PARTNERSHIP TAXATION

January 2023 Supplement
to
FIFTH EDITION

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ADDITIONS, SUBSTITUTIONS AND INSERTIONS

CHAPTER 2: FORMATION OF THE PARTNERSHIP

§ 2.02 TRANSFER OF PROPERTY TO PARTNERSHIP

B. What Constitutes Property

2. Contract Rights

a. Promissory Notes

ii. Third-Party Note

The paragraph is restated as follows:

In the context of I.R.C. § 721, what is usually meant by "property" when a promissory note is contributed is a third-party note. In other words, a note that arose when the contributing partner lent money to a third party and received a promissory note in return. If that note is contributed to the partnership, it constitutes property for the purposes of I.R.C. § 721(a).[1]

Add after 8. Recapitalizations:

9, Cryptocurrencies and Other Digital Assets

The IRS concluded in Notice 2014-21 that cryptocurrency is "property."[2] This would generally make cryptocurrencies eligible for contribution under I.R.C. § 721(a), subject to the discussion of transfers to investment companies, below.

For years after 2022, digital assets will be treated as "covered securities" and "specified securities" for the purposes of I.R.C. § 6045(g). For these purposes, a "digital asset" means any digital representation of value which is recorded on cryptographically secured distributed ledger or any similar technology specified by the Treasury.[3] It is questionable whether this definition is broad enough to include all types of digital assets (*e.g*., non-fungible tokens),[4] but it is likely that both digital assets as defined in I.R.C. § 6045(g) and other digital assets will be teated as property for the purposes of I.R.C. § 721.

[1] *See, e.g.,* PLR 8117210 (Jan. 30, 1981).

[2] Notice 2014-21, 2014-16 IRB 938.

[3] I.R.C. § 6045(g)(3)(D).

[4]. *See* Michael Lukacs (EY, New York), Oren Margulies (EY, Washington, D.C.) & Lakshmi Jayanthi (EY Boston), ABCs of NFTs: Key Tax Considerations, 177 Tax Notes Fed. 819 (Nov. 7, 2022).

CHAPTER 3: OUTSIDE BASIS AND ALLOCATION OF LIABILITIES

§ 3.04 EFFECT OF PARTNERSHIP LIABILITIES

B. Definition of Recourse and Nonrecourse Liabilities

1. *Definition of Liability*

THE FIRST PARAGRAPH IS RESTATED AS FOLLOWS:

Before you can distinguish between a recourse liability and a nonrecourse liability, it is first necessary to know what is included in the term "liability." For purposes of I.R.C. § 752, an obligation is a liability to the extent that the incurring of the liability: (i) creates or increases the basis of the obligor's assets (including cash), (ii) gives rise to an immediate deduction to the obligor,[5] or (iii) gives rise to an expense that is not deductible and not properly chargeable to capital.[6] However, some obligations are not "liabilities" for the purposes of I.R.C. § 752. In Rev. Rul. 88-77,[7] the cash-basis taxpayer owed (but had not paid) a deductible interest expense and also had accounts payable outstanding. The IRS generally concluded that these liabilities were not liabilities for I.R.C. § 752 purposes, because they would be deductible when paid. Specifically, the IRS concluded that a liability counts as such for I.R.C. § 752 purposes to the extent "incurring the liability creates or increases the basis to the partnership of any of the partnership's assets (including cash attributable to borrowings) [or] gives rise to an immediate deduction to the partnership [when incurred as opposed to paid]…."[8] Since the interest expense that was owed and the accounts payable did not increase the basis of assets and did not give rise to a deduction when incurred (but only when paid), they were not I.R.C. § 752 liabilities.

2. *Definition of Recourse Liability*

THE SECOND AND THIRD FULL PARAGRAPHS ARE RESTATED AS FOLLOWS:

First some basics: Economic risk of loss speaks to bottom-line obligation on a recourse debt, after taking into account all facts and circumstances, including rights of contribution among partners. Assume a general partnership, that is not a limited liability partnership, has two partners, one who holds a 60% interest and one who holds a 40% interest. Unsurprisingly, they will usually share the economic risk of loss on any partnership recourse debt 60/40. Now assume a limited partnership, where A is the general partner and B is the limited partner. Generally, on the basis of limited partnership law generally, the general partner has all of the economic risk of loss on any partnership recourse debt and the limited partner has none. It is possible for a limited partner to voluntarily take on some part of that economic risk of loss, however, by making an agreement to that effect with the lender, the partnership and/or the general partner. Limited partners often want to do this to increase their bases in their partnership interests, allowing them to deduct more losses,[9] to avoid recognizing gain,[10] or because the lender (or another party) insists upon it.

We also need to preview "capital accounts," a topic on which we go into detail in Chapter 5. Usually,

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[5]. Clause (ii) would primarily apply to an accrual basis taxpayer, because, as discussed below, cash basis taxpayers are generally not entitled to a deduction until an expense is paid. However, there may be situations in which a cash basis taxpayer is required to use an accrual method, such as for original issue discount or deferred rent. *See* I.R.C. §§ 163(e)(1), 467.

[6]. Treas. Reg. § 1.752-1(a)(4)(i).

[7]. 1988-2 C.B. 128.

[8]. *Id.*

[9]. Under I.R.C. § 704(d), a partner cannot deduct losses in excess of his basis in his partnership interest.

[10]. *See* I.R.C. § 752(b), (d).

each partner has a capital account. For now, think of a capital account as a measure of a partner's economic investment in the partnership. Generally, capital accounts are increased by money contributed, the (net) fair market value (not basis) of property contributed, and allocated income.[11] They are decreased by money distributed, the (net) fair market value of property distributed, and allocated losses.[12] Note that, unlike the calculation of tax basis, liabilities do not go into the calculation of capital accounts (other than reducing the value of contributed and distributed property). Accordingly, capital accounts can be negative, while a partner's outside basis can never be negative. One way capital accounts can become negative is if partnership debt increases a partner's outside basis. For a partner who, for example, contributes cash and is allocated partnership liabilities, initially, the partner's outside basis will exceed the partner's capital account. For example, assume A contributes $1,000 to a new partnership and is properly allocated $500 of partnership recourse liabilities that are incurred on formation of the partnership. Initially, A's outside basis is $1,500, but his capital account is $1,000. Deductions allocated to A, say for losses, reduce A's outside basis in the partnership interest and A's capital account. Since the outside basis was higher to begin with, the capital account will go negative before the tax basis is "used up." For example, if at the end of the first tax year A is allocated a net partnership loss of $1,100, A's outside basis is reduced to $400, and his capital account balance becomes negative ($100). Generally, partners may have negative capital accounts to the extent they have an obligation to pay to the partnership any negative balance no later than the liquidation of the partnership interest or when the partnership has allocated nonrecourse debt to the partner.[13] A partner may have economic risk of loss on partnership debt to the extent the partner has an obligation to restore a negative capital account, since the money the partner is obligated to pay to the partnership can be used to satisfy recourse debt.[14]

THE CARRY OVER PARAGRAPH FROM PAGE 87 TO PAGE 88 IS RESTATED AS FOLLOWS:

Treas. Reg. § 1.752-2(c)(1) provides a general rule that a partner also bears the economic risk of loss for a partnership liability to the extent the partner or related person has made a nonrecourse[15] loan to the partnership and the economic risk of loss with respect to that loan is not borne by another partner.[16] Though the loan is nominally nonrecourse, the lending partner of course bears the economic risk of loss if the partnership fails to pay the debt. It sometimes occurs, however, that a commercial lender will take a (typically small) profits interest in the partnership in addition to being paid interest. In order to facilitate financial institutions making such loans, the Regulations contain a *de minimis* exception to the general rule. If the partner's interest in each item of partnership income, gain, loss, deduction, or credit for every taxable year is 10% or less, and that partner or a person related to that partner makes a loan to the partnership which constitutes qualified nonrecourse financing within the meaning of I.R.C. § 465(b) (determined without regard to the type of activity financed), then the partner is not deemed to bear the economic risk of loss.[17] Generally, qualified nonrecourse financing means financing by a person regularly engaged in the business of lending who is not a related person, or from a government or guaranteed by a governmental agency, which is secured by real property, with respect to which no person is personally liable for repayment and which is not

[11]. Treas. Reg. § 1.704-1(b)(2)(iv)(b).

[12]. *Id.*

[13]. *See* § 5.03.B. Negative capital accounts may occur in other circumstances as well.

[14]. *See* Treas. Reg. § 1.752-2(b)(3)(i)(B); though a "deficit restoration obligation" in the view of the Tax Court may not increase a taxpayer's "at risk" amount. *See* § 4.07.B; Hubert Enterprises, Inc. v. Commissioner, T.C. Memo 2008-46.

[15]. "Nonrecourse" here is used in its state law meaning: the full faith and credit of the borrower is not pledged for the payment of the loan.

[16]. If a partnership liability is owed to a partner or related person and that liability includes a nonrecourse obligation encumbering partnership property that is owed to another person, the partnership liability is treated as two separate liabilities. The portion of the partnership liability corresponding to the wrapped debt is treated as a liability owed to another person. Treas. Reg. § 1.752-2(c)(2).

[17]. Treas. Reg. § 1.752-2(d)(1).

convertible debt.[18]

D. Allocation of Nonrecourse Liabilities

THE EXAMPLE ON PAGE 99 IS RESTATED AS FOLLOWS:

Example: A and B form an LLC, with A contributing $10,000 and B contributing $190,000. The LLC obtains an $800,000 interest-only nonrecourse loan and purchases a $1,000,000 building. The Operating Agreement provides that losses are allocated entirely to B until B's capital account is reduced to $0, then to A until A's capital account is reduced to $0 and then shared 40% to A and 60% to B. Income is allocated entirely to A until such time as the allocations of income are equal to prior allocations of loss to A, then to B until allocations are equal to prior allocations of loss to B, and thereafter income is allocated 40% to A and 60% to B. The Operating Agreement provides that excess nonrecourse liabilities are allocated 40% to A and 60% to B. During each of its first 10 years of operations, the rental income from the building is offset by the interest deduction on the loan, so the LLC has a $25,000 loss, all of which is attributable to the depreciation of the building.

Footnote 73 is restated as follows:

[73] TD 8385, 56 Fed. Reg. 66978, 66982 (Dec. 27, 1991) provides that taxpayers may treat allocations attributable to exculpatory liabilities in a manner that reasonably reflects the principles of I.R.C. § 704(b). The IRS further discussed this reasonable manner in PLR 200340024 (Apr. 10, 2003). Recall that a PLR may only be relied upon by the taxpayer to whom it is issued. Nonetheless, PLRs often receive heightened attention when there is little (or no) other authority in the area. PLR 200340024 involves a limited partnership and not an LLC, but the underlying issue is the same. The limited partnership had "Unsecured Debt" that was an exculpatory liability. The PLR treats the Unsecured Debt as nonrecourse debt for I.R.C. § 752 purposes. Referencing Treas. Reg. § 1.752-3(b), the PLR provides that the partnership may allocate the Unsecured Debt among its properties using any reasonable method, provided that the aggregate allocation to each property, when combined with any other liabilities allocated to the property, do not exceed the fair market value of the property at the time the liabilities are incurred.

G. Sales of Partnership Interests

The first two paragraphs are restated as follows:

As indicated above, I.R.C. § 752(d) provides that in the case of a sale or exchange of a partnership interest, liabilities are treated in the same fashion as in the case of an exchange not involving a partnership interest. Outside of the partnership context, if a taxpayer sells property and the purchaser assumes a liability of the seller, or takes the property subject to a liability, the amount of the liability is part of the amount realized for purposes of computing gain or loss from the sale. Although a transfer of a partnership interest may not directly result in the selling partner's liabilities being formally assumed, and the partnership interest itself may not be subject to liabilities, nevertheless the liabilities of the partnership must be taken into account. This is the purpose of I.R.C. § 752(d). Assume a 25% partner of a partnership has a basis for her partnership interest of $20,000 and her basis includes her 25% share of the $100,000 liabilities of the partnership (i.e., $25,000). Assume she sells her partnership interest for cash of $15,000. If the gain or loss recognized by the partner is simply the difference between her basis for her partnership interest and the amount of cash received, she would have a loss on the transaction (i.e., $20,000 − $15,000). The amount realized in this situation, however, includes her $25,000 former share of the partnership's liabilities for which she no longer has a share. Thus, the amount realized is $40,000 ($15,000 + $25,000) and a gain in the amount of $20,000

[18]. I.R.C. § 465(b)(6)(A). The actual rule is more complex than we state in the text.

($40,000 – $20,000) is recognized.[19]

With respect to a partner who acquired his interest in the partnership by making a contribution to the partnership, for the partner to have a basis for his partnership interest which is less than his share of the partnership liabilities, the partner would have had to previously been allocated deductions and/or received distributions in excess of the capital account balance (i.e., a negative capital account). Where a partner has a negative capital account, the amount of gain realized upon a sale of the partnership interest is generally equal to the consideration received plus the amount of the negative capital account. Practitioners will often use this as a short cut means of determining the gain or loss.

H. Treas. Reg. § 1.752-7: Another Anti-Abuse Rule

The first paragraph is restated as follows:

In an effort to fight tax shelters, the IRS has issued Regulations relating to the inclusion of partnership liabilities in a partner's basis. Treas. Reg. § 1.752-7 is designed to prevent the acceleration or duplication of loss through the assumption of certain types of obligations.[20] Prior to the promulgation of Treas. Reg. § 1.752-7, taxpayers would transfer assets to a partnership and have the partnership assume a contingent liability (such as a potential environmental liability). The taxpayer would take the position that the assumed liability was not a liability for purposes of I.R.C. § 752 and, therefore, the taxpayer was not required to reduce the basis of the taxpayer's partnership interest to the extent the taxpayer was relieved of the liability (assume completely). The taxpayer would then sell the partnership interest to a third party for an amount which was significantly less than the taxpayer's basis (because the purchaser would take the liability into account) and claim a loss. When the liability was paid, the partnership would claim a deduction. Thus, the same liability would produce a double deduction.[21]

1. Assumption by Partnership

a. Transfer of Partnershp Interest

The last sentence of the second paragraph is moved to the end of the first paragraph, so that the first paragraph reads as follows:

If the § 1.752-7 liability partner were to transfer her partnership interest prior to the satisfaction of the § 1.752-7 liability, the rule of Treas. Reg. § 1.752-7(c) would not prevent the § 1.752-7 liability partner from having an excessive basis. To eliminate this problem, Treas. Reg. § 1.752-7(e)(1) provides that if a § 1.752-7 liability partner disposes of her partnership interest, the basis of the § 1.752-7 liability partner's partnership interest is reduced immediately prior to the disposition. The amount of the reduction is referred to as the § 1.752-7 liability reduction. The § 1.752-7 liability reduction is equal to the lesser of (i) the excess of the § 1.752-7 liability partner's basis in the partnership interest over the adjusted value of that interest, or (ii) the remaining built-in loss associated with the § 1.752-7 liability.[22] The term "adjusted value" means the fair market value of the partnership interest increased by the partner's share of partnership liabilities under Treas. Reg. §§ 1.752-1 through 1.752-5.[23]

b. Assumption of § 1.752-7 Liability

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19. *See* § 6.02 for a discussion of the rules when a partner sells less than her entire interest in the partnership.
20. Treas. Reg. § 1.752-7(a).
21. *See* Notice 2000-44, 2000-2 C.B. 255.
22. Treas. Reg. § 1.752-7(b)(7)(i).
23. Treas. Reg. § 1.752-7(b)(2).

The first sentence of the last paragraph is restated as follows:

There are two important exceptions to the rules of Treas. Reg. § 1.752-7(e), (f), and (g). First, those sections do not apply if a partnership assumes a § 1.752-7 liability as part of a contribution to the partnership of a trade or business with which the liability is associated and the partnership continues to carry on that trade or business after the contribution.[24]

§ 3.06 READING, QUESTIONS AND PROBLEMS

B. QUESTIONS AND PROBLEMS

QUESTION 3 IS RESTATED AS FOLLOWS;

3. Same as Problem 2 except A and B form an LLC rather than a general partnership and there is no deficit restoration obligation (and assuming no novation).

24. Treas. Reg. § 1.752-7(d)(2)(A).

CHAPTER 4: CALCULATION OF PARTNERSHP TAXABLE INCOME

§ 4.10 READING, QUESTIONS AND PROBLEMS

B. QUESTIONS AND PROBLEMS

Problem 1 is restated as follows:

1. During its first taxable year, the calendar year, Partnership ABCD has the following results:

Income		
Gross Receipts—domestic inventory sales		$750,000
Gross Receipts—foreign inventory sales		$500,000
Total Gross Receipts		$1,250,000
Cost of Goods Sold—domestic sales	$375,000	
Cost of Goods Sold—foreign sales	$250,000	
Total Cost of Goods Sold		$625,000
Gross Profit from Operations		$625,000
Interest Income	$10,000	
Municipal Bond Income (tax-exempt)	$2,000	
Domestic Dividends	$5,000	
Total Other Income		$17,000
Total Income		$642,000
Expenses		
Selling, General & Administrative	$250,000	
Section 179 Expenditures	$100,000	
Depreciation	$150,000	
Organization Expenses	$11,000	
Foreign Income Taxes	$50,000	
Charitable Contributions	$5,000	
Interest	$10,000	
Total Expenses		$576,000
Net Income		$66,000

A, B, and C have 10% profit and loss sharing ratios and D has a 70% profit and loss sharing ratio. A is a nonresident alien and all of the other partners are U.S. citizens.

a. How will Partnership ABCD report its operations to its partners?

b. Does it matter that D personally has $950,000 of I.R.C. § 179 expenditures?

CHAPTER 5: ALLOCATION OF PARTNERSHIP INCOME AND LOSSES

§ 5.04 PARTNER'S INTEREST IN THE PARTNERSHIP AND COMMON ALLOCATION STRUCTURES

F. Avoiding Negative Capital Accounts as PIP

Add to the end of the section:

A recent Tax Court memorandum decision concluded that a qualified income offset provision that was included in an LLC agreement in respect of which the allocations lacked substantial economic effect reflected the partners' agreement that income should be shared in a manner that brought negative capital accounts up to zero and, thus, reflected the partners' interests in the partnership.[25]

§ 5.07 ALLOCATIONS OF NONRECOURSE DEDUCTIONS

C. Subsequent Nonrecourse Borrowing

Add to the end of the section:

What if a partnership makes additional nonrecourse borrowings but neither invests the proceeds in the property nor distributes them to the partners? For minimum gain allocation purposes, the funds are effectively held in abeyance until one of those two events occurs.[26]

[25] *Clark Raymond & Co., PLLC v. Commissioner*, T.C. Memo 2022-105 (Oct. 13, 2022).
[26] *See* Treas. Reg. § 1.704-2(g), (h).

CHAPTER 6: DISPOSITIONS OF PARTNERSHIP INTERESTS

§ 6.07 OPTIONAL ADJUSTMENT TO BASIS OF PARTNERSHIP PROPERTY

B. MAKING THE I.R.C. § 754 ELECTION

I.R.C. § 754 further provides that once an election is made, it applies to all applicable transfers of partnership interests during the taxable year in which the election is made, as well as for all subsequent taxable years. While an election under I.R.C. § 754 may be revoked, it may only be revoked with the consent of the IRS.[27]

Treas. Reg. § 1.754-1(b) provides that an election under I.R.C. § 754 is to be made in a written statement filed with the partnership return for the taxable year in which the transfer occurs. For the election to be valid, the return must be timely filed (including extensions). The statement must set forth the name and address of the partnership making the election and contain a declaration that the partnership elects under I.R.C. § 754 to apply the provisions of I.R.C. § 734(b) and I.R.C. § 743(b).[28] The IRS has provided in a Revenue Procedure, however, that an election filed within 12 months of the original due date for the election will be treated as timely if all affected taxpayers report their income consistently with the election for the election year and each subsequent year.[29] If a valid election under I.R.C. § 754 has been made and not revoked, a new election is not required to be made.[30]

As we discuss in § 7.07, an I.R.C. § 754 election can also apply to certain distributions. Once made, an I.R.C. § 754 election applies to all applicable distributions and all applicable transfers of partnership interests, it is not possible to make an election only with respect to distributions of partnership property, or only with respect to sales of partnership interests.

If a partnership wishes to revoke an election under I.R.C. § 754, it must file with the IRS an application setting forth the grounds on which the revocation is desired.[31] The application has to be filed not later than 30 days after the close of the partnership taxable year with respect to which the revocation is intended to apply.[32] The Regulations give as examples of situations that might result in a favorable response to an application for revocation: (i) a change in the nature of the partnership's business, (ii) a substantial increase in the assets of the partnership, (iii) a change in the character of partnership assets, or (iv) an increased frequency of retirements or shifts of partnership interests that would result in an administrative burden to the partnership. The Regulations make clear, however, that an application for revocation will not be approved where the revocation is intended primarily (in our current context) to permit a transferee partner to take advantage of preexisting losses.[33]

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[27]. *See* Treas. Reg. § 1.754-1(c).

[28] Treas. Reg. § 1.754-1(b). Note that effective August 5, 2022, Treas. Reg. § 1.754-1(b) was amended to remove the requirement that a partner must sign the I.R.C. § 754 election statement. TD 9963, 87 F.R. 150, 47931 (Aug. 5, 2022).

[29]. Rev. Proc. 92-85, § 4.01, 1992-2 C.B. 490, *as amended by* Rev. Proc. 93-28, 1993-2 C.B. 344.

[30] Treas. Reg. § 1.754-1(b)(1).

[31]. Treas. Reg. § 1.754-1(c)(1).

[32]. *Id.*

[33]. *Id.*

CHAPTER 7: PARTNERSHIP DISTRIBUTIONS

§ 7.03 NONLIQUIDATING DISTRIBUTIONS OF PROPERTY

C. Marketable Securities

Add the following to footnote 16:

In particular, the term "financial instrument" is itself defined broadly to include stocks and other equity interests, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, and derivates. I.R.C. § 731(c)(2)(C). Under this definition, a cryptocurrency future would be a "financial instrument" even if the cryptocurrency itself was not.

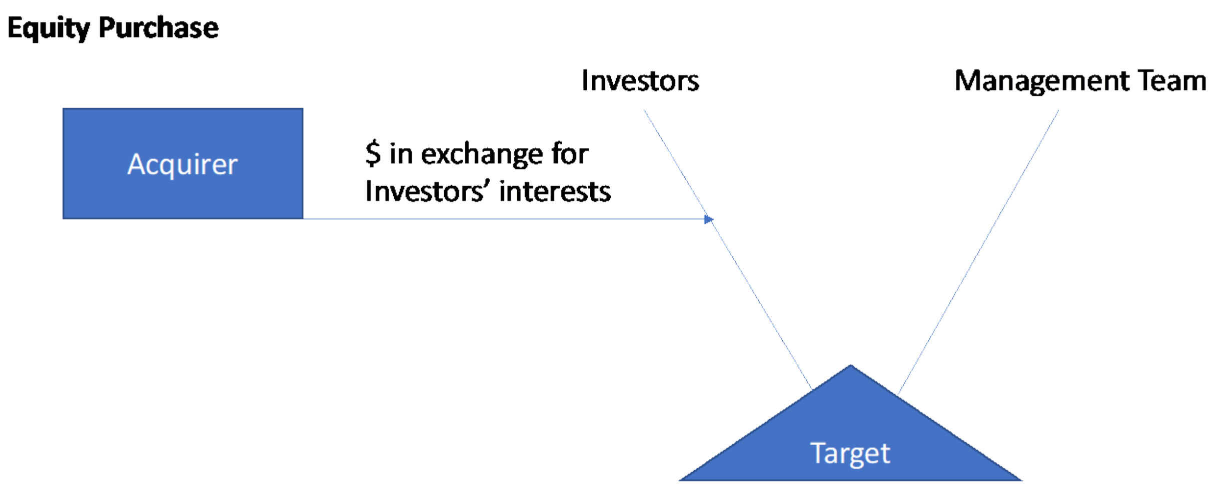
CHAPTER 9: BUSINESS COMBINATIONS

THE FOLLOWING IS ADDED BEFORE THE CURRENT § 9.05 AND §§ 9.05 AND 9.06 ARE RENUMBERED 9.06 AND 9.07, RESPECTIVELY.

§ 9.05 PARTNERSHIP CONTINUATIONS

We have discussed so far in this chapter partnership combinations and divisions which involve, either at the beginning or at the end, two or more partnerships. Sometimes combinations only involve one partnership, in which case the partnership continuation rules discussed in § 6.08, above, would apply. To refresh your recollection, under the general rules of I.R.C. § 708(b)(1), a partnership is terminated if no part of any business of the partnership is carried on by any of its partners in partnership form. This language is surprisingly broad when you think about it in the context of common acquisition structures.

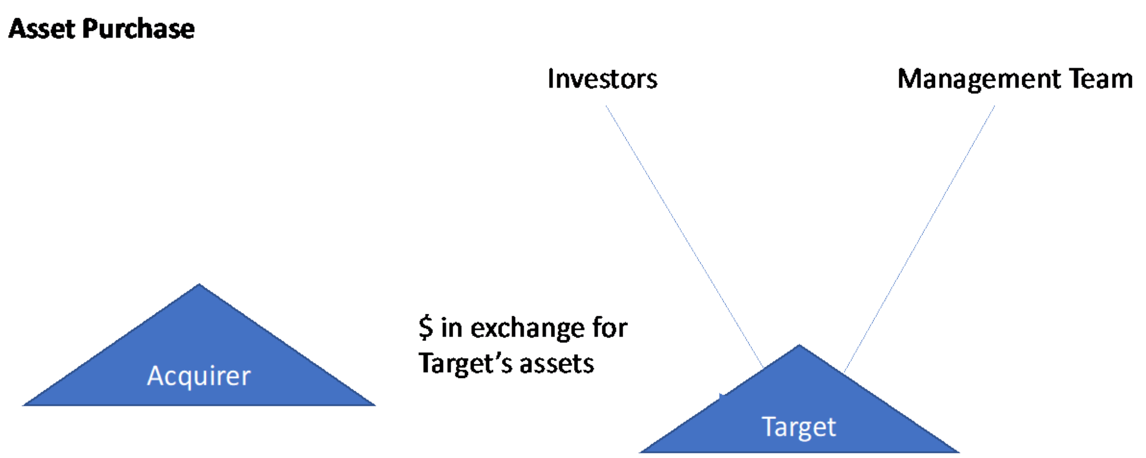
It is common in current practice for an acquirer to request or require a successful management team to continue all or part of their equity interest in the post acquisition entity. The simplest structure would look



like this:

In this structure the Target would continue because the Management Team continues to carry on the business of Target in partnership form.

If the Acquirer is itself a partnership and the acquisition is in the form of an asset purchase, then the analysis is also relatively straightforward – unless the Acquirer requires the Management Team to contribute their interests to the Acquirer.



If Acquirer does not require the Management Team to contribute their interests to Acquirer, then this is a simple asset acquisition. If Acquirer does require the Management Team to contribute their interests to Acquirer, now some of Target's partners are continuing the business of Target in partnership form. If the acquisition fits under the merger rules discussed in § 9.02, above, then the Regulations would likely terminate Target (though you would need to go through the mechanical tests of those rules).

The more interesting questions arise if Acquirer only has one owner until the acquisition occurs and the Management Team is required to contribute its interests in Target to the Acquirer (after the investors are distributed cash). Under these facts, Acquirer does not exist as a partnership until the Management Team contributes their interests, so it is not clear that the merger rules apply. If they do not apply, I.R.C. § 708(b)(1) would indicate that Acquirer is a continuation of Target.

There are more questions than answers about the application of I.R.C. § 708(b)(1) in the context of acquisitions. Fortunately, the IRS has opened a guidance project that will hopefully answer some of the questions in this context.[34]

[34] *See,* Kristen A. Parillo, "Guidance Will Address Post-TCJA Partnership Termination Rules," 175 TAX NOTES FEDERAL 1903 (June 20, 2022).

CHAPTER 12: FOREIGN PARTNERSHIPS, FOREIGN PARTNERS, AND PARTNERSHIPS WITH TAX-EXEMPT ENTITIES

§ 12.02 FOREIGN PARTNERSHIPS

B. FOREIGN TAX CREDIT RULES IN REGARD TO FOREIGN PARTNERSHIP

1. Generally

THE FIRST PARAGRAPH IS RESTATED AS FOLLOWS:

The United States employs a worldwide tax system under which U.S. individuals and domestic corporations generally are taxed on all income, whether derived in the United States or abroad. The foreign tax credit provided under I.R.C. § 901 allows some relief for U.S. taxpayers from double taxation of income generated (and taxed) outside of the U.S. Subject to certain limitations, a U.S. taxpayer is allowed to claim a credit against its U.S. income tax liability for the foreign income taxes that it pays or accrues. (It is also possible to instead deduct foreign taxes from income, but, if the credit is not limited, a credit provides a greater after-tax benefit.) A "foreign income tax" is any income, war profits, or excess profits tax paid or accrued to any foreign country or to any U.S. possession.[35] A "foreign income tax" includes any tax paid in lieu of such a tax within the meaning of I.R.C. § 903. A domestic corporation that owns at least 10% of the vote or value of the stock of a foreign corporation (a "*U.S. Shareholder*") is allowed a deemed-paid credit for foreign income taxes paid by the foreign corporation that the U.S. Shareholder is deemed to have paid when the foreign corporation's earnings are included in the U.S. Shareholder's income under the provisions of subpart F.[36] Subpart F is the portion of the Code dealing with the conditions under which U.S. shareholders are required to currently include income recognized by a controlled foreign corporation. A controlled foreign corporation is a foreign corporation if more than 50% of (i) the total combined voting power of all classes of stock of such corporation entitled to vote, or (ii) the total value of the stock of such corporation, is owned or is considered as owned by United States shareholders on any day during the taxable year of such foreign corporation.[37] Controlled foreign corporations are sometimes referred to as "CFCs."[38]

§ 12.08 READING, QUESTIONS AND PROBLEMS

B. QUESTIONS AND PROBLEMS

PROBLEM 9 IS RESTATED AS FOLLOWS:

ABC manufactures and sells widgets in the United States. A and B are U.S. domestic individuals, but C is a non-U.S. entity that is primarily engaged in the business of manufacturing and selling widgets around the world. C's stock is not publicly traded. ABC makes annual allocations and distributions of the partner's allocable shares of income. C also loaned $100x to ABC on April 1, 2021, to support the capitalization of ABC. ABC pays C $5x of interest annually. What portions of the allocations, distributions, and payments to C will be subject to FATCA withholding? What must C do to avoid the withholding?

[35] I.R.C. § 901(b)(1). Whether a tax is a creditable tax is determined under principles of U.S. law. Treas. Reg. § 1.901-2(a)(2)(i).
[36] I.R.C. § 960.
[37] I.R.C. § 957.
[38] *Id. See* Treas. Reg. § 1.901-1(a).

CHAPTER 14: FAMILY PARTNERSHIPS

§ 14.03 INCOME TAX ISSUES FOR VACATION/RENTAL HOMES

ADD AT THE END OF THE SECTION:

As discussed below in § 14.06, expenses from activities not engaged in for profit, even if otherwise deductible under the hobby loss rules, are considered miscellaneous itemized deductions.[39] Thus, such expenses are not deductible for tax years 2018 through 2025.[40]

Certain expenses, such as property taxes and interest on mortgages, are deductible without regard to the limitations on the deductibility of miscellaneous itemized expenses – subject to some limitations. Property taxes are not miscellaneous itemized deductions because they are excluded by I.R.C. § 67(b)(2). Similarly, interest is excluded from miscellaneous itemized deductions under I.R.C. § 67(b)(1).

However, property taxes are subject to a separate limitation under I.R.C. § 164. Prior to 2026, an individual may not claim a deduction of more than $10,000 in the aggregate per year of certain taxes, including state and local income and property taxes ($5,000 in the case of a married individual filing a separate return).[41]

Investment interest expense is deductible to the extent of investment income of the taxpayer for the year.[42] Interest attributable to a passive activity is deductible to the extent of the passive activity income.[43] However, the deductibility of interest from a trade or business is subject to an overall limitation of 30% of the taxpayer's earnings before depreciation, amortization, interest and taxes (depreciation and amortization are backed out only for years before 2022), provided, generally, that the average annual gross receipts for the taxpayer's three-year taxable period ending prior to the current taxable year exceed $25 million (adjusted for inflation).[44]

Personal interest is an allowable deduction only if it fits in certain specified preferred categories.[45] One of those categories is acquisition indebtedness for a qualified residence.[46] A "qualified residence" means the taxpayer's principal residence and one other residence of the taxpayer which is used by the taxpayer as a residence for the purposoes of I.R.C. § 280A(d)(1).[47] For years prior to 2026, the interest on no more than $750,000 ($375,000 in the case of a married individual filing separately) of acquisition indebtedness is deductible. After 2025, the limits go up to $1,000,000 and $500,000, respectively.

So one might asked, "What does all this have to do with a family limited partnership?" In Chapter 1 we talked about the entity and the aggregate theories. I.R.C. § 280A is applied to a partnership under the aggregate theory. Prop. Reg. § 1.280A-1(e)(3) provides that, for the purposes of I.R.C. § 280A, the

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[39]. Temp. Reg. § 1.67-1T(a)(1)(iv).
[40]. I.R.C. § 67(g).
[41]. I.R.C. § 164(b)(6).
[42]. I.R.C. § 163(d)(1).
[43]. Temp. Reg. § 1.469-2T(d)(3). The passive activity loss rules do not apply to a residence subject to I.R.C. § 280A(c)(5). *See* I.R.C. § 469(j)(10).
[44]. I.R.C. §§ 163(j)(3), 448(c)(1), (4).
[45]. I.R.C. § 163(h)(1) and (2).
[46]. I.R.C. § 163(h)(3)(A)(i).
[47]. I.R.C. § 163(h)(4)(A).

partnership is treated as making personal use of property on any calendar day which any member of the partnership would be considered to have made personal use of the property.[48]

So if a vacation home is placed in a partnership, the I.R.C. § 280A limitations apply in the same manner as if the partners owned the property directly.

However, CCA 200029046 indicated that the entity theory applies to determine ownership of a residence for the purposes of I.R.C. § 121, finding that the ownership of a residence by a family limited partnership did not qualify for the exclusion of gain of a principal residence because the residence was owned by the partnership rather than the taxpayer. The taxpayer considered in the CCA had also requested a ruling that the interest paid on the debt used to acquire the residence qualified as home mortgage interest under I.R.C. § 163(h). The IRS declined to rule on the I.R.C. § 163(h) issue.

So if a residence is placed in a partnership, the individual taxpayer may lose the benefit of the I.R.C. § 121 exclusion, and it is unclear whether the taxpayer would be entitled to a home mortgage deduction.

[48]. *See also* S. Rept No. 94-938 (PL 94-455), Tax Reform Act of 1976, 1976-3 C.B. (Vol. 3) pp. 153-54 (June 10, 1976).

CHAPTER 17: LEGISLATIVE UPDATES AND NON-SUB K PROVISIONS

Add after 17.04 Qualified Opportunity Zone Funds:

§ 17.05 QUESTIONS AND PROBLEMS

A. TAX CUTS AND JOBS ACT ("TCJA")

1. ABC is in the construction equipment leasing business. Substantially all of the value of the business is in the equipment, all of which has a recovery period of less than 20 years. DEF purchases all of the equipment from ABC in 2022. Absent other facts, would you expect that DEF would be able to take 100% bonus depreciation in regard to the cost of the equipment under I.R.C. § 168(k) in 2022?

2. ABC is in the construction equipment leasing business. Substantially all of the value of the business is in the equipment, all of which has a recovery period of less than 20 years. D purchases C's interest in the partnership from C in 2022. The partnership has an I.R.C. § 754 election in place. Absent other facts, would you expect that D would be able to take 100% bonus depreciation in regard to the cost of the equipment under I.R.C. § 168(k) in 2022?

3. ABC runs a cryptocurrency mining business. Though the income of the partnership fluctuates, the partnership has $50,000,000 of income in 2021. The partnership has $20,000,000 unadjusted basis invested in computer equipment in 2021. The partnership has no employees. Absent other facts, what would the aggregate deduction available to the partners under I.R.C. § 199A.

4. ABC is the operator of a shopping mall. In 2021, ABC has $50,000,000 of gross rental income, $20,000,000 of depreciation deductions and $20,000,000 of interest expense.

a. Assuming ABC has no other items of income or deduction, what would ABC's I.R.C. § 163(j) limitation be for 2021?

b. How would your answer change if the same facts existed in 2022?

c. How would your answer change for 2022 if ABC makes the election to be treated as an electing real property trade or business?

B. QUALIFIED OPPORTUNITY ZONE FUNDS

5. In January 2022, Money Bags sells bitcoin, which he has held as a capital asset since 2009. His basis in the bitcoin is $10. He sells the bitcoin for $10,000,000. Within 180 days of the sale Money Bags invests $10,000,000 in a qualified opportunity zone fund ("QOF").

a. How much gain does Money Bags recognize in 2022?

b. What is Money Bags' initial basis in the QOF?

c. What will Money Bags recognize in 2026?

d. In 2027, Money Bags will have held the interest in the QOF for five years. Does anything happen?

e. In 2029, Money Bags will have held the interest in the QOF for seven years. Does anything happen?

f. In 2023, Money Bags sells the interest in the QOF for $12,000,000 and elects to treat the basis in the QOF as equal to the fair market value. How much gain does Money Bags recognize in 2023?

CHAPTER 18: PARTNERSHIP DEBT WORKOUTS

Add after 18.10 Abandonment or Worthlessness of Partnership Interests:

§ 18.11. QUESTIONS AND PROBLEMS

1. ABC buys a fleet of business cars from Quick Fingers paying 10% down and agreeing to pay the rest over five years. Although the cars were represented to ABC as being new, upon delivery and inspection all of the cars are refurbished. ABC files a suit claiming that the debt to pay the balance is not valid under state law. Quick Fingers settles for one quarter of the face amount of the debt. Does ABC have cancellation of indebtedness income?

2. ABC buys a fleet of business cars from Honest Abe paying 10% down and agreeing to pay the rest over five years. The week after ABC buys the cars the Environmental Protection Agency promulgates regulations requiring new cars to have an upgraded catalytic converter with an effective date prior to the date of the purchase. ABC is, thus, required to upgrade the catalytic converters of the new cars. ABC complains to Honest Abe, and since ABC is a repeat customer, Honest Abe agrees to reduce the purchase price of the cars by the amount of the cost to upgrade the catalytic converters. Does ABC have cancellation of indebtedness income?

3. ABC, an LLC treated as a partnership, borrowed money from Neighborhood Bank to buy Strip Mall. ABC was a newly formed entity but had capitalization equal to 50% of the purchase price of Strip Mall. Neighborhood Bank initially offers a recourse loan (for state law purposes) at 7% per annum, but in further discussions Neighborhood Bank says that it will offer a loan at 4% if C guarantees the debt. A and B do not have personal liability for the debt. The Strip Mall is very successful, and after a few years Neighborhood Bank releases C from the guarantee. Does C have income from the release of the guarantee?

4. ABC, an LLC treated as a partnership, borrowed money from Neighborhood Bank to buy Strip Mall. ABC was a newly formed entity but had capitalization equal to 50% of the purchase price of Strip Mall. Neighborhood Bank extends ABC a recourse loan (for state law purposes) at 7% per annum. A, B and C do not have personal liability for the debt. After a few years, the neighborhood in which Strip Mall is located starts to decline. Strip Mall is not able to break even. ABC files for bankruptcy. Pursuant to the plan in bankruptcy, Strip Mall is sold, the proceeds are distributed to Neighborhood Bank, and the LLC is dissolved with nothing being distributed to A, B or C. The debt to Neighborhood Bank is also discharged pursuant to the plan. At the time of the discharge, the amount of the debt is $20,000,000 and the sale proceeds from the Strip Mall were $10,000,000. None of A, B or C are subject to the jurisdiction of the bankruptcy court. A had put every penny A had into the deal and is now approximately $2,000,000 insolvent. Neither B nor C are insolvent. Do A, B or C have income on the cancellation?

5. ABC, an LLC treated as a partnership, borrowed money from Neighborhood Bank to buy Strip Mall. ABC was a newly formed entity but had capitalization equal to 50% of the purchase price of Strip Mall. Neighborhood Bank extends ABC a recourse loan (for state law purposes) at 7% per annum. A, B and C do not have personal liability for the debt. Initially, the project does very well, and after a few years, ABC refinances the bank debt so that outstanding debt is $500, interest only nonrecourse. The neighborhood in which Strip Mall is located starts to decline. Strip Mall is not able to break even. Neighborhood Bank forecloses on the property. At the time of the foreclosure, the amount of the debt is $500 and the cash proceeds from the foreclosure sale from the

Strip Mall are $100. ABC's basis in Strip Mall at the time of the foreclosure sale is $100. None of A, B or C are subject to the jurisdiction of the bankruptcy court. A had put every penny A had into the deal and is now approximately $2,000,000 insolvent. Neither B nor C are insolvent. Do A, B or C have income on the cancellation? Does ABC recognize gain on the foreclosure sale?

6. ABC, an LLC treated as a partnership, borrowed money from Mezz Fund to buy Strip Mall. ABC was a newly formed entity but had capitalization equal to 50% of the purchase price of Strip Mall. Mezz Fund extends ABC a recourse loan (for state law purposes) at 7% per annum. The neighborhood in which Strip Mall is located starts to decline. Strip Mall is not able to break even, and ABC enters into negotiations with Mezz Fund. At the time of the negotiations, the amount of the debt is $500. The value of Step Mall at the time of the negotiations is $600. ABC agrees to issue Mezz Fund a preferred equity interest valued at $500 in exchange for the cancellation of the debt. A had put every penny A had into the deal and is now approximately $2,000,000 insolvent. Neither B nor C are insolvent. Do A, B or C have income on the cancellation?

7. ABC, an LLC treated as a partnership, borrowed money from Mezz Fund to buy Strip Mall. ABC was a newly formed entity but had capitalization equal to 50% of the purchase price of Strip Mall. Mezz Fund extends ABC a recourse loan (for state law purposes) at 7% per annum. The neighborhood in which Strip Mall is located starts to decline. Strip Mall is not able to break even, and ABC enters into negotiations with Mezz Fund. At the time of the negotiations, the amount of the debt is $500. The value of Step Mall at the time of the negotiations is $100. ABC agrees to issue Mezz Fund a preferred equity interest valued at $100 in exchange for the cancellation of the debt. A had put every penny A had into the deal and is now approximately $2,000,000 insolvent. Neither B nor C are insolvent. Do A, B or C have income on the cancellation?

ERRATA

PAGES 206 AND 207

In each table, the word "lane" should be changed to "land."

PAGE 408

Footnote 36 should be restated as follows:

36. *See, e.g.,* Kwiat v. Commissioner, 1989 T.C.M. (P-H) ¶ 1989-382; Penn-Dixie Steel Corp., 69 T.C. 837 (1978); Rev. Rul. 82-150, 1982-2 CB 110. *See also* Griffin Paper Company v. Commissioner, 1997 T.C.M. (RIA) ¶ 1997-409, *aff'd* 180 F.3d 272 (8th Cir. 1998).

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In the last paragraph, the reference to "I.R.C. § 208A(f)(1)(B)" should be "I.R.C. § 280A(f)(1)(B)."