; 3) Rental income 27,500; 4) Trade or business income 85,000; and 5) Farm loss (before Sec. 179 deduction) (36,000). His "trade or business taxable income" for purposes of the Sec. 179 deduction would be calculated as follows: Guaranteed payment 43,500 + Sec. 1231gain 8,500 + trade or business income 85,000 - Farm loss 36,000 = $101,000. **(Code §179; Immediate Expensing)**

Comment: Of course, if he was a mere investor in the LLC and did *not* "actively participate" in at least one of the underlying trades or businesses of the company, then none of the $85,000 of the LLC's T/B (i.e., K-1, line 1) income, or the $8,500 Sec. 1231 gain, could be counted for the Sec. 179 taxable income limitation (even though it would certainly still be shown on his Schedule E, page 2 and Form 4797, respectively; and he probably would *not* be receiving a guaranteed payment). And, of course, if this investor was not "active" in the business, he would *not* be receiving any guaranteed payments.

Comment: So, for this particular tax year, the taxpayer would receive his share of $125,000 Sec. 179 deduction, but $24,000 would have to be carried over to a succeeding tax year in which additional "trade or business taxable income" existed so as to take the remainder of this write-off. And, this example assumes that the cost of the equipment placed into service did *not* exceed the beginning point of the phase-out rules (i.e., $2,010,000 for 2016). Finally, regardless of the requirement that he carried over the excess $24,000 Sec. 179 deduction, the basis in his LLC interest would be reduced by the full $125,000 immediately (which could affect the possible taxation of any distributions from the LLC in the meantime).

☞Comparing Sec. 179 to Bonus Depreciation

Sec. 179 v.	**Bonus Depreciation***,**
Elective - specific assets & amounts	Automatic - must elect out MACRS class
Annual cap	N/A
Phaseout limits	N/A
"T/B taxable income"	N/A
New or used property	New or used property (after9/27/17)
QIP (Commercial bldgs. - Interior)***	QIP (Commercial bldgs. - Interior)
"High-efficiency HVAC" (Commercial bldgs.)***	N/A
Roofs (Commercial bldgs.)***	N/A
Fire alarm systems (Commercial bldgs.)***	N/A
Security systems (Commercial bldgs.)***	N/A
TPP "used in connection w/ lodging"	TPP or real property - ≤ 20-years MACRS
Limited to $25,000 for "heavy vehicles"	Adds $8,000 to 1st year "luxury car cap"
Includes off-the-shelf-software	Includes off-the-shelf-software
Sec. 338(h)(10) step-up eligible	Sec. 338(h)(10) step-up eligible
Sec. 336(e) step-up eligible	Sec. 336(e) step-up eligible
Acquired by "purchase" - Sec. 754 N/A	Sec. 754 step-up; Sec. 743; *not* Sec. 734
"Non-corporate lessor" - "1st year test"	N/A
Purchase from unrelated party	Purchase from unrelated party
Not previously used by taxpayer	Not previously used by taxpayer
Avoids AMT depreciation adjustment	Avoids AMT depreciation adjustment
Preserves UBIA for Sec. 199A purposes	Preserves UBIA for Sec. 199A purposes
Check state law for availability	Check state law for availability

Make or reject on amended return	"Catch up" with missed depreciation
"Repair deduction" as an alternative?	"Repair deduction" as an alternative?

***Comment:** There is no longer a need for any asset to be "leased" such as "qualified leasehold improvements" placed in service prior to 2018. And, bonus depreciation is on "qualified property" (new or used, real or tangible personal) with a MACRS class life of 20 years or less, including QIP (once a technical correction is made to the TCJA). Also included for bonus depreciation are "qualified film, television and live theatrical productions," along with certain plants bearing fruit or nuts planted or grafted after Sept. 27, 2017.

****Comment:** "Qualified property" does *not* include property used in a business that is *not* subject to the new **Code §163(j)** "net business interest expense limitation," but it does include property used in farm business.

*****Comment:** The major difference between immediate expensing deductions under Sec. 179 v. bonus depreciation is that these real estate assets written off under the Sec. 179 need to have already been placed in service. On the other hand, with bonus depreciation, the only prerequisite is that the asset (either real estate or tangible personal property) be classified as MACRS property with a recovery period of 20 years or less.

B. Impact of Sec. 754 Election on Bonus Depreciation

☞**Bonus Depreciation and Sec. 754 Step-ups to Partnership Assets**

Bonus depreciation, **now set at 100% through 2022**, is permitted on *both* tangible personal and real property having a **MACRS classlife of 20 years or less**. It is not, however, allowed for intangible assets such as goodwill which must instead be amortized over 180-months pursuant to **Code §197** (commencing with the month that the asset is first placed in service).

Comment: This "refresher" on the bonus depreciation rules involving assets acquired indirectly through a §754 step-up is taken from the completely revised "2022 COMPLETE GUIDE TO DEPRECIATION, AMORTIZATION & TRANSFERS OF PROPERTY - ISSUES, ANSWERS & PLANNING STRATEGIES" which is now available for purchase for your firm's tax department.

Before 9/28/17, "used" assets were *not* eligible for bonus depreciation (which was set at a rate of 50% at that time). Instead, the "original use" (i.e., initial use) of the asset had to have commenced with the taxpayer seeking to claim bonus depreciation (and, this included lessees who decided to purchase the asset at the end of the rental period, such as a vehicle or equipment, so long as the lessee was the *first* (i.e., "original") taxpayer to have ever used the property in question).

With the passage of the **TCJA**, however, the *outright purchase* of *previously-used* assets is now permitted when claiming bonus depreciation. But, what about the "deemed acquisition of assets" where a partnership interest was transferred in a taxable sale or exchange? Under the "aggregate theory" of partnership taxation, the entity's owners are treated as possessing an indirect interest in each and every one of the assets that the partnership has on its balance sheet. So, has not the purchaser of a partnership interest essentially bought the selling partner's underlying share of their right to each and every one of the entity's assets? And, if so, how does that impact the use of bonus depreciation on the assets (or, portion thereof with regard to a "step-up in basis") deemed purchased?

The "answer" is that, with a valid Sec. 754 election, there is a step-up to the "inside bases" of the partnership assets deemed acquired indirectly when a partnership interest is purchased (or, inherited, but *not* received by gift since there is no "step-up" as to the donee's carryover basis). This is reflected on the **Form 4562** where a "Sec. 754 adjustment" is listed in the same fashion as any other purchased (depreciable) asset. Before changes made by the **TCJA**, "used" assets were *not* eligible for bonus depreciation. But, for assets acquired and placed into service *after* 9/27/17, bonus depreciation will be allowed for outright purchases of previously-used assets. The Service has now clarified as to how this change would apply to the acquisition of an interest in an existing partnership holding previously-used assets, to the distribution of such assets from an existing partnership, or to similar transactions. As a result, bonus depreciation is now allowed on used assets held by the partnership where the Sec. 754 adjustment is made pursuant to **Code §743** (i.e., purchases or inheritances of a partnership interest) as opposed to **Code §734** (i.e., where the step-up is due to "disappearing basis" or gain resulting from a liquidating distribution of property to an exiting partner).

Furthermore, where a partnership asset is distributed under the provisions of **Code §731** and the distributee partner has insufficient basis to absorb the basis that the entity had in that asset (i.e., since their "outside basis" is less than what the "inside basis" of the asset was to the partnership), can this "disappearing basis" be used to step-up the bases of the remaining assets that the partnership has and be treated as "qualified property" for which bonus depreciation can be claimed? **The IRS has clarified that bonus depreciation would *not* be available where the step-up is pursuant to Code §734**.

The Treasury issued proposed regs in August, 2018 (Cf. **REG-104397-18**) which address the bonus depreciation rules and how they apply to "qualified property" acquired and placed in service after 9/27/17. Although these proposed regs are technically *not* effective until finalized, they can be relied upon in the meanwhile. More importantly, they do serve to clarify that **Code §743** step-ups in partnership assets are to be treated as if additional "qualified property" (i.e., at least for those MACRS assets, both real and personal, which have a recovery period of 20 years or less) for purposes of the 100% bonus depreciation rules **(but not step-ups under Code §734)**. This distinction is covered in more detail below.

Step-ups Under Code §743: The bottom line is that purchases of assets (or, ownership interests in assets, such as with a partnership) that result in the recognition of gain by the seller (including partners) are generally eligible for bonus depreciation due to the changes made by the **TCJA** (i.e., namely the elimination of the "original use" requirement), so long as the purchaser is *not* considered to be a "prior user" of that *same* property. On the other hand, purchases that generally do *not* result in recognition of gain by the seller are *not* treated as "qualified property" otherwise eligible for bonus depreciation.

These proposed regs provide guidance on how the new bonus depreciation rules will apply to a wide variety of transactions involving partnerships (and, disregarded entities) holding assets for which bonus depreciation may be claimed (unless the taxpayer elects out of taking this immediate write-off). More importantly, all of the facts and circumstances should be evaluated to determine the appropriate treatment of a given transaction. But, set out below are the general guidelines for the most typical situations.

1. If an existing interest in an existing partnership is purchased directly from an existing partner, and an election is in effect under **Code §754** to adjust the purchaser's share of the "inside bases" of the partnership's assets equal to the "outside basis" paid pursuant to **Code §743**, bonus depreciation will be available for the purchasing partner's **corresponding increase in the stepped-up portion of the otherwise qualifying assets deemed acquired**.

2. If one of the owners of an existing multi-member LLC (or, partnership) decides to acquire all of the interests owned by the remaining members (or, partners), so that the entity becomes "disregarded" for income (but, *not* necessarily for employment) tax purposes, the owner of this SMLLC may be entitled to bonus depreciation for the portion of the otherwise qualifying assets that were deemed acquired when the other owners were bought out (Cf. **Rev. Rul. 99-6**).

> **Example:** As of the beginning of the current tax year, A buys out the interests of B and C with regard to the ABC, LLC for $600,000. This results in the former entity now being treated as a SMLLC. Assumed that the only asset that the former LLC held was building which was used as a gas station/convenience store with an adjusted basis of $600,000 and a FMV of $900,000 which was properly classified as a MACRS 15-year asset (i.e., so that bonus depreciation would otherwise be allowed).
>
> A already owned the one-third of the building with a basis of $200,000 and would continue the *same* MACRS recovery period and method for this portion of the building on the **Form 4562** that will now be filed on a **Schedule E** on his personal tax return.
>
> As to the other two-thirds of the building deemed purchased, A is treated as having paid $600,000 which, under **Code §1001**, would give him an initial basis equal to the cost paid for the asset. And, even though this was a "used" asset as of the time that it is now being purchased, bonus depreciation could be taken for this entire $600,000 acquisition cost.

3. If all of the interests in an existing partnership are purchased by a single unrelated outside third-party (i.e., who is currently *not* a partner or an LLC member, and has never been so), the partnership/LLC becomes a "disregarded entity" with the transaction being treated for tax purposes as an *outright purchase* of the entity's assets. As a result, these "used" assets are eligible for bonus depreciation.

> **Comment:** This is one example of where the purchase of a "partnership interest" potentially meets the definition of "qualified replacement property" for purposes of the like-kind exchange rules under **Code §1031**. For example, real estate assets are exchanged with the proceeds deposited in an escrow account held by a qualified intermediary who then purchases all of the interests held by partners in a partnership holding only real estate assets as well. As stated above, this is treated as if an *outright purchase* of real estate (i.e., a qualifying replacement type of asset) was in fact made. "Tenant-in-common" (TIC) interests, if the prescribed requirements set out in **Rev. Proc. 2002-22** are met, can also be treated as an *outright purchase* of the underlying assets represented by these interests.

4. If all of the ownership interest in a SMLLC is purchase, then this too can be treated as an outright purchase of the assets held by this disregarded entity, thus potentially qualifying their cost for bonus depreciation.

5. If, on the other hand, only part of the SMLLC owner's interest in this disregarded entity are purchased (thus

effectively converting the entity into an LLC treated as a partnership), the availability of bonus depreciation will depend on how the transaction was structured as follows:

a. If the interest was acquired in exchange for money or property that is either transferred directly to the current owner of the SMLLC, or is contributed to the entity and subsequently distributed to this current owner (i.e., it essentially is a "disguised sale"), the transaction will be treated as an *outright purchase* of the entity's asset's with the bases being equal to the FMV of the consideration paid. Then, the asset's are deemed transferred to a new partnership/LLC with bonus depreciation being available as if the assets were purchased directly from the "old" partnership/LLC.

b. If the cash or property contributed to the SMLLC is *not* distributed out to its owner, the transaction is treated as if a new partnership/LLC was formed first, followed by a contribution of the money (or, property) in exchange for a partnership interest (i.e., governed by **Code §721** as a tax-deferred exchange, and with **Code §§722** and **723** controlling the basis determination to both the entering partner (i.e., "substituted basis"), as well as the partnership (i.e., "carryover basis").

Comment: Although the new partner/LLC member might get special allocations of other depreciation benefits under **Code §704(c)**, bonus depreciation will *not* be available for their share of any of the entity's depreciable assets (since no property was actually, or deemed, "purchased" as a result of the transaction).

For example, under one of the permissible methods under **Code §704(c)** (i.e., the "remedial method"), the investing partner's allocable share of depreciation on existing assets is calculated by reference to "any" recovery period and depreciation method available to the partnership for newly-purchased property. But, the language in the proposed regs clarifies that bonus depreciation would *not* be available in making this allocation under **Code §704(c)** to the contributing partner who, as a large cash investor, might otherwise be allocated a significant initial year deduction.

In the situation where the owner of a SMLLC only has part of their interest in the entity purchased by a third-party, and thus the entity becomes a partnership for tax purposes, the proposed regs make it clear that bonus depreciation will *not* apply to any of the "rollover basis" that the original owner might have had in the entity's assets. In essence, the regs treat the assets being transferred over to this new entity (i.e., the partnership, now that there are two or more owners) as being "previously used" by the original owner of the SMLLC. But, the purchaser who is treated as having acquired a share of the former SMLLC's assets (i.e., when the "single LLC member's interest" was partially bought out) which are then deemed contributed to the new partnership entity would, if a **Code §754** election was in effect, be eligible to claim bonus depreciation on this stepped-up portion of the asset's inside basis to the entity.

Step-ups Under Code §734(b): Where distributions of cash or securities results in gain being recognized by a distributee partner (i.e., since the FMV of the property distributed exceeds the partner's basis in their interest), this might result in a step-up pursuant to **Code §734(b)** to the entity's remaining assets, given an election under **Code §754** is in effect. Nevertheless, under the theory that this step-up relates to assets "previously used" by the partnership, the proposed regs make it clear that bonus depreciation is *not* available in such situations (despite the fact that gain was recognized by the distributee partner).

If the partnership distributes property, either as a current or liquidating distribution to a partner, the partner may be required to step-up (or, step-down) the basis in the property received. Again, in this situation, the proposed regs deny the use of any bonus depreciation on the "stepped-up portion" for the property received.

Aggregate v. Entity Theory: The above discussion centers predominantly around the concept that a partnership is nothing more than a "transparent aggregation of its owners" with regard to the assets which the entity otherwise holds. Thus, purchases of a partner's interest in the entity can in fact be treated as "deemed purchases" of the entity's underlying assets. On the other hand, an S corporation though possessing many of the same characteristics of a partnership, is governed by the "entity theory" of taxation. As a result, many of the transactions mentioned above would *not* be treated as a purchase of the S corp's assets when a shareholder sells their stock.

The only exception would be a "deemed asset sale" where the seller of S corp stock agreed to make an election under **Code §338(h)(10)** to instead treat the sale of their stock as if it were a sale of the corporation's assets. The basic requirement for this type of transaction is that the purchaser be a corporation (e.g., including an LLC electing to be treated as an S corporation) which is infused with the cash that an individual purchaser would have used to make the acquisition (i.e., under **Code §351**) and that **100% of the target S corp's stock be acquired within a 12-month period so that a QSUB election can be made and the acquiring S corp therefore becomes an eligible shareholder**.

Since this would be deemed as an "asset purchase" where the inside bases of the target's assets would be stepped-up to the FMV of the consideration paid for the S corp stock, this *total* amount for otherwise "qualified property" (even though it involves the acquisition of "used assets") would be eligible for bonus depreciation (let alone, Sec. 179

immediate expensing). To be clear, unlike a step-up under **Code §754**, the *entire* amount of the stock purchase price would be eligible for bonus depreciation on any "qualified property" deemed acquired. Intangible assets such as goodwill, however, would have to instead be amortized (i.e., pursuant to **Code §197**). And, if the S corp target had been on the cash basis of accounting, a reasonable allocation of the stock's purchase price would have to be allocated to any outstanding accounts receivable (or, inventory, if instead on the accrual method).

> **Comment:** Stock purchases of an S corp's QSUB stock could also be treated as a "deemed asset purchase" if an election was made under **Code §336(e)**. Furthermore, the purchaser could be an individual and *not* necessarily a corporation (as is the case with an election under **Code §338(h)(10)**).

Notes:

CHAPTER XVI: Supplement - Medicare Surtaxes on K-1 Income

Note: The major change with the 3.8% Sec. 1411 Medicare surtax is that two significant deductions which had served to offset "gross investment income" and passive income have now been eliminated by the TCJA. Namely, 2% miscellaneous deductions such as investment management or advisory fees, along with a cap on state and local taxes (SALT), will no longer serve to reduce a taxpayer's "net investment income" (NIIT). As a result, especially for high net worth clients, this could mean a must larger surtax will need to be paid when filing Form 8960.

☞C Corporation Dividends Subject to 3.8% Medicare Surtax Regardless of Shareholder's Material Participation (CCA 202118009)

The IRS has confirmed that C corporation dividends (directly or constructively received) are subject to the **Code §1411** Medicare surtax. And, since this is *not* a flowthrough entity, it does *not* matter what level of material participation (i.e., under **Code §469**) the shareholder recipient might assert in such instances. **(Code §1411; Medicare Surtax)**

Comment: The same would be true of any capital gains realized on the sale or exchange of stock that such shareholders might have. However, if an S election was made before the stock was sold (or, the corporation liquidated), then material participation might be considered as to avoid the classification of the activity as passive under **Code §469**. Of course, the conversion of the C corporation to S corp status might be subject to the **Code §1374** "built-in gains" tax, if a sale of assets (v. a stock sale) were to occur.

Comment: And, for partners, if they are materially participating in the underlying business of the entity in the year that their interest is sold, any gain would also *not* be subject to the 3.8% Medicare surtax. The surtax, at this point in time, only applies to passive and portfolio income.

☞Issues Remain with Sec. 1411 3.8% Medicare Surtax

The **Code §1411** surtax on the certain sources of unearned income of higher-income individuals is going to play an even more prominent role in year-end planning, as well as tax planning in general, now that taxpayers and their advisors have a greater understanding of the mechanics of the surtax and who is most likely to be impacted by it.

Comment: This summary provides an overview of how the surtax works, as well as a number of techniques to potentially reduce or avoid it. One of areas that we may need to examine more closely concerns the owners of C corporations and how the surtax might result in "triple taxation" on the sale of C corp assets (or, at least "double taxation" on the sale of any C corp stock). Is there any distinction between the sale of IBM stock or that of a dentist or doctor who has worked (i.e., "materially participated") day-to-day in their business over numerous years? Would it matter if it could be shown that "personal goodwill" was involved (especially in those situations where no covenant-not-to-compete existed)? How should monies received by the selling owner of a regular C corporation be treated for purposes of the surtax? And, how would an S election impact such sales (even if they resulted in imposition of the "built-in gains" tax)?

Comment: Another area of concern involves "triple net leases," especially with regard to real estate rentals. When a grouping election is made, the dictate is that it be done on an "all-or-nothing" basis. And, this would include such leases, along with any other real estate rental activities of a "real estate professional" in which they did *not* materially participate.

Comment: Triple net lease situations involving tangible personal property (e.g., trucking operations, planes, heavy construction or high-cost medical equipment such at CAT scans, MRIs, or x-ray machines) would have to constitute a separate grouping election apart from any rental real estate activities that the taxpayer might otherwise have (i.e., as they would likely *not* constitute an "appropriate economic unit" for purposes of the passive loss rules). Of course, such tangible personal property rentals might be grouped with the related trade or business in a "self-rental" situation. But, this would have to be looked at on a case-by-case basis.

Background: For tax years beginning *after* Dec. 31, 2012, certain unearned income of individuals, trusts, and estates is subject to this surtax. The surtax is 3.8% of the *lesser* of (1) net investment income (NII) or (2) the excess of modified adjusted gross income (MAGI) over the threshold amount ($250,000 for joint filers or surviving spouses, $125,000 for a married individual filing a separate return, and $200,000 in any other case). (**Code §1411(a)(1), Code §1411(b)**)

Comment: Note, that for the 2014 tax year onward, these threshold amounts are *not* indexed for inflation.

Comment: And, keep in mind how much broader this definition of "net investment income" is for purposes of the **Code §1411** Medicare surtax v. what we have used for years on **Form 4952** when seeking to deduction investment interest expense. The main difference is that any net passive income is also included in NIIT.

MAGI is adjusted gross income plus any amount excluded as foreign earned income under **Code §911(a)(1)** (net of the deductions and exclusions disallowed with respect to the foreign earned income). (**Code §1411(d)**)

Comment: Additional adjustments to MAGI may be required for an individual that is a U.S. shareholder of a controlled foreign corporation (CFC) or that is a U.S. person that directly or indirectly owns an interest in a passive foreign investment company (PFIC). (**Reg. §1.1411-2(c)(2)**)

For an estate or trust (i.e., when filing an income tax return on **Form 1041**), the surtax is 3.8% of the *lesser* of (1) undistributed NII or (2) the excess of AGI (as defined in **Code §67(e)**) over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins ($12,150 for 2014). (**Code §1411(a)(2)**)

Comment: Under **Code §67(e)**, a trust's AGI is computed in the *same* way as an individual's AGI, except that the following items are deductible in full: (1) trust administration expenses that would *not* have been incurred if the property were *not* held in trust; (2) personal exemptions under **Code §642(b)**; (3) trust income required to be distributed currently under **Code §651**; and (4) other amounts properly paid or credited or required to be distributed under **Code §661**.

Sec. 1411 "Net Investment Income:" For purposes of the 3.8% surtax, NII is broadly defined as investment income less any deductions "properly allocable to such income." (**Code §1411(c)**) Specifically, NII is:

1. Gross income from interest, dividends, annuities, royalties, and rents (unless derived in the ordinary course of a trade or business to which the NII tax does *not* apply). (**Code §1411(c)(1)(A)(I)**)

Comment: For an overview of which types of businesses the NII applies, see "2.", below. But, the most important factor in this analysis is whether or not the activity is otherwise subject to the **Code §469** passive loss rules.

If an individual owns or engages in a trade or business directly or indirectly through a disregarded or flowthrough entity such as a SMLLC, partnership/LLC or an S corporation, **Reg. §301.7701-3** dictates that the determination of whether an item of gross income from interest, dividends, annuities, royalties, and rents is derived in a trade or business is made at the *individual* level. (**Reg. §1.1411-4(b)(1)**)

2. Other gross income derived from a trade or business to which the 3.8% surtax does apply. (**Code §1411(c)(1)(A)(ii)**)

Comment: Again, the 3.8% surtax only applies to a trade or business if it is a **Code §469** passive activity of the taxpayer, or a trade or business of trading in **Code §475(e)(2)** financial instruments or commodities (i.e., a "trading activity"). (**Code §1411(c)(2)**)

3. Net gain (to the extent otherwise taken into account in computing taxable income) attributable to the disposition of property, other than property held in a trade or business to which the 3.8% tax does *not* apply. (**Code §1411(c)(1)(A)(iii)**)

Comment: Gain or loss from a disposition of an interest in a partnership or S corporation is taken into account by the partner or shareholder as NII only to the extent of the net gain or loss that the transferor would take into account if the entity had sold all its property for fair market value immediately before the disposition. (**Code §1411(c)(4)**)

Comment: Remember that, regardless of the participation level of an owner, income, gain, or loss which is attributable to an investment of working capital is *not* treated "as derived from a trade or business and thus is subject to the tax. (**Code §1411(c)(3)**) Furthermore, such "active" owners must keep this in mind (i.e., by doing an analysis of the balance sheet of the partnership or S corporation) when selling or otherwise disposing of their interests in a taxable sale or exchange.

Comment: Suppose you only do the owner's personal tax return and *not* that of the flowthrough entity? And, there might *not* even be a balance sheet to analyze (i.e., gross receipts and assets below the $250,000 threshold). Or, the balance sheet is on a tax basis with no suggestion of any current FMVs. If there were no "extraneous assets" such as invested working capital, then maybe the issue does *not* have to be addressed. But, with partnership/LLCs, one has to discern **Code §741** "cold assets" (i.e., capital assets) from **Code §751** "hot assets" (i.e., ordinary income assets), let alone the potential for any "unrecaptured Sec. 1250 gain" due to S/L depreciation which needs to be taxed at 25%. And, even with S corp owners, the gain or loss on the sale of their stock is *not* necessarily free of any Sec. 1411 Medicare surtax as an analysis has to been performed to uncover whether there are "extraneous" (i.e., non-Sec. 1231) assets present on the balance sheet as of the time of the stock sale.

Comment: The **Code §1411** regs do offer a not so "simplified method" of doing this calculation. There are also "caps" on the impact of such extraneous assets (e.g., working capital investments) with regard to how much of an difference they can have on the surtax calculation where they have either appreciated or depreciated in value as of the point at which the flowthrough owner is otherwise selling their interest in the entity.

For purposes of **Code §1411**, "net investment income" does *not* include amounts that are otherwise subject to self-employment tax (**Code §1411(c)(6)**), distributions from tax-favored retirement plans (e.g., qualified employer plans and IRAs) (**Code §1411(c)(5)**), or tax-exempt income (e.g., earned on state or local obligations).

Comment: And, obviously, NIIT would *not* include any tax-free distributions from a Roth IRA since such amounts are *not* part of a taxpayer's gross income in the first place (unless "early distributions" are made from the Roth IRA *before* the later of 5 years or before the owner turns age 59½).

Also, the surtax does *not* apply to a nonresident alien or trusts all the unexpired interests in which are devoted to charitable purposes. (**Code §1411(e)**)

Specific Examples of Sec. 1411 "Net Investment Income: The following types of income are included in NIIT:

- Passive activity income: The 3.8% surtax applies to income from a passive activity as defined under **Code §469**. A "passive activity" is any activity that involves the conduct of any trade or business in which the taxpayer does *not* "materially participate" (i.e., as specified in any of the "seven tests" contained in the regs).

Comment: It goes without saying that the passive activity loss rules can be complex. For example, any rental activity is generally per se a passive activity, even if the taxpayer materially participates in the activity, unless the taxpayer qualifies as a "real estate professional." But, even for those taxpayers who qualify as "real estate professionals," their rental activities are *not* automatically nonpassive since they must also satisfy at least one of the seven distinct material participation standards with respect to that activity to be nonpassive and, thus, excluded from NIIT. (**T.D. 9644**) Furthermore, in the process of proving that the REP does, in fact, "materially participate" in their rental activities, it is often necessary to make a grouping election to treat all such activities as just one activity for purposes of the passive loss rules.

Comment: Under the "self-rental rule" for taxpayers that rent property for use in their trade or business activity in which they materially participate (i.e., whether it is a C corporation, or a flowthrough entity such as a partnership/LLC or an S corp), the rental income is *automatically* recharacterized as nonpassive. As a result, that income is *not* subject to the NIIT. (**Reg. §1411-4(g)(6)**) And, this is the case whether or not a grouping election is made. However, if there are other third-party investors in the real estate (i.e., investors who do *not* materially participate in the lessee's trade or business), they would treat such rental income as passive income (unless they met the "real estate professional" exception), and thus would be subject to the surtax.

Comment: Note that material participation of a employee who otherwise had no ownership in the trade or business paying the rents would not create a "self-rental" situation. For example, a father owned 100% of an S corporation which also employed his 4 sons. Meanwhile, the father and these 4 sons owned the real estate being leased to the business, Here, even though the sons were involved in the day-to-day activities of the business, their share of the rent flowing to them in Box 2 of their K-1s would still be subject to the 3.8% Medicare surtax while the father's material participation as an owner/employee would exempt him from paying the surtax. So, the obvious planning point from the standpoint of the sons avoiding the surtax would be to give them at least some minimal interest in the S corp (even though the ownership of this LLC holding the real estate would certainly *not* be identical to the ownership of the S corp).

Comment: There have been suggestions that a "passive" investor should examine the passive activity income rules to see whether it would be possible (and, worthwhile) to increase participation in the activity before the end of the year to qualify as a material participant in the activity. But, consider a REP who has had significant amounts of passive rental income. Should a grouping election be made so that the 3.8% surtax would *not* apply against this rental income? Or, instead, would it be better to "preserve" this source of passive income? For example, suppose a REP with at least $100,000 of rental income also had $100,000 of passive losses in a given tax year. Should they make a grouping election so as to treat their rental activities as nonpassive? If this passive rental income now became unavailable to be offset against these passive losses, the losses could be suspended due to the lack of passive income on **Form 8582** (i.e., given there were no other sources of passive income available to the taxpayer), and that would represent a potential lost tax benefit of $39,600. Was that worth it just to save $3,800 (3.8% x $100,000) of Medicare surtax? Or, is it more important to have any eventual gains on the sale of such real estate *not* be subject to the surtax (i.e., due to the grouping election by this REP and their material participation in this, now, *one* activity)?

Comment: In addition, taxpayers who own interests in a number of passive activities should reexamine the way they group their activities as special "grouping" rules may apply that would be advantageous in offsetting passive gains against passive losses. This would possibly apply to a client who is simultaneously in multiple business endeavors. Of course, such groupings must otherwise result in an “appropriate economic unit.”

- Gains resulting from sales or exchanges: The following gains (to the extent taken into account in computing taxable income) are taken into account in computing the 3.8% Medicare surtax:

(1) Gains from the sale of stocks, bonds, and mutual funds;

(2) Capital gain distributions from mutual funds;

(3) Gains from the sale of investment real estate (including gain from the sale of a second home that is *not* a “principal residence” as well as passive rental activities);

(4) Gains from the sale of interests in partnerships and S corporations (to the extent the partner or shareholder was a passive owner); and

(5) Gain attributable to the investment of working capital. (**Reg. §1.1411-4(d)(4)**)

Comment: These items were drawn from the “Questions and Answers” on the NII Tax. (**Q&A 10**)

The following gains (or other sources of taxable income) are *not* taken into account in computing the 3.8% Medicare surtax:

(1) Wages;

(2) Self-employment income;

(3) Operating income from a business that's *not* a passive activity under **Code §469**;

(4) Unemployment compensation;

(5) Social Security benefits;

(6) Alimony;

(7) Alaska Permanent Fund dividends. (**Reg. §1.1411-4(d)(4)**)

Comment: These items were drawn from the “Questions and Answers” on the NII Tax. (**Q&A 9**)

The following items are excluded from gross income for income tax purposes. (**Reg. §1.1411-1(a)**) As a result, items of tax-exempt income (e.g., interest on exempt state and local bonds, and nontaxable SSBs) are *not* only not included in the AGI threshold but also are *not* included in the calculation of the NIIT.

Income from an active (i.e., nonpassive) trade or business, whether conducted by a sole proprietor, partnership, or S corporation, is *not* subject to the Medicare surtax. An employee is treated as engaged “in the trade or business of being an employee.” Therefore, amounts paid by an employer to an employee that are treated as wages are *not* included in the definition of “net investment income” for purposes of the surtax.

Comment: But, income from profits of a regular C corporation, including a PSC, paid out in the form of a dividend (as well as gain from the sale of stock therein) would be subject to the surtax no matter how much the owners materially participated in the day-to-day activities of the corporation.

Other items of deferred gains which would have no impact on the NIIT calculation:

(1) $250,000 ($500,000 for a married couple) of gain excluded under the homesale exclusion;

(2) Deferred gain on an installment sale (until it is finally included in gross income);

(3) Deferred gain on a like-kind exchange; and

(4) Deferred gain on an involuntary conversion. (**Reg. §1.1411-4(d)(4)**)

Comment: These items were drawn from the "Questions and Answers" on the NII Tax. (**Q&A 11**)

Comment: An obvious planning tip that a taxpayer may want to consider would be donating appreciated long-term stock to a charity rather than donating cash. This will avoid capital gains tax on the built-in gain of the security and avoid the 3.8% NIIT on that gain, while generating an income tax charitable deduction equal to the fair market value of the security.

The definition of Sec. 1411 "net investment income" also does *not* include:

(1) Veterans' benefits;

(2) Worker's compensation;

(3) Life insurance proceeds received by reason of the insured's death, which are *not* included in the recipient's gross income; and

(4) The tax-free inside buildup of the cash surrender value on a life insurance policy.

Deductible Expenses: The following expenses may be deductible in computing NII, at least to the extent allowed in computing a taxpayer's regular taxable income:

Comment: The fact that some of these expenses are preference items for AMT purposes does *not* factor into the calculation of NIIT. But, as noted below, some expenses such as itemized deductions might be subject to the 80% phaseout rule (**prior to 2018**), or other limitations such as an AGI threshold (e.g., 2% miscellaneous deductions **prior to 2018**) or investment interest expense (limited to "net investment income" as defined for purposes of **Form 4952**).

(1) Adjustments to income;

(2) Itemized deductions (to the extent that are allocable to NII);

Comment: With the passage of the TCJA, 2% miscellaneous deductions were eliminated. As a result, deductions such as state and local income taxes (i.e., above the $10,000 annual SALT cap) or management advisory fees will no longer serve to reduce "gross investment income" for purposes of the Code §1411 3.8% Medicare surtax.

(3) Losses;

(4) Other deductions allowed by subtitle A of the Code and identified by the IRS in published guidance, that are properly allocable to gross income or net gain for NIIT purposes and are allowable in computing NII;

(5) Investment interest expenses (to the extent otherwise allowed on **Form 4952**);

(6) Investment advisory fees (to the extent they exceed 2% of AGI and the 80% phaseout rule **prior to 2018**);

(7) Brokerage fees;

(8) Expenses related to rental and royalty income (to the extent *not* suspended on Form 8582 by the PAL rules);

(9) Tax preparation fees (to the extent they exceed 2% of AGI and the 80% phaseout rule **prior to 2018**);

(10) Fiduciary expenses (in the case of an estate or trust); and

(11) State and local income taxes (to the extent they exceed 2% of AGI and the 80% phaseout rule **prior to 2018**). (**Reg. §1.1411-4(f)**)

Comment: These items were drawn from the **"Questions and Answers"** on the NII Tax. (**Q&A 13**)

Comment: Taxpayers should consider whether it is advisable to accelerate deductions or "harvest" capital losses to offset capital gains that are subject to the surtax. And, again, only properly allocable deductions for regular tax may be taken into account in determining NII. In other words, only amounts paid or incurred by a taxpayer to produce gross income or net gain that is included in NII may be deducted in determining NII. So, the income tax principles that apply in determining the amount and timing of a deduction generally apply for NII tax purposes. (**Reg. §1.1411-4(f)(1)**)

Comment: If a "properly allocable deduction" is allocable to *both* NII and items that are excluded from gross income for income tax purposes (i.e., excluded income), taxpayers may use "any reasonable method" to determine the portion that is properly allocable to NII (such as an allocation based on the ratio of the taxpayer's gross income (including net gain) included in NII to the taxpayer's AGI). (**Reg. §1.1411-4(g)(1)**)

Comment: A deduction carried over to a tax year and allowed for that year in determining AGI is also allowed in determining NII, even if the deduction is carried over from a pre-2013 tax year in which the NII tax was *not* in effect. Even though the preamble to the regs state this, it is *not* true of NOL carryovers (as noted on page 11 of the **instructions** to **Form 8960**).

Comment: Suppose for example a taxpayer had a capital gain from a stock sale in December. And, being in an AMT position for that year (but, *not* for the next tax year), decides to make his 4th quarter estimated tax payment in January of the following year. Then, when calculating his final state income tax liability, it comes to $7,500 without the Form 8960 "net investment income" amount and $10,000 when this amount is included. Meanwhile, assume that through W-2 withholding and earlier estimated tax payments, this taxpayer paid at least $7,500 during the tax year, and $2,500 with the January 4th quarter estimated tax payment. Being on the cash basis, there is no question that the itemized deduction (whether phased out or not) for this latter estimated state tax payment would *not* be allowed until the following year. Nevertheless, what is the deduction for Sec. 1411 purposes that would be "properly allocable" to total state income taxes paid on this capital gain recognized in December? Would the appropriate amount be 3/4's of the $7,500 paid during the course of the year? If so, what happens to deduction for the $2,500 in estimated state tax payments paid in January but which are clearly allocable to the capital gain included for Sec. 1411 purposes on the prior year's return? And, whether or not the taxpayer is otherwise subject to the 3.8% Medicare surtax in the following year, is this deduction lost forever (i.e., since it was "clearly allocable" to the surtax from the *prior* tax year)?

Deferral or Disallowance Provisions: These provisions which are used in determining AGI are also applicable in the determination of the 3.8% Medicare surtax. But, as previously discussed, any deductions in excess of the gross income and net gain that are included in NII are *not* taken into account in determining NII in any other tax year, except as allowed for income tax purposes. These provisions include:

(1) The **Code §163(d)** limitation on investment interest;

(2) The **Code §465(a)(2)** at-risk limitation;

(3) The **Code §265** disallowance of expenses relating to tax-exempt interest;

(4) The **Code §469(b)** passive activity loss limitation;

(5) The **Code §704(d)** partner loss limitation;

(6) The **Code §1212(b)** capital loss limitation; and

(7) The **Code §1366(d)(2)** S corporation shareholder loss limitation.

Comment: Based on the instructions to **Form 8960** (Cf. page 11), NOLs, regardless of source, incurred *before* 2013 (i.e., that year that the Sec. 1411 Medicare surtax first came into the law), cannot be used as an "otherwise allowable deduction" in computing the NIIT. And, for NOLs incurred on or after 2013, such carryforwards must be segregated into "non-Sec. 1411 NOLs" v. "Sec. 1411 NOLs" (i.e., the latter essentially coming from activities subject to the **Code §469** passive loss rules and which are now allowed due to the PAL "complete disposition" rule, regardless of gain or loss on that sale or exchange).

Comment: Capital losses incurred *before* 2013 can be used as a deduction in computing NIIT on **Form 8960**, but they must first be allowed for regular tax purposes. And, to the extent that these carryforwards must first be offset by any capital gains, this deduction would be limited to the annual $3,000 excess capital loss threshold. And, for capital losses incurred *on or after* 2013, such carryforwards must be segregated into "non-Sec. 1411 NOLs" v. "Sec. 1411 NOLs" (i.e., the latter essentially coming from activities subject to the **Code §469** passive loss rules).

Comment: This "segregation" process must also be performed for any investment interest expense carryovers arising in 2013 or thereafter with only Sec. 1411 investment interest expense being allowed for Form 8960 purposes.

Retirement Plans and IRAs: Income from the following qualified retirement plans or arrangements are *not* subject to the Sec. 1411 3.8% Medicare surtax:

(1) Pension, stock bonus, or profit-sharing plans;

(2) Individual retirement accounts (IRAs);

(3) Roth IRAs;

(4) **Code §403(a)** annuity plans;

(5) **Code §403(b)** tax-sheltered annuities; and

(6) Deferred compensation plan of a State and local government or a tax-exempt organization.

Comment: The 3.8% Medicare surtax can make Roth IRAs look like a more attractive alternative for higher-income individuals. Qualified distributions from Roth IRAs are tax-free. As a result, they will *not* be included in either MAGI or in NII. By contrast, distributions from regular IRAs (except to the extent of after-tax contributions) will be included in MAGI, although they will be excluded from NII.

Comment: Taxpayers who are thinking of converting regular IRAs to Roth IRAs this year should proceed with care, as the move will increase MAGI, and therefore potentially expose (or, expose more of) their NII to the 3.8% surtax.

Comment: Distributions out of an estate or trust income tax return (i.e., Form 1041) traceable to retirement plan assets should also *not* be subject to the 3.8% Medicare surtax. And, of course, if and when these retirement plan assets are ultimately distributed out of an estate, they would keep their character as such with the beneficiary being exempt from the surtax. **(Code §1411; Medicare Surtax)**

☞Sale of Building by Former "Active Owners" Subject to 3.8% Medicare Surtax

The "active owners" of a trade or business sold all of the company's assets except the building that had housed the operations. Instead, they decided to rent the premises to the new business owners under a 5-year lease. But, after only one year, the lessees decided to exercise an option to purchase the building. The sale produced a sizable Sec. 1231 gain (some of which was treated as "unrecaptured §1250 gain" taxed at 25%). Neither of these former owners currently qualified as a "real estate professional" for purposes of the **Code §469** PAL rules, nor did they "materially participate" in this rental activity.

As to the sale of the building, had it been disposed of in the previous year along with the sale of the other business assets, it would *not* have been subject to the 3.8% Medicare surtax since they were materially participating in the business at that time. But, since this sale took place after the property had been converted to a "rental activity," and the owners were *not* "real estate professionals," the gain would be to the surtax. **(Code §1411; Medicare Surtax)**

Comment: Even if the building is "substantially appreciated," so that any gain would be recharacterized as "nonpassive," since it was *not* rented for at least the 24-month period leading up to the date of sale, the gain would still flow from Form 4797 and over to **Form 8939** and Schedule D (i.e.,) as a capital gain, which is normally a source of net investment (i.e., portfolio) income subject to the 3.8% surtax.

☞Sec. 1231 Gain Flowing on K-1 to "Non-REP Spouse" Also Treated as Nonpassive & Not Subject to Medicare Surtax

A married couple owned an LLC which had title to a **Form 8825** rental real estate property. When it was sold, the LLC included the separately-stated Sec. 1231 gain on each of the K-1s flowing to the spouses, one of whom qualified as a "real estate professional." Even though the gain flowing to the REP spouse would *not* be subject to the **Code §1411** 3.8% Medicare surtax (assuming that he materially participated in this rental activity), what about the gain going to his wife?

This gain flowing to the "non-REP spouse" is also *not* subject to the surtax since there is only *one* "taxpayer" on this Form 1040. The way to look at this issue is to ask what would have been the result had the couple owned the rental activity directly on Schedule E with the husband again being a "real estate professional" with at least one of the spouses "materially participating" in this rental activity? The answer is that the §1231 gain (along with any net rental income) would be "nonpassive" and, therefore, *not* subject to the surtax. **(Code §1411; Medicare Surtax)**

Comment: The bottom line on this issue is that you cannot get a different answer just because the couple decided to shield themselves from liability by having an LLC (i.e., partnership) hold title to the rental property v. owning it directly as tenants by the entirety. Furthermore, the answer would *not* change had the "non-REP spouse" had title to the property solely in her name (i.e., with a SMLLC), given that her husband was a REP and at least one of them materially participated in this rental activity. As a result, assuming that the husband is a REP who is materially participating in the rental activity on **Form 8825**, then this counts for the "taxpayer" on a joint return. In other words, you do *not* have to separate the Sec. 1231 gain into "two pieces" for this joint tax return when making a determination as to whether this is a passive activity with any net rental income (or, Sec. 1231 gain, in this case) that is subject to the **Code §1411** 3.8% Medicare surtax.

Notes:

CHAPTER XVII: 20% Deduction for K-1 and Proprietorship Profits and Net Rental Income

- Passive v. Nonpassive K-1 Investors & Rental Property Owners

- The final version of the **Code §199A deduction makes no distinction between a passive v. nonpassive investor, or owners of rental properties.** Furthermore, rental income that is treated as "nonpassive" (e.g., "self-rental income" or rental income of a "real estate professional" who has grouped their rentals as one activity for purposes of the passive loss rules) appears to qualify for the 20% deduction just the same as passive rental income.

Comment: There is a question as to whether "self-rental income" (which is considered nonpassive for the **Code §469** PAL rules and, therefore, *not* subject to the **Code §1411** 3.8% Medicare surtax, whether or not a grouping election is made) will be treated as "qualified business income" for purposes of the this new **Code §199A** 20% deduction. Based on the final Sec. 199A Treasury regulations rents (or, leased payments) received from a "controlled" (i.e., > 50% or more, directly or indirectly) tenant or lessee are automatically treated as being from a "Sec. 162 trade or business" (i.e., regardless of whether the "250-hour safe-harbor test" is satisfied).

Comment: Although rental activities are apparently treated as "trades or businesses" for purposes of the new Sec. 199A deduction, there is some doubt that "triple net lease" situations would also qualify since the landlord/lessor has so little involvement in the underlying rental activity. This is, again, another area where the IRS will have to issue some clear-cut guidance, one way or the other. Also, sporadic rentals, such as those received in "Airbnb" or VRBO rentals, would probably *not* qualify as "Sec. 162 trades or businesses" since they fail to be "regular and continuous," along with lacking a long-term profit motive.

Comment: Especially with rental real estate, it is important to hold title to it in any format (i.e., in a flowthrough entity such as an LLC or S corporation, or directly as a Schedule E activity) except a C corporation in order to secure this new Sec. 199A 20% deduction (let alone, having the "double taxation" issue of holding appreciating property of any type in a C corporation).

- 20% Deduction for K-1 Income and Net Profit from Proprietorships

Comment: As a caveat, this is one of the most complex provisions in the new law. There are a number of special rules and restrictions, most of which apply to high earners, as well as unsettled issues begging for IRS guidance. Also, at this point, the Sec. 199A deduction expires after 2025.

- Calculating QBI with Multiple Businesses

- If the taxpayer is involved in multiple businesses, you **determine QBI of each one separately**, and you calculate the deduction, subject to any limitations, on each business. Of course, more information will be needed for K-1s, including the allocable share of any wages paid (both to the owners, as well as rank-and-file employees, for an S corporation), or the allocable share of any wages paid to rank-and-file employees for a partnership, along with any capital investment (determined using the "unadjusted bases" of qualifying assets) of the business. Also, the K-1 recipient would need the necessary information to determined whether a "specified service business" was involved (or, a "blended T/B).

Comment: K-1 recipients from professional firms (law, accounting, medicine, etc.) will have no problem with this determination. But, the characterization of other "blended businesses" will be far from clear. Nevertheless, the preparer of the entity's tax return (partnership or S corp) is probably in the best position to make this determination, based on what is the predominant function of the company. But, the K-1 for 2019 only has "Code Z" for "qualified business income" while eliminating "Code AA" (wages), "Code AB" (UBIA), "Code AC" (REIT dividends) and "Code AD" (PTP income or loss). Now, all of this additional information will have to be supplied in Box 20 of the K-1.

- Other Special Limitations for Sec. 199A Deduction

- In the case of **property that is sold before yearend, the property would no longer available for use in the trade or business and is *not* taken into account in determining the 2.5% limitation**.

- Rules are to be provided for applying the **limitation in cases of a short taxable year** of where the taxpayer acquires, or disposes of, the major portion of a trade or business or the major portion of a separate unit of a trade or business during the year.

- Similar to the rules of **Code §179(d)(2)** to address acquisitions of property from a related party, as well as in a sale-leaseback or other transaction, regulations are to be issued "as needed to carry out the purposes of the provision and to provide anti-abuse rules, including under the limitation based on W-2 wages and capital."

- Guidance was provided which prescribes rules for **determining the unadjusted basis (UBIA) immediately after acquisition of qualified property acquired in like-kind exchanges or involuntary conversions. The good news is that the "old" UBIA will, in fact, carry over to the replacement property in these exchanges**.

Comment: The final regs cross reference to **Code §168(i)(7)** which list certain tax-deferred transfers (i.e., **Code §§332, 351, 361, 721** and **731**), but fail to address transfers made pursuant to **Code §§1014 (gifts), 1015 (inheritances)** and **1041 (divorces).**

☞**IRS Adds & Updates FAQs on Sec. 199A Deduction** (**Rev. 03/01/2021**)

The IRS has added and updated answers to frequently asked questions about the **Code §199A** qualified business income deduction (i.e., QBID or pass-through deduction).

Background: Under **Code §199A**, an individual with a "qualified trade or business" (QTB) who operates that QTB as a sole proprietorship, partnership, or S corporation is permitted to deduct up to 20% of their "qualified business income" (QBI). QBI includes "qualified items" of income, gain, deduction and loss from a trade or business that is effectively connected with the conduct of a trade or business in the U.S. This includes qualified items from partnerships (other than publicly traded partnerships (PTPs)), S corporations, sole proprietorships, and certain estates and trusts, "that are allowed in calculating the taxpayer's taxable income for the year" (i.e., if the at-risk basis, passive loss, **Code §461(l)** excess business or capital loss rules apply, then the potential QBI item is suspended until such time as it can be used in calculating one's tax).

Generally, a "specified service trade or business" (SSTB) is *not* a QTB (but, the Sec. 199A deduction would still apply if the taxpayer's modified AGI is below the "applicable threshold" which is the end of the 24% marginal tax bracket). An SSTB is any trade or business providing services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing and investment management, trading or dealing in securities, partnership interests, commodities, or any trade or business "where the principal asset is the reputation or skill of one or more of its employees or owners."

Comment: Surprisingly, this last SSTB "field" does *not* include teaching or consulting, or writing tax newsletters or other explanatory guides.

QBID FAQs Added or Updated: The IRS has added or updated the following QBID FAQs:

Q6: What if a *single* trade or business has *multiple* sources of income, some from specified service activities (SSTB) and some from other activities?

A6: There is a "de minimis rule" for a single trade or business that has income from both specified service activities and other activities. Under the de minimis rule, if a trade or business has gross receipts of $25 million or less and less than 10% of its gross receipts are attributable to specified service activities, or gross receipts of more than $25 million and less than 5% of its gross receipts are attributable to specified service activities, the trade or business as a whole is *not* an SSTB. However, if the gross receipts from specified service activities exceed the percentage specified above, the *entire* trade or business is treated as an SSTB.

Comment: Where does the IRS get the authority to make this kind of conclusion? For instance, if an eye doctor operates their business as an S corporation, and clearly keeps the books and records to segregate the gross receipts from rending professional services (e.g., providing eye exams, performing surgeries, etc.) as opposed to fitting and selling eye glasses and contact lenses, arguably the understanding has been that this S corporation has a combination of both SSTB income along with non-SSTB gross receipts. The same would hold true for an audiologist who provides hearing tests, but also sells hearing aids.

Q9: What are the "W-2 wages" for purposes of applying the W-2 wage limitation? Do W-2 wages paid to the officer of an S corporation qualify as QBI and towards the W-2 wage limitation?

A9: For purposes of the W-2 wage limitation, W-2 wages include:

1. The total amount of wages paid to employees; and

2. Certain deferred compensation.

Both wages and deferred compensation must be reported to the Social Security Administration on a timely-filed return. Additionally, the W-2 wages must be "properly allocable to QBI." W-2 wages are properly allocable to QBI if the associated wage expense is taken into account in computing QBI for the trade or business. W-2 wages paid to an S corporation officer will generally *not* qualify as a source of QBI to the employee. However, such wages will generally be included in the employer's QBI. Additionally, W-2 wages paid to an S corporation officer that are:

1. Properly allocable to QBI, and

2. Are reported to the SSA on a timely-filed return, will qualify as W-2 wages attributable to a trade or business identified by the S corporation for purposes of applying the W-2 wage limitation.

Q10: What is the "unadjusted basis immediately after acquisition" (UBIA) of qualified property?

A10: A taxpayer's UBIA of qualified property is its basis in the qualified property on its placed-in-service date, *before* any adjustments except an adjustment to reflect a reduction in basis for the taxpayer's personal use of the property during the tax year. "Qualified property" for purposes of the QBID is any depreciable tangible property:

1. Which is held by, and available for use in, the taxpayer's trade or business at the close of the tax year;

2. Which is used at any point during the tax year in the production of QBI, and

3. The depreciable period for which has *not* ended before the close of the tax year.

The depreciable period ends on the *later* of 10 years after the property is first placed in service, or on the last day of the last full year in the applicable recovery period (i.e., so property in the MACRS 3-, 5-, or 7- classes are assured of having at least a 10-year period as UBIA) as long as they are still in service as of the close of the tax year.

> **Comment:** So, if an asset of any MACRS classification is sold or exchanged in a taxable transaction on the last day of the tax year (or, before), then it does *not* count toward the UBIA calculation for that tax year.

Q17: Is there a form for reporting the QBID? And if so, where can I find it?

A17: Yes, for tax years 2019 and after, **Form 8995, Qualified Business Income Deduction Simplified Computation**, and **Form 8995-A, Qualified Business Income Deduction**, are used to compute and report the QBID. Before 2019, there was no specific form. However, worksheets were available in the **Form 1040** Instructions and **Pub. 535, Business Expenses**, to assist with the calculations in 2018.

> **Comment: Form 8995** is used when the taxpayer's taxable income, before the Sec. 199A deduction, is below the end of the 24% marginal tax rate for their filing status. On the other hand, **Form 8995-A** must be used when the taxpayer's taxable income, before the Sec. 199A deduction, is beyond the end of the 24% marginal tax rate (i.e., and the taxpayer is therefore impacted by the phaseout rules).

Q28: What requirements must be met to make an election to aggregate *multiple* trades or businesses as *one* QTB and how does such aggregation election effect any election made to "group" activities under another Code section?

A28: To aggregate multiple trades or businesses, the following requirements must be met:

1. The same person or group of persons, directly or by attribution, own 50% or more of each trade or business for more than half of the tax year, including the last day of the tax year;

2. All the items attributable to each trade or business are reported on returns with the same tax year, without regard to short-tax years;

3. None of the trades or businesses is an SSTB, and

4. Two of the following three factors are met:

A. The trades or businesses provide products, property, or services that are the same or customarily offered together;

B. The trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources, and/or

C. The trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group.

Once an aggregation election is made, the aggregation must be consistently applied to the trades or businesses unless there has been a "significant change to the facts and circumstances that would render the aggregation no longer appropriate." Furthermore, an election to aggregate for QBID purposes has no effect on an the election to "group" under another Code section (e.g., such as for purposes of the passive loss rules under **Code §469**).

Q33: Does QBID reduce the adjusted basis of a shareholder in a S corporation or the adjusted basis of a partner in a partnership?

A33: No. The QBID has no effect on an S corporation shareholder's adjusted basis in its S corporation stock or a partner's adjusted basis in its partnership interest.

Q40: Are charitable contributions attributable to a trade or business for purposes of determining QBI?

A40: No. For purposes of determining QBI, QBI is *not* reduced by amounts that constitute charitable contributions under **Code §170** (e.g., where a partnership or an S corporation were to make a otherwise deductible charitable contribution at the entity level). **(Code §199A; QBI Deduction)**

> **Comment:** Keep in mind that certain expenses such as interest expense on borrowed monies to either buy into, or make a capital contribution to, an S corporation or partnership (i.e., a flowthrough entity for which the K-1 results on reported on **Schedule E** of **Form 1040**) will reduce any net QBI reported by that entity (i.e., as per **Part IV** of IRS **Notice 89-35**). Also, unreimbursed expenses of a partner otherwise deducted on **Schedule E** would reduce QBI received from that partnership.

☞Final Sec. 199A Regs - Answers, Surprises & Outstanding Issues

Introduction: The IRS noted that the final regulations (**REG-107892-18**) have been modified from the proposed regs issued last August as a result of comments that it received, as well as testimony at a public hearing that it held. They go on to state that the final regs are effective for tax years ending after the regs are publish in the *Federal Register*. Nevertheless, the preamble to these regs also state:

> *"However, taxpayers may rely on the rules set forth in **Reg. §§1.199A-1** through **1.199A-6**, in their entirety, **or on the proposed regulations under Reg. §§1.199A-1 through 1.199A-6 issued on August 16, 2018, in their entirety, for taxable years ending in calendar year 2018.**"*

So, **where the final regs have created an unfavorable position** (or, result) for a taxpayer when preparing their 2018 tax return (e.g., where 50% of S/E tax or S/E health insurance deductions, along with contributions to certain retirement plans now will reduce QBI, and correspondingly, the 20% deduction under Sec. 199A), they **can instead look to the proposed regs where this was *not* the case**.

> **Comment:** But, note that the language above in the preamble to the final regs state that either the proposed regs, or these final regs, must be **"used in their entirety."** So, it appears that a taxpayer **cannot "cherry pick" which sections of these respective regs would be advantageous when preparing their 2018 tax return**.

At the same time that the Treasury released the *final* regs, it **also published *newly-revised* proposed regulations (REG-134652-18) which now address certain issues *not* cover in the original version of the proposed regs** issued last August. These include: (1) the **treatment under Sec. 199A of previously suspended losses and deductions** (i.e., due to the lack of basis, or at-risk basis as shown on **Form 6198**, or due to the passive loss rules and suspended on **Form 8582**, along with Sec. 179 immediate expensing deductions suspended due to the lack of "T/B taxable income" which can be due to the lack of "active participation" by mere investors in the underlying endeavors of the entity); (2) **"Sec. 199A dividends" paid by a regulated investment company (RIC)**; and (3) the **treatment of amounts received from split-interest trusts and charitable remainder trusts (CRT)**.

> **Comment:** These final (and, newly-revised regs), delayed slightly by the partial U.S. government shutdown, **were released just 10 days ahead of the Jan. 28th start of the filing season for 2018 income taxes**. They adopt many of the rules described in the *proposed* regs, with certain revisions in response to comments. Also, "clarifying language" and additional examples have been added throughout the final regs.

The discussion of the regs in the Treasury Decision is broken down as follows:

- **Part I** provides an overview of the Code provisions addressed by the final regs

- **Part II** discusses the operational rules, including definitions, computational rules, special rules, and reporting requirements

- **Part III** addresses the determination of W-2 wages and unadjusted basis immediately after acquisition (UBIA) of qualified property

- **Part IV** discusses the determination of qualified business income (QBI), qualified real estate investment trust (REIT) dividends, and qualified publicly traded partnership (PTP) income

- **Part V** addresses the optional aggregation of trades or businesses

- **Part VI** discusses specified services trades or businesses (SSTBs) and the trade or business of being an employee

- **Part VII** addresses the rules for relevant passthrough entities (RPEs), PTPs, beneficiaries, trusts, and estates

- **Part VIII** discusses the treatment of multiple trusts

☞**IRS Releases Corrected Sec. 199A Final Regs**

The IRS has released corrected final regulations on the new Qualified Business Income (QBI) deduction under **Code §199A**. Included are corrections to the definition and computation of excess Sec. 743(b) basis adjustments, a correction to the description of a "disregarded entity" (i.e., SMLLC) for purposes of **Code §199A**, along with other minor edits. **(Misc.; Code §199A)**

> **Example: "Excess Sec. 743(b) Adjustment Impact on UBIA"**
> The ABC partnership is owned evenly by three individuals. It purchase a building for $600,000 several years ago which now has an adjusted basis of $300,000. The property is *not* encumbered by any mortgages and currently has a FMV of $900,000. C dies and D (her daughter) inherits C's one-third interest in the building, taking a basis of $300,000 (i.e., 1/3 x $900,000 FMV). A Sec. 754 election is in effect for the partnership, so D is able to step-up her "inside basis" of the building from $100,000 (i.e., 1/3 x $300,000 adjusted basis) to equal her "outside basis" of $300,000. **Her share of the partnership's UBIA is 1/3 x $600,000 (i.e., original cost of the building) plus $100,000 (out of the total $200,000 Sec. 754 step-up to the inside basis) for a total UBIA of $300,000. In other words, D is not allowed to claim a share of UBIA equal to $400,000 (i.e., $200,000 share of partnership's UBIA based on $600,000 original cost, plus the entire Sec. 754 step-up of $200,000).**
>
> **Comment:** This is a "fair" result insomuch as you would be getting a "double benefit" if the LLC could claim depreciation on an asset and then the recipient of the Sec. 754 would also get a deduction on some of the same dollars.

☞**IRS Releases 2019 Form 8995 "Qualified Business Income Deduction - Simplified Computation"**

The IRS recently released (2/12/19) a draft version of the 2019 QBI **Form 8995** which will be used to calculation the Sec. 199A deduction when the taxpayer's taxable income, before any deduction, is at or below the otherwise applicable threshold (i.e., $321,400 for MFJ filers; $160,700 for all other filers). Since it is a "simplified version," it does not deal with either the "wage" or "UBIA" limitation tests, or the phaseout rules. It does, however, provide for any carryovers of either "qualified business losses" (QBLs) from 2018, or excess losses from the sale of a PTP investment. **(Code §199A; Form 8995)**

> **Comment:** Form 8995-A has now been released in draft form and will be used for the 2019 tax year to calculate the Sec. 199A deduction. It is more "complex" than the **Form 8995** since it is intended for taxpayers whose taxable income, before any Sec. 199A deduction, is above the "applicable threshold." As a result, it deals with "wages," UBIA and the phaseout limitations.

☞**Issues Confirmed/Answered in Final Regs: The *final* Sec. 199A regs did answer a number of questions, while also affirming various issues addressed in the proposed regs**. These include:

1. Two Separate and Distinct Categories of Income Eligible for Sec. 199A Deduction: If you were to picture a

"T-account," the "debit side" would list QBI from: (1) non-SSTBs; (2) SSTBs; and (3) net rental income (which can, at times, be classified as coming from *either* an SSTB or a non-SSTB). Meanwhile, on the "credit side," you would list REIT dividends and net PTP income. Technically, these *latter* items are *not* sources of "qualified business income." But, Congress saw fit to make them also eligible for the 20% deduction accorded under **Code §199A**.

> **Comment:** Normally, you will only have a "positive" source of income from the aforementioned "credit side" of this T-account. That is, you will either have REIT dividends, or not, in a given tax year. And, the same is usually true with PTP income as well, because if there is a PTP loss, it can only be offset with income from that *same* PTP (otherwise, it is suspended in the meantime on **Form 8582**). The only exception would be in a year when a PTP with a current (or, suspended) loss is disposed of in a fully taxable transaction (i.e., it is freed up under the PAL "disposition rule").

2. Application of "Wage" and "Capital" Limitations: Once a taxpayer has taxable income, before any Sec. 199A deduction, beyond the end of the respective phaseout ranges (i.e., in 2018, $207,500 for unmarried taxpayers, including MFS filers, and $415,000 for MFJ filers), these "limitations" (i.e., the *greater* of 50% of wages, or 25% of wages + 2.5% of capital) are fully implemented. As a result, the initial "QBI component" (i.e., 20% x QBI for each separate T/B, unless an aggregation is made) must be entirely supported by the *greater* of these two limiting factors.

> **Comment:** Keep in mind that **there are no such "limitations" with regard to the Sec. 199A deduction allowed for REIT dividends or PTP income.** In other words, it does *not* matter how much taxable income is reported on Form 1040 when it is this type of income against which the 20% Sec. 199A deduction is applied.

> **Comment:** And, regardless of the level of the taxpayer's taxable income, before any Sec. 199A deduction (and, where the Sec. 199A deduction was coming from - that is, QBI from the "debit side," or REIT dividends or PTP income from the "credit side"), **every taxpayer must have sufficient taxable income in excess of any "net capital gains" to support the final Sec. 199A deduction to be listed on Line 9 of the Form 1040.**

3. Treatment of Net Overall Losses on Either Side of the "T-Account:" If the "debit side" from T-account analysis above has an overall "qualified business loss" (QBL), it must be carried over and used to offset any QBI in future tax years until it is fully exhausted from these *same* "debit-side" sources of QBI. Likewise, any overall QBL from the "credit side" must also be carried over until it is fully offset by net REIT dividends and/or PTP income. As a result, the key thing to remember is that these respective sources of QBL carryover do *not* serve to decrease net income from the "other side " of the T-account. In other words, they can only reduce QBI if they originally arose from that category, and the same is true of QBLs arising from the dispositions of PTP holdings (i.e., on the "credit side").

- Examples Illustrating above Rules: Review the following examples to understand the implementation of the above rules, while also realizing that just because a taxpayer has taxable income, before any Sec. 199A deduction, above the end of their respective phaseout range and therefore cannot offset any SSTB income, it does *not* mean that they will *not* have other sources of income (i.e., non-SSTB income and rents, along with REIT dividends and PTP income) which can result in a potential Sec. 199A deduction.

> **Example #1: "Sec. 199A Deduction for High-Income Owners of SSTBs"**
> An orthopedic surgeon owns 100% of an S corporation medical practice. But, since this business is in the "field of health" and the fact that the surgeon's taxable income on their joint return will be far above the end of the MFJ "phaseout range" (i.e., $415,000), there will be no chance for a Sec. 199A deduction, given that this source of the QBI is from "specified service trades or business." In other words, once a married taxpayer has taxable income of $415,000 **before any Sec. 199A deduction** and all of their QBI is from an SSTB, the **"applicable percentage" for purposes of Sec. 199A goes from 20% down to 0%**. Therefore, it would *not* matter if they otherwise had sufficient "wages" or "investment in capital" to cover a potential 20% Sec. 199A deduction.

> **Comment:** In final regs, **ownership in a surgical center does *not* necessarily equate to a business "in the field of health."** It is not uncommon for surgeons to also own an interest in an LLC that leases a building to a group of surgeons. But, if only real estate is being provided and the doctors otherwise provide all of the professional services and employees needed to run the surgical center, then the *final* regs now offer an example (discussed below in the SSTB clarifications) that this rental income might *not* be tainted as additional "SSTB income." Of course, this assumes that the LLC holding the real estate and the SSTB surgery practice to which the building is being rented are *not* under "common control."

> **Example #1 (Cont'd.): "Sec. 199A Deduction for High-Income Owners of SSTBs w/ Rental Income & Non-SSTB Income"** Assume that this taxpayer **also receives $300,000 of net rental income from various investment properties, as well as $300,000** from other K-1 trade or business investments (whether or not

these sources of income were treated as passive under the **Code §469** rules). As mentioned above, assuming his taxable income on a joint return is well over the end of the phaseout range (i.e., $415,000), **he would *not* be entitled to any Sec. 199A deduction for the QBI received from the SSTBs in the "field of health." Nevertheless, as long as he has sufficient "wages" or UBIA, he might still be able to claim a Sec. 199A deduction on his rental income, along with the K-1 income flowing from his other business investments.**

Comment: As seen in the Example below, if the taxpayer also had any net PTP income, along with any REIT dividends, **he would also receive an additional Sec. 199A deduction, regardless of the level of his taxable income, and without any limitations based on "wages" or UBIA.**

Example #1 (Cont'd.): "Sec. 199A Deduction for High-Income Owners of SSTBs w/ REIT Dividends or PTP Income"
Assume that the orthopedic surgeon **also has $100,000 of REIT dividends along with $50,000 of PTP income**. This portion of the Sec. 199A deduction calculation (i.e., from the "credit side" of the T-account) is **completely separate** from the Examples above where the deduction was unavailable. In other words, any SSTB income due to the taxpayer's high level of taxable income **has no effect on this second (but, separate) calculation**. With this latter type of QBI, **there are no phaseout rules, and no "limitation tests" based on wages or investment in capital.** As a result, you would simply take the aggregate $150,000 of QBI from the REITs and PTPs, multiple by 20% and deduct $30,000 (i.e., **on Line 9 of Form 1040**) in arriving at the final taxable income number for this couple.

Example #2: "Negative QBI from REITs and PTPs Has No Impact on QBI from Other Sources"
In **2018**, an married accountant has **$315,000 of taxable income and QBI**, before any Sec. 199A deduction, and it is **made up of "debit side" $265,000 QBI** and **$50,000 from the REIT dividends (i.e., from the "credit side")**. The taxpayer also has a **$100,000 loss from a PTP**. Given that there is **no passive income from that specific PTP**, the $100,000 loss is suspended on **Form 8582** (and, will be until sufficient passive income **from that same PTP** exists to free up the $100,000 loss, or the taxpayer disposes of their *entire* interest in the PTP in a *fully-taxable* transaction). As a result, the taxpayer would be allowed a 20% Sec. 199A deduction (i.e., 20% x $315,000 QBI = $63,000), and with being in a 24% MFJ marginal tax bracket (i.e., 24% bracket runs from $165,000 to $315,000 of taxable income), **this would result in a tax savings of $15,120**.

Example #2 (cont'd.): Assume that in **2019**, the taxpayer disposes of their *entire* interest in the PTP, while also receiving $50,000 again from their REIT dividend investments. Now, the $100,000 of 2018 suspended loss from the PTP would be freed up and subtracted fully on page 2 of Schedule E. Furthermore, for purposes of the Sec. 199A deduction, it would offset the REIT dividends. **As a result, there would be no Sec. 199A deduction for this taxpayer in 2019 (assuming that they have no other sources of QBI).** In addition, this "excess" $50,000 of loss resulting from the sale of the PTP would have to be carried over to **2020** and would offset any REIT dividends or PTP income from other sources. It would not, however, have any effect on the Sec. 199A deduction calculation from other sources of QBI such as SSTB income, non-SSTB income or rents.

Comment: So, if this taxpayer from **Example #2** above continued to have $315,000 of taxable income in **2019** coming entirely from QBI sources (i.e., the "debit side" of the T-account), they **would still enjoy a $63,000 Sec. 199A deduction which would *not* be offset in any way by the QBL stemming from the net $50,000 loss on the disposition of the PTP interest** (i.e., from the "credit side" of the T-account).

Example #3: "Negative QBI from Non-REIT and PTP Sources Has No Impact on QBI from REITs and PTPs"
A taxpayer has **"negative QBI" of $100,000 from a business investment** (i.e., it could a passive or nonpassive, SSTB or non-SSTB, flowthrough entity). He **also has $50,000 of REIT dividends and $50,000 of PTP income**. Regardless of his taxable income before any Sec. 199A deduction, he will received a $20,000 (20% x $100,000 REIT/PTP QBI) deduction. Furthermore, the **$100,000 of "negative QBI" from the non-REIT/PTP sources will only serve to reduce non-REIT/PTP QBI as a carryover in the subsequent tax year**.

Comment: If the "negative QB of $100,000" is from a passive activity, or the taxpayer cannot otherwise use it fully in offsetting their income from other sources due to the lack of basis (or, at-risk basis as shown on **Form 6198**), **then it would be suspended for that current tax year**. As a result, **it would no effect on the Sec. 199A calculation for *any* other sources of QBI (SSTB or non-SSTB income, or rents), as well any REIT dividends or PTP income (i.e., until such time as it frees up for purposes of calculating taxable income).**

4. "Net Capital Gains" Broadly Defined: The **final step in calculating the Sec. 199A deduction is to compare 20% of the taxpayer's taxable income before the deduction, but in excess of any "net capital gains,"** to see if this net amount of taxable income is at least equal to (or, in excess of) the potential Sec. 199A deduction. The reason for this final "cap" on the Sec. 199A deduction is that a taxpayer is *not* going to be accorded a special lower marginal tax rate (e.g., 15%, 20%, 25% or 28%) on sources of taxable income such as: (1) net LTCG; (2) Sec. 1231 gains, included "unrecaptured Sec. 1250 gain;" (3) qualified dividends; and (4) gains from the sale or exchange of "collectibles," while also receiving a 20% deduction under Sec. 199A.

"Net capital gain" is defined in **Code §1(h)**, but the *proposed* regs did *not* contain a specific definition for purposes of Sec. 199A. The *final* regs now state that:

> "**Code §1222(11)** defines net capital gain as the excess of net long-term capital gain for the taxable year over the net short-term capital loss for such year. **Code §1(h)(11)** provides that for purposes of **Code §1(h)**, net capital gain means net capital gain (determined without regard to **Code §1(h)(11)**) increased by "qualified dividend income." Accordingly, **Reg. §1.199A-1(b)(3)** defines 'net capital gain' for purposes of **Code §199A** as net capital gain within the meaning of **Code §1222(11)** plus any 'qualified dividend income' (as defined in **Code §1(h)(11)(B)**) for the taxable year."

> **Comment:** This definition in the *final* regs, however, leaves out a specific mention of both Sec. 1231 gains and unrecaptured Sec. 1250 gain (which is taxed at a marginal rate of no more than 25%). Nevertheless, since these are treated on the **Form 8949** worksheet for **Schedule D** purposes as additional LTCG, they would be included in the definition of "net capital gain" for purposes of Sec. 199A.

> **Comment:** What is *not* mention in the final regs as an additional source of "net capital gain" are "collectibles" (which are taxed at a special rate of 28%). But, since they already receive a special marginal tax rate, the intent of Sec. 199A has been *not* to give an additional 20% deduction on top of any income that receives a preferential rate. So, arguably, gain from the sale or exchange of "collectibles" (e.g., paintings, sculptures, gems, etc.) would also be included in the definition of "net capital gains."

> **Comment:** Under **Code §1(h)(2)**, "net capital gain" is reduced by the amount that the taxpayer takes into account as additional "investment income" under **Code §163(d)(4)(B)(iii)** (i.e., for purposes of deducting additional investment interest expense on **Form 4952**). **Nevertheless, this reduction does *not* change the definition of "net capital gain"** for purposes of **Code §1(h)**. Instead, it reduces the amount of gains that can be taxed at the maximum capital gains rates as a tradeoff for allowing a taxpayer to elect to deduct more investment interest under **Code §163(d)**. **As a result, capital gains and qualified dividends, even though treated as investment income on Form 4952, are still treated as "net capital gain" for purposes of determining the Code §199A deduction.**

5. Sec. 1231 Items Otherwise Treated as Ordinary Income or Losses Taken into Account for QBI: The final regs reiterate that "any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss, **including any item treated as one of such items under any other provision of the Code (e.g., Sec. 1231 gains, included unrecaptured Sec. 1250 gain, which flow from Form 4797 to the Schedule D worksheet, Form 8949)**, is *not* taken into account as a qualified item of income, gain, deduction, or loss (i.e., for QBI purposes).

But, the final regs make clear that **"to the extent an item is *not* treated as an item of capital gain or capital loss** under any other provision of the Code, it is taken into account as a qualified item of income, gain, deduction, or loss unless otherwise excluded by **Code §199A** or these regs." As a result, Sec. 1231 gains which are recharacterized as "ordinary income" (i.e., due to the fact that a Sec. 1231 ordinary loss was claimed within the prior five tax years), along with Sec. 1231 "ordinary losses," will be factored into the calculation of QBI.

> **Comment:** When Sec. 1231 gains are listed in Box 10 of the K-1, it is not until the flowthrough entity owner otherwise lists them on their personal tax returns (i.e., **Form 4797** of **Form 1040**) that a determination is made as to whether any other Sec. 1231 losses exist for that particular tax year, and whether the overall result is a net Sec. 1231 gain (i.e., flowing to **Schedule D**) or loss (i.e., otherwise treated as an "Other Income/Deduction" **ordinary loss on page 1 of Form 1040**).

> **Comment:** The same is true of Sec. 179 immediate expense deductions listed in **Box 12** of the K-1 where the final determination of current deductibility is found on the individual owner's Form 1040 (especially where they are not an "active participant" in the business that generated this deduction and, therefore, are *not* permitted to use the "trade or business income" otherwise found in **Box 1** of that same K-1).

> **Comment:** The bottom line is that the final determination of QBI might differ from what the RPE preparer listed

on the K-1 and "coded" as "Code Z" qualified business income for Box 20 "Other Information." Yet, this is arguably not an "inconsistent position" requiring the filing of **Form 8082** alerting the IRS.

6. **IRS Notice 2019-07 - Special "Safe Harbor" for Treating Rental Activities as "Trades or Businesses:"** For those taxpayers who hold numerous rental properties (or, a large commercial building or apartment complex) which requires them to spend a good deal of their time managing them (either directly, or through a management company), the final regs and IRS **Notice 2019-07** provide for a "safe harbor" whereby these rental properties will *automatically* be considered "trades or businesses" under the "**Code §162** standard."

Under this "safe harbor," a "rental real estate enterprise" will be treated as "trade or business" under **Code §162** given the "250-hour annual test" discussed below is satisfied. A "rental real estate enterprise" is defined for purposes of this safe harbor as an interest in real property held for the production of rents. It may consist of multiple properties but the individual (or, RPE) relying on this revenue procedure "**must hold such interests directly or through a disregarded entity (i.e., SMLLC).**"

Comment: So, it appears that holding real estate with other owners as a tenant-in-common or as the sole landlord on a Schedule E would satisfy this definition. On the other hand, **what would *not* qualify for the possible use of this "safe harbor" is an individual merely holding an "indirect interest" as a member of an LLC which held the actual title to the rental property.**

According to this IRS notice, taxpayers either must treat each property held for the production of rents as a "separate enterprise," or must treat *all* "similar properties" held for the production of rents as a *single* enterprise. For this purpose, however, **the IRS states that commercial v. residential real estate *cannot* be combined in the *same* enterprise**.

Comment: It is interesting to note that although various types of real estate are "like-kind" for purposes of **Code §1031** (e.g., commercial or residential real estate, as well as raw land), this is apparently *not* the case for Sec. 199A purposes.

Comment: What this would mean is that if a taxpayer held multiple properties of each "type" (i.e., commercial and residential), then the 250-hour "safe harbor" test **would have to be met separately** for each aggregated group of properties.

The "safe harbor" calls for the taxpayer to spend > 250 hours annually on "rental services" with regard to *each* rental activity unless multiple rental activities can be aggregated under Sec. 199A (i.e., regardless of any "grouping elections" under **Code §469**). In addition, **this IRS notice requires extremely strict recordkeeping to demonstrate that this 250-hour test has been met.**

Comment: Obviously, this IRS notice does *not* require that the taxpayer raise to the level of being a "real estate professional" under **Code §469** (i.e., where they annually spend > 750 hours involved with real estate trades or businesses and this comprises > 50% of their available time in all trades or businesses). They also declined to use any of the other "material participation" standards set out in **Code §469** (e.g., 500 hours annually, 100 hours and not less than anyone else or "substantially all" of the hours involved in the activity, etc.), stating that **"whether a trade or business exists is a different determination than that applied to the passive loss rules."**

For this 250-hour requirement, "rental services" would include advertising to rent, negotiating and executing leases, verifying tenant applications, collection of rent, daily operation and maintenance, management of the real estate, purchase of materials, **and supervision of employees and independent contractors who otherwise perform some or all of these services on the behalf of the lessor/landlord.**

Comment: Some practitioners have asserted that hours spent by others (e.g., independent contractors such as plumbers, electricians, carpenters, etc.), for example, in a major renovation project can be counted by the landlord/lessor in meeting this 250-hour test. **But, the purpose of this "safe harbor" arguably calls for *personal involvement* of the taxpayer. That is why it mentions time spent "supervising" these other third-parties.** Nevertheless, the IRS notice states that, as one of the requirements, "250 or more hours of rental services are performed (as described in this revenue procedure) per year with respect to the rental enterprise." And, **"rental services may be performed by owners or by employees, agents, and/or independent contractors of the owners."**

Questions that might be asked of clients holding rental property include:

1) Whether on a regular basis does the taxpayer consult with advisors, negotiate and execute leases, consult

with or act as property managers or personally maintain, manage or supervise the rental activity of the particular rental property?

2) Does this activity continue throughout the year?

3) Does the taxpayer spend at least 250 hours annually dealing with the advisors, managers or personally with tenants, repair or maintenance companies or on-site issues?

4) Does the taxpayer maintain contemporaneous written calendar time records to prove the above regular, continuous activity?

Comment: What continues to be the position of the reg writers is that a rental property leased on an annual basis, for instance, with minimal involvement of the landlord would *not* qualify for the Sec. 199A deduction since it is (arguably) is *not* a "trade or business" under the "Sec. 162 standard." And, this "safe harbor" definitely does *not* help to meet such a landlord to meet a "250- hour test."

Example - "Retired Couple Owning Several Rental Properties Leased on an Annual Basis"
Jack and Shirley are retired and own a rental duplex locally which they have rented out on an continuous basis for the last 15 years to the same two tenants. They also own a condo in FL and use a property management company to lease it on either a weekly (or, if possible seasonal) basis. They spend a minimal amount of time on these properties (and, not anywhere near 250 hours each year). As a result, they could *not* take advantage of this "safe harbor" and would have to assert that Congress intended their rental income to qualify for this new Sec. 199A deduction under other relevant provisions of the Code.

But, the reg writers state that the "safe harbor" applies if the 250-hour test is satisfied this minimal amount of time is devoted to the property on an annual basis **"by the property's owner, employees or independent contractors."** And, as discussed above, time spent on repairs, collecting rents, negotiating leases, and providing tenant services count. On the other hand, as mentioned below, **hours put in for arranging financing, constructing long-term capital improvements, and driving to and from the location of the real property** are *not* included in meeting the 250-hour requirement.

Hours spent in the "owner's capacity as an investor," however, such as arranging financing, procuring property, reviewing financial statements or reports on operations, and traveling to and from the rental real estate **will *not* be considered "hours of service" for purposes of this "safe harbor."**

The regs also state that a **taxpayer is *not* permitted to use this "safe harbor" for the rental of any residence** that the taxpayer uses personally for the *greater* of: (1) **14 days or more** during the year, or (2) **10% of the days rented at FMV** (i.e., the "personal use standard" as outlined in **Code §280A** which defines a taxpayer's "residence").

In addition, the **safe harbor *cannot* be used for property rented under a "triple net lease."** "Triple net leases" are defined for Sec. 199A purposes as any lease where the landlord shifts the responsibility for paying real estate taxes, insurance, and maintenance expenses to the tenant under the terms of the lease, along other "benefits and burdens of ownership."

Comment: Previously, the IRS has treated the ownership of real estate rented on a triple-net-lease basis as being similar to "holding stock." As a result, it considered it to be investment property rather than a "Section 162 trade or business." (Cf. ***Neill*** and **Rev. Rul. 73-522**).

Comment: Would it make any difference if it was a "double-net-lease" where the real estate taxes and maintenance expenses were paid by the tenant, but the lessor paid to insure the property being rented? The point is, would it make any difference where the lessor/landlord shifted some of the benefits and burdens of ownership to the lessee/tenant, but still retain other responsibilities of ownership?

As an additional requirement, taxpayers **must include a signed statement with the return** that they meet the requirements of this procedure as follows:

"Under penalties of perjury, I (we) declare that I (we) have examined the statement, and, to the best of my (our) knowledge and belief, the statement contains all the relevant facts relating to the revenue procedure, and such facts are true, correct, and complete."

Comment: This IRS notice goes on to state that "If an enterprise fails to satisfy the requirements of this safe harbor, **the rental real estate enterprise may still be treated as a trade or business for purposes of section 199A if the enterprise otherwise meets the definition of trade or business in Reg.**

§1.199A-1(b)(14).” And, this means that it must be treated as a trade or business for purposes of **Code §162**. By way of explanation, the Joint Committee on Taxation (i.e., in their “Blue Book”) clarified that this would be the case if it is “an activity that is treated as a trade or business for ***‘all relevant Federal income tax purposes’”*** (and, that keeps a complete and separable set of books and records).

Comment: Practitioners have recommended that the “safe harbor election” be made without requiring a taxpayer’s signature with regard to this “perjury statement.” Because many tax software programs allow the election to be electronically filed without the signature, what is the service’s position if the election gets filed without a signature, or with just one signature if the taxpayer is filing jointly? Will the return still be processed? Will the taxpayer receive a notice to allow an opportunity for the statement to be signed so the election is valid? If the election is omitted in error, can the election be attached post filing with an amended return?”

Comment: As far as the requirement to keep “adequate books and records,” this should be satisfied by simply keeping a rental schedule of income and expenses (i.e., **Schedule E** or **Form 8825**) sufficient to determine overall net rental income or loss on the taxpayer’s return.

Comment: The **question remains as to whether these regs truly reflect what the Congress intended** when it decided to include rental income in the definition of “qualified business income” and also provided a special “alternative test” where, **knowing that rental schedules normally lacked “wages,”** it could instead look to “2.5% of UBIA” to support the 20% “QBI component.” Otherwise, the decision by Congress to add “rental income” to the definition of QBI would have made no sense at all since basically all landlords and lessors of property would *not* be able to claim the Sec. 199A deduction (unless their taxable income before the 20% deduction otherwise fell under the “threshold” amounts).

Comment: And, looking to the JCT explanation, again considered how the **“relevant Federal income tax Code sections”** treat rental activities for “trade or business” purposes:

(1) Any taxable sale or exchange of rental property meeting the definition of “**Code §1231**" is **considered to have been “used in a trade or business.”**

(2) Any deduction for insurance, utilities, maintenance and repairs, etc. is allowed specifically under **Code §162** because they are **considered to be “trade or business expenses.”**

(3) The regs under **Code §469** **treats rental real estate activities as “trades or businesses”** for purposes of the “real estate professional” test.

(4) If a rental activity results in a net loss, **it is treated as a “business loss”** for purposes of computing any net operating loss under **Code §172**.

(5) Under the revision made to **Code §179** for 2018 and later years, “assets used in connection with lodging” (e.g., a furnished residential rental condo) are now permitted an immediate expensing election. And, it is the **net rental income from this activity that is treated as “trade or business taxable income”** when meeting the overall requirements for being able to take this deduction.

(6) Rental activities are **now able to elect to be “real estate trades or businesses”** in order to *not* be subject to the interest expense limitation under **Code §163(j)**.

The other “weaker” arguments is that rental income is *not* subject to self-employment tax under **Code §1401** (but, then, the activity would *not* be shown on either **Schedule E** or **Form 8825**). And, as a Schedule E activity, it does *not* have to issue **Form 1099s** to noncorporate third-party vendors or service providers (even though that question remains at the top of Schedule E despite Congress acting to repeal it after it was originally included in the **Affordable Care Act**).

Comment: But, if one were to argue that a rental activity satisfied the “Section 162 T/B standard,” would it now have to file Form 1099s and otherwise have its “business interest” (e.g., mortgage interest) subject to the **Code §163(j)** limitation (especially if it met the definition of a “tax shelter”) unless it made an election as a “real estate trade or business?”

Comment: As to the Form 1099 requirement, the final regs do now state that “taxpayers that treat a rental activity as a ‘trade or business’ for purposes of **Code §199A**” should also comply with the information reporting requirements of **Code §6041**.

Comment: Many (most?) of the practitioners that I have taught around the country over the last year or so agree that Congress clearly did *not* mean to "attach any strings" to the addition of rental income to the definition of "qualified business income." And, as stated above, the **introduction of an alternative "2.5% x capital investment" (i.e., UBIA) test**, demonstrated that **rental schedules would almost never have any "wages" present on them**. So, **this "substitute test" was clearly included to enable lessors and landlords to claim a potential Sec. 199A deduction.** The **question then becomes whether the authors of the regs, even with the legislative (v. interpretative) reg writing authority granted to them, have reflected the true intent of the Congress in passing the TCJA and Sec. 199A** as an attempt to equalize out the 21% flat tax rate now granted to C corporations. That being said, and with the recent release of the *final* regulations, **should a Form 8275-R be attached to a taxpayer's return, at least in those instances where there is a question as to whether a rental activity rises to the level of being a "trade or business" under Code §162?**

Comment: Watch for major real estate lobbyist groups to challenge this position taken in the final regs should the IRS contest (and, possibly deny) the Sec. 199A deduction where there is a "close call" as to whether a rental activity meets this very subjective "test" as to whether it is a "trade or business" under **Code §162**.

Comment: But, in the meanwhile, should "Jack and Shirley who own a few rental properties," but otherwise do *not* spend an inordinate amount of time being "landlords" (e.g., < 250 hour/year) be denied a 20% deduction under Sec. 199A against their net rental income on their 2018 tax return (especially where their taxable income before any Sec. 199A deduction falls below the threshold amount)? Did Congress intend, when adding "rental income" to the QBI definition, to only grant this 20% deduction to only those landlords who "eat, sleep and breathe rental real estate activities?"

Comment: And, as discussed below, where the rental is to an RPE trade or business in which the property's owners also materially participate, does this always satisfy the "Sec. 162 T/B standard?" Suppose this "self-rental" only involved a business that occupied 10% of the building's square footage, with the other 90% of the tenants being unrelated third-parties?

7. **"Self-Rentals" to Commonly-Controlled Businesses:** The *final* regulations do provide one exception to the "Section 162 trade or business" requirement for rentals. The *final* regs repeat the exception found in the *proposed* regs and state that a rental activity will be treated as a "Section 162 trade or business" if it is rented to a "commonly controlled" trade or business owned by the taxpayer (i.e., whether or not it is a non-SSTB, or an SSTB). In other words, a "self-rental" is automatically granted "de facto Section 162 status," even if the rental activity by itself might *not* have otherwise satisfied that standard.

Comment: To be "commonly controlled," the property must be rented to an individual or pass-through (i.e., but *not* to a C corporation), and the same owner (or, group of owners) must own ≥ 50% of both the property and tenant business. For these purposes, the 50% control standard is measured by using the attribution rules of **Code §§707** and **267**, which is different from what had been stated in the *proposed* regs. The *final* regs also clarify this rule by limiting its use to only those situations in which the related party is an individual or an RPE.

Comment: Keep in mind, though, when a rental activity is "pulled back into a commonly-controlled trade or business," that T/B might be a SSTB which means that the rents are now going to be treated as an additional source of SSTB income. And, if the taxpayer is otherwise restricted on claiming a Sec. 199A deduction with regard to QBI flowing from an SSTB (e.g., due to having taxable income exceeding the threshold amounts), this associated rental income would be impacted as well.

Comment: Rents are potentially eligible for the Sec. 199A deduction regardless of what type of entity the tenant might be conducting their business as. Nevertheless, the "de facto status" of a rental activity meeting the **Code §162** standard as a "trade or business" will *not* be available if the tenant is a C corporation.

What happens, though, where there is a "mixture" of tenants and your "commonly-controlled trade or business" is just one of them? Does this "de facto status" as a T/B under Code §162 cover all of the rents flowing from the other tenants and therefore qualify the rents as QBI?

Example - "Commonly-Controlled T/B Is Sole Tenant"
A and B **own an S corporation (or, partnership) business**. They also own the LLC which holds title to the building where this business is the sole tenant. Under the "de facto rule" discussed above, the rental activity is *automatically* treated as a "trade or business" under **Code §162** and, therefore, the rents are treated as "qualified business income" (QBI) eligible for a potential 20% deduction under Sec. 199A.

Example - "Commonly-Controlled T/B Is Just One of the Tenants"

Same facts as above, but A and B's T/B is just occupying 10% of the building's square footage while other third-party tenants occupy the remaining space. Apparently, the rent paid by this business would *automatically* be treated as QBI, while the other rental income would have to *separately* qualify by independently satisfying the "T/B standard" under **Code §162** (or, possibly, under the "250-hour safe harbor" test).

Example - "Commonly-Controlled Business is a C Corporation"
Same facts as above, but A and B **operate their business as a C corporation**. Based on the statement in the regs, this "de facto status" as a "trade or business" under **Code §162** would *not* be available. Nevertheless, as with any rental income being received (i.e., from this business, or an unrelated third-party), it could still possibly be treated as "qualified business income" (QBI) given, at least according to the regs, that it was a "trade or business" under **Code §162**.

Comment: If the tenant, for instance, is your commonly-controlled C corporation, an interesting question arises. Since it is *not* a flowthrough entity (i.e., partnership or S corporation), then **would the rents received by the LLC holding title to the rental property still be tainted as additional SSTB income?** In the absence of further guidance from the IRS, there is certainly an argument that **such rents are non-SSTB income**. Of course, the taxpayer would still have to, at least according to the reg writers, satisfy a "T/B standard" under **Code §162** for this rental activity. Moreover, **for every $25,000 of Sec. 199A deduction, they would need $1 million of UBIA**.

Example - Bare Ground Rentals to Commonly Controlled Ag/Horticultural Businesses
This *automatic* exception for applying the "Code Sec. 162 T/B standard" can be extremely useful where, for instance, bare ground is rented for a straight cash rent to a commonly-controlled agricultural or horticultural business and there is little in the way of UBIA (i.e., land with a few older fully-depreciated buildings). By not having the "rent expense" deduction on the T/B tax return, QBI is correspondingly increased. More importantly, though, the "QBI component" for the rental income (20% x net rental income) can now be covered by any "wages" of the commonly-controlled trade or business (and, "wages" if needed for the "50% wage limitation test" are 20-times more valuable than the presence of UBIA, which is only applied at a rate of just 2.5%).

For example, a Schedule F LLC has a $200,000 profit after paying to a SMLLC (i.e., Schedule E) holding title to the land and buildings $50,000 of rental expense. Assume that the buildings are fully depreciated as of the last day of the tax year (even though they are still in service), along with the fact that the land is nondepreciable. Meanwhile, the Schedule F proprietorship has $100,000 of wages paid to rank-and-file employees. With the "automatic classification" of this rental activity as meeting the "Sec. 162 T/B standard" that is at least one potential limitation (at least according to the reg writers) out of the way. But, even more importantly, since the T/B and rental are commonly controlled and assuming that they meet at least 2 out of the 3 factors needed, they can be aggregated for purposes of the Sec. 199A deduction. As a result, there is now $250,000 of QBI in total to be considered and, with the 20% deduction, this equals a "QBI component" of $50,000. Not having to solely rely on UBIA to support a $10,000 "QBI component" had this rental activity remained separate from the T/B, the farmer can now take the entire $50,000 combined "QBI component" as a preliminary Sec. 199A deduction. Even if they are over the end of the applicable phaseout range (i.e., $207,500 or $415,000) since 50% x wages = $50,000, it would be enough to support the "QBI component" of $50,000 (i.e., 20% x $250,000 QBI).

Comment: The only other "test" that would have to be met in order to list the $50,000 Sec. 199A deduction on Line 9 of the farmer's Form 1040 would be that 20% of their taxable income over any "net capital gain," before any Sec. 199A deduction, be in excess of the $50,000 deduction.

8. Taxpayers with Taxable Income Below Threshold: If a taxpayer has taxable income before the Sec. 199A deduction of less than $157,500 ($315,000 MFJ filers), **you do *not* have to analyze what type of business is involved (i.e., non-SSTB, SSTB, or rents treated as flowing from either type of business),** along with having to possibly apply the limitations involving W-2 wages or UBIA. None of it matters since the taxpayer is entitled to claim 20% of QBI and, if any, 20% of qualified REIT dividends and PTP income, as a Form 1040, Line 9 Sec. 199A deduction. The **only other limitation would be the application of the overall 20% cap on taxable income in excess of "net capital gain," if any.**

Example #1: A, an unmarried individual, owns and operates a computer repair shop as a sole proprietorship. The business generates a $100,000 profit for 2018. A has no "net capital gains." After allowable deductions *not* relating to the business, A's total taxable income for 2018 is $81,000. The business's QBI is $100,000, which is the net amount of its qualified items of income, gain, deduction, and loss. A's Sec. 199A deduction for 2018 is equal to $16,200, the *lesser* of 20% of A's QBI from the business ($100,000 x 20% = $20,000) and 20% of A's total taxable income for the taxable year ($81,000 x 20% = $16,200).

Example #2: Assume the same facts as in **Example #1**, except that A also has $7,000 in "net capital gain" (e.g., LTCG, qualified dividends, Sec. 1231 gain or unrecaptured Sec. 1250 gain) for 2018 and that, after allowable deductions not relating to the business, A's taxable income for 2018 is $74,000. A's taxable income minus "net capital gain" is $67,000 ($74,000 - $7,000). A's Sec. 199A deduction is equal to $13,400, the *lesser* of 20% of A's QBI from the business ($100,000 x 20% = $20,000) and 20% of A's total taxable income minus "net capital gain" for the taxable year ($67,000 x 20% = $13,400).

Example #3: B and C are married and file a joint return. B earns $50,000 in wages as an employee of an unrelated company in 2018. C owns 100% of the shares of X, an S corporation that provides landscaping services. X generates $100,000 in net income from operations in 2018. X pays C $150,000 in wages in 2018. B and C have no "net capital gains." After allowable deductions not related to X, B and C's total taxable income for 2018 is $270,000. B's and C's wages are *not* considered to be income from a trade or business for purposes of the Sec. 199A deduction. Because X is an S corporation, its QBI is determined at the S corporation level. X's QBI is $100,000, the net amount of its qualified items of income, gain, deduction, and loss. The wages paid by X to C are considered to be a qualified item of deduction for purposes of determining X's QBI. B and C's Sec. 199A deduction is equal to $20,000, the lesser of 20% of C's QBI from the business ($100,000 x 20% = $20,000) and 20% of B and C's total taxable income for the taxable year ($270,000 x 20% = $54,000).

Example #4: Assume the same facts as in **Example #3** except that B also earns $1,000 in qualified REIT dividends and $500 in qualified PTP income in 2018, increasing taxable income to $271,500. B and C's Sec. 199A deduction is equal to $20,300, the *lesser* of (i) 20% of C's QBI from the business ($100,000 x 20% = $20,000) plus 20% of B's combined qualified REIT dividends and qualified PTP income ($1,500 x 20% = $300) and (ii) 20% of B and C's total taxable for the taxable year ($271,500 x 20% = $54,300).

Comment: Notice that in all of these examples that since the couple's taxable income before any Sec. 199A deduction is below the applicable threshold of $315,000 that was no need for "testing" the initial QBI component against any "wages" or "2.5% x UBIA."

9. "Blended Businesses" and Allocation of Income and Expenses: The *proposed* regs provided that if an individual (or, a relevant passthrough entity (RPE)) directly conducts **multiple trades or businesses** (and, these can be *both* non-SSTB v. SSTB), and has items of QBI which are properly attributable to more than one trade or business, the individual or RPE must allocate those items among the several trades or businesses to which they are attributable **"using a reasonable method based on all the facts and circumstances."** Moreover, the chosen reasonable method for each item **"must be consistently applied from one tax year to another and must clearly reflect the income and expenses of each trade or business."** The *final* regs retain the rule in the proposed regs. And, they provide that **once a method is chosen for an item, it must be applied consistently with respect to that item.**

Example: An S corp business operating as eye clinic is owned 100% by an M.D. Along with cataract surgeries, all manner of eye exams and treatments are offered. This SSTB portion of the business generates a net profit (after payment of a "reasonable salary" to the owner) of $400,000. In addition, the S corporation also sells eyeglasses and other eye ware. This side of the business generates about $100,000 in profits each year and has one full-time employee paid $40,000 in wages annually. Overall, the S corp has three receptionists who answer calls and make appointments, along with a full-time office manager.

Based on the Sec. 199A guidelines cited above, **any expenses allocable to both sides of the business (e.g., receptionists and office manager) would have to be allocated under some reasonable basis each year on a consistent basis.**

Comment: Keep in mind that "5% de minimis non-SSTB gross receipts rule" from the *proposed* regs was dropped in *final* regs whereby if a non-SSTB business was being simultaneously conducted with an SSTB, the non-SSTB portion could be ignored for Sec. 199A purposes and the *entire* business would have been treated as an SSTB. Now, the implication in the final regs appears to be that if the non-SSTB side of the business cannot be broken out (i.e., separate books and records are *not* kept and the non-SSTB sales are *not* tracked and invoiced separately), then the *entire* business is deemed to be an SSTB, **regardless of the percentage of sales allocable to each type of business**.

Example: A dermatologist (i.e., a SSTB) also sells OTC skin creams to her patients when they come in for exams or other office procedures. Even if the gross receipts from this "side business" were 5% or less, they could be accounted for as a **non-SSTB source of QBI** (with expenses reasonably allocated between the two types of business). This would be permissible for Sec. 199A purposes unless the dermatologist failed to keep separate books and records (such as invoicing separately for each type of business), and otherwise could *not* break out the income and expenses.

Comment: Another example would be a case where an audiologist did exams and provided professional services, but also sold hearing aids (i.e., arguably, a non-SSTB segment of their otherwise SSTB).

10. Absent "Aggregation Election" Sec. 199A Deduction Must Be Separately Calculated for Each T/B: The 20%-of-QBI calculation is **separately made for each trade or business** and, if necessary, the **wage and capital limitations are then apply to see if this initial amount is fully supported**. If there is a QBL, it is **applied to each T/B pro rata to the positive QBI that each one had**.

Example: A taxpayer has taxable income before any Sec. 199A deduction of less than the threshold amount. His three T/Bs have the following: **Business A = $40,000 of QBI**; **Business B = $40,000 of QBI**; and **Business C = $20,000 of QBL**. The QBI components for Business A and B are $8,000 from each business, while Business C has QBI component of ($4,000). Assuming that the taxpayer's Sec. 199A deduction is *not* limited by 20% of taxable income in excess of net capital gain (NCG), the Form 1040, Line 9 deduction will be $14,000 (i.e., $8,000 + 8,000 - 4,000).

Comment: If the "wage" and "capital" limitation tests came into play (i.e., because the taxpayer's taxable income before any Sec. 199A deduction exceeded the applicable threshold), then the *greater* of each of these limits would be applied to support the initial QBI components of $8,000 from each of the businesses in the above example. Finally, any remaining QBI component amounts (after the application of the limits) would be further reduced by the QBL component of $4,000 with the net amount being entered on Form 1040, Line 9.

11. Positive and Negative QBI Simply Netted for Taxpayers with Multiple Businesses Where Taxable Income Before Any Sec. 199A Deduction Below Applicable Threshold: Even though the law states that the QBI for each trade or business must be separately calculated, if a taxpayer has multiple business activities, the bottom line is that any positive and negative QBI is simply netted together before the deduction is computed.

Example: A, a married taxpayer, operates two businesses. An S corporation allocates $100,000 to A, while an LLC allocates to A a loss of $40,000. A simply nets the loss against the income and deducts 20% of $60,000, or $12,000, subject to the overall limitation (i.e., 20% x taxable income over NCG).

The *final* regs state that if the net of all positive and negative QBI is *positive*, but at least one business produces a loss, the **loss must be allocated among all of the businesses that produce QBI in proportion to their respective amounts of QBI**. Only **after this allocation and netting takes place are the W-2 and basis limitations applied**, and no part of the W-2 amounts or basis of property attributable to the *loss* business are taken into account by the *income-producing* businesses.

Comment: But, if the taxpayer does in fact have taxable income above the applicable threshold, the "wage" and "capital investment" tests must be applied to determine the final Sec. 199A deduction. As a result, the final regs state that "the **statute does *not* address the ordering** for how the W-2 wages and UBIA of qualified property limitations should be applied when taxpayers have *both* positive and negative QBI from different businesses." To address this, the **final regulations "clarify that in such cases the negative QBI should offset positive QBI *prior to* applying the wage and capital limitations."**

Comment: By requiring a taxpayer to allocate a loss *proportionately* among multiple businesses that generate QBI, the *final* regs state that it is intended to "prevent potential abuse."

Example: In 2018, a married taxpayer whose taxable income before any Sec. 199A deduction is in excess of the end of the phaseout range (i.e., $415,000). He is allocated **$200,000 of QBI from business A along with $100,000 of W-2 wages**. He is also allocated **$200,000 of QBI from business B that has paid no W-2 wages**. Finally, he is allocated a **$200,000 loss from business C that pays $70,000 in W-2 wages**. All of these businesses are **non-SSTBs**. Without the aforementioned rule, the taxpayer could try to net the $200,000 loss from business C with the $200,000 of income from business B, because he realizes that would *not* get a deduction attributable to business B in any case, because business B has paid no wages.

To prevent this result, the *final* regs require the **$200,000 loss from business C to be allocated to business A and business B in proportion to their QBI**. As a result, **each business is allocated a $100,000 loss**. Business A then has a net QBI of $100,000, and a deduction equal to the *lesser* of $20,000 (20% of $100,000) or $50,000 (50% of W-2 wages of $100,000). Business B also has net QBI of $100,000 as well, but no deduction because business B paid no W-2 wages. A's **total deduction is $20,000**. Without this rule, the Sec. 199A deduction would have been $40,000 (i.e., 20% x business A QBI of $200,000).

Example: If the taxpayer in the Example above **had been able to aggregate** these three businesses for purposes of the Sec. 199A deduction above, he would have simply computed just one Sec. 199A deduction, using the following combined amounts: $200,000 of QBI and $120,000 of W-2 wages. And, his deduction would have been the lesser of $40,000 or $60,000, or $40,000. By aggregating, the **taxpayer has increased his Sec. 199A deduction by $20,000**.

Comment: And, if a taxpayer has an **overall net loss for the tax year** (i.e., after netting positive and negative QBI as stated above), the **loss is carried forward and will reduce QBI in the following year**, even if the loss is used in the current year to reduce taxable income.

Example: A, a married taxpayer, operates two businesses. An S corporation allocates $100,000 to A, while an LLC allocates to A a loss of $120,000. Because A has a net QBI loss of $20,000, A gets **no Sec. 199A deduction**. In addition, A is **required to carry the net $20,000 loss** to 2019, where it will reduce QBI.

Comment: Given that A in the above example has sufficient basis to take the $120,000 loss from the LLC (and, is *not* otherwise subject to the passive loss rules), he **would reduce his overall taxable income by the loss (i.e., even though $20,000 of it will be carried over to reduce any positive QBI in a subsequent tax year).**

12. Calculation of Sec. 199A Deduction with Negative QBI:

(REFER TO EXAMPLES #9 to 12 STARTING ON PAGE 170 OF THE FINAL REGS)

Example #9: "Offset of QBL v. QBIs from Multiple Businesses"

- **Unmarried sole proprietor** with three separate businesses
- No business has any UBIA
- $750,000 of wages from unrelated business employment
- **No aggregation election for any business**
- Taxable income before Sec. 199A deduction = $2,120,000

  - Business X: $1,000,000 QBI w/ $500,000 in wages
  - Business Y: $1,000,000 QBI w/ no wages
  - Business Z: ($600,000) QBL w/ $500,000 in wages

Part A:

- Because Business Z had negative QBI, it must be used to offset the positive QBI from Business X and Business Y **in proportion to the relative amounts of positive QBI from Business X and Business Y**.
- Because Business X and Business Y produced **same amount of positive QBI**, negative QBI from Business Z is **apportioned equally among Business X and Business Y**.
- **Adjusted QBI for each of Business X and Business Y is $700,000** ($1 million less 50% of the negative QBI of $600,000).
- **Adjusted QBI in Business Z is $0**, because its negative QBI has been fully apportioned to Business X and Business Y.

Part B:

- Because F's **taxable income is above the threshold amount**, the QBI component of the Sec. 199A **deduction is subject to the W-2 wage and UBIA** limitations
- Limitations must be applied on a business-by-business basis.
- None of the businesses hold qualified property, therefore **only the 50% of W-2 wage limitation must be calculated**
- **Business X:** *lesser* of 20% of QBI ($700,000 x 20% = $140,000) and 50% of W-2 wages ($500,000 x 50% = $250,000) = **$140,000**
- **Business Y:** *lesser* of 20% of Business Y's QBI ($700,000 x 20% = $140,000) and 50% of its W-2 wages (zero) = **zero**

Part C:

- Taxpayer required to combine the amounts determined in "Part B" above and compare the sum to 20% of taxable income in excess of any "net capital gains."
- Sec. 199A deduction equals *lesser* of combined amount from "Part B"= **$140,000** ($140,000 + zero) v. 20% of taxable income over NCG = **$424,000** ($2,120,000 x 20%)

<u>Example #10</u>: "Aggregation of Businesses w/ Both QBIs v. QBL"
- **Unmarried sole proprietor** with three separate businesses
- No business has any UBIA
- $750,000 of wages from unrelated business employment
- **Aggregation election combining all three businesses**
- Taxable income before Sec. 199A deduction = $2,120,000

- Business X: $1,000,000 QBI w/ $500,000 in wages
- Business Y: $1,000,000 QBI w/ no wages
- Business Z: ($600,000) QBL w/ $500,000 in wages

<u>Part A</u>:
- Because F's **taxable income is above the threshold amount**, QBI component of Sec. 199A **deduction is subject to the W-2 wage and UBIA** limitations.
- But, because the businesses are aggregated, **limitations applied on aggregated basis**
- Again, none of the businesses hold qualified property, therefore **only the 50% of W-2 wage limitation must be calculated**
- Limitation applied by determining the *lesser* of **20% of the QBI** from aggregated businesses (**$1,400,000 x 20% = $280,000**) and **50% of W-2 wages** from the aggregated businesses (**$1,000,000 x 50% = $500,000**), or **$280,000**.
- Sec. 199A deduction is equal to the *lesser* of **$280,000** v. 20% of taxable income in excess of any "net capital gains" ($2,120,000 x 20% = **$424,000**).
- No carryover of any loss to the following taxable year for purposes of Sec. 199A

<u>Example #11</u>: "Excess QBL Resulting in Carryover with No Aggregation Election"
- **Unmarried sole proprietor** with three separate businesses
- No business has any UBIA
- $750,000 of wages from unrelated business employment
- **No aggregation election made for the three businesses**
- Taxable income before Sec. 199A deduction = $2,120,000

- Business X: $1,000,000 QBI w/ $500,000 in wages
- Business Y: $1,000,000 QBI w/ no wages
- Business Z: ($2,150,000) QBL w/ $500,000 in wages

Part A:
- Results in **"negative combined QBI" of ($150,000)** when the QBI from all of the businesses are added together ($1 million plus $1 million minus loss of ($2,150,000))
- With a "negative combined QBI" for 2018, there is **no Sec. 99A deduction with respect to any trade or business for 2018**.
- Instead, "negative combined QBI" of ($150,000) **carries over and treated as negative QBI from a *separate* trade or business** for computing the Sec. 199A deduction in following tax year
- None of the W-2 wages carry forward
- $150,000 loss may offset F's $750,000 of wage income (assuming the loss *not* otherwise disallowed under any other Code section such as at-risk basis or PAL limitations)

Part B:
- 2019 tax year: Business X - QBI = $200,000; Wages = $100,000
Business Y - QBI = $150,000; Wages = zero
Business Z - QBL = ($120,000); Wages = $500
- $750,000 of wage income from employment with an unrelated company
- Taxable income before any Sec. 199A deduction = $960,000

Part C:
- ($150,000) negative QBI carryover from 2018 treated as arising in 2019 from separate trade or business
- **Overall net QBI = $80,000** (($200,000 + $150,000) less $120,000 minus the carryover loss of $150,000)
- Because Business Z had a QBL ($120,000) and there was **also negative QBI carryover amount ($150,000)**, QBI from Business X and Business Y **offset by negative QBI from Business Z and carryover amount in proportion to relative amounts of positive QBI** from Business X and Business Y.
- Because Business X produced 57.14% (i.e., 4/7's, or **$200,000/350,000**) of the total QBI from

Business X and Business Y, 57.14% of the negative QBI from Business Z and the negative QBI carryforward must be apportioned to Business X, and the remaining 42.86% (i.e., 3/7's, or **$150,000/350,000**) allocated to Business Y.
- **Adjusted QBI in Business X = $45,722** ($200,000 minus 57.14% of the loss from Business Z ($68,568), minus 57.14% of the carryover loss ($85,710)
- **Adjusted QBI in Business Y = $34,278** ($150,000, minus 42.86% of the loss from Business Z ($51,432) minus 42.86% of the carryover loss ($64,290))
- **Adjusted QBI in Business Z is $0**, because its negative QBI has been apportioned to Business X and Business Y

Part D:
- Because **taxable income above the threshold amount** (i.e., $157,500), QBI component subject to wage and UBIA limitations
- Limitations applied on business-by-business basis
- No businesses holds qualified property, therefore **only the 50% of W-2 wage limitation applies**
- **Business X:** Sec. 199A deduction equals *lesser* of 20% x QBI = $9,144 ($45,722 x 20%) and 50% x wages = $50,000 ($100,000 x 50%), or **$9,144**
- **Business Y:** Sec. 199A deduction equals *lesser* of 20% x QBI = $6,856 ($34,278 x 20%) and 50% x wages = zero (zero x 50%), or **zero**

Part E:
- 20% x taxable income in excess of any NCG equals $192,000 ($960,000 x 20%), so Sec. 199A deduction = **$9,144**
- No carryover of any negative QBI to following taxable year for purposes of Sec. 199A

<u>Example #12</u>: "Excess QBL Resulting in Carryover with Aggregation Election"
- **Unmarried sole proprietor** with three separate businesses
- No business has any UBIA
- $750,000 of wages from unrelated business employment
- **Aggregation election made to combine the three businesses**
- Taxable income before Sec. 199A deduction = $2,120,000

  - Business X: $1,000,000 QBI w/ $500,000 in wages
  - Business Y: $1,000,000 QBI w/ no wages
  - Business Z: ($2,150,000) QBL w/ $500,000 in wages

Part A:
- For 2018, **combined QBI from the aggregated trade or business is ($150,000)**
- Given combined negative QBI for 2018, no Sec. 199A deduction with respect to any trade or business for 2018
- Instead, the negative combined QBI of ($150,000) carries over and will be treated as negative QBI from a separate trade or business for 2019
- $150,000 loss may offset F's $750,000 of wage income for 2018 (assuming the loss *not* otherwise disallowed under any other Code section such as at-risk basis or PAL limitations)

Part B:
- For 2019, assume **QBI of $230,000** and **wages of $100,500** from the aggregated trade or business
- Also, $750,000 of wage income from employment with an unrelated company
- Taxable income before any Sec. 199A deduction = $960,000
- **Negative QBI carryover loss ($150,000) from 2018** treated as a loss from a separate trade or business for 2019
- Loss **will offset the positive QBI from the aggregated trade or business**, resulting in an **adjusted QBI of $80,000 ($230,000 - $150,000)**

Part C:
- Because **taxable income is above the threshold amount (i.e., $157,500)**, the **QBI component subject to the W-2 wage and UBIA limitations**
- Limitations applied on a business-by-business basis
- No businesses holds qualified property, therefore **only 50% of wage limitation must be calculated**
- For aggregated trade or business, *lesser* of 20% of QBI ($80,000 x 20% = **$16,000**) and 50% of W-2 wages ($100,500 x 50% = **$50,250**) is **$16,000**
- Sec. 199A deduction equals *lesser* of **$16,000** v. 20% of taxable income ($960,000 x 20% =

$192,000), or **$16,000**
- And, there is **no carryover of any negative QBI into the following taxable year** for Sec. 199A purposes

13. Complexity Where Taxable Income Above Threshold Amount: If the taxpayer's taxable income before any Sec. 199A deduction exceeds the applicable threshold (i.e., $315,000 for MFJ filers; $157,500 for all other taxpayers), the Sec. 199A calculation becomes more complex since, above these income levels, the type of business would have to be ascertained (non-SSTB, SSTB, or rents characterized as either type), while also dealing with the aggregation and netting rules, and applying the "wage" and "capital investment" limitations.

Comment: As seen in the final regs (Cf. **Examples #5** and **#6** on **pages 167 and 168** discussed below), when taxable income is between $157,500 and $207,500 ($315,000 and $415,000 for MFJ filers), the **deduction for a SSTB is phased-out, while the W-2 and property-based limitations are phased-in**.

Example #5: "Phase-In Range w/ No SSTB"

Part A:
- B and C are **married** and file a joint individual income tax return.
- B is a shareholder in M, an entity taxed as an S corporation for Federal income tax purposes that conducts a single trade or business which is **not an SSTB**.
- **M holds no qualified property**.
- B's share of the M's **QBI is $300,000** in 2018.
- B's **share of the W-2 wages** from M in 2018 is **$40,000**.
- C earns wage income from employment by an unrelated company.
- After allowable deductions unrelated to M, B and C's **taxable income** for 2018 is **$375,000**.
- B and C are **within the phase-in range** because their taxable income exceeds the applicable threshold amount, $315,000, but does *not* exceed the threshold amount plus $100,000, or $415,000.
- Consequently, the **QBI component** of B and C's Sec. 199A deduction **may be limited by the W-2 wage and UBIA of qualified property limitations** but the limitations will be phased in.

Part B:
- The **UBIA of qualified property limitation amount is zero** because M does *not* hold qualified property.
- B and C must apply the W-2 wage limitation by first determining 20% of B's share of M's QBI.
- **20% of B's share of M's QBI of $300,000 is $60,000.**
- Next, B and C must determine 50% of B's share of M's W-2 wages.
- **Fifty percent of B's share of M's W-2 wages of $40,000 is $20,000**.
- Because 50% of B's share of M's W-2 wages ($20,000) is less than 20% of B's share of M's QBI ($60,000), B and C **must determine the QBI component of their section 199A deduction by reducing 20% of B's share of M's QBI by the "reduction amount**" (which is described in **Part C** below).

Part C:
- B and C are **60% through the phase-in range** (that is, their taxable income exceeds the threshold amount by $60,000 and their phase-in range is $100,000).
- B and C **must determine the "excess amount**," which is the **excess of 20% of B's share of M's QBI, or $60,000, over 50% of B's share of M's W-2 wages, or $20,000**.
- Thus, the **excess amount is $40,000**.
- The **"reduction amount" is equal to 60% of the excess amount, or $24,000**.
- Thus, the **"QBI component"** of B and C's Sec. 199A deduction is **equal to $36,000, 20% of B's $300,000 share M's QBI (that is, $60,000), reduced by $24,000**.
- B and C's **Sec. 199A deduction is equal to the lesser of (i) 20% of the QBI from the business as limited ($36,000) or (ii) 20% of B and C's taxable income ($375,000 x 20% = $75,000).**
- Therefore, B and C's section 199A deduction is $36,000 for 2018.

Comment: Realize that if B and C's taxable income, before the Sec. 199A deduction was **above the end of the phaseout range (i.e., $415,000)**, their Sec. 199A deduction would simple be **limited to just $20,000**. That is, their share of 50% of the company's wages (i.e., 50% x $40,000), or $20,000. **So, with their taxable income of $375,000 being only 60% through the phaseout range of $315,000 to $415,000, they got to keep a Sec. 199A deduction of $36,000 instead of just $20,000.**

Example #6: "Phase-In Range w/ SSTB"

Part A:

- Assume the same facts as in **Example 5** above, except that **M was engaged in an SSTB**.
- Because B and C are **within the phase-in range**, B **must reduce *both* the QBI and W-2 wages** allocable to B from M to the "applicable percentage" of those two items.
- B and C's **"applicable percentage" is 100% reduced by the percentage equal to the ratio that their taxable income for the taxable year ($375,000) exceeds their threshold amount ($315,000), or $60,000, bears to $100,000.**
- Their **applicable percentage is 40%**.
- As a result, the **"applicable percentage" of B's QBI is ($300,000 x 40% =) $120,000, and the applicable percentage of B's share of W-2 wages is ($40,000 x 40% =) $16,000.**
- These reduced numbers represent what these taxpayers "get to keep" of their initial QBI, wage and UBIA amounts (if any) and they must then be used to determine how B's Sec. 199A deduction is limited.

Part B:
- B and C **must apply the W-2 wage limitation by first determining 20% of B's share of M's QBI as limited by Part A** of this example.
- **20% of B's share of M's QBI of $120,000 is $24,000**.
- Next, B and C must determine 50% of B's share of M's W-2 wages.
- **50% of B's share of M's W-2 wages of $16,000 is $8,000**.
- Because **50% of B's share of M's W-2 wages ($8,000) is less than 20% of B's share of M's QBI ($24,000), B and C's must determine the "QBI component" of their Sec. 199A deduction by reducing 20% of B's share of M's QBI by the "reduction amount."**

Part C:
- B and C are **60% through the phase-in range** (that is, their taxable income exceeds the threshold amount by $60,000 and their phase-in range is $100,000).
- B and C must determine the "excess amount," which is the excess of 20% of B's share of M's QBI, as adjusted in **Part B** of this example or **$24,000**, over 50% of B's share of M's W-2 wages, as adjusted in paragraph (i) of this example, or **$8,000**.
- Thus, the **excess amount is $16,000**.
- The **"reduction amount" is equal to 60% of the excess amount or $9,600**.
- Thus, the **"QBI component" of B and C's Sec. 199A deduction is equal to $14,400, 20% of B's share M's QBI of $24,000, reduced by $9,600**. B and C's **Sec. 199A deduction is equal to the *lesser* of (i) 20% of the QBI from the business as limited ($14,400) or 20% of B's and C's taxable income ($375,000 x 20% = $75,000).**
- **Therefore, B and C's section 199A deduction is $14,400 for 2018.**

Comment: Taxpayers finding themselves with taxable income before any Sec. 199A deduction, but with QBI from an SSTB, that QBI **must be reduced before the netting and carryover rules** described in **Reg. §1.199A-1(d)(2)(iii)(A)**. Furthermore, the final regs clarify that the SSTB limitations also apply to "qualified income" (i.e., QBI) received by an individual from a PTP.

14. "Wage Limitation" Test Does Not Include Guaranteed Payments: If a taxpayer's taxable income before any Sec. 199A deduction is expected to exceed their applicable threshold, then either the "wage" or "capital" test must be met to support the initial QBI component. But, the final regs repeat the stance taken in the proposed regs by insisting that **guaranteed payment to owners of partnerships for services performed do *not* equate to wages paid to an S corporation owner/employee**. As a result, **guaranteed payments serve no useful purpose when calculating the potential Sec. 199A deduction**. Consideration should **instead be given to making a "special allocation" under Code §704(b)(2)** to compensate a specific partner for services performed. That way, **overall QBI will *not* be reduced while the recipient partner's T/B income on Schedule K-1, Box 1 will be correspondingly increased.**

Comment: Another **alternative approach**, if the entity is *not* in a position to make an S election, is to **have the partner form a SMLLC and file an S election on Form 2553**. Then, transfer the partnership/LLC interest to this newly-formed S corp with any "wages" being paid out of it (and, the remainder of the net profit on Form 1120S being treated as QBI).

Comment: A partnership has **65 days after yearend to modify its current agreement** to make a **Code §704(b)(2)** "special allocation." And, **what is done one year does *not* necessarily lock the entity into making the same election in a subsequent tax year**.

Comment: Obviously, if the taxpayer's taxable income before any Sec. 199A deduction is expected to **be below their applicable threshold**, then a **partnership (or, proprietorship) may be the preferred type of entity** since there would *not* be the need to pay any "wages" to an owner that would otherwise reduce QBI (as would be the case of an S corporation which must pay "reasonable compensation" to its owner/employees).

15. NOLs Limited by Sec. 461(l) Reduce QBI in Future Years: Generally, a net operating loss carried into the current year does *not* factor into QBI at all (i.e., since it is *not* considered to have come from a specific trade or business). And, this continues to be true with "old" NOLs (i.e., carryovers from pre-2018 tax years). However, under the TCJA, if a **portion of the NOL is attributable to a loss denied under *new* Code §461(l)** (i.e., which limits a taxpayer's annual utilization of a net business loss to $500,000 for MFJ filers ($250,000 other taxpayers), that portion of the NOL **will reduce QBI in the succeeding year** (in the same fashion as a excess QBL from a post-2017 tax year).

Comment: How did the NOL come about in the first place? Wasn't it the excess of business deductions over business income? And, wouldn't this have already reduced QBI for a post-2017 NOL? **Nevertheless, this excess NOL will serve to reduce QBI "again" when carried over to the post-2018 tax year.**

Example: A married couple have a $600,000 NOL in 2018. And, the excess business deductions making up this NOL would have reduced their various sources of QBI in 2018 as well. But, because of the **Code §163(j)** limit of $500,000, they will have to carry over $100,000 of this "excess NOL" while also being limited to 80% of their taxable income for utilization of the $500,000 NOL allowed in the 2018 tax year. And, according to the *final* regs, when the "excess NOL" carryover of $100,000 is used in the future tax year, it **will again reduce any QBI that the couple might otherwise have**.

Comment: It is interesting to note that the TCJA made **no change for the utilization cap of a post-2017 NOL against AMTI which still stands at 90%**. So, the **regular tax utilization limit has gone from 100% to only 80%, but the AMT rate stayed at 90%**. And, of course, the AMT NOL can be an entirely different amount from the NOL for regular tax purposes.

16. Ordinary Gains on Sale/Redemption of Partner's Interest under Sec. 751 Result in QBI: The final regs follow the proposed regs and correctly classify **such ordinary income as additional sources of QBI**. And, this makes sense given that if the partner had stayed an owner in the entity at such time as these sources of income were realized and recognized for tax purposes, they would indeed have been treated as QBI.

Comment: This rule only applies for gain recharacterized as *ordinary* income and not, for instance, gain treated as "unrecaptured Sec. 1250 gain" which is taxed at no more than 25% (i.e., since this type of gain is already receiving a preferential tax rate v. ordinary income).

17. "Sudden Switches" from Employee to Independent Contractor Remain Suspect: Employee are normally *not* permitted to claim the Sec. 199A deduction (but, there would be an exception for "statutory employees"), but an independent contractor can. As a result, that distinction would motivate some taxpayers to **abandon their role as an employee and instead begin working for their former employer as an independent contractor**. The *final* regs continue the presumption found in the *proposed* regs and prevent such abuses by creating an preliminary test whereby if a person was formerly an employee of an employer, but suddenly becomes an independent contractor **while providing substantially the same services directly or indirectly to the former employer**, it is presumed for the *next three years* that they are *still* an employee for purposes of **Code §199A**, and thus ineligible for the 20% deduction.

Comment: The *final* regs add the "3-year waiting period" until this presumption is dismissed. In the meantime, such taxpayers could otherwise provide specific facts and circumstances to rebut this rule. An example would be were a senior manager is promoted to partner.

Example: C is an attorney employed as an associate with Law Firm 1. C and the other associates in Law Firm 1 have taxable income below the threshold amount. Law Firm 1 terminates its employment relationship with C and its other associates. C and the other former associates form a new partnership, Law Firm 2, which contracts to perform services to Law Firm 1. C **continues to provide substantially the same services** to Law Firm 1 and its clients through Law Firm 2. The goal, obviously, was for C to convert wage income into pass-through income from Law Firm 2 that is eligible for the 20% deduction (even though Law Firm 2 is a SSTB, C is below the taxable income threshold).

Because C was formerly an employee of Law Firm 1 and continues to provide substantially the same services to Law Firm 1, C is **presumed to be in the trade or business of being an employee** of Law Firm 1. Unless the presumption is rebutted, C's distributive share of income from Law Firm 2 will be treated as akin to wages, and will *not* be treated as “qualified business income.”

18. Some Clarifications re: SSTBs: The *final* regulations follow some of the principles found in **Code §448** while also providing additional interpretations of the “disqualified fields.”

Comment: The *final* regs include changes to the *proposed* regs in the following areas: general SSTB rules, specific industries, services or property provided to an SSTB, and the trade or business of being an employee.

Comment: A significant portion of the preamble to the *final* regulations was devoted to addressing the numerous comments received regarding the classification of a trade or business as being an SSTB, or not. **But, except for a few clarifications are indicated below, the final regs basically ignored these suggestions**.

- General SSTB rules: The *final* regs make the following changes to the SSTB rules in general:

a. A **franchiser** will *not* be considered to be an SSTB based solely selling a franchise in a listed field of service (**Reg. §1.199A-5(b)(3)(xii)**); and

b. Income, deduction, gain, or loss from a **hedging transaction** entered into in the normal course of a trade or business is included as income, deduction, gain, or loss from that trade or business.

Comment: A “hedging transaction” for these purposes is defined in **Reg. §1.1221-2(b)**, and the “timing rules” of **Reg. §1.446-4** are also applicable. (**Reg. §1.199A-5(b)(2)(i)(B)**)

- Specific industries - Clarifications in Final Regs: The final regs provide additional information as to whether particular activities in particular industries are considered to be activities of an SSTB.

1) Field of Health: Would include doctors, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other "similar healthcare professionals." It is important to note that in the *proposed* regs, the language included "other similar healthcare professionals who provide medical services *directly to a patient*." The ***final* regulations *removed the italicized section*, which arguably broadens the scope of the “field of health.”** For example, removal of that language means that someone like a **radiologist or technician** (e.g., oncology lab specialist analyzing test results), who **may *not* meet directly with a patient** and might have previously argued that they were *not* in the field of health, **would now fall directly under this revised definition**.

Comment: The *final* regs opined that since **“proximity to patients is *not* a necessary component of providing services in the field of health,”** the requirement in the *proposed* regs that medical services be “provided directly to the patient” has been eliminated. (**Reg. §1.199A-5(b)(2)(ii)**)

The preamble to the *final* regs clarify that “the sale of pharmaceuticals and medical devices by a retail pharmacy (e.g. Walgreen’s or CVS) is *not* by itself a trade or business performing services in the ‘field of health.’ However, **some services provided by a retail pharmacy through a pharmacist are the performance of services in the field of health**.”

With regard to **veterinarians**, the preamble to the final regs notes that included them in the “field of health” for Sec. 199A purposes was consistent with **Rev. Rul. 91-30** and with **Reg. §1.448-1T(e)(4)(ii)**.

Conversely, based on numerous comments received from practitioners, **assisted living facilities and nursing homes might fall outside of this definition**. This is due to the fact that **such facilities provide services that are unrelated to health care**, including housing, meals, laundry, facilities, security, and socialization activities.

The final regs **continue to exclude those taxpayers who provide services that may improve the overall health of the recipient**, such as the operator of a health club or spa, and as stated above, companies that provide **research, testing, and sales of pharmaceuticals or other medical devices**. **Personal trainers** would also fall under this exclusion.

Example - Pharmacists: B is a **board-certified pharmacist** who contracts as an independent contractor with X, a small medical facility in a rural area. X employs one full time pharmacist, but contracts with B when X’s needs exceed the capacity of its full-time staff. When engaged by X, **B is responsible for receiving and reviewing orders from physicians providing medical care at the facility; making recommendations on dosing and alternatives to the ordering physician; performing inoculations, checking for drug interactions, and filling pharmaceutical orders for patients** receiving care at X. **B is engaged in the**

performance of services in the field of health within the meaning of **Code §199A(d)(2)** and **Reg. §199A-5(b)(1)(i)** and **(b)(2)(ii)**.

Example - Retirement Facility: X is the **operator of a residential facility** that provides a variety of services to senior citizens who reside on campus. For residents, X **offers standard domestic services including housing management and maintenance, meals, laundry, entertainment, and other similar services**. In addition, X **contracts with local professional healthcare organizations to offer residents a range of medical and health services** provided at the facility, including skilled nursing care, physical and occupational therapy, speech-language pathology services, medical social services, medications, medical supplies and equipment used in the facility, ambulance transportation to the nearest supplier of needed services, and dietary counseling. **X receives all of its income from residents for the costs associated with residing at the facility**. Any **health and medical services are billed directly by the healthcare providers** to the senior citizens for those professional healthcare services even though those services are provided at the facility. **X does *not* perform services in the field of health** within the meaning of **Code §199A(d)(2)** and **Reg. §199A-5(b)(1)(i)** and **(b)(2)(ii)**.

Example - Surgical Centers: Y operates specialty surgical centers that provide outpatient medical procedures that do *not* require the patient to remain overnight for recovery or observation following the procedure. **Y is a private organization that owns a number of facilities throughout the country**. For each facility, Y ensures compliance with state and Federal laws for medical facilities and manages the facility's operations and performs all administrative functions. **Y does *not* employ physicians, nurses, and medical assistants**, but enters into agreements with other professional medical organizations or directly with the medical professionals to perform the procedures and provide all medical care. **Patients are billed by Y for the facility costs relating to their procedure and by the healthcare professional or their affiliated organization** for the actual costs of the procedure conducted by the physician and medical support team. **Y does *not* perform services in the field of health** within the meaning of **Code §199A(d)(2)** and **Reg. §199A-5(b)(1)(i)** and **(b)(2)(ii)**.

Example - Diagnostic Testing: Z is the **developer and the only provider of a patented test used to detect a particular medical condition**. Z accepts test orders only from health care professionals (Z's clients), **does *not* have contact with patients**, and Z's **employees do *not* diagnose, treat, or manage any aspect of patient care**. A, who manages Z's testing operations, is the only employee with an advanced medical degree. **All other employees are technical support staff and not healthcare professionals**. Z's workers are highly educated, but the skills the workers bring to the job are *not* often useful for Z's testing methods. In order to perform the duties required by Z, employees receive more than a year of specialized training for working with Z's test, which is of no use to other employers. Upon completion of an ordered test, Z analyses the results and provides its clients a report summarizing the findings. **Z does *not* discuss the report's results, or the patient's diagnosis or treatment with any health care provider or the patient**. Z is *not* informed by the healthcare provider as to the healthcare provider's diagnosis or treatment. **Z is *not* providing services in the field of health** within the meaning of **Code §199A(d)(2)** and **Reg. §199A-5(b)(1)(i)** and **(b)(2)(ii)** or where the "principal asset of the trade or business is the reputation or skill of one or more of its employees" within the meaning of **Reg. §§199A-5(b)(1)(xiii)** and **(b)(2)(xiv)**.

2) Performing arts: Actors, singers, musicians, entertainers, directors, **and similar professionals who provide services that lead to the creation of performing arts** continue to fall under this definition. But, the *final* regulations also clarified that if a taxpayer composed a song or wrote a screenplay **that "will be integral to the creation of a performing art," they would also be included in this field**.

Comment: Those who broadcast or disseminate video or audio to the public, and those who maintain or operate equipment or facilities used in the performing arts continue to be excluded from this field. But, **now also excluded with this clarification in the *final* regs would be an author of a work that is *not* turned into "performing art."**

Example - Singer/Song Writer: A, a singer and songwriter, writes and records a song. A is **paid a mechanical royalty** when the song is licensed or streamed. A is also **paid a performance royalty** when the recorded song is played publicly. **A is engaged in the performance of services in an SSTB in the field of performing arts** within the meaning of **Code §199A(d)(2)** or **Reg. §§1.199A-5(b)(1)(v)** and **(b)(2)(vi)**. The royalties that A receives for the song are *not* eligible for a deduction under section 199A.

Example - Movie Production Company: B is a partner in Movie LLC, a partnership. **Movie LLC is a film production company**. Movie LLC **plans and coordinates film production**. Movie LLC shares in the profits of the films that it produces. Therefore, **Movie LLC is engaged in the performance of services in an SSTB in the field of performing arts** within the meaning of **Code §199A(d)(2)** or **Reg. §§1.199A-5(b)(1)(v)** and

(b)(2)(vi) . B is a passive owner in Movie LLC and does *not* provide any services with respect to Movie LLC. However, because Movie LLC (i.e., the entity and *not* a particular investor) is engaged in an SSTB in the field of performing arts, B's distributive share of the income, gain, deduction, and loss with respect to Movie LLC is *not* eligible for a deduction under Sec. 199A.

3) Consulting: Taxpayers who **provide professional advice and counsel to clients** to assist in achieving goals and solving problems continue to be **included**. But, **salespeople and those who provide training or educational courses remain excluded**. This category also does *not* include any services ancillary to the sale of goods in a business that is *not* an SSTB (e.g., building contractor or purveyor of computer software) **as long as there is *no separate fee* for the consulting services**.

Comment: This **category is definitely broad and may ensnare anyone who provides for compensation professional advice and counsel such as marriage and addition counselors, expert witnesses, and other business consultants**.

Comment: "Head-hunters," on the other hand, merely find potential employees (or, independent contractors) who might be able to assist business clients with their needs.

Comment: Engineers who perform cost segregation studies are **already excluded** from being considered an SSTB, but **appraisers** who simply provide a business valuation report or real estate/property values for other professionals to use on behalf of their clients would also be excluded.

Comment: Property management companies are also excluded.

Example - Personnel Support Services Company: D is in the business of **providing services that assist unrelated entities in making their personnel structures more efficient**. D studies its client's organization and structure and compares it to peers in its industry. D then **makes recommendations and provides advice to its client regarding possible changes in the client's personnel structure**, including the use of temporary workers. **However, D does *not* actually provide any temporary workers to its clients and D's compensation and fees are *not* affected by whether D's clients used temporary workers**. Nevertheless, D **is engaged in the performance of services in an SSTB in the field of consulting** within the meaning of **Code §199A(d)(2)** or **Reg. §§1.199A-5(b)(1)(vi)** and **(b)(2)(vii)**.

Example - Temporary Staffing Agency: E is an individual who **owns and operates a temporary worker staffing firm** primarily focused on the software consulting industry. Business clients hire E to provide temporary workers that have the necessary technical skills and experience with a variety of business software to provide consulting and advice regarding the proper selection and operation of software most appropriate for the business they are advising. E **does *not* have a technical software engineering background and does *not* provide software consulting advice** herself. E **reviews resumes and refers candidates to the client** when the client indicates a need for temporary workers. E **does *not* evaluate her clients' needs** about whether the client needs workers and **does *not* evaluate the clients' consulting contracts** to determine the type of expertise needed. Rather, the **client provides E with a job description indicating the required skills for the upcoming consulting project**. E is **paid a fixed fee for each temporary worker** actually hired by the client and receives a bonus if that worker is hired permanently within a year of referral. E's fee is *not* contingent on the profits of its clients. **E is *not* considered to be engaged in the performance of services in the field of consulting** within the meaning of **Code §199A(d)(2)** or **Reg. §§1.199A-5(b)(1)(vi)** and **(b)(2)(vii)**.

Comment: The question has come up several times in workshops regarding the supplying of lawyers to law firms that otherwise need temporary help. Using this example above, it seems that perhaps this type of "temporary legal help agency" might escape the definition of being "in the field of law?"

Example - Software Licensing Company: F is in the business of **licensing software to customers**. F **discusses and evaluates the customer's software needs** with the customer. The taxpayer advises the customer on the particular software products it licenses. F is **paid a flat price for the software license**. After the customer licenses the software, F **helps to implement the software**. **F is engaged in the trade or business of licensing software and *not* engaged in an SSTB in the field of consulting** within the meaning of **Code §199A(d)(2)** or **Reg. §§1.199A-5(b)(1)(vi)** and **(b)(2)(vii)**.

Example - Financial Consulting: G is in the business of **providing services to assist clients with their finances**. G will study a particular client's financial situation, including, the client's present income, savings, and investments, and anticipated future economic and financial needs. Based on this study, G will then **assist the client in making decisions and plans regarding the client's financial activities**. Such financial planning includes the **design of a personal budget to assist the client** in monitoring the client's financial situation, the **adoption of investment strategies tailored to the client's needs**, and other similar services. **G is engaged in the performance of services in an SSTB in the field of financial services** within the meaning of **Code §199A(d)(2)** or **Reg. §199A -5(b)(1)(viii)** and **(b)(2)(ix)**.

Example - Franchising Financial Services: H is in the **business of franchising a brand of personal financial planning offices**, which generally provide personal wealth management, retirement planning, and other financial advice services to customers for a fee. H **does *not* provide financial planning services himself**. H licenses the right to use the business tradename, other branding intellectual property, and a marketing plan to third-party financial planner franchisees that operate the franchised locations and provide all services to customers. In exchange, the franchisees compensate H based on a fee structure, which includes a one-time fee to acquire the franchise. **H is *not* engaged in the performance of services in the field of financial services** within the meaning of **Code §199A(d)(2)** or **Reg. §199A -5(b)(1)(viii)** and **(b)(2)(ix)**.

4) Brokers - Securities, Insurance and Real Estate: Only those taxpayers directly involved with securities would be SSTBs. So, **real estate and insurance brokers continue to be excluded**.

5) Skill and Reputation as SSTB: The *final* regs **continue the very narrow definition of this "field."** As a result, only those taxpayers receiving money for endorsing a product or business, along with those receiving appearance fees, or otherwise allowing their image, voice, signature, name, etc. for marketing purposes would be included.

Comment: An interesting question arises where a taxpayer continues collects endorsement income, but the person whose fame (or, name) generated the income by being associated with a product is no longer alive? Is that income ineligible for the Section 199A deduction even though the current business owners were *not* the ones who endorsed the product? It is likely that the IRS would look at the origins of this income stream and continue to treat it as "tainted" for SSTB classification purposes.

Comment: The ***final* regs retain the "de minimis" rule** whereby if the **SSTB tainted income is < 10% of the taxpayer's overall non-SSTB gross receipts**, such income can be ignored and the **entire business would be considered a non-SSTB** for Sec. 199A purposes. But, if SSTB tainted gross receipts pushed the taxpayer over the 10% threshold, then it would appear that you had a "blended business" whereby each respective source of gross receipts (and, correspondingly a pro rata portion of QBI) would be deemed to come from a non-SSTB v. an SSTB. This, of course, **assumes that separate books and records for each business are kept whereby this breakdown can be supported for tax purposes**.

Example - "RN with Expert Witness Practice" An RN had a Schedule C business where she wrote numerous nursing textbooks and articles, taught CPE workshops, while also serving as a medical expert for multiple law firms. Under the narrow definition of "skill and reputation" mentioned, the **teaching and writing** aspects of her business **would be a non-SSTB**. But, on the other hand, **offering professional advice** to law firms on medical malpractice cases **clearly falls under the SSTB "consulting" classification**. As a result, given that she maintained separate books and records and can easily break out the gross receipts from each side of her business, she would have to calculate her potential Sec. 199A deduction while being cognizant of the separate phaseout rules that might come into play (i.e., in a similar fashion as would be the case had she set up two separate Schedule C proprietorships for each business).

19. "Crack and Pack" Continues to Be Shot down in the Final Regs: If a business rents property (or, provides services) to a **commonly-controlled SSTB**, the **rental income** (or, service income) generated from the SSTB is **treated as SSTB income as well** (at least for the "related parties" involved). And, "common control" is achieved when a person or group of people own 50% or more of both businesses, after applying the attribution rules of **Code §§267** and **§707**.

Comment: The ***final* regs, however, drop the "80% test"** (that was contained in the *proposed* regs) whereby once the "controlling tenant" occupied at least 80% of the building being rented, for instance, ***all* of the rents (even from an unrelated third-party occupying the other 20% of the building) would be "tainted" as SSTB income**. Now, under the *final* regs, **only the rents paid by the "controlling tenant" would be recharacterized**.

Comment: The *final* regs state that the **recharacterization of the rents as additional SSTB income will only apply "with respect to the related parties."**

Comment: The *final* regs, however, **decline to exempt real estate rentals or structures that existed *before***

December 22, 2017 (i.e., the date on which the TCJA was signed into law), "as the rule is intended to address goods and services that are provided to an SSTB **regardless of the type of good or service provided or the date on which the structure was put into place."**

Example - "Common Control and Sole SSTB Tenant" A and B own an S corp accounting firm while also owning the LLC which rents the building and the accounting firm is the **sole tenant**. Since common ownership exists between the two trades or businesses and this property is being solely provided to a SSTB, ***all* of the rent is treated as additional SSTB income**.

Example - "Ownership of Rental with Unrelated Third-Party" A owns 100% of the accounting firm, but only 60% of the LLC which rents the building to his firm. The other 40% of the LLC is owned by an unrelated third-party investor B. The "common-control test" is met, but only the 60% of the rent received by A would be tainted as additional SSTB income. On the other hand, B's share of the rental income is non-SSTB income.

Example - "Rental to SSTB & Other Unrelated Third Parties" The taxpayer, owns a dental practice and also owns an office building. He rents half the building to the dental practice and half the building to unrelated third-parties. Under **Reg. §1.199A-5(c)(2)**, **the renting of half of the building to the dental practice will be treated as an SSTB**. As a result, this portion of the rental income would be treated as flowing from an SSTB and, unless the dentist's taxable income before the Sec. 199A deduction is below the applicable $157,500/315,000 threshold, he could lose some or all of this deduction. **But, the other half of the rent received from an unrelated third-party would *not* be affected (i.e., it would *not* be treated as an additional source of SSTB income).**

20. "W-2 Wages" Defined for Purposes of Sec. 199A Deduction: "W-2 wages" are defined under **Code §3401(a)** as the total wages subject to wage withholding, elective deferrals, and deferred compensation paid by the qualified trade or business with respect to its employees "during the calendar year ending during the tax year of the taxpayer." In August, the IRS published **Notice 2018-64**, which provides three methods for computing W-2 wages. Now, along with the final regs, the IRS has offered additional guidance in the form of **Rev. Proc. 2019-11**.

Code §199A(b)(4) defines "W-2 wages" to include amounts listed in **Code §6051(a)(3)** (i.e., generally enumeration paid to an employee for services rendered to the employer) and **Code §6051(a)(8)** (i.e., elective deferrals and deferred compensation) "paid by a person claiming the deduction with respect to the employment of employees by that person during the year." Nevertheless, the term "W-2 wages" does *not* include any amount that "is *not* properly allocable to QBI under **Code §199A(c)(1)**" or any amount "*not* properly included in a return filed with the Social Security Administration (SSA) on or before the 60th day after the due date for the return."

Rev. Proc. 2019-11 provides **three separate methods** for calculating "W-2 wages:"

(1) Unmodified box method;
(2) Modified box 1 method; or
(3) Tracking changes method

Comment: The IRS warns that using one of these three methods "does *not* necessarily calculate the W-2 wages that are properly allocable to QBI" and, therefore eligible for use in the computing of the Sec. 199A "wage" limitation.

The "unmodified box method" involves taking, without modification, the *lesser* of: (1) the total entries in **Box 1** of the W-2 (i.e., wages, tips and other compensation) v. (2) the total entries in **Box 5** of the W-2 (i.e., Medicare wages and tips).

The "modified box method" also involves making modifications to the total entries in **Box 1** of the W-2 by subtracting amounts that are *not* wages for federal income tax withholding purposes (e.g., supplemental unemployment compensation benefits) and adding the total amounts of various elective deferrals that are reported in **Box 12** of the W-2.

Under the "tracking wages method," the taxpayer tracks total wages subject to federal income tax withholding and elective deferrals in **Box 12** of the W-2.

Under the *final* regs taxpayers are offered a great deal of flexibility when allocating W-2 wages paid by another party (e.g., PEO or professional employee organization) to a business as long as those wages were paid on behalf of common-law employees of the business receiving the allocation. And, with regard to a common law employer, the business who actually paid and reported the W-2 wages that are being allocated to the other employers **must reduce**

its W-2 wages for purposes of Section 199A by that corresponding amount.

Comment: While allocating W-2 wages among businesses will *not* be necessary if an aggregation election has been made, in some cases, aggregation is *not* going to be available. For example, if a business uses a professional employer organization (PEOs) to pay its employees. By allowing for an allocation, a taxpayer who uses leased employees may allocate a portion of the PEO's W-2 wages to the taxpayer.

21. Only "Qualified Property" Counts for UBIA Purposes: Only the UBIA of "qualified property" is counted towards the "2.5% x UBIA" limitation. Qualified property **only includes tangible property** (i.e., so intangible assets such as goodwill are *not* included) **subject to depreciation**. As a result, the **basis of raw land and inventory, for example, would *not* be taken into account**. Furthermore, the business **must own the property *on the last day of the tax year***, and the **owner must also own an interest in the business *on the last day of the business' tax year*** as well. So, if a **partner or shareholder were to sell their interest** sometime during the tax year, they would *not* be able to count any of the UBIA of the partnership or S corporation towards the 2.5% limit. The same would be true if the **business entity were to sell "qualified property"** (e.g., rental property) at some point during the tax year.

Comment: When business assets are sold for a lump sum, **Code §1060** requires the both the buyer and the seller sign off on the allocation of the purchase price on **Form 8594**. Traditionally, the seller has wanted capital gains treatment by insisting that the majority of the purchase price be allocated to goodwill, while the buyer want MACRS 5- 7-year assets (i.e., so 100% bonus depreciation can be claimed, even for used property). **Now, there is an additional "struggle" insomuch as the buyer would like to maximize UBIA, but any goodwill allocation would be excluded.**

22. When an Asset's Basis is Fully Depreciated in Year of Acquisition: When the cost of an asset is completely written off for tax purposes (e.g., 100% bonus depreciation or Sec. 179 immediate expensing) in the year acquired, **who gets the UBIA in subsequent years**? The regs state that the **UBIA should flow to those owners allocated the depreciation deductions**. But, in this instance, there would be none after the initial year that the asset was first placed in service. Some commentators have suggested that UBIA should go to those owners who would be allocated any gain or loss had the asset in question been disposed of. **In an S corporation setting, given that there would be just one class of common stock, UBIA would be shared on a pro rata basis**.

On the other hand, with a partnership with "Sec. 704(c) property" (i.e., assets with pre-contribution gain when first transferred to the entity), for instance, depreciation deductions are required to be allocated away from this particular partner and over to cash-contributing partners. Yet, on sale, any pre-contribution gain is allocated to the Sec. 704(c) partner, with post-contribution gain most probably being shared on a pro rata basis. So, in this latter situation, how does UBIA get shared in the interim for Sec. 199A purposes? And, with large commercial buildings or apartment complexes, the allocation of any UBIA can be vital to securing a Sec. 199A deduction.

The final regs *modify* the proposed regs with regard to the allocation to partners of the UBIA of qualified property. In the *proposed* regs, in the case of a partnership with "qualified property," that does *not* produce tax depreciation deductions during the year in question, each partner's share of the UBIA of the qualified property would be based on how the gain would be allocated to the partners pursuant to the rules contained in **Code §§704(b)** and **704(c)** if the qualified property were sold in a hypothetical transaction for cash equal to the FMV of the qualified property. **But, in the *final* regs, it was decided that only Code §704(b) (i.e., based on the partner's distributive share, or by way of a "special allocation" if instead elected by the partnership) would control, and *not* Code §704(c) (i.e., which deals with pre-contribution gain or loss), to determine each partner's share of UBIA.** As a result, each partner's share of the UBIA for qualified property is determined in accordance with how depreciation would be allocated for **Code §704(b)** "book purposes" under **Reg. §1.704-1(b)(2)(iv)(g)** as of the last day of the tax year.

23. UBIA and Older Fully-Depreciated Assets: It is very likely that **older buildings, for instance, placed into service before 1987 are now fully depreciated**. And, **even some MACRS real estate placed into service before 1991 is likewise fully written off as of the 2018 tax year** (e.g., 27.5-year residential real estate), **even though these assets can certainly still be in service as of the close of the taxpayer's current tax year**. But, under the general UBIA rules discussed in both the *proposed* and *final* regs, there **would be no UBIA accorded to such realty as it has been fully depreciated**. And, if 100% bonus depreciation had been claimed (so that there were no depreciation deductions remaining in future tax years), then the discussion above regarding **Code §704(b)** being used to determine each partner's share of UBIA would control.

Comment: Taxpayers finding themselves in this situation with **"older" buildings** which, nevertheless, are **still quite valuable and which are generating a great deal of rental income**. One of the options previously discussed would be to **make an aggregation election** (if possible) so as to include the UBIA of more recently-purchased buildings.

Comment: Of course, **MACRS 3-, 5- and 7-year assets are guaranteed a minimum 10-year period during which their UBIA can still be counted even if fully depreciated**, so long as the asset in question is still in service as of the last day of the taxpayer's year. But, you still have the same issue that, with the half-year convention, **such assets would be fully depreciated** as of the middle of the 4th, 6th or 8th tax year. And, the ***final*** **regs fail to address this type of situation and how UBIA is to be allocated**.

Comment: Keep in mind that it is **only the *remainder* of the holding period that carries over to the transferee for assets transferred in a tax-deferred transaction**. For example, with a gas station/convenience store with a MACRS 15-year depreciation period, assume that it was transfer into a partnership solely for a partnership interest. Under **Code §723**, the basis to the partnership is the carryover basis from this transferor. And, for example, **if the transferor had held this asset for 10 years, then the UBIA of the building would only be the remaining 5 years for the transferee** (i.e., the partnership) with regard to any UBIA.

24. Miscellaneous Items Confirmed in the Final Regs:

1) Sec. 199A Impact on Basis of Flowthough Interests: The **Sec. 199A deduction has no effect** on the adjusted basis of a partner's interest in the partnership, the adjusted basis of a shareholder's stock in an S corporation, or an S corporation's accumulated adjustments account.

2) Sec. 199A Impact on S/E Tax or 3.8% Medicare Surtax: The **Sec. 199A deduction does *not* reduce** net earnings from self-employment or net investment income tax (i.e., on **Form 8960**).

3) Sec. 199A Impact on Regular Tax v. AMT: To the extent that a taxpayer receives a Sec. 199A deduction for regular tax purposes it is **also allowed for AMT purposes** (i.e., since **Form 6251** starts with **Form 1040, Line 10** taxable income).

4) Accuracy Related Tax Penalty Reduced for Sec. 199A Purposes: The threshold for the accuracy related penalty under **Code §6662** for anyone claiming the Sec. 199A deduction is reduced so that it applies to **any understatement that exceeds the *greater* of $5,000 or 5% of the tax required to be shown on the return** (normally, it is a 10% threshold).

5) RPE's Failing to Report Correct Sec. 199A Information: A flowthrough entity is required to allocate and disclose QBI, W-2 wages, and UBIA of property. **If any one item is *not* allocated, that item is presumed to be zero.**

The *proposed* regulations provide that if an RPE fails to separately identify or report *any* QBI, W-2 wages, UBIA of qualified property, or SSTB determinations, the owner's share (and, the share of any upper-tier indirect owner) of QBI, W-2 wages, and UBIA of qualified property attributable to trades or businesses engaged in by that RPE **will be presumed to be zero**.

In response, the *final* regs state that *all* of an RPE's items related to section 199A **should *not* be presumed to be zero** because of a failure to report *one* item. For example, an RPE may have sufficient W-2 wages and send out that information, but decline to provide information for UBIA of qualified property "because it is *not* necessary or is an insignificant amount."

The *final* regs also provide that such missing information **can be reported on an amended or late filed return for any open tax year.**

Comment: The *final* regs confirm that **such information must be provided** by the "RPE preparers" **even if it is a de minimis amount**, or **even if this preparer also does all of the owners' returns and know that all of them will be below the respective "threshold amounts."**

Comment: If possible, if a taxpayer finds that the information being provided by the preparer of a flowthough entity is most likely incorrect (or, nonexistent), then the Form 1040 prepare should try to get this corrected v. having to file a **Form 8082** for "inconsistent treatment." Furthermore, any K-1 recipient is entitled to a complete copy of the return, along with accompanying schedules.

6) SMLLCs Treated as Disregarded Entities for Sec. 199A: Although the proposed regs did *not* address this issue, the final regs state that such entities are also ignored for Sec 199A purposes. As a result, trades or businesses conducted by a SMLLC are treated as conducted *directly* by the owner of the entity.

Comment: The **original version of the final regs were "corrected" as of 2/4/19**. And, the statement above regarded SMLLCs (i.e., "disregarded entities) is accurate. That is, T/Bs held in such entities are considered to be "conducted directly" by the taxpayer for purposes of Sec. 199A.

Surprises Contained in Final Regs: As discussed above, for the most part, the *final* regs follow what was contained in the *proposed* regs. However, there are a **few instances where these *final* regs differ** (perhaps due to the numerous comments received back from practitioners during the hearing process). Below is a summary of the more prominent items which vary from what was suggested in the *proposed* regs.

1. Impact of Freed-Up Pre-2018 Suspended Losses/Deductions on QBI in Post-2017 Tax Year: This clarification helps to resolve some confusion created by the JCT Report which (on **page 32 at the top in an example**) stated that such losses would reduce QBI. But, the *newly-revised* **proposed regs** clarify that this is *not* the case, which makes sense because how could a pre-2018 suspended loss come from a "qualified trade or business" when **Code §199A** was *not* yet even in the law?

These newly-revised proposed regs amend **Prop. Regs. §1.199A-3(b)(1)(iv)** that previously denied, suspended, limited, or carried over losses (e.g., due to **Code §465** at-risk rules; **Code §469** passive loss rules; **Code §704(b)** - partnership basis rules; and **Code §1366(b)** - S corporation basis rules) state that **such losses from pre-2018 tax years are to be taken into account for Sec. 199A purposes on a "first-in, first-out" basis and are treated as coming from a "non-qualified trade or business"** (i.e., since **Code §199A** was *not* yet part of the law prior to 2018).

To the extent that a previously suspended (i.e., pre-2018 tax year) loss relates to a PTP and is freed up in a post-2017 tax year, it must be treated as a loss from a *separate* trade or business for Sec. 199A purposes that also does *not* impact the QBI calculation in a post-2017 tax year.

And, the "oldest" carryover suspended pre-2018 losses and deductions would be the ones treated as freed up first in a post-2017 tax year.

Comment: The somewhat confusing thing about these newly-proposed regs on the treatment of pre-2018 suspended losses (or, deductions) is that the **exact reading states** the when they are finally allowed in the tax year, they "are taken into account for purposes of computing QBI so long as the losses were incurred in a **tax year beginning after Jan. 1, 2018**." **In other words, for suspended losses in a post-2017 tax year, to the extent that they would first be taken into account in the 2019 tax year, or later, and these freed-up losses and deductions would impact the calculation of QBI.** But, again, these losses come from a pre-2018 tax year when **Code §199A** was *not* yet even in the tax law.

Comment: Given that PTP losses can only be freed up to the extent of income from that *same* PTP, this would result in a "net-zero offset" when a previously denied PTP loss is allowed due to a corresponding income amount from that *same* PTP. As a result, **freed-up PTP net losses will normally only occur where the passive loss "disposition rule" otherwise comes into play** (i.e., the taxpayer has disposed of their "entire interest in a fully taxable transaction").

Comment: Such pre-2018 losses **could also have been suspended due to the taxpayer's lack of basis, or sufficient basis at-risk** (i.e., as shown on Form 6198), or **due to the Code §469 passive loss rules**. With regard to a deduction such as immediate expensing under Code §179, it could have been suspended **due to the lack of "trade or business taxable income" especially for investors who are *not* "active participants" in the business and therefore are *not* permitted to use the T/B taxable income otherwise flowing from the entity on their K-1**, who do *not* have adequate sources of T/B taxable elsewhere on their personal returns (i.e., other wage or S/E income).

Comment: This "relief" comes with a price, though. For the 2018 tax year, any suspended losses would be coming from a pre-2018 tax year and, therefore, **would be fully exempt from their use in the Sec. 199A deduction calculation**. But, **starting in 2019, a taxpayer could have a "combination" of both pre-2018 and post-2017 suspended losses or deductions**. And, as a result, **proper recordkeeping would have to be implemented to keep track of each type of loss carryover.**

2. Sec. 199A Dividends Can Be Paid by RICs: In newly-revised **Prop. Reg. §1.199A-3(d)**, regulated investment companies under **Code §852** would now be able to pay "Sec. 199A dividends" which are defined as any dividend that a RIC pays to its shareholders and reports as such in a *written* statement to its shareholders. The rules under which a RIC would compute and report "Sec. 199A dividends" are based on the rules for capital gains distributions contained in **Code §852(b)(3)** and "exempt interest dividends" in **Code §852(b)(5)**. Finally, the amount of a RIC's "Sec. 199A dividends" for a given tax year will be limited to the excess of the RIC's qualified REIT dividends for the tax year over allocable expenses.

> **Comment:** These proposed rules are intended to allow mutual fund shareholders to receive a Sec. 199A deduction on dividends from real estate investment trusts (REITs) otherwise received through a RIC in the same fashion as if the dividend had instead been received directly from a REIT.

3. Split-Interest Trusts and CRTs: Newly-revised **Prop. Reg. §1.199A-6(d)(3)(iii)** now states that a trust "with substantially separate shares and independent beneficiaries" is nevertheless treated as *a single* trust for determining the application of the threshold under **Code §199A(e)(2)**. In addition, newly-revised **Prop. Reg. §1.199A-6(d)(v)** provides in the case of a CRT, any taxable recipient of a unitrust or annuity amounts received from the trust may take into account any included QBI, qualified REIT dividends, or qualified PTP income so distributed for purposes of determining their Sec. 199A deduction.

4. Aggregation Elections Can Be Made at the Entity Level: If a flowthrough entity in which a taxpayer owns an interest **has already elected to aggregate at the entity level**, then the taxpayer **must abide by that result**, although the final regs state that the taxpayer **might be able to add an additional business to this aggregated group on their personal return**, given that the necessary requirements for second aggregation election have been met. And, this resulting aggregation **must be reported by the RPE and also by all of its owners on annual statements detailing the aggregated T/B groups.**

The *proposed* regulations provide that an RPE must determine and separately report QBI, W-2 wages, UBIA of qualified property, and whether the trade or business is an SSTB for each of the RPE's trades or businesses. But, to help simplify the administration and compliance burden, the ***final* regulations allow an RPE to aggregate its trades or businesses** provided the rules of **Reg. §1.199A-4** are satisfied.

An RPE that chooses to aggregate **can report *combined* QBI, W-2 wages, and UBIA of qualified property for the aggregated trade of business.** This aggregation, however, **must be maintained and reported by *all* direct and indirect owners of the RPE, including upper-tier RPEs.**

> **Comment:** Each entity in a tiered structure is subject to the disclosure and reporting requirements.

> **Comment:** One of the requirements for making an aggregation election was that "common control" (i.e., 50% or more) test of the underlying trades or businesses was satisfied. The final regs clarify that the attribution rules of **Code §§267** and **707** will be used to make this determination. In addition, the final regs make clear that to be considered part of a "group" of owners, the *same* people do *not* need to own an interest in *each* entity being considered for aggregation. Finally, the "control test" **must be met for the majority of the tax year and this must include the last day of the tax year in question**.

> **Comment:** The *final* regs **continue the prohibition that SSTBs are *not* eligible for the aggregation election. Nor, can SSTBs be aggregated with non-SSTBs**.

The *final* regs repeat the exact same language as contained in the *proposed* regs and require that the businesses to be aggregated must satisfy *two of the following three factors*:

> 1) They must provide products, services, or property that are the same or customarily offered together;
>
> 2) They must share facilities or significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, **or** information technology resources; or
>
> 3) The businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group.

> **Example: "Aggregation of Restaurant and Catering Businesses"**
> A, B, C, and D each own 25% of two businesses, a restaurant and a catering business. The businesses **share a kitchen, centralized purchasing to obtain volume discounts and a centralized accounting office that performs all of the bookkeeping, tracks and issues statements on all of the receivables, and prepares**

the payroll for each business. Even though none of A, B, C or D own 50% directly, because the same group of taxpayers control 50% or more of both businesses, *anyone of* A, B, C and D may (**but, are *not* required to**) aggregate the businesses (assuming that the other tests for aggregation are met). For instance, before any can aggregate, the two businesses must satisfy *two of the three* factors. And, in this example, they do as they **both offer prepared food to customers**, and they **share facilities and centralized business elements**. As a result, any of A, B, C, or D can elect to aggregate the respective businesses together.

Comment: Unlike the "real estate professional" grouping election, **this aggregation election is *not* an "all or nothing" decision**. Instead, a taxpayer may elect to group some activities while leaving others as separate. As a result, this aggregation more closely resembles the "appropriate economic unit" grouping rules under **Code §469**.

Comment: Another important point to understand with regard to this "aggregation election" for purposes of the Sec. 199A is that the electing owner (e.g., minority owner) does *not* have to own more than 50% of each business directly. Rather, they must simply establish that *someone* owns 50% or more of all of the entities the owner wishes to aggregate.

Comment: Keep in mind that a self-rental activity will *automatically* be treated as a "Section 162 trade or business," and therefore can be aggregated with the business to which the property is leased.

Aggregation under **Reg. §1.199A-4** is purely elective, and **generally cannot be revoked once an election is made**. But, if the taxpayer acquires a new business, for instance, they are free to add the new business to any previously aggregated businesses provided all of the requirements are met. If at any point, previously aggregated businesses no longer meet the requirements for aggregation, the aggregation will cease to exist for that business.

Every year, individuals (and, electing passthrough entities) **must attach a statement to their returns** identifying each aggregated business, or the Service is free to come in and "dis-aggregate" if they so choose.

Comment: Such an "aggregation statement" can be found in **IRS Pub. 535** and is designated as **Schedule B "Aggregation of Business Operations."**

Since these aggregation rules are still being unraveled, the IRS has provided two "easing rules" for their implementation. effects. First, if you fail to elect to aggregate in 2018, you **can do so in a future year**. More importantly, however, **for 2018 only**, you **can elect to aggregate on an *amended* return**.

Comment: The obvious caveat is that what might look promising as a potential aggregation election in 2018 might prove to be *not* so advantageous in a future tax year. But, as stated above, you are basically stuck with your initial decision to aggregate once made.

If a taxpayer decides *not* to aggregate everything together(or, otherwise cannot because they failed some of the prerequisites for making an aggregation), qualified business losses (QBLs) from one business must be netted against any activities with qualified business income (QBI). And, under the final regulations, if the net amount of all positive and negative QBI is a loss, as was provided in **Code §199A**, no deduction is allowable in the current year and the net loss is carried over to the subsequent tax year. The ***final* regs make clear, however, that no W-2 or UBIA amounts ever get carried forward**.

5. Aggregation of Multiple Rental Properties: The *final* regs finally have an example for multiple rental properties. The obvious limitation is that this example **represents a very narrow set of circumstances with a surprising interpretation of what will be considered "similar properties."**

Example - "Aggregation of Multiple Commercial Rental Properties": PRS1, a partnership, owns 60% of a *commercial* rental office building in state A, and 80% of a *commercial* rental office building in state B. **Both commercial rental office building operations share centralized accounting, legal, and human resource functions**. PRS1 treats the two commercial rental office buildings as an aggregated trade or business under paragraph (b)(1) of this section.

Analysis: PRS1 **owns more than 50% of each trade or business** thereby satisfying paragraph (b)(1)(i) of this section. Under paragraph (b)(1)(v) of this section, PRS1 **may aggregate its commercial rental office buildings because the businesses provide the *same* type of property (i.e., both are commercial properties) and share accounting, legal, and human resource functions.**

Example - "Aggregation of Commercial v. Residential Rental Properties Not Allowed": S, an S corporation owns 100% of the interests in a ***residential* condominium building** and 100% of the interests in a ***commercial* rental office building**. Both building operations share centralized accounting, legal, and human resource functions.

Analysis: S **owns more than 50% of each trade or business** thereby satisfying paragraph (b)(1)(i) of this section. **Although both businesses share significant centralized business elements, S cannot show that another factor** under paragraph (b)(1)(v) of this section is present because the **two building operations are *not* of the same type of property**. S **must treat** the *residential* condominium building and the *commercial* rental office building **as separate trades or businesses** for purposes of applying **Reg. §1.199A-1(d)**.

Comment: At least according to the reg writers, commercial v. residential real estate is *not* "similar" even though they both are "like-kind" for purposes of **Code §1031** exchanges (i.e., as shown on **Form 8824**).

Comment: Keep in mind that under the "mixed-use" real estate rule that is contained in **Code §280A** where if 20% or more of the gross rents are from the commercial portion of the rental building, then the *entire* building is deemed to be *commercial* property (i.e., MACRS 39-year classification). Otherwise, the *entire* building is treated as MACRS 27.5 *residential* property (i.e., where the gross rents from the residential use $\geq$ 80%). After you have made this determination for such real estate, then you can apply the Sec. 199A reg's interpretation of what is "similar" for possibly doing an aggregation election.

Example - "Aggregation of Multiple Residential Rental Properties": M owns 75% of a **residential apartment building**. M also owns 80% of PRS2. PRS2 owns 80% of the interests in a **residential condominium building** and 80% of the interests in a **residential apartment building**. PRS2's residential condominium building and residential apartment building operations **share centralized back office functions and management**. M's residential apartment building and PRS2's residential condominium and apartment building **operate in coordination with each other in renting apartments to tenants**.

Analysis: PRS2 may aggregate its residential condominium and residential apartment building operations. PRS2 **owns more than 50% of each trade or business** thereby satisfying paragraph (b)(1)(i) of this section. Paragraph (b)(1)(v) of this section is satisfied because **the businesses are of the same type of property (i.e., both are residential properties) and share centralized back office functions and management**. M **may also add** its residential apartment building operations to PRS2's aggregated residential condominium and apartment building operations. M **owns more than 50% of each trade or business** thereby satisfying paragraph (b)(1)(i) of this section. Paragraph (b)(1)(v) of this section is also satisfied because **the businesses operate in coordination with each other**.

6. Impact of Deductions for 50% of S/E tax, Self-Employed Health Insurance Deduction and Certain Retirement Plan Contributions on QBI: The *final* regs **take the *opposite* approach** than that expressed in the *proposed* regs and state that deductions for items such as 50% of self-employment tax, self-employed health insurance, and certain retirement contributions (e.g., to a SEP plan) **reduce QBI to the extent the income from the business was taken into account to determine those deductions**. This is the case even though any Sec. 199A deduction will have no impact on the calculation of self-employment tax on Schedule S/E.

The final regs (**Cf. Pages 43 and 44**) make the following statement:

"All deductions attributable to a trade or business should be taken into account for purposes of computing QBI except to the extent provided by section 199A and these regulations. Accordingly, ***Reg. §1.199A-3(b)(1)(vi)*** *provides that, in general, deductions attributable to a trade or business are taken into account for purposes of computing QBI to the extent that the requirements of* ***Code §199A*** *and* ***Reg. §1.199A-3*** *are otherwise satisfied. Thus, for purposes of* ***Code §199A****, deductions such as the* ***deductible portion of the tax on self-employment income*** *under* ***Code §164(f)****, the* ***self-employed health insurance deduction*** *under* ***Code §162(l)****, and the* ***deduction for contributions to qualified retirement plans*** *under* ***Code §404*** *are considered attributable to a trade or business to the extent that the individual's gross income from the trade or business is taken into account in calculating the allowable deduction, on a proportionate basis."*

Comment: Again, the *final* regs make clear that the **Sec. 199A deduction** has no impact on calculation of S/E tax.

Comment: This is an **extremely unfair, last-minute switch in interpretation**, given that taxpayers had relied on the proposed regs issued last August (along with numerous articles) which stated that QBI was *not* reduced by these items on the taxpayer's personal return. More importantly, **taxpayers have made their estimated tax payments (or, adjusted their withholding taxes)** to take into account that any QBI (and, therefore, the potential 20% Sec. 199A deduction) would *not* be impacted by these items. Hopefully, the IRS (and, Treasury) will reverse their stance on this issue, or at least waive any underpayment penalty (i.e., on **Form 2210**) for

2018 tax returns. In this regard, the **final regs state that they "apply to tax years ending after their publication in the *Federal Register*."** So, given that they only apply, for instance, to tax years ending 12/31/19 (assuming a calendar year taxpayer), this could be a possible "escape hatch." In addition, they go on to state that "taxpayers may rely on the proposed regs for tax years ending in 2018" (i.e., which did *not* call for the reduction of QBI by these items). But, once you decide to go with the proposed (v. final) regs, **you are suppose to use them "in their entirety."**

7. De Minimis Non-SSTB Gross Receipts Rule Dropped in Final Regs: The *proposed* regs provided a rule whereby if an SSTB (e.g., an eye doctor or audiologist) had a separate business that generated non-SSTB revenue (e.g., selling glasses or hearing aids) and 1) the business were commonly controlled; 2) they shared expenses, and 3) the **non-SSTB revenue was less than 5% of the total revenue** of the two businesses, the **non-SSTB side of the business would ignored and treated as additional SSTB revenue**. In other words, it effectively acted as the "opposite" of the regular "10% *de minimis* rule" discussed previously. The ***final* regs, however, eliminated this rule**. As a result, given that the taxpayer maintains separate books and records and can therefore break out each type of gross receipts, the Sec. 199A calculation would take into account both QBI sources for purposes of the potential 20% deduction (regardless of the percentage of non-SSTB gross receipts).

Comment: But, apparently, if the taxpayer was incapable of breaking out these two respective sources of QBI, or chose *not* to do so due to the de minimis amount of non-SSTB gross receipts, then the entire business, by default, would just be treated as a SSTB.

8. Sec. 754 Step-Ups Can Increase UBIA in Certain Instances: The *final* regs make a change to the *proposed* regulations and provide that a taxpayer purchasing a partnership interest will now get to include a **Code §743** step-up pursuant to a **Code §754** election in UBIA of their share of property on the partnership balance sheet. **But, as the *final* regs state, this is only true to the extent that the step-up exceeds what it would have been if it were made in relation to the original UBIA, rather than the tax basis of the property.**

Example: A, B, and C put in $300,000 each to a partnership and the partnership buys a building with a UBIA (i.e., cost) of $900,000. Then, when the building's FMV is $1,200,000 and the adjusted basis of the property is only $600,000, C sells his interest to D for $400,000. **D has a $200,000 Section 743 adjustment** (i.e., $400,000 sales price less C's $200,000 share of basis). Under the *final* regs (but, *not* the proposed regs), this $200,000 adjustment will increase D's UBIA of property, but only to the extent that the step-up exceeds the adjustment that would have occurred if the purchase price ($400,000) were compared to C's original UBIA of the property ($300,000), or $100,000. As a result, **the UBIA to D *related to the step-up* is only $100,000 ($200,000 - $100,000) and the *total UBIA* that D would now receive is $400,000 (i.e., $300,000 "original UBIA" plus the $100,000 due to the Sec. 754 step-up).**

Comment: What this "restriction" on the step-up is trying to accomplish is that **C has already "enjoyed" their $100,000 share of depreciation deductions** which brought C's adjusted basis of the asset (even if it was for a pre-2018 tax year) down from $300,000 to $200,000 (i.e., 1/3 x $900,000 v. 1/3 x $600,000) **before the sale of their partnership interest to D**. And, now, there **will only be allowed an increase above the $300,000 share of UBIA that C originally had**. So, the **UBIA increase is only from D's share of "inside basis" of $200,000 to just $300,000 (despite the fact that D did have an outlay of "fresh cash" of $400,000).**

Comment: Since the regs only mention step-up due to **Code §743**, it appears that "fresh" UBIA will *not* be created when property basis is stepped-up upon a redemption of a partnership interest under **Code §734**.

Comment: Nevertheless, **Code §743** step-ups **also occur when a partnership interest is inherited upon death**. So, in the Example above, if D simply inherited C's partnership interest upon their death, **D would receive an initial basis equal to the FMV as of the date of death** (i.e., $400,000 in the Example). But, even upon the death of C, **D would still only get a $100,000 Sec. 754 step-up to their inside basis** for the asset held by the partnership.

Comment: Refer to the **Examples starting on page 177** of the *final* regs for additional guidance on these step-ups and their impact on UBIA.

UBIA, like W-2 wages, must be allocated among partners and shareholders. For partners, the *final* regs differ from the *proposed* regs and provide that the UBIA of each property is allocated among the partners in the same manner in which the book depreciation generated by the asset is allocated.

9. Clarification Made by Revised Final Regs @ 2-4-19 to Sec. 743 Adjustments: In the "final corrected regs," the IRS agrees that Sec. 743(b) basis adjustments should be treated as "qualified property" to extent the Sec. 743(b) basis adjustment "reflects an increase in the FMV of the underlying qualified property."

As a result, the final regs define an "excess section 743(b) basis adjustment" as **an amount that is determined with respect to each item of qualified property and is equal to an amount that would represent the partner's Sec. 743(b) basis adjustment with respect to the property as determined under Reg § 1.743-1(b) and Reg § 1.755-1, but calculated as if the adjusted basis of *all* of the partnership's property was equal to the unadjusted basis immediately after acquisition (UBIA) of such property.**

Furthermore, the "absolute value of the excess section 743(b) basis adjustment" will *not* be permitted to exceed the "absolute value of the total Sec. 743(b) basis adjustment with respect to qualified property."

The "excess section 743(b) basis adjustment" is then treated as a *separate* item of "qualified property" placed in service when the transfer of the partnership interest occurs (i.e., a new holding period is accorded this stepped-up basis adjustment).

This rule is limited solely to the determination of the depreciable period for purposes of Sec. 199A and is *not* applicable to the determination of the placed-in-service-date for depreciation or tax credit purposes.

The recovery period for such property is determined under **Reg §1.743-1(j)(4)(i)(B)** with respect to *positive* basis adjustments and **Reg §1.743-1(j)(4)(ii)(B)** with respect to *negative* basis adjustments.

> **Comment:** The version of the final regs that existed prior to the current correction had provided that an "excess section 743(b) basis adjustment" was defined as an amount determined with respect to *each* item of qualified property equal to the *excess* of the partner's Sec. 743(b) basis adjustment with respect to each item over an amount that would represent the partner's Sec. 743(b) basis adjustment with respect to the property, but calculated as if the adjusted basis of *all* of the partnership's property was equal to the unadjusted basis immediately after acquisition (UBIA) of qualified property of such property.

10. SSTB Limitations Also Apply to QBI Received from PTP: The final regs clarify that the SSTB limitations (i.e., restrictions which otherwise apply within the applicable phaseout ranges) also apply to such QBI received through a publically traded partnership (PTP). In other words, QBI from an SSTB does not lose its characterization as such merely because it is coming on a K-1 from a PTP.

Outstanding Issues Remain Despite Final Sec. 199A Regs: Even though the final regs have given us some needed clarification on a number of issues, there are still a number of unanswered questions.

1. Impact of Partner's Unreimbursed Expenses on QBI: Partners can incur **significant unreimbursed expenses** in connection with the conduct of the partnership's business. And, given that these expenses pass the "ordinary and necessary" standard under **Code §162**, they would be deductible on **Schedule E, page 2** (i.e., against K-1 income flowing through from the entity).

Another expense taken on Schedule E would be **interest expense** incurred to **buy into a flowthrough entity** (i.e., partnership or S corp), or to make a **capital contribution** to such entities. (Cf. **IRS Notice 89-35, Part IV.**) But, the *final* regs decline comment (**Cf. Page 44**) on whether these expenses will serve to reduce QBI as follows:

> *"The Treasury and IRS decline to address whether deductions for unreimbursed partnership expenses, the interest expense to acquire partnership and S corporation interests, and state and local taxes are attributable to a trade or business as such guidance is beyond the scope of these regulations."*

> **Comment:** It would seem that if the final regs require a reduction in QBI for: (1) the 50% of S/E tax for AGI; (2) self-employed health insurance premiums; and (3) certain contributions to retirement plans, **then these expenses would also be taken against any QBI flowing from that business**.

2. UBIA in Tax-Deferred Transactions with Carryover Basis: Reg. §1.199A(c)(3)(iv) provides that, solely for purposes of **Code §199A**, if "qualified property" is acquired in a transaction described in **Code §168(i)(7)(B)** (i.e., **Code §332** - liquidation of a sub into a parent corporation**, Code §351** - tax-free incorporation**, Code §361** - reorganizations**, Code §721** - transfers to partnership and **Code §731** - liquidating distributions from a partnership), the transferee's UBIA in the property received will be the *same* as the transferor's, *decreased* by any money (or, FMV of property) received, or *increased* by any money paid to acquire the property in the transaction.

> **Comment:** The *proposed* regs had insisted that it should only be the *carryover basis* (i.e., adjusted basis at the time of the transfer) which would be the "unadjusted basis immediately after acquisition" (UBIA) that the transferee would have received for Sec. 199A purposes.

The *final* regs also clarify that the UBIA of the transferor will flow to the transferee in a **Code §1031** like-kind exchange or a **Code §1033** casualty situation. Nevertheless, the final regs fail to address what the UBIA should be where property is received by way of a gift (i.e., **Code §1015**) or pursuant to a property settlement in a divorce (i.e., **Code §1041**).

However, if a taxpayer either receives money or property *not* of a like kind to the relinquished property (i.e., "boot") or provides money or other property as part of the exchange, the taxpayer's UBIA in the replacement property is correspondingly adjusted.

The taxpayer's UBIA in the replacement property is *adjusted downward* by the excess of any money (or, FMV of other property) received by the taxpayer in the exchange over the taxpayer's appreciation in the relinquished property (i.e., excess boot).

"Appreciation" for this purpose is the excess of the relinquished property's FMV on the date of the exchange over the FMV of the relinquished property on the date of acquisition by the taxpayer. This reduction for "excess boot" in the taxpayer's UBIA in the replacement property "reflects a partial liquidation of the taxpayer's investment in qualified property."

If the taxpayer adds money (or, other property) to acquire replacement property, the taxpayer's UBIA in the replacement property is *adjusted upward* by the amount of money paid (or, the FMV of the other property transferred) to reflect additional taxpayer investment.

If the taxpayer receives other property in the exchange that is "qualified property," the taxpayer's UBIA in the qualified other property will equal the FMV of this other property. As a result, a taxpayer who receives qualified other property in the exchange is treated, for UBIA purposes, as if the taxpayer receives cash in the exchange and uses that cash to purchase the qualified property.

If the taxpayer reinvests in assets that do *not* meet the requirements for "qualified replacement property" (i.e., they are *not* considered to be of a "like-kind" for **Code §1031** purposes), or if they otherwise fail this same test for **Code §1033** (i.e., the stricter "like-kind" standard in casualty situations, **such qualified property is treated as *separate* qualified property that the individual (or, RPE) first placed in service on the date on which such qualified property was first placed in service by the individual (or, RPE)** (i.e., the "old" UBIA does *not* carry over and the "new" UBIA becomes whatever the cost basis would be for the new property since these are now taxable v. tax-deferred exchanges).

Comment: Inherited property which receives a new basis equal to the FMV as of the date of death (i.e., under **Code §1014**), would receive a "fresh" UBIA equal to this amount, along with a new holding period. Likewise, property received in a non-liquidating distribution from a corporation (i.e., under **Code §311(b)**) or in liquidation (i.e., under **Code §331**) **would receive a UBIA equal to the FMV at the time of the distribution**.

Comment: Since a step-up to the FMV paid for the acquisition of stock is instead treated as an "asset acquisition" pursuant to the **Code §338(h)(10)** election **should also receive a "fresh" UBIA amount equal to the amount paid for the corporation's stock**.

Comment: Absent gain or loss recognition, upon a dissolution of a partnership with each partner receiving a pro rata portion of each of the entity's assets (i.e., under **Code §708(a)**), the **UBIA of the assets received should carry over with the property**.

Example: An LLC holding title to a appreciated building passes out the asset in either a nonliquidating or liquidating distribution so that the partners can carry out a "drop and swap" where some partners enter into a taxable sale's transaction (i.e., maybe due to the fact that they have a large capital loss carryover, or substantial suspended passive losses, to cover any gain), while other partners carry out a like-kind exchange (Cf. ***Bolker*** and ***Magneson***). The UBIA for the qualified replacement property received in the LKE is covered in the discussion above. And, for those partners that carry out a taxable sale, their UBIA would simply be the cost of the newly-acquired asset.

Comment: If the dissolution of the partnership was so that the former partners were going to hold the assets as tenants-in-common (or, go their separate ways such as where a professional firm is broken up and the former partners are now proprietors in their respective SMLLCs), the **UBIA that the partnership had in the assets distributed should carry over**. But, the final regs do *not* address partnership dissolutions.

Comment: In a transaction where an **LLC member buys out the remaining members** (e.g., A buys out B and C effective as of 1/1/18) so that a SMLLC results, he would have 1/3 of the UBIA from the former partnership. And, for the other 2/3's interest purchased from B and C, he would get the equivalent of a Sec. 754 step-up to the FMV of what was paid for UBIA purposes.

3. Who Should Be Subject to the Understatement Penalty?

- Underpayment Penalty Threshold Lowered for Misstatement of Sec. 199A Deduction

Special rules for Code §6662 underpayment penalty: Code §6662(a) provides a penalty for an underpayment of tax required to be shown on a return. Under **Code §6662(b)(2)**, the penalty applies to the portion of any underpayment that is attributable to a "substantial understatement" of income tax. **Code §6662(d)(1)** defines "substantial understatement" of income tax, which is generally an understatement that exceeds the *greater* of 10% of the tax required to be shown on the return or $5,000. But, **Code §6662(d)(1)(C)** provides a special rule in the case of any taxpayer who claims the deduction allowed under **Code §199A** for the for the taxable year, which requires that **Code §6662(d)(1)(A)** is applied by substituting "5 percent" for "10 percent." (Cf. **Reg. §1.199A-1(e)(5)**)

So, if the RPE preparer provides misinformation (or, no Sec. 199A information at all) and the taxpayer receiving this erroneous K-1 uses it to their detriment, should it be the Form 1040 taxpayer (and, their preparer) who "suffer" from the mistakes make?

Comment: Any recipient of a K-1 is entitled to a complete copy of the return (e.g., Form 1065 or Form 1120S) so that might help in being able to verified (or, obtain) any missing information. The best course of action in the case of mistakes or disagreements would not to file a **Form 8082** for "inconsistent treatment." Instead, the missing information can be obtain (or, erroneous information corrected) and used, even if it is on an amended tax return.

Example: The RPE preparer fails to list any UBIA for a **Form 8825** rental activity otherwise part of a **Form 1065** tax return filing. Nevertheless, the LLC member (and, their preparer) obtain the **Form 4562** depreciation schedule and can ascertain the original cost of the property (and, the fact that the depreciation recovery period had *not* ended as of the last day of the tax year, or that it was sold sometime during the year - as would be indicated on **Form 4797**). As a result, the Form 1040 preparer proceeds to use this UBIA to support a Sec. 199A deduction for any rental income.

4. Pre-2018 Installment Gains or Sec. 481(a) Adjustments

Since these both reflect items that occurred before **Code §199A** was even in the law, it is *not* possible that they could have come from a "qualified trade or business" for purposes of the new Sec. 199A deduction. Neither the proposed or final regs address this issue specifically though. But, as is the case with pre-2018 suspended losses or deductions (e.g., passive losses now freeing up for the first time in 2018 due to the PAL "disposition rule"), the portion of an installment gain resulting from a sale that took place prior to 2018 (or, a Sec. 481(a) deduction due to "catching up" on missed depreciation) should be ignored for Sec. 199A.

Comment: Keep in mind that for **A/REC, on the accrual basis**, this **represents income already picked up in a prior tax year**. So, when you have "negative" adjustment (i.e., from filing a Form 3115 for a change from the accrual to cash method of accounting), **it should *not* represent a reduction of current year's QBI**. In other words, for example, when you actually get the cash for an outstanding A/REC in 2018 and you are on the cash method of accounting, **do *not* reduce this source of "qualified business income."**

Comment: The **opposite is true with A/PAY**. You took an accrued deduction in a prior tax year that now you are adding back (since you have *not* yet expended any actual cash for its payment). **When you do, in fact, pay cash in 2018 to satisfy an outstanding expense, it would represent a reduction of QBI.**

Comment: The jury is still out on "cancellation of debt" (COD) income that cannot otherwise be excluded (i.e., on **Form 982**), if the original debt obligation arose prior to 2018 (and, the enactment of TCJA). Arguably, the income being recognized by a trade or business upon the forgiveness of debt should *not* be tied to when the debt first arose. Instead, it is simply an other income item to be reported for tax years after 2017.

5. Handling Rental Income as Potential QBI

It seems as though we have four distinct types of "landlords" based on the Sec. 199A final regs as follows:

A. Taxpayer with Just a Few Schedule E Rentals Whose Tenants Renew Their Leases on an Annual Basis.

- These landlords have a few properties which they report on Schedule E (or, maybe to limit liability as H & W owning the property through an LLC and on Form 8825). They may even use a property management company for out-of-town rentals such as vacation homes at resort destinations.

- They would almost never meet the "250-hour safe harbor" outlined in **Notice 2019-07** (discussed above). So, they would have to look to "other relevant Code sections" to determine if they meet the "Sec. 162 T/B standard" in order to possible qualify for the new Sec. 199A deduction.

B. "Busy Professional" with Multiple Rental Properties

- This scenario might involve a busy professional such as a doctor, lawyer, dentist, accountant, etc. who invests in multiple rental properties and who spends much more time on an annual basis than the couple described above. Nevertheless, it is again no where near the 250 hours needed to meet the IRS "safe harbor."

- Again, they would have to insist that Congress intended their rental income to qualify for the Sec. 199A deduction by looking to the "other relevant Code sections" (including the fact that the very reason that they are allowed to deduct insurance, utility and maintenance costs is because they are, in fact, a "trade or business" under **Code §162**.

C. Taxpayers Who "Eat, Sleep and Breathe Real Estate"

- These landlords/lessors normally have no other sources of W-2 or self-employment income and derive a good deal of their overall gross income from rental properties. In addition, there is probably a good chance that they qualify as "real estate professionals" for purposes of the **Code §469** passive loss rules (i.e., > 750 hours and > 50% of their time in "real estate trades or businesses").

- As far as the Sec. 199A deduction, they need not worry about the "250-hour safe harbor" since that test is probably being met as well so that (at least on an aggregated basis) their rental activities are meeting the "Sec. 162 T/B standard." Their bigger concern is that lacking any substantial "wages" on their rental schedules (even on an aggregated basis), they need sufficient UBIA (which is only 5% as effective v. the "50% of wage test") in supporting an initial 20% deduction under Sec. 199A.

D. "Self-Rentals" to "Materially Participating" RPE Business Owners

- The "Sec. 162 T/B test" is deemed met for these owners, especially where they are the sole tenants of the rental property. The question arises, however, when they only occupy a small percentage of the overall square footage of a building (Cf. **"Examples" above in #7. "Self-Rentals to Commonly-Controlled Businesses"**).

- Again, however, there must still be sufficient UBIA to support the initial Sec. 199A deduction, unless a proper "aggregation election" is made in which case the "wages" of the commonly-controlled business may be considered instead of the UBIA for support purposes.

Comment: Whether the rental activity meets the "trade or business standard under Code Sec. 162," there still will *not* be sufficient UBIA to support the initial Sec. 199A deduction **if the property in question has been sold during the tax year**. Or, even if it is still on-hand and in service, **if the property has been fully depreciated** under whatever appropriate method the taxpayer is employing to write off the cost of the property, **there will likewise be no UBIA at yearend to support the Sec. 199A deduction**.

Comment: If there is a hesitation to claim a rental activity as meeting the "Sec. 162 T/B standard," taxpayers may be inclined to instead invest in real estate through a "real estate investment trust" (REIT) where there is no such standard necessary to claim the Sec. 199A deduction. Moreover, there is no need to have any "wages" or "UBIA" to support this deduction.

6. Self-Employed Health Insurance Deduction Associated with S Corporation Income or Partners

This expense **should *not* serve to reduce QBI since this deduction is attributed to the wages of the S corporation** (i.e., the shareholder wage was increased by health insurance attributed to that shareholder as reported in Box 1 "Federal Wages" on their W-2). And, this should be the **same conclusion with respect to self-employed health insurance of a partner**. Because the health insurance increased the partner's guaranteed payments (income which does *not* generate QBI), the health insurance deduction does *not* reduce QBI. Consequently, the self-employed health insurance deduction is a reduction of QBI for only sole proprietors.

<u>Comment</u>: Furthermore, retirement plan contributions of partners do *not* reduce QBI if the amount was treated as a guaranteed payment by the partnership.

<u>Comment</u>: But, remember in the final Sec. 199A regs discussed previously, they stated that these aforementioned deductions would reduce QBI at the owner level. Nevertheless, if that were the case, you would be “reducing QBI twice” (i.e., once at the K-1 entity level, and then again on the owner’s personal return).

<u>Notes</u>: