IRS

SMALL BUSINESS/SELF-EMPLOYED

PARTNERSHIP JOB AID*

OBJECTIVE OF THIS PARTNERSHIP JOB AID

This Partnership Job Aid creates a baseline level of capacity for SB/SE field agents to know where to begin in a partnership audit, what types of issues to focus on, and why those issues are significant from an adjustment standpoint. The Partnership Job Aid provides suggested Information Document Request (IDR) items and interview questions for common and recurring tax issues. The Partnership Job Aid also provides suggested action steps, legal analyses using simple terms, and explanations as to why these steps should be taken. We intend that the Partnership Job Aid will help agents identify the issues to examine in their cases more often, save them time in the process, and give them a greater appreciation of the untapped value to the Service in pursing partnership audit issues.

HOW TO USE THIS PARTNERSHIP JOB AID

This Partnership Job Aid is divided by topic into seven separate sections. Each topic section begins with suggested IDR items for common and recurring partnership tax issues to send to the taxpayer or taxpayer's representative at the onset of a partnership audit. This Partnership Job Aid is designed so that you can simply print the page(s) with the questions applicable to your case for each topic section and attach the page of questions to your IDR. We recommend always sending the IDR items contained in the first topic section "Partnership Agreement, Legal Status, and Description of Each Activity." The remaining IDR items contained in the other topic sections should be sent to the taxpayer or taxpayer's representative depending on the issues in your case. It has been our experience that most, if not all, of the IDR items contained in this Partnership Job Aid should be sent in partnership cases involving partnership liabilities, negative capital accounts, and loss allocations. The explanations are for internal IRS use and should not be sent to the taxpayer or taxpayer's representative. Do not forget to look at non-subchapter K issues since all the normal business issues could arise in partnership cases (e.g., deductibility or capitalization of expenses, limitations on interest, accounting methods, and charitable deductions). Please consult with your Senior Flow-Through Specialist or local Area Counsel partnership cadre with any questions about how to use this Partnership Job Aid.

*The scope of this Partnership Job Aid is limited to partnership-level items and does not address items determined at the partner level that are not referenced in the Final Partnership Administrative Adjustment (FPAA) or Final Partnership Adjustment (FPA).

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NOTE ON THE PARTNERSHIP AUDIT REGIME UNDER BBA

For tax years beginning on or after January 1, 2018, all partnerships required to file a Form 1065 are subject to the centralized partnership audit regime established by the Bipartisan Budget Act of 2015 (BBA) unless the partnership makes a valid election out of BBA during each tax year. Additionally, if the entity files a partnership return, it is subject to BBA (unless it elects out) even if it is determined during the exam that the entity is not actually a partnership. BBA applies to all entities that file a partnership return. See I.RC. § 6241(8), Treas. Reg. § 301.6241-5.

Partnerships may elect to have BBA apply to their returns filed for tax periods beginning after November 2, 2015 and before January 1, 2018. BBA replaced the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) partnership audit procedures and the Elective Large Partnership provisions. TEFRA allowed for partner-level adjustments to affected items resulting from adjustments to partnership items. BBA no longer allows this.

BBA applies only to determining tax liabilities of any person under chapter 1 of subtitle A of the Code. Under BBA, partnership adjustments, any penalties, additions to tax, or additional amounts that relate to any partnership adjustments must be determined at the partnership level. Any legal or factual determinations underlying any partnership adjustments or determinations must also be determined at the partnership level.

A partnership adjustment under BBA is any adjustment to a partnership-related item (PRI) and includes any portion of an adjustment to a PRI. BBA defines a PRI as including any item or amount with respect to the partnership which is relevant in determining the tax liability of any person under chapter 1 of subtitle A of the Code and any partner's distributive share of any such item or amount. An "item or amount with respect to the partnership" means an item or amount required to be shown or reflected on the partnership return for the partnership's taxable year or is required to be maintained in the partnership's books or records.

Only if the partnership has made a valid election out of BBA is the partnership subject to deficiency examination procedures at the partner level.

I. PARTNERSHIP[1] AGREEMENT, LEGAL STATUS, AND DESCRIPTION OF EACH ACTIVITY

1. Provide copies of all agreements including, but not limited to, the partnership agreement or limited liability company (LLC) operating agreement, term sheets, management contracts, licensing arrangements, joint marketing/development agreements, participatory lease or loan agreements (hereafter referred to as the "partnership agreements"). Also, provide copies of all appendices, attachments, and schedules, and all amendments in effect during the audit period. To the extent any partnership agreements are oral, provide proof of the agreement between the parties.

2. Provide a structure chart showing entities owned in whole or in part by the partnership and entities or individuals that own the partnership, tracing it up through tiers if need be to reach the terminal partners.

3. Confirm the legal status/entity type of the partnership (e.g., general partnership (GP), limited partnership (LP), limited liability partnership (LLP), or LLC) and identify what jurisdiction the entity was organized in and what state's laws apply to the partnership. Provide copies of any legal entity classification elections filed on behalf of the entity, e.g., Forms 8832, Entity Classification Election.

4. For each audit year, provide a brief description for each of the partnership's activities (e.g., trade or business or investment, rental real estate, and other activities, including activities conducted through other partnerships in which this partnership owns an interest ("lower-tier partnerships")) and how each activity is treated.

5. Provide the number and names of partners of the partnership. This is presented in the Form 1065, Schedules K-1. For each partner identified, provide the following: legal status of each partner (e.g., individual, corporation, partnership, trust, wholly owned entity) and any relationship between partners recognized by the Internal Revenue Code and the regulations thereunder (e.g., husband and wife, parent-child, corporation-owner, and trust-beneficiary).

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[1] The term "partnership," as used herein, includes all entity types which are required to file a Form 1065: U.S. Return of Partnership Income (e.g., general partnership, limited partnership and limited liability company).

A. <u>Why Are We Asking</u>

(1) <u>The Partnership Agreement</u>

In general, the partnership agreement represents the economic arrangement among the partners, which determines how items of the partnership (i.e., income, deduction, gain and loss) are to be allocated among the partners. The partnership agreement should also explain how distributions are made and each partner's rights or obligations on liquidation of the partnership. It may also describe what tax elections the partnership should make (e.g., section 754) The partnership agreement is essential to audit a partnership return. Subchapter K provides rules governing partnership arrangements and allows partners to be flexible in determining their economic deal. <u>See</u> Treas. Reg. § 1.701-2(a). Partners may misuse the flexibility of the Subchapter K rules to allocate items that do not match the economics of the arrangement. The partnership agreement is used to determine if and how the partners are following the rules of Subchapter K. The types of issues we often see from reviewing partnership agreements are income/loss allocation issues, disguised sales, and gain triggers, which are discussed in detail below.

The partnership agreement is a contract among partners in a partnership that sets out the terms and conditions of their relationship. The partnership agreement includes the original agreement, collateral agreements, and any modifications. The agreements must be agreed to by all partners or adopted in any other manner provided by the partnership agreement. The agreements or modifications can be oral or written. Partners can modify the partnership agreement for a tax year after the close of the year (but not later than the date for filing the partnership return for the year). This filing date doesn't include any extension of time. <u>See</u> Treas. Reg. § 1.761-1(c).

> **Example 1**: A calendar year partnership adopts an amendment applicable to its 2016 tax year in July 2017; the amendment changes the percentage interests of the partners for the 2016 tax year. The amendment is not considered part of the partnership agreement for 2016 pursuant to Treas. Reg. § 1.761-1(c) but may be considered part of the partnership agreement for 2017 and later years.

If the partnership agreement or any modification is silent on any matter, the provisions of local law are controlling.

The partnership agreement should set forth each partner's percentage ownership, each partner's expected economic benefit (e.g., cash or property distributions), and economic burden (e.g., cash or property contributions). Some partnership agreements also describe how the partnership's book capital accounts are maintained (a partner's book capital account reflects the partner's economic interest in the partnership) and if any partner is obligated to restore a negative capital account balance when the partner leaves the partnership (i.e., through a deficit restoration obligation). Finally, the partnership agreement should establish who has the authority to manage the partnership.

The partnership agreement should also reflect how the partners anticipate sharing in the economic benefits or burdens of the partnership. The partnership agreement should establish each partner's share of income, deductions, gains, losses, and credits. The allocations of income, deductions, gains, losses, and credits made per the partnership agreement govern how partnership items relevant for federal income tax purposes are allocated to the partners (i.e., tax follows book), which are reported on each partner's Schedule K-1.

You may be tempted to jump to the tax sections of the partnership agreement. We recommend that you first try to understand the business deal between the partners. This should enable you to better understand the tax allocations. In many cases, the tax allocations will try to follow the way in which profits and losses are shared from an economic persepctive.

Finally, the partnership agreement should also reflect who has the authority to act for the partnership during an audit by the Internal Revenue Service (Service). The partnership agreement may specifically designate a Tax Matters Partner (TMP) (for TEFRA) or a Partnership Representative (PR) (for BBA), although the PR is officially designated on Form 1065 for each respective taxable year.

(2) Legal Status/Jurisdiction

To be treated as a partnership for tax purposes, two or more persons must agree to carry on a trade or business, or an investment activity, and each partner must: (1) contribute money, property, or services; (2) own a capital interest or profits interest in the activity; and (3) share in the profits and losses of the partnership. See I.R.C. § 761(a), I.R.C. § 7701(a)(2), Treas. Reg. § 301.7701-1, -2, and -3; see also Culbertson v. Commissioner, (337 US 733 (1949)) and Luna v. Commissioner, (42 TC 1067 (1964)). No formal partnership agreement needs to be made. A joint undertaking to share expenses is not a partnership. In addition, mere co-ownership of property is not a partnership. See Treas. Reg. § 301.7701-1.

Form 1065 is an information return which gives the Service a snapshot of the partnership's financial status and reportable activity for the year. It can be more difficult to understand a partnership's activity through the Form 1065 than it might be for a corporate tax return, because in some way the 1065 merely slices and dices numbers and sends them out to its partners. So in order to understand the tax allocation provisions, it is important to understand the partnership's business deal before studying the Form 1065. The partners must report and pay tax (including possible self-employment tax) on their allocable share of taxable income from the partnership regardless of whether such income was distributed to the partners (as reported on the Schedule K-1 attached to the Form 1065 and sent to each partner).

All entities that are U.S. partnerships for federal tax purposes must file a partnership return - regardless of their local law status as a GP, LP, or LLP. This includes most LLCs that are classified as partnerships for federal tax purposes under Treas. Reg. § 301.7701-3. An entity filing a Form 1065 should report whether it is a GP, LP, LLP, or LLC. Individuals, corporations, and trusts cannot file a Form 1065. Simply because an entity has filed a partnership return (Form 1065) does not mean that the entity is eligible to file a partnership return. However, if an entity

that is not otherwise a partnership files a Form 1065, that entity is still subject to the BBA provisions for the years in which the Form 1065 are filed.

Certain foreign partnerships with income in the U.S. must also file Form 1065. As of 2018, a foreign partnership with U.S. partners is not required to file a Form 1065 if it has no effectively connected income (ECI) during its tax year; had U.S. source income of $20,000 or less during its tax year; less than 1% of any partnership item of income, gain, loss, deduction or credit was allocable in the aggregate to direct U.S. partners at any time during its tax year; and the partnership isn't a withholding foreign partnership as defined in Treas. Reg. § 1.1441-5(c)(2)(i). A foreign partnership with no U.S. partners is not required to file a Form 1065 if the partnership has no ECI during its tax year; had no U.S. partners at any time during its tax year; it (or another withholding agent) filed all required Forms 1042 and 1042-S as required by Treas. Reg. § 1.1461-1(b) and (c); the tax liability of each partner for amounts reportable under Treas. Reg. § 1.1461-1(b) and (c) has been full satisfied by the withholding of tax; and the partnership isn't a withholding foreign partnership as defined in Treas. Reg. § 1.1441-5(c)(2)(i). A U.S. person (including individuals and corporations) might also be required to file Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships, to report items of income, deduction, gain, loss, and credit because of being a partner in a foreign partnership.

Local law controls the rights of the parties in any transaction (e.g., contract rights, property rights, and creditor's rights). Therefore, local law is essential in understanding the economic reality of any transaction reported on a Form 1065. Federal income tax rules control the tax results of transactions, but property rights and obligations are determined under local law. Therefore, an understanding of how a transaction is characterized under local law is essential.

(3) Description of Each Activity

Generally, a partnership may conduct more than one activity, and in such cases, it is important to understand the different activities being conducted by a partnership to properly determine whether certain items reported by the partnership can be claimed by the partner on the partner's personal income tax return. Certain provisions of the Internal Revenue Code require that items of income, deduction, gain, loss, and credit be reported on an activity-by-activity basis. For example, the at-risk rules under § 465 and the passive activity loss rules under § 469 specifically require activity-based reporting. These provisions may limit the amount of losses a partner can claim on its personal return for any given activity being conducted by the partnership. Proper activity-based reporting to partners makes it possible for partners to apply these limitations. Loss limitation provisions like § 465 and § 469 are applied at the partner level. Activities, however, must be reported at the partnership level.

B. What Do I Need to Do When I Get the Information?

- Confirm that the arrangement is a partnership.

- Confirm that you have obtained complete copies of all partnership agreements (as defined above), appendices, attachments, and schedules, and all amendments that are in effect for the year(s) of the examination.

- Check whether the partners identified in the agreements are the same as the partners who received the Schedules K-1 for the years of the examination.

- If any amendment to the partnership agreement is dated or was signed: 1) after the close of the taxable year to which it relates; and 2) later than the due date (not including extensions) for the filing of the Form 1065 for such year, then such amendment should not be considered in analyzing the terms of the partnership agreement for that year. Treas. Reg. § 1.761-1(c). If the partnership agreement provides that oral agreements/amendments are permitted and the TMP or PR argues that a later date to memorialize this prior change should be allowable, this is a question of proof you should coordinate with your local Area Counsel partnership cadre.

- Verify the entity type, including through account transcripts and Forms 8832, and what local law applies.

- Determine whether the partnership followed activity-based reporting requirements. This is necessary to properly prepare the affected-items report.

II. <u>Tax Allocations/Substantial Economic Effect</u>

6. Identify whether the partnership agreement uses the safe harbor in § 704(b) in terms of allocations to the partners or targeted allocations or uses allocations based on the partners' interests in the partnership.

7. If the partnership uses the § 704(b) safe harbor, identify any provisions in your partnership agreement that relate to the partners' allocations of income/expense, gain/loss, deductions, and credits (or other items) for each partnership activity (the "distributive share" provision(s)). Specifically identify any "special allocation" provision(s) (i.e., with respect to allocations not made in accordance with the partner's economic interests in the partnership). Source any deductions to equity or liabilities and, if to liabilities, to recourse, nonrecourse, or partner nonrecourse liabilities. Provide the § 704(b) book workpapers.

8. Were all allocations of income/expense, gain/loss, deductions, and credits (or other items) made in accordance with the provisions of the partnership agreement? If not, explain why.

9. Did the partnership maintain partners' capital accounts under any of the following methods (please check all methods that apply)? Tax Basis___ § 704(b)___ GAAP___ Other___. For each method used (whether for tax or internal reporting purposes), provide copies of the partnership's capital accounting workpapers and reconciliations to the items reported on the Schedule K-1 return.

10. For each audit year, does any partner have a deficit § 704(b) capital account balance? If yes, please explain the reason for the negative amount. Confirm if the partners agreed to a deficit restoration obligation, qualified income offset, or minimum gain chargeback provision or whether any partner guaranteed the liabilities of the partnership.

11. For each audit year, were any tax allocations made (directly or indirectly) to any tax-exempt or foreign partner(s)? If yes, please identify any such allocations.

12. Has the partnership made any capital account revaluation adjustments since its inception? If yes, separately identify and explain any § 704(b) capital account revaluation adjustments ("book up" or "book down") and any resulting reverse or forward § 704(c) tax allocations. What method did the partnership use to value its assets for purposes of revaluation? Please provide any appraisals for purposes of the revaluation.

13. Does the partnership have any built-in gain or loss property that was contributed by any of the partners ("§ 704(c) property") or due to any § 704(b) capital account revaluation adjustments resulting in built-in gain or loss property inside the partnership ("reverse § 704(c) property")? If yes, did the partnership have depreciation or other income or loss items allocated under section 704(c)? For each § 704(c) property and reverse § 704(c) property, please identify which method of § 704(c) allocation was followed (i.e., the "traditional" method, the "traditional method with curative allocations," or the "remedial method"). Identify where the partnership agreement provides for such § 704(c) method to be used. Provide copies of the partnership's § 704(c) workpapers. Did the partnership sell or

distribute any property that had built-in gain or loss during the audit period? If yes, please identify which method of § 704(c) allocation was applied (i.e., the "traditional" method, the "traditional method with curative allocations," or the "remedial method").

14. For the audit period, does any partner hold an interest in the partnership that was received (in whole or in part) through a debt-for-equity exchange? If yes, explain and support your position. Provide an appraisal of the equity and transactional documents relating to the debt-for-equity exchange.

15. Did the partnership make a § 754 election by attaching a statement to the partnership's timely filed return (including any extensions) for the year or prior to the year under audit? If yes, did the partnership make a § 734(b) adjustment (related to a property distribution) or a § 743(b) adjustment (related to the transfer of a partnership interest) during the tax period?

16. If the partnership does not have a § 754 election in effect for the year under audit, does the partnership have a substantial built-in loss for the year under audit (i.e., 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 for sales or exchanges of partnership interests occurring before December 31, 2017; or a substantial built-in loss exists if the partnership's adjusted basis in partnership property exceeds the fair market value of such property by more than $250,000, or if 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 for sales or exchanges of partnership interests occurring after December 31, 2017)? If yes, did the partnership make a § 734(b) adjustment (related to a property distribution) or a § 743(b) adjustment (related to the transfer of a partnership interest) during the tax period?

17. Did the partnership make any adjustment to reduce the disparity between the partner's share of inside basis and the partner's outside basis under § 743(b)? If yes, separately identify and explain any § 743-related basis adjustments ("step up" or "step down"). In connection with this, identify any Treas. Reg. § 1.752-7 contingent liabilities, whether organic or acquired, and quantify the effect on § 743(b) basis adjustments of any Treas. Reg. § 1.752-7 liabilities. Confer with the National Office on the effect of any Treas. Reg. § 1.752-7 liability (A Treas. Reg. § 1.752-7 liability is any obligation, the incurrence of which did not (A) create or increase the basis of any of the obligor's assets, (B) give rise to an immediate deduction to the obligor, or (C) give rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital).

18. Did the partnership make any adjustment to the basis of partnership assets under § 734(b)? If yes, separately identify and explain any § 734(b) basis adjustments ("step up" or "step down"). Confer with the National Office on the effect of any Treas. Reg. § 1.752-7 liability.

A. <u>Why Are We Asking: Common Issues: I.R.C. §§ 704(a)-(c)?</u>

The Service is charged with verifying that all tax allocations by the partnership to its partners are accurate. Section 704(a) states a partner's tax allocation of income, gain, loss, deductions, or credit shall be determined by the partnership agreement. This means that any tax allocation shall be determined by, among other things, the economic deal agreed to by the partners. Therefore, the Service must understand the economic deal between the partners, as a starting point, in determining if the tax allocations are proper.

However, the regulations do not require that all allocations be done proportionately with each partner's economic interest. The regulations allow the partnership to make special allocations of income and loss items as long as these allocations meet the requirement under the § 704(b) regulations.[2] Allocations will be respected if they have substantial economic effect as provided in the § 704(b) regulations or, considering all the facts and circumstances, they are made in accordance with the partners' interests in the partnership (PIP).[3] This means that the item will be allocated to those partners who actually bear the economic burden or enjoy the economic benefit of that item based upon all the facts and circumstances. Factors considered include relative contributions, interests in economic profits and losses, interests in cash flow and other non-liquidating distributions, and rights to distribution on liquidation.

(1) Does a Tax Allocation Match Economic Reality?

a. Make Sure Book Capital Accounts Have Correct Balances

The economic deal between the partners is measured by each partner's book capital account. Each partner's positive book capital account, if maintained and revalued correctly, represents what that partner could expect to get out of the partnership upon liquidation of their interest. Thus, if a partner's book capital account has been maintained correctly, it represents that partner's net economic investment in the partnership. Therefore, it is important to know if the book capital accounts have been maintained properly.

The Service must compare the partnership's § 704(b) workpapers to the rules governing the proper maintenance of book capital accounts. Treas. Reg. § 1.704-1(b)(2)(iv) provides detailed instructions on the maintenance of book capital accounts that must be followed. Under Treas. Reg. § 1.704-1(b)(2)(iv)(a) and (b), book capital accounts are considered properly determined and maintained only if each partner's capital account is increased by:

- The amount of money contributed to the partnership by the partner.
- the fair market value of property contributed by the partner to the partnership (net of liabilities that the partnership is considered to assume); and
- book allocations to the partner of partnership income and gain, including tax-exempt interest.

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[2] See Treas. Reg. § 1.704-1(a)(1)(i)

[3] Note: The Service is required to reallocate items of tax in accordance with the partners' interests in the partnership (PIP) if that allocation fails the substantial economic effect safe harbor discussed below. See Treas. Reg. § 1.704-1(b)(3).

And is decreased by:

- the amount of money distributed to the partner by the partnership.
- the fair market value of property distributed to the partner by the partnership (net of liabilities that the partnership is considered to assume).
- allocations to the partner of partnership expenditures that are neither deductible in computing taxable income nor properly chargeable to capital account, including § 705(a)(2)(B) items (e.g., gambling, losses, bribes, charitable contributions), § 709 organizational and syndication expenses that are not amortized under Section 709(b) and losses disallowed under § 267(a)(1); and
- book allocations of partnership loss and deduction (excluding the items listed in the prior bullet point).

The Service must allocate income/gain and expense/loss items to correct the book capital account balance that has not been properly maintained.

b. Make Sure Any Negative Book Capital Account is Supported by a Legal Obligation to Eliminate the Negative Balance

Look to see if there is a special allocation, and if a special allocation exists, look to see whether it causes a deficit balance. A negative book capital account shows a partner has taken more economically from the partnership than that partner has contributed (or earned in the form of net profits or gains from partnership activities). This is much like an overdrawn checking account. The partner must show they will replace the excess they have taken out.

The Service must see something in writing evidencing the partner's requirement to repay the negative book capital account balance. Relevant provisions can be found in the partnership agreement (an unlimited deficit restoration obligation, qualified income offset, and/or minimum gain chargeback), or a separate contractual agreement (a guarantee or promissory note). These types of agreements require the partner to make up the negative balance.

(2) Safe Harbors Under the § 704 Regulations

The § 704(b) regulations provide a framework for determining whether tax allocations contained in a partnership agreement will be respected, and, if not, how the invalid allocations will be reallocated. The overriding principle is that the allocations must follow the partners' interests in the partnership. If a partner will benefit economically from an item of partnership income or gain – the tax item representing that income or gain must be allocated to him so that he bears the correlative tax burden. Conversely, if a partner will suffer the economic burden of an item of partnership loss or deduction, he must be allocated the associated tax benefit. In other words, tax must follow economics.

Regulations under § 704(b) set forth safe harbor the partnership can choose to adopt. A partnership is not required to maintain capital accounts. A partnership may choose to maintain capital accounts and will do so if it wants the benefits of the § 704(b) regulation safe harbor. The

Service will respect any allocation that falls within the safe harbor of Treas. Reg. § 1.704-1(b)(1)(i), which provides that a tax allocation is valid if it has "substantial economic effect."[4]

a. Substantial Economic Effect

i. Economic Effect

An allocation must have economic effect (i.e., it must effect the amount a partner can expect to receive from the partnership on liquidation – as measured by that partner's book capital account). An allocation that fails economic effect will not be respected and the allocation will be made in accordance with the partners' interest in the partnership.

Economic effect is shorthand for – (1) whether the partner has a right to receive cash or property for each tax allocation of income and gain made to the partner; or (2) whether the partner will be required to pay for each tax allocation of expense or loss. In other words, whether the partner will receive an economic benefit equivalent to the tax burden suffered or suffer economic harm equivalent to the tax benefit received. An allocation will be deemed to have economic effect (under the safe harbor) if it satisfies one of three tests: (a) the Primary Test, (b) the Alternate Test, or (c) the Economic Equivalency Test.

1) The Primary Test

Under the Primary Test, a tax allocation will have economic effect if the partnership agreement provides: (1) the partners' capital accounts will be determined and maintained in accordance with Treas. Reg. § 1.704-1(b)(2)(iv); (2) upon liquidation of the partnership (or a partner's interest), liquidating distributions will be made in accordance with positive capital account balances; and (3) if a partner has a deficit capital account balance after all adjustments for the year, the partner is unconditionally obligated to restore the deficit by the end of the partnership taxable year (or, if later, within 90 days of the liquidation) in order to pay partnership creditors or partners with positive capital account balances.

The first prong of the Primary Test helps to ensure that partners' capital accounts will mirror the partners' contributions and distributions and allocations of income and loss. The second prong of the Primary Test helps to ensure that partners, upon leaving the partnership, will receive the amount they are economically entitled to from the partnership. The third prong of the Primary Test helps to ensure that partners, upon leaving the partnership, will contribute money to the partnership in satisfaction of any benefit the partners received more than their investment (e.g., when a partner receives § 704(b) allocations of deductions/losses more than their economic investment).

[4] An allocation outside the safe harbor will still be respected if it represents the economic deal between the partners (i.e., the partners' interest in the partnership). See Treas. Reg. § 1.704-1(b)(3). See also FN 3.

Example 1: A and B form a general partnership to which each contributes $50 (for a total of $100). The partnership agreement satisfies all three requirements of the Primary Test. The partnership agreement allocates all partnership income and gain 50% to A and 50% to B, and allocates all partnership losses 80% to A and 20% to B. The partnership loses $80 in year 1. The partnership allocates $64 of tax losses to A and $16 to B.

After year 1, AB's balance sheet is as follows:

Assets				Liabilities & Capital		
	Tax	*Book*		Liabilities		
Cash	$20	$20		None		
				Capital Accounts		
					Tax	*Book*
				A	($14)	($14)
				B	$34	$34
Totals	**$20**	**$20**			**$20**	**$20**

Because the partnership agreement satisfies all three requirements of the Primary Test, the loss allocations have economic effect and will be respected. The capital accounts accurately reflect how the partners are sharing the economic burden of the $80 loss. If the partnership sold all its assets for book value and liquidated, A would be required to make up the deficit in A's capital account by contributing $14 to the partnership. The $14 contribution (together with the cash already in the partnership) would allow the partnership to distribute $34 to B, which is an amount equal to B's positive book capital account.

Notice that A's tax capital account is ($14). This is a red flag concerning A's ability to claim the deduction during the year. This is because A's outside basis cannot be negative. Therefore, § 704(d) limits A's tax loss (on his Form 1040) to $50. This is the amount he contributed to the partnership (i.e., his economic loss). The remaining $14 of tax loss allocated to A (beyond his $50 investment) will be suspended until (1) A is allocated income from the partnership, or (2) A contributes money or property to the partnership, including deemed contributions for A's increased share of partnership liabilities.

2) The Alternate Test

The Primary Test works for general partners in a partnership. However, limited partners and limited liability company members generally do not want a deficit restoration obligation to apply to them. Limited partners and LLC members, by the nature of having limited liability, do not have to pay back deficits.

Therefore, the regulations set forth another test called the alternate economic effect test (The Alternate Test), which can be used when the partnership agreement satisfies the first two requirements of the Primary Test but fails to include an unconditional deficit restoration

obligation if there is a qualified income offset in the agreement. Treas. Reg. § 1.704-1(b)(2)(ii)*(d)*.

A "qualified income offset" (QIO) is a provision requiring that partners who unexpectedly receive an adjustment, allocation, or distribution that brings their capital account balance negative, will be allocated all income and gain in an amount sufficient to eliminate the deficit balance as quickly as possible. Treas. Reg. § 1.704-1(b)(2)(ii)(d)(6). A QIO (not unlike a minimum gain chargeback) results in a tax price (i.e., allocation of income) in lieu of an economic price (i.e., contributions) to pay back a deficit balance.

Example 2: Assume the same facts as the previous example, except that the entity is an LLC, the agreement does not have a deficit restoration obligation, and that the loss was unexpected at the time the special allocation was made part of the partnership agreement. Instead, the agreement contains a qualified income offset. Let's revisit the balance sheet at the end of the last example:

Assets				Liabilities & Capital		
	Tax	*Book*		Liabilities		
Cash	$20	$20		None		
				Capital Accounts		
					Tax	*Book*
				A	($14)	($14)
				B	$34	$34
Totals	**$20**	**$20**			**$20**	**$20**

The loss allocation satisfies the regulation because if it was unexpected. The qualified income offset requires the first $14 of income during the next year be allocated to A to eliminate A's negative capital account balance. The remaining income/loss from the next year will be allocated in a manner consistent with the partnership agreement.

3) The Economic Effect Equivalence Test

If a partnership agreement fails to meet the Primary and Alternate Tests (because it does not have a deficient restoration obligation or a qualified income offset provision), the allocation may still have economic effect through the economic effect equivalence test.

Allocations failing the two economic effect tests above will still be deemed to have economic effect, provided that as of the end of each partnership taxable year a liquidation of the partnership at the end of the year (or at the end of any future year) would produce the same economic result to the partners as would occur had the test above been satisfied. Treas. Reg. § 1.704-1(b)(2)(ii)(*i*). You can think of this as the "dumb but lucky rule."[5]

[5] *See* paragraph 11.02 of McKee, Nelson & Whitmire: Federal Taxation of Partnerships & Partners (WG&L 4th edition) for characterization of this rule as the "dumb but lucky" rule.

This test checks to see if the results were the same as the Primary or Alternate Tests, even though the partnership agreement does not contain the proper provisions. Thus, generally, tax allocations will be respected if the book capital accounts are maintained properly, especially where book capital accounts are positive.

The Service must look at all the facts and circumstances where book capital accounts are negative. Assuming the partnership agreement is silent (i.e., no Primary or Alternate Tests), look for other agreements between the partners (i.e., exculpatory agreements or guarantees). The key question is: "will the partner ever be called upon to pay the liabilities that caused the partner's capital account to go negative?" That is, will the partner be allocated income or gain (for tax purposes) that economically will go to pay the liabilities? Will the partner be called upon to contribute capital to pay the liabilities? Will the partner be allocated cancellation of debt income or gain if the partnership never pays the liabilities – and simply walks away?

Think of it this way: The partnership agreement is a set of rules designed for a rainy day (that is, if the partnership loses money). Who will have to pay the loss? The partners who pay the loss should be allocated the loss they paid. If there is no loss, then we simply need to look at the proper maintenance of the positive book capital accounts to verify the allocations have been done correctly. Ultimately, it comes down to a matter of proof for the partners claiming tax benefits from loss allocations when their book capital accounts are negative. They should have something in writing.

ii. Substantiality

A special allocation that passes economic effect must also pass substantiality. A special allocation that fails substantiality will be disregarded and the allocation will, instead, be made in accordance with the partners' interest in the partnership. The substantiality test includes both a pre-tax and a post-tax test. The test for substantiality takes into consideration all the tax attributes for each partner.

The pre-tax test requires partnerships to establish that there is a "reasonable possibility" that the special allocation (as compared to the proportionate allocation) will effect the economic arrangement (as measured by the partners' book capital accounts) independent of the tax consequences. Under the pre-tax test, the regulations address two types of special allocations that do not have substantiality (as measured at the time the special allocation becomes part of the partnership agreement): (1) shifting allocations, and (2) transitory allocations.

- Under the shifting allocations test, a special allocation is not substantial if at the time the special allocation becomes part of the partnership agreement, there is a "strong likelihood" that the net effect of the special allocation on the book capital accounts of the partners will not be significantly different than if the special allocation was not made, <u>and</u> the total tax liability of the partners would be less than if there was no special allocation. Treas. Reg. § 1.704-1(b)(2)(iii)(b).

Shifting allocations are special allocations that occur within the same year among partners to take advantage of the tax attributes being held by the partners (e.g., capital losses or net operating losses).

- Under the transitory allocations test, special allocations are not substantial if at the time the special allocations become part of the partnership agreement, there is a "strong likelihood" that the net effect of the original and offsetting special allocations on the partners' book capital accounts will not be significantly different than if the special allocations were not made, and the total tax liability of the partners would be less than if there were no special allocations. Treas. Reg. § 1.704-1(b)(2)(iii)(c).

  Transitory tax allocations are offsetting special allocations that occur in different tax years (within a 5-year period). Transitory tax allocations involve an original special allocation in one year and then offsetting special allocations in later years. These offsetting special allocations allow the partners to take advantage of the different tax attributes held by partners between different years without effecting the overall economic arrangement.

Under the post-tax test, a special allocation will lack substantiality if there is a strong likelihood that at least one partner ends up in a better post-tax economic position while no partner ends up in a worse post-tax economic position. Treas. Reg. § 1.704-1(b)(2)(iii)(a).

The post-tax test compares the following:

- The post-tax economic results of tax allocations when the income/gain and loss allocations are proportionate with the partners' interest in the partnership with…

- The post-tax economic results of tax allocations when the income/gain and loss allocations are not proportionate with the partners' interest in the partnership (i.e., a special allocation).

  Example 3: A and B form a general partnership to which each contributes $50 (for a total of $100). The partnership agreement satisfies all three requirements of the Primary Test. The partnership agreement allocates all partnership income and gain 50% to A and 50% to B, and allocates all partnership losses 50% to A and 50% to B. The partnership invests the $100. The investment generates $100 of taxable dividends. The investment is then sold for a $100 capital gain in Year 1.

  A has a $100 capital loss carryforward that A has not been able to use to date. Therefore, the partners agree to allocate the entire $100 of capital gain to A and the entire $100 amount of dividend income to B. Assume that all taxable income is taxed at 10% for both A and B.

After Year 1, AB's balance sheet is as follows:

Assets				Liabilities & Capital		
	Tax	***Book***		**Liabilities**		
Cash	$300	$300		None		
				Capital Accounts		
					Tax	***Book***
				A	$150	$150
				B	$150	$150
Totals	**$300**	**$300**			**$300**	**$300**

Notice, the tax allocations have economic effect. Both A and B will be able to liquidate their partnership interest and receive their book capital account amount of $150.

However, the allocation lacks substantiality under the pre-tax shifting allocations test and the post-tax test. Under the shifting allocations test, there is no change in the economic results. All that occurred, is a shifting of the character of income between the partners. In addition, this shifting allocation lowers the aggregate tax liability of the partners as demonstrated below.

The special allocation also fails the post-tax test. This is because A can benefit economically from tax savings while B is not harmed in any way. This is demonstrated as follows by looking at how the allocation plays out on A's & B's tax returns for the year:

Proportionate Allocation				Special Allocation		
	A	*B*			*A*	*B*
Dividends:	$50	$50		Dividends:	$0	$100
Capital Gain:	$50	$50		Capital Gain:	$100	$0
Capital Loss:	($50)	$0		Capital Loss:	($100)	$0
Taxable Income:	**$50**	**$100**			**$0**	**$100**

Cash Received:	$100	$100		Cash Received:	$100	$100
Taxes:	($5)	($10)		Taxes:	$0	($10)
Economic Result:	**$95**	**$90**			**$100**	**$90**

The proportionate tax allocation results in taxable income of $50 to A and $100 to B. The tax rate for both taxpayers is 10%. Therefore, A must pay $5 in taxes and B must pay $10 in taxes. This means that A ends up with **$95** (out of the $100 allocation) after taxes and B ends up with **$90** (out of the $100 allocation) after taxes.

Substantiality requires that we compare this base, after-tax result with the special allocation after-tax result.

The special tax allocation results in taxable income of $0 to A and $100 to B.[6] Again, the tax rate for both taxpayers is 10%. Therefore, A does not pay any tax and B still must pay $10 in taxes. This means that A ends up with **$100** (out of the $100 allocation) after taxes and B still ends up with **$90** (out of the $100 allocation) after taxes.

So, A is saving $5 of taxes from the special allocation while B still must pay $10 in taxes. A benefits from tax savings from the special allocations while B does not suffer any additional burden. Therefore, the special allocation lacks substantiality under the post-tax test.

Example 4: Let's go back to the previous example. Assume that A has a $100 capital loss carryover. The partners agree to specially allocate all the capital gains to A in Year 1. The partners agree to still allocate the dividend income 50% to A and 50% to B. This special allocation, taken by itself, has substantiality under the pre-tax shifting allocations test because the special allocation substantially changes the dollar amounts to be received by each partner (as measured by the book capital accounts). Here are the Year 1 results:

Proportionate Allocation				**Special Allocation**		
	A	*B*			*A*	*B*
Dividends:	$50	$50		Dividends:	$50	$50
Capital Gain:	$50	$50		Capital Gain:	$100	$0
Capital Loss	($50)	$0		Capital Loss	($100)	$0
Taxable Income	$50	$100			$50	$50
Cash Received:	$100	$100		Cash Received:	$150	$50
Taxes:	($5)	($10)		Taxes:	($5)	($5)
Economic Result:	$95	$90			$145	$45

Notice that A received a post-tax economic benefit from the special allocation - A received $145 (after taxes). Notice that A's tax bill did not increase because of his increased economic cash flow. This is because A had significant tax attributes (capital losses) to offset the fact A received more money. Notice that B suffered a post-tax economic burden. B receives $90 after taxes in a proportionate allocation, but only $45 after taxes in the special allocation. Therefore, taken by itself, the Service would respect this allocation.

However, assume in year 1 there is a strong likelihood that in year 2 the partnership would again have $100 of capital gains and $100 of dividend income, and that the parties in year 1 agreed to allocate the first $100 of capital gains to B in year 2 and to again split the dividend income equally. This special allocation in year 2 equally offsets the special allocation in year 1. This puts both parties in the same economic position they would have been in as without the special allocations. In addition, the total tax liability of the partners

[6] A is able to use the full $100 capital loss carryforward because of the special allocation, whereas A would have been limited to using $50 of the capital loss carryforword under the proportionate allocation.

would be less than if there were no special allocations as demonstrated below. Therefore, the two special allocations (taken together) fail the pre-tax transitory allocations test for substantiality.

The two special allocations taken together also fail the post-tax test. This is because the two special allocations (taken together) lower A's tax liability without increasing B's tax liability.

We are left with the following after tax economic effect because of the special allocation:

Proportionate Allocation				Special Allocation		
	A	*B*			*A*	*B*
Dividends:	$50	$50		Dividends:	$50	$50
Capital Gain:	$50	$50		Capital Gain:	$0	$100
Capital Loss:	$0	$0		Capital Loss:	$0	$0
Taxable Income:	**$100**	**$100**			**$50**	**$150**

Cash Received:	$100	$100		Cash Received:	$50	$150
Taxes:	($10)	($10)		Taxes:	($5)	($15)
Economic Result:	**$90**	**$90**			**$45**	**$135**

A's and B's tax liabilities under the proportionate allocation for both years is ($15) and ($20), respectively, while under the special allocation for both years is ($10) and ($20). We see that A received an economic boost, and B did not suffer any economic harm, if we compare the after-tax economic results for both Year 1 and Year 2 (combined):

Proportionate Allocation				Special Allocation		
Year 1:	$95	$90		Year 1:	$145	$45
Year 2:	$90	$90		Year 2:	$45	$135
Economic Result:	**$185**	**$180**			**$190**	**$180**

b. Allocations Deemed to be Accordance with the Partners' Interests in the Partnership: Nonrecourse Deductions

A nonrecourse deduction cannot have economic effect. This is because the partners will not be responsible for repaying a nonrecourse liability if the partnership defaults. This means the lender, rather than the partners, economically suffers if the partnership does not repay the nonrecourse liabilities. Nonetheless, the rules allow the partnership to allocate deductions attributable to nonrecourse liabilities (i.e. nonrecourse deductions). In addition, the regulations allow for a partner's book capital account to go negative due to nonrecourse deductions if: (1) there is "partnership minimum gain" **and** (2) the partnership agreement contains a minimum gain chargeback. The minimum gain chargeback provision assures a partner who gets the tax benefit of a nonrecourse deduction will suffer a tax burden when the partner's share of partnership minimum gain is decreased without the nonrecourse liability being satisfied by the partnership.

i. Partnership Minimum Gain

Partnership minimum gain is the amount by which the face value of nonrecourse liabilities exceed the basis of asset(s) securing the nonrecourse liabilities. The borrower is required to recognize gain under §1001 whenever the partnership exchanges property in satisfaction of the nonrecourse liabilities and the face value of those liabilities exceeds the partnership's basis in the asset securing the liability. See Commissioner v. Tufts, 461 U.S. 300 (1983). This is because the borrower can include the amount of the nonrecourse liabilities in the basis of the property acquired with the liabilities because it is assumed that the borrower will eventually pay the liabilities. Crane v. Commissioner, 331 U.S. 1 (1947).

In Tufts, the taxpayer argued that nonrecourse liabilities should not be included as part of the amount realized upon disposition of the encumbered property when the amount of liabilities exceeds the fair market value of the property. The Court rejected this argument and noted that the taxpayer had included the liabilities in basis for depreciation purposes and had (based upon a repayment expectation) failed to include the loan proceeds in income upon receipt: "[A] taxpayer must account for the proceeds of obligations he has received tax-free and included in basis." Id. at 313.

A partner who has a share of partnership minimum gain (or potential Tufts gain) has a future income allocation should the partnership exchange the collateral in full satisfaction of the nonrecourse liabilities. Thus, that partner's book capital account will be increased by that partner's share of minimum gain (or Tufts gain) when the partnership exchanges property securing the nonrecourse liability in full satisfaction of the debt. This means that a partner can have a negative book capital account to the extent of the minimum gain. This makes sense because the partner will pick up income if the partnership does not pay the liabilities. Therefore, the partner can take deductions connected to these liabilities to the extent of the potential future income. Think of it as a safeguard.

Example 5: A (general partner) and B (limited partner) form a limited partnership to which each contributes $100 in property. A contributes $100 in cash. B contributes a building with a fair market value of $150 and a basis of $20 (which is subject to a $50 nonrecourse note). The building has one year left on its useful life for depreciation purposes. A & B agree to split profits of the partnership equally. The partnership agreement has a minimum gain chargeback provision. Assume that the test under the Treas. Reg. § 1.704-2(e) are met. The partnership has the following balance sheet on formation:

Assets				Liabilities & Capital		
				Liabilities		
	Tax	*Book*			*Tax*	*Book*
Cash	$100	$100		NR Debt		$50
Building	$20	$150		A	$10	
				B	$40	
				Capital Accounts		
					Tax	*Book*
				A	$100	$100
				B	($30)	$100
Totals	**$120**	**$250**			**$120**	**$250**

There is potential Tufts gain of $30 connected to the building. That is the face value of the note less the basis of the building that secures the note. Thus, there is generally § 704(c) minimum gain (defined below) connected to the building of $30. This § 704(c) minimum gain belongs to B because the minimum gain existed prior to the contribution of the building to the partnership. Thus, the partnership would have a $30 gain if the partnership were to immediately exchange the building for the nonrecourse note. This entire gain would be allocated to B.

A's tax capital is $100 (which was the basis of the cash contributed). B's opening tax capital account would be $20 less $50, or negative $30.

B's outside basis (without the liabilities) would be negative $30 (that is $20-$50). This is before factoring in the allocation of liabilities under § 752. Under § 752 there are three tiers of allocation for non-recourse liabilities. Tier 1 is zero because there have been no nonrecourse deductions allocated to either partner. Tier 2 requires that all pre-contribution minimum gain connected to the nonrecourse liabilities must be allocated to the contributing partner ("§ 704(c) minimum gain"). Here, there is $30 of § 704(c) minimum gain. This brings B's outside (or tax) basis in the partnership interest back up to zero. The remaining $20 of nonrecourse liabilities is split 50/50 under tier 3 assuming the partners agreed to an allocation of the liabilities based on the division of profits (under the assumption that future profits will be used to pay down the nonrecourse liabilities). Thus, each partner's outside basis is increased by $10. Thus, A's outside basis is now $110 and B's outside basis is now $10.

Assume that in Year 1 the partnership breaks even except for the depreciation of the building. The building's book depreciation is $150, and its tax depreciation is $20. Assume this is all allocated to B under the partnership agreement and that such allocation is reasonably consistent with allocations of some other significant partnership item that has substantial economic effect. This illustrates the sourcing of a deduction from both equity of $100 and nonrecourse liabilities of $50. The latter is tested by looking at the reasonably consistent test of Treas. Reg. § 1.704-2(e)(2). The partnership's balance sheet would look like this at the end of Year 1:

Assets				**Liabilities & Capital**		
				Liabilities		
	Tax	***Book***			***Tax***	***Book***
Cash	$100	$100		NR Debt		$50
				A	$0	
				B	$50	
Building	$0	$0				
				Capital Accounts		
					Tax	***Book***
				A	$100	$100
				B	($50)	($50)
Totals	**$100**	**$100**			**$100**	**$100**

Based on the assumptions above, this allocation is treated as made in accordance with the partner's interest in the partnership under § 704(b). The capital accounts accurately reflect how the partners are sharing the economic burden of the $150 of book depreciation. If the partnership transferred the building to the lender to extinguish the nonrecourse liabilities and liquidated it would have $100 to distribute to its partners. The partnership liquidating in accordance with capital accounts would distribute $100 to A, the full amount of his positive capital account balance. The exchange of the building for the extinguishment of the nonrecourse liabilities would result in the $50 liabilities being included in the amount realized by the partnership. This $50 gain would be allocated to B under the minimum gain chargeback provision. Thus, B's book and tax capital accounts would increase from ($50) to $0, and B would receive nothing from the partnership in liquidation of his interest.

The allocation of the entire $20 of tax depreciation attributable to the nonrecourse liability results in an increase to B's share of partnership minimum gain by $20. Thus, B's share of the nonrecourse liability for purposes of § 752 increases from $10 to $20, and A's share of the nonrecourse liability decreases from $10 to $0. The increase in B's share of the nonrecourse liability results in an increase to B's outside basis from $10 to $20, which allows B to use the $20 loss allocation in Year 1, reducing his outside basis to $0. The decrease in A's share of the nonrecourse liability results in a decrease to A's outside basis from $110 to $100.

Now, assume in Year 2 that the partnership incurred $100 of expenses with the cash contributed by A. Although A and B agreed to share the items of the partnership 50/50, the allocation of the $100 of expenses must go to A unless B has a deficit restoration obligation or some other agreement to make up for his negative capital account. Assuming no such provisions have been agreed to, for the allocation of the $100 of expenses to have economic effect, they must all be allocated to A. The partnership has the following balance sheet at the end of Year 2:

Assets				**Liabilities & Capital**		
				Liabilities		
	Tax	***Book***			***Tax***	***Book***
Cash	$0	$0		NR Debt		$50
				A	$0	
				B	$50	
Building	$0	$0				
				Capital Accounts		
					Tax	***Book***
				A	$0	$0
				B	($50)	($50)
Totals	**$0**	**$0**			**$0**	**$0**

Notice that B's tax and book capital accounts are both ($50). This is permitted because of the minimum gain (or potential Tuft's gain) sitting in the partnership. Recall that B was allocated the entire amount of the nonrecourse depreciation deduction in Year 1 which increased his share of the minimum gain from $30 at contribution to $50 at the end of Year 1. Nonrecourse deductions result in an increase of partnership minimum gain.

If B had a deficit restoration obligation and could be allocated any of the $100 of deductions from Year 2, B's loss would be suspended under § 704(d). Recall that B's basis in his partnership interest after Year 1 was $0. So any tax loss properly allocated to B would be suspended under § 704(d). Any such loss properly allocated to B would be suspended until (1) B is allocated income from the partnership, or (2) B contributes money or property to the partnership.

ii. Minimum Gain Chargeback

Minimum gain arises on the exchange of the collateral for the nonrecourse liabilities under Tufts. But what happens if a partner has a negative book capital account due to nonrecourse deductions (supported by minimum gain) and that partner's share of minimum gain goes down when there is no exchange of the collateral for the nonrecourse liabilities? There is no Tufts gain without the exchange. The regulations deal with this situation by requiring the partnership to have a minimum gain chargeback provision. This provision goes together with minimum gain.

A Minimum Gain Chargeback is an allocation of gain to partners who have received the benefit of prior nonrecourse deductions or who have received distributions of partnership proceeds attributable to nonrecourse borrowing (think negative book capital account supported by minimum gain as discussed in the example above – that is how you know the negative book capital account was caused by nonrecourse deductions).

These deductions or distributions are "charged back" to such partners or members upon either (a) a sale of the underlying property securing the nonrecourse liabilities, (b) a change in the character of the nonrecourse liabilities (most commonly by a conversion to recourse liabilities, or by forgiveness of the liabilities), or (3) a reduction in the minimum gain caused by a pay down of the nonrecourse liabilities. Notice, in these instances, the collateral was not exchanged in satisfaction of the nonrecourse liabilities.

Example 6: Return to the previous example. At the beginning of year 3 the partnership had the following balance sheet:

Assets				**Liabilities & Capital**		
				Liabilities		
	Tax	***Book***			***Tax***	***Book***
Cash	$0	$0		NR Debt		$50
				A	$0	
				B	$50	
Building	$0	$0				
				Capital Accounts		
					Tax	***Book***
				A	$0	$0
				B	($50)	($50)
Totals	**$0**	**$0**			**$0**	**$0**

Assume the partnership earns net income in Year 3 of $80, and uses $50 of the cash from its earnings to pay off the nonrecourse liabilities. This would eliminate the possibility of Tufts gain. B had $50 of total minimum gain with respect to the nonrecourse liability as he was previously allocated nonrecourse deductions of $50 and had § 704(c) minimum gain of $30 upon contribution of the building to the partnership subject to the liabilities. When the liabilities are paid off, there is no Tufts gain to allocate. So, the minimum gain chargeback provision in the partnership agreement requires the partnership to allocate the first $50 of partnership income to B. The partnership then would allocate the remaining $30 of income $15 to A and $15 to B and has the following balance sheet at the end of Year 3.

Assets				**Liabilities & Capital**		
				Liabilities		
	Tax	***Book***			***Tax***	***Book***
Cash	$30	$30		NR Debt		$0
				A	$0	
				B	$0	
Building	$0	$0				
				Capital Accounts		
					Tax	***Book***
				A	$15	$15
				B	$15	$15
Totals	**$30**	**$30**			**$30**	**$30**

In addition, B's share of the nonrecourse liability has gone from $50 to $0 because the liabilities have been paid off. This $50 reduction in B's share of partnership liabilities is treated as a deemed distribution of cash under § 752(b). B's outside basis at the beginning of Year 3 was $0, but the allocation of $65 of income during the year would increase it to $65. Then, the deemed cash distribution $50 would reduce his outside basis down to $15 and would not be taxable as a distribution more than basis because B had sufficient outside basis.

(3) How to Handle Built-in Gain or Loss

Partners share in gain or loss on property while that property is in the partnership. However, any pre-existing gain or loss (i.e., built-in gain or loss) belongs to the partner who contributed the asset to the partnership in exchange for their partnership interest. There are two central reasons for this: (1) Partners do not realize gain or loss (or pay tax) when they contribute assets to a partnership in exchange for their interest under § 721, and (2) partners only share in any gain or loss earned on an asset when it is in the partnership.

a. Amount of Gain/Loss

Partners generally do not realize gain or loss (or pay tax) when they contribute assets to a partnership in exchange for their interest under § 721. Section 704(c) locks in any built-in gain or loss to the partner(s) that contributed the assets. Thus, a partner cannot avoid gain for tax purposes by contributing an appreciated asset to a partnership. Any pre-existing gain/loss stays with the partner so that the partner will eventually have to pay tax (or take a loss) when the partnership disposes of the property. In addition, partners only share in any gain or loss earned on an asset when it is in the partnership.

b. Character of Gain/Loss

The character of gain/loss on certain types of assets also stays with the contributing partner (for 5 years in the case of inventory) after the property is contributed under § 724. This means that the character of the gain/loss (to the contributing partner) is not determined at the partnership level – but at the partner level.

> **Example 7**: A contributes an asset to the AB partnership. The asset was inventory to A but is a capital asset to the AB partnership. The AB partnership sells the asset within 5 years of A's contribution and allocates A his share of gain – which included built in gain. The portion of the gain up to the amount representing his pre-contribution built-in gain is ordinary to A (even through it was capital to the AB partnership). The post-contribution portion of the gain would be a capital gain to A. See section 724(b).
>
> Note: Had the contributed property been a capital loss asset to A rather than inventory, and the AB partnership sold the asset for a loss, and allocated a loss to A, the loss would have been capital. See section 724(c). The ordinary character taint only applies to the pre-contribution built-in gain or loss from contributed unrealized receivables or inventory (for 5 years).

c. Dealing with the ceiling rule

i. Traditional Method

Under the traditional method, the noncontributing partner is taxed only on gains or losses that accrue after formation of the partnership, and the contributing partner is allocated the built-in gain or loss. By allocating the depreciation deductions first to the noncontributing partner to match his or her book gain, the traditional method moves toward equality between the noncontributing partner's book and tax capital accounts. There is one important limitation under the traditional method called the "ceiling rule." The ceiling rule limits the amount of tax income, gain, loss, or deduction allocated to the partners with respect to property to the total partnership income, gain, loss, or deduction with respect to that property for the taxable year. This limitation can cause distortions by shifting a portion of a built-in gain to the noncontributing partners. For example, if A contributes land to AB partnership that is sold at a loss by the partnership, but results in tax gain to A, there will be no tax loss to match cash-contributor B's book loss. The

ceiling rule prevents allocating any tax loss to B, which creates a tax/book disparity in B's accounts.

ii. Traditional Method with Curative Allocations

To eliminate potential distortions caused by the ceiling rule under the traditional method, Treas. Reg. § 1.704-3(c) allows the partnership to use the "traditional method with curative allocations." This method allows the partnership to allocate an item for tax purposes if the allocated amount does not exceed the amount of the limited item under the ceiling rule for the tax year and is of the same type or character of that item. For example, if AB partnership had a stock gain during the same year as the land loss in the previous example, then because the land and stock are the same character (i.e., capital assets), some or all of the tax gain on the sale of the stock may be allocated to A to eliminate the disparity caused by the ceiling rule, even though the corresponding book gain is allocated to B.

iii. Remedial Allocation Method

The remedial allocation method is the third method that can be used to eliminate book/tax disparities caused by the ceiling rule. This method allows the partnership to make a fictional tax allocation of the same character of the item limited by the ceiling rule. These allocations are treated as actual tax items by the partners. As a result, these allocations affect both partners' tax liability and outside basis. For example, to eliminate the tax/book disparity in B's capital account in the previous Traditional Method example, under the remedial allocation method the partnership could create a fictional capital loss to allocate to B to match B's book loss with a matching capital gain to A.

d. Dealing with reverse 704(c) allocations

Section 1.704-3(a)(6) provides that the principles of § 1.704-3 apply to allocations with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property under § 1.704-1(b)(2)(iv)(f) (reverse § 704(c) allocations). A partnership that makes allocations with respect to revalued property must use a reasonable method that is consistent with the purposes of § 704(b) and § 704(c).

> **Example 8**: C is a new partner in the AB partnership. The entry of C as a new partner causes partnership AB to revalue its property. When C enters as a new partner of AB, Asset 1 has a basis of $300 and a book value of $300. The FMV of the property upon C's entry is $900. The revaluation results in the creation of $600 of reverse § 704(c) gain in Asset 1. This layer of reverse § 704(c) gain is shared equally by A and B ($300 each).

B. What Do I Need to Do When I Get the Information

- Check the partnership's § 704(b) work papers to verify that the partnership has properly maintained its book capital accounts under § 1.704-1(b)(2)(iv). Check to see if the partnership properly revalued its capital accounts for any new partner.

- If the parties use targeted capital accounts that do not follow the § 704(b) regulations, confirm with the taxpayer the economics of the deal and follow the distribution provisions to see where there is alignment with the taxpayer's waterfall calculations / worksheet/ modelling of the waterfall.

- Check to see if the allocations have economic effect:

  - Confirm if the partnership agreed to use the safe harbor in § 704(b) in terms of allocations to the partners, or targeted allocations; confirm distribution rights, liquidation rights, and who represents the partnership during audit (i.e., TMP, PR); and confirm the terms and conditions of any transactions involving the partnership.

  - Did the partners agree to allocate § 704(b) book items under one of the three safe-harbor tests (i.e., Primary, Alternate Test, or Economic Equivalence)? If yes, were the allocations made consistent with the rules governing these tests? If yes, the Service will respect the allocation. If no, the Service must reallocate the items to make the allocation consistent with the Safe Harbor test chosen by the partnership.

  - The partnership agreement may not follow the § 704(b) regulations because the parties use targeted capital accounts. In this case, confirm with the taxpayer the economics of the deal and follow the distribution provisions to see where there is alignment with the taxpayer's waterfall calculations/worksheet/modelling of the waterfall.

  - If no safe harbor was chosen in the partnership agreement, then confirm that the allocations were made in accordance with each partner's interest in the partnership? If yes, the Service will respect the allocations. If no, the Service must reallocate the items in accordance with each partner's interest in the partnership.

- In checking for economic effect, look for negative book capital account balances for any partner. This means a partner has economically taken more from the partnership than they have contributed. A negative book capital account needs to be supported by liabilities or some agreement to force the partner to eliminate that negative balance at some point in the future:

- Look at the partnership agreement to see if it contains an unqualified deficit restoration obligation, qualified income offset, and/or minimum gain chargeback that could support the negative book capital account. If not, then -

- Look to see if there are liabilities or some other contractual arrangement to support the negative book capital account balance. For example, did the partner sign a guarantee or contribute a promissory note?

- What you're looking for is an explicit or deemed obligation requiring the partner to make up a negative balance in their book capital account. Without this – any allocation that causes a partner's book capital to go negative or increase a negative balance lacks economic effect. Such allocations must be reallocated.

- Look at the Schedules K-1 to make sure the partnership is allocating all types of income or loss (e.g., ordinary income/loss, capital gains/loss tax exempt income) proportionately to each partner's interest in the partnership. If the answer is no, verify that at least one partner's tax burden is greater than if the allocation was proportionate. Otherwise, the allocation may lack substantiality.

- Determine whether the partnership made special allocations (directly or indirectly) to any tax-exempt or foreign partner(s). These are red flags that the economic effect of these allocations might not be substantial.

- Determine if the partnership holds any property with a built-in gain or a built-in loss that is required to be allocated to the partner who contributed the property or is required to be allocated to existing partners upon the admission of a new partner. Verify that any built-in gain or built-in loss was properly allocated. To do so, check the partnership agreement to determine what method the partnership uses in dealing with the "ceiling" rule: (1) Traditional, (2) Traditional with Curative Allocations, or (3) Remedial. Verify the partnership properly used the selected method.

- Determine if the partnership adjusted the basis of any assets under § 743(b). The code permits an inside/outside basis disparity if a § 754 election is not made. In such a case, determine if the disparity creates a problem such as a non-economic loss. If a § 754 election was made, verify that the basis adjustment was made only for the new partner. The basis adjustment should not affect allocations made to old (or existing) partners.

III. PARTNERSHIP LIABILITIES

19. During the audit period, did the partnership have any beginning or ending balances due to partnership liabilities? If not, skip to Q.#22 (or the first question at the beginning of the next attached section to this IDR). If there are liabilities, please provide a summary of each loan item, including the following information: name of lender, relationship (if any) of lender to partners of the partnership (for purposes of applying Treas. Reg. § 1.752-4 and § 465(b)(3)(C)), loan date, maturity date (including any extensions), original principal amount, beginning and ending balances for each audit year, whether the loan is secured or unsecured, and whether the creditor's remedies against the partnership are limited to collateral. For each loan item, provide complete copies of all agreements relating to such liabilities (e.g., loan agreements, promissory notes, and related security agreements).

20. For each loan item identified in Q. #19, is the partnership current on all amounts due under the agreement? If not, identify defaulted loans, foreclosures, deeds in lieu of foreclosure, deficiency judgment proceedings, and other lawsuits. Identify any loan items reported by the partnership for which creditors have ceased collection efforts.

21. For each loan item identified in Q. #19, identify the extent to which such liabilities were required to be reported in the partners' ending share of liabilities (i.e., Schedule K-1, Part K) for the current and prior year, and identify each loan item as a nonrecourse, qualified nonrecourse, or recourse liability to the partner. Provide liabilities characterization and allocation work papers for each audit year, including any work papers used to determine whether the lender or guarantor was a related person to any partner.

22. Did any partner's share of liabilities at year end decrease during an audit year? If yes, identify the extent to which each partner had deemed distributions under § 752(b).

23. Did the partnership have any of its liabilities cancelled, acquired by a related party, or exchanged for equity during the audit period? If yes, please provide the following: (a) a list of persons acquiring the liabilities and their relationship to a partner in the partnership as specified in § 267(b) or § 707(b)(1); (b) a list of partnership assets (including the assets' basis) exchanged for the cancellation of the debt; (c) a list of any equity exchanged for the cancellation of the debt; and (d) an explanation of how any partnership gain or income resulting from the cancellation was allocated to the partners.

24. Do Schedules K-1 of the partners include any partnership liabilities which were not reported on the partnership's balance sheet (Schedule L) (e.g., allocations of liabilities from lower-tier partnerships)? Were there any balance sheet liabilities not reported on Schedules K-1? Identify and explain each loan item that either is not reported on the balance sheet or is not reported on Schedules K-1. Provide copies of Schedules K-1 received from lower-tier partnerships, and identify any amounts shown which represent loans the partnership made to such lower-tier partnerships.

25. With respect to each liabilities identified as recourse on Schedule K-1, identify the extent to which any partner(s) bore the economic risk of loss during each audit year. For this purpose, "economic risk of loss" (EROL) has the meaning set forth in Treas. Reg. § 1.752-2. Identify the reason(s) why such partner(s) is considered to bear the EROL (e.g., guaranty or loan from a partner or related person, or personal liability as a state law general partner) and provide copies of agreements to support your position (e.g., guarantees, pledges, indemnification agreements, along with waivers of rights of subrogation). Identify any contingencies affecting the liability, including any recourse/"bad-boy carve-out" provisions.

26. Did any partner use bottom-dollar payment obligations to increase their liabilities allocation or at-risk amount during any audit year? If yes, did the partnership disclose the bottom-dollar payment obligations by filing Form 8275, Disclosure Statement, or any successor form, with the return of the partnership for the taxable year in which the bottom-dollar payment obligation was undertaken or modified? Identify whether the bottom-dollar payment obligation is a guarantee, a reimbursement, an indemnity, or a deficit restoration obligation.

A. Why Are We Asking: Common Issues: I.R.C. § 752?

Congress allows a partner to include partnership liabilities in its outside basis for a couple reasons.

- First, the rules under § 705 in connection with § 752 are interested in maintaining a balance between the partnership's total bases in its assets (inside basis) and the partners' total bases in their partnership interests (outside basis). The partnership includes borrowed funds (liabilities) in its cost basis of property. See Crane v. Commissioner, 331 U.S. 1 (1947). The assumption is that the partnership will eventually pay for the asset by paying off the liabilities used to acquire the asset. This means that the partnership's inside basis increases when it borrows funds and either retains the cash proceeds for future use or uses those funds to purchase assets. Under § 705, a partner's outside basis is increased by deemed contributions under § 752 (i.e., an increase in a partner's share of partnership liabilities). Conversely, when for example the partnership repays the liability with the assets of the partnership, the partnership's inside basis decreases. Under § 705, the partner's outside basis is decreased by deemed distributions under § 752 (i.e., a decrease in a partner's share of partnership liabilities) and the partner's distributive share of the partnership's losses and deductions. Therefore, § 705 in connection with § 752 helps to maintain parity between inside basis and outside basis with respect to partnership liabilities.

- Second, the inclusion of liabilities in a partner's outside basis allows the partner to avoid the basis limitations under § 704(d). A partner cannot claim a loss from a partnership if the partner does not have basis in its partnership interest (i.e., does not have outside basis greater than zero). See § 704(d). The rules under § 752 allow a partner to claim a current tax benefit for losses generated by liabilities without concern for running into the limit set forth in § 704(d). Note that if there is no § 704(d) limitation, then the partner's loss might still be limited under §§ 465 and 469, discussed below.

Ultimately, recourse partnership liabilities are allocated to the partner who will suffer the economic burden connected with paying the liabilities (e.g., the partner who will directly pay the liabilities). Alternatively, nonrecourse partnership liabilities are generally allocated to the partner whose share of the partnership's profits will be used to pay for the liabilities). Therefore, a partner must show responsibility for paying the liabilities (directly or indirectly – through the partnership) to be allocated partnership liabilities under § 752.

Two things should be noted at the outset: (1) all partnership liabilities (as defined under § 752) must be allocated (to maintain inside/outside basis equilibrium), and (2) partnership liabilities will be allocated to the partners expected to pay the liabilities (either directly or indirectly).

(1) What are Partnership Liabilities for § 752 Purposes?

A partnership's liabilities will be allocable under § 752. However, not all partnership obligations are considered liabilities for § 752 purposes. With this in mind, a partnership liability must have one of the following characteristics to be considered allocable liabilities under § 752: (1) the

liabilities increases the partnership basis in at least one asset; (2) the liabilities gives rise to an immediate deduction to the borrower; or (3) the liabilities gives rise to an expense that is not deductible in computing the borrower's taxable income and is not properly capitalized. Treas. Reg. § 1.752-1(a)(4). However, the Service has taken the position that a liability which would give rise to a deduction (if/when paid) by a cash basis taxpayer (e.g., accounts payable) is not considered a liability for § 752 purposes. See Rev. Rul. 88-77, 1988-2 C.B. 128; see also Treas. Reg. § 1.752-6 and -7 (describing other examples of items that are not partnership liabilities). There is no reason to allocate liabilities to partners under § 752 under this scenario because there is no expense incurred until the liability is paid. When it is paid, the asset used to pay the obligation is removed from the books at the same time the expense is allocated.

(2) Are we Dealing with a Bona-Fide Debt?

Bona fide debt arises from "a debtor-creditor relationship based on a valid and enforceable obligation to pay a fixed or determinable sum of money." Kean v. Commissioner, 91 T.C. 575, 594 (1988); see Treas. Reg. §1.166-1(c). "Whether a bona fide debtor-creditor relationship exists is a question of fact to be determined upon a consideration of all the pertinent facts in the case." Fisher v. Commissioner, 54 T.C. 905, 909 (1970). In Fisher v. Commissioner, the Court found that an essential element of a bona fide debtor-creditor relationship is the existence of a good faith intent on the part of the recipient to repay the debt, and a good faith intent on the part of the party advancing the funds to enforce repayment. 54 T.C. at 909-910. In gauging whether the borrower has a good faith intent to repay the loan, the Court looks to (among other things) the financial condition of the borrower at the time of the loan, and whether there is a realistic possibility of repayment. See McCain v. Commissioner, T.C. Memo. 1987-285, aff'd. per order (9th Cir., Apr. 11, 1989).

While a partnership may be able to provide loan documents to establish a liability to a third-party lender, it is important to know whether the loan is being repaid in accordance with its terms, whether there has been a default, and/or whether unpaid interest (and/or principal) is simply being added to the outstanding debt without any actual repayment. On occasion, a partnership will continue to carry a liability on its books that was written off as a bad debt by the lender in a prior year. Other times, the absence of any meaningful repayment will signify that the liability was illusory and therefore should not be considered a liability for tax purposes.

When the liability arises between a partner and the partnership, courts may rely on different factors to determine whether the liability is bona fide debt, or equity. The Tax Court relied on the following 13 factors in its debt versus equity analysis involving advances made by a stockholder to a company: (1) names or labels given to the instruments; (2) presence or absence of a fixed maturity date; (3) source of payments; (4) right to enforce payments; (5) participation in management as a result of the advances; (6) status of the advances in relation to regular corporate creditors; (7) intent of the parties; (8) identity of interest between creditor and stockholder; (9) "thinness" of capital structure in relation to debt; (10) ability of the corporation to obtain credit from outside sources; (11) use to which advances were put; (12) failure of debtor to repay; and (13) risk involved in making advances. See Dixie Dairies Corp. v. Commissioner, 74 T.C. 476, 493 (1980). The relevant factors vary, depending on the particular factual circumstances; the Tax Court noted that the ultimate question is "Was there a genuine intention

to create a debt, with a reasonable expectation of repayment, and did that intention comport with the economic reality of creating a debtor-creditor relationship?" Dixie Dairies Corp., 74 T.C. at 494 quoting Litton Business Sys., Inc. v. Commissioner, 61 T.C. 367, 377 (1973).

(3) Allocation of Liabilities under § 752

Section 752 separates partnership liabilities into two categories: (1) recourse liabilities and (2) nonrecourse liabilities. A liability can also be bifurcated. See 1.752-2(a). The determination of whether a partnership liability is recourse or nonrecourse (for § 752 purposes) is based on whether any one or more of the partners (or related person) has an economic risk of loss (EROL) for that liability. To the extent one or more partners bears the EROL for the liability, the liability is "recourse"; if no partner (or related person) has an EROL for the liability, the liability is "nonrecourse." Treas. Reg. §§ 1.752-1(a)(1) and (a)(2). A single liability may be bifurcated and will be treated as "recourse" to the extent that any partner bears the EROL and "nonrecourse" to the extent no partner bears the EROL.

a. Recourse Liabilities for § 752

Recourse liabilities under § 752 are allocated to the partner(s) who bears the EROL for those liabilities. To the extent a partner has EROL with respect to a partnership liability, the partner's outside basis increases.

i. Economic Risk of Loss

A partner generally bears the EROL for a partnership liability if the partner or related person has an obligation to make a payment to any person within the meaning of Treas. Reg. § 1.752-2(b) (i.e., whether the partner or related person would have to make a payment if, upon a constructive liquidation of the partnership, the partnership's assets were worthless and the liability became due and payable) and the partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner. For purposes of making this determination, all statutory and contractual obligations relating to the partnership liability are taken into account including payment obligations imposed by state or local law and the governing state or local law partnership statute, all contractual obligations outside the partnership agreement (i.e., indemnifications, reimbursement agreements, insurance, loan agreements, promissory notes, guarantees, pledges, subordination agreements, deeds of trust), and obligations to the partnership that are imposed by the partnership agreement (i.e., an obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership under 1.704-1(b)(2)(ii)(b)(3)).

Treas. Reg. § 1.752-2(b)(6) presumes that partners (or related persons) will make required payments regardless of their actual net worth (i.e., there is a "satisfaction presumption"), unless the facts and circumstances indicate (1) a plan to circumvent or avoid the obligation under the anti-abuse rule under Treas. Reg. § 1.752-2(j), or (2) that there is not a commercially reasonable expectation that the payment obligor will have the ability to make the required payments under the terms of the obligation if the obligation becomes due and payable as described in Treas. Reg. § 1.752-2(k). A partner or related person's ability to pay may be based on documents such as

balance sheets, income statements, cash flow statements, credit reports, and projected future financial results.

Under the anti-abuse rule in Treas. Reg. § 1.752-2(j)(3), the following non-exclusive factors are weighed to determine whether a payment obligation should be respected (if the payment obligation is not respected, then the partner is not considered to bear the EROL for the partnership liability): (1) the partner or related person is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment, (2) the partner or related person is not required to provide commercially reasonable documentation regarding the partner's or related person's financial condition to the benefited party, (3) the term of the payment obligation ends prior to the term or the partnership liability or the partner or related has the right to terminate its payment obligation, (4) there exists a plan or arrangement in which the primary obligor or any other obligor with respect to the partnership liability directly or indirectly holds money or other liquid assets in an amount that exceeds the reasonably foreseeable needs of such obligor (without taking into account standard commercial insurance), (5) the payment obligation does not permit the creditor to promptly pursue payment following a default, (6) in the case of a guarantee, the terms of the partnership liability would be substantially the same had the partner or related person not agreed to provide the guarantee, and (7) the creditor or other party benefiting from the obligation did not receive executed documents with respect to the payment obligation from the partner or related person. See Canal Corp. & Subs. v. Commissioner, 135 T.C. 199 (2010).

General partners are liable for liabilities of the partnership that are recourse under state law (i.e., general partner is obligated under state law to contribute to the partnership when the partnership cannot pay its liabilities). Thus, general partners will always bear an EROL for all partnership liabilities that is recourse under state law. The definition of a recourse liability under § 752 is related to, but distinct from, the concept of recourse liabilities under state law. Limited partners are not generally liable for the liabilities of the partnership under state law. Thus, limited partners will not bear an EROL unless they sign a guarantee or otherwise pledge property (in both cases the limited partner would have to waive their right of reimbursement against a general partner under state law). However, limited partners will be deemed to bear an EROL for money they lend to the partnership.

> **Example 1:** The ABC general partnership owns Asset 1 and Asset 2, neither of which is encumbered. The partnership borrows money on a recourse basis from Bank to purchase Asset 3. The partnership is not able to pay the liabilities and the sale of the assets does not result in enough cash to satisfy the loan. Assume A, B, and C are all general partners. The liabilities will be a recourse liability for § 752 purposes because Bank can pursue A, B, or C (under state law) to satisfy the unpaid amount of the loan.

Example 2: The ABC limited partnership owns Asset 1 and Asset 2, neither of which is encumbered. The partnership borrows money on a recourse basis (under state law) from Bank to purchase Asset 3. The partnership is not able to pay the liabilities and the sale of the assets does not result in enough cash to satisfy the loan. Assume A is a general partner and B and C are limited partners. The liabilities will be a recourse liability for § 752 purposes because Bank can pursue A (under state law) to satisfy the unpaid amount of the loan.

ii. Bottom Dollar Payment Obligations

Bottom dollar payment obligations (AKA bottom dollar guarantees) do not represent real EROL because they are structured to insulate the obligor from having to pay their obligations. Moreover, bottom dollar payment obligations are not relevant to loan risk underwriting generally. These obligations generally lack a significant non-tax commercial business purpose. Therefore, bottom dollar payment obligations should not be recognized as payment obligations.

The § 752 regulations provide that a bottom dollar payment obligation is not recognized as a payment obligation for purposes of Treas. Reg. § 1.752-2(b)(3). These regulations provide that a bottom dollar payment obligation is the same as or like one of the following four types of payment obligations or arrangements:

- With respect to a guarantee or similar arrangement, any payment obligation other than one in which the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied;

- With respect to an indemnity or similar arrangement, any payment obligation other than one in which the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation, if, and to the extent that, any amount of the indemnitee's or benefited party's payment obligation is recognized;

- With respect to an obligation to make a capital contribution or to restore a deficit capital account upon liquidation of the partnership as described in § 1.704–1(b)(2)(ii)(b)(3) (taking into account § 1.704–1(b)(2)(ii)(c)), any payment obligation other than one in which the partner is or would be required to make the full amount of the partner's capital contribution or to restore the full amount of the partner's deficit capital account; and

- Taxpayers may attempt to re-create bottom dollar guarantees by dividing a single obligation into tiers, or tranches, of liabilities with different levels of seniority. A guarantee of the most senior liabilities tranche is akin to a bottom dollar obligation. So, you must consider whether the tranches of liabilities should be respected, particularly where all the tranches are liabilities to the same lender or lenders. The regulations address this issue.

The § 752 regulations provide a narrow exception for certain bottom dollar payment obligations resulting from an indemnity, a reimbursement agreement, or a similar arrangement. In such

circumstances, the obligation will nevertheless be recognized where a partner or related person is liable for at least 90 percent of the partner's or related person's initial payment obligation considering the indemnity, reimbursement agreement, or similar arrangement. See Treas. Reg. § 1.752-2(b)(3)(ii)(B).

Note that a payment obligation is not a bottom dollar payment obligation merely because a maximum amount is placed on the partner's or related person's payment obligation, a partner's or related person's payment obligation is stated as a fixed percentage of every dollar of the partnership liability, or there is a right of proportionate contribution running between partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable. See Treas. Reg. § 1.752-2(b)(3)(ii)(C)(2).

The § 752 regulations require taxpayers to disclose bottom dollar payment obligations by filing Form 8275, Disclosure Statement, or any successor form, with the return of the partnership for the taxable year in which a bottom dollar payment obligation is undertaken or modified. The partnership must identify the payment obligation with respect to which disclosure is made and state whether the obligation is a guarantee, a reimbursement, an indemnity, or deficit restoration obligation. See Treas. Reg. § 1.752-2(b)(3)(ii)(D).

The rules for bottom dollar payment obligations 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 October 5, 2016, other than liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken pursuant to a written binding contract in effect prior to that date. However, a transitional rule applies to any partner whose allocable share of partnership liabilities under § 1.752-2 exceeded its adjusted basis in its partnership interest as determined under § 1.705-1 on October 5, 2016 (Grandfathered Amount). To the extent of that excess, those partners may continue to apply the prior regulations under § 1.752-2 with respect to a partnership liability for a seven-year period beginning October 5, 2016. The amount of partnership liabilities subject to transition relief decreases for certain reductions in the amount of liabilities allocated to that partner under the transitional rule and, upon the sale of any partnership property, for any tax gain (including § 704(c) gain) allocated to the partner less that partner's share of amount realized.

b. Nonrecourse Liabilities for § 752

Nonrecourse liabilities under § 752 means that no partner (or related person) has an EROL for the partnership liability. If a liability is nonrecourse, it means that in the event of default the lender cannot pursue at least one of the partners for collection of the liabilities assuming the partnership has insufficient collateral (or assets) to satisfy the loan. The definition of a nonrecourse liability under § 752 is related to, but distinct from, the concept of nonrecourse liabilities under state law.

General partners are not liable for liabilities of the partnership that are nonrecourse under state law, meaning that the lender's remedy (on default) is limited to the stated collateral (generally set forth in the loan documents). Thus, general partners will not bear an EROL for the partnership liabilities that is nonrecourse under state law.

Example 3: The ABC general partnership owns Asset 1 and Asset 2, neither of which is encumbered. The partnership borrows money on a nonrecourse basis (under state law) from Bank to purchase Asset 3. Asset 3 is the only asset used to secure the nonrecourse liabilities. The partnership is not able to pay the liabilities and the sale of Asset 3 does not result in enough cash to satisfy the loan. Assume A, B, and C are all general partners. The liabilities will be nonrecourse because Bank's remedies are limited to the stated collateral. Therefore, under the loan agreement, Bank cannot pursue A, B, or C to satisfy the unpaid amount of the loan.

Example 4: The ABC LLC owns Asset 1 and Asset 2, neither of which is encumbered. The LLC borrows money on a recourse basis (under state law) from Bank to purchase Asset 3, which is used as collateral for the loan. The loan agreement provides that Bank can pursue LLC's other assets, including Asset 1 and Asset 2, if the sale of Asset 3 does not result in enough cash to satisfy the loan. A, B, and C are LLC members. Although the liabilities will be recourse for state law purposes because Bank's remedies are not limited to the stated collateral, the liabilities will be nonrecourse under § 752 to A, B, and C. This because state law states the liabilities of the LLC are not the liabilities of its members. Therefore, Bank cannot pursue A, B, or C to satisfy the unpaid amount of the loan and none bear the EROL with respect to the loan.

Nonrecourse liabilities are allocated without considering EROL because no partner bears an EROL if the liabilities cannot be paid by the partnership. A partner's outside basis is increased to the extent that a partner is allocated nonrecourse liabilities of a partnership. The § 752 regulations devised a three-tier analysis for allocation of nonrecourse liabilities. The § 752 regulations contemplate allocating basis to partners who gained (or will gain) a tax benefit from deductions claimed because of the nonrecourse liabilities.

- ***Tier 1:*** The partner's share of "partnership minimum gain." See Treas. Reg. § 1.752-3(a)(1). Basis is allocated to the extent that partners have already claimed losses or received distributions generated by the partnership taking deductions connected to nonrecourse liabilities (this is a partner's share of minimum gain – or a partner's share of any future Tufts gain).

- ***Tier 2:*** The amount of any taxable gain that would be allocated to the partner under § 704(c) if the partnership disposed of its property subject to nonrecourse liabilities for relief of such liabilities and no other consideration (Treas. Reg. § 1.752-3(a)(2)). This is generally the face value of nonrecourse liabilities (e.g., contributed to a partnership in connection with an asset) over the partnership § 704 book basis in the asset (linked to the nonrecourse liabilities) at the time of contribution (this is the allocation of built-in gain). The logic behind this is that deductions (or losses) are not allowed more than the partner's outside basis. The deduction or loss connected with the payment of the liabilities (more than the partnership § 704 book basis in the asset) would have been enjoyed by the partner who contributed the asset. Therefore, that partner is allocated that amount of nonrecourse liabilities that is more than the partnership's basis in the asset

thereby increasing his outside basis and allowing him to take deductions or loss connected with the payment of the liabilities.

- ***<u>Tier 3</u>:*** Generally, a partners' shares in partnership profits. The reasoning behind this is that the profits of the partnership will be used to pay the partnership liabilities. Thus, each partner will be presumed as paying for the liabilities through the partnership – even though they have no EROL individually. There are other way to allocate nonrecourse debt under Tier 3 presribed in regulations under 752. However, how the partners share partners is the most common way that that nonrecourse liabilities are allocated under Tier 3.

(4) <u>Allocation of Losses Generated by Liabilities (Between the Partners): The Interplay between §§ 752 and 704(b)</u>

Losses generated by liabilities will be allocated depending on whether the liabilities are recourse or nonrecourse (i.e., which ultimately depends on whether any partner or person related to a partner bears an EROL). There is an interplay between the "allocation of liabilities" rules (under § 752) and the "substantial economic effect" rules (under § 704(b)).

- Losses associated with recourse liabilities are allocated to those partners who bear the EROL. It is assumed the partners will eventually contribute the money needed to pay off the partnership liabilities (or pay for the liabilities if the partnership cannot). Therefore, losses associated with recourse liabilities have substantial economic effect.
- Losses associated with nonrecourse liabilities are allocated according to the partnership agreement (e.g., what each partner is committed to contributing to pay for the liabilities). The rules assume that the partners will follow their agreement and pay the nonrecourse liabilities through the partnership. Allocations of nonrecourse deductions are deemed to be in accordance with the partners' interests in the partnership only if the requirements of the primary or alternative tests are met and, if the partnership has nonrecourse deductions or makes a distribution of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain, the partnership agreement contains a minimum gain chargeback provision. In addition, the partnership agreement provides for allocations of nonrecourse deductions in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities. <u>See</u> Treas. Reg. § 1.704-2(e) (providing a safe harbor for allocations attributable to nonrecourse liabilities).

(5) <u>Income/Gain from the Cancelation of Debt</u>

a. COD Income Discharge of Indebtedness under § 61(a)(11)

Discharge of indebtedness (whether recourse or nonrecourse) is income pursuant to § 61(a)(11) when the debt is cancelled, and no property is exchanged. Cancellation or discharge of indebtedness results in includable income in the year of the cancellation. <u>United States v. Kirby Lumber Co.</u>, 284 U.S. 1 (1931); <u>Cozzi v. Commissioner</u>, 88 T.C. 435 (1987).

The moment it becomes clear that a debt will never be repaid, that debt must be viewed as having been discharged. Cozzi v. Commissioner, 88 T.C. at 445. The test for determining such moment requires a practical assessment of the facts and circumstances relating to the likelihood of payment. Id. "Any 'identifiable event' that fixes the loss with certainty may be taken into consideration." Id.

The issuance of a Form 1099–C, Cancellation of Debt, is an identifiable event, but it is not dispositive of an intent to cancel indebtedness. Owens v. Commissioner, T.C. Memo. 2002–253, aff'd. in part, rev'd. in part and remanded 67 Fed. Appx. 253 (5th Cir. 2003). The nonreceipt of a Form 1099-C, however, does not convert otherwise taxable income into nontaxable income. Rinehart v. Commissioner, T.C. Memo. 2002-71.

Treas. Reg. § 1.6050P-1(b)(2)(i) (in effect after November 10, 2016 for information returns required to be filed, and payee statements required to be furnished after December 31, 2016) provides the following list of identifiable events under which debt is discharged solely for purposes of information reporting requirements:

(A) A discharge of indebtedness under title 11 of the United States Code (bankruptcy);

(B) A cancellation or extinguishment of an indebtedness that renders a debt unenforceable in a receivership, foreclosure, or similar proceeding in a federal or state court, as described in § 368(a)(3)(A)(ii) (other than a discharge described in Treas. Reg. § 1.6050P-1(b)(2)(i)(A));

(C) A cancellation or extinguishment of an indebtedness upon the expiration of the statute of limitations for collection of an indebtedness, subject to the limitations described in Treas. Reg. § 1.6050P-1(b)(2)(ii), or upon the expiration of a statutory period for filing a claim or commencing a deficiency judgment proceeding;

(D) A cancellation or extinguishment of an indebtedness pursuant to an election of foreclosure remedies by a creditor that statutorily extinguishes or bars the creditor's right to pursue collection of the indebtedness;

(E) A cancellation or extinguishment of an indebtedness that renders a debt unenforceable pursuant to a probate or similar proceeding;

(F) A discharge of indebtedness pursuant to an agreement between an applicable entity and a debtor to discharge indebtedness at less than full consideration; or

(G) A discharge of indebtedness pursuant to a decision by the creditor, or the application of a defined policy of the creditor, to discontinue collection activity and discharge debt.

b. Gain from Dealings in Property under § 61(a)(3)

Generally, discharge of indebtedness will result in gain under § 61(a)(3) where the partnership exchanges a partnership asset in exchange for the liability. If property secured the debt and the creditor takes that property in full or partial satisfaction of the debt, this is treated as the partnership having sold that property to the creditor. The tax treatment depends on whether the creditor could collect beyond repossessing the property (recourse debt) or whether the creditor's collection was limited to repossession (nonrecourse debt). Note these definitions of recourse and nonrecourse are distinct from the recourse and nonrecourse for purposes of § 752 that are addressed above.

If property was subject to a recourse debt, the amount realized is the fair market value (FMV) of the property. The ordinary income from the cancellation of the debt is the amount of the debt more than the FMV of the property that the lender forgives. This cancellation of debt must be included in income unless an exception or exclusion applies. The difference between the FMV and adjusted basis will be gain or loss on the disposition of the property.

If property was subject to a nonrecourse debt, the amount realized is the entire amount of the nonrecourse debt plus the amount of cash and the FMV of any property received. There is no ordinary income resulting from nonrecourse debt cancellation when property is exchanged.

The examples below show the difference between how recourse and nonrecourse debt is treated.

> **Example 5:** Partnership bought a boat for business use for $20,000, paying $2,000 down and signing a recourse note for $18,000. After paying down $4,000 on the note, partnership is no longer able to make payments. The boat dealer repossesses the boat, which is now worth $11,000. Partnership will have ordinary income from cancellation of debt of $3,000 ($14,000 remaining debt owed minus $11,000 FMV of boat). Partnership will have a loss upon disposition of the boat (equal to adjusted basis minus FMV at the time of repossession) if the partnership's adjusted basis in the boat (including depreciation deductions) is greater than the boat's FMV of $11,000 (the amount partnership realized on repossession).
>
> **Example 6:** The facts are the same except that partnership signed a nonrecourse note when buying the boat. When the dealer repossesses the boat, partnership will have a loss equal to the partnership's adjusted basis in the boat (including depreciation deductions) minus the $14,000 amount realized (the face amount of the remaining debt). Partnership has no ordinary income from cancellation of the debt.

B. What Do I Need to Do When I Get the Information

- Verify you received the following in every case in which the Service is auditing debt: (1) all loan contracts, (2) security agreements, and (3) promissory notes.

- Make sure that you received signed copies of all guarantees, pledges, and any other document related to the loan, including any amendments to those documents. You should ask the taxpayer or representative to verify they've provided you every document that can possibly affect the loan arrangement.

- Make sure any guarantee or pledge is valid. Generally, to be valid under state law, a guarantee or pledge will only be enforceable if the lender provided the borrower with consideration to induce the guarantee or pledge. The best way to think of this is: "Did the guarantee or pledge induce the loan?" If not, the guarantee or pledge is probably invalid unless the lender gave the borrower something else at the time the guarantee or pledge was signed.

- Verify the guarantee is not a bottom dollar payment obligation. In other words, verify whether payment on the guarantee is too remote.

- Verify all security agreements, deeds of trust, collateral agreements or other documents that provide collateral for the loan have been recorded. This is equivalent to the recording of a federal tax lien. This could arise, for example, if we are trying to determine if a debt is, in fact, a bona-fide debt between parties in an arm's length transaction.

- Compare the outstanding principal amounts of all loans to the books and records of the partnership. If a loan is not reflected in the books of the partnership, follow up with the partnership to ask why it's not listed.

- Compare the outstanding principal amounts of any loan to those listed on Line 19a of Schedule L (balance sheet) of the Form 1065. If the loan is not reflected on the Form 1065 for the partnership, follow up with the partnership to ask why it's not listed.

- Determine whether any partner's share of partnership liabilities decreased at the end of the year. This may result in a § 752(b) deemed distribution or may result in the application of a minimum gain chargeback provisions.

- Determine whether a portion of a loan was forgiven and determine whether any partnership property was exchanged. This could result in COD income, gain, or a bifurcation of COD income and gain. Note that partner insolvency is irrelevant for the determination of COD income at the partnership level. Also, partnership insolvency when dealing with gain under §61(a)(3).

- Debt workouts can be complex and might be tax motivated (e.g., an insolvent partner would want the debt to be treated as COD income so they would be eligible for exclusion

under §108, whereas a partner who is not insolvent would want capital gain treatment). Please consult your SFTS and Counsel Partnership Cadre for assistance reviewing workout arrangements.

- Large multi-nationals often book "due to" and "due from" to account for cash transfers among affiliates. Make sure to determine whether those constitute liabilities for U.S. federal income tax purposes.

- For cases involving original issue discount (OID) issues, review the loans and promissory notes to determine if the loans contain "qualified stated interest," which is defined in § 1.1273-1(c)(1)(i) as "stated interest that is unconditionally payable in cash or in property (other than debt instruments of the issuer), or that will be constructively received under § 451, at least annually at a single fixed rate (within the meaning of paragraph (c)(1)(iii) of this section)." Stated interest that is not qualified stated interest is treated as OID. If the loan or promissiory note does not contain adqueate stated interest within the meaning of § 1274 and the regulations thereunder, then a portion of the stated principal amount of the loan or promissory note is recharacterized as OID. Any OID must be included in income as it accrues each year in accordance with § 1272 and the regulations thereunder, regardless of the taxpayer's regular method of accounting. For other Code sections that may raise unstated or imputed interest issues for loans and promissory notes, see § 483 (contracts for the sale or exchange of property not subject to § 1274) and § 7872 (certain below-market loans).

- Verify: (1) the debt has been classified properly on the Schedules K-1; and (2) the debt has been allocated properly under § 752. This will affect whether a partner is subject to basis limitations under § 704(d).

- Verify the partnership agreement contains a minimum gain chargeback provision to the extent that there are nonrecourse deductions (and it has been applied properly to the extent a partner's share of minimum gain has been decreased for the year).

IV. LIMITS ON PARTNER'S ABILITY TO CLAIM LOSSES

A Note about Partner Level Adjustments

Under TEFRA, partner level adjustments could be made after a partnership exam concluded as a result of those partner level items being treated as affected items. There are no affected items under BBA. As mentioned at the beginning of this guide, generally under BBA, any adjustment to a PRI is determined, and any tax imposed by Chapter 1 attributable thereto is assessed and collected, at the partnership level. Therefore, under BBA, to the extent the adjustments made in the following sections are adjustments to PRI's, they must be made at the partnership level during the partnership exam and cannot be made in a subsequent partner exam. Any legal or factual determinations underlying any partnership adjustments or determinations must also be determined at the partnership level. To the extent there is a question as to how to appropriately capture the adjustment at the partnership level, please reach out to the appropriate subject matter expert.

Basis Limitation

27. If the partnership reported a partner's beginning or ending tax basis capital account balance as a negative amount, explain how what caused the negative amount (e.g., losses or deductions, distributions, or property contributed subject to liabilities in excess of its adjusted tax basis to the partnership). Did the partnership revalue its book capital accounts during the years at issue (e.g., if the partnership admitted a new partner)? If yes, provide any appraisals of the partnership property, information of the measuring event, and documentation used to support the revaluation of the § 704(b) book capital accounts.

At-Risk Limitations

28. Was the partner's share of nonrecourse liabilities, partnership-level qualified nonrecourse financing, and other recourse liabilities reported on the Schedule K-1 for each activity included in the at-risk rules? If so, how did the partnership determine that the liabilities qualify as amounts at-risk?

29. For at-risk purposes, did the partnership conduct more than one activity, including activities conducted by lower-tier partnerships? Did the partnership report on an attachment to Schedule K-1 information relating to each activity, including items of income, loss, and deduction? If no, explain and support your position.

30. Did the partnership aggregate activities for at-risk purposes? If so, did the partnership identify the aggregation on Form 1065?

Passive Activity Loss Limitations

31. Did the partnership report on Schedules K-1 income or loss, credits, and all items required to be separately stated under section 702(a) separately by activity for each of the following: trade or business activities, rental real estate activities, rental activities other than real estate,

portfolio income for purposes of the passive activity rules? If not, explain and support your position.

32. Did the partnership group one or more trades or businesses or rental activities as a single activity for purposes of the passive activity rules? If so, what factors were considered in determining whether the activities make up an appropriate economic unit (e.g., similarities and differences in types of trades or business; common control; common ownership; geographical location; and reliance between or among the activities)?

A. **Why Are We Asking: Common Issues: I.R.C. §§ 704(d), 465, and 469?**

A loss that is properly allocated to a partner under § 704(b) may still not be deductible by the partner (even though the amount appears on that partner's Schedule K-1). There are three major limitations to a partner's ability to claim its share of loss from the partnership. In order of application, the limits are:

- The partner's adjusted basis in its partnership interest (outside basis) under § 704(d);
- The partner's at-risk amount under § 465; and
- The passive-activity rules under § 469.

Any disallowed loss will be suspended and carried forward. Note, none of these limitations will cause a reallocation of losses among the partners. Rather, the losses remain suspended with the partner to whom the losses were allocated. That partner will eventually be able to claim the loss once the code section preventing the claimed loss allows for such loss. Any losses tested under § 465 and § 469 will have already passed through the § 704(d) limitation, and therefore any such losses will have already reduced outside basis before reaching those Code sections. Therefore, losses under § 465 and § 469 will have no further effect on outside basis.

Suspended losses under § 465 and § 469 may be claimed on the disposition of an activity. The disposition rule for § 465 is narrower than for § 469. Section 469(g) allows all the suspended passive losses from the activity to be "freed up" upon a disposition of a taxpayer's entire interest in an activity in a fully taxable transaction to an unrelated party. Conversely, § 465 treats the gain recognized from a disposition of an activity as income from the activity that can be used against the suspended losses from the same activity. In other words, disposition gain will increase the taxpayer's amount at risk in the activity by the amount of the gain. If there are suspended losses more than the disposition gain, those losses will be lost forever. There is no provision in § 465 that permits these excess losses to be "freed up", unlike § 469(g). In essence, such excess losses were never economic losses to begin with, for purposes of § 465.

(1) Outside Basis Limitations

Under § 704(d), a partner can claim its allocable share of loss from a partnership if the partner has sufficient outside basis. A partner's outside basis can be reduced to zero, but never less than zero. Therefore, the Service must know the amount of a partner's outside basis.

a. Outside basis

i. Generally

In general, a partner's outside basis is equal to the amount of money and the adjusted basis of property contributed, net of any liabilities of the partner assumed by the partnership, plus any gain recognized under § 721(b). Alternatively, if a partnership interest is acquired other than because of a contribution of property (e.g., by purchase of an existing partner's interest or acquisition of a partnership interest from a decedent), the partner's outside basis is determined under the general basis rules of §§ 1011, 1012, 1014, 1015, etc.

Section 705 and the regulations thereunder provide that a partner's outside basis is increased by the sum of the partner's contributions and distributive share for the taxable year and prior taxable years of:

- taxable income of the partnership determined under § 703(a),
- tax-exempt income of the partnership,
- depletion deductions more than the basis of the property subject to depletion

A partner's outside basis is decreased (but not below zero) by:

- Distributions from the partnership under § 733
- By the sum of the partner's share for the taxable year and prior taxable years of:
    - partnership losses (including capital losses)
    - nondeductible, noncapitalized partnership expenditures
- The partner's deduction for depletion with respect to certain oil and gas property of the partnership (but not more than the partner's proportionate share of adjusted basis of such property)

A partner's outside basis also reflects the changes in the partner's share of partnership labilities and assumptions of liabilities. Increases in a partner's share of partnership liabilities and assumptions of partnership liabilities by a partner are treated as contributions of money and thus increase a partner's outside basis. Conversely, decreases in a partner's share of partnership liabilities and assumptions of a partner's individual liabilities by a partnership are treated as distributions of money and thus decrease a partner's outside basis.

Treas. Reg. § 1.705-1 provides that a partner is required to determine his outside basis only when necessary for the determination of his tax liability or that of any other person. The determination of the adjusted basis of a partnership interest is ordinarily made as of the end of a partnership taxable year. For example, a partner must determine its outside basis in determining whether its share of partnership losses is allowed under § 704(d) or when there is a sale or exchange of all or a part of its partnership interest or a liquidation of the partner's entire interest in a partnership. Moreover, Treas. Reg. § 1.705-1 provides that a partner's outside basis is determined without regard to any amount shown in the partnership books as the partner's "capital," "equity," or similar account.

Partnerships do not report a partner's outside basis on Form 1065 or on the Schedule K-1. However, the Service may generally be able to estimate a partner's outside basis by reviewing the partner's tax basis capital account and share of partnership liabilities. Beginning in tax year 2020, all partnerships will be required to report its partners' tax basis capital accounts.

ii. Basis Suspense Restoration

If a partner is allocated losses from a partnership in a year more than its outside basis pursuant to § 704(d) and improperly claims tainted losses more than the partner's outside basis in that year, the partner's improperly-claimed tainted losses are carried forward to future years, and the

partner must cure this by reducing the tax basis increase in the earliest subsequent tax year when the partner's outside basis would otherwise be increased pursuant to § 705(a)(1). This adjustment is consistent with the "basis suspense restoration" rule for S corporations described in TAM 200619021, which states that "the correct basis adjustment for gain/loss in closed tax years must be used for purpose of determining taxpayer's correct stock basis for open tax years." In other words, a partner is not entitled to claim losses allocated to that partner until the partner recovers the basis reduction caused by the tainted loss (i.e., outside basis has accounted for the suspended loss carryforward). This adjustment is consistent with applying the ordering rules for determining a partner's basis in a partnership to tainted losses in much the same manner as the ordering rules for determining a shareholder's basis in an S corporation with respect to tainted losses. The partner's tainted loss in the closed tax year must be considered for computing basis for the subsequent open tax year of the examination pursuant to § 6214(b), and to eliminate double deductions of basis pursuant to Treas. Reg. § 1.1016-6(a). Without this adjustment, the partner would be able to deduct these tainted losses when the partner lacked basis in the closed tax year, and then deduct the same amount in the subsequent tax year when partner does have basis. Accordingly, the partner is not entitled to claim losses in the subsequent open tax year before restoring its outside basis in the subsequent tax year for losses it improperly deducted more than its outside basis in the closed tax year.

b. Tax Basis Capital Account

In the absence of a partner's outside basis, it may be possible to estimate a partner's outside basis by reference to the partner's tax basis capital account (reported on Schedule K-1, Item L, beginning in tax year 2020) and share of partnership liabilities (reported on Schedule K-1, Item K).

Prior to 2020, partnerships were not required to report a partner's tax basis capital account but could report partner's capital accounts using Generally Accepted Accounting Principles (GAAP), § 704(b) book, tax basis, or any other method. In 2018, instructions to the Form 1065 first required partnerships to report a partner's tax basis capital account only if the beginning or ending balance was negative. The instructions for the 2018 Schedule K-1 (Form 8865) incorporated this requirement by reference to the instructions for Form 1065.

A partner may have a negative tax basis capital account if the partnership allocates deductions or losses, or makes a distribution to a partner in excess of the partner's contributions and share of income from the partnership. It can also arise when a partner contributes property subject to liabilities more than the property's adjusted tax basis. If a partner's tax basis capital account is negative, the negative amount may result in taxable income or gain to the partner, unless the partner is allocated a sufficient share of the partnership's liabilities to offset the negative amount. For example, if a partner has a tax basis capital account balance of negative ($50), and withdraws $100 from the partnership, to avoid $150 of taxable income, the partner's share of liabilities would need to be at least $150.

Four common audit issues associated with partnerships with large negative tax capital accounts reported on Schedules K-1 are: (1) losses in excess of outside basis or amount at risk; (2) cash distributions (and §752(b) deemed cash distributions) in excess of outside basis; (3) gain on the

sale or deemed sale of partnership interests; and (4) final partnership return issues, including cancellation of debt income, shifting liabilities, or foreclosure of partnership property.

(1) Losses in Excess of Outside Basis or Amount At Risk

The partner must have adequate outside basis under §§ 704(d) and 705 and amount at risk under § 465 to claim the losses from the partnership. A partner may have sufficient outside basis, but not sufficient at-risk basis to claim loss/deduction. Determine if a partner is at risk for the share of liabilities included in the partner's outside basis. I.R.C. § 465.

(2) Cash Distributions (and §752(B) Deemed Cash Distributions) in Excess of Outside Basis

Cash distributions (and § 752(b) deemed cash distributions) in excess of outside basis must be recognized as gain from the sale or exchange of a capital asset. I.R.C. § 731. A decrease in a partner's share of partnership liabilities is a deemed distribution of cash to the partner per § 752(b). Deemed distributions can be identified by comparing beginning and ending liability balances shown on the Schedule K-1.

(3) Gain on the Sale or Deemed Sale of Partnership Interests

When a partner disposes of (or is deemed to dispose of) some or all the partner's partnership interest, you must determine gain or loss as the amount realized minus outside basis. The amount realized on the disposition of a partnership interest includes cash and property received for the interest, plus any decrease in the selling partner's share of partnership liabilities.

(4) Final Partnership Return Issues, Including Cancellation of Debt Income, Shifting Liabilities, or Foreclosure of Partnership Property

The ending balance of a partner's capital account is generally restored to zero in the final year. Positive capital account balances are reduced by distributions and loss allocations. Negative capital accounts are increased by contributions and income allocations. To the extent that a partner's tax basis capital is not zeroed out on the final return, the partner should have tax consequences. For example, if a partnership does not pay its liabilities, upon termination, there is COD that is allocated among partners. A partnership may fail to report a discharge of indebtedness by carrying non-bona fide debt, ceasing operations but continuing to file returns (known as a "zombie partnership"), or failing to file returns (known as a "stop-filer").

c. Calculating a Partner's Tax Basis Capital Account

In general, a partner's tax basis capital account represents its equity in the partnership calculated using federal income tax principles, not GAAP, § 704(b) book, or other principles.

Four common audit issues associated with partnerships with large negative tax capital accounts reported on Schedules K-1 are: (1) losses in excess of amount at risk; (2) cash distributions in excess of outside basis; (3) gain on the sale or deemed sale of partnership interests; and (4) final

partnership return issues, including cancellation of debt income, shifting liabilities, or foreclosure of partnership property.

Based on the 2021 Instructions to Form 1065, a partner's tax basis capital account is equal to:

- The amount of cash plus the adjusted tax basis of all property contributed by the partner to the partnership during the year, reduced by any liabilities assumed by the partnership in connection with, or liabilities to which the property is subject immediately before, the contribution, and

adjusted by:

- The partner's distributive share of partnership income and gain (including tax-exempt income) as computed for tax purposes for the year, minus the partner's distributive share of partnership loss and deductions (including nondeductible, noncapital expenditures) as computed for tax purposes for the year, and
- The amount of cash plus the adjusted tax basis of all property distributed by the partnership to the partner during the year, reduced by any liabilities assumed by the partner in connection with, or liabilities to which the property is subject immediately before, the distribution.

The partner's tax basis capital account is increased by the partner's distributive share of the excess of the tax deductions for depletion (other than oil and gas depletion) over the adjusted tax basis of the property subject to depletion, and the partner's share of any increase to the adjusted tax basis of partnership property under § 734(b).

The partnership will also decrease the partner's tax basis capital account by the partner's distributive share of tax deductions for depletion of any partnership oil and gas property, but not exceeding the partner's share of the adjusted tax basis of that property, and the partner's share of any decrease to the adjusted tax basis of partnership property under § 734(b).

If the partnership has a § 754 election in effect, increases and decreases to the adjusted tax basis of partnership property under § 743(b) are not included on Schedule K-1, Item L. Note that the instructions to Form 1065 require the partnership to separately report § 743(b) adjustments in a statement attached to the return.

Note that a partner's tax basis capital account does not include changes in the partner's share of partnership liabilities.

> **Example 1:** A contributes $100 in cash and B contributes unencumbered, non-depreciable property with a fair market value (FMV) of $100 and an adjusted tax basis of $30 to newly formed Partnership AB. A's initial tax basis capital account is $100, and B's initial tax basis capital account is $30.
>
> **Example 2:** The facts are the same as in Example 1, except B contributes non-depreciable property with an FMV of $100, an adjusted tax basis of $30, and subject to liability of $20. B's initial tax basis capital account is $10 ($30 adjusted tax basis of property contributed, less the $20 liability to which the property was subject).

Example 3: The facts are the same as in Example 1, except in Year 1, the partnership earns $100 of taxable income and $50 of tax-exempt income. A and B are each allocated $50 of the taxable income and $25 of the tax-exempt income by the partnership. At the end of Year 1, A's tax basis capital account is increased by $75, to $175, and B's tax basis capital account is increased by $75, to $105.

Example 4: The facts are the same as in Example 3. Additionally, in Year 2, the partnership has $30 of taxable loss and $20 of nondeductible noncapitalizable expenditures. A and B are each allocated $15 of the taxable loss and $10 of the nondeductible noncapitalizable expenditures. At the end of Year 2, A's tax basis capital account is decreased by $25, to $150, and B's tax basis capital account is decreased by $25, to $80.

Example 5: On January 1, 2019, 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 § 168(k), for $1,000. Assume that the partnership properly allocates the $800 liability equally to A and B under § 752. Immediately after the partnership acquires Asset X, both A and B have tax basis capital accounts of $100 ($100 cash contributed) and outside bases of $500 ($100 cash contributed, plus $400 share of partnership liabilities under § 752). In 2019, the partnership recognizes $1,000 of tax depreciation under § 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, 2019, A and B both have tax basis capital accounts of negative $400 ($100 cash contributed, minus $500 share of tax depreciation) and outside bases of zero ($100 cash contributed, plus $400 share of partnership liabilities under § 752, and minus $500 share of tax depreciation).

(2) At-Risk Limitations

If a partner has sufficient outside basis to claim its share of partnership loss, such loss may nevertheless be limited by the amount the partner has at-risk determined under § 465 and the regulations thereunder. In general, § 465 operates to limit losses attributable to an activity for which the partner bears no economic burden.

In general, § 465(b)(1) provides that a taxpayer shall be considered at-risk for an activity with respect to amounts including (A) the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity, and (B) certain amounts borrowed with respect to such activity. An amount at-risk includes an amount borrowed for use in an activity to the extent that the taxpayer (A) is personally liable for the repayment, or (B) has pledged property, other than property used in such activity, as security for such borrowed amount (to the extent of the fair market value of the taxpayer's interest in such property).

A borrowed amount will not qualify as an amount at-risk if such amount is borrowed from any person who has an interest in such activity or from a related person to a person (other than the taxpayer) having such an interest. Under § 465(b)(4), an amount is not treated at-risk if it is

protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.

The at-risk rules apply to the following activities:

(A) Holding, producing, or distributing motion picture films or video tapes
(B) Farming (as defined in § 464(e))
(C) Leasing any § 1245 property (as defined in § 1245(a)(3))
(D) Exploring for, or exploiting, oil and gas resources
(E) Exploring for, or exploiting, geothermal deposits (as defined in § 613(e)(2)) as a trade or business or for the production of income

Section 465 also applies to each activity (i) engaged in by the taxpayer in carrying on a trade or business or for the production of income, and (ii) which is not listed above.

Generally, a partner can only claim losses (associated with liabilities) for which that partner is personally liable. Under the case law, a taxpayer is personally liable for repayment of a liability if the taxpayer is the "payor of last resort in a worst case scenario" with respect to that liability. This test is applied by assuming that the value of all the property of the borrower is reduced to zero, and all obligations of the borrower with respect to those liabilities correspondingly become immediately due, [but also if all other obligations of any other party (besides the borrower) with respect to such liabilities will be fulfilled., but qualified nonrecourse financing may increase the partners' amounts at-risk.]

Recourse liabilities will increase a partner's amount at risk only if the partner is personally liable for repayment of such liabilities. For example, if another partner guarantees such liabilities, the non-guaranteeing partners will no longer be personally liable for repayment of such liabilities in a worst-case scenario, even though the liabilities remain recourse liabilities of the partnership.

Partners will be considered at-risk for certain non-recourse financing if it is "Qualified nonrecourse financing." In order to be qualified nonrecourse financing the debt must meet the following requirements: (i) the debt was borrowed by the taxpayer with respect to the activity of holding real property, (ii) the debt was borrowed by the taxpayer from a qualified person or represents a loan from, or is guaranteed by, any federal, state, or local government, (iii) it is debt for which no person is personally liable for repayment, and (iv) the debt is not convertible debt.

A partner's amount at-risk is increased by the taxable and tax-exempt income from the activity and decreased by loss, distributions, and repayments of liabilities by other parties, along with nondeductible, noncapitalizable expenses relating to the tax-exempt income from the activity. In general, a partner's amount at-risk cannot be less than zero. If a partner's amount at-risk is reduced below zero, the partner recognizes ordinary income equal to the amount of the excess. The recaptured amount is allowable as a deduction allocable to the activity in the first succeeding tax year.

(3) Passive Activity Losses

The passive activity loss rules under § 469 and the regulations thereunder apply to limit the amount of loss claimed by individuals, estates, and trusts, certain closely held C corporations, and certain personal service corporations, all of which may be partners in a partnership. The passive activity loss rules apply to limit the partner, not the partnership, from claiming the loss. These rules apply after considering the rules under §§ 704(d) and 465. In general, passive activity losses are disallowed. Any passive activity loss (i.e., the amount by which the aggregate of losses from all passive activities for the year exceeds the aggregate income from all passive activities) is suspended and carried forward to the next tax year until the taxpayer has sufficient passive activity income to claim the loss.

A taxpayer who disposes of an interest in a passive activity may deduct suspended losses allocable to an activity if: (1) the disposition is of his entire interest in the activity; (2) the disposition is in the form of a fully taxable transaction; and (3) the person acquiring the interest is not related to the taxpayer.

Section 469(c) defines a passive activity as any activity that involves the conduct of any trade or business and in which the taxpayer does not materially participate. Any rental activity is a per se passive activity, regardless of the level of participation by the taxpayer unless the taxpayer is a qualified real estate professional under § 469(c)(7).

A taxpayer is treated as materially participating in an activity under § 469(h) only if the taxpayer is involved in the operations of the activity on a regular, continuous, and substantial basis. Further, 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. Treas. Reg. § 1.469-5T(a) sets forth seven tests for determining material participation that look, among other things, to the number of hours a taxpayer is engaged in the activity, the substance of the participation, and the time spent participating in the activity.

Treas. Reg. § 1.469-2T(e)(1) provides that the character (as an item of passive activity gross income or passive activity deduction) of each item allocated to a taxpayer from a partnership is determined by reference to the participation of the taxpayer in the activity (or activities) that generated such item. Such participation is determined for the taxable year of the partnership (and not the taxable year of the taxpayer).

The partnership agreement may provide a description of the partner's level of participation in the activities of the partnership. Note that courts have held that owners of LLPs and LLCs are not subject to § 469(h)(2) if local law does not preclude the owners of the LLP or LLC interests from participating in the activity of the partnership. See Paul D. Garnett v. Commissioner, 132 T.C. 368 (2009); Gregg v. United States, 186 F. Supp. 2d 1123 (D.Or. 2000).

Prop. Reg. § 1.469-5(e)(3)(i) (on which taxpayers may rely on, but are not binding on taxpayers) would define an interest in an entity as an interest in a limited partnership as a limited partner, for purposes of applying section 469 and the regulations thereunder, if the entity in which the interest is held is classified as a partnership for federal income tax purposes under Treas. Reg.

§ 301.7701-3 and the holder of such interest does not have rights to manage the entity at all times during the entity's taxable year under the law of the jurisdiction in which the entity is organized and under the governing agreement. (76 FR 72875-01, 2012-9 I.R.B. 434, November 28, 2011). But under Prop. Reg. § 1.469-5(e)(3)(ii) an individual is not treated as holding an interest in a limited partnership as a limited partner if such individual also holds an interest in the partnership that is not an interest in a limited partnership as a limited partner (as defined in Prop. Reg. § 1.469-5(e)(3)(i)), such as a state-law general partnership interest, at all times during the entity's taxable year ending with or within the individual's taxable year (or the portion of the entity's taxable year during which the individual (directly or indirectly) owns such interest in a limited partnership as a limited partner).

B. **What Do I Need to Do When I Get the Information?**

- Prepare a report for each partner to be included in the administrative file. These reports must be completed even though the audit is for partnership items. The Service needs to know how each partnership level adjustment will affect each partner's tax liabilities for the year under audit.

- Check for potential common issues with Schedules K-1 showing large negative tax capital accounts, including (1) whether the partner has sufficient outside basis or at-risk amount to claim losses; (2) whether the partner has cash distributions (including §752(b) deemed distributions) in excess of outside basis; (3) whether the partner has gain on the sale or deemed sale of the partner's partnership interest (watch out for departing partner or shifting liabilities); and (4) whether there are final partnership return issues, including COD income, shifting liabilities, or foreclosure of partnership property.

- A partner may be properly allocated liabilities that are not reflected in the partner's tax capital account and increase the partner's outside basis. Therefore, where there are negative tax basis capital accounts, make sure that (1) liabilities were classified properly on the Schedules K-1 and (2) liabilities were allocated properly under § 752 (see the § 752 discussion in the Partnership Liabilities section above).

- Verify whether the partnership revalued its book capital accounts during the audit period(s) (e.g., if the partnership admitted a new partner). If the answer is yes, then verify the revaluation of the § 704(b) book capital accounts did not affect the tax capital accounts. A revaluation of the § 704(b) book capital accounts does not affect the tax basis capital accounts.

- For at-risk purposes, verify that the liabilities were classified properly on the Schedule K-1. Generally, a partner is at-risk for both recourse liabilities and qualified nonrecourse debt. Generally, a partner is not at-risk for a nonrecourse liability (unless it is qualified nonrecourse debt).

- Check whether the Schedules K-1 include statements separately reporting the activities (e.g., income, deductions, liabilities, and capital) for at-risk (§ 465) and passive activity loss (§ 469) purposes.

- Make sure you understand what liabilities are attributable to an activity for at-risk purposes.

- Verify partners materially participated in an activity if the activity was reported as nonpassive and the partner is claiming a loss with respect to the activity.

V. SELF-EMPLOYMENT TAX

33. Did the partnership exclude any income or loss items from "net earnings from self-employment"? If not, skip to Q.#34. If yes, identify the extent to which such income and loss items were excluded under § 1402(a) (other than under the limited partner exception of § 1402(a)(13)).

34. Did the partnership exclude any partner's share of income or loss items from "net earnings from self-employment" under the "limited partner" exception of § 1402(a)(13)? If not, skip to Q.# 36 (or the first question at the beginning of the next attached section to this IDR). Identify the status of any such partner(s) under state or local law (e.g., as a limited partner or limited liability company member).

35. Did any partner have personal liability for the liabilities or claims against the partnership by reason of being a partner? If yes, identify such partner(s).

36. Did any partner have authority to contract on behalf of the partnership? If yes, identify which partner(s) exercised such power. Identify which provision(s) in the partnership agreement set forth the partner's authority, along with any addenda to the partnership agreement that modify such provision(s).

37. Did any partner perform services (in their capacity as a partner) on behalf of the partnership during the audit period(s)? If yes, how many hours did each partner perform? Identify any partners who participated in the partnership's management or otherwise in the trade or business for more than 500 hours during the audit period(s). Provide a brief description of duties performed and an allocation of hours worked by each partner for the partnership and related entities.

38. Did any partner receive wages or guaranteed payments from the partnership during the audit period(s)? If yes, identify who made the decision and what criteria were considered in determining the amounts these partners were compensated. Provide all contracts (e.g., employment agreements) relating to wage and guaranteed payments to partner(s).

39. Did the partnership have any manager who was not a partner? If yes, identify how many hours the manager(s) performed in the trade or business activities of the partnership (and related entities) and to whom the manager(s) reported.

Did any partner receive a "preferred return" on invested capital? If so, please identify the extent to which these returns on capital were reported within guaranteed payments and any other Schedule K-1 items (e.g., the partners' share of ordinary business income (loss)). Identify which provisions in the partnership agreement set forth any preferred returns. Provide a detailed history of capital contributions made to the partnership (and related entities).

A. Why Are We Asking: Common Issues: I.R.C. § 1402(a)(13)

The imposition of self-employment ("SE") tax on an individual member's/partner's distributive share of income in a partnership is an issue required to be coordinated with SBSE Counsel. The key question is whether the partner is providing services and actively involved in the partnership as opposed to acting as a mere investor.

(1) Net Earnings from Self-Employment

In general, an individual partner's distributive share of a partnership's ordinary business income is included in net earnings from self-employment under § 1402(a) and subject to SE tax.[7] Section 1402(a) provides exclusions, including, for example, rental income (unless the rental amounts are received as part of a real estate dealer's trade or business), interest income (unless received during a trade or business), and a "limited partner's" distributive share of partnership income or loss other than guaranteed payments paid to that partner for services rendered to or on behalf of the partnership.

(2) Limited Partner Exclusion

Section 1402(a)(13) provides an exclusion from SE tax for a "limited partner's" distributive share of partnership income other than guaranteed payments paid to that partner for services rendered to or on behalf of the partnership to the extent that those payments are made in the nature of remuneration for those services. However, the statute does not define a "limited partner." Additionally, there are no final regulations under § 1402(a)(13) that define "limited partner." As a result, the application of § 1402(a)(13) and limited partner determination depends on the statute, legislative history, and case law. State-law labels may be relevant for determining the substance of the partner's relationship with the partnership, but they are not afforded any weight in determining the partner's status as a "limited partner" within the meaning of § 1402(a)(13). That status is determined using a functional test that analyzes the substance of the partner's role in the partnership. See Renkemeyer, Campbell, and Weaver LLP v. Commissioner, 136 T.C. 137 (2011).

As § 1402(a)(13) provides an exception for limited parnters, general partners of a juridical partnership are subject to self-employment tax. For partners with limited liability under state law in entities such as limited liability companies (LLCs), limited liability partnership (LLPs), limited partnerships (LPs), and limited liability limited partnerships (LLLPs), determining whether § 1402(a)(13) applies is more complex.

To determine if a person with limited liability from creditors ("owner") is not a "limited partner" of the entity for purposes of self-employment tax, we look primarily at three factors.

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[7] While Chapter 2 of the Code imposes the tax on self-employment income (not subject to BBA audit procedures), if a partnership is subject to BBA, the IRS must determine the partnership's income at the partnership level even if that might result in a change to any of the partner's self-employment income tax. If there are multiple tiers of entities, the IRS should consider opening all entities for examination to ensure that the self-employment income is properly reported and SE tax is ultimately paid by all relevant individuals.

a. What portion, if any, of the distributive share is a return on investment?

To establish that there is no return on investment (ROI), or that the ROI is only a portion of the distribution, it is crucial that we have an accurate accounting of all capital contributions and the changes in those accounts for all owners over the years. Thus, we ask for:

- Original, complete "partnership agreements" (not selected pages) that state what each owner's capital contribution was. If the capital contributions are set forth in an appendix to the "partnership agreement" or another document, we need those documents. If there are related entities that the owner has an interest in, we need to know capital contributions of those entities as well to accurately trace the extent of the owner's investment in the entire business of related entities.

- Any documents that show the history of contributions from the establishment of the entity through the tax year at issue.

- If any wages or guaranteed payments were made, we need to know the details so that we can take the payments into account in determining return on investment. Regarding the wages or guaranteed payments, the Service needs to know who made the decision (or who comprised a group that made the decision) as to what wages or guaranteed payments would be paid. If there are business records addressing the amount of the wages or guaranteed payments, we need those. All contracts, employment agreements, and job descriptions should be obtained to determine who was running the business. Note that bona fide partners cannot be employees of the partnership; therefore, if a partner is receiving wages, this presents an issue outside of § 1402(a)(13) (in this instance, a direct partner receiving wages raises a Revenue Ruling 69-184 issue).

- A list of any related entities that are holding companies for real estate and the income that is generated from those entities.

We also need to determine whether the partner actively participated in the partnership, see (c), below.

b. Does the owner have the ability to bind the entity to third parties?

The Service needs to know if the partner has the ability to bind the partnership. Thus, we ask for:

- All addenda to the original partnership agreement to see what powers are given and/or modified for all the various owners.

- A copy of three actual agreements that the owner has signed binding the entity with a third party. The power to bind the partnership is relevant to this determination even if not exercised.

- At least one purchase order/contract signed by the owner about something mundane (e.g., cleaning services, office supplies, or snow removal).

c. Was the partner involved with the day-to day operations of the business?

Participation by a partner in the partnership's trades or businesses for more than 500 hours during the partnership's taxable year is significant, but less than that can be significant, depending upon how many hours are required to run that business and who else was performing management duties. Thus, we ask for:

- An allocation of the number of hours worked for each entity. To adequately develop the case, an examiner should request records of hours worked. It is not ideal to have interview notes that the owner said he worked 40 hours per week in the business or a vague statement that a partner contributed a majority of the partner's time to the partnership.

- A list of duties. We need to know what duties the partners performed for each entity.

- A list of other compensated managers, the number of hours of service other compensated managers performed for each entity, a description of the other compensated managers' responsibilities for each entity, a description of how the other compensated managers were compensated, and who the other compensated mangers reported to. This helps to evaluate the typical argument that the owner hung around the business (to watch over his/her investment), while someone else was running the business on a day-to-day basis.

- Supervision of employees. If the partnership has employees, determine whether the partners managed, hired, or fired employees or had the authority to do so.

- Key person/insurance provisions. If the partnership agreement or any agreement to which the partnership is a party contains a "key person" provision tied to substantial participation of the partner in the affairs of the partnership or an insurance policy under which the partnership is covered in the event the parnter dies or becomes disabled.

B. What Do I Need to Do When I Get the Information?

- Because this is a coordinated issue, please contact your local Area partnership cadre if you have a case involving this issue.

VI. Disposition of Partnership Interest and Operating/Liquidating Distributions

40. Was any interest in the partnership interest sold, exchanged, redeemed, or otherwise transferred or disposed of (e.g., abandoned) during the audit period(s)? If not, skip to Q.#43. If yes, explain the pertinent facts and circumstances of each transaction (e.g., identify the partner whose interest was sold, the buyer or transferee, the date of each such event, what consideration, if any, was received, and the legal form of the transaction). If the partnership interest that was sold, exchanged, redeemed, or otherwise transferred or disposed was held by a foreign person, see Q.# 54 regarding whitholding under § 1446(f). The transferee had an obligation to report certain of that information to the partnership under Treas. Reg. § 1.1446(f)-2(d)(2). Provide all agreements executed in connection with such transaction(s).

41. If any interest in the partnership was treated as abandoned during the audit period(s), how was the partnership notified of the partner's withdrawal? Provide any relevant communications between the exiting partner and the partnership. Did the exiting partner receive any allocation of partnership liabilities prior to withdrawal, assume any partnership liability, or receive a Schedule K-1 after exiting the partnership? If yes to any of these questions, explain and support your position.

42. Did the partnership hold any unrealized receivables (within the meaning of § 751(c)) or inventory items (within the meaning of § 751(d)), collectively, referred to as "hot assets" during the audit period(s)? If yes to either question, did any partner transfer or otherwise dispose of any portion of his partnership interest or did any partner receive a distribution that changed their share of such hot assets? Was the partnership required to file (and did it file) any Form(s) 8308? If no, explain and support your position. Identify any profit and loss sharing provisions of the partnership agreement used to determine the partner's share of hot assets.

43. Did the partnership make any distributions to partner(s) during the audit period(s)? If not, skip to Q#49 (if Q#49 is attached to this IDR). If yes, identify whether each distribution was an operating or liquidating distribution. Be sure to include any constructive or deemed distributions (e.g., § 752(b) reduction of a partner's share of partnership liabilities).

44. Identify any provision in the partnership agreement that addresses distributions to partners. Were all distributions during the audit period(s) made in accordance with the provision(s) identified? If not, explain and support your position.

45. Did the partnership make any distributions to any partner other than in cash during the audit period(s)? If yes, describe the nature of the property distributed, identify how and when it was acquired (e.g., contribution by partner), and provide information sufficient to determine the adjusted basis of such property to the partnership on the distribution date.

46. During the audit period(s), did any partner(s) receive payments from the partnership other than in their capacity as a partner? If yes, identify the amount and nature of payments. If no, please explain and support the following: (a) whether the distributions were subject to

entrepreneurial risk; (b) whether the partners' interest in the partnership was limited to a period involving distributions; (c) whether there were any distributions made close in time to property transactions or services provided by the partner; (d) whether the partnership made allocations and distributions to any partner for tax avoidance purposes; and (e) whether the partner's interest in the partnership was disproportionate to the allocations/distributions made to him during the year.

47. Did any partner receive a capital or profits interest in exchange for services or the use of property during the audit period(s)? If yes, explain the pertinent facts and circumstances of the transaction (e.g., whether the partnership reported compensation to the partner).

48. Did any partner sell property to the partnership or buy property from the partnership for a loss during the audit period(s)? If yes, describe the facts and circumstances of the transaction.

49. During the audit period(s), did any partner receive distributions of money or property, within seven years after the same partner contributed § 704(c) property? If yes, explain and support any such transactions (e.g., identify transaction dates and provide a detailed description of the property and the parties involved).

50. During the audit period(s), did any partner receive distributions of § 704(c) property, within seven years after another partner contributed the § 704(c) property? If yes, identify transaction dates and provide a detailed description of the property and parties involved.

51. Separately identify and explain any § 704(b) capital account revaluation adjustments ("book ups" or "book downs").

52. Did the partnership have a § 754 election in place during the year(s) under audit? If yes, did the partnership make a § 734(b) adjustment (related to a property distribution) or a § 743(b) adjustment (related to the transfer of a partnership interest) during the tax period?

A. Why Are We Asking: Common Issues: I.R.C. §§ 731, 734, 741, 743 and 751?

The Service needs to verify whether a partner properly recognized gain on the distribution of cash (or in rare situations on the distribution of property) or on the sale of a partner's partnership interest. In addition, the Service needs to verify the character of that gain.

(1) Sales and Exchanges of Partnership Interests

a. Character of the Gain

Section 741 provides that the gain or loss recognized from the sale or exchange of a partnership interest is capital gain or loss, except as otherwise provided in § 751. If § 751 applies, it overrides the general rule in § 741.

Section 751(a) provides that the consideration received by a selling partner in exchange for all or part of his interest in "unrealized receivables" or "inventory items," is considered as an amount realized from the sale or exchange of property producing ordinary income rather than capital gain. Under § 751(c), unrealized receivables are rights (contractual or otherwise) to payment for goods delivered, or to be delivered (to the extent sale of the property would produce ordinary income), and services rendered or to the extent they have not previously been included in income under the partnership's accounting method. Unrealized receivables also include the gain that would be characterized as ordinary income on a disposition of an asset for FMV under the depreciation recapture provisions (e.g., § 1245) and other rules requiring recapture of deductions. Under § 751(d), inventory items are all property of the partnership (including § 1221(1) "dealer" property) which if sold by the partnership or the selling partner would not be considered a capital or § 1231 asset. Under Treas. Reg. § 1.751-1(d)(2)(ii), the definition of inventory items is broad enough to include all of a partnership's unrealized receivables. Even though an asset may be both an unrealized receivable and an inventory item, it will only be taxed once under § 751(a).

In accordance with Rev. Rul. 93-80, 1993-2 C.B. 239, a loss incurred on the abandonment or worthlessness of a partnership interest results in an ordinary loss. But if there is an actual or deemed distribution to the partner, the partner recognizes a capital loss except to the extent § 751(a) provides otherwise.

b. Tax Basis Capital Accounts/Partnership's Inside Basis of Assets

A partner that acquires its partnership interest by transfer from another partner (e.g., by purchase or in a non-recognition transaction) has a tax capital account immediately after the transfer equal to the transferring partner's tax capital account immediately before the transfer. This may result in an inside/outside basis issue because the new partner takes a cost basis in their partnership interest ("outside basis"). The partnership can eliminate the inside/outside basis disparity if it has a § 754 election in effect or it its required to make the adjustment because it has a substantial built-in loss (i.e., greater than $250,000) immediately after the partnership transfer.

Section 743(a) provides that the sale of a partnership interest generally has no impact on the partnership's basis in its assets. Section 743(b) allows the partnership to increase or decrease the

new partner's share of the partnership's inside basis in partnership assets to bring it in line with the new partner's cost (outside) basis. This is an adjustment to the basis of partnership property with respect to the transferee partner only. The common basis of partnership property is not adjusted. This allows the partnership to maintain the basic accounting equation: Assets = Liabilities + Owners Equity (or Capital Accounts).

Remember, the § 743(b) basis adjustment only affects the new partner's allocations. The adjustment never affects the old partners.

c. Special Rules for Dispositions of Partnership Interests by Nonresident Alien Individuals or Foreign Corporations

Section 864(c)(8)(A) provides that gain or loss of a nonresident alien individual or foreign corporation (together, the "foreign transferor") from the sale, exchange, or other disposition ("transfer") of an interest in a partnership that is engaged in any trade or business within the United States is treated as effectively connected gain or loss to the extent such gain or loss does not exceed the amount determined under §864(c)(8)(B). Section 864(c)(8)(B) limits the amount of effectively connected gain or loss to the portion of the foreign transferor's distributive share of gain or loss that would have been effectively connected if the partnership had sold all of its assets at fair market value (the deemed sale limitation). Treas Reg. § 1.864(c)(8)-1 provides guidance for calculating the amount of effectively connected gain or loss. Treas. Reg. § 1.864(c)(8)-2 provides the notification requirements when a transfer occurs, which includes a requirement that the partnership provide the foreign transferor of its aggregate deemed sale effectively connected items. The partnership provides this information on Part XIII of Schedule K-3 (Form 1065). Section 1446(f) provides the withholding mechanism for collecting the tax on the amount realized on the transfer described in § 864(c)(8).

Section 897(a)(1) provides that gain or loss of a foreign transferor from the disposition of a United States real property interests ("USRPI") is subject to tax as if the foreign transferor were engaged in a trade or business within the United States during the taxable year and such gain or loss were effectively connected with that trade or business. Section 897(g) provides that the amount of any money, and the fair market value of any property, received by a foreign transferor in exchange for all or part of its interest in a partnership, trust, or estate shall, to the extent attributable to USRPIs, be considered as an amount received from the sale or exchange in the United States of such property. If a partnership is subject to both §§ 864(c)(8) and 897(g) on the foreign transferor's transfer of a partnership interest, the amount of the foreign transferor's effectively connected gain or loss will be determined under § 864(c)(8) and not under § 897(g).

(2) Look for Disguised Payments

Generally, under the statutory framework of Subchapter K of the Code, an allocation or distribution between a partnership and a partner for the provision of services can be treated in one of three ways: (1) a distributive share under § 704(b); (2) a guaranteed payment under § 707(c); or (3) a transaction in which a partner has rendered services to the partnership in its capacity as other than a partner under § 707(a).

Partners need to report payments made to them under § 707. Partners will often try to disguise § 707 payments as distributions of profits in order to avoid having to include the amount in gross income. If a partner has sufficient basis, the partner may attempt to treat a receipt of cash from the partnership as a distribution that reduces the partner's outside basis instead of a taxable payment to the partner.

a. Transactions under § 707

Payments under § 707 break down into two overriding categories: (1) payments made to a partner who is not acting in his capacity as partner under § 707(a); and (2) payments made to a partner who is acting in his capacity as partner BUT who receives a guarantee payment under § 707(c) that is not dependedent on the profits of the partnership.

The partner must recognize income if any of these two situations apply. It does not matter how much basis the partner has in the partnership when they receive the payment.

> **Example 1**: A is a partner in the AB partnership, which makes widgets for its customers. A is a return preparer on the side. A prepares the partnership's tax return for the year. A receives a $50 payment from the partnership. A must report the payment as if he were an independent contractor under the provisions of § 707(a). The partnership can take a deduction, subject to capitalization, for the payment to A based on the accounting method of the partnership.
>
> **Example 2**: Now assume that A does work selling widgets to customers of the partnership. The partnership agreement guarantees A payment of $50 for his work in the partnership irrespective of whether the partnership makes a profit. A receives a $50 payment from the partnership. A must report the payment as a guaranteed payment under the provisions of § 707(c). The partnership can take a deduction for the payment to A in the year A is required to include the payment in income.

The Service must take steps to determine why a partner was paid by the partnership, especially when that partner is providing services to the partnership or is engaging in transactions with the partnership.

b. Distributions of Profits

Partnership allocations that are determined with regard to partnership income and that are made to a partner for services rendered by the partner in its capacity as a partner are treated as distributive shares of partnership income, taxable under the general rules of §§ 702, 703, and 704.

Therefore, any payment received by a partner who performs services in their capacity as a partner (but for which they were not guaranteed) will be covered by the allocation rules discussed above.

(3) Cash and Property Distributions

a. General Rules for Operating Distributions

Under § 731(a)(1), the cash distributed that exceeds the partner's outside basis is recognized as gain from the sale or exchange of a partnership interest. A partner does not recognize gain on the receipt of a cash distribution from a partnership to the extent that the partner has sufficient outside basis. Under §§ 705(a)(2) and 733, a partner's basis is reduced (but not below zero) by the amount of any money distributed by the partnership. Under Treas. Reg. § 1.731-1(c)(2), loans are not treated as distributions, unless cancelled. Under Treas. Reg. § 1.731-1(a)(1)(ii), advances and draws of money or property by a partner against his distributive share of income are considered distributions on the last day of the partnership's taxable year because they are contingent on the profitability of the partnership and need to be repaid to the extent that the partnership does not have sufficient profits. In accordance with Rev. Rul. 94-4, 1994-1 C.B. 196, a deemed distribution of money under § 752(b) is treated as an advance or draw and is considered to occur at the end of the partnership year. Under § 731(c)(1), marketable securities are treated as cash, as opposed to property, to the extent of their FMV on the date of the distribution.

Under § 731(a) and (b), when a partnership distributes property to a partner in a non-liquidating distribution, generally neither the partner nor the partnership recognizes gain. Exceptions to this general rule include the following: (1) distributions treated as constructive sales or exchanges under § 751(b); (2) where a partner contributes property to a partnership that is distributed to another partner within 7 years under § 704(c)(1)(B); and (3) if a partner contributes property to a partnership and the partnership distributes other property to the partner within 7 years of the contribution under § 737.

Under §§ 732(a)(1) and 733(2), a partner generally takes a transferred basis in the property distributed by the partnership, and the distributee partner's outside basis is reduced by the basis of the distributed property. Under § 732(a)(2), a partner's basis in distributed property may not, however, exceed the partner's outside basis less any money received in the same transaction. If the outside basis limitation is reached, the basis to be allocated (i.e., the partner's outside basis less the cash received in the transaction) must be allocated among the various properties received by the distributee partner.

b. General Rules for Liquidating Distributions

A partner can terminate his or her interest in a partnership by selling the interest to a third party and recognize capital gain under § 741, except to the extent provided in § 751. This is discussed in detail below under "(2) Sales and Exchanges of Partnership Interests." A partner's interest may also be "liquidated" through the termination of a partner's entire interest in a partnership by means of a distribution (or series of distributions) to the partner by the partnership under § 761(d). A partner whose interest is being liquidated is often referred to as the "retiring partner."

Section 736 determines the tax consequences of payments in liquidation of a partner's interest in a partnership or to a deceased partner's successor in interest. Under § 736(b), payments to a partner are generally treated as distributions by the partnership and taxed under the rules discussed above for operating distributions. However, special rules under § 736(b)(2) and (3) provide that in the case of a "general partnership interest" in which "capital is not a material income-producing factor," payments for the partner's share of unrealized receivables and "unstated goodwill" (i.e., where a partnership agreement does not provide for specific payments regarding goodwill) are excluded from § 736(b). Under § 736(a), payments excluded from § 736(b) are considered to be: (1) a distributive share if the amount of the payment is dependent on partnership income; or (2) a § 707(c) guaranteed payment if the amount is determined without reference to partnership income.

i. Recognition of Gain or Loss for Liquidating Distributions

Because § 736(b) payments are generally treated like nonliquidating distributions, gain is only recognized if the retiring partner receives cash more than his or her outside basis. Similarly, for distributions of property, the partner's basis in any distributed property from the partnership is equal to his or her outside basis reduced by any cash distributed in the same transaction under § 732(b). If the outside basis limitation is reached, the basis to be allocated (the partner's outside basis less any cash received) must be allocated among the various properties received by the distributee partner. The distributee partner may tack the partnership's holding period in distributed property under § 735(b).

Section 731(a)(2) provides that a partner may recognize a loss on a liquidating distribution if only cash, § 751(c) unrealized receivables, and § 751(d)(2) inventory items are distributed. In that case, loss is recognized to the extent the partner's outside basis exceeds the sum of the money distributed and the partner's transferred basis in the unrealized receivables and inventory items. The loss is a capital loss because it is considered as arising from the sale or exchange of a partnership interest.

c. Partnership's Inside Basis of Assets

Whenever a distributee partner recognizes gain on a distribution or takes a basis in distributed property that differs from the partnership, there will be a disparity between the total partnership's inside basis and the partners' outside bases (i.e., an inside/outside basis disparity). Under the general rule of § 734(a) no adjustment is made to the partnership's inside basis. However, § 734(b) provides an exception.

If the partnership has made a § 754 election or there is a "substantial basis reduction," a distribution triggers a § 734(b) adjustment whenever the distributee recognizes either gain (or loss on a liquidating distribution) or takes a basis in the distributed property different from that which the partnership had in the property. If there is a substantial basis reduction, the partnership is required to adjust the basis of its remaining property under § 734(b) even if the partnership has not made a § 754 election. There is a substantial basis reduction if the negative adjustment under § 734(b) exceeds $250,000. A negative § 734(b) adjustment (i.e., a reduction in the inside basis of partnership assets) can only be triggered by a liquidating distribution.

The amount of the § 734(b) adjustment is determined by the sum of the gain or loss recognized by the distributee and the increase or decrease in the basis of the partnership assets caused by the distribution. The partnership must allocate the § 734(b) adjustment among is remaining assets pursuant to § 755. In contrast to § 743(b) adjustments, which are partner-specific, § 734(b) adjustments affect the basis of remaining partnership property of all partners. For example, if a distributee takes a basis that is $100 less than the partnership's basis in that property (because of the limitation of § 731(a)(1)), then there is a positive § 734(b) adjustment to the partnership's inside basis of its remaining assets of $100. If the distributed property is capital gain property, then the positive § 734(b) adjustment can only be made to the partnership's inside basis of remaining capital gain property, and if the distributed property is ordinary income property, then the § 734(b) adjustment can only be made to the partnership's inside basis of remaining ordinary income property. If the partnership has no remaining assets of the class of property distributed, then the § 734(b) adjustment is suspended until the partnership acquires property of that type.

(4) Death of a Partner

When a partner dies, his or her partnership interest is disposed of in one of three ways: (1) it may pass to the partner's successor in interest, who continues as a partner; (2) it may be sold at the partner's death under an existing buy-sell agreement; or (3) it may be liquidated pursuant to a preexisting agreement among the partners.

When a partner dies, his or her taxable year closes as of the date of death under § 443(a)(2). The deceased partner's final tax return includes the distributive share of partnership income or loss for the portion of the partnership's taxable year prior to death. Generally, the partnership's taxable year does not close when a partner dies under § 706(c)(1), but the partnership's taxable year does close with respect to a partner under § 706(c)(2) if the partner's entire interest in the partnership terminates (e.g., by reason of death, liquidation, or otherwise).

Note that when a partner dies, the estate or transferee should take over the tax capital account of the decedent. This is true even though the partnership interest will be stepped up to its fair market value on the date of death. In such cases (as well as for most transfers of partnership interests), the tax capital account after the transfer will not represent a reasonable estimate of outside basis when added to the partner's share of partnership liabilities.

B. What Do I Need to Do When I Get the Information?

Sale or Exchange of Partnership Interest

- Confirm the total percentage of partnership interests transferred in any 12-month period covered, in part, by the taxable year. For partnership tax years beginning prior to 2018, the partnership may have "technically" terminated if more than 50% of the total interest in the partnership capital and profits is sold or exchanged during a 12-month period. I.R.C. § 708(b).

- For each sale or exchange of a partnership interest, confirm the exchanging partner's basis in the exchanged partnership interest. Review the documents related to the sale or exchange to determine the amount realized by the partner on the exchange. Check that the partner correctly reported gain or loss from sale or exchange of the interest.

- Check whether the partnership owned unrealized receivables (within the meaning of § 751(c)) or inventory items (within the meaning of § 751(d)) at the time of any sale or exchange. If yes, any amount realized by the partner due to his or her share of the partnership's unrealized receivables and inventory items will result in ordinary income or loss. Section 751(a). Confirm that the partnership filed Form 8308, Report of a Sale, or Exchange of Certain Partnership Interests.

- If any partnership interest was deemed worthless, confirm whether distributions were made to any partner claiming a loss. If the partner received even a de minimis actual or deemed distribution, the entire loss generally is a capital loss.

- If the partnership has made a § 754 election or has a substantial built-in loss, check whether the partnership made any basis adjustments under § 743(b) and determine whether the transaction involves any liabilities under Treas. Reg. § 1.752-7.

Disguised Payments

- Look to see if partners received payments from the partnership for some reason other than in their role as partner. For example, did the partner provide services to the partnership or engage in transactions with the partnership that did not depend on his role as partner.

- Look to see if partners received payments that were not tied to the profits of the partnership (e.g., guaranteed payments).

Distributions

- Confirm the basis of the partner receiving the distribution at the time of such distribution. Confirm the amount of money (including marketable securities treated as money under § 731(c)) and the adjusted basis of any property distributed to the partner. Check whether the partner recognized gain or loss on the distribution. I.R.C. § 731.

- Check whether the property distributed included the distributee partner's own liabilities.

- Confirm whether unrealized receivables (within the meaning of § 751(c)) or inventory items (within the meaning of § 751(d)) were distributed to the partner. In addition, check whether other property was distributed in exchange for the partner's interest in unrealized receivables or inventory items.

- If the partnership has made a § 754 election or has a substantial basis reduction with respect to any distribution, check whether the partnership made any basis adjustments under § 734(b).

VII. REPORTING AND WITHHOLDING REQUIREMENTS

53. During the audit period(s), did the partnership acquire a United States real property interest (USRPI) from a foreign person? If yes, did the partnership withhold tax under § 1445 (FIRPTA) on the amount it paid for the property? Describe the transaction and provide the partnership tax return(s) for such year(s). If the partnership did not withhold tax under § 1445 (FIRPTA) on the amount it paid for the property, explain why.

54. During the audit period(s), did the partnership dispose of a USRPI? If yes, and if the partnership is a domestic partnership with a foreign partner, did the partnership withhold tax under § 1445(e)? Describe the transaction and provide the partnership tax return(s) for such year(s). If the partnership did not withhold tax under § 1445 (FIRPTA) on the amount it paid for the property, explain why.

55. Did the partnership have taxable income effectively connected with the conduct of a trade or business within the United States (ECTI)? If so, was that income allocable to a foreign partner? If yes, the partnership was required to report and pay withholding tax on the ECTI under § 1446 (partnership withholding) to the IRS on Form 8804. Describe the transaction(s) and provide the partnership Form(s) 8804 for such year(s). If the partnership had ECTI that was allocable to a foreign partner during any audit year, but did not report and pay withholding tax under § 1446 to the IRS, explain and support your position.

56. If a partnership interest was sold, exchanged, redeemed, or otherwise transferred or disposed of, did the transferee withhold tax under § 1446(f)? Describe the transaction and (if the transferee was other than the partnership) provide the certification the transferee provided the partnership as required under Treas. Reg. § 1.1446-2(d)(2) for such transfer(s). If the transferee did not provide the partnership the required certification, did the partnership deduct and withhold from distributions to the transferee under §1446(f)(4)? If the partnership did not withhold under §1446(f)(4), explain why. If the partnership was required to withhold on a distribution to the partner, request from the partnership the Form(s) 8288 and 8288-A it filed or the certification for an exception to withholding under Treas. Reg. § 1.1446(f)-2(b) it received from the transferee.

A. Why Are We Asking: Common Issues: I.R.C. §§ 1445 and 1446

If a partnership acquires a USRPI from a foreign person, the partnership may have to withhold tax under § 1445(a) (FIRPTA) on the amount it pays for the property. In addition, if a partnership has foreign partners and it disposes of a USRPI, it may have to withhold tax under § 1446(a) rather than § 1445(e). See 1.1446-3(c)(2). If a partnership has income effectively connected with a trade or business in the United States, it must withhold on the income allocable to its foreign partners (Partnership Withholding). A partnership may have to withhold tax on a foreign partner's distributive share of fixed or determinable annual or periodical gains and income (FDAP income) not effectively connected with a U.S. trade or business, as well as withhold on any other FDAP income paid to a foreign person regardless of whether he is a partner or not (NRA Withholding).

(1) FIRPTA Withholding

Section 1445(a) generally provides that a transferee, including a partnership, that acquires a USRPI from a foreign person must withhold 15% of the amount realized by the foreign person on the disposition. It is important to note that, because withholding is based on the foreign transferor's amount realized, as opposed to its gain recognized, the amount that the transferee is required to withhold under §1445(a) may be significantly higher than the foreign transferor's ultimate tax liability on the disposition. Withholding may be reduced or eliminated in these situations pursuant to a withholding certificate from the IRS.

A partnership (both domestic and foreign) with a foreign partner that disposes of a USRPI may be subject to withholding, pursuant to both § 1445 (FIRPTA) and § 1446 (partnership withholding). A domestic partnership will be subject to the payment and reporting requirements of § 1446 only, and not to § 1445, with respect to partnership gain from the disposition of a USRPI. A partnership that has complied with the requirements of § 1446 will be deemed to satisfy the withholding requirements for FIRPTA. However, a domestic partnership that would otherwise be exempt from § 1445 withholding by operation of a non-recognition provision must continue to comply with the FIRPTA requirements. (See Treas. Reg. § 1.1445-5(b)(2)). In the event amounts are withheld under FIRPTA at the time of the disposition of a USRPI, such amounts may be credited against the partnership's § 1446 tax. A partnership that fails to comply fully with the requirements of § 1446 may be liable for any unpaid § 1446 tax and subject to any applicable addition to the tax, interest, and penalties under § 1446.

A foreign partnership that is subject to withholding under § 1445(a) (FIRPTA) during its taxable year may credit the amount withheld under § 1445(a) against its § 1446 tax liability for that taxable year only to the extent such amount is allocable to foreign partners. Refer to Treas. Reg. § 1.1446-4(f)(4) for rules coordinating the withholding liability of publicly traded partnerships under §§ 1445 and 1446.

(2) Partnership Withholding

a. Section 1446(a) Withholding

It is important to note that if during a partnership's tax year, the partnership has taxable income effectively connected with the conduct of a trade or business within the United States that is allocable to a foreign partner, the Internal Revenue Code requires the partnership to report and pay a withholding tax under § 1446 to the IRS. The partnership must pay the § 1446 withholding tax regardless of the amount of foreign partners' ultimate U.S. tax liability and regardless of whether the partnership makes any distributions during its tax year, unless the partnership is a publicly traded partnership under § 7704 which has special rules discussed below. Treas. Reg. § 1.1446-3 sets forth the time and manner for paying the withholding tax, as well as the general reporting obligations with respect to the tax. Refer to Form 8804, Annual Return for Partnership Withholding Tax (Section 1446), Form 8805, Foreign Partner's Information Statement of Section 1446 Withholding Tax, and Form 8813, Partnership Withholding Tax Payment Voucher (Section 1446), for further guidance on reporting and paying the § 1446 withholding tax. A partnership that fails to comply with § 1446 reporting and withholding requirements may be subject to penalties and interest.

The partnership may reduce the foreign partner's allocable share of the partnership's effectively connected taxable income (ECTI) by certain partner level deductions and losses if the foreign partner certifies these deductions and losses on Form 8804-C, Certificate of Partner-Level Items to Reduce § 1446 Withholding. (See Treas. Reg. § 1.1446-6 and Publication 515, Withholding of Tax on Nonresident Aliens, and Foreign Entities, for additional information.) The partnership should have attached Form 8804-C and a calculation of the reduced withholding to its return. Treas. Reg. § 1.1446-3(d)(3)(i). The partnership must file Forms 8804 and 8813 even if, because of the certified deductions and losses, no § 1446 tax is due. See Treas. Reg. § 1.1446-3(d)(1)(iii).

Special rules apply to publicly traded partnerships (PTPs). PTPs that have effectively connected taxable income must pay withholding tax on any distributions of that income made to its foreign partners. The amount of the distribution includes the amount of any tax under §1446 required to be withheld. In the case of a partnership that receives a partnership distribution from another partnership (a tiered partnership), the distribution also includes the tax withheld from that distribution. PTPs must use Forms 1042 and 1042-S to report withholding from distributions to its foreign partners.

b. Section 1446(f) Withholding

Section 1446(f) generally requires that a transferee of an interest in a partnership to withhold 10% of the amount realized on the disposition of the portion of the gain (if any) that would be treated under §864(c)(8) as effectively connected with the conduct of a trade or business within the United States. A transfer can occur when a partnership distribution results in gain under § 731. Under §1446(f)(4), if the transferee fails to withhold any required amount, the partnership must deduct and withhold from distributions to the transferee the amount that the transferee failed to withhold (plus interest). Special rules apply to transfers of PTP interests on or after

January 1, 2023. See Notice 2021-51, announcing the intent to amend the applicability dates of certain regulations relating to PTPs under sections 1446(a) and 1446(f) to January 1, 2023.

The transfer of a partnership interest may be subject to withholding under § 1445(e)(5) or Treas. Reg. § 1.1445-11T(d)(1) if 50% or more of the value of the partnership's gross assets consist of USRPI, and 90% or more of the value of its gross assets consist of USRPIs plus any cash or cash equivalents. In such case, where both §§ 1445(e)(5) and 1446(f)(1) could apply to the same transfer, the transfer is generally subject to the payment and reporting requirements of section 1445 only, and not section 1446(f)(1). However, if the transferor has applied for a withholding certificate under the last sentence of Treas. Reg. § 1.1445-11T(d)(1), the transferee must withhold the greater of the amounts required under § 1445(e)(5) or 1446(f)(1). A transferee that has complied with the withholding requirements under either § 1445(e)(5) or 1446(f)(1) will be deemed to satisfy its withholding requirement.

B. What Do I Need to Do When I Get the Information?

- Please contact your Senior Flow-Through Specialist if you have a case involving this issue.