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PARTNERSHIP TAXATION

January 2021 Supplement
to
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RICHARD M. LIPTON, ESQ.

Partner, Baker & McKenzie LLP

PAUL CARMAN, ESQ.

Partner, Chapman and Cutler LLP

ROSS D. COHEN, ESQ.

Partner, Bingham Greenebaum Doll LLP

WALTER D. SCHWIDETZKY

Professor of Law

University of Baltimore School of Law

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Carolina Academic Press
700 Kent Street
Durham, North Carolina 27701
Telephone (919) 489-7486
Fax (919) 493-5668
E-mail: cap@cap-press.com
www.cap-press.com

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PARTNERSHIP TAXATION

ADDITIONS, SUBSTITUTIONS AND INSERTIONS

INTRODUCTION

THE SPIRIT OF PARTNERSHIPS AND PARTNERSHIP TAXATION

Most of this textbook focuses on the rules concerning partnership taxation – when a partnership exists, the tax treatment of contributions to a partnership, the basis of partnership assets and interests in a partnership, how income is allocated to the partners, the tax treatment of distributions, the consequences of partnership liabilities, partnership mergers, the retirement of a partner and dissolution of the partnership. There also is significant attention paid to the numerous "anti-abuse" rules that have been adopted by Congress and the Internal Revenue Service ("Service") over the past several decades, including the disguised sale rules, the treatment of "mixing-bowl" transactions, the complex rules to prevent basis abuse, and the overriding "partnership anti-abuse regulations" adopted by the Service. These rules are embodied in the Code, the regulations, rulings from the Service and numerous precedents, all of which are explored and discussed below. Put simply, this textbook contains a thorough discussion of the rules of partnership taxation.

In addition, this textbook explores one of the fundamental questions which always arises in partnership taxation – is a partnership to be treated as a separate taxable entity or an aggregate of its partners. The tension between entity and aggregate treatment of a partnership is one of the recurring issues in determining the tax consequences of partnership transactions. Indeed, it can be argued that Congress created perpetual uncertainty when it decided in 1954 that for tax purposes a partnership was not solely an aggregation of its partners or a separate legal entity, but at times one and at times the other. Many of the questions addressed in this textbook arise, at their heart, because of the bifurcated nature of a partnership as both a separate entity and an aggregate of its partners. Some of the more complex areas in partnership taxation (like the TEFRA rules governing partnership controversies) arise because of Congress' unwillingness to draw the line between treating a partnership as a separate entity versus an aggregation of its partners.

However, this introduction focuses on a third aspect of partnership taxation – the spirit of partnerships and partnership taxation. The concept that individuals and corporations will, in the furtherance of legitimate business enterprise, want to enter into partnerships is one of the unspoken axioms of the tax law. The practical consequences of people coming together is the focus of the complex rules governing partnership taxation, but the underlying reason why people want to combine their efforts is not addressed frequently. People coming together to promote their individual and collective self-interests is what underlies every partnership.

In order to understand partnership taxation, you need to take into account the fact that partnerships are one of the fundamental building blocks of human economic interaction. Partnerships have long existed, and they will continue to exist, although the success of partnerships may depend upon the tax rules applicable to them. The rules concerning partnership taxation need to be judged by whether they further or inhibit this basic goal. In other words, as you read each of the chapters below, you should consider not only the technical partnership tax issues that are discussed but also whether the rules are consistent with the undiscussed spirit of partnerships and partnership taxation. If the rules further these goals without fostering abuse, then the rules may be considered to be "spiritually" appropriate. On the other hand, if out of a desire to prevent some perceived abuse, the rules make it harder for people to combine their resources and energy, or result in

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uncertain or disproportionately inappropriate tax consequences, then the wisdom of the rule needs to be carefully considered.

Why are there Partnerships? Anyone who wants to consider the origin of partnerships (and partnership taxation) needs to go no further than pre-historic times, as men banded together to hunt. The cave drawings found in Southern France all illustrate groups of men joining together to slay beasts, whether for food or protection. The proceeds of these efforts were shared by the hunters (partners), although a written agreement was not needed to determine how a slaughtered animal would be divided.

Indeed, it can be argued that the entire impetus of the change in civilization from a hunter/gatherer society to one in which people primarily lived in cities was a result of partnerships being formed. Although cities furthered economic growth and development by allowing individuals to exchange their efforts and goods, the impact of this interchange was greatly magnified as people joined together to increase the impact of their efforts. Partnerships provided the means for people to work together, and the law quickly developed to address the legal relationship of partners.

A survey of the laws of antiquity indicates that partnerships have been present for a long, long time. Dating back to the time of Sumer, there was a complex commercial system that included business partnerships. The transactions of these partnerships were recorded on clay tablets, some of which have been found in temple complexes.[1]

In his book on Mesopotamian contracts, Paul Halsell highlighted two contracts from the reign of Nebuchadnezzar II (c. 568-564 BC). In the first contract, Nabu-adki-iddin was an investor – a member of the great Egibi family. He contributed four manas of capital to a partnership, while Bel-shunu, who was to carry on the business, contributed one half mana and seven shekels, whatever property he might have and his time. Any expenses in excess of four shekels was considered to be extravagant and had to be paid by Bel-shunu from his own pocket. The contract was witnessed by three men and a scribe. In another partnership, entered into four years later, there were no initial contributions, but each of the partners drew 20 shekels of income one year later, and additional funds were used by the partnership to pay its obligations.[2]

This business model was carried over to ancient Greece and Rome. In Rome, in particular, "associations" were formed which functioned as partnerships. Partnerships were used, especially for transmarine transactions in which risk sharing was necessary in an age before insurance. Cato advised a capitalist not to fit out a single ship but, in concert with forty nine other capitalists, to send out fifty ships and to take an interest in each to the extent of a fiftieth part.[3]

When Rome fell, and "darkness" spread upon the West, partnerships continued in the thriving intellectual climate in the Arab world. Indeed, partnerships were the primary form of business enterprise because interest is forbidden in the Koran. Partnerships were regularly used to compensate the party who provided money to a venture, using a variable rather than a fixed rate of return. Indeed, there were different types of partnerships for the situation where one person contributed money and another contributed labor (Mudararah) and the situation in which both persons contributed capital (Musharakah).[4]

Even in the so-called Dark and Middle Ages, partnerships were the primary vehicle of commerce. For example, in 1235, a Jew (Saltell) and a Christian (Berenguer) formed a partnership to operate a mill. They originally agreed that Saltell would have one quarter of the income and bear one quarter of the losses.

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1 Paul Guisepi and F. Roy Willis, History-World.org/sumeria, 2003.

2 Paul Guisepi and F. Roy Willis, History-World.org/sumeria, 2003.

3 Theodor Mommsen, The History of Rome, Book III.

4 M.A. Mannan, Economic Development and Social Peace in Islam (1989) and M.U. Chapra, Towards a Just Monetary System (19860.

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Seven years late a dispute arose, with Saltell claiming he was owed money as a result of a premature disposition of the mill, and Berenguer claiming that there was a loss for which he was entitled to compensation. The matter was submitted to jointly-accepted arbitrators, who found in favor of Saltell and awarded him monetary damages.[5]

The emergence of the West from the Dark Ages was accompanied by the growth of mercantile partnerships. Indeed, on his voyage of discovery, Christopher Columbus formed a partnership with the Spanish crown and Italian investors, in which he shared the proceeds from his discoveries.[6] The explorations by Sir Francis Drake were supported by partnerships of investors.[7] And the great growth of trade in the Netherlands during the 16th century can be directly traced to partnerships in which investors held shares and entrusted their capital to the hands of active partners.[8]

The use of partnerships is also inextricably linked to the founding of this country. Although the original Virginia Company that founded the Jamestown settlement was a corporation chartered by the Crown, the Pilgrims who landed at Plymouth Rock conducted their enterprise as a partnership. There were "Adventurers" who provided the capital and supplies needed for the settlement. The settlers themselves were often described as "partners in land" who would be entitled to a sharing of the proceeds with the Adventurers.[9]

Partnerships were so common that they could be found in everyday conversation and in famous literature. For example, in A Christmas Carol, when Ebenezer Scrooge and Jacob Marley left to form their own business, they formed a partnership, Scrooge and Marley. Shakespeare referred to partners in business enterprises in several of his plays.[10]

The story goes on and on. People joining together to collectively promote their interests – to form partnerships – are a fundamental part of the history of man. Partnerships are simply a part of fundamental human relationships – people enter into partnerships in order to conduct commercial enterprise, with the hope that this will improve their lives.

Why are there Separate Tax Rules for Partnerships? If partnerships are such a fundamental building block for human relations, why is it necessary to have separate tax rules for partnerships? This seemingly simple question can be answered with an equally simple statement -- our tax system focuses on income, and income eventually goes to the people who receive it. The income tax originally applied only to individuals, and the taxation of partnerships was always focused on the taxation of the people who formed those partnerships.

There is, needless to say, a long history of partnership taxation that pre-dates the current income tax. However, for much of antiquity, there was no income tax (as we currently understand such taxes), although partnerships would have been subject to wealth, property and similar taxes. However, as far back as 519 B.C., King Darius of Persia established a tax system that was based on the anticipated yield of land. Although this was not a true "income" tax, the tax was imposed upon the source of production of income. Even earlier, in ancient Sumer and Babylon, professional workers had to pay "taxes" to royal collectors in order to remain employed. Thus, both individuals and partnerships have long had tax burdens, although much

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5 Medieval Sourcebook: A Business Partnership between a Jew and a Christian in Barcelona, 1235-1242, based on Arxiu Capitular de Barcelona 1-6-3475.

6 Wikipedia.org, "Columbus' Campaign for Funding".

7 The Beginning of the End: The Drake-Norris Expedition, 1589," www.loc.gov/rr/rarebook/catalog/drake.

8 Jan de Vries, "The Dutch Atlantic Economies," Coclanis Books, p. 10 (2005).

9 "The Present [1624] Estate of New Plymouth," from the Mayflower Web Pages, Mayflo1620.

10 *See, e.g.*, The Winter's Tale, Act 4, Scene 2; Coriolanus, Act 5, Scene 6.

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of this taxation was not directly related to income.

Of course, it also is possible to tax business entities, as the tax treatment of corporations shows. Arguments have been made that all business entities – corporations, partnerships, limited liability companies, business trusts – should be directly subject to taxation. The difficulty with this argument is that there is little difference between a sole proprietorship, which is difficult to tax as a separate business entity, and a two-person general partnership. The distinction becomes even harder to discern when families are involved. For example, if a woman sets up a business in her home and it is not taxable, but then brings her daughter into the business to help her and gives her daughter an ownership interest in the business, would the former not be a business entity subject to taxation but the latter would? Unless every business entity of any size, and without regard to the number of owners, is subject to entity-level taxation, there will always be some business entities that are effectively taxed to their owners directly and not to the entity itself.

Moreover, some state and local governments (and some foreign countries) currently tax partnerships as business entities, so it is clear that there is no fundamental cosmic reason why a partnership could not be subject to taxation. But in the United States, as a general rule, a partnership has been viewed not as a separate taxable entity but, instead, as a "passthrough" entity in which its owners (and not the partnership itself) is subject to taxation. This axiom – that income tax is paid by the partners in a partnership, and not the partnership itself – underlies many of the issues that will be discussed herein.

Aggregate versus Entity Treatment. The assumption that a partnership will be treated as a pass-through entity that is not directly subject to income taxation does not answer the question whether the calculation of income will be imposed at the partner or partnership level. In other words, even if the partners in the partnership (and not the partnership itself) are directly subject to taxation on income, the computation of income can be made either at the entity level (by treating the partnership as a separate entity for purposes of computing the income that is taxable to its owners) or at the partner level (by disregarding the partnership and treating it as an aggregation of its owners, each of whom determines his own income separately).

There is no clearly "correct" way to determine how a partnership should be treated, i.e., both entity and aggregate treatments are appropriate at different times. Many of the chapters that follow will illustrate the tension between aggregate and entity treatment of partnerships in calculating the income that is taxable to the partners in a partnership. This is particularly evident in the various anti-abuse rules that have been adopted by Congress or promulgated by the IRS. Most of the anti-abuse rules address situations in which treating a partnership as a separate taxable entity results in more favorable tax consequences than would occur if the partnership were treated as an aggregation of its owners – the anti-abuse rules frequently treat the partnership as an aggregate in order to "correctly" determine the taxable income of its partners.

Where Do Substance and Form Fit In? If simplicity is ever to be achieved in the area of partnership taxation, then "substance" and "form" will remain significant determinants of the tax consequences of partnership transactions. It can be argued that much of the complexity in the more recent legislation and regulations concerning partnership taxation are the result of Congress and the IRS not trusting that the courts will look at the substance (rather than the form) of partnership transactions. Many of the more recent rules appear to be designed to address situations in which the form of the transaction differed from its substance. It is possible that some of this complexity could be eliminated if Congress and the IRS would simply allow the courts to do their job in weighing the bona fides of partnership transactions.

For example, consider the decision in *ASA Investerings v. Commissioner*, 1998 RIA TC Memo ¶ 98,305, *aff'd*, 201 F.3d 505 (D.C. Cir. 2000). The case involved the application of the installment sale rules under Section 453 in the context of a partnership with foreign and domestic partners. The partnership was

11 Michael Hudson, "Mesopotamia and Classical Antiquity – Taxation History," The American Journal of Economics and Sociology (December 2000).

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formed so as to cause an allocation of income (resulting from the installment sale) to the foreign partner. To address this transaction, the court could not rely upon the technical words in the Code, because these rules supported the taxpayer's position. Instead, the court had to look at the substance of the transaction (rather than its form) to find that the foreign party was not a "partner" to whom income could be allocated.

What About Anti-Abuse Rules? Recent years have seen significant legislative and regulatory developments in the partnership area. Many of the newest rules can only be described as "anti-abuse" provisions which are intended to address one particular transaction or another that was considered to be abusive. The result is that the laws concerning partnership taxation have metamorphosed from the broad, general principles that were established in the 1950s into particularized rules that attempt to address every potential abuse. Of course, it is impossible to cover every conceivable situation, so Congress and the IRS have crafted numerous rules that unfortunately can be aptly described as "heads I win, tails you lose."

Several examples illustrate the approach taken by Congress in these new rules. For example, Sections 737 and 704(c)(1)(B) both provide for the potential recognition of gain, but not loss, when appreciated property is contributed to a partnership by a partner and either that property is distributed to another partner or the contributing partner receives a distribution of other property. If the transaction is an appropriate event to trigger the recognition of gain, why is it not also an appropriate event for the recognition of loss?

Likewise, the basis rules in Sections 734 and 743 were amended in 2004 to address situations in which an election is not made under Section 754 to adjust the basis of partnership assets. Basically, the amendment functions so that (1) if there would be a basis increase that would potentially benefit partners, an election must be filed, and if no election is timely filed, the partners could face double recognition of gain, but (2) if there is a loss that would result in a basis reduction (which benefits the IRS), an election will be deemed to have been filed except in some very limited circumstances. This provision is a classic "heads I win, tails you lose" situation[12] and is representative of the approach taken in recent legislation and regulations.

How Do the Tax Rules Affect Partnerships? Any practitioner who has worked with partnerships is well aware that the tax laws impact every single transaction. It would be naïve to assume that a partnership would be formed, enter into transactions, distribute its profits, bring in new partners and redeem old ones, incur liabilities and (eventually) dissolve without looking at the applicable tax rules each and every step of the way. In fact, because partnerships receive more favorable tax treatment than corporations (one level of taxation instead of two), it is possible that even more attention is paid to the tax consequences of partnership transactions than to corporate ones.

The impact of the tax rules can be seen in everyday transactions. For example, assume that Jack wants to contribute property to a partnership, and Jill wants to contribute money. The contributing partners will need to consider numerous tax issues in forming their partnership, including the impact of any built-in gain or loss with respect to the contributed property, the manner in which basis will be allocated and depreciation calculated, the potential application of the disguised sale rules as distributions are made to Jack, the allocation of liabilities that encumber the property, and on and on. Even the simplest transaction can result in significant confusion.

If the goal of partnerships is to allow people or corporations to pool their efforts for the common good, then partnership tax rules should be judged by whether they make it easier or more difficult to attain this goal. Many of the more complex rules in the Code will certainly fail this test. Indeed, the most significant issue in partnership taxation is the complexity, much of which arises from more recent rules and regulations.

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12 This provision was enacted to address a transaction, undertaken by Enron Corporation prior to its demise, in which a failure to make an I.R.C. § 754 election resulted in basis duplication.

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Take, for example, the potential application of the disguised sale rules to the partnership formed by Jack and Jill. Even a simple transaction, in which one partner contributes property and the other contributes cash, will need to be carefully reviewed to make sure that the transaction is not treated as a disguised sale. Moreover, all distributions by the partnership to Jack and Jill will need to be carefully monitored for at least 7 years to make certain that Jack is not treated as having engaged in a "mixing bowl" transaction. Thus, the simple contribution of property to a partnership can result in years of diligence. This complexity is one of the banes of the partnership tax rules at the present time.

The Spirit of Partnership Taxation. If there is an underlying "spirit" to partnerships, it is people getting together to conduct business in a manner which provides mutual benefits. This is how partnerships have always been used, and this is why partnerships have generally been treated as non-taxable entities, because it is the partners (and not the partnership as an entity) that should be subject to income taxation.

The tax rules for partnerships should be approached with the intention of furthering this goal by allowing persons to enter into mutually-beneficial economic arrangements the tax consequences of which can be simply (and definitively) determined. Moreover, the tax results should be self-evident to both the partners in the transaction and their tax advisors. The spirit which underlies partnership taxation should be the same as the spirit underlying partnerships – partnerships should be taxed in a manner which reflects the underlying business arrangements of the partners. If partnerships are a "basic" form of human economic organization, the tax rules for partnerships should also be built on the "basics" that tax consequences should be related to the underlying economic relationships of the partners.

The remainder of this book will be filled with discussion of the actual rules for partnership taxation. You will encounter complex rules, with exceptions, exceptions to the exceptions and "heads I win, tails you lose" anti-abuse rules. We will leave it to you to determine whether each of these rules – particularly the more recent statutory and regulatory limitations on partnerships and their transactions -- are consistent with or contrary to the underlying spirit of partnerships and their transactions.

The foregoing said, it is purely wishful thinking that the tax rules concerning partnerships can return to the days of yore, in which there were a few simple rules and general principles guiding partnership taxation. Complexity is here to stay, and the ongoing trend is to make the rules more complex rather than simpler. Moreover, as tax practitioners find ways to take advantage of the rules, it can be anticipated that Congress and the IRS will continue to attempt to make the rules for partnership taxation more one sided than ever.

How Practitioners Can Further the Spirit of Partnerships and Partnership Taxation. The following chapters will illustrate many of the aspects of partnership taxation. You will learn about the definition of a partnership, the tax consequences of forming a partnership, the effect of contributions to the partnership and distributions by the partnership, the determination of basis and the tax treatment of partnership liabilities, the calculation and allocation of partnership income, the disposition of partnership interests and the tax treatment of retiring partners, the tax treatment of transactions between a partnership and its partners, partnership mergers and divisions, and the myriad anti-abuse rules that are now part of the partnership tax universe. Each of these areas has its own rules, some of which are instinctual, some of which are artificial and many of which are subject to complex rules and regulations.

As a tax practitioner in the partnership area, you will need to be fully conversant with the rules that are discussed herein. But you also need to have a fundamental understanding of the "spirit" which underlies these rules, which is that a partnership provides a means for different persons to jointly conduct economic arrangements. The tax consequences of the partnership should be linked inextricably to the underlying economic arrangement, and although the rules are complex, they are generally intended to reach that result. Indeed, it is most likely that an anti-abuse rule will apply any time that the partnership tax rules lead to a result which is non-economic or does not appear to be consistent with the underlying economic arrangement

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of the partners. And in those situations which happen to lie outside of one of the anti-abuse rules, it is still possible that a court would attempt to recharacterize the transaction – whether under substance over form principles or simply on the basis of "economic reality" – so as to cause the tax consequences of the transaction to comport with the economic arrangement of the partners.

When you are advising partnerships, therefore, you should always be mindful of the underlying economic arrangement. The partnership agreement, and all of the other documents evidencing the partnership and the arrangements of the partners, should be drafted so as to clearly embody and further the partners' intent. Indeed, it often is best to state clearly in the agreement both the intended economic effect and intended tax consequences of the partnership transaction. If it cannot be stated clearly and succinctly, or if the partners are not willing to allow their intent to see the light of day, then the practitioner should be concerned about the substance of the transaction and the resulting tax consequences. However, if the partners' economic arrangement is clear and the intended tax consequences flow inevitably from the partners' economic arrangement, then it is likely that both will be respected. The practitioner's goal should be to create partnership arrangements and transaction where, notwithstanding the complexity of the Code, the regulations, the rulings and the case law, there is little doubt as to what the tax consequences will be.

CHAPTER 1: DEFINING PARTNERSHIPS AND PARTNERS FOR TAX PURPOSES

§ 1.03 CLASSIFYING PARTNERSHIPS FOR TAX PURPOSES

D. RECLASSIFYING PARTNERSHIPS AS CORPORATIONS

2. Publicly Traded Partnerships

For purposes of determining whether a partnership is a publicly traded partnership, the interests in the partnership are readily tradable on a secondary market or the substantial equivalent thereof, if, taking into account all of the facts and circumstances, the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market.[13] Interests in a partnership will be deemed to be readily tradable on a secondary market or the substantial equivalent thereof if:

(i) interests in the partnership are regularly quoted by any person, such as a broker or dealer, making a market in the interests;

(ii) any person regularly makes available to the public (including customers or subscribers) bid or offer quotes with respect to interests in the partnership and stands ready to effect buy or sell transactions at the quoted prices for itself or on behalf of others;

(iii) the holder of an interest in the partnership has a readily available, regular, and ongoing opportunity to sell or exchange the interest through a public means of obtaining or providing information of offers to buy, sell, or exchange interests in the partnership; or

(iv) prospective buyers and sellers otherwise have the opportunity to buy, sell, or exchange interests in the partnership in a time frame and with the regularity and continuity that is comparable to that described in the other tests listed above.[14]

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13 Treas. Reg. § 1.7704-1(c)(1).
14 Treas. Reg. § 1.7704-1(c)(2).

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3. Taxable Mortgage Pools

For purposes of the definition of a TMP, real estate mortgages (or interests therein) include: (i) obligations (including participations or certificates of beneficial ownership therein) that are principally secured by an interest in real property; (ii) regular and residual interests in a real estate mortgage investment conduit; and (iii) stripped bonds and stripped coupons which are stripped from bonds or coupons that would have qualified as real estate mortgages or interests therein.[15] An obligation is principally secured by an interest in real property if the fair market value of the interest in real property securing the obligation was at least equal to 80% of the adjusted issue price of the obligation on the issue date.[16] An obligation is also principally secured by an interest in real property if substantially all of the proceeds of the obligation were used to acquire, improve, or protect an interest in real property that, on the issue date, is the only security for the obligation.[17]

Debt obligations have two or more maturities if they have different stated maturities or if the holders of the obligations possess different rights concerning the acceleration of or delay in the maturities of the obligations.[18] Debt obligations are not treated as having two or more maturities merely because they allocate credit risk unequally.[19] Real estate mortgages (or interests therein) include: (i) obligations (including participations or certificates of beneficial ownership therein) that are principally secured by an interest in real property; (ii) regular and residual interests in a real estate mortgage investment conduit; and (iii) stripped bonds and stripped coupons which are stripped from bonds or coupons that would have qualified as real estate mortgages or interests therein.[20] An obligation is principally secured by an interest in real property if the fair market value of the interest in real property securing the obligation was at least equal to 80% of the adjusted issue price of the obligation on the issue date.[21] An obligation is also principally secured by an interest in real property if substantially all of the proceeds of the obligation were used to acquire, improve, or protect an interest in real property that, on the issue date, is the only security for the obligation.[22]

§ 1.04 DISTINGUISHING PARTNERSHIPS FROM OTHER CONTRACTUAL ARRANGEMENTS

E. DISTINGUISHING PARTNERSHIPS FROM TRUSTS

1. Grantor Trusts

For income tax purposes, there are complex trusts, simple trusts, split-interest trusts and grantor trusts. Because grantor trusts are closest to partnerships, we will focus on grantor trusts. But first, it is necessary to have a basic understanding of what a "trust" is.

For income tax purposes, a "trust" is an arrangement by which title to property is held by a person or persons, with a fiduciary responsibility to conserve or protect the property for the benefit of another person or persons.[23] Trusts may be formed under common law or under statutory provisions. A trust formed under common law may have the necessary fiduciary duty imposed by the applicable trusts and trustees act. A trust

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15 Treas. Reg. § 301.7701(i)-1(c)(5)(ii)(C).
16 Treas. Reg. § 301.7701(i)-1(d)(3)(i)(A).
17 Treas. Reg. § 301.7701(i)-1(d)(3)(i)(B).
18 Treas. Reg. § 301.7701(i)-1(e)(1).
19 Treas. Reg. § 301.7701(i)-1(e)(2).
20 Treas. Reg. § 301.7701(i)-1(c)(5)(ii)(C).
21 Treas. Reg. § 301.7701(i)-1(d)(3)(i)(A).
22 Treas. Reg. § 301.7701(i)-1(d)(3)(i)(B).
23 Treas. Reg. § 301.7701-4(a).

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formed under statutory provisions may or may not have fiduciary duties. If an entity is formed as a state law trust without fiduciary duties, the arrangement may be recharacterized as something other than a trust.

A grantor trust is defined under subpart E of Subchapter J of the Code. Under these provisions, a grantor who has retained certain powers which may be exercised without the approval or consent of an adverse party is treated as the owner of the trust and is taxed individually.[24] This retention of control may be manifested by either the grantor's or a nonadverse party's ability to control the beneficial enjoyment of the corpus or the income therefrom, to revoke the trust or a portion thereof, or to receive income from the trust, actually or constructively.[25]

I.R.C. § 671 provides that where the grantor or another person is treated as the owner of any portion of a trust, there will be included in computing taxable income and credits of the grantor or other person, those items of income, deduction and credits against tax of the trust attributable to that portion of the trust to the extent that such items would be taken into account in computing the taxable income or credit against the tax of an individual. Treas. Reg. § 1.671-2(e)(3) provides that a "grantor" includes a purchaser of an interest in an investment trust described in Treas. Reg. § 301.7701-4(c).

2. *Business Trusts*

Forming an entity as a trust may not prevent the entity from being classified as a business entity. In general, if the organizational documents of a trust explicitly authorize the trust to conduct business[26] or the trust does, in fact, conduct business,[27] an entity formed as a trust may be viewed as a business entity.[28] However, business transactions which are necessary to an orderly liquidation or the preservation of the trust property will not cause the trust to be taxed as an association.[29] If a business trust indeed exists, it is not classified as a trust for tax purposes, but instead falls within the classification rules set out above. If it has one beneficiary, it will be treated as a disregarded entity. If it has two or more beneficiaries, it will be classified as a partnership. It can, alternatively, elect to be taxed as a C corporation.[30] A typical business trust will not qualify to elect S corporation status.

3. *Investment Trusts*

Certain trusts formed to make investments may also be classified as business entities. Although both *Tower* and *Andantech*, discussed above, could be read to hold that conducting business is an essential characteristic of a business entity, there is a long tradition of authority that will classify an investment trust as a business entity even if the only activity of the trust is investing unless certain conditions are met.[31]

Treas. Reg. § 301.7701-4(c)(1) provides that an investment trust will be treated as a business entity if the trustees have a power to vary the investment of the trust certificate holders. For example, in Rev. Rul. 78-

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24 United States v. Buttorff, 563 F.Supp. 450, 454 (N.D. Tex. 1983), aff'd761 F.2d 1056, 1060 (5th Cir. 1985).

25 I.R.C. §§ 675, 676, 677.

26 Morrissey v. Commissioner, 296 U.S. 344 (1935); Elm Street Reality Trust v. Commissioner, 76 TC 803 (1981).

27 Abraham v. United States, 406 F.2d 1259 (6th Cir. 1969).

28 Treas. Reg. § 301.7701-4(b).

29 *See* Nee v. Main Street Bank, 174 F.2d 425 (8th Cir. 1949).

30 *See* Treas. Reg. § 301.7701-4(b); *see also* Lee-Ford Tritt and Ryan Scott Teschner, Re-imagining the Business Trust as a Sustainable Business Form, 97 Washington U. L. Rev. 1 (2019), and Carter G. Bishop, Forgotten Trust: A Check-the-Box Achilles' Heel, 43 Suffolk U. L. Rev. 529 (2010).

31 *See* Commissioner v. North American Bond Trust, 122 F.2d 545 (2d Cir. 1941), *cert. denied*, 314 U.S. 701 (1942). Under current law, investing for one's own account is not a trade or business. Commissioner v. Groetzinger, 480 U.S. 23 (1987).

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371,[32] the IRS ruled that a real estate trust, which was formed to collect and distribute income from the trust property, was a business entity where the trustees had the power to change the property into which the trust assets were invested.[33] In contrast, in Rev. Rul. 79-77,[34] the IRS ruled that a real estate trust, which was similarly formed to act as a signatory to leases and collect and distribute the income from the property, was organized to conserve property (and, thus, treated as a trust) because the trustees lacked the powers given to the trustees in Rev. Rul. 78-371.[35]

Separately, an investment trust with multiple classes of ownership interest will ordinarily be classified as a business entity unless (i) there is no power to vary the investment of the certificate holders and (ii) the trust is formed to facilitate direct investment in the assets of the trust and the existence of multiple classes of ownership interests is incidental to that purpose.[36]

If a trustee has additional powers under the trust agreement such as the power to do one or more of the following: (i) dispose of the trust's property and acquire new property; (ii) renegotiate the lease leases of the trust's property with the original lessee or enter into leases with tenants other than the original lessee; (iii) renegotiate or refinance the obligation used to purchase the trust's property; (iv) invest cash received to profit from market fluctuations; or (v) make more than minor non-structural modifications to the trust's property not required by law, the trust will be a business entity.[37]

F. Comparison Charts

Entity	State Law Issues	Tax Issues
C corporation	Limited liability	Double taxation
S corporation	Limited liability	Single level of taxation Single class of stock
General partnership	Joint and several liability (unless LLP)	Single level of taxation Multiple classes possible Special allocations possible

32 1978-2 C.B. 344.

33 The trustees had the power to:
(a) purchase and sell contiguous or adjacent real estate;
(b) accept and retain contributions of contiguous or adjacent real estate from the beneficiaries or members of their families;
(c) raze or erect any building or other structure and make any improvements they deem proper on the land originally donated to the trust or on any adjacent or contiguous land subsequently acquired by the trust; and
(d) borrow money and mortgage and lease the property.

34 1979-1 C.B. 448.

35 *See also* Rev. Rul. 77-349, 1977-2 C.B. 20 and Rev. Rul. 84-10, 1984-1 C.B. 155 (mortgage-back security pool classified as a trust where trustee did not have the power to vary the investments).

36 Treas. Reg. § 301.7701-4(c)(1).

37 Rev. Rul. 2004-86, 2004-2 C.B. 191.

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Limited partnership	General partner has unlimited liability (unless LLLP)	Single level of taxation Multiple classes possible Special allocations possible
Limited liability company	Limited liability	Single level of taxation Multiple classes possible Special allocations possible
Investment Trust	Limited liability	Single level of taxation No power to vary Limited ability to have multiple classes No special allocations possible

Partnerships and LLCs	
Formation:	A contribution of property in exchange for a partnership interest is generally not taxable.
Operations:	The net income of a partnership is taxable to the partners.
Distributions:	A distribution is taxable to the extent that the amount of cash distributed is in excess of the recipient's basis in the recipient's partnership interest.
Liquidations:	A distribution is taxable to the extent that (i) the amount of cash distributed is in excess of the recipient's basis in the recipient's partnership interest and (ii) the income allocated.
Sales and Reorganizations:	Partnerships are quite limited in the types of reorganizations in which they may participate.

C Corporations	
Formation:	A contribution of property for stock is generally not taxable if the contributors hold at least 80% of the stock immediately after the exchange.
Operations:	The net income of a C corporation is taxable to the corporation.
Distributions:	A distribution from a C corporation is taxable to the recipient to the extent that (i) the distribution is out of earnings and profits or (ii) the distribution is in excess of the recipient's stock basis.

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Liquidations:	A distribution in liquidation is generally taxable to the recipient to the extent that the value of the distribution exceeds the recipient's tax basis.
Sales and Reorganizations:	Corporations may participate in a variety of tax-free reorganizations.

S Corporations	
Formation:	A contribution of property for stock is generally not taxable if the contributors hold at least 80% of the stock immediately after the exchange.
Operations:	The net income of an S corporation is taxable to the shareholders of the corporation.
Distributions:	A distribution from an S corporation is taxable to the recipient to the extent that the distribution is in excess of the recipient's stock basis.
Liquidations:	A distribution in liquidation is generally taxable to the recipient to the extent that the distribution exceeds the recipient's tax basis.
Sales and Reorganizations:	Corporations may participate in a variety of tax-free reorganizations.

§ 1.08 Series LLCs

A. Introduction

The last paragraph in the subsection should be changed to:

While Delaware went to great lengths to make its series statutes flexible, series still should not be thought of as miniature LLCs. Series cannot exist independent of an LLC, but only as part of an LLC. A series, by itself, may not merge with another LLC, convert to another entity, or domesticate. Further, dissolution of the LLC dissolves the series. The revised Delaware statute does not explicitly say that the series is a separate entity, but it does explicitly provide that a registered series is an association.[38] An "association" is recognized as a "person" under Delaware law.[39] That said, at least in its home state a series has most of the capacities of a typical entity, including the right to own property, sue, and be sued.

38 6 Del. Code Ann. 18-218(c)(12).
39 6 Del. Code Ann. 18-101(14).

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D. SIDE POCKETS AND ALTERNATIVE INVESTMENT VEHICLES

Although when the Proposed Regulations for series LLCs first came out there was a strong push from several quarters to get the series of series LLCs recognized as separate entities for tax purposes, no uniform market practice has developed at this point. Part of the reason for this lack of uniformity is the treatment of side pockets and alternative investment vehicles.

A practice called "side pockets" is common for investment partnerships that have partners that have regulatory or other legal restrictions on the partners' investments. If an investment is made by the partnership that will run into one of these regulatory restrictions, the investment is put into what is commonly called a side pocket. The income and cash flow from the investment is allocated and distributed only to the partners without the regulatory restriction. It is common practice for investment partnerships to treat such arrangements as "special allocations" rather than a distribution of certain assets to a portion of the partners (or to a new partnership for the benefit of certain partners).

A separate, but similar, issue is raised by alternative investment vehicles. Sometimes investment partnerships allow investors that prefer not to have certain types of income to have their investment routed through a separate legal entity with the goal of changing the type of income to one which these partners prefer. For example, a tax-exempt entity typically does not want to earn unrelated business taxable income (on which it would be taxed). Partnership income allocated to the tax-exempt entity commonly will be unrelated business taxable income. The tax-exempt entity may choose to invest in the partnership via a C corporation that it forms. The C corporation will be taxable on its income. Any dividends it distributes to the tax-exempt entity, however, will not be unrelated business taxable income. A C corporation used in this manner is sometimes called a "blocker." From a business perspective, it is common for the economics of the main fund and the alternative investment vehicle to be calculated together for many purposes with the two entities sharing income and expenses on a proportionate basis. It is also common industry practice to treat as the main fund and alternative investment vehicle as separate entities for federal and state tax purposes -- without creating a deemed partnership between the two entities.

So, on the one hand, the treatment of side pockets does not recognize the existence of a separate entity for tax purposes where segregated assets are not put into a separate state-law entity. This creates tension with the fact the series LLCs are usually not separate legal entities. On the other hand, alternative investment vehicles are treated as separate entities if they are recognized as separate entities for state law purposes. This, again, puts the emphasis on the recognition of the state law series LLC rather than the economic units created by the series under the series LLC.

§ 1.10 READING, QUESTIONS AND PROBLEMS

B. QUESTIONS AND PROBLEMS

2. c. I.R.C. § 121 provides an exclusion of $250,000 for individuals (or $500,000 for joint returns) on the sale of their principal residence (subject to some restrictions). I.R.C. § 121 makes no reference to partnerships. If David and Ebony are a partnership and make an explicit or implicit election out of Subchapter K, would they be eligible for the § 121 exclusion?

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CHAPTER 2: FORMATION OF THE PARTNERSHIP

§ 2.02 TRANSFERS OF PROPERTY TO PARTNERSHIP

B. WHAT CONSTITUTES PROPERTY

2. *Contract Rights*

a. Promisory Notes

i. Contributor's Promissory Note

Revise the first sentence to read:

If a partner contributes his or her own promissory note to the partnership (*i.e.*, a promissory note of which the partner is the maker and the partnership is the payee), it is likely that such transaction would not be considered a transfer of property at that time,[40] although opinions may differ as to whether this is the appropriate result.

b. Right to Acquire Property

The first paragraph should be changed to:

In many instances, a party has an option to acquire real property or has entered into a contract to purchase real property. The option or contract may then be transferred to a partnership that will acquire the property subject to the option or contract. It would appear that the contributing party's rights under the option or contract should constitute property for purposes of I.R.C. § 721(a). The IRS has issued Regulation dealing with contributing contracts.[41] Under these Regulations, if a partner contributes to a partnership a contract that is I.R.C. § 704(c) property and the partnership subsequently acquires property pursuant to that contract, then the acquired property is treated as I.R.C. § 704(c) property with the same amount of built-in gain or built-in loss as the contract.[42] This would imply that the contract could be contributed to the partnership without the recognition of gain.

4. *Assignment of Income*

One of the bedrock principles of federal income tax law is that income must be taxed to the earner of the income and that an assignment of the right to the income will not transfer the incidence of taxation, the "assignment of income doctrine."[43] Thus, there is a question as to whether the assignment of income doctrine would cause a taxpayer to be taxable if the taxpayer assigned to a partnership in exchange for a partnership interest accounts receivable of the taxpayer for services rendered or from the sale of property. In fact, however, accounts receivable have been recognized as property for I.R.C. § 721(a) purposes.[44] But note that I.R.C. § 704(c)(1) mostly moots the assignment of income question.Under I.R.C. § 704(c)(1), when accounts receivable are collected or sold, income from contributed accounts receivable are typically allocated to the

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40 Oden v. Commissioner, TC Memo 1981-184; VisionMonitor Software LLC v. Commissioner, TC Memo 2014-182; Gemini Twin Fund III v. Commissioner, TC Memo 1991-315, *aff'd* (9th Cir. 1993).

41 Treas. Reg. § 1.704-3(a)(8)(iii).

42. *Id*.

43. Lucas v. Earl, 281 U.S. 111 (1930); Helvering v. Horst, 311 U.S. 112 (1940).

44 *See* Rev. Rul. 80-198, 1980-2 C.B. 113, involving transfers of unrealized receivables to a corporation in transaction governed by I.R.C. § 351; *also see* I.R.C. § 724.

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contributing partner.[45] We discuss I.R.C. § 704(c)(1) in detail in Chapter 5.

E. STOCK OF CORPORATE PARTNERS

If a corporation transfers its own stock to a partnership in exchange for a partnership interest, it is clear that the stock is treated as property for purposes of I.R.C.§ 721. On the basis of the rules of Subchapter K, alone, one would expect the corporation to have nonrecognition on the transaction.

However, if a partnership engages in an I.R.C. § 337(d) transaction, the corporate partner must recognize gain.[46] Under the Regulations, an I.R.C. § 337(d) transaction may occur if (i) a corporate partner contributes appreciated property to a partnership that owns stock of the corporate partner; (ii) a partnership acquires stock of the corporate partner, (iii) a partnership that owns stock of a corporate partner distributes appreciated property to a partner other than the corporate partner, (iv) a partnership distributes stock of a corporate partner to the corporate partner, or (v) a partnership agreement is amended in a manner that increases a corporate partner's interest in the stock of the corporate partner.[47] So, although a corporation's transfer of its own stock to a partnership may qualify for I.R.C. § 721 treatment, it is still required to recognize gain under I.R.C. § 337(d).

For these purposes, "stock of a corporate partner" includes stock, warrants and other similar options to acquire stock, and similar interests (each an "equity interest") in the corporation partner.[48] Stock of the corporate partner also includes equity interests in a corporation that controls the corporate partner within the meaning of I.R.C. § 304(c) and which also has a direct or indirect equity interest in the corporate partner.[49]

If an equity interest is not stock in a corporate partner, then the equity interst is treated as stock of a corporate partner to the extent that the value of the equity interest is attributable to the stock of a corporate partner.[50]

The amount of gain the corporate partner recognizes equals the product of the corporate partner's gain percentage[51] and the gain from the appreciated property that is the subject of the exchange that the corporate partner would recognize if, immediately before the I.R.C. § 337(d) Transaction, all assets of the partnership and any assets contributed to the partnership in the I.R.C. § 337(d) Transaction were sold in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account I.R.C. § 7701(g)), reduced, but not below zero, by any gain the corporate partner is required to recognize with respect to the appreciated property in the I.R.C. § 337(d) Transaction under any other provision of the Code.[52] This gain is computed taking into account allocations of tax items applying the principles of I.R.C. § 704(c), including any remedial allocations under Treas. Reg. § 1.704-3(d), and also taking into account any basis adjustments including adjustments made pursuant to I.R.C. § 743(b).

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45. *See* discussion at § 5.05.
46 Treas. Reg. § 1.337(d)-3(d)(1).
47 Treas. Reg. § 1.337(d)-3(c)(3).
48 Prop. Reg. § 1.337(d)-3(c)(2)(i).
49 *Id.*
50 Prop. Reg. § 1.337(d)-3(c)(2)(ii).
51 The gain percentage is the fraction, (i) the numerator of which is the corporate partner's interest in appreciated property effectively exchanged, and (ii) the denominator is the corporate partner's interest in appreciated property before the exchange. Treas. Reg. § 1.337(d)-3(c)(4).
52 Treas. Reg. § 1.337(d)-3(d)(3)(i).

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The basis of the corporate partner's interest in the partnership is increased by the amount of gain recognized.[53] Similarly, the partnership's basis in the stock contributed is increased by the amount of gain that the corporate partner recognized.[54]

§ 2.03 Transfers to Investment Companies

B. Table

I.R.C. § 721(b) Transfers to Investment Companies	
Background	To qualify as tax-free under I.R.C. § 351, contributions to a partnership that would be treated as an investment company under I.R.C. § 351 must either be diversified portfolio(s) or identical assets.
What is tested?	To be a "diversified portfolio," each transferor's contribution must pass both a 25% diversification test and a 50% diversification test.
25% test	Not more than 25% of the value of its total assets may be invested in the stock and securities of any one issuer.
50% test	Not more than 50% of the value of its total assets investments may be in the stock and securities of 5 or fewer issuers.
Government Securities	Government securities are included in total assets (the denominator), but are not treated as securities of an issuer (the numerator) for both the 25% and 50% test. However, government securities acquired for purposes of meeting the tests are not included in the total assets (denominator), but are still included in the numerator.
Securities of RICs or REITs	Look through the RICs or REITs to underlying assets.
Cash items	Cash and cash items (including receivables) are excluded from the numerator and denominator for both the 25% and 50% tests.
De minimis rule	Insignificant transfers are ignored (one or more transfers of nonidentical assets which, taken in the aggregate, constitute an insignificant portion of the total value of assets transferred).
Controlled groups	All members of a controlled group are treated as one issuer. Controlled group means chains of corporations connected through 80% control of voting power or value.

53 Treas. Reg. § 1.337(d)-3(d)(4)(i).
54 Treas. Reg. § 1.337(d)-3(d)(4)(ii).

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§ 2.06 EFFECT OF LIABILITIES

The last paragraph should be changed to:

Under I.R.C. § 752(b), any decrease in a partner's individual liabilities by reason of the deemed or actual assumption by the partnership of those individual liabilities is treated as a cash distribution to the partner by the partnership. Under I.R.C. § 752(a), any deemed or actual assumption of partnership liabilities by a partner is treated as a contribution of money by the partner to the partnership. If a partner transfers property to a partnership and the partnership assumes any of the partner's liabilities, or acquires the contributed property subject to liabilities, the amount of these liabilities is treated as a distribution to the contributing partner. The Regulations make clear that if as a result of a single transaction a partner incurs both an increase in the partner's share of the partnership's liabilities and a decrease in the partner's share of the partner's individual liabilities, only the net decrease is treated as a distribution from the partnership.[55] If that distribution exceeds the contributing partner's basis in her partnership interest, she recognizes gain to the extent of the excess under I.R.C. § 731(a)(1).[56] Assume partner A contributes property to a partnership with a basis of $10,000, but subject to a liability of $20,000, in exchange for a partnership interest. Under I.R.C. § 722, A's "starting basis" is $10,000. If these are the partnership's only liabilities, and $15,000 of the liabilities are allocated to other partners, under I.R.C. § 752, A's individual liabilities will be reduced by $20,000 and increased by $5,000, for a net decrease of $15,000. Under I.R.C. § 752(b), there will be a deemed distribution of cash of $15,000 to A. Under I.R.C. § 731(a)(1), A will recognize $5,000 of gain ($15,000 − $10,000). It is also possible for contributed property to be subject to debt, but for the partnership and partners take no steps to formally assume any part of the debt. It is more common, in this case, for the debt to be nonrecourse. But if the debt is recourse, and the contributing partner after the contribution remains fully liable on the debt, and no other partners have accepted any liability on the debt, gain under I.R.C. § 752 should not be triggered, as the contributing partner has 100% of the liability on the debt before and after the contribution. Likely, the most common fact pattern where this might arise is when the partner contributes the encumbered property to an LLC. In an LLC, definitionally, the members normally are not liable for the obligations of the LLC except to the extent they voluntarily accept them. There is an important caveat top this discussion: Usually, mortgages and deeds of trust contain "due-on-sale" clauses, causing the entire debt to become due on any transfer (even if not an actual sale, such as a contribution to a partnership). Obviously, in these cases, the lender must agree to waive the application of the due-on-sale clause to a contribution of property to the partnership. More to come in Chapter 3.

CHAPTER 3: OUTSIDE BASIS AND ALLOCATION OF LIABILITIES

§ 3.03 GENERAL RULES FOR COMPUTING BASIS

C. SPECIAL ADJUSTMENTS

3. Nondeductible Expenditures

Substitute the following for the last paragraph:

Under I.R.C. § 702(a)(4), charitable contributions made by a partnership are separately taken into account by the partners. The IRS has held that if a partnership makes a charitable contribution of property, each partner's basis for her partnership interest is decreased by the partner's share of the partnership's basis

55. Treas. Reg. § 1.752-1(f).
56. It is also possible for the transaction to be treated as a disguised sale; *see* § 8.06.

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for the property contributed.[57] I.R.C. § 704(d)(3), which was enacted as part of the 2017 Tax Cuts and Jobs Act, clarifies that a partner's distributive shares of partnership charitable contributions and foreign taxes (described in I.R.C. § 901) are also taken into account as reductions in that partner's basis loss limitation under I.R.C. § 704(d).

§ 3.04 EFFECT OF PARTNERSHIP LIABILITIES

B. DEFINITION OF A RECOURSE AND NONRECOURSE LIABILITIES

1. Definition of the Liability

Add at the end of the section:

In Rev. Rul. 88-77,[58] 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]…."[59] 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.

Substitute the following for the current 3.04 B.2:

2. Definition of Recourse Liability

Treas. Reg. § 1.752-1(a)(1) provides that a liability is a recourse liability of a partnership to the extent that any partner or related person bears the economic risk of loss for that liability under Treas. Reg. § 1.752-2.

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 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,[60] to avoid recognizing gain,[61] or because the lender insists upon it.

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57. Rev. Rul. 96-11, 1996-1 C.B. 140.
58. 1988-2 C.B. 128.
59. *Id.*
60. Under I.R.C. § 704(d), a partner cannot deduct losses in excess of his basis in his partnership interest.
61. *See* I.R.C. § 752(b), (d).

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We also need to preview "capital accounts," a topic on which we go into excruciating detail in Chapter 5. Usually, 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 income. They are decreased by money distributed, the (net) fair market value of property distributed, and losses. Note that liabilities do not go into the calculation of capital accounts (other than reducing the value of contributed property), unlike tax basis. Accordingly, capital accounts can be negative, while tax basis can never be negative — one of the few rules in tax without an exception. One way capital accounts can become negative is if partnership debt increases the tax basis of a partner's partnership interest. For a partner who contributes cash and is allocated partnership liabilities, initially, the partner's tax basis will exceed the partner's capital account. Deductions allocated to a partner, say for depreciation, can reduce the partner's tax basis in the partnership interest and the partner's capital account. Since the tax basis was higher to begin with, the capital account will go negative before the tax basis is "used up." 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 the partnership has nonrecourse debt allocable to the partner. 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.[62]

The partnership also keeps track of its assets for economic or what is more commonly called "book purposes." Thus, if property is contributed to the partnership, the partnership accounts will show its carryover tax basis under I.R.C. § 723. But the partnership accounts will also show the property's "book value" (or what a few law professors like to call book basis). The book value of a property is its (gross) fair market value on acquisition by the partnership. If the partnership pays cash for a property, its tax basis and book value in the property will be the same. Further, in calculating the partners' capital accounts, gains and losses from property are calculated using book value.

For example, if A contributes land to a partnership with a tax basis of $1,000 and a fair market value of $1,500, A's tax basis in her partnership interest goes up by $1,000, but A's capital account goes up by $1,500. The partnership's tax basis in the land is $1,000, but its book value is $1,500. If the partnership sells the land for $2,000, there is $1,000 of tax gain and $500 of book gain.

On to the Regulations: What could be seen as a baseline technique for ascertaining the economic risk of loss is contained in Treas. Reg. § 1.752-2(b)(1), which we discuss below. Ultimately, though, the economic risk of loss is determined based on all of the facts and circumstances.[63] All statutory and contractual obligations relating to the partnership liability are taken into account, including (1) contractual obligations outside the partnership agreement, such as guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors, to other partners, or to the partnership; (2) obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership; and (3)

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62 *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* § 4.07B; Hubert Enterprises, Inc. v. Commissioner, T.C. Memo 2008-46.

63 Treas. Reg. § 1.752-2(b)(3)(i).

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payment obligations (whether in the form of direct remittances to another partner or a contribution to the partnership) imposed by state or local law, including the governing state or local law partnership statute.[64]

As indicated above, a partner's share of a recourse partnership liability equals the portion of that liability for which the partner or a related person bears the economic risk of loss.[65] Treas. Reg. § 1.752-2(b)(1) provides that a partner or related person bears the economic risk of loss with respect to a liability if: (i) the partnership is constructively liquidated, (ii) as a result of the constructive liquidation, the partner or related person would be obligated to make a payment to any person because the liability became due and payable, and (iii) the partner or related person would not be entitled to reimbursement from another partner or a related person to another partner.

In a constructive liquidation, the following events are deemed to have occurred simultaneously (this is sometimes called "the nuclear bomb test"):

(i) all of the partnership's liabilities become payable in full;

(ii) all of the partnership's assets, including cash, have a value of zero, other than property contributed by a partner to secure a partnership liability;

(iii) the partnership disposes of all of its property in a fully taxable transaction for no consideration other than the release of liability with respect to nonrecourse liabilities;

(iv) all items of income, gain, loss, etc. are allocated among the partners; and

(v) the partnership liquidates.[66]

As indicated above, in the constructive liquidation, property is generally considered to be sold for no consideration and, thus, generates losses that are allocated to the partners. These hypothetical losses could create hypothetical negative capital accounts that partners could have an obligation to restore; a partner may have economic risk of loss on a debt to the extent of such a deficit restoration obligation.

In the nuclear bomb test, there is an exception to the zero consideration rule for property subject to nonrecourse debt. In that case, the property subject to that debt is treated as sold for an amount equal to the amount of the subject nonrecourse debt, and gain or loss is recognized depending upon the partnership's basis for the asset subject to the nonrecourse debt.[67]

Even if a partner is obligated to make a payment, the partner's obligation to make the payment is reduced to the extent that the partner or a person related to the partner is entitled to reimbursement from another partner or a person related to another partner.[68] In determining whether a person has a payment obligation, it is generally assumed that all partners and related persons who have obligations to make payment actually perform those obligations, notwithstanding their net worth, unless there was (i) a plan to "circumvent or avoid the obligation" or (ii) there is not a commercially reasonable expectation that the payment obligor

64 *Id.* (providing to the extent that the obligation of a partner or related person to make a payment with respect to a partnership liability is not recognized, Treas. Reg. § 1.752-2(b) is applied as if the obligation did not exist).

65 Treas. Reg. § 1.752-2(a).

66 Treas. Reg. § 1.752-2(b)(1).

67 Treas. Reg. § 1.752-2(b)(2).

68 Treas. Reg. § 1.752-2(b)(5).

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will have the ability to make the required payments.[69] In determining whether there is a commercially reasonable expectation of repayment, all the facts and circumstances that a third party lender would consider in determining whether to make a loan are taken into account.[70] For these purposes, both a disregarded entity and a grantor trust may be treated as payment obligors.[71] Examples in the Regulations indicate that under capitalization is a strong indicator that there is not a commercially reasonable expectation that the payment obligor will have the ability to pay.

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[72] loan to the partnership and the economic risk of loss with respect to that loan is not borne by another partner.[73] In order to facilitate financial institutions making loans to partnerships in which they are a partner, the Regulations contain a *de minimis* exception to the this rule. Thus, 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.[74] 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 convertible debt.[75]

Essentially the same rule applies to guarantees: In the case of a partner having a 10% or smaller interest in each item of partnership income, gain, loss, deduction, or credit, a guaranty by that partner is deemed not to give the partner any economic risk of loss, and thus leaves the loan nonrecourse, provided it would be qualified nonrecourse financing if the guarantor had made the loan to the partnership.[76]

Under prior Regulations, the nuclear bomb test sometimes created results that may not have been intended. For example, consider ABC LLC that owns High End Mall. High End Mall is worth $500. ABC LLC has borrowed $100 on a recourse basis (that is the full faith and credit of ABC LLC is pledged) from Big Bank. Small Partner has provided Big Bank with a bottom dollar guarantee for $10. Under the guarantee, Big Bank may pursue Small Partner only after Big Bank has exhausted its remedies against ABC LLC. Under the nuclear bomb test, High End Mall would be deemed to be worthless, and Small Partner would have the economic risk of loss to the extent of $10 – even though there would be very little chance that Small Partner would need to pay on the guarantee.

69 Treas. Reg. § 1.752-2(b)(6). This is subject to the bottom -dollar guarantee discussion, below.

70 Treas. Reg. § 1.752-2(k)(1).

71 *Id.*

72 "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.

73 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).

74 Treas. Reg. § 1.752-2(d)(1).

75 I.R.C. § 465(b)(6)(A).

76 Treas. Reg. § 1.752-2(d)(2).

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Under current Regulations, a partner generally does not have the economic risk of loss on a "bottom dollar payment obligation."[77] An example of a bottom dollar payment obligation is as follows: An LLC taxed as a partnership has a liability of $1,000, and partner B gives a guarantee (without right of reimbursement) under which B is only liable to the creditor to the extent the creditor collects less than $200 in the aggregate on the debt from all other obligors. B, thus, has no liability if the creditor collects more than $200 from the other obligors. B has essentially guaranteed the bottom layer of the debt, hence the name. As stated above, in the past, B could have had the economic risk of loss on this type of guarantee, but typically not under the current Regulations. Generally, a bottom dollar payment obligation exists unless a partner (or related person) is liable up to the full amount of the partner's payment obligation if any of the partnership's liability is unpaid.[78] In the example, for B to have economic risk of loss on the $200 guarantee, under the general rule B must be liable if any part of the $1,000 liability goes unpaid. If the $200 is a bottom dollar payment obligation for which no partner under the Regulations has the economic risk of loss, $200 of the debt is treated as nonrecourse debt and is allocated under the rules for nonrecourse debt.

With respect to an obligation to make a capital contribution or to restore a deficit capital account upon liquidation of the partnership, a bottom dollar payment obligation includes 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.[79]

A payment obligation is not a bottom dollar payment obligation merely because a maximum amount is placed on the partner's payment obligation, a partner's payment obligation is stated as a fixed percentage of every dollar of the partnership liability to which such obligation relates, or there is a right of proportionate contribution running between partners who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable.[80] Thus, in the example, the fact that B's maximum liability is limited to $200 does not in and of itself create a bottom dollar payment obligation. Nor would a bottom dollar payment obligation be created if, for example, B were liable for 20% of the partnership debt, or liable for all of it but with a right to contribution of $800 from the other partners.

Another example demonstrating the distinction between a guarantee recognized as an obligation under the Regulations and a bottom dollar payment obligation that is not is as follows:[81] A, B, and C are equal members of ABC LLC. ABC is treated as a partnership for federal tax purposes. ABC borrows $1,000 from Bank. A guarantees payment of up to $300 of the ABC liability if any amount of the full $1,000 liability is not recovered by Bank. B guarantees payment of up to $200, but only if Bank otherwise recovers less than $200. Both A and B waive their rights of contribution against each other. Because A is obligated to pay up to $300 if, and to the extent that, any amount of the $1,000 partnership liability is not recovered by Bank, A's guarantee is not a bottom dollar payment obligation. Therefore, A's payment obligation is recognized, and the amount of A's economic risk of loss is $300. Because B is obligated to pay up to $200 only if and to the extent that Bank otherwise recovers less than $200 of the $1,000 partnership liability, B's guarantee is a

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77 Treas. Reg. § 1.752-2(b)(3)(ii)(A).

78 Treas. Reg. § 1.752-2(b)(3)(ii)(C).

79 Treas. Reg. § 1.752-2(b)(ii)(C)(1)(iii).

80 Treas. Reg. § 1.752-2(b)(3)(ii)(C)(2).

81 The following examples and discussion are drawn from the Regulations and from Richard M. Lipton, Samuel P. Grilli, and Nicole D. Renchen, *Final, Temporary, and Proposed Regulations: Is the Road to Hell Paved with Good Intentions*, 126 J. Tax'n 53 (2017) (hereinafter "Lipton II").

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bottom dollar payment obligation and, therefore, is not recognized. Accordingly, B bears no economic risk of loss for ABC's liability. In sum, $300 of ABC's liability is allocated to A under Treas. Reg. § 1.752-2(a), and the remaining $700 liability is allocated to A, B, and C under the three tiers of Treas. Reg. § 1.752-3 (the rules for allocating nonrecourse debt, discussed below).

A special rule is provided in the Regulations with respect to indemnities and reimbursement obligations in Treas. Reg. § 1.752-2(b)(3)(iii). Under this rule, an indemnity, reimbursement agreement, or similar arrangement will be recognized only if, before taking into account the indemnity, reimbursement agreement or similar arrangement, the indemnitee's or other benefited party's payment obligation is recognized and not treated as a bottom dollar payment obligation. As an example, assume the facts are the same as in the prior example, except that, in addition, C agrees to indemnify A up to $100 that A pays with respect to its guarantee and agrees to indemnify B fully with respect to its guarantee. The determination of whether C's indemnity is recognized under the Regulations is made without regard to whether C's indemnity itself causes A's guarantee not to be recognized. Because A's obligation would be recognized but for the effect of C's indemnity and C is obligated to pay A up to the full amount of C's indemnity if A pays any amount on its guarantee of ABC's liability, C's indemnity of A's guarantee is not a bottom dollar payment obligation under the Regulations and, therefore, is recognized. The amount of C's economic risk of loss under Treas. Reg. § 1.752-2(b)(1) for its indemnity of A's guarantee is $100. Because C's indemnity is recognized, A is treated as liable for $200, i.e., to the extent any amount beyond $100 of the partnership liability is not satisfied. Because A is not liable if, and to the extent, any amount of the parnership liability is not otherwise satisfied, A's guarantee is a bottom dollar payment obligation, and A bears no economic risk of loss under Treas. Reg. § 1.752-2(b)(1) for ABC's liability.[82] Because B's obligation is not recognized independent of C's indemnity of B's guarantee, C's indemnity with regard to B is not recognized either. Therefore, C bears no economic risk of loss under Treas. Reg. § 1.752-2(b)(1) for its indemnity of B's guarantee. In sum, $100 of ABC's liability is allocated to C under Treas. Reg. § 1.752-2(a) and the remaining $900 liability is allocated to A, B, and C under Treas. Reg. § 1.752-3.

This second example illustrates how the Regulations can easily result in a trap for the unwary. In the first example, A has $300 of economic risk of loss, but it is completely ignored under these rules in the second example as a result of another partner taking the first $100 of A's risk. It may have been the intention of the parties that A and C would split the $300 top dollar economic risk of loss, $200 allocated to A and $100 allocated to C. However, even though two partners in the aggregate make a $300 "top dollar" guarantee, which would be respected if made by one partner, A's $200 of that economic risk of loss is instead completely ignored for debt allocation purposes. In our view, this may not reflect the parties' intent or economic reality, and places an unfortunate emphasis on the tax adviser participating in the drafting process.[83]

There is a *de minimis* exception for bottom dollar payment obligations. A bottom dollar payment obligation will be recognized as an existing obligation if the partner is liable for at least 90% of the partner's initial payment obligation.[84] Thus, in the above example, B can have the economic risk of loss on the entire $200 guarantee, as long as B is liable up to at least $180 (90% of $200) if any part of the $1,000 debt goes unpaid

82 It should be noted that, if C's obligation to indemnify A was on a proportionate basis rather than just a first-dollar basis, A would have economic risk of $200.

83 And also in the view of Lipton II, from which we derived this discussion.

84 Treas. Reg. §1.752-2(b)(3)(ii)(B).

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The Regulations also contain an obligation to report any bottom dollar payment obligation.[85]

Generally, in determining whether a partner bears the economic risk of loss for a partnership liability under the rules discussed above, the obligation of any person related to the partner is taken into account. Thus, for example, a partner has the economic risk of loss on partnership debt if the partner's wife has the economic risk of loss on the debt, notwithstanding the fact that the partner himself has no liability. The term "related person" means a partner and a person who bears a relationship to that partner that is specified in I.R.C. § 267(b) or 707(b)(1), except that: (i) 80% is substituted for 50%, (ii) brothers and sisters are excluded, and (iii) I.R.C. § 267(e)(1) and (f)(1)(A) are disregarded.[86]

Substitute the following for the current 3.04 B.3.:

3. Anti-Abuse Rules

Recent Regulations would make it more difficult for a partner to have the economic risk of loss on recourse debt. The previous I.R.C. § 752 Regulations were biased in favor of finding recourse debt. The current Regulations have almost the exact opposite bias. The current Regulations are designed to address abuses that the IRS believes exist with the current system. In addition to the technical rules just discussed, the Regulations include broad anti-abuse rules.

Under Treas. Reg. § 1.752-2(j)(1), an obligation of a partner or related person to make a payment may be disregarded or treated as an obligation of another person if the facts and circumstances indicate that a principal purpose of the arrangement is to eliminate the partner's economic risk of loss or create the appearance of the partner or a related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise.[87] Irrespective of the form of a contractual obligation, a partner is considered to bear the economic risk of loss for the purposes of the anti-abuse rules with respect to a partnership liability, or a portion thereof, to the extent that (i) the partner or related person undertakes one or more contractual obligations so that the partnership may obtain or retain a loan; (ii) the contractual obligations of the partner or related person significantly reduce the risk to the lender that the partnership will not satisfy its obligations under the loan, or a portion thereof; and (iii) (1) one of the principal purposes of using the contractual obligations is to attempt to permit partners (other than those who are directly or indirectly liable for the obligation) to include a portion of the loan in the basis of their partnership interests; or (2) another partner, or a person related to another partner, enters into a payment obligation and a principal purpose of the arrangement is to cause the payment obligation to be disregarded.[88] For the purposes of the anti-abuse rules, partners are considered to bear the economic risk of loss for a liability in accordance with their relative economic burdens for the liability pursuant to the contractual obligations. For example, a lease between a partner and a partnership that is not on commercially reasonable terms may be tantamount to a guarantee by the partner of the partnership liability.[89]

An obligation of a partner or related person to make a payment is not recognized under the nuclear bomb test if the facts and circumstances evidence a plan to circumvent or avoid the obligation.[90] Treas. Reg. § 1.752-2(j)(3)(ii) provides a non-exclusive list of factors that may indicate a plan to circumvent or avoid

85 Treas. Reg. § 1.752-2(b)(3)(ii)(D).
86 Treas. Reg. § 1.752-4(b)(1).
87 Treas. Reg. § 1.752-2(j)(1).
88 Treas. Reg. § 1.752-2(j)(2).
89 Treas. Reg. § 1.752-2(j)(2)(ii).
90 Treas. Reg. § 1.752-2(j)(3)(i).

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the payment obligation. The presence or absence of a factor is based on all of the facts and circumstances at the time the partner or related person makes the payment obligation or if the obligation is modified, at the time of the modification. The weight to be given to any particular factor depends on the particular case and the presence or absence of a factor is not necessarily indicative of whether a payment obligation is or is not recognized. The factors are:

(1) The partner or related person is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment, including, for example, restrictions on transfers for inadequate consideration or distributions by the partner or related person to equity owners in the partner or related person.

(2) The partner or related person is not required to provide (either at the time the payment obligation is made or periodically) commercially reasonable documentation regarding the partner's or related person's financial condition to the benefited party, including, for example, balance sheets and financial statements.

(3) The term of the payment obligation ends prior to the term of the partnership liability, or the partner or related person has a right to terminate its payment obligation, if the purpose of limiting the duration of the payment obligation is to terminate such payment obligation prior to the occurrence of an event or events that increase the risk of economic loss to the guarantor or benefited party (for example, termina- tion prior to the due date of a balloon payment or a right to terminate that can be exercised because the value of loan collateral decreases). This factor typically will not be present if the termination of the obligation occurs by reason of an event or events that decrease the risk of economic loss to the guarantor or benefited party (for example, the payment obligation terminates upon the completion of a building construction project, upon the leasing of a building, or when certain income and asset coverage ratios are satisfied for a specified number of quarters).

(4) There exists a plan or arrangement in which the primary obligor or any other obligor (or a person related to the obligor) with respect to the partnership liability directly or indirectly holds money or other liquid assets in an amount that exceeds the reasonable foreseeable needs of such obligor (but not taking into account standard commercial insurance).

(5) The payment obligation does not permit the creditor to promptly pursue payment following a payment default on the partnership liability, or other arrangements with respect to the partnership liability or payment obligation otherwise indicate a plan to delay collection.

(6) In the case of a guarantee or similar arrangement, the terms of the partnership liability would be substantially the same had the partner or related person not agreed to provide the guarantee.

(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 before, or within a commercially reasonable period of time after, the creation of the obligation.[91]

As mentioned above, the Regulations further provide, in a sort of catch-all, that a payment obligation is not recognized if the facts and circumstances indicate that there is not a reasonable expectation that the payment obligor will have the ability to make the required payments if the payment

91 Treas. Reg. 1.752-2(j)(3)(ii).

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obligation becomes due and payable.[92] Under the Regulations, a payment obligor includes an entity disregarded as an entity separate from its owner, including grantor trusts.

A difficulty with these rules is that, in contrast with the prior regime, it often may be very difficult to reliably know when a partner does or does not have the economic risk of loss. It is uncertain that any obligation, even one with irrefutable economic substance, would meet all of the seven factors.[93] The most egregious factor may be the sixth one, as it requires a partner to prove what would have happened in an alternative universe where the partner made no such guarantee – an alternate universe that never actually existed.[94]

There is an example in this regard in the Regulations that involves fairly egregious facts: (i) In 2020, A, B, and C form a domestic limited liability company (LLC) that is classified as a partnership for federal tax purposes. Also in 2020, LLC receives a loan from a bank. A, B, and C do not bear the economic risk of loss with respect to that partnership liability, and, as a result, the liability is treated as nonrecourse in 2020 under Treas. Reg. § 1.752–1(a)(2). In 2022, A guarantees the entire amount of the liability. The bank did not request the guarantee and the terms of the loan did not change as a result of the guarantee. A did not provide any executed documents with respect to A's guarantee to the bank. The bank also did not require any restrictions on asset transfers by A and no such restrictions exist.

(ii) Under [Treas. Reg. § 1.752-2(j)(3)]…, A's 2022 guarantee … is not recognized under [Treas. Reg. § 1.752-2(b)(3)]… if the facts and circumstances evidence a plan to circumvent or avoid the payment obligation. In this case, the following factors indicate a plan to circumvent or avoid A's payment obligation: the partner is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment, such as restrictions on transfers for inadequate consideration or equity distributions; the partner is not required to provide (either at the time the payment obligation is made or periodically) commercially reasonable documentation regarding the partner's or related person's financial condition to the benefited party; in the case of a guarantee or similar arrangement, the terms of the liability are the same as they would have been without the guarantee; and the creditor did not receive executed documents with respect to the payment obligation from the partner or related person at the time the obligation was created. Absent the existence of other facts or circumstances that would weigh in favor of respecting A's guarantee, evidence of a plan to circumvent or avoid the obligation exists and, pursuant to [Treas. Reg. § 1.752-2 (j)(3)(i)]…, A's guarantee is not recognized under [Treas. Reg. § 1.752-2 (b)]…. As a result, LLC's liability continues to be treated as nonrecourse.[95]

D. ALLOCATION OF NONRECOURSE LIABILITIES

Substitute the following for the Example on page 87 and the immediately preceding paragraph:

If one nonrecourse liability is secured by multiple properties, the partnership may allocate the liability among the multiple properties using "any reasonable method." A method is not reasonable if it allocates to any item of property an amount of the liability that, when combined with any other liabilities allocated to the property, is in excess of the fair market value of the property at the time the liability is incurred.[96] The portion of the nonrecourse liability allocated to each item of partnership property is then treated as a separate loan. In general, a partnership may not change the method of allocating a single nonrecourse liability while any

92 Treas. Reg. § 1.752-2(k)(1).
93 *See* Lipton II.
94 *Id.*
95 Treas. Reg. § 1.752-2(j)(4), Ex.
96 Treas. Reg. § 1.752-3(b)(1).

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portion of the liability is outstanding. However, if one or more of the multiple properties subject to the liability is no longer subject to the liability, the portion of the liability allocated to that property must be reallocated among the properties still subject to the liability so that the amount of the liability allocated to any property does not exceed the fair market value of such property at the time of reallocation.[97]

Example: A and B form an LLC, A contributing $10,000 and B contributing $190,000. The LLC obtains an $800,000 interest-only 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, then to B until allocations are equal to prior allocations of loss, 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.

During the first eight years, the basis of the property would be equal to or greater than the amount of the nonrecourse liability. This being the case, there is no minimum gain. Based upon the provisions of the Operating Agreement, the excess nonrecourse liabilities would be shared 40% by A and 60% by B.

Also, at the end of the eighth year, both A and B would have received allocations of losses equal to their capital accounts, so their capital accounts at the end of year eight are both at zero.

At the end of year nine, however, the LLC's basis for the building would have been reduced to $775,000, resulting in $25,000 of minimum gain which must be allocated under Tier 1. Under the agreement, the $25,000 of depreciation for year nine is allocated 40% to A ($10,000) and 60% to B ($15,000). The balance of the nonrecourse debt is allocated under Tier 3. Thus, A's share of the minimum gain is $10,000 and B's share of the minimum gain is $15,000. At the end of year nine, $320,000 of the nonrecourse liability is allocated to A [$10,000 + (40% · ($800,000 − $25,000))], and $480,000 of the liability is allocated to B [$15,000 + (60% · ($800,000 − $25,000))].

§ 3.05 TAX BASIS CAPITAL

As we discussed briefly in § 3.04B2, and we will discuss in more detail in Chapter 5, capital accounts play an important role in determining the validity of allocations of income and deduction.

Even though a partnership normally is not a taxable entity, it files a Form 1065 tax return and provides each partner with a Schedule K-1 which tells the partner what his share of partnership income and deduction is. Ultimately, the information on the Schedule K-1 is integrated with the partner's own tax return so that, for example, a partner can pay the tax owed on his share of partnership net income.

In a startling shift, the IRS is in the process of making a significant change to the Form 1065/Schedule K-1 reporting requirements for capital accounts. The new requirements appear to be an effort by the IRS to insure that capital account reporting is done consistently. In the past, partnerships have used different methods for reporting taxpayer capital accounts that were often inconsistent with each other and with the rules we discuss in § 3.04B2 and Chapter 5. Note that this is a new reporting requirement, rather than a new substantive rule. Initially, in 2018 the IRS required partnerships to report on the Form 1065 when a partner's share of "tax basis capital" was negative at either the beginning or the

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97 *Id.*

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end of the tax year. Thereafter, early releases of drafts of the 2019 Form 1065 and the Schedule K-1 expanded partner tax capital reporting to require all partnerships to report all partners' tax capital accounts using the tax basis method, whether or not negative. The only problem was that it was not clear how tax basis capital was to be calculated. And even if that hurdle were overcome (and we will get to its definition shortly), commenters stated that some partnerships might be unable to comply, either in a timely manner or ever, explaining that partnerships that have not historically maintained partner tax basis capital accounts may face difficulties in calculating their partners' tax basis capital. Many partnerships have been operating for many years and either do not have the documentation to make the calculation, or the documentation does exist, but its volume or complexity precludes reconstruction of accurate tax basis capital accounts. Accordingly, the IRS released Notice 2019-66[98] delaying the requirement that partnerships report partner capital accounts using the tax basis method until 2020. For 2019, a partnership that does not report tax basis capital accounts to its partners must nevertheless report to a partner on the Schedule K-1 the amount of such partner's tax basis capital both at the beginning of the year and at the end of the year if either amount is negative, but there is no capital account reporting requirement beyond that for 2019.

In 2019, the IRS also issued "Frequently Asked Questions" ("FAQs") essentially providing rules that partnerships should use to report tax basis capital.[99] FAQs are a method by which the IRS gives taxpayers guidance. FAQs are somewhat controversial, since their value as authority is somewhat in question, and by using FAQs the IRS is able to avoid the notice and comment process required for Regulations.[100] In some ways these new rules can be seen as analogous to the rules we discussed in § 3.04B2 and Chapter 5, except tax values rather than fair market values are used for property contributions and distributions, hence the term *tax basis* capital account. A partner's share of partnership liabilities under I.R.C. § 752 are not part of the capital account in either system. Note that tax values may be more readily determinable than fair market values in many cases.

Under the FAQs:

A. In general, a partner's tax basis capital account is equal to the amount of money contributed by the partner to the partnership, increased by—

(i) The adjusted tax basis of non-cash property contributed by the partner to the partnership, less the liabilities assumed by the partnership (or to which the property is subject) in connection with the contribution;

(ii) The sum of the partner's distributive share for the taxable year and prior taxable years of partnership income or gain (including tax-exempt income);

(iii) The partner's distributive share of the excess of the tax deductions for depletion (other than oil and gas depletion) over the tax basis of the property subject to depletion;

(iv) The amount of liabilities of the partnership assumed by the partner, excluding liabilities described in (B)(ii) below — this is not an I.R.C. § 752 analog, but rather speaks to actual assumption of partnership debt by the partner; and

(v) The partner's distributive share of any increase to the tax basis of partnership property

98 2019-52 I.R.B. 1509 (December 11, 2019).

99 https://www.irs.gov/businesses/partnerships/form-1065-frequently-asked-questions.

100 *See* Monte A. Jackel, A Question or Two About FAQs, Tax Notes Federal, March 2, 2020.

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under I.R.C. § 734(b) or with respect to partnership property under I.R.C. § 743(b) (discussed in Chapters 6 and 7).

(B) In general, a partner's tax basis capital account is decreased by —

(i) The amount of money distributed to the partner;

(ii) The adjusted tax basis of property distributed to the partner from the partnership, less the liabilities assumed by the partner (or to which the property is subject) in connection with the distribution;

(iii) The sum of the partner's distributive share for the taxable year and prior taxable years of partnership losses and deductions (including expenditures which are not deductible in computing partnership taxable income and which are not capital expenditures);

(iv) The partner's distributive share of the tax deductions for depletion of any partnership oil and gas property, not to exceed the partner's share of the adjusted tax basis of that property;

(v) The partner's distributive share of the adjusted tax basis of charitable property contributions and foreign taxes paid or accrued;

(vi) The amount of the partner's individual liabilities that are assumed by the partnership, excluding liabilities described in (A)(i) above — again, this is not an I.R.C. § 752 analog, but rather speaks to actual assumption of partner debt by the partnership; and

(vii) The partner's distributive share of any decrease to the tax basis of partnership property under I.R.C. § 734(b) or with respect to partnership property under I.R.C. § 743(b).

The following examples are provided to show the effects on the tax basis capital accounts of a partnership's assumption of a partner's liability:

Example 1: A contributes $100 in cash and B contributes unencumbered, nondepreciable 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 nondepreciable property with a FMV of $100, an adjusted tax basis of $30, and subject to a 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).

A partner's tax basis capital account can be negative when its outside basis is zero or positive because outside basis is increased by the partner's share of partnership liabilities under I.R.C. § 752, while the partner's tax basis capital account is not. A partner's tax basis capital account can be negative if a partnership allocates tax losses or deductions or make distributions to the partner in excess of the partner's tax basis equity in the partnership, or when a partner contributes property subject to debt in excess of its adjusted tax basis to a partnership.

Under the FAQs, a partner that acquires its partnership interest by transfer from another partner, for example, by purchase or in a non-recognition transaction, has a tax basis capital account immediately after the transfer equal to the transferring partner's tax basis capital account immediately before the

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transfer with respect to the portion of the interest transferred, except no portion of any I.R.C. § 743(b) adjustment the transferring partner may have is transferred to the partner acquiring the interest as part of the transaction. If the partnership has a I.R.C. § 754 election in effect, the partnership increases or decreases the tax basis capital account acquired by the transferee partner by an amount equal to the positive or negative adjustment to the tax basis of partnership property under I.R.C. § 743(b) as a result of the transfer. We discuss I.R.C. § 743(b) adjustments and I.R.C. § 754 elections in Chapter 6.

The FAQs also provide a safe harbor: Partnerships may calculate a partner's tax basis capital account by subtracting the partner's share of partnership liabilities under I.R.C. § 752 from the partner's outside basis. If a partnership elects to use the safe harbor approach, the partnership must report the negative tax basis capital account information as equal to the excess, if any, of the partner's share of partnership liabilities under I.R.C. § 752 over the partner's outside basis.

Smaller partnerships are not subject to these requirements. A partnership does not have to report negative tax basis capital if the following four requirements are met: (1) the partnership's total receipts for the tax year were less than $250,000; (2) the partnership's total assets at the end of the tax year were less than $1 million; (3) Schedules K-1 are filed with the return and furnished to the partners on or before the due date (including extensions) for the partnership return; and (4) the partnership is not filing and is not required to file Schedule M-3 (a complex form some larger partnerships must file that asks certain questions about the partnership's financial statements and reconciles financial statement net income).

More recently, the IRS issued Notice 2020-43.[101] This Notice is in the form of a proposal that asks for comments and was issued in response to the difficulties many commentators said they would have in computing tax basis capital. In the Notice, the IRS restates its belief that a consistent framework for reporting capital accounts will aid the IRS in administering the tax law. The Notice then proposes two alternative methods that a partnership would be required to use to comply with the tax basis capital reporting requirement: A partnership may report, for each partner, either (i) the partner's basis in its partnership interest, reduced by the partner's allocable share of partnership liabilities, as determined under I.R.C. § 752 ("modified outside basis method") (the FAQ safe harbor) or (ii) the partner's share of "previously taxed capital," as calculated under a modified version of Treas. Reg. § 1.743-1(d) ("modified previously taxed capital method"). We discuss previously taxed capital in Chapter 6. The latter calculation typically requires the partnership to determine the fair market value of its assets. The IRS acknowledges that some partnerships will not readily be able to determine fair market values, and allows partnerships to use other values for its assets, as long as done consistently, such as GAAP, I.R.C. § 704(b), or another basis set forth in the partnership agreement for purposes of determining what each partner would receive if the partnership were to liquidate.

Accordingly, as we go to press, it is not yet certain how tax basis capital must be reported. But is seems clear that starting with 2020 tax returns, the IRS will require more consistent reporting of partners' capital accounts. Recall that 2020 tax returns are filed starting in 2021, so there is still time to bring the matter to closure before the 2020 tax returns are due.

101 2020-27 I.R.B. 1 (6/29/2020).

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CHAPTER 4: OPERATION OF THE PARTNERSHIP: CALCULATION OF PARTNERSHIP TAXABLE INCOME

§ 4.02 PASS-THROUGH NATURE OF PARTNERSHIPS

Add after the second paragraph:

For many years, the IRS has taken the view that a partner cannot be an employee of a partnership.[102] We are aware of no cases to the contrary. Indeed, a 2016 10th Circuit decision supports the government's view.[103] Thus, currently one has to assume that the entirety of a general partner's share of partnership business income is self-employment income, which is subject to self-employment taxes (e.g. Social Security and Medicare taxes). Some types of investment income, such as dividends, are not treated as self-employment income.[104] While the relevant statutes do not address LLCs, there are cases that treat members of LLCs the same as general partners if they are members of member-managed LLCs. The answer is presumably the same for member-managers of manager-managed LLCs.[105] Currently, Social Security taxes are 12.4% of self-employment income up to a maximum, for 2021, of $142,800. Medicare taxes are 2.9% of self-employment income; there is no income cap.[106] Further, the Health Care and Education Affordability Reconciliation Act of 2010, starting on January 1, 2013, applies an additional 0.9% Medicare tax on earned income and a 3.8% Medicare tax on, generally speaking, net investment income, for taxpayers with adjusted gross incomes exceeding certain thresholds (generally these thresholds are $250,000 if married, filing jointly, and $200,000 for single taxpayers; these amounts are adjusted for inflation).[107] Many believe that S corporations can be used to at least partially avoid Social Security and Medicare taxes.[108]

It has become increasingly common to give persons who are otherwise employees of a tax partnership (typically an LLC), a small profits interest in the enterprise to attract, retain, and motivate them. Well intended though it might be, this form of compensation has huge backfire potential. The receipt of a profits share can convert the employee into a partner, convert all of the employee's income to self-employment income, and subject the employee to self-employment taxes. There can be numerous other adverse consequences. Some have attempted to bifurcate the employee's status, giving the employee a W-2 on the employee side and a K-1 on the partner side. But there is little support for this in the law. Tread with care.[109]

Employers withhold federal payroll and other taxes from employees and are required to pay them to the federal government. If a business is in financial distress, it is tempting to use this source of funds to keep the business afloat. It is unwise to do so, however. Penalties can apply, and if the taxes are ultimately unpaid, any person responsible for paying the taxes to the federal government becomes personally liable for the

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102 *See* Rev. Rul. 69-184, 1969-1 C.B. 256; *see also* Treas. Reg. § 301.7701-2(c)(2)(iv); IRS Gen. Couns. Mem. 34001 (Dec. 23, 1969); IRS Gen. Couns. Mem. 34173 (July 25, 1969); Riether v. United States, 919 F. Supp. 2d 1140 (NM 2012).

103 *See* Methvin v. Commissioner, 2016 WL 3457623 (10th Cir. 2016), in which the taxpayer entered into a contractual arrangement that the court concluded was a partnership. The taxpayer held a 2-3% interest in the deemed partnership. The partnership owned working interests in oil and gas ventures. The taxpayer's income from the partnership was subject to self-employment taxes notwithstanding his passive role.

104 I.R.C. § 1402(a)(2).

105 *See* J. Leigh Griffith, Partners and W2 Employee Status, Taxes The Tax Magazine, 27-38 (February 2015); David Culpepper et al. Self-Employment Taxes and Passthrough Entities: Where are We Now?, 109 Tax Notes 211 (2005).

106 I.R.C. § 1401.

107 I.R.C. §§ 1401(b)(2), 1411.

108 *See* Chapter 16.

109 *See* J. Leigh Griffith, Partners and W2 Employee Status, Taxes The Tax Magazine, 27-38 (February 2015); *see also* Riether v. United States, 919 F. Supp. 2d 1140 (NM 2012); Rev. Rul. 68-184, 1968-1 CB 7.

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obligation.[110] Further, in a general partnership, the partners can be jointly and severally liable for this obligation as well, including those partners not charged with the responsibility for paying the withheld taxes to the federal government.

§ 4.03 Computing Income, Gain, Loss, Deductions, and Credits of Partnerships

C. Separately Computed Items

1. Gains and Losses from Sales

Add to end of subsection:

In addition, each partner subject to I.R.C. § 1061 must take into account gains and losses from sales of capital assets held for more than one year as provided in the Regulations under I.R.C. § 1061.[111] This generally applies to partners that have received their interest in the partnership in respect of services.

D. Bottom Line Profit or Loss

Add to the end of the subsection:

Although the expenses might otherwise be required to be separately stated, the

§ 4.05 Accounting Method

C. Accrual Method Taxpayers that Issue Financial Statements

I.R.C. § 451(b) revises the timing rules for the recognition of income for accrual method taxpayers. Accrual method taxpayers are generally subject to the "all events test."[113] Under the "all events test", income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.[114] I.R.C. § 451(b) requires an accrual method taxpayer to recognize such income no later than the taxable year in which such income is taken into account as revenue in an applicable financial, but provides an exception for taxpayers without an applicable or other specified financial statement. In the case of a contract which contains multiple performance obligations, the provision requires the taxpayer to allocate the transaction price in accordance with the allocation made in the taxpayer's applicable financial statement.[115]

Under the statute, accrual method taxpayers with an applicable financial statement must apply the income recognition rules under I.R.C. § 451 before applying the special rules for OID, market discount,

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110 I.R.C. § 6672.
111 Prop. Reg. § 1.702-1(a)(2). The requirements of I.R.C. § 1061 are discussed in greater detail in § 8.08D.
112 Notice 2020-75, 2020-49 IRB 1.
113 Treas. Reg. § 1.451-1(a).
114 I.R.C. § 451(b)(1)(C); Treas. Reg.§ 1.451-1(a).
115 I.R.C. § 451(b)(4).

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discounts on short-term obligations, OID on tax-exempt bonds, and stripped bonds and stripped coupons.[116] However, Proposed Regulations would generally exclude OID and market discount from these rules.[117]

The provision also codifies the current deferral method of accounting for advance payments for goods, services, and other specified items provided by the IRS under Revenue Procedure 2004–34.[118] That is, the provision allows accrual method taxpayers to elect to defer the inclusion of income associated with certain advance payments to the end of the tax year following the tax year of receipt if such income also is deferred for financial statement purposes.[119] The provision requires the inclusion in gross income of a deferred advance payment if the taxpayer ceases to exist.[120]

For purposes of the provision, the term "applicable financial statement" means: (A) a financial statement which is certified as being prepared in accordance with generally accepted accounting principles and which is (i) a 10–K (or successor form), or annual statement to shareholders, required to be filed by the taxpayer with the United States Securities and Exchange Commission ("SEC"), (ii) an audited financial statement of the taxpayer which is used for (I) credit purposes, (II) reporting to shareholders, partners, or other proprietors, or to beneficiaries, or (III) any other substantial nontax purpose, but only if there is no statement of the taxpayer described in clause (i), or (iii) filed by the taxpayer with any other federal agency for purposes other than federal tax purposes, but only if there is no statement of the taxpayer described in clause (i) or (ii); (B) a financial statement which is made on the basis of international financial reporting standards and is filed by the taxpayer with an agency of a foreign government which is equivalent to the SEC and which has reporting standards not less stringent than the standards required by the SEC, but only if there is no statement of the taxpayer described in subparagraph (A); or (C) a financial statement filed by the taxpayer with any other regulatory or governmental body specified by the Treasury, but only if there is no statement of the taxpayer described in (A) or (B).[121] If the financial results of a taxpayer are reported on the applicable financial statement for a group of entities, such statement is treated as the applicable financial statement of the taxpayer.[122]

D. FARMING PARTNERSHIPS

1. Partnerships Having Corporations as Partners

Under I.R.C. § 447(a), a partnership engaged in the business of farming must generally use the accrual method of accounting if the partnership has a corporation as a partner. This general rule does not apply if the corporation is an S corporation or if the corporation meets the gross receipts test of I.R.C. § 448(c).[123] The gross receipts test of I.R.C. § 448(c) generally requires that the average annual gross receipts of such entity for the 3-taxable-year period ending with the taxable year in question do not exceed $25,000,000.

§ 4.06 CHARACTERIZATION

C. HOBBY LOSS RULES

116 I.R.C. § 451(b)(2).
117 Prop. Reg. § 1.451-3(c)(5).
118 2004-22 I.R.B. 991.
119 I.R.C. § 451(c).
120 I.R.C. § 451(c)(3).
121 I.R.C. § 451(b)(3).
122 I.R.C. § 451(b)(5).
123. I.R.C. § 447(c).

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The deduction for hobby losses is suspended until 2026.[124]

§ 4.07 Loss Limitation Rules

C. Passive Loss Limitation

6 Real Estate Professionals

Qualifying real estate professionals can elect to treat otherwise-passive losses from rental real estate activities as nonpassive, so as to be able to offset those losses with wages, interest, and other nonpassive income. They may also be able to elect to group activities so as to facilitate qualifying for nonpassive treatment.[125] A taxpayer qualifies as a real estate professional if (i) more than half the taxpayer's personal services performed during the year are performed in real property trades or businesses in which the taxpayer "materially participates," and (ii) the taxpayer spends more than 750 hours during the tax year in real property trades or businesses in which the taxpayer materially participates.[126]

"Real property trade or business" means any real property development, redevelopment, construction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.[127] For purposes of determining whether a taxpayer is in a real estate trade or business, participation as an employee does not count unless the employee is also a 5% owner.[128]

§ 4.09 Partnership Level Liability on Audits

Under the centralized partnership audit rules ("CPAR"), which became effective for partnership tax years beginning after December 31, 2017, the default position is that a partnership (and not the partners) is required to pay any federal tax deficiency arising from an audit (the "imputed underpayment"), unless an alternative to the default position is elected as described below.[129] This was a significant change from the previous partnership audit regime, which had involved partnership audit adjustments being assessed and collected at the partner level. Instead, unless a partnership has the ability and elects to opt out of the rules or files an timely push-out election (described below), tax deficiencies will now be assessed to, and the tax collected directly from, the partnership. Under the default approach, partners in the year in which the assessment is finalized (the "adjustment year") will bear the cost of the partnership adjustment from a prior year (the "reviewed year"). This is the case even if a partner was not a partner in the partnership during the reviewed year or obtained no benefit from the pre-adjustment tax reporting position.

Pursuant to CPAR, when the IRS issues a Notice of Proposed Partnership Adjustment at the close of a partnership audit, the notice will net the partnership adjustments and will calculate the imputed underpayment for the adjustment year at the highest marginal federal tax rate in effect for the reviewed year.[130] In general, the tax calculation will not take into consideration the extent that any adjustment reallocates partnership items from one partner to another partner, such adjustment will not take into account any decrease in any item of income or gain, and any increase in any item of deduction, loss, or credit.[131] Instead, the partnership will have

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124 I.R.C. § 67(g).
125 I.R.C. § 469(c)(7)(A).
126 I.R.C. § 469(c)(7)(B).
127 I.R.C. § 469(c)(7)(C).
128 I.R.C. § 469(c)(7)(D)(ii).
129. I.R.C. § 6225.
130. I.R.C. § 6225(b).
131. I.R.C. § 6225(b)(2).

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the burden to prove the existence of downward adjustments to the imputed underpayment amount through submitting a "modification request," but not until after the IRS has determined the "presumed" amount of the imputed underpayment. The modification request process generally involves the filing of amended tax returns by the partners, however, as discussed below, an election to "pull-in" the affected partners may be made in connection with the modification request, which should avoid the need for partners to amend previously-filed tax returns.

As an alternative to the default position discussed above, a partnership may elect to have adjustments from a partnership-level audit reflected on adjusted Schedules K-1 (which are provided to both the partners as well as the IRS) and paid at the partner level by those partners that were partners during the reviewed year (the "Push Out Election").[132] The Push Out Election must be made no later than 45 days after the date of the issuance of the Notice of Final Partnership Administrative Adjustment, and once made, the Push Out Election is revocable only with the consent of the IRS.[133] The reviewed year partners would be required to take the adjustments into account on their own tax returns for the adjustment year. An effective Push Out Election will essentially allow the audited partnership to absolve itself of liability for the imputed underpayment and limit its further involvement in the audit process.[134]

Similar to the Push Out Election, another optional procedure, known as the "pull-in procedure," is available to partnerships to cause the reviewed year partners to bear the burden of the adjustments, and without having to file amendments to prior years' tax returns.[135] Under the pull-in procedure, the IRS determines the partnership's imputed underpayment as reduced by the portion of the adjustments to partnership-related items that direct and indirect reviewed year partners take into account and, with respect to which, those partners pay the tax due, provided all of the requirements of the pull-in procedure are met. Reviewed year partners are required to (1) pay the tax that would have been due if prior years' returns had been amended, (2) make binding changes to their tax attributes for subsequent years, and (3) provide the IRS with the information necessary to substantiate that the tax was correctly computed and paid. This allows each affected partner to take into account its own tax position and other attributes when calculating the ultimate amount to be paid by that partner as a result of the adjustments.

Unlike the Push Out Election, the pull-in procedure generally does not require the participation of all direct and indirect reviewed year partners of the partnership. It also does not allow the partnership to wash its hands of the imputed underpayment. If all of the requirements are satisfied by a reviewed year partner, then the imputed underpayment can be modified at the partnership level. In the event that a partner provides the required information, but, for example, does not make the required payment, the imputed underpayment of the partnership is not modified with respect to those adjustments.

Certain partnerships may opt out of CPAR altogether, but they must elect to do so every year on their Forms 1065. Eligible partnerships are those that issue fewer than 100 Schedules K-1 for the particular year and only have individuals, C corporations (including comparable foreign entities), S corporations, or estates of deceased partners as partners.[136] Each S corporation shareholder is counted for purposes of the 100-Schedule K-1 limit.[137] Importantly, partnerships that have a trust, a disregarded entity or another partnership as a partner (i.e., tiered partnership structures) cannot opt out of the rules.[138] It is not unusual for family

[132]. I.R.C. § 6226.
[133] Treas. Reg. § 301.6226-1(c).
[134] Treas. Reg. § 301.6226-1(b)(2).
[135] *See* I.R.C. § 6225(c)(2)(B) and Treas. Reg. § 301.6225-2(d)(2)(x).
[136]. I.R.C. § 6221(b).
[137] I.R.C. § 6225
[138] I.R.C. § 6225

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partnerships, including relatively small ones, to have a trust or other partnerships as partners. Thus, CPAR can mandatorily apply to many smaller partnerships.

Another side effect of being subject to CPAR is that partnerships no longer have the ability to issue amended Schedules K-1 to partners to change partnership-related items once the due date for Form 1065 has passed, except in limited circumstances. Instead, a separate procedure involving the partnership filing an administrative adjustment request ("AAR") with the IRS would need to be utilized in order to revise the information previously reported to partners on the originally issued Schedules K-1.[139]

To explain, I.R.C. § 6031(a) requires every partnership to file a return for each taxable year stating the items of its gross income, deductions and such other information as required by forms and regulations, including information about the partners in the partnership. For a partnership, the return required by I.R.C. § 6031(a) is Form 1065, which includes Schedules K-1. A Schedule K-1 reports the partner's name, taxpayer identification number, and distributive share of partnership-related items and other information related to the partner's interest in the partnership. For any partnership required to file a return under I.R.C. § 6031(a), I.R.C. § 6031(b) mandates such partnership to furnish a copy of the Schedule K-1 to each partner that includes such information as may be required to be shown by the applicable regulations.

Beginning with the 2018 tax year, I.R.C. § 6031(b) prohibits partnerships subject to CPAR from amending the information required to be furnished to their partners on Schedules K-1 after the due date of the partnership return, unless specifically permitted by the Secretary of the Treasury. One example of such specific situation where the Secretary of Treasury permitted amendments is contained in Rev. Proc. 2020-23,[140] which allowed partnerships subject to CPAR to file amended returns (and issued amended Schedules K-1) for tax years beginning in 2018 and 2019 instead of having to file AARs in order to obtain the tax benefits from the 2020 CARES Act's provisions that allowed taxpayers to carry back net operating losses to tax years 2018 and 2019.[141]

CHAPTER 5: OPERATION OF A PARTNERSHIP; ALLOCATION OF PARTNERSHIP INCOME AND LOSSES

§ 5.03 SUBSTANTIAL ECONOMIC EFFECT RULES

B. ECONOMIC EFFECT RULES

1. "Regular Rules"

Add at the end of the section:

If a partner is not expressly obligated to restore the deficit balance in such partner's capital account, such partner will still be treated as having a deficit restoration obligation to the extent of (i) the outstanding principal balance of any promissory note (of which such partner is the maker) contributed to the partnership by such partner (other than a promissory note that is readily tradable on an established securities market), and

[139] *See* I.R.C. § 6227.
[140] 2020-18 IRB 1.
[141] For further discussion of this aspect of the CARES Act, see § 4.07.D.2.

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(ii) the amount of any unconditional obligation of such partner (whether imposed by the partnership agreement or by state or local law) to make subsequent contributions to the partnership.[142]

A promissory note or unconditional obligation is taken into account only if it is required to be satisfied at a time no later than the end of the partnership taxable year in which such partner's interest is liquidated (or, if later, within 90 days after the date of such liquidation).[143] If a promissory note is negotiable, a partner will be considered required to satisfy such note within the required period if the partnership agreement provides that, in lieu of actual satisfaction, the partnership will retain such note and such partner will contribute to the partnership the excess, if any, of the outstanding principal balance of such note over its fair market value at the time of liquidation.[144]

If a partner contributes a promissory note to the partnership during a partnership taxable year, and the maker of such note is a person related to such partner, then such promissory note is treated as a promissory note of which such partner is the maker.[145]

A partner will not be considered obligated to restore the deficit balance in his capital account to the partnership to the extent such partner's obligation is a bottom dollar payment obligation[146] or is not legally enforceable, or the facts and circumstances otherwise indicate a plan to circumvent or avoid such obligation. To the extent a partner is not considered obligated to restore the deficit balance in the partner's capital account to the partnership, the obligation is disregarded under the economic effect rules and the rules for recourse liabilities are applied as if the obligation did not exist.

In the case of an obligation to restore a deficit balance in a partner's capital account upon liquidation of a partnership, the Regulations provide the following non-exclusive list of factors that may indicate a plan to circumvent or avoid the obligation:

(i) The partner is not subject to commercially reasonable provisions for enforcement and collection of the obligation.

(ii) The partner is not required to provide (either at the time the obligation is made or periodically) commercially reasonable documentation regarding the partner's financial condition to the partnership.

(iii) The obligation ends or could, by its terms, be terminated before the liquidation of the partner's interest in the partnership or when the partner's capital account is negative other than when a transferee partner assumes the obligation.

(iv) The terms of the obligation are not provided to all the partners in the partnership in a timely manner.[147]

It should be noted that these rules are similar to, but different from, the anti-abuse rules discussed in Section 3.04, above, for disregarding a payment obligation in general.

142 Treas. Reg. § 1.704-1(b)(2)(ii)(c)(1).
143 Treas. Reg. § 1.704-1(b)(2)(ii)(c)(2).
144 *Id*.
145 Treas. Reg. § 1.704-1(b)(2)(ii)(c)(3).
146 See discussion at § 3.04.
147 Treas. Reg. § 1.704-1(b)(2)(ii)(c)(4).

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

B. PARTNER'S INTEREST IN THE PARTNERSHIP, IN GENERAL

The first sentence of the last paragraph on page 150 should be changed to:

Although PIP has been an important consideration in determining the partners' distributive shares for over 40 years,[148] there has been less than universal agreement as to the approach and reliability of PIP.

C. BOOK-VALUE LIQUIDATION AS PIP

Add before the last paragraph of this section:

The practical effect of this approach is that income to a service partner may be delayed because the gain inherent in assets has not yet been recognized even though it is economically present. This may push disproportionate amounts of current income to investors. Although this may initially sound like a good deal for the service partner, if the partnership liquidates in accordance with capital accounts the service partner is gambling that there will be sufficient book income at the back end for the service partner to catch up. Outside of the safe harbor for book-value liquidations, other factors discussed below may have greater significance.

M. FOREIGN TAX CREDITS

A partnership is not eligible to claim a foreign tax credit (an "FTC") under I.R.C. § 901 (or a deduction for foreign taxes under I.R.C. § 164).[149] Instead, under I.R.C. §§ 702(a)(6), 706(a), and 901(b)(5) each partner takes into account its distributive share of the creditable foreign taxes paid or accrued by the partnership in the partner's tax year with or within which the partnership's tax year ends.[150] Under I.R.C. § 702(a)(6), this amount, known as a creditable foreign tax expenditure ("CFTE"), is accounted for as a separately stated item. A CFTE is a foreign tax paid or accrued by a partnership that is eligible for a credit under I.R.C. § 901(a) or an applicable U.S. income tax treaty.[151] A foreign tax is a CFTE for these purposes without regard to whether a partner receiving an allocation of such foreign tax elects to claim a credit for such tax. Foreign taxes paid or accrued by a partner with respect to a distributive share of partnership income are not taxes paid or accrued by a partnership and, therefore, are not CFTEs.

Allocations of CFTEs do not have substantial economic effect, and accordingly a CFTE must be allocated in accordance with the partners' interests in the partnership.[152] Treas. Reg. § 1.704-1(b)(4)(viii) provides a safe harbor under which CFTE allocations are deemed to be in accordance with the partners' interests in the partnership. In general, the purpose of the safe harbor is to match allocations of CFTEs with the income to which the CFTEs relate.

In order to apply the safe harbor, a partnership must (1) determine the partnership's "CFTE categories," (2) determine the partnership's net income in each CFTE category, and (3) allocate the partnership's CFTEs to each category. Treas. Reg. § 1.704-1(b)(4)(viii)(c)(2) requires a partnership to assign its income to activities and provides for the grouping of a partnership's activities into one or more CFTE categories based generally on whether net income from the activities is allocated to partners in the same sharing ratios. Treas. Reg. § 1.704-1(b)(4)(viii)(c)(3) provides rules for determining the partnership's net

148 The use of PIP in I.R.C. § 704(b) was added by The Tax Reform Act of 1976, Pub. L. 94-455 § 213(d) (Oct. 4 1976).
149 *See* I.R.C. § 703(b)(3).
150 Treas. Reg. § 1.702-1(a)(6).
151 Treas. Reg. § 1.704-1(b)(4)(viii)(b).
152 Treas. Reg. § 1.704-1(b)(4)(viii).

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income (for U.S. federal income tax purposes) in a CFTE category, including rules for allocating and apportioning expenses, losses, and other deductions to gross income. Treas. Reg. § 1.704-1(b)(4)(viii)(d) assigns CFTEs to the CFTE category that includes the related income. In order to satisfy the safe harbor, partnership allocations of CFTEs in a CFTE category must be in proportion to the allocations of the partnership's net income in the CFTE category.

§ 5.05 BOOK-TAX DISPARITIES – I.R.C. § 704(C) ALLOCATIONS

C. I.R.C. 704(c)(1)(C)

Add at the end of the section:

The built-in loss is reduced over time by decreases in the difference between the property's adjusted tax basis and book value (other than through adjustments to capital accounts to reflect the then fair market value).[153] Under Proposed Regulations, the partnership first computes its items of income, deduction, gain or loss at the partnership level under I.R.C. § 703.[154] The partnership would then allocate the partnership items among the partners, including the I.R.C. § 704(c)(1)(C) partner, in accordance with I.R.C. § 704, and adjusts the partnership capital accounts accordingly. The partnership then adjusts the I.R.C. § 704(c)(1)(C) partner's distributive share of the items to reflect the I.R.C. § 704(c)(1)(C) basis adjustment.

Proposed Regulations approach the management of the built-in loss similarly to an I.R.C. § 743(b) adjustment.[155] The excess of the adjusted basis of contributed property over the fair market value of that property at the time of contribution is referred to as the I.R.C. § 704(c)(1)(C) basis adjustment.[156] The I.R.C. § 704(c)(1)(C) basis adjustment is an adjustment to the basis of partnership property with respect to the I.R.C. § 704(c)(1)(C) partner only.[157] An I.R.C. § 704(c)(1)(C) basis adjustment amount is excluded from the partnership's basis of I.R.C. § 704(c)(1)(C) property. Thus, for the purposes of calculating income, deduction, gain and loss, the I.R.C. § 704(c)(1)(C) partner will have a special basis for I.R.C. § 704(c)(1)(C) property for which the partner has an I.R.C. § 704(c)(1)(C) basis adjustment. The I.R.C. § 704(c)(1)(C) basis adjustment has no effect on the partnership's computation of any item under I.R.C. § 703.

§ 5.06 REVERSE I.R.C. § 704(C) ALLOCATIONS

Add at the end of the section:

A special rule applies to reverse I.R.C. § 704(c) allocations in the context of securities partnerships. In general, I.R.C. § 704(c) must be applied on an asset by asset basis. However, for purposes of making reverse I.R.C. § 704(c) allocations, a securities partnership may aggregate gains and losses from qualified financial assets using any reasonable approach that is consistent with the purpose of I.R.C. § 704(c).[158] Among the methods that are generally reasonable are a partial netting approach and a full netting approach, in which the gains and losses from qualified financial assets are netted.[159]

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153 Prop. Reg. § 1.704-3(a)(3)(ii).
154 Prop. Reg § 1.704-3(f)(3)(ii)(B).
155 Discussed in § 6.07.
156 Prop. Reg. § 1.704-3(f)(2)(iii).
157 Prop. Reg. § 1704-3(f)(3)(ii)(A).
158 Treas. Reg. § 1.704-4(e)(3).
159 Treas. Reg. § 1.704-4(e)(3)(iv), (v).

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A partnership is a securities partnership if the partnership is either a management company or an investment partnership, and the partnership makes all of its book allocations in proportion to the partners' relative book capital accounts (except for reasonable special allocations to a partner that provides management services or investment advisory services to the partnership).[160]

Other other hand, if any interests in the securities partnership were issued for services, the partial netting or full netting approaches will not be considered reasonable unless the application of I.R.C. § 1061 is taken into account (generally requiring a 3-year holding period to have long-term capital gains if the partnership interest was issued for services).[161]

Section 5.10 is renumbered 5.11 and new section 5.10 is inserted before it:

§ 5.10 Deduction for Qualified Business Income/I.R.C. § 199A

I.R.C. § 199A, created by the 2017 Tax Cuts and Jobs Act (TCJA), allows many individuals, trusts and estates owning sole proprietorships, partnerships, or S corporations to deduct up to 20 percent of their qualified business income. The IRS has issued final I.R.C. § 199A Regulations and a corrected version implementing the new qualified business income (QBI) deduction (the I.R.C. § 199A deduction).[162] Concurrently the IRS released three related guidance items: (i) proposed I.R.C. § 199A Regulations, (addressing the treatment of previously suspended losses and the treatment of real estate investment trust (REIT) dividends flowing through a Registered Investment Company (RIC)),[163] (ii) Notice 2019-07 (containing a proposed safe harbor to define rental real estate trade or business)[164] and (iii) Rev. Proc. 2019-11 (providing three methods for calculating W-2 wages).

The I.R.C. § 199A deduction is available in tax years beginning after Dec. 31, 2017, meaning eligible taxpayers were able to claim it for the first time on their 2018 Form 1040. The I.R.C. § 199A deduction expires in 2026.[165] The I.R.C. § 199A deduction applies to individuals and certain trusts with qualified business income earned directly or through pass-through entities. Eligible taxpayers can also deduct 20% of their qualified real estate investment trust (REIT) dividends and publicly traded partnership income. The QBI deduction has additional restrictions for high-earning taxpayers with taxable income above $315,000 (for 2018) for joint returns and $157,500 (for 2018) for other filers. For high-earning taxpayers, the QBI deduction is capped at the greater of 50% of W-2 wages paid; or 25% of W-2 wages plus 2.5% of the unadjusted basis, immediately after acquisition ("UBIA"), of all depreciable qualified property used in the eligible trade or business.

Thus, in the case of a taxpayer other than a corporation, a deduction is allowed equal to the *sum* of (1) the *lesser* of (a) the combined QBI amount or (b) 20% of the excess of (i) the taxable income over (ii) the sum

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160 Treas. Reg. § 1.704-4(e)(3)(iii)(A).

161 Prop. Reg. § 1.704-3(e)(3)(vii)(A). The rules related to I.R.C. § 1061 are discussed in greater detail in § 8.08.D.

162 TD 9847, 84 Fed. Reg. 2952 (Feb. 8, 2019).

163 REG-134652-18 (January 18, 2019).

164 Rev. Proc. 2019-38, 2019-42 IRB 942, issued on September 24, 2019, contains the final safe-harbor rules for treating a rental real estate enterprise as a trade or business for purposes of I.R.C. § 199A.

165 I.R.C. § 199A(i).

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of net capital gain[166] and any qualified cooperative dividends, *plus* (2) the *lesser* of (a) 20% of the aggregate amount of qualified cooperative dividends or (b) taxable income reduced by net capital gain.[167]

The combined QBI amount is further defined by another formula. The combined QBI amount is the sum of (what we will call) an income/wage amount with respect to all of the taxpayer's qualified trades or businesses plus 20% of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income for the taxable year.[168] The income/wage amount with respect to each qualified trade or business is the *lesser* of (1) 20% of the taxpayer's QBI with respect to such qualified trade or business or (2)[169] the *greater* of (a) 50% of the W-2 wages with respect to the qualified trade or business or (b) the sum of (i) 25% of the W-2 wages with respect to the qualified trade or business plus (ii) 2.5% of the unadjusted basis immediately after the acquisition of all qualified property (mainly, tangible, depreciable, personal and real property).[170] The objective of the 50% W-2 wage limitation is to encourage the employment of US citizens and residents by the business. Note that if a taxpayer's business paid no wages, under the 50% test, the taxpayer would get no deduction, as 50% of 0 is 0. However, an alternative to this limitation (the 25% W-2 wage plus 2.5% of adjusted basis) was added by the Conference Committee late in the process as part of reconciliation, which extends the benefits of I.R.C. § 199A to owners of businesses with large holdings of "qualified property" (e.g., real estate) having few or even no employees.

QBI is the net amount of qualified items of income, gain, deduction and loss from any qualified trade or business.[171] Only items included in taxable income are counted. Items such as capital gains and losses, C corporation dividends, and interest income are excluded from QBI.[172] In addition, the items must be effectively connected with a U.S. trade or business.[173] A qualified trade or business is any trade or business, except for any specified service trade or business (SSTB),[174] which includes a trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, investing and investment management, trading, dealing in certain assets or any trade or business where the principal asset is the reputation or skill of one or more of its employees.[175] The SSTB limitation does not apply if a taxpayer's taxable income is below $315,000 for a married couple filing a joint return, or $157,500 for all other taxpayers.[176] If a taxpayer's taxable income is above the $315,000/$157,500 thresholds, the deduction may be limited based on whether the taxpayer's business is an SSTB, the W-2 wages paid by the business, and the unadjusted basis of certain property used by the business. These limitations are phased in for joint filers with taxable income between $315,000 and $415,000, and all other taxpayers with taxable income between $157,500 and $207,500. These threshold amounts and phase-in ranges are for tax year 2018 and will be adjusted for inflation in subsequent years.[177] For taxpayers with

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166 Treas. Reg. § 1.199A-1(b)(3) defines net capital gain for purposes of I.R.C. § 199A as net capital gain within the meaning of I.R.C. § 1222(a) plus any qualified dividend income as defined in I.R.C. § 1(h)(11)(B).
167 I.R.C. § 199A(a).
168 I.R.C. § 199A(b)(1).
169 The limitations in (2) does not apply if the taxpayer's income is less than $157,500 for 2018 (200% of such amount in the case of a joint return), subject to a cost of living adjustment for post-2018 tax years. I.R.C. § 199A(b)(3)(A). Additional special rules apply to phase-in the application of these limitations if a taxpayer's taxable income exceeds the above thresholds by less than $50,000 for single filers or $100,000 in the case of a joint return. I.R.C. § 199A(b)(3)(B).
170 I.R.C. § 199A(b)(6).
171 I.R.C. § 199A(c)(1).
172 I.R.C. § 199A(c)(3)(B).
173 I.R.C. § 199A(c)(3)(A)(i).
174 I.R.C. § 199A(d)(1)(A).
175 I.R.C. § 199A(d)(2).
176 I.R.C. § 199A(d)(3).
177 I.R.C. § 199A(e)(2)(B).

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taxable income in excess of the phase-in range, a trade or business' characterization as an SSTB excludes the trade or business from being treated as a qualified trade or business.

The Regulations allow taxpayers to aggregate trades or businesses.[178] Aggregation is allowed (but not required) if certain criteria are met, providing some flexibility to taxpayers. Aggregation allows taxpayers to treat multiple trades or businesses as a single trade or business for purposes of applying the wage and qualified property limitations. To aggregate multiple trades or businesses each trade or business must independently qualify as a trade or business, and there must be 50% or more ownership (directly or indirectly) of each trade or business to be aggregated by the same person or group of persons. Further, no trade or business may be a SSTB, and trades or businesses must be integrated.[179] Trades or businesses are integrated if at least two of the following factors exist (1) the trades or businesses provide products, property or services that are the same or customarily offered together; (2) the trades or businesses share facilities or share significant centralized business elements; and (3) the trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group.[180]

The Regulations provide a de minimis rule pursuant to which a trade or business is not an SSTB if its gross receipts in a taxable year are $25 million or less and less than 10% of its gross receipts is attributable to the performance of services in an SSTB (including activities incident to the performance of those services),[181] or its gross receipts in a taxable year are more than $25 million and less than 5% of its gross receipts is attributable to the performance of services in an SSTB (including activities incident to the performance of those services).[182] These rules provided essentially a "cliff effect": if a taxpayer's receipts from banned services for a business that has less than $25 million of gross receipts is 11%, then none of the income from that business is allowed to use the I.R.C. § 199A deduction.

The final Regulations continue to use the I.R.C. § 162 standard for defining a trade or business, specifically declining to use the more liberal concepts under I.R.C. § 469.[183] The Preamble to the Proposed Regulations observed that this fact-specific inquiry is guided by case law requiring (i) profit motive, and (ii) scope of the activities that is "considerable, regular, and continuous."[184] The Preamble also observes that if a taxpayer is reporting a business as an I.R.C. § 162 business under I.R.C. § 199A, the taxpayer should be consistent with other tax reporting such as reporting for Treas. Reg. § 301.7701-1(a)(2) (making it difficult for a tenancy in common interest to claim trade or business status) and I.R.C. § 6041 (ensuring consistent compliance with reportable payment rules for trades or businesses).[185]

Rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a I.R.C. § 162 trade or business is nevertheless treated as a trade or business for the purposes of I.R.C. § 199A, if the property is rented or licensed to a trade or business conducted by the individual or a passthrough entity which is commonly controlled.[186]

New guidance provides a safe harbor to determine when rental real estate activities rise to the level of a trade or business. Rev. Proc. 2019-38[187] provides a limited safe harbor for taxpayers with real estate rental

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178 Treas. Reg. § 1.199A-4.
179 Treas. Reg. § 1.199A-4(b).
180 Treas. Reg. § 1.199A-4(b)(1).
181 Treas. Reg. § 1.199A-5(c)(1)(i).
182 Treas. Reg. § 1.199A-5(c)(1)(ii).
183 Treas. Reg. § 1.199A-1(b)(14).
184 TD 9847, 84 Fed. Reg. at 2954.
185 *Id.* at 2956.
186 Treas. Reg. § 1.199A-1(b)(14).
187 2019-42 IRB 942.

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enterprises (other than triple-net leases) that involve the performance of either (a) 250 or more annual rental service hours each year, if such enterprises are in existence for less than 4 taxable years, or (b) 250 or more annual rental servce hours for any 3 of the 5 consecutive years ending with the current taxable year, if such enterprises have been in existence for at least 4 taxable years. Rental services include (i) advertising to rent or lease the real estate; (ii) negotiating and executing leases; (iii) verifying information in tenant applications; (iv) collection of rent; (v) daily operation, maintenance, and repair of the property; (vi) management of the real estate; and (vii) supervision of employees and independent contractors. Rental services may be performed by owners or by employees, agents, and/or independent contractors of the owners. The safe harbor requires that the taxpayer maintain separate books and records for the rental business and contemporaneous hours logs including (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services. Also, qualifying rental service hours do not include financial or investment management activities, such as arranging financing; procuring property; studying and reviewing financial statements or reports on operations; improving property; or hours spent traveling to and from the real estate.

As mentioned above, one of the limitations on the QBI deduction is based on a percentage of the UBIA of qualified property. In the case of qualified property held by a partnership, each partner's share of the UBIA of qualified property is determined in accordance with how the partnership would allocate depreciation.[188] The Regulations do not reduce UBIA in a tax-free transaction such as an I.R.C. § 1031 like-kind exchange or an I.R.C. § 721 transfer of property to a partnership, although the place-in service date may vary depending upon whether the UBIA of the replacement property is above or below the UBIA of the relinquished property.[189] The Regulations provide UBIA adjustments for items like receipt of boot, although the specific mechanics may need some further refinement. Similarly, the Regulations provide that basis in depreciable property under I.R.C. § 743(b) upon the acquisition of a partnership interest creates UBIA to the extent the adjustment is not duplicative of UBIA inside the partnership (providing that the qualified portion of the I.R.C. § 743(b) adjustment is the adjustment that would result if the inside basis of the partnership assets is equal to the UBIA basis the partnership is using for I.R.C. § 199A purposes).[190] Although helpful, this formula fails to recognize that the amortization period for the new I.R.C. § 743(b) UBIA has a longer life than the UBIA inside the partnership, thus still causing a detriment to the purchasing partner for the period after the inside UBIA depreciable life ends.

The I.R.C. § 199A deduction is calculated based on the lower of 20% of QBI or the "W-2 wages/qualified property limitation." The Regulations confirm that W-2 wages are not reduced by elective deferrals (such as retirement plan deferrals).[191] Rev. Proc. 2019-11[192] provides three alternative methods for computing W-2 wages, including a simplified method. In conjunction with the final rules, Rev. Proc. 2019-11 clarifies that W-2 wages include elective deferrals to Simplified Employee Pensions, simple retirement accounts, and other qualified plans. It also specifies that amounts reported on W-2s for statutory employees (as checked in Box 13) should not be included in the calculation of W-2 wages. The summary also states that W-2 wages include amounts paid to S Corporation shareholders and common-law employees. The final Regulations confirm that a partnership's guaranteed payments for services do not create favorable W-2 wages[193] and are not qualified business income of the recipient partner.[194] Similarly, a partnership's

188 Treas. Reg. § 1.199A-2(a)(3)(ii).
189 Treas. Reg. § 1.199A-2(c)(2)(iii).
190 Treas. Reg. § 1.199A-2(a)(3)(iv).
191 Treas. Reg. § 1.199A-2(b)(2)(i).
192 2019-9 IRB 742.
193 Treas. Reg. § 1.199A-2(b)(2).
194 Treas. Reg. § 1.199A-3(b)(2)(ii)(I).

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guaranteed payments to its partners for the use of capital are not considered attributable to a trade or business and thus is not taken into account in caculcating partners' qualified business income..[195]

CHAPTER 6: DISPOSITIONS OF PARTNERSHIP INTERESTS

§ 6.03 CHARACTER OF GAIN OR LOSS

C. UNRECAPTURED I.R.C. § 1250 GAIN AND COLLECTIBLES GAIN

I.R.C. § 1(h)(1)(E) provides that the maximum long-term capital gain rate for individuals for unrecaptured I.R.C. § 1250 gain is 25%, rather than the 15% or 20% that applies to the general basket for long-term capital gains. Unrecaptured I.R.C. § 1250 gain is the long-term capital gain equal to the depreciation taken on real property.[196] Similarly, I.R.C. § 1(h)(4) provides that the maximum long-term capital gain rate for individuals for collectibles gain is 28%, rather than the 15% or 20% that applies to the general basket for long-term capital gains. Collectibles gain means long-term capital gain from the sale of any work of art, any rug or antique, any metal or gem, any stamp or coin, any alcoholic beverage or certain other specified tangible personal property.[197] A similar issue exists for these types of long-term capital gains that exists for partnership unrealized receivables and inventory. If the partner sells a partnership interest held over one year, any long-term capital gain the partner would recognize would be taxable at the 15% or 20% rate, less than the higher taxed long-term capital gain rates.

To address this issue, the Regulations provide that if a partner sells an interest in a partnership held for over one year, the partner recognizes as unrecaptured I.R.C. § 1250 gain or collectibles gain the amount of unrecaptured I.R.C. § 1250 gain or collectibles gain that would be allocated to the partner if the partnership had sold its I.R.C. § 1250 property and collectibles for cash equal to the fair market value of the property.[198]

1. Example

A partner sells her partnership interest held for more than one year. Before the application of I.R.C. § 751(a) and the Regulations, the partner has $50,000 of I.R.C. § 741 gain. (There is no special term for this in the Regulations, but one of the authors calls this "initial I.R.C. § 741 gain".) Assume the partner's share of partnership ordinary income from unrealized receivables is $10,000 and from inventory is $20,000. The partner is required to recognize this ordinary income and the initial I.R.C. § 741 gain is reduced to $20,000 ($50,000 - $10,000 - $20,000). The Regulations call this $20,000 "pre-look through" capital gain.[199] Next, the regulations require the partner to determine if the partnership holds assets with more highly-taxed long-term capital gains. Assume that the partnership has no unrecaptured I.R.C. § 1250 gain, but that the selling partner's share of long-term collectible gain is $5,000. The Regulations require that on the sale of the partnership interest, the partner recognize this $5,000 of collectible gain, reducing the "pre-look through" capital gain by that amount, i.e. $20,000 - $5,000 = $15,000. The Regulations call this $15,000 "residual" capital gain (taxed at a 15% or 20% rate since it is long term).[200]

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195 Treas. Reg. § 1.199A-3(b)(1)(ii).
196 I.R.C. § 1(h)(6)(A).
197 I.R.C. § 1(h)(5)(A).
198 Treas. Reg. § 1.1(h)-1(b)(2)(ii) and (b)(3)(ii).
199 *See* Treas. Reg. § 1.1(h)-1(c).
200 *See id.*

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The aggregate approach does not apply for unrecaptured I.R.C. § 1250 gain or collectibles gain on the redemption of a partnership interest.[201]

§ 6.07 OPTIONAL ADJUSTMENT TO BASIS OF PARTNERSHIP PROPERTY

A. I.R.C. § 743(b)

Add after the final paragraph

Starting in 2018, under I.R.C. § 743(d)(1)(B), in addition to the definition under I.R.C. § 743(d)(1)(A), a substantial built-in loss also exists if the transferee would be allocated a net loss in excess of $250,000 upon a hypothetical disposition by the partnership of all partnership's assets in a fully taxable transaction for cash equal to the assets' fair market value, immediately after the transfer of the partnership interest, even if there is not a net loss in excess of $250,000 in the partnership assets overall.

> For example, a partnership of three taxable partners (partners A, B, and C) has not made an election pursuant to I.R.C. § 754. The partnership has two assets, one of which, Asset X, has a built-in gain of $1 million, while the other asset, Asset Y, has a built-in loss of $900,000. Pursuant to the partnership agreement, any gain on sale or exchange of Asset X is specially allocated to partner A. The three partners share equally in all other partnership items, including in the built-in loss in Asset Y. In this case, each of partner B and partner C has a net built-in loss of $300,000 (one third of the loss attributable to asset Y) allocable to his partnership interest. Nevertheless, the partnership does not have an overall built-in loss, but a net built-in gain of $100,000 ($1 million minus $900,000). Partner C sells his partnership interest to another person, D, for $33,333. With the amendment to I.R.C. § 743(d), the test for a substantial built-in loss applies *both* at the partnership level and at the transferee partner level. If the partnership were to sell all its assets for cash at their fair market value immediately after the transfer to D, D would be allocated a loss of $300,000 (one third of the built-in loss of $900,000 in Asset Y). Consequently, a substantial built-in loss exists under I.R.C. § 743(d)(1)(B), and the partnership must give D a negative $100,000 I.R.C. § 743(b) adjustment with regard to asset Y, notwithstanding the fact that no actual I.R.C. § 754 election is in effect.[202]

B. MAKING THE I.R.C. §754 ELECTION

Add at the end of the section:

Proposed Regulations would remove the signature requirement for the I.R.C. § 754 election, requiring only 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).[203]

E. ALLOCATION OF BASIS ADJUSTMENT AMONG PARTNERSHIP ASSETS UNDER I.R.C. § 755

Add before the first full paragraph on page 233:

As an example, assume Minshu, Alberto and Bernadette form a partnership that invests in real estate. Each owns a one-third interest in the partnership. At a time when the total value of the assets of the

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201 Treas. Reg. § 1.1(h)-1(b)(2)(ii) and (b)(3)(ii). *See* Chapter 7.

202 Conference Report to Accompany H.R. 1, 115 Cong. 1st Sess., Rep. 115-466, p. 512-13 (Dec. 15, 2017).

203 Prop. Reg. § 1.754-1(b)(1).

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partnership is $300 and the aggregate bases of the assets is $90, Bernadette sells her interest in the partnership to Jutta for $100. For simplicity's sake, let us assume the partnership has no debt. The partnership has an I.R.C. § 754 election in effect.

The adjustments are made in a four step process: (i) the outside basis of the interest sold is determined in the hands of the transferee; (ii) the transferee's share of the adjusted basis of partnership property is determined; (iii) the difference between the transferee's basis in the partnership interest and the transferee's basis in partnership property is determined; and (iv) the adjustment is allocated among the classes of assets and within the classes of assets.

With no debt in the partnership, the first step is quite simple. Jutta has an outside basis of $100 immediately after the purchase.[204]

For the second step, although you might think that you would divide the aggregate bases of the assets by the number of the partners, the Regulations take a more circuitous route. The transferee's share of the adjusted basis of partnership property is the sum of (i) the transferee's interest in previously taxed capital, plus (ii) the transferee's share of partnership liabilities.[205] The transferee's interest in previously taxed capital is (i) the amount of cash that would be distributed to the transferee in a hypothetical liquidation of the partnership's assets for fair market value immediately after the transaction, plus (ii) any loss that would be allocated to the transferee in the hypothetical liquidation (attributable to the transferred interest), and minus (iii) any gain that would be allocated to the transferee in the hypothetical liquidation (attributable to the transferred interest).[206]

Applying these steps to our simple facts, the amount of cash that would be distributed to Jutta on a hypothetical liquidation would be $100, and there would be a $70 gain allocated to Jutta on the hypothetical liquidation. In other words, Jutta's interest in previously taxed property would be $30. This, of course, is the same number that you would get with these facts if you had just divided the aggregate bases by the number of partners, but, if there had been special allocations or the partnership had debt that was not shared pro rata, then you might not get the same result.

So, in the third step, we subtract the transferee's share of the adjusted basis of partnership property from the transferee's basis in the partnership: $100 - $30. This gives us an adjustment of $70.

If the partnership only has a single property, we make the $70 adjustment and have a cup of coffee. If the partnership has multiple properties, you have to go on to the fourth step (you may still want that cup of coffee).

Let's assume the partnership has three properties. Property 1 has a value of $150 and a basis of $60. Property 2 has a value of $50 and a basis of $20. Property 3 has a value of $100 and a basis of $10. The gain allocable to Jutta in a deemed liquidation immediately after the sale of the three properties would be $30, $10 and $30 respectively, so those amounts are the partnership's adjustments to basis for Jutta's account.

If we change the example so there is a loss in one of the properties, we take the same approach, though the numbers may seem a bit odd. Property 1 has a value of $200 and a basis of $20. Property 2 has a value of $20 and a basis of $50. Property 3 has a value of $80 and a basis of $20. The gain (loss) allocable to Jutta in a deemed liquidation immediately after the sale of the three properties would be $60, ($10) and $20 respectively, so those amounts are the partnership's adjustments to basis for Jutta's account.

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204 I.R.C. § 1012.

205 Treas. Reg. § 1.743-1(d)(1).

206 *Id.*

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Thus, even if the overall adjustment is positive, there can be upward and downward I.R.C. § 743(b) adjustments to the assets. This makes sense when you recall that a purpose of an I.R.C. § 743(b) adjustment is to "zero out" (as much as possible) taxable gains and losses inherent in partnership assets that arose before the buying partner became a partner. Ideally, the buying partner is only taxed on gains and may only deduct losses that arose after he became a partner. As we discuss below, this ideal cannot always be achieved.

If all the properties are capital assets, then that is all there is to it. If one or more of the properties is an ordinary income property, such as inventory, then the adjustment is made to those properties first, so, if the partnership interest is sold for less than the liquidation value, the shortfall of the basis adjustments will be to the capital assets.

Let's change the facts so that at a time when the total value of the assets of the partnership is $300 and the aggregate bases of the assets is $90, Bernadette sells her interest in the partnership to Jutta for $90. On a hypothetical liquidation, there would still be $70 of gain allocated to Jutta, but now the adjustment is capped at $60. The $60 is because the adjustment is capped at an amount that would increase Jutta's share of partnership assets to Jutta's $90 purchase price.[207]

If all the properties are capital assets, the short fall gets allocated among the properties based upon their relative values.[208] Let's assume the partnership has three properties. Property 1 has a value of $150 and a basis of $60. Property 2 has a value of $50 and a basis of $20. Property 3 has a value of $100 and a basis of $10. The $60 adjustment gets allocated among the properties based on their values. The gain allocable to Jutta in a deemed liquidation immediately after the sale of the three properties would be $30, $10 and $30 respectively, but those numbers need to be reduced by the $10 excess of the gain recognized in the deemed liquidation over the $60 total adjustments available. So Property 1 gets an adjustment of $25 ($30 – ($10 * $150 / $300)). Property 2 gets an adjustment of $8.66 ($10 – ($10 * $50 / $300)). Property 3 gets an adjustment of $26.33 ($30 – ($10 * $100 / $300)).

If some of the properties are ordinary income property, the adjustment is allocated first to the ordinary income property and then to the capital assets.[209] Let's assume the same property values and sale price as above, except that Property 1 is an ordinary income asset. The $60 adjustment gets allocated first to Property 1 and then among the Properties 2 and 3 based on their values. The gain allocable to Jutta in a deemed liquidation immediately after the sale of the three properties would be $30, $10 and $30 respectively. Once again, these numbers need to be reduced to account for the $10 excess of the gain recognized in the deemed liquidation over the $60 total adjustments available. Under these facts, a $30 adjustment is first allocated to Property 1 since it is the ordinary income asset, and the remaining $30 of adjustment gets allocated between Properties 2 and 3. Property 2 gets an adjustment of $6.66 ($10 – ($10 * $50 / $150)). Property 3 gets an adjustment of $23.33 ($30 – ($10 * $100 / $150)).

F. ADDITIONAL ASPECTS OF ADJUSTMENT

Add at the end of subsection 6:

Regulations would also allow bonus depreciation under I.R.C. § 168(k) to be taken in respect of an I.R.C. § 743 basis adjustment if certain conditions are met.[210]

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207 I.R.C. § 743(b).
208 Treas. Reg. § 1.755-1(b)(3)(ii)(B)(2).
209 Treas. Reg. § 1.755-1(b)(2)(i).
210 Treas. Reg. § 1.168(k)-2(b)(3)(iv)(D).

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Section 6.08 of the text is restated as follows:

§ 6.08 TERMINATION OF PARTNERSHIPS

I.R.C. § 708(a) provides that a partnership is considered to continue until it is terminated (it is rare, but sometimes the Code states the obvious). Under I.R.C. § 708(b)(1), which applies for tax years beginning after December 31, 2017, a partnership is only deemed to be terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in the partnership form.[211] Under pre-2018 I.R.C. § 708(b)(1)(B), for tax years beginning before December 31, 2017, a partnership is terminated if: (i) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in the partnership form, *or* (ii) within a 12-month period there is a sale or exchange of 50% or more of the total interest in partnership capital and profits.

A. GENERAL RULE

Under the general rules of I.R.C. § 708(b)(1), the partnership is terminated if no part of any business of the partnership is carried on by any of its partners in partnership form.[212] There are two possible ways a termination might be triggered. First, it might be triggered if no part of the partnership business is carried on by any of the partners. Second, it might be triggered if the business is no longer being carried on in partnership form, even though it might be continued outside the partnership.

The Regulations interpreting I.R.C. § 708(b)(1)(A) (now I.R.C. § 708(b)(1)) establish a liberal approach to a finding of a business nexus sufficient to maintain a partnership. A partnership continues to exist even when its operations are substantially changed or reduced in a period of winding up, and even when its sole asset during that period is cash.[213] The Ninth Circuit, in affirming the Tax Court, held that no termination occurs until all the assets of a partnership are distributed to the partners and all partnership activity ends.[214]

The Regulations provide an example of a business not being continued in partnership form.

> For example, on [DATE]. A and B, each of whom is a 20-percent partner in partnership ABC, sell their interests to C, who is a 60-percent partner. Since the business is no longer carried on by any of its partners in a partnership, the ABC partnership is terminated as of [DATE].[215]

Thus, since ABC only had one partner, it could no longer be a partnership and had terminated. The Regulations caution about taking this principal too far, however. Upon the death of one partner in a 2-member partnership, the partnership will not be considered as terminated if the estate or other successor in interest of the deceased partner continues to share in the profits or losses of the partnership business.[216]

Note that if a partnership converts to a corporation, the business will not be continued by any partner

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211 For special rules with respect to the termination of a partnership in the case of mergers or divisions, see § 9.02.

212 Treas. Reg. § 1.708-1(b)(1).

213 Treas. Reg. § 1.708-1(b)(1). Harbor Cove Marina Partners Partnership v. Comm'r, 123 T.C. 64, 81 (2004).

214 Baker Commodities, Inc. v. Comm'r, 415 F.2d 519 [24 AFTR 2d 69-5516] (9th Cir. 1969), aff'g 48 T.C. 374 (1967) (cert. denied).

215 Treas. Reg. § 1.708-1(b)(1). (original dates removed).

216 Treas. Reg. § 1.708-1(b)(1)(i).

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in partnership form.[217]

B. The Old Twelve-Month Rule

Under pre-2018 I.R.C. § 708(b)(1)(B), for tax years beginning before December 31, 2017, a partnership is terminated if within a 12-month period there is a sale or exchange of 50% or more of the total interest in partnership capital and profits.

Since there must be a sale or exchange of a 50% interest in both capital and profits during a 12-month period, a natural question is presented as to whether a sale can be structured so that less than 50% is sold within the 12-month period, and the balance is sold following the expiration of the 12-month period. In Private Rulings, the IRS has approved transactions of this type.[218]

1. What Transactions Were Taken into Account

Not all transfers of partnership interests were necessarily taken into account in determining whether the required 50% change had occurred. A sale from one partner to an existing partner was taken into account.[219] A transfer of a partnership interest by gift, bequest, or inheritance, and a liquidation of a partnership interest was not treated as a sale or exchange for purposes of pre-2018 I.R.C. § 708(b)(1)(B).[220] Likewise, a contribution of property to a partnership was not treated as a sale or exchange.[221]

If a sale or exchange of an interest in an upper-tier partnership resulted in a termination of the upper-tier partnership, the upper-tier partnership was treated as exchanging its interest in the capital and profits of the lower-tier partnership. If, however, the sale or exchange of an interest in the upper-tier partnership did not result in a termination of the upper-tier partnership, then the sale or exchange was *not* treated as a sale or exchange of a proportionate part of the upper-tier partnership's interest in the capital and profits of the lower-tier partnership.[222]

Was there a sale or exchange for purposes of pre-2018 I.R.C. § 708(b)(1)(B) where a partnership interest is transferred in a nontaxable transaction? The IRS has generally taken the position that as long as there is an exchange, the fact that the exchange qualifies for tax-free treatment did not prevent the transaction from being treated as an exchange for purposes of pre-2018 I.R.C. § 708(d)(1)(B). It has been held that a transfer of a 50% interest in capital and profits by a partner to a corporation in a transaction which was tax-free pursuant to I.R.C. § 351 qualified as an exchange for purposes of pre-2018 I.R.C. § 708(b)(1)(B).[223]

In Private Rulings, the IRS has held that the transfer of a partnership interest to another partnership is an exchange for purposes of pre-2018 I.R.C. § 708(b)(1)(B).[224] Where a partnership interest is owned by a corporation which participates in a tax-free reorganization within the meaning of I.R.C. § 368(a) in which the

217 Rev. Rul. 84-11, 1984-2 1970-1 C.B. 88.
218 *See* PLR 8517022 (Jan. 25, 1985); PLR 7952057 (Sept. 25, 1979).
219 Treas. Reg. § 1.708-1(b)(2).
220 *Id.*
221 *Id.*
222 *Id.*
223 Evans v. Commissioner, 54 T.C. 40 (1970), *aff'd*, 447 F.2d 547 (7th Cir. 1971); *see also* Rev. Rul. 81-38, 1981-1 C.B. 386.
224 PLR 8116041 (Jan. 21, 1981); PLR 8229034 (Apr. 20, 1982).

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assets of the corporate partner are transferred to another party to the reorganization, the IRS has held that the transfer of the partnership interest is an exchange to which I.R.C. § 708(d)(1)(B) applies.[225]

2. *Transactions Deemed to Occur*

Treas. Reg. § 1.708-1(b)(4) provided that if a partnership was terminated pursuant to pre-2018 I.R.C. § 708(b)(1)(B) as a result of a sale or exchange, the partnership was deemed to have contributed all of its assets and liabilities to a new partnership in exchange for the interests in the new partnership and to immediately thereafter distribute those interests in the new partnership to the purchasing partner and the other remaining partners, in proportion to their respective interests in the terminated partnership, in liquidation of the terminated partnership. As a result of these deemed transactions, the new partnership's basis for its assets was unchanged, as were the capital accounts of the partners.[226] Even though the assets of the old partnership may have been appreciated, no new I.R.C. § 704(c) gain was created as a result of the deemed transfer by the old partnership of its assets to the new partnership.[227] If a partnership was terminated by a sale or exchange of an interest in the partnership, an I.R.C. § 754 election (including an I.R.C. § 754 election made by the terminated partnership on its final return) that was in effect for the taxable year of the terminated partnership in which the sale occurs, applies with respect to the incoming partner.[228] Therefore, the bases of partnership assets were adjusted pursuant to I.R.C. §§ 743 and 755 prior to their deemed contribution to the new partnership. A partner with a basis adjustment in property held by a partnership that terminated under I.R.C. § 708 (b)(1)(B) will continue to have the same basis adjustment with respect to property deemed contributed by the terminated partnership to the new partnership under Treas. Reg. § 1.708-1(b)(1)(iv), regardless of whether the new partnership makes an I.R.C. § 754 election.[229] Proposed Regulations suggest that the deemed liquidation in a pre-2018 I.R.C. § 708(b)(1)(B) termination could also result in an adjustment if the resulting partnership made an I.R.C. § 754 election for its first year.[230]

3. *Effect of Partnership Termination*

Under the pre-2018 I.R.C. § 708(b)(1)(B) termination rules, the new partnership retained the taxpayer identification number of the old partnership.[231]

Since the Regulations treated the old partnership as having transferred its assets to a new partnership, the new partnership should have been able to make all new tax elections, although this is not specifically stated. If the old partnership had an I.R.C. § 754 election in effect, if this is desired by the new partnership, prudence dictated that the new partnership make a new I.R.C. § 754 election.

A termination of a partnership under pre-2018 I.R.C. § 708(b)(1)(B) did not trigger gain recognition under either I.R.C. § 704(c)(1)(B) or 737.[232]

The principal issue which occured with respect to a termination of a partnership under pre-2018 I.R.C. § 708(b)(1)(B) related to depreciation. Under I.R.C. § 168(i)(7)(A), if depreciable property is

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225 Rev. Rul. 87-110, 1987-2 C.B. 159. The Revenue Ruling carved out an exception for those reorganizations which are described in I.R.C. § 368(a)(1)(F).
226 Treas. Reg. § 1.708-1(b)(4), example (ii); Treas. Reg. § 1.704-1(b)(2)(iv)(l).
227 Treas. Reg. § 1.708-1(b)(4), example (iii); Treas. Reg. § 1.704-3(a)(3)(i).
228 Treas. Reg. § 1.708-1(b)(5).
229 Treas. Reg. § 1.743-1(h)(1).
230 Prop. Reg. § 1.755-1(c)(2)(vi).
231 Treas. Reg. § 1.708-1(b)(4), example (ii); Treas. Reg. § 301.6109-1(d)(2)(iii)
232 Treas. Reg. §§ 1.704-4(c)(3), 1.737-2(a).

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transferred to a partnership in a transaction to which I.R.C. § 721 applies, the transferee partnership steps in the shoes of the transferor with respect to depreciation. The provisions of I.R.C. § 168(i)(7)(A), however, did not apply in the case of a termination of a partnership under pre-2018 I.R.C. § 708(b)(1)(B). Thus, the new partnership is treated as having newly acquired the assets of the old partnership and must depreciate the basis of those assets using the appropriate life under the modified accelerated cost recovery system.

CHAPTER 7: PARTNERSHIP DISTRIBUTIONS

§ 7.03 NONLIQUIDATING DISTRIBUTIONS OF PROPERTY

D. DISTRIBUTIONS WHEN STOCK IS HELD OF A CORPORATE PARTNER

It may seem like ancient history now, but in Chapter 2 we discussed transactions which may cause gain recognition on a contribution of property because a partnership holds stock of a corporate partner.[233] Because the IRS was concerned that some transactions had already completed the first step (the acquisition of the stock of a corporate partner) before the original guidance was released, the Regulations also treat as gain recognition events (i) the distribution by a partnership that owns stock of a corporate partner of appreciated property to a partner other than the corporate partner and (ii) the distribution of stock of the corporate partner to the corporate partner.[234]

The calculation of the amount of gain is the same as discussed in Chapter 2.[235]

§ 7.07 I.R.C. § 734(B) ADJUSTMENTS

C. MANDATORY "AS IF" I.R.C. § 754 ELECTIONS

Add at the end of the section:

An example of Modified Book follows: Assume that A, B, and C form a partnership. In Year 1, A and B each contribute $300,000 and C contributes $600,000. A and B are each 25% partners and C is a 50% partner. The partnership purchases two parcels of land. Both are capital assets. The partnership pays $400,000 for Parcel #1 and $800,000 for Parcel #2. In Year 2 Parcel #2 drops in value to $200,000, or an inherent loss of $600,000. In the event of a sale of Parcel #2 for $200,000, $300,000 of loss would be allocated to C and $150,000 of loss would be allocated each to A and B. In Year 2, the partnership distributes 75% of Parcel #1, with a fair market value and basis of $300,000, to C in liquidation of her interest. Under the liquidation rules, discussed in detail below, C's basis in 75% of Parcel #1 is $600,000, her entire outside basis. If the values do not change, C will recognize a $300,000 capital loss when she sells this parcel. As we discussed above, if a I.R.C. § 754 election were in effect, the partnership would reduce its basis in Parcel #2 by $300,000, the excess of C's basis in 75% of Parcel #1 over the basis the property had to the partnership. That would give the partnership a basis of $500,000 in Parcel #2. Assuming no value changes, the partnership would then recognize a $300,000 capital loss on the sale of Parcel #2 ($200,000 − $500,000), or $150,000 per remaining partner (i.e. A and B). But if an I.R.C. § 754 election were not in effect (and I.R.C. § 734(d) did not exist), there would be no basis adjustment, and the partnership will recognize a $600,000 loss on the sale of Parcel #2 ($200,000 − $800,000), effectively duplicating C's loss on the sale of 75% of Parcel #1. To prevent that outcome, I.R.C. § 734(d) requires the basis of Parcel #2 to be reduced by $300,000, notwithstanding the lack of a I.R.C. § 754 election, because if one had been in effect, the adjustment would have exceeded $250,000.

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233 *See* § 2.02E. The background of these provisions are discussed in § 13.04A.
234 Treas. Reg. § 1.337(d)-3(c)(3)(iii) & (iv).
235 Treas. Reg. § 1.337(d)-3(d)(3).

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Thus, going forward, the partnership has a basis in Parcel #2 of $500,000. But note that the I.R.C. § 734(d) adjustment does not trigger a I.R.C. § 754 election, as such. Thus, notwithstanding the I.R.C. § 734(d) adjustment, the partnership still has no I.R.C. § 754 election in effect going forward, and there will be no I.R.C. § 734 adjustments, except those mandated by I.R.C. § 734(d), until the election is made.

CHAPTER 8: TRANSACTIONS BETWEEN PARTNER AND PARTNERSHIP; ISSUANCE OF A PARTNERSHIP INTEREST FOR SERVICES

§ 8.06 DISGUISED SALES

SUBSTITUTE THE FOLLOWING FOR 8.06 A. 3.:

A. THE DISGUISED SALE OF ASSETS

3. Liabilities

Big picture: As discussed up to this point, an easy way to end-run I.R.C. § 707(a)(2)(B) would be for a partner to encumber a property with a liability shortly before contributing it to the partnership. The partner has cash in his pocket from the liability and can correctly claim that he has received no money from the partnership. The Regulations contain a complex set of rules to address this problem. One of the reasons the Regulations are so complex is that not all liabilities are created equal. Some liabilities, for example a liability to acquire a property that puts no cash in the partner's pocket, are unobjectionable. As a consequence, the Regulations divide the world into "qualified liabilities" and "nonqualified liabilities." Many, but not all, qualified liabilities will not trigger I.R.C. § 707(a)(2)(B). As we will discuss, some qualified liabilities can be tainted.

Partner's Share of Liability for Disguised Sale Purposes: A partner's share of a recourse liability of the partnership equals the partner's share of the liability under the rules of I.R.C. § 752 and the Regulations under I.R.C. § 752.[236] A partnership liability is a recourse liabilitiy to the extent that the obligtions is a recourse liability under Treas. Reg. § 1.752-1(a)(1) or would be treated as a recourse liability under that section if it were treated as a partnership liability for the purposes of that section.[237]

> **Example 1:** (i) C transfers property Y to a partnership. At the time of its transfer to the partnership, property Y has a fair market value of $10,000,000 and is subject to an $8,000,000 liability that C incurred, immediately before transferring property Y to the partnership, in order to finance other expenditures. Upon the transfer of property Y to the partnership, the partnership assumed the liability encumbering that property. The partnership assumed this liability solely to acquire property Y. Under I.R.C. § 752 and the Regulations thereunder, immediately after the partnership's assumption of the liability encumbering property Y, the liability is a recourse liability of the partnership and C's share of that liability is $7,000,000.
>
> (ii) Under the facts of this example, the liability encumbering property Y is not a qualified liability (discussed below). Accordingly, the partnership's assumption of the liability results in a transfer of consideration to C in connection with C's transfer of property Y to the

236 Treas. Reg. § 1.707-5(a)(2)(i). See § 3.04 for a discussion of those rules.
237 *Id.*

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> partnership in the amount of $1,000,000 (the excess of the liability assumed by the partnership ($8,000,000) over C's share of the liability immediately after the assumption ($7,000,000)).[238]

Recall that nonrecourse liabilities are, in general, shared for the purposes of I.R.C. § 752 under a three-part stacking rule.[239] For the purposes of the disguised sale rule, a partner's share of nonrecourse liabilities is determined by applying the same percentage that was used in the third tier. "Tier 3" of that rule addresses "excess nonrecourse liabilities," i.e., liabilities not covered by the first two parts. Excess nonrecourse liabilities (liabilities subject to Tier 3) are generally shared based on partnership profits, though there are also other options. (See § 3.04D.)

> **Example 2:** (i) A and B form partnership AB, which will engage in renting office space. A transfers $500,000 in cash to the partnership, and B transfers an office building to the partnership. At the time it is transferred to the partnership, the office building has a fair market value of $1,000,000, has an adjusted basis of $400,000, and is encumbered by a $500,000 nonrecourse liability, which B incurred 12 months earlier to finance the acquisition of other property and which the partnership assumed. No facts rebut the presumption that the liability was incurred in anticipation of the transfer of the property to the partnership. Assume that this liability is a nonrecourse liability of the partnership within the meaning of I.R.C. § 752 and the Regulations thereunder. The partnership agreement provides that partnership items will be allocated equally between A and B, including excess nonrecourse liabilities under Treas. Reg. § 1.752-3(a)(3). The partnership agreement complies with the requirements of Treas. Reg. § 1.704-1(b)(2)(ii)(b).
>
> (ii) The nonrecourse liability secured by the office building is not a qualified liability. B would be allocated 50% of the excess nonrecourse liability under the partnership agreement. Accordingly, immediately after the partnership's assumption of that liability, B's share of the liability is $250,000 (B's 50% share of the partnership's excess nonrecourse liability as determined in accordance with B's share of partnership profits under Treas. Reg. § 1.752-3(a)(3)).
>
> (iii) The partnership's assumption of the liability encumbering the office building is treated as a transfer of $250,000 of consideration to B (the amount by which the liability ($500,000) exceeds B's share of that liability immediately after the partnership's assumption of the liability ($250,000)). B is treated as having sold $250,000 of the fair market value of the office building to the partnership in exchange for the partnership's assumption of a $250,000 liability. This results in a gain of $150,000 ($250,000 minus ($250,000/$1,000,000 multiplied by $400,000)).[240]

For the purposes of the disguised sale rules, a partner's share of a liability, immediately after a partnership assumes or takes property subject to the liability, is determined taking into account a subsequent reduction in the partner's share if (i) at the time of the transfer, it is anticipated that the transferring partner's share of the liability will be subsequently reducted; (ii) the anticipated reduction is not subject to

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238 Treas. Reg. § 1.707-5(f) ex. 2.

239 "Tier 1" is a partner's share of minimum gain. Treas. Reg. § 1.752-3(a)(1). Tier 2 is a partner's share of I.R.C. § 704(c) gain from properties subject to nonrecourse debt. Treas. Reg. § 1.752-3(a)(2).

240 Treas. Reg. § 1.707-5(f) ex. 1.

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entrepreneurial risks of partnership operations; and (iii) the reduction is part of a plan that has as one of its principal purposes the reduction of the amount treated as a sale.[241]

Qualified Liabilities: A liability assumed or taken subject to by a partnership in connection with a transfer of property to the partnership by a partner is a "qualified liability" of the partner only to the extent the liability is:

(1) A liability that was incurred by the partner more than two years prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property throughout that two-year period;

(2) A liability that was not incurred in anticipation of the transfer of the property to a partnership, but that was incurred by the partner within the two-year period prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property since it was incurred (but see presumption below);

(3) A liability that is allocable under the rules of Temp. Reg. § 1.163-8T to capital expenditures with respect to the property (meaning that the liability proceeds were invested in the property);

(4) A liability that was incurred in the ordinary course of the trade or business in which property transferred to the partnership was used or held but only if all the assets related to that trade or business are transferred other than assets that are not material to a continuation of the trade or business (an example would be an account payable); or

(5) A liability that was not incurred in anticipation of the transfer of the property to a partnership, but that was incurred in connection with a trade or business in which property transferred to the partnership was used or held but only if all the assets related to that trade or business are transferred other than assets that are not material to a continuation of the trade or business.[242] (Note that unlike in 4, the liability need not be incurred in the ordinary course of a trade or business. An example would be a "one-off" liability, the proceeds of which were necessary for the operation of the business.).

Further, in any of the above cases, if the liability is a recourse liability, the amount of the liability may not exceed the fair market value of the transferred property (less the amount of any other liabilities that are senior in priority and that either encumber such property or are liabilities described in paragraphs 3 and 4 above) at the time of the transfer.[243]

Presumption: A liability incurred within two years of transfer is generally presumed to be in anticipation of the transfer (making it a nonqualified liability), unless the liability falls within paragraphs 3 and 4 above or unless the facts and circumstances clearly establish that the liability was not incurred in anticipation of the transfer.[244]

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241 Treas. Reg. § 1.707-5(a)(3).

242 Treas. Reg. § 1.707-5(a)(6). Liabilities covered by paragraphs 2 or 5 must be disclosed to the IRS. Treas. Reg. § 1.707-5(a)(7)(ii).

243 Treas. Reg. § 1.707-5(a)(6)(ii).

244 Treas. Reg. § 1.707-5(a)(7)(i).

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Example 3: F purchases property Z in 2012. In 2017, F transfers property Z to a partnership. At the time of its transfer to the partnership, property Z has a fair market value of $165,000 and an adjusted tax basis of $75,000. Also, at the time of the transfer, property Z is subject to a $75,000 nonrecourse liability that F incurred more than two years before transferring property Z to the partnership. The liability has been secured by property Z since it was incurred by F. Upon the transfer of property Z to the partnership, the partnership assumed the liability encumbering that property. The partnership made no other transfers to F in consideration for the transfer of property Z to the partnership. Assume that immediately after the partnership's assumption of the liability encumbering property Z, F's share of that liability for disguised sale purposes is $25,000. The $75,000 liability secured by property Z is a qualified liability. Therefore, since no other transfer to F was made as consideration for the transfer of property Z, the partnership's assumption of the qualified liability of F encumbering property Z is not treated as part of a sale. Thus, F is deemed to have contributed property Z to the partnership in F's capacity as a partner.

If a partner transfers property subject to a nonqualified liability to the partnership, but also transfers money to the partnership, it is only the liabilities in excess of the money transferred that normally will be part of a disguised sale. Consequently, the Regulations provide that if pursuant to a plan a partner pays or contributes money to the partnership and the partnership assumes or takes subject to one or more liabilities (other than qualified liabilities) of the partner, the amount of those liabilities that the partnership is treated as assuming or taking subject to is reduced by the money transferred.[245]

"Tainted" Qualified Liabilities: A special rule applies if a partner transfers property to the partnership subject to a qualified liability, but the partner also transfers property subect to a nonqualified liability and/or receives a distribution from the partnership that triggers the disguised sale rules. The (now somewhat tainted) qualified liability is treated as a transfer of consideration made pursuant to a a sale or the property to the partnership only to the extent of the lesser of (1) the amount of consideration that the partnership would treated as transferring to the partner if the liability were not a qualified liability; or (2) the amount obtained by multiplying the amount of the qualified liability by th epartner's net equity percentage with respect to that property.[246] A partner's net equity percentage with respect to an item of property equals the perntage determined by dividing (1) the aggregate transfers of money or other consideration to the partner by the partnership (other than any transfer at issue) that are treated as proceed realized from the sale of the transferred property; by (2) the excess of the fair market value of the property at the time it is transferred to the partnership over any qualified liability encumbering or properly allocable to the property.[247]

There is a complex *de minimis* exception to the tainted qualified liability rule: If in connection with a transfer of property by a partner to a partnership that is treated as a sale due solely to the partnership's assumption of or taking property subject to a nonqualified liability, the partnership's assumption of or taking property subject to a qualified liability is not treated as a transfer of consideration made pursuant to the sale if the total amount of all nonqualified liabilities that the partnership assumes or takes subject to is the lesser of

245 The amount of the liabilities so treated cannot be reduced below zero. Treas. Reg. §1.707-5(d).
246 Treas. Reg. § 1.707-5(a)(5)(i).
247 Treas. Reg. § 1.707-5(a)(5)(ii).

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10% of the total amount of all qualified liabilities the partnership assumes or takes subject to, or $1,000,000.[248]

> **Example 4:** The facts are the same as in Example 3, except that the partnership makes a transfer to F of $30,000 in money that is consideration for F's transfer of property Z to the partnership. As in Example 3, the $75,000 liability secured by property Z is a qualified liability of F. Since the partnership transferred $30,000 to F in addition to assuming the qualified liability, assuming no other exception to disguised sale treatment applies to the transfer of the $30,000, the partnership's assumption of this qualified liability is treated as a transfer of additional consideration to F to the extent of the lesser of (1) the amount that the partnership would be treated as transferring to F if the liability were not a qualified liability ($50,000 — that is, the excess of the $75,000 qualified liability over F's $25,000 share of that liability); or
>
> (2) the amount obtained by multiplying the qualified liability ($75,000) by F's net equity percentage with respect to property Z (which is one-third, or $25,000). F's net equity percentage with respect to property Z equals the fraction determined by dividing the aggregate amount of money or other consideration (other than the qualified liability) transferred to F and treated as part of a sale of property Z under Treas. Reg. § 1.707-3(a) ($30,000 transfer of money); by (2) F's net equity in property Z ($90,000 (that is, the excess of the $165,000 fair market value over the $75,000 qualified liability)). Accordingly, the partnership's assumption of the qualified liability of F encumbering property Z is treated as a transfer of $25,000 (one-third of $75,000) of consideration to F pursuant to a sale. Therefore, F is treated as having sold $55,000 of the fair market value of property Z to the partnership in exchange for $30,000 in money and the partnership's assumption of $25,000 of the qualified liability. $55,000 is one-third of the fair market value of property Z. As discussed in § 8.06A.1, F is thus deemed to have sold one-third of the property to the partnership. One-third of F's basis in property Z is $25,000. Accordingly, F must recognize $30,000 of gain on the sale (the excess of the $55,000 amount realized over $25,000).

Liability Incurred by Partnership: Of course, instead of the partner borrowing the money, the partnership could borrow the money and give it to the partner. The disguised sale rules should still be able to apply. Consequently, the Regulations provide that if a partner transfers property to a partnership and the partnership incurs a liability that is allocable in whole or in part to a transfer of money or other consideration to the partner within 90 days of the partnership incurring the liability, the transfer of money or other consideration to the partner is taken into consideration under the disguised sale rules, but only to the extent that the money or other consideration exceeds the partner's allocable share of the partnership liability.[249] This is sometimes called the "debt-financed distribution exception," since a partner can avoid disguised sale treatment to the extent he is allocated a share of the parnership liability.

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[248] Treas. Reg. § 1.707-5(a)(5)(iii).

[249] Treas. Reg. § 1.707-5(b)(1) and (2). Rules similar to those set forth in Treas. Reg. § 1.707-3 apply in determining whether a transfer of property by a partnership to a partner and one or more transfers of money or other consideration by that partner to the partnership are treated as a sale of property, in whole or part, to the partner. Treas. Reg. § 1.707-6. The allocation of the liability to the transfer to the partner occurs under the rules of Temp. Reg. § 1.163-8T. Treas. Reg. § 1.707-5(b)(1).

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Example 5: K transfers property Z to partnership KL in exchange for a 50% interest in the partnership on April 9, 2017. On September 13, 2017, the partnership incurs a nonrecourse liability of $20,000. (Note that there is no limit, as such, on the time between when the partner contributed the property to the partnership and when the partnership incurred the liability.) On November 17, 2017, the partnership transfers $20,000 to K, and $10,000 of this transfer is determined to be allocable to proceeds of the partnership liability. The remaining $10,000 is paid from other partnership funds. Assume that on November 17, 2017, for disguised sale purposes, K's share of the $20,000 liability is $10,000. Because a portion of the transfer made to K is allocable to proceeds of a partnership liability that was incurred by the partnership within 90 days of that transfer, K is required to take the transfer into account in applying the disguised sale rules, but only to the extent that the amount of the transfer exceeds K's allocable share of the liability used to fund the transfer. K's allocable share of the $20,000 liability used to fund $10,000 of the transfer to K is $5,000 (K's share of the liability ($10,000) multiplied by the fraction obtained by dividing (1) the amount of the liability that is allocable to the distribution to K ($10,000) by (2) the total amount of such liability ($20,000)). Therefore, K is required to take into account $15,000 of the $20,000 partnership transfer to K for disguised sale purposes ($5,000 attributable to the partnership liability plus $10,000 that came from other partnership funds). Under these facts, assuming no other exception applies and the within-two-year presumption is not rebutted, this $15,000 transfer will be treated as part of a sale by K of property Z to the partnership.[250]

Ordering Rules: The debt-financed distribution exception applies before the exceptions for preferred returns, guaranteed payments, operating cash flow distributions, and preformation expenditures.[251]

Anti-Abuse Rules: Treas. Reg. § 1.707-5 contains a number of anti-abuse provisions. We will not burden you with them, but know that it is not easy to end-run these Regulations.[252]

§ 8.07 LIMITATIONS ON RECOGNITION OF LOSSES AND RECHARACTERIZATION OF GAINS IN RELATED PARTY TRANSACTIONS

Add after the last paragraph on page 310:

Although it is arguably not clear from the statute itself, the legislative history to Tax Reform Act of 1986 indicates that it was the intent of Congress to limit the application of the deferral rules of I.R.C. § 267(a)(2) to two partnerships in which the same persons hold a more than 50% interest in capital or profits.[253] In addition, the legislation history indicates that the provisions of I.R.C. § 707 were intended to replace the existing Regulations relating to transactions between related partnerships with common partners.[254]

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250 *See* Treas. Reg. § 1.707-5(f) Ex. 10.

251 Treas. Reg. § 1.707-5(b)(3).

252 *See, e.g.*, Treas. Reg. § 1.707-5(a)(3); Treas. Reg. § 1.707-5(f) Ex. 3.

253 S.Rep. 99-313, Report of the Committee on Finance United States Senate to Accomany H.R. 3838, 99th Cong. 2d Sess. 960 (May 29, 1986); H. Rep. 99-426 Report of the Committee on Ways and Means House of Representatives on H.R. 3838, 99th Cong. 1st Sess. 940 (Dec. 7, 1985).

254 *Id.*

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Although the legislative history appears clear, the Regulations have remainded outstanding and have been cited by the IRS Chief Counsel's office.[255] This leaves taxpayers in an ambiguous situation.

§ 8.08D HOLDING PERIOD FOR PARTNERSHIP INTERESTS ISSUED FOR SERVICES

A. GENERAL RULE

For many years, there have been complaints about managers of private equity funds unfairly paying low rates of taxes on income from services they provide to the fund. It is common to give the managers a 20% profits interest, in this context commonly called a "carried interest." The income of the fund tends to be long term capital gains and dividends, both of which typically are taxed at a rate of 20% to the managers under I.R.C. § 1(h), rather than the 37% rate that typically would apply if they earned ordinary income.[256] In general, new I.R.C. § 1061 requires a three-year holding period to qualify for long-term capital gain with respect to any applicable partnership interest held by the taxpayer.[257] For the purposes of determining the taxpayer's holding period, the rules of I.R.C. § 83 do not apply, including the election under I.R.C. § 83(b).[258]

Holding periods have generally been discussed before in Chapter 2 and 4. It is worthy of repetition, that the partners' holding period in the partner's partnership interest may be different from the partnership's holding period for its assets.[259] The statute itself appears to refer to the "taxpayer's" holding period.[260] However, other parts of the statute appear to look-through to the holding period of the partnership assets.[261]

B. SHORT-TERM CAPITAL GAIN

I.R.C. § 1061(a) treats as short-term capital gain the amount of the taxpayer's net long-term capital gain with respect to an applicable partnership interest for the taxable year that exceeds the amount (if any) that would be long-term capital gain if a three-year (instead of a one-year) holding period applied for the purposes of determining long term gain or loss.[262] Recall that short-term capital gains are commonly taxed at ordinary income rates.

The Proposed Regulations determine the amount to be recharacterized through a series of layered calculations. The amount recharacterized is the excess of the owner taxpayer's one year gain less the owner taxpayer's three-year gain.[263] The owner taxpayer's one-year gain is the sum of (i) the owner taxpayer's combined net one-year distributive share amount from all applicable partnership interests and (ii) the owner taxpayer's one-year disposition amount.[264] As you might expect, an owner taxpayer's three-year gain has the same definition, substituting "three-year" for "one-year."[265]

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255 *See* CCA 200617036 (Apr. 28, 2006).
256 *See* Walter Schwidetzky, Carried Interests Under the TCJA: Progress or Regress?, 160 Tax Notes 1673 (2018).
257 I.R.C. § 1061(a).
258 *Id.*
259 *See, e.g.,* Rev. Rul. 68-79, 1968-1 C.B. 310.
260 I.R.C. § 1061(a)(2). The reference to the determination of the taxpayer's gain is under I.R.C. § 1222 rather than I.R.C. 704(b).
261 I.R.C. § 1061(d)(1)(A).
262 *Id.*
263 Treas. Reg. § 1.1061-4(a)(1).
264 Treas. Reg. § 1.1061-4(a)(2)(i).
265 Treas. Reg. § 1.1061-4(a)(2)(ii).

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As was probably apparent from the use of the phrase "distributive share" in both definitions, the recharacterization applies to gain recognized at the partnership level in respect of property held by the partnership for less than three years. The recharacterization also applies to gain recognized by a partner in respect of a partnership interest held for less than three years.

Certain amounts that otherwise be included in the calculation are excluded by Proposed Regulations. Long-term capital gain and loss determined under I.R.C. § 1231 (relating to property used in a trade or business) are excluded.[266] Long-term capital gain and loss determined under I.R.C. § 1256 (relating to certain property required to be marked to market on an annual basis) are excluded.[267] Qualified dividends included in net capital gains for the purposes of I.R.C. § 1(h)(11)(B) are excluded.[268] In addition, capital gains and losses that are characterized as long-term or short-term without regard to the holding period rules in I.R.C. § 1222 (such gains under the mixed straddle rules) are excluded.[269]

C. Applicable Partnership Interest

An applicable partnership interest is any interest in a partnership that, directly or indirectly, is transferred to (or held by) the taxpayer in connection with performance of services in any applicable trade or business (defined below).[270] For the purposes of I.R.C. § 1061, an applicable partnership interest includes any financial instrument or contract, the value of which is determined in whole or in part by reference to the partnership (including the amount of partnership distributions, the value of partnership assets or the results of partnership operations).[271] The services may be performed by the taxpayer or by any other related person or persons in any applicable trade or business. The legislative history indicates that is intended that partnership interests shall not fail to be treated as transferred or held in connection with the performance of services merely because the taxpayer also made contributions to the partnership.[272] An applicable partnership interest does not include an interest held by a person who is employed by another entity that is conducting a trade or business (which is not an applicable trade or business) and who provides services only to the other entity.[273] An example might be an interest in the partnership held by a lawyer whose law firm is providing services to the partnership.

An applicable partnership interest does not include an interest in a partnership directly or indirectly held by a "corporation."[274] Unfortunately, this only includes "C corporations" not "S corporations."[275] For example, if two C corporations form a partnership to conduct a joint venture for developing and marketing a pharmaceutical product, the partnership interests held by the two corporations are not applicable partnership interests.

An applicable partnership interest does not include any capital interest in a partnership giving the taxpayer a right to share in partnership capital commensurate with either (i) the amount of capital contributed

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266 Treas. Reg. § 1.1061-4(b)(7)(i).
267 Treas. Reg. § 1.1061-4(b)(7)(ii).
268 Treas. Reg. § 1.1061-4(b)(7)(iii).
269 Treas. Reg. § 1.1061-4(b)(7)(iv).
270 I.R.C. § 1061(c)(1).
271 Treas. Reg. § 1.1061-1(a)
272 Conference Report to Accompany H.R. 1, 115 Cong. 1st Sess., Rep. 115-466, p. 420 (Dec. 15, 2017).
273 I.R.C. § 1061(c)(1).
274 I.R.C. § 1061(c)(4)(A).
275 Notice 2018-8, 2018-2 I.R.B. 443.

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by the taxpayer (as of the time the partnership interest was received), or (ii) the value of the partnership interest that is taxed to the taxpayer under I.R.C. § 83 on receipt or vesting of the partnership interest.[276]

For example, if Elinore contributes 10% of the total capital to a partnership in exchange for a 10% capital interest in the partnership (as of the time the partnership interest was received), Elinore's partnership interest is not an applicable partnership interest to that extent.[277] If Elinore additionally receives a profits interest for services, the profits interest could be an applicable partnership interest.

D. APPLICABLE TRADE OR BUSINESS

An applicable trade or business means any activity conducted on a regular, continuous, and substantial basis that consists, in whole or in part, of: (1) raising or returning capital, *and either* (2) investing in (or disposing of) specified assets (or identifying specified assets for investing or disposition), or (3) developing specified assets.[278]

The legislative history indicates that developing specified assets takes place, for example, if it is represented to investors, lenders, regulators, or others that the value, price, or yield of a portfolio business may be enhanced or increased in connection with choices or actions of a service provider or of others acting in concert with or at the direction of a service provider.[279]

E. SPECIFIED ASSETS

"Specified assets" means securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any of the foregoing, as well as an interest in another partnership to the extent of the partnership's proportionate interest in the foregoing.[280]

A partnership interest in another partnership is treated as a specified asset even if the partnership interest is not otherwise treated as a security for purposes of I.R.C. § 1061.[281] For example, assume that a private equity fund acquires an interest in an operating business conducted in the form of a non-publicly traded partnership that is not widely held; the partnership interest is a specified asset for purposes of the provision.[282]

I.R.C. § 1061 can yield results that some would find surprising. For example, if Wolfgang receives an interest in a partnership solely in exchange for raising funds for and supervising the construction of an apartment building for the partnership, Wolfgang holds an applicable partnership interest.

F. CAPITAL INTEREST DISPOSITION AMOUNT

In the case of a disposition of a portion of a Passthrough Interest, Revenue Ruling 84–53[283] applies and basis must be equitably apportioned between the portion of the interest disposed of and the portion

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276 I.R.C. § 1061(c)(4)(B).

277 Conference Report to Accompany H.R. 1, 115 Cong. 1st Sess., Rep. 115-466, p. 420 (Dec. 15, 2017).

278 I.R.C. § 1061(c)(2).

279 Conference Report to Accompany H.R. 1, 115 Cong. 1st Sess., Rep. 115-466, p. 421 (Dec. 15, 2017).

280 I.R.C. § 1061(c)(3).

281 Conference Report to Accompany H.R. 1, 115 Cong. 1st Sess., Rep. 115-466, p. 421 (Dec. 15, 2017).

282 Conference Report to Accompany H.R. 1, 115 Cong. 1st Sess., Rep. 115-466, p. 421-22 (Dec. 15, 2017).

283 1984–1 C.B. 159. Rev. Rul. 84-53 rules that when only part of a taxpayer's interest in the partnership is sold the basis must be allocated between the piece sold and the piece retained based on their relative fair market values.

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retained. The Regulations contain amendments to Treas. Reg. § 1.1223–3 for determining a divided holding period when a partnership interest includes an API and/or a profits interest.

Treas. Reg. § 1.1223–3(a) provides that a partnership has a divided holding period if portions of the interest are acquired at different times or the partner acquired portions of the partnership interest in exchange for property transferred at the same time but resulting in different holding periods. The general rule in Treas. Reg. § 1.1223–3(b)(1) is that the portion of the interest to which the holding period relates is determined by reference to a fraction, the numerator of which is the fair market value of the portion of the partnership interest received in the transaction to which the holding period relates, and the denominator of which is the fair market value of the entire partnership interest determined immediately after the acquisition transaction. In the case of the portion of a partnership interest that is comprised in part by one or more APIs or profits interests, the Proposed Regulations modify the timing of this determination as to that portion to the time immediately before the disposition (as compared to the acquisition) of all or a part of the interest.[284] The holding period of the portion of the interest that does not include the profits interest continues to be determined under Treas. Reg. § 1.1223–3(b)(1).

The Proposed Regulations provide that the amount of long-term capital gain or loss recognized on a disposition that is treated as a capital interest disposition amount is determined in a multi-step process.[285] Amounts that are treated as ordinary income under I.R.C. § 751(a) or (b) as a result of the disposition are excluded from all steps of the calculation. The computation then proceeds as follows. First, the amount of gain or loss that would be allocated to the partnership interest (or the portion of the partnership interest sold) if all of the assets of the partnership were sold for their fair market value in a fully taxable transaction (deemed liquidation) immediately before the disposition is determined (Step One).[286] Second, the amount of gain or loss from the deemed liquidation that is allocable to the partnership interest as a result of capital interest allocations, and passthrough interest capital allocations is determined (Step Two).[287] Third, if the transferor recognized long-term capital gain upon disposition of the interest and only net short-term capital losses, net long-term capital losses, or both, are allocated to the interest from the hypothetical asset sale, all of the long-term capital gain is API Gain. If the transferor recognized long-term capital loss on the disposition of the interest and only net short-term capital gains, net long-term capital gains, or both, are allocated to the interest, then all the long-term capital loss is API Loss.[288]

CHAPTER 10: PARTNERSHIP OPTIONS

§ 10.03 Scope of the Regulations on Noncompensatory Options

The Regulations have now been finalized.

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284 Prop. Reg. § 1.1223-3(b)(5)(i).

285 Treas. Reg. § 1.1061-3(c)(4).

286 Treas. Reg. § 1.1061-3(c)(4)(ii)(A).

287 Treas. Reg. § 1.1061-3(c)(4)(ii)(B).

288. Treas. Reg. § 1.1061-3(c)(4)(ii)(C).

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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 PARTNERSHIPS

Substitute the following for the first three paragraphs of § 12.02B:

1. Generally

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 from double taxation. 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. 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. 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.[289]

Although partnerships cannot benefit directly from the foreign tax credit, the Regulations provide that a U.S. citizen, a resident alien, or a domestic corporation may claim a share of a partnership's taxes that are attributable to such person.[290] In addition, under I.R.C. § 703(b)(3), the election under I.R.C. § 901 (whether to take a credit in respect of the foreign taxes) is made by each partner separately. In Rev. Rul. 71-141,[291] the IRS held that two domestic corporations are entitled to a foreign tax credit on foreign taxes withheld on payments to a partnership with they jointly owned.

Regulations contain separate rules for allocating foreign tax credits and the expenses related to the income associated with the taxes.[292] If a domestic corporation owns an interest in a CFC through a domestic partnership, to the extent the domestic corporation is a United States shareholder with respect to the CFC, the Regulations provide that the domestic corporation is deemed to have paid foreign income taxes as if the domestic corporation had included the income from the CFC directly rather than as a distributive share of the partnership's income.[293] A domestic corporation that has a distributive share of a domestic partnership's subpart F inclusion and is also a United States shareholder with respect to the CFC that gives rise to a subpart F inclusion is treated as a subpart F inclusion of the domestic corporation for purposes of I.R.C. § 960(a).[294]

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289 I.R.C. § 960. 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. I.R.C. § 957. Controlled foreign corporations are sometimes referred to as "*CFCs*."

290 Treas. Reg. § 1.901-1(a). See discussion at 5.04 M.

291 1971-1 C.B. 211.

292 Treas. Reg. § 1.861-8(e)(6); Prop. Reg. § 1.861-8(e)(6); Prop. Reg. § 1.960-3.

293 Treas. Reg. § 1.960-2.

294 Treas. Reg. § 1.960-2(b)(4).

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Similarly, the domestic corporation's distributive share of a domestic partnership's receipt of previously taxed income is treated as a receipt by the domestic corporation directly for purposes of the tax credit rules.[295]

2. Foreign Tax Credit Splitter Transactions

The second and third sentences of the second paragraph are deleted.

C. U.S. PARTICIPATION EXEMPTION

Although historically the foreign tax credit has been the primary method under the U.S. system for avoiding double taxation in international transactions and structures, the TCJA added a participation exemption to the Code, which may be of increasing importance in the future. Participation exemptions have been used in a number of countries to create or support a territorial or quasi-territorial system. Although prior to the TCJA there was a great deal of discussion of the United States moving to a territorial system, the final approach of the TCJA was to layer the participation exemption on top the existing U.S. worldwide system.

The participation exemption comes in the form of a deduction for dividends paid from non-U.S. corporations. Under the provision, a U.S. corporation that is a U.S. shareholder of a 10% owned non-U.S. corporation (other than a passive foreign investment company) may now take a deduction for the non-US source portion of any dividend received from the 10% owned non-U.S. corporation.[296] A U.S. shareholder is a U.S. person that owns 10% or more of the vote or value of all classes of stock of the non-U.S. corporation after the application of certain attribution rules.[297] The non-U.S.-source portion of the dividends are dividends other than dividends attributable to a US trade or business or dividends received from an 80% owned U.S. corporation.[298] The non-US portion of the dividend is equal to the ratio of the undistributed non-U.S. earnings of the non-U.S. corporation compared to the non-U.S. corporation's entire undistributed earnings multiplied by the amount of the dividend.[299]

For some purposes with regard to the participation exemption, if an I.R.C. § 245A shareholder or a U.S. tax resident is a direct or indirect partner in a domestic partnership that is a United States shareholder with respect to a CFC and includes in gross income its pro rata share of the CFC's subpart F income under I.R.C. § 951(a), then, solely for purposes of I.R.C. § 245A, a reference to the I.R.C. § 245A shareholder's or U.S. tax resident's pro rata share of the CFC's subpart F income included in gross income under I.R.C. § 951(a) includes such person's distributive share of the domestic partnership's pro rata share of the CFC's subpart F income.[300] A person is an indirect partner with respect to a domestic partnership if the person indirectly owns the domestic partnership through one or more specified entities (other than a foreign corporation).

However, the Treasury has expressed concern that partnerships may be used to avoid the purposes of the Regulations and indicated that further guidance will be provided on the application of I.R.C. § 245A to partnerships.

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295 *See* Treas. Reg. § 1.960-3(b)(5).

296 I.R.C. § 245A(a). A deduction for the U.S. source portion is separately available. I.R.C. § 245.

297 I.R.C. § 951(b): Conference Report to Accompany H.R. 1, 115 Cong. 1st Sess., Rep. 115-466, p. 597 (15 Dec. 2017).

298 I.R.C. § 245A(c).

299 I.R.C. § 245A(c)(3).

300 Treas. Reg. § 1.245A-5T(g)(6).

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D. CONTROLLED FOREIGN CORPORATIONS AS PARTNERS IN FOREIGN PARTNERSHIPS

The first full sentence at the top of page 393 is replaced with the following:

A "U.S. shareholder" for these purposes is a shareholder that owns or is considered as owning 10% or more of the total combined voting power of all classes of stock of the relevant foreign corporation or 10% or more of the total value of shares of all classes of stock of such foreign corporation. Current Regulations would treat a U.S. partnership as an owner and, potentially, a 10% shareholder, so a partner in a U.S. partnership could potentially be required to include income from the CFC even thought the partner's indirect interest was very small.[301] Non-U.S. partnership, on the other hand, are given aggregate treatment.[302] In other words, a partner that only held 5% of a CFC (directly and indirectly) would not have income inclusions. Proposed Regulations would also apply aggregate treatment to U.S. partnerships, but not for the purposes of determining whether a person was a U.S. shareholder or whether the corporation was a CFC.[303]

Insert before the text accompanying footnote 35:

The global intangible low-taxed income (GILTI) tax adds another layer of world-wide taxation to the U.S. system to provide a minimum tax for types of income that may have escaped Subpart F.

Under I.R.C. § 951A, a U.S. shareholder of any CFC must include in gross income for a taxable year its GILTI in a manner generally similar to inclusions of Subpart F income. GILTI means the excess (if any) of the shareholder's net CFC tested income over the shareholder's net deemed tangible income return.[304]

Net CFC tested income means, with respect to any U.S. shareholder, the excess of the aggregate of the shareholder's pro rata share of the tested income of each CFC with respect to which it is a U.S. shareholder over the aggregate of its pro rata share of the tested loss of each CFC with respect to which it is a U.S. shareholder.[305] Pro rata shares are determined under the rules of I.R.C. § 951(a)(2).[306]

The tested income of a CFC means the excess (if any) of the gross income of a corporation—determined subject to certain exclusions—over deductions (including taxes) properly allocable to such gross income.[307] The exclusions to tested income are: (1) the corporation's ECI under I.R.C. § 952(b); (2) any gross income taken into account in determining the corporation's subpart F income; (3) any gross income excluded from foreign base company income or insurance income by reason of the high-tax exception under I.R.C. § 954(b)(4); (4) any dividend received from a related person (as defined in I.R.C. § 954(d)(3)); and (5) any foreign oil and gas extraction income (as defined in I.R.C. § 907(c)(1)).[308]

The shareholder's net deemed tangible income return is an amount equal to 10% of the aggregate of the shareholder's pro rata share of the qualified business asset investment ("QBAI") of each CFC with respect to which it is a U.S. shareholder. QBAI means, with respect to any CFC for a taxable year, the average of the aggregate of its adjusted bases, determined as of the close of each quarter of the taxable year, in specified tangible property used in its trade or business and of a type with respect to which a deduction is generally

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301 Treas. Reg. § 1.951-1(g). A U.S. partnership is a U.S. person. I.R.C. § 7701(a)(30).
302 Treas. Reg. § 1.958-1(b).
303 Prop. Reg. § 1.958-1(d).
304 I.R.C. § 951A(b)(1).
305 I.R.C. § 951A(c).
306 I.R.C. § 951A(e)(1).
307 I.R.C. § 951A(c)(2)(A).
308 I.R.C. § 951A(c)(2)(A)(i).

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allowable under I.R.C. § 167.[309] Specified tangible property means any property used in the production of tested income.[310] If such property was used in the production of both tested income and income that is not tested income (i.e., dual-use property), the property is treated as specified tangible property in the same proportion that the amount of tested gross income produced with respect to the property bears to the total amount of gross income produced with respect to the property.[311]

I.R.C. § 951A(d)(3)1 (the "partnership QBAI paragraph") states that if a CFC holds an interest in a partnership at the close of the CFC's taxable year, the CFC takes into account under I.R.C. § 951A(d)(1) its "distributive share of the aggregate of the partnership's adjusted bases (determined as of such date in the hands of the partnership)" in specified tangible property in computing its QBAI. The partnership QBAI paragraph further provides that a CFC's "distributive share of the adjusted basis of any property shall be the controlled foreign corporation's distributive share of income with respect to such property."

Add to footnote 35:

The Regulations allow a reduction of the I.R.C. § 956 inclusion to the extent that a recipient would have been allow a dividends received deduction from foreign income had the earnings actually been distributed. Treas. Reg. § 1.956-1(a)(2). Regulations would also deny a foreign tax credit for an I.R.C. § 956 inclusion. Treas. Reg. § 1.960-2(b)(1).

G. TRANSFERS TO PARTNERSHIPS WITH RELATED FOREIGN PARTNERS

1. General Rules

In Chapter 2 we discussed the general rule under I.R.C. § 721(a) that a transfer to partnership in exchange for a partnership interest does not result in gain or loss to the partnership or the contributing partner. Treas. Reg. § 1.721(c)–2 provides a rule that overrides I.R.C. § 721(a) nonrecognition of gain upon a contribution of I.R.C. § 721(c) property to a partnership. In general, I.R.C. § 721(c) property is property with built-in gain that is contributed to a partnership by a U.S. transferor.[312] Cash equivalents, securities, tangible property with a book value that exceeds the adjusted tax basis by no more than $20,000, and an interest in a partnership in which 90% or more of the property (measured by value) held by the partnership (directly or indirectly) is excluded from the meaning of "I.R.C. § 721(c) property".[313]

Except as allowed under the gain deferral method, described below, Treas. Reg. § 1.721(c)–2(b) provides that nonrecognition under I.R.C. § 721(a) will not apply to gain realized upon a contribution of I.R.C. § 721(c) property to an I.R.C. § 721(c) partnership. An I.R.C. § 721(c) partnership is any U.S. or non-U.S. partnership if there is a contribution of I.R.C. § 721(c) property to the partnership and after the contribution and all transactions related to the contribution, (a) a non-U.S. person related to the U.S. transferor is a direct or indirect partner in the partnership and (b) the U.S. transferor and related persons own 80% or more of the interests in partnership capital, profits, deductions, or losses.[314] Nonrecognition under I.R.C. § 721(a) continues to apply to a direct contribution of I.R.C. § 721(c) property by an ''unrelated'' U.S. transferor (in other words, a U.S. transferor that does not, together with related persons with respect to it, satisfy the ownership requirement).

309 I.R.C. § 951A(d)(1).
310 I.R.C. § 951A(d)(2)(A).
311 I.R.C. § 951A(d)(2)(B).
312 Treas. Reg. § 1.721(c)-1(a)(15).
313 Treas. Reg. § 1.721(c)-1(a)(6).
314 Treas. Reg. § 1.721(c)-1(a)(14).

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Treas. Reg. § 1.721(c)–2(c) provides a de minimis exception to the general rule. Under the de minimis exception in the Temporary Regulations, contributions of I.R.C. § 721(c) property will not be subject to immediate gain recognition if the sum of all built-in gain for all I.R.C. § 721(c) property contributed to an I.R.C. § 721(c) partnership during the partnership's taxable year does not exceed $1 million.

Treas. Reg. § 1.721(c)–2(d)(1) provides a look-through rule for identifying an I.R.C. § 721(c) partnership when an upper-tier partnership in which a U.S. transferor is a direct or indirect partner contributes property to a lower-tier partnership. For purposes of determining if the lower-tier partnership is an I.R.C. § 721(c) partnership, the U.S. transferor will be treated as contributing to the lower-tier partnership its share of the property actually contributed by the upper-tier partnership to the lower-tier partnership. If the lower-tier partnership is an I.R.C. § 721(c) partnership, absent application of the gain deferral method by the lower-tier partnership to the entire property and by the upper-tier partnership to the partnership interest in the lower-tier partnership, the uppertier partnership will recognize the entire built-in gain in the I.R.C. § 721(c) property under the general gain recognition rule, because the entire property will be I.R.C. § 721(c) property.

2. Gain Deferral Method

Treas. Reg. § 1.721(c)–3 describes the gain deferral method, which generally must be applied in order to avoid the immediate recognition of gain upon a contribution of I.R.C. § 721(c) property to an I.R.C. § 721(c) partnership. There are five general requirements under Treas. Reg. § 1.721(c)–3(b) for applying the gain deferral method to an item of I.R.C. § 721(c) property. First, either (i) the I.R.C. § 721(c) partnership must adopt the remedial allocation method for the purposes of I.R.C. § 704(c) and allocate I.R.C. § 704(b) items of income, gain, loss, and deduction with respect to the I.R.C. § 721(c) property in a manner that satisfies the consistent allocation method, described below or (ii) all distributive shares of income and gain with respect to the I.R.C. § 721(c) property is subject to taxation as income effectively connected with a U.S. trade or business. Second, the U.S. transferor must recognize gain equal to the remaining built-in gain with respect to the I.R.C. § 721(c) property upon an acceleration event, or an amount of gain equal to a portion of the remaining built-in gain upon a partial acceleration event or certain transfers to foreign corporations described in I.R.C. § 367. Third, certain procedural and reporting requirements are satisfied. Fourth, the U.S. transferor extends the period of limitations on assessment of tax. Fifth, the rules for tiered partnerships are also applied.

Treas. Reg. § 1.721(c)–3(c)(1) describes the consistent allocation method, which, like the gain deferral method, applies on a property-by-property basis. The consistent allocation method requires an I.R.C. § 721(c) partnership to allocate the same percentage of each book item of income, gain, deduction, and loss with respect to the I.R.C. § 721(c) property to the U.S. transferor.

3. Acceleration Events

Treas. Reg. § 1.721(c)–4 provides rules regarding acceleration events, which, like the gain deferral method, apply on a property-by-property basis. When an acceleration event occurs with respect to I.R.C. § 721(c) property, remaining built-in gain in the property must be recognized and the gain deferral method no longer applies. An acceleration event with respect to I.R.C. § 721(c) property is any event that either would reduce the amount of remaining built-in gain that a U.S. transferor would recognize under the gain deferral method if the event had not occurred or could defer the recognition of the remaining built-in gain.[315] An acceleration event includes a contribution of I.R.C. § 721(c) property to another partnership by an I.R.C. § 721(c) partnership and a contribution of an interest in an I.R.C. § 721(c) partnership to another partnership.

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315 Temp. Reg. § 1.721(c)-4T(b).

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§ 12.03 U.S. PARTNERSHIPS WITH FOREIGN PARTNERS

E. DISPOSITION OF INTERESTS IN U.S. PARTNERSHIP BY NON-U.S. PERSONS.

Add at the end of the section:

The Tax Court concluded in 2017 that Rev. Rul. 91-32 is invalid,[316] allowing a non-U.S. person to dispose of a partnership interest in a partnership that was engaged in a U.S. trade or business without the income on the disposition being treated as income effectively connected with a U.S. trade or business through an office in the United States. However, for dispositions of partnership interests after November 27, 2017, I.R.C. § 864(c)(8) would effectively frustrate the conclusion of *Grecian Magnesite*. In addition, the new provision requires withholding on the payments for the partnership interest for dispositions after December 31, 2017.

Under I.R.C. § 864(c)(8), gain or loss from the sale or exchange of a partnership interest is effectively connected with a U.S. trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. However, the amount of gain or loss on the transaction is limited to the gain or loss otherwise recognized under the Code.[317] The provision requires that any gain or loss from the hypothetical asset sale by the partnership be allocated to interests in the partnership in the same manner as nonseparately stated income and loss. This portion of the provision applies to dispositions of partnership interests after November 27, 2017.

As a result of I.R.C. § 864(c)(8), non-U.S. partners would be subject to a return filing requirement in the United States from the disposition of the partnership interest, and, potentially be subject to tax in the United States.[318] Treas. Reg. § 1.864(c)(8)-2(b) requires a partnership engaged in a U.S. trade or business to furnish a notifying transferor of the information necessary for the transferor to comply with the transferor's reporting requirements.

I.R.C. § 1446(f) also requires the transferee of a partnership interest to withhold 10% of the amount realized on the sale or exchange of a partnership interest unless the transferor certifies that the transferor is not a nonresident alien individual or foreign corporation. If the transferee fails to withhold the correct amount, the partnership is required to deduct and withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold. The statutory language indicates that the provision is effective for dispositions of partnership interests after December 31, 2017.

The IRS has indicated that it will defer application of I.R.C. § 1446(f) in respect of a disposition of an interest in a publicly traded partnership until January 1, 2022.[319] Under the Regulations, if a transfer of an interest in a publicly traded partnership is effected through a broker, then the broker rather than the transferee has the withholding obligation.[320]

Exceptions and modifications similar to those for non-publicly traded partnerships, discussed below.

As to non-publicly traded partnerships, the Regulations repeat the statutory exception for U.S. persons and provide five non-statutory exceptions. First, if the transferee receives a certification that the transferor is a U.S. person, no withholding is required (unless the transferee has actual knowledge that the

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316 Grecian Magnesite Mining v. Commissioner, 149 T.C. No. 3 (2017).

317 Treas. Reg. § 1.864(c)(8)-1(b)(2)(ii).

318 Treas. Reg. § 1.6012-1, -2.

319 Treas. Reg. § 1.1446(f)-4(f).

320 Treas. Reg. § 1.1446(f)-4(a)(1).

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certification is false).[321] Second, if the transferee receives a certification that no gain will be realized, no withholding is required (unless the transferee has actual knowledge that the certification is false).[322] However, a transferor may not provide the certificate if I.R.C. § 751 would cause the transferor to recognize ordinary income, even if the transferor recognizes an overall loss. Third, if the transferee receives a certificate that the transferor's share of income from the partnership for the three preceeding taxable years was comprised of less than $1 million of income effectively connected to a U.S. trade or business and less than 10% of the transferor's total distributive share of gross income, no withholding is required.[323] Fourth, if the transferee receives a certificate that if partnership sold all of its assets less than 10% of the gain would be was income effectively connected to a U.S. trade or business, no withholding is required.[324] Fifth, no withholding is required if the transferor realizes gain but is not required to recognize gain because the transfer is a non-recognition transaction.[325] If only a portion of the transaction is subject to a nonrecognition provision, an adjustment to the amount required to be withheld may be permitted.[326] Finally, the Regulations provide an exception to withholding when a transferor certifies that it is not subject to tax on any gain from the transfer pursuant to an income tax treaty in effect between the United States and another country.[327]

In determining the transferor's share of partnership liabilities (for the purposes of determining the amount realized on the transfer), a transferor may rely upon the most recent Form K-1 received by the transferor, if the partnership year for the Form K-1 was within 22 months of the transfer.[328] If a transferor's share of liabilities would cause the withholding obligation to exceed the cash or other consideration given in the transaction, a transferee may ignore the liabilities of the partnership in determining the amount to withhold, but this is not the general rule.[329]

F. BASE EROSION AND ANTI-ABUSE TAX

I.R.C. § 59A imposes a tax on certain corporate taxpayers in addition to any other regular tax liability the taxpayer may have. Liability for this additional tax is generally limited to those taxpayers with substantial gross receipts and is determined, in part, by the extent to which the taxpayer has made deductible payments to foreign related parties. Taxpayers potentially liable for this additional tax have three-year average gross receipts in excess of $500 million and a "base erosion percentage" exceeding a specified threshold. The base erosion percentage is generally determined by dividing "base erosion tax benefits" by the amount of deductions allowable to the taxpayer for the taxable year. The taxpayer's additional tax is computed by comparing the taxpayer's "modified taxable income" to the taxpayer's regular tax liability (as defined in I.R.C. § 26(b)) after the regular tax liability has been reduced by certain credits against tax. Modified taxable income is the taxpayer's regular taxable income increased by any base erosion tax benefit with respect to any ''base erosion payment'' and an adjustment for the taxpayer's NOL deduction, if any. The taxpayer has an additional tax liability equal to the difference between 10% of the taxpayer's modified taxable income and the taxpayer's regular tax liability after adjustment has been made to account for certain credits against the taxpayer's regular tax liability. The term 'base erosion payment' means any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer and with respect to which a deduction is allowable under the Code.[330]

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321 Treas. Reg. § 1.1446(f)-2(b)(2).
322 Treas. Reg. § 1.1446(f)-2(b)(3)(i).
323 Treas. Reg. § 1.1446(f)-2(b)(5)(i).
324 Treas. Reg. § 1.1446(f)-2(b)(4).
325 Treas. Reg. § 1.1446(f)-2(b)(6).
326 Treas. Reg § 1.1446(f)-2(c)(4).
327 Treas. Reg. § 1.1446(f)-2(b)(7)(i).
328 Treas. Reg. § 1.1446(f)-2(c)(2)(ii)(B).
329 Treas. Reg. § 1.1446(f)-2(c)(3).
330 I.R.C. § 59A(d)(1).

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Special rules apply in the case of banks and securities dealers. Special rules also apply in the case of the taxpayer's taxable year beginning in 2018 and for taxable years beginning after December 31, 2025.

A partnership is not an "applicable taxpayer" as defined in I.R.C. § 59A; only corporations can be applicable taxpayers. In general, a partnership also is not subject to the income tax. Instead, partners are liable for income tax only in their separate capacities. Each taxpayer that is a partner in a partnership takes into account separately the partner's distributive share of the partner's income or loss in determining its taxable income. Accordingly, an item of income is subject to federal income taxation based on the status of the partners, and not the partnership as an entity. Similarly, a partnership does not itself benefit from a deduction. Instead, the tax benefit from a deduction is taken by the taxpayer that is allocated the deduction under I.R.C. § 704. I.R.C. § 702(b) provides that the character of any item be taken into account as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership. I.R.C. § 702(b) acknowledges that differences in partner tax characteristics (for example, whether the partner is a corporation or an individual, or domestic or foreign) may result in differences in the tax consequences of items the partnership allocates to its partners.

The Regulations generally provide that partnerships are treated as an aggregate of the partners in determining whether payments to or payments from a partnership are base erosion payments.[331] Thus, when determining whether a corporate partner that is an applicable taxpayer has made a base erosion payment, amounts paid or accrued by a partnership are treated as paid by each partner to the extent an item of expense is allocated to the partner under I.R.C. § 704. Similarly, any amounts received by or accrued to a partnership are treated as received by each partner to the extent the item of income or gain is allocated to each partner under I.R.C. § 704. The rules and exceptions for base erosion payments and base erosion tax benefits then apply accordingly on an aggregate basis.

§ 12.08 FATCA

Add to footnote 158:

Proposed Regulations would eliminate the requirement to withhold on gross proceeds. REG-132881-17, 83 Fed. Reg. 64757 (Dec. 18, 2018).

Section 12.09 is renumbered as 12.10 and new 12.09 inserted as follows:

§ 12.09 HYBRID TRANSACTIONS AND HYBRID ENTITIES

I.R.C. § 267A denies a deduction for any disqualified related party amount paid or accrued pursuant to a hybrid transaction or by, or to, a hybrid entity. A disqualified related party amount is any interest or royalty paid or accrued to a related party to the extent that: (1) such amount is not included in the income of the related party under the tax law of the country of which such related party is a resident for tax purposes or is subject to tax,[332] or (2) such related party is allowed a deduction with respect to such amount under the tax law of such country.[333] A disqualified related party amount does not include any payment to the extent such payment is included in the gross income of a U.S. shareholder under I.R.C. § 951(a).[334] A related party for these purposes is determined under the rules of I.R.C. § 954(d)(3), except that such section applies with respect to the payor of the payment that is being tested as a potential hybrid transaction as opposed to the CFC otherwise referred to in such section.

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331 Treas. Reg. § 1.59A-7(b).
332 I.R.C. § 267A(b)(1)(A).
333 I.R.C. § 267A(b)(1)(B).
334 *See* discussion of controlled foreign corporations in § 12.02C.

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A disqualified related party does not include a partnership because a partnership generally is not liable to tax and therefore is not the person allowed a deduction. However, a partner of a partnership may be a disqualified related party. For example, in the case of a payment made by a partnership a partner of which is a domestic corporation, the domestic corporation is a disqualified party and its allocable share of the deduction for the payment is subject to disallowance under I.R.C. § 267A

A hybrid transaction is any transaction, series of transactions, agreement, or instruments, one or more payments with respect to which are treated as interest or royalties for U.S. federal income tax purposes and which are not so treated for purposes of the tax law of the non-U.S. country of which the recipient of such payment is resident for tax purposes or is subject to tax.[335] This could occur when the instrument itself is treated as debt for U.S. tax purposes but treated as equity for purposes of the jurisdiction in which the related party is tax resident.[336] It could also occur when the U.S. tax system deems payments to include interest, such as occurs with a notional principal contract with substantial non-periodic payments, but the jurisdiction in which the related party is tax resident treats the instrument according to its terms.[337]

A hybrid entity is any entity which is either: (1) treated as fiscally transparent for U.S. federal income tax purposes but not so treated for purposes of the tax law of the non-U.S. country of which the entity is resident for tax purposes or is subject to tax, or (2) treated as fiscally transparent for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or is subject to tax but not so treated for U.S. federal income tax purposes.[338]

I.R.C. § 267A further provides that the Treasury will issue guidance as may be necessary to carry out the purposes of the provision, including Regulations or other guidance providing rules for: (1) denying deductions for conduit arrangements that involve a hybrid transaction or a hybrid entity, (2) the application of this provision to branches or domestic entities, (3) applying I.R.C. § 267A to certain structured transactions, (4) denying a deduction claimed for interest or a royalty that is included in the recipient's income under a preferential tax regime of the country of residence of the recipient and has the effect of reducing the country's generally applicable statutory tax rate by at least 25%, (5) denying all of a deduction claimed for an interest or a royalty payment if such amount is subject to a participation exemption system or other system which provides for the exclusion or deduction of a substantial portion of such amount, (6) rules for determining the tax residence of a foreign entity if the foreign entity is otherwise considered a resident of more than one country or of no country, (7) exceptions to the general rule, and (8) requirements for record keeping and reporting.[339]

Although Regulations cover many of these issues, of particular relevance to the topic of this text is the treatment of hybrid entities. A reverse hybrid is an entity that is fiscally transparent for purposes of the tax law of the country in which it is established but not for purposes of the tax law of its owner.[340] An entity is treated as being fiscally transparent if under the laws of the entity's jurisdiction an interest holder's respective share of an item of income is required to be taken into account by an interest holder in the entity on a current basis without regard to whether the item is distributed.[341] Thus, payments to a reverse hybrid may result in a D/NI outcome because the reverse hybrid is not a tax resident of the country in which it is

[335] I.R.C. § 267A(c).

[336] *See, e.g.*, Hewlett-Packard Co. & Consolidated Subsidiaries v. Commissioner, T.C. 2012-135, aff'd, 120 AFTR 2d 2017-6542 (investment in the form of preferred stock recharacterized as debt).

[337] *See* Treas. Reg. § 1.446-3(f)(2)(iii)(B).

[338] I.R.C. § 267A(d).

[339] I.R.C. § 267A(e).

[340] Treas. Reg. § 1.267A-2(d)(1).

[341] Treas. Reg. § 1.894-1(d)(3)(ii).

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established, and the owner does not include the payment in income under its tax law.[342] Because this D/NI outcome may occur regardless of whether the establishment country is a non-U.S. country or the United States, the Proposed Regulations provide that both U.S. and non-U.S. entities may be reverse hybrids. A U.S. entity that is a reverse hybrid for this purpose differs from a "domestic reverse hybrid entity" under Treas. Reg. § 1.894-1(d)(2)(i), which defines domestic reverse hybrid entity as a US entity that is treated as not fiscally transparent for U.S. tax purposes and as fiscally transparent under the laws of an interest holder's jurisdiction. Thus, under the Proposed Regulations, a U.S. LLC that is treated as partnership or a disregarded entity for U.S. tax purposes, but treated as a corporation under laws of the jurisdiction of the owners. would be a U.S. reverse hybrid. In contrast, under Treas. Reg. § 1.894-1(d)(i), a U.S. limited partnership that has elected to be taxed as corporation would be a domestic reverse hybrid if it has non-U.S. owners. For an entity to be a reverse hybrid under the Proposed Regulations, two requirements must be satisfied. First, the entity must be fiscally transparent under the tax law of the country in which it is established, whether or not it is a tax resident of another country.[343] Second, the entity must not be fiscally transparent under the tax law of an "investor."[344] An investor means a tax resident or taxable branch that directly or indirectly owns an interest in the entity. If an investor views the entity as not fiscally transparent, the investor generally will not be currently taxed under its tax law on payments to the entity.

When a specified payment is made to a reverse hybrid, it is generally a disqualified hybrid amount to the extent that an investor does not include the payment in income.[345] For this purpose, whether an investor includes the specified payment in income is determined without regard to a distribution or a right to a subsequent distribution by the reverse hybrid.[346]

CHAPTER 13: ANTI-ABUSE PROVISIONS

§ 13.04 MIXING BOWL TRANSACTIONS

A. INTRODUCTION

Substitute the following for the next-to-last paragraph:

Upon hearing of the May Company transaction, the IRS promptly issued a notice under its corporate taxation regulatory authority, stating that in the future such transactions would be treated for tax purposes in the same manner they were treated for financial accounting purposes.[347] That was followed with proposed, final and temporary Regulations to the same effect.[348] Finally, in 2018 the Treasury and the IRS released final Regulations that addressed the May Company transaction.[349] Proposed Regulations were again issued in 2019.[350] Under the Regulations, an "I.R.C. § 337(d) transaction" may occur if (i) a corporate partner contributes appreciated property to a partnership that owns stock of the corporate partner; (ii) a partnership acquires stock of the corporate partner, (iii) a partnership that owns stock of a corporate partner distributes appreciated property to a partner other than the corporate partner, (iv) a partnership distributes stock of a corporate partner to the corporate partner, or (v) a

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342 Treas. Reg. § 1.267A-2(d)(1).
343 Treas. Reg. § 1.267A-2(d)(2).
344 Treas. Reg. § 1.267A-2(d)(2).
345 Treas. Reg. § 1.267A-2(d)(1).
346 Treas. Reg. § 1.267A-3(a)(3).
347 1989-1 C.B. 679, Notice 89-37.
348 *See* Prop. Reg. § 1.337(d)-3 and TD 9722, 80 Fed Reg. 33402 (June 2, 2015).
349 TD 9833, 83 Fed. Reg. 26580 (June 8, 2018).
350 REG-135671-17, 84 Fed. Reg. 11005 (Mar. 25, 2019).

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partnership agreement is amended in a manner that increases a corporate partner's interest in the stock of the corporate partner.[351] If a partnership engages in an I.R.C. § 337(d) transaction, the corporate partner must recognize gain.[352]

CHAPTER 14: FAMILY PARTNERSHIPS

Renumber current §14.06 as §14.07 and insert the following as new §14.06.

§ 14.06 FAMILIES AND I.R.C. § 162 AND 212

The term "trade or business" is not defined in the Code. The Supreme Court made it clear many years ago in *Higgins*[353] that managing one's own investments is not a trade or business, irrespective of how substantial and justified the management activities are. In response, Congress enacted I.R.C. § 212 which generally allowed taxpayers to deduct ordinary and necessary expenses incurred by a taxpayer in conducting investment activities. The expenses of this type were, however, "below the line" and thus only available to taxpayers who itemized. Further, under I.R.C. § 67 they were usually "miscellaneous itemized deductions," and, as such, could only be deducted to the extent they exceeded 2% of adjusted gross income.[354] I.R.C. § 162 expenses, on the other hand, are deductible under I.R.C. § 62 (i.e. above the line). The 2017 Tax Cuts and Jobs Act dramatically changed the rules in this regard, prohibiting the deduction of miscellaneous itemized deductions altogether. Going forward, therefore, taxpayers commonly will want to bring expenses within I.R.C. § 162 and avoid I.R.C. § 212 to the extent possible.

What if family members jointly manage their investments? Generally, that will not bring any expenses within I.R.C. § 162, as the Supreme Court has held that to be engaged in a trade or business the taxpayer must seek compensation beyond a normal investor's return.[355]

What if some family members manage the family's investments on behalf of other family members and are compensated for their efforts? That issue was addressed by the Tax Court in 2017 in *Lender Management, LLC*.[356] There, a subset of family members formed an LLC ("Lender Management") which was tasked with managing investments held by other LLCs owned by family members. All the LLCs were classified as partnerships for tax purposes. Lender Management did not receive any fixed fees for its services (though it is common for professional investment managers to charge such fees). To the extent that the net assets of the investment LLCs increased in value, however, the operating agreements provided that Lender Management could receive compensation separate from and in addition to the amounts that it received for its membership interests. Thus, Lender Management was seeking a return beyond simply that of an investor. Further, Lender Management's efforts primarily benefited family members other than the members of Lender Management. In a nonfamily setting, the Tax Court had rules that activities such as those of Lender Management could constitute a trade or business.[357] The Tax Court acknowledged that transactions within

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351 Treas. Reg. § 1.337(d)-3(c)(3). These transactions are discussed in greater detail at § 2.02E.

352 Treas. Reg. § 1.337(d)-3(d)(1).

353 Higgins v. Commissioner, 312 US 212 (1941).

354 Most I.R.C. § 212 expenses are miscellaneous itemized deductions, but deductions for interest and taxes are not (though taxpayers may still have to itemize to take these latter deductions). Further, losses from the sale or exchange of investment properties and deductions "attributable to rents and royalties" from investment properties (e.g. interest, taxes, and depreciation) are deductible under I.R.C. § 62(a)(3) and (4), respectively.

355 Whipple v. Commissioner, 373 US 193 (1963).

356 Lender Management, LLC v. Commissioner, T.C. Memo. 2017-246.

357 Dagres v. Commissioner, 136 T.C. 263 (2011).

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a family group are subjected to heightened scrutiny, but are not barred from trade or business status. The court concluded that even after applying heightened scrutiny, Lender Management was engaged in a trade or business, emphasizing the following facts: Lender Management's employees worked full time, no more than two members of the family owned Lender Management, and the investment LLCs were not required to use Lender Management if they became dissatisfied with its efforts. The court also noted that the family was widely dispersed and many family members did not know each other, though the court's reasoning suggests that it is unlikely that the court would have reached a different decision if the family had been less dispersed and more closely knit.

Lender Management is an important case in light of the prohibition against deducting miscellaneous itemized deductions. Practitioners often structure family investments with Lender Management in mind.

CHAPTER 17: LEGISLATIVE UPDATES AND NON-SUB K PROVISIONS

§ 17.01 INTRODUCTION

In this chapter we will cover important, typically recent, legislative changes that are not part of Subchapter K, but are highly relevant to the practice of partnership taxation. While "Opportunity Zones" were enacted as part of the Tax Cuts and Job Act, due to their complexity and the comprehensive nature of our discussion we discuss them separately in § 17.04.

§ 17.02 TAX CUTS AND JOBS ACT ("TCJA")

A. INTRODUCTION

TCJA, generally effective for tax years starting in 2018, made numerous changes to the Code, including lowering the corporate tax rate from a maximum of 35% to a flat rate of 21%. We will review the changes most relevant to partnership taxation. In § 17.03 we will review the even more recent Coronavirus Aid, Relief, and Economic Security Act ("CARES"), which retroactively changed certain rules and made important, albeit temporary, changes to TCJA. In our discussion of TCJA, we will alert you to areas affected by CARES. For the most part, provisions covered in this chapter are not covered in any detail elsewhere in the text. But there is one exception, I.R.C. § 461(l). This Code section that was enacted by TCJA and significantly changed by CARES. While we will cover it in this chapter, in brief. We go into greater detail in § 4.07, Loss Limitation Rules.

B. I.R.C. § 168(k)

The TCJA expanded the benefits of I.R.C. § 168(k), which can be thought of as I.R.C. § 179 on steroids. I.R.C. § 179 allows taxpayers to immediately deduct the cost of certain otherwise depreciable property. But the maximum per year that can be deducted is $1,000,000 and I.R.C. § 179 is phased out for taxpayers who put more than $2,500,000 of the relevant property in service during the tax year. I.R.C. §179 thus mostly applied to small and medium-sized businesses. I.R.C. § 168(k), on the other hand, has no dollar limits of any type and thus can be used by businesses of any size. It permits the cost of covered depreciable property to be immediately expensed in the year of acquisition, regardless of cost and the amount of property placed in service during the tax year. I.R.C. § 168(k) applies to property that has a "recovery period" of 20 years or less. This means that I.R.C. §168(k) primarily applies to personal property, but thanks to a technical correction by CARES, can also apply to "qualified improvement property," essentially the cost of renovating real property (*see* I.R.C. § 168(e)(6) and (e)(3)(E)). Example: Taxpayer buys personal property to be used in business for $2,000,000. Before 2018, taxpayer might have been required to depreciate the property using a five year "applicable recovery period." From 2018-2022, taxpayer may deduct the entire $2,000,000 cost in the year of purchase. After 2022, I.R.C. § 168(k) benefit is phased out through 2027. I.R.C. § 179 remains on

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the books, but likely will have a small (or perhaps no) role to play through at least 2022. References to depreciation in this text include the I.R.C. §§ 168(k) and 179 deductions.

C. Excess Business Losses

These rules were changed by CARES (see below). I.R.C. § 461(l) provided that, for tax years beginning after December 31, 2017 and before January 1, 2026, "excess business losses" of a taxpayer other than a corporation were not allowed as deductions. As noted, we discuss this Code provision in § 4.07 and will be brief here. An excess business loss for the taxable year is the excess of aggregate deductions of the taxpayer attributable to trades or businesses of the taxpayer, over the sum of aggregate gross income or gain of the taxpayer plus a threshold amount.[358] The threshold amount for a taxable year is $250,000 ($500,000 for married filing jointly). The threshold amount is indexed for inflation.[359] Excess business losses are carried forward and treated as part of the taxpayer's net operating loss amount in subsequent taxable years (see below).[360] For the most part, I.R.C. § 461(l) applies to businesses in which the taxpayer materially participates.

D. Net Operating Losses

In the main, under I.R.C. § 172 a net operating loss ("NOL") is the excess of business expenses over business income.[361] Under TCJA, an NOL may be carried forward indefinitely and deducted against income in future tax years but may not be carried back. (Pre-TCJA law permitted both carrybacks and carryforwards.) The NOL generally is allowed as a deduction for a taxable year up to the lesser of the NOL amount or 80% of taxable income determined without regard to the deduction for NOLs.[362] CARES made substantial changes to the NOL rules.

E. I.R.C. § 199A and the Passthrough Deduction

Sometimes called the passthrough deduction, I.R.C. § 199A was created by the 2017 Tax Cuts and Jobs Act ("TCJA"). The IRS has issued final I.R.C. § 199A Regulations.[363]

The I.R.C. § 199A deduction is available in tax years beginning after Dec. 31, 2017 and expires on December 31. 2025.[364] The I.R.C. § 199A deduction applies to individuals and certain trusts with qualified business income ("QBI") earned directly or through passthrough entities. QBI does not include income earned by the taxpayer as an employee. Eligible taxpayers can also deduct 20% of their qualified real estate investment trust (REIT) dividends and publicly traded partnership income. We will ignore REIT dividends and publicly traded partnership income for the balance of our discussion.

1. *Basic Rule for QBI Deduction*

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358 I.R.C. § 461(l)(3).
359 I.R.C. § 461(l)(3)(B).
360 I.R.C. § 461(l)(2).
361 *See* I.R.C. § 172(d).
362 I.R.C. § 172(a).
363 *See* 84 Fed. Reg. 2952 (Feb. 8, 2019). Concurrently, the IRS released three related guidance items: (i) proposed I.R.C. § 199A Regulations (addressing the treatment of previously suspended losses and the treatment of real estate investment trust (REIT) dividends flowing through a Registered Investment Company (RIC)), REG-134652-18 (January 18, 2019); (ii) Notice 2019-07 provides a new safe harbor to define rental real estate trade or business); (iii) Rev. Proc. 2019-11 provides three methods for calculating W-2 wages.
364 I.R.C. § 199A(i).

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I.R.C. § 199A is anything but simple. In the case of a taxpayer other than a corporation, a deduction is allowed equal to the the *lesser* of (a) "the combined QBI amount" or (b) 20% of the excess of (i) the taxable income over (ii) the sum of net capital gain.[365]

2. *Combined QBI Amount in General*

The combined QBI amount is further defined by another formula. The permitted deduction for a given qualified trade or business is the *lesser* of (1) 20% of the taxpayer's QBI or (2) the *greater* of (a) 50% of the business' W-2 wages or (b) the sum of (i) 25% of the business' W-2 wages (ii) 2.5% of the unadjusted basis immediately after ("UBIA") of the business' qualified property (mainly, tangible, depreciable, personal and real property).[366] The objective of the W-2 wage/UBIA limitation is to encourage the employment of U.S. citizens and residents by the business. Note that if a taxpayer's business paid no wages, under the 50% test, the taxpayer would get no deduction, as 50% of $0 is $0.

Qualified property counts toward UBIA during the "depreciable period," which is the later of later of 10 years from when the property is placed in service or the end of the "regular" I.R.C. § 168 depreciation term (without subsection "g"). Thus, typically, personal property will have a 10-year depreciation period and real property will have either a 27 ½ year (for residential property or 39-year (for nonresidential property) depreciation period. Note that UBIA is not reduced for depreciation deductions. In the case of qualified property held by a partnership, a partner's share of the UBIA of qualified property is determined in accordance with how the partnership allocates depreciation to that partner.[367] The Regulations do not reduce UBIA if the taxpayer engages in a tax-free transaction such as an I.R.C. § 1031 like-kind exchange or an I.R.C. § 721 transfer of property to a partnership.[368]

3. *Combined QBI Amount for Taxpayers with Lower Taxable Income*

The QBI deduction is liberalized for taxpayers with taxable income below $315,000 for joint returns and $157,500 for other filers ("the threshold amount;" these figures are adjusted for inflation[369]).[370] For eligible taxpayers with taxable income below the threshold amount, the combined QBI amount is simply 20% of the taxpayer's QBI. The wage/UBIA rules do not apply. A complex phase-out applies if taxable income exceeds the threshold amounts but is less than $415,000 for taxpayers filing jointly or is less than $207,500 for other taxpayers.

4. *Aggregating Combined QBI Amount for Businesses*

While QBI is computed for each business of the taxpayer, ultimately the combined QBI amount of the various businesses are added together in applying I.R.C. § 199A.[371] Note that a business that operates at a loss is not entitled to any I.R.C. § 199A deduction and losses from a given business will typically reduce both total QBI and taxable income, thereby also reducing the deduction allowed by I.R.C. § 199A. If the total QBI

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365 Treas. Reg. § 1.199A-1(b)(3) defines net capital gain for purposes of I.R.C. § 199A as net capital gain within the meaning of I.R.C. § 1222(a) plus any qualified dividend income as defined in I.R.C. § 1(h)(11)(B). We ignore the special rules that apply to cooperatives.

366 I.R.C. § 199A(b)(6).

367 Treas. Reg. § 1.199A-2(a)(3)(ii).

368 Treas. Reg. § 1.199A-2(c)(2)(iii). That said, the place-in service date may vary depending upon whether the UBIA of the replacement property is above or below the UBIA of the relinquished property.

369 I.R.C. § 199A(e)(2)(B).

370 There are a number of taxable income limitations in I.R.C. § 199A. Almost always, taxable income in this context is sensibly computed without the I.R.C. § 199A deduction, including the calculation of the threshold amount.

371 I.R.C. § 199A(b)(1)(A).

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amount is negative, the Regulations create a carryforward of the negative amount, which can reduce positive QBI in future years.[372]

5. QBI

QBI is the net amount of qualified items of income, gain, deduction and loss from any qualified trade or business.[373] Only items included in taxable income are counted. Investment returns such as capital gains and losses, C corporation dividends, and interest income are excluded from QBI.[374] In addition, the items must be effectively connected with a U.S. trade or business.[375] Foreign income in not part of QBI.

A qualified trade or business is any trade or business, except for any specified service trade or business (SSTB).[376] An SSTB includes a trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, investing and investment management, trading, dealing in certain assets, or any trade or business where the principal asset is the reputation or skill of one or more of its employees.[377] For reasons that are not entirely clear, engineering and architecture are not SSTBs.

The SSTB limitation does not apply if a taxpayer's taxable income is below the thresholds amounts (plus phaseouts).[378] Recall, however, that QBI never includes income earned as an employee. Accordingly, this exception from the SSTB limitation assumes the taxpayer is self-employed (including a partner in a partnership). Note that I.R.C. § 199A can violate principles of horizontal equity. A self-employed attorney with taxable income of $100,000 per year may take the I.R.C. § 199A deduction and thus pay a lower rate of income tax that an associate/employee of a law firm with taxable income of $100,000 per year, assuming all of the earnings of both are from the practice of law.

The Regulations allow taxpayers to aggregate trades or businesses.[379] Aggregation is allowed (but not required) if certain criteria are met, providing some flexibility to taxpayers. Aggregation allows taxpayers to treat multiple trades or businesses as a single trade or business, which may make it easier to increase the wage and UBIA limitations. To aggregate multiple trades or businesses, 50% or more of each trade or business to be aggregated must be owned by the same person or group of persons, after applying attribution rules (*e.g.*, interests owned by family members can be aggregated for purposes of the 50% test). Further, no trade or business may be an SSTB, and the trades or businesses must be integrated.[380] Trades or businesses are integrated if at least two of the following factors exist (1) the trades or businesses provide products, property or services that are the same or customarily offered together; (2) the trades or businesses share facilities or share significant centralized business elements; and (3) the trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group.[381]

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372 Treas. Reg. § 1.199A-1(c)(2).
373 I.R.C. § 199A(c)(1).
374 I.R.C. § 199A(c)(3)(B).
375 I.R.C. § 199A(c)(3)(A)(i).
376 I.R.C. § 199A(d)(1)(A).
377 I.R.C. § 199A(d)(2). The Regulations make clear that "reputation or skill" of an employee refers, essentially, to people famous enough to make money off of their fame. *See* Treas. Reg. § 1.199A-5(b)(1)(xiv).
378 I.R.C. § 199A(d)(3). Again, there is a phase-out.
379 Treas. Reg. § 1.199A-4.
380 Treas. Reg. § 1.199A-4(b).
381 Treas. Reg. § 1.199A-4(b)(1).

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The Regulations provide a de minimis rule pursuant to which a trade or business is not an SSTB if (i) its gross receipts in a taxable year are $25 million or less and less than 10% of its gross receipts is attributable to the performance of services in an SSTB,[382] or (ii) its gross receipts in a taxable year are more than $25 million and less than 5% of its gross receipts is attributable to the performance of services in an SSTB.[383] These rules provide essentially a "cliff effect": If, for example, a taxpayer's gross receipts from a business is less than $25 million, but the SSTB portion is 11%, then none of the income from that business is allowed to use the I.R.C. § 199A deduction (assuming, as is likely, the taxpayer's taxable income exceeds the threshold amounts plus the phase-out).

QBI does not include for the recipient (1) compensation for services paid to a shareholder/employee of an S corporation,[384] (2) "guaranteed payments" under I.R.C. 707(c) made to a partner for services (essentially a fixed amount payable to a partner for services rendered to the partnership in her capacity as a partner) or (3) I.R.C. § 707(a) payments made to a partner (essentially, payments made to a partner for services performed in a nonpartner capacity, e.g. a lawyer who is a partner in a real estate partnership doing legal work for the partnership). We discuss I.R.C. § 707(a) and (c) in detail in Chapter 8.

6. Some Examples

Two basic I.R.C. § 199A examples:

1. A, an unmarried individual, owns and operates a computer repair shop as a sole proprietorship. The business generates $100,000 in net taxable income from operations in 2019. A has no capital gains or losses. After allowable deductions not relating to the business, A's total taxable income for 2019 is $81,000. The business's QBI is $100,000, the net amount of its qualified items of income, gain, deduction, and loss. A's I.R.C. § 199A deduction for 2019 is $16,200, the lesser of

20% of A's QBI from the business ($100,000 x 20% = $20,000) and

20% of A's total taxable income (- $0 net capital gains for the taxable year ($81,000 x 20% = $16,200).[385]

2. B and C are married and file a joint individual income tax return. B earns $50,000 in wages as an employee of an unrelated company in 2019. C owns 100% of the shares of X, an S corporation that provides landscaping services. X generates $100,000 in net income from operations in 2019. X pays C $150,000 in wages in 2019. B and C have no capital gains or losses. After allowable deductions not related to X, B and C's total taxable income for 2019 is $270,000 (less than $315,000 threshold). B's and C's wages are not considered to be income from a trade or business for purposes of the I.R.C. § 199A deduction. Because X is an S corporation, its QBI is determined at the S corporation level. X's QBI is $100,000, the net amount of its qualified items of income, gain, deduction, and loss. The wages paid by X to C are considered to be a qualified item of deduction for purposes of determining X's QBI. The I.R.C. § 199A deduction with respect to X's QBI is then determined by C, X's sole shareholder, and is claimed on the joint return filed by B and C. B and C's I.R.C. § 199A deduction is $20,000, the lesser of

20% of C's QBI from the business ($100,000 x 20% = $20,000) and

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382 Treas. Reg. § 1.199A-5(c)(1)(i).

383 Treas. Reg. § 1.199A-5(c)(1)(ii).

384 *See* Treas. Reg. 1.199A-3(b)(2)(ii)(H).

385 Treas. Reg. § 1.199A-1(c), Exp. 1.

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20% of B and C's total taxable income (- $0 net capital gain) for the taxable year ($270,000 x 20% = $54,000).[386]

E. I.R.C. § 163(j)

1. In General

Interest paid or accrued by a trade or business on funds borrowed for use in the trade or business generally has been deductible in the computation of taxable income.[387] For taxable years beginning after 2017, the TCJA added a substantial new limitation.

The deduction for any business interest expense ("BIE") is limited to the sum of (1) business interest income; (2) 30% of the adjusted taxable income ("ATI") of the taxpayer for the taxable year; and (3) the floor plan financing interest of the taxpayer for the taxable year.[388] The amount of any BIE not allowed as a deduction for any taxable year is treated as BIE paid or accrued in the succeeding taxable year.[389] These rules were modified by CARES (see below).

BIE means any interest paid or accrued on indebtedness properly allocable to a trade or business.[390] In general, any amount treated as interest for purposes of the Code is interest for purposes of the provision. Under this definition, interest would include not only stated interest on traditional debt instruments, but would also include any amount treated as interest, such as original issue discount or accrued market discount. The Regulations do not explicitly treat guaranteed payments by a partnership for the use of capital as interest for the purposes of the limitation on deductibility (see Chapter 8). Guaranteed payments for the use of capital provided by a partner to a partnership have both equity and debt characteristics. However, under the anti-avoidance rules, any expense economically equivalent to interest expense is treated as interest expense if a principal purpose of structuring the transaction was to reduce an amount incurred by the taxpayer that would otherwise be treated as interest.[391] Under the Regulations, any expense is economically equivalent to interest to the extent that the expense is (i) deductible by the taxpayer; (ii) incurred in a transaction in which the taxpayer secured the use of funds for a period of time: (iii) substantially incurred in consideration of the time value of money; and (iv) not otherwise classified as interest under the I.R.C. § 163(j) Regulations.[392] The anti-avoidance rules include an example of a situation in which a guaranteed payment for the use of capital is treated as interest for the purposes of I.R.C. § 163(j). Under the example, a partner makes a contribution to a partnership in exchange for a guaranteed payment instead of having the partnership borrow from a third party.[393] The anti-abuse provision could eliminate an obvious way to avoid the limitations of I.R.C. § 163(j), but it also encourages taxpayers to avoid guaranteed payments on capital.

Business interest income means the amount of interest includible in the gross income of the taxpayer for the taxable year that is properly allocable to a trade or business. BIE does not include investment interest expenses, and business interest income does not include investment income within the meaning of I.R.C. § 163(d).[394]

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386 Treas. Reg. § 1.199A-1(c), Exp. 3.
387 I.R.C. § 163.
388 I.R.C. § 163(j)(1).
389 I.R.C. § 163(j)(2).
390 I.R.C. § 163(j)(5).
391 Treas. Reg. § 1.163(j)-1(b)(22)(iv)(A)(1).
392 *Id.*
393 Treas. Reg. § 1.163(j)-1(b)(22)(v)(E), Exp. 5.
394 I.R.C. § 163(j)(6).

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Under I.R.C. § 163(j)(7), the term "trade or business" does not include: (i) the trade or business of performing services as an employee, (ii) any electing real property trade or business, (iii) any electing farming business, or (iv) the trade or business of the furnishing or sale of electrical energy, water, or sewage disposal services, gas or steam through a local distribution system, or transportation of gas or steam by pipeline, if (to be brief) rates are regulated by a state, the federal government, or other political body.

I.R.C. § 163(j)(7)(B) provides the election out of I.R.C. § 163(j) for real property trades or businesses and comes at a price. Under I.R.C. § 168(g)(1)(F), the election requires the business to use the "alternative depreciation system" for its real property, which would extend the deprecation term for residential property from 27 ½ years to 30 years and for nonresidential property from 39 to 40 years. This is pennies in the larger scheme of things. But CARES made a technical correction to I.R.C. § 168. This correction (which had been intended to be part of TCJA) provides that "qualified improvement property" ("QIP") may be depreciated over 15 years (see I.R.C. § 168(e)(3)(E)). This change was retroactive to the effective date of TCJA.[395] Under I.R.C. § 168(e)(6), QIP is essentially the cost of renovating real property. Because the depreciation term is less than 20 years, these costs could be deducted immediately under I.R.C. § 168(k). But if the election out of I.R.C. § 163(j) is made, QIP must be depreciated over 30 or 40 years. Accordingly, in some cases this cost of electing out of I.R.C. § 163(j) will not be trivial. Still, we expect most taxpayers will elect out.

ATI means the taxable income of the taxpayer computed without regard to (1) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business; (2) any BIE or business interest income; (3) the amount of any net operating loss deduction; (4) the amount of any deduction allowable under I.R.C. § 199A, and (5) (for taxable years beginning before January 1, 2022) any deduction allowable for depreciation, amortization, or depletion.[396] Partner basis items and remedial items are not taken into account in determining the partnership's ATI but are taken into account in determining a partner's ATI.[397]

To the extent that interest income or expense of a partnership is properly allocable to trades or businesses that are per se non-passive activities and is allocated to partners that do not materially participate (within the meaning of I.R.C. § 469), under Proposed Regulations such interest income or expense is not considered business interest income for purposes of determining the I.R.C. § 163(j) limitation;[398] such amounts are also excluded from the partnership's ATI.[399] For these purposes a per se non-passive activity is an activity that is not treated as a passive activity for the purposes of I.R.C. § 469 regardless of whether the owners materially participate.

2. *As Applied to Partnerships and Partners*

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395 The retroactive application of this change creates some complexity for taxpayers who renovated property after 2017 and used the required longer depreciation periods of 27 ½ or 39 years. The taxpayers' depreciation method was correct when the return for the relevant tax year was filed but was made incorrect by the CARES change which mandates a 15 year depreciation term for QIP. Changing from what became an impermissible depreciation method to a permissible one ordinarily requires the consent of the IRS. *See* I.R.C. § 446 and Treas. Reg. § 1.446-1(e)(2)(i)). In response to this dilemma, the IRS issued Rev. Proc. 2020-25, 2020-19 IRB 1, in which it gave its consent to an automatic method change for 15-year depreciation (and I.R.C. § 168(k)) for eligible QIP for tax years 2018-2020. Rev. Rul. 2020-22, 2020-18 I.R.B. 745 allows taxpayers to change (or make) the I.R.C. § 163(j)(7)(B) election out of I.R.C. § 163(j) for real property trades or businesses. *See* Lee A. Shepard, QIP Accounting Method Changes for Partnerships (Tax Notes Today Federal, p. 741 (5/4/20)).

396 I.R.C. § 163(j)(8).

397 Treas. Reg. 1.163(j)-6(d)(2), (e)(2).

398 Treas. Reg. § 1.163(j)-6(c).

399 Treas. Reg. § 1.163(j)-6(d)(4).

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In the case of any partnership, the I.R.C. § 163(j) limitation is first applied at the partnership level.[400] Any deduction for BIE is taken into account in determining the non-separately stated taxable income or loss of the partnership.[401] To avoid a partner using the same income to calculate a partnership level BIE deduction and her personal BIE from non-partnership activities, a partner cannot use the partner's share of the partnership's business interest income in calculating her non-partnership BIE except to the extent of the partner's share of the excess of (i) the partnership's business interest income over (ii) the partnership's business BIE (not including floor plan financing) (such excess called "excess business interest income").[402]

Again to avoid double counting, the ATI of each partner from non-partnership activities is determined without regard to the partner's distributive share of the non-separately stated income or loss of such partnership.[403] In the absence of such a rule, the same dollars of ATI of a partnership could generate additional interest deductions as the income is passed through to the partners.

> Example: ABC is a partnership owned 50-50 by XYZ Corporation and an individual. Assume I.R.C. § 163(j) applies. ABC generates $200 of noninterest income. Its only expense is $60 of BIE. The deduction for BIE is limited to 30% of adjusted taxable income, that is, 30% x $200 = $60. ABC deducts $60 of BIE and reports ordinary business income of $140. XYZ's distributive share of the ordinary business income of ABC is $70. XYZ has net taxable income of zero from its other operations, none of which is attributable to interest income. XYZ has a BIE of its own of $25. In the absence of any special rule, the $70 of taxable income from its interest in ABC would permit the deduction of up to an additional $21 of interest (30% x $70 = $21), resulting in a deduction disallowance of only $4 ($25-$21=$4). The double counting rule, however, provides that XYZ has adjusted taxable income computed without regard to the $70 distributive share of the non-separately stated income of ABC. As a result, XYZ has adjusted taxable income of $0. XYZ's deduction for BIE is limited to 30% x $0 = $0, resulting in a disallowance of the entire $25 BIE.[404]

The amount of any BIE *not* allowed as a deduction to a partnership subject to I.R.C. § 163(j) for any taxable year is *not* treated as BIE paid or accrued by the *partnership* in the succeeding taxable year (the general rule of I.R.C. § 163(j)(2) for non-partnership taxpayers), and instead is treated as "excess business interest expense" which is allocated to each partner.[405] This excess business interest expense is treated as BIE paid or accrued by the partner in the next succeeding taxable year in which the partner is allocated excess taxable income ("ETI") (defined below) or "excess business interest income" from the same partnership, but only to the extent of such excess income items.[406] ETI also increases the partners' own ATI.[407]

The ATI of a partner also includes any gain or loss on the sale of a partnership interest, if the partnership holds non-excepted trade or business assets.[408]

ETI means the amount which bears the same ratio to the partnership's adjusted taxable income as (1) the excess (if any) of (i) the 30% of ATI limit over (ii) the amount (if any) by which the BIE of the

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400 For a comprehensive look at how I.R.C. § 163(j) and the first set of Proposed Regulations apply to partnerships, see Walter Schwidetzky, Complexity Cubed: Partnerships, Interest, and the Proposed Regulations, 165 Tax Notes 1113 (2019).
401 I.R.C. § 163(j)(4)(A)(i); Treas. Reg. § 1.163(j)-6(a).
402 *See* Notice 2018-28, 2018-16 IRB 492 (April 2, 2018).
403 I.R.C. § 163(j)(4)(A)(ii)(I).
404 Conference Report to Accompany H.R. 1, 115 Cong. 1st Sess., Rep. 115-466, p. 388 (Dec. 15, 2017).
405 Treas. Reg. § 1.163(j)-6(g).
406 Treas. Reg. § 1.163(j)-6(g)(2)(i).
407 I.R.C. § 163(j)(4)(A)(ii)(II).
408 Treas. Reg. § 1.163(j)-6(e)(3).

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partnership, reduced by the floor plan financing interest, exceeds the business interest income of the partnership, bears to (2) the 30% of ATI limit.[409] Putting this into an algebraic equation where one solves for X, X/ATI = (.3ATI –(BIE -BII))/.3ATI, where BII stands for business interest income. BIE-BII cannot be less than zero.

> Example: Assume in the current year that Partnership ABC has ATI of $300,000. 30% of the ATI is $90,000. The partnership incurs $50,000 of BIE, $10,000 of business interest income, and zero of floor financing interest. The $50,000 of the BIE is currently deductible by the partnership as it is less than 30% of ATI plus the business interest income, which adds up to $100,000. The BIE of $50,000 exceeds the business interest income of $10,000 by $40,000. Do the latter half of the equation first. ($90,000 – ($50,000-$10,000))/$90,000 = .555. ETI is thus ATI of $300,000 x .555 = $166,666. That amount increases the partners' ATI. Excess business interest expenses allocated to a partner from Partnership ABC in prior years (and not yet deducted) can be deducted from ETI from Partnership ABC.

A remaining issue is basis adjustments. The adjusted basis of a partner in a partnership interest is reduced (but not below zero) not just by the currently deductible BIEs, but also by the amount of excess business interest expense allocated to the partner.[410] If excess business interest expense allocated to a partner is greater than the partner's outside basis, the excess amount is treated as excess business expense in any subsequent year in which the amount is no longer suspended under I.R.C. § 704(d). This is fair enough to the extent the partner is allowed to eventually deduct the excess business interest expense. What if the partner does not get to deduct all of the excess business interest expense before disposing of the partnership interest? I.R.C. § 163(j)(4)(iii) and Treas. Reg. § 1.163(j)-6(h)(3) come to the rescue, providing that if a partner disposes of his partnership interest in a taxable or nontaxable transaction (including death), the partner's basis in the partnership interest is *increased* immediately before the disposition by any excess business interest expense that was allocated to that partner but not yet "converted" (i.e. deductible the partner).[411] If all of the partnership interest is disposed of, no deduction is allowed to the transferor or transferee for any excess business interest expense from the partnership (presumably attributable to the time prior to the disposition). If less than all of the partnership interest is disposed of, a proportionate share of the excess business expense is disallowed. As mentioned above, gain or loss from the sale of the partnership interest adjusts ATI.[412]

> Example: Assume $20,000 of excess business interest expense is allocated to partner A, who sells his partnership interest in a fully taxable transaction to new partner X before any of the $20,000 was converted. Partner A will have a $20,000 basis increase in her partnership interest and the excess business interest expense will never be deductible. To that extent of the basis adjustment, partner A will have less gain or more loss on the sale.

I.R.C. § 163(j) does not apply to a taxpayer if the taxpayer's average annual gross receipts for the three-taxable-year period ending with the prior taxable year does not exceed $25 million.[413] But there is a highly important exception to the exception. The $25 million gross receipts exception does not apply to tax shelters.[414] "Tax shelter" is extraordinarily broadly defined and includes many ventures that one might not ordinarily think of as tax shelters. The definition of tax shelter is complex and we will not detail it here. It is

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409 Treas. Reg. § 1.163(j)-1(b)(17).

410 Treas. Reg. § 1.163(j)-6(h)(2).

411 Two things are worthy of note in regard to this "rescue." First, if the excess business interest expense was suspended under I.R.C. § 704(d), no adjustment to basis is made on disposition. Second, the adjustment to basis reduces the amount that would otherwise be included in ATI on the sale.

412 Treas. Reg. § 1.163(j)-6(e)(3).

413 I.R.C. § 163(j)(4).

414 *See* Treas. Reg. § 1.448-1T(a)(2)(iii).

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discussed in more detail in Chapter 4.05B. But note that many legitimate partnerships (e.g. ones having substantial ownership by passive investors—see Chapter 4) will likely be tax shelters under the Code's definition, and thus will have I.R.C. § 163(j) apply even if gross receipts are under $25 million, unless the partnership is in a business excluded under I.R.C. § 163(j)(7).

Even if a partnership qualifies for the small business exception, a partner includes the partner's share of non-excepted trade or business item of income, gain, loss and deduction (including business interest expense and business interest income) of the partnership in calculating the partner's ATI.[415] However, if the partner's share of non-excepted items of loss or deduction from a partnership qualifying for the small business exclusion exceeds the partner's share of non-excepted income, the net loss does not reduce the partner's ATI.[416]

To the extent a partnership is engaged in an excluded trade or business, I.R.C. § 163(j) does not apply to limit the business interest expense that is allocable to the excluded trade or business. A partner share of items from the excluded trade or business are not taken into consideration in the partner's I.R.C. § 163(j) calculation.[417]

I.R.C. § 163(j)(4) provides that a partner's distributive share of partnership excess taxable income and excess business interest will be determined in the same manner as the partner's distributive share of nonseparately state taxable income or loss from the partnership. In general, allocations of deductible business interest and excess items are considered made in th same manner as the nonseparately state items only if an 11-step method of determining a partner's share of a BIE from a partnership is used.[418] A provision was added to the I.R.C. § 704(b) Regulations to clarify that if the 11-step process is followed, the allocation will be deemed to be in accordance with the partners' interests in the partnership.[419] We will not go into this exceptionally complex part of the Proposed Regulations, but a primary purpose is to prevent taxpayers from using the allocation rules discussed in Chapter 5 to end-run I.R.C. § 163(j). Effectively, the rules of the Regulations overlay the partnership allocation rules in determining whether or not a BIE is deductible, but never actually change an otherwise valid allocation. [420] However, the 11-steps do have an impact in Subchapter K and can affect outside basis and capital accounts.[421]

The Regulations do allow a simplified approach for partnerships that use the pro rata method of allocation.[422] Under the simplified approach, if a partnership determines that each partner has a pro rata share of allocable ATI, allocable business income, and allocable business interest expense, then the partnership may bypass steps three through eleven and allocate its excess items in the same proportions.[423]

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415 Treas. Reg. § 1.163(j)-6(m)(1).

416 *Id.*

417 I.R.C. § 163(j)-6(m)(2).

418 Treas. Reg. § 1.163(j)-6(f)(1)(i).

419 Treas. Reg. § 1.704-1(b)(4)(xi).

420 *See* Walter Schwidetzky, Complexity Cubed: Partnerships, Interest, and the Proposed Regulations, 165 Tax Notes 1113 (2019) and Monte Jackel, Small Business Tax Shelters Under the Business Interest Expense Limitation, 165 Tax Notes Federal 607 (2019). Both articles, independently of each other, conclude that the definition of tax shelters is overbroad. For a somewhat more user-friendly look at the first set of Proposed Regulations, see Walter Schwidetzky, Code Sec. 163(j), the Proposed Regulations, and Partnerships: The Nightmare Basics, 98 Taxes The Tax Magazine, Issue 2, 19 (2020).

421 *See,* Treas. Reg. § 1.163(j)-6(o)(17) Exp 17.

422 *See* Treas. Reg. § 1.163(j)-6(f)(2)(ii). "Pro rata" is not defined in the Regulations, but the context of the discussion in the preamble suggests that the exception was intended to apply in situations in which the allocation was made similarly to the allocations of an S corporation.

423 *See* Treas. Reg. § 1.163(j)-6(f)(2)(ii). .

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CARES introduced significant temporary changes to I.R.C. §163(j).

§ 17.03 TAX BASICS OF CORONAVIRUS AID, RELIEF, AND ECONOMIC SECURITY ACT (CARES)

CARES retroactively suspended I.R.C. § 461(l) for tax years beginning before January 1, 2021. CARES also changed the NOL rules in important ways, which, in turn, affected I.R.C. § 461(l). For tax years beginning in 2018, 2019, and 2020, CARES amended I.R.C. § 172 to permit a five-year NOL carryback (pre-CARES only a carryforward was allowed for those years).[424] The idea is for taxpayers to carry back current losses, get tax refunds for prior years, and thereby improve current liquidity. A common strategy is to amend prior returns to which I.R.C. § 461(l) applied, necessarily increasing the taxpayer's NOL for that year, and carry that NOL back to positive business income years, to the extent they exist, and obtain a refund. I.R.C. § 172 was also changed in other important ways. A full NOL carryforward (i.e., not subject to the 80% TCJA limit) is permitted for tax years beginning before 2021. For tax years beginning in 2021 or thereafter, a full carryforward is permitted for NOLs arising in tax years beginning before January 1, 2018, plus the lesser of (1) the aggregate amount of NOLs arising in tax years beginning after December 31, 2017, or (2) 80% of the excess of taxable income (computed without regard to I.R.C. §§ 172, 199A, or 250) over the NOL deduction attributable to pre-2018 NOL carryovers.[425]

CARES provided temporary, but significant changes to I.R.C. § 163(j). For taxable years beginning in 2019 and 2020, for those subject to I.R.C. § 163(j), the interest expense deduction is limited to business interest income plus 50% of adjustable taxable income (ATI) (instead of 30%). Inexplicably, there is a different rule for partnerships. For partnerships, 50% of "excess business interest" (see TCJA discussion) for the first taxable year beginning in 2020 is deductible (no 2019 benefit). The other 50% is subject to normal rules. In 2020, taxpayers may elect to substitute 2019 ATI (which is presumably higher) for 2020 ATI. For partnerships, including multi-member LLCs under the default rule, the election is made by the partnership.

Ordinarily, under I.R.C. § 265, taxpayers may not deduct expenses related to tax exempt income. This raises an important question with regard to CARES. CARES expanded the Small Business Administration (SBA) loan availability for businesses that employ no more than 500 employees.[426] Recipients of these new SBA loans are eligible for loan forgiveness equal to the recipient's payroll costs, mortgage interest payments, rent, and utilities incurred or paid by a recipient during an 8-week period beginning when the loan was originated. The amount of loan forgiveness is ordinarily income under I.R.C. § 61(a)(11). I.R.C. § 108 provides exceptions to this rule, the most important of which are loan forgiveness that occurs in bankruptcy and loan forgiveness when the taxpayer is insolvent, to the extent of the insolvency. Section 1106(i) of the CARES Act provides an additional exception and excludes from income the forgiveness of the noted SBA loans. That leaves the question of whether the expenses incurred by the expenditure of loan proceeds (e.g. for employee salaries) can be deducted if the loan is ultimately forgiven. Nothing in CARES prohibits the deduction of these expenses. But, the IRS in Notice 2020-32 has now effectively ruled that I.R.C. § 265 indeed applies and any business expenses associated with the forgiven SBA loans are not deductible. That said, the IRS has gotten correspondence from Congress in this regard that said there was no intention to deny the business expense deductions. In a Tax Analyst webinar, the Chief Counsel to the IRS said that the Notice was "carefully considered" and the "issue is being looked at," but could not give a "signal" one way or the other. As we go to press, there is bipartisan legislation pending in Congress to override the Notice.[427]

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424 I.R.C. § 172(b)(1)D)(i).

425 I.R.C. § 172(a)(2), (b)(1)(A)(ii), (b)(1)(D)(i), (b)(2). There are special rules for farming losses, insurance companies, REITS, and transactions to which I.R.C. § 965 applies.

426 Or, if greater and applicable, the size standard in number of employees established by the SBA for the industry in which the business operates

427 There is not yet a bill number, but the bill was introduced in the Senate by Senators Mr. Cornyn, Mr. Grassley, Mr. Wyden, Rubio, and Carper.

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§ 17.04 QUALIFIED OPPORTUNITY ZONE FUNDS

A. GENERAL BACKGROUND

1. Overview

I.R.C. § 1400Z-2 provides two main U.S. federal income tax benefits to eligible taxpayers that make longer-term investments of new capital in one or more designated qualified opportunity zones (QOZs) through qualified opportunity zone funds (QOFs) and qualified opportunity zone businesses (QOBs). The first benefit is the ability of an eligible taxpayer, upon the making of a valid election, to defer until as late as December 31, 2026, the inclusion in gross income of certain gains that would otherwise be recognized in a taxable year if the taxpayer invests a corresponding amount of such gain in a qualifying investment in a QOF within a 180-day statutory period.[428] The cost of making the roll-over election is that the basis of the taxpayer in the fund is initially zero.[429] The eligible taxpayer may potentially exclude 10 percent of such deferred gain from gross income if the eligible taxpayer holds the qualifying investment in the QOF for at least five years.[430] An additional five percent of such gain may potentially be excluded from gross income if the eligible taxpayer holds that qualifying investment for at least seven years.[431] The second benefit is the ability for the eligible taxpayer, upon the making of a separate valid election, to exclude from gross income any appreciation on the eligible taxpayer's qualifying investment in the QOF if the eligible taxpayer holds the qualifying investment for at least 10 years.[432]

2. The Gain that May be Deferred

The Code provides that the gain deferred must be from the sale to, or exchange with, an unrelated person of any property held by the taxpayer.[433] One of the issues raised from the face of the statute is what types of gain may be deferred. In a variety of places, the Code recharacterizes gain as ordinary income. The Regulations clarify that it is intended that only capital gain or qualified I.R.C. § 1231 gain is eligible for deferral.[434] In addition, the gain included must otherwise be required to be recognized not later than December 31, 2026. The Regulations do have a special calculation of gain produced by I.R.C. § 1231 property. Solely for the purposes of I.R.C. § 1400Z-2, the capital gain is the gross gain, before netting with losses, unless otherwise required by the Regulations.[435] However, I.R.C. § 1400Z-2 does not apply to gain recharacterized as ordinary income under I.R.C. § 1245 or I.R.C. § 1250.[436]

The Regulations allow the deferral of net gain from the mark to market requirements of I.R.C. § 1256, generally dealing with regulated futures contracts and certain traded futures and options.[437] However, the Regulations would not allow deferral of gains from mixed straddles or straddles, both of which are positions of the taxpayer that vary inversely with each other.[438] A straddle is created with positions if there is a

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428 I.R.C. § 1400Z-2(a)(1).
429 I.R.C. § 1400Z-2(b)(2)(B)(i).
430 I.R.C. § 1400Z-2(b)(2)(B)(iii).
431 I.R.C. § 1400Z-2(b)(2)(B)(iv).
432 I.R.C. § 1400Z-2(c).
433 I.R.C. § 1400Z-2(a)(1).
434 Treas. Reg. § 1.1400Z2(a)-1(b)(11)(i)(A).
435 Treas. Reg. § 1.1400Z2(a)-1(b)(11)(i)(A)(1).
436 Treas. Reg. § 1.1400Z2(a)-1(b)(11)(i)(A)(2).
437 Treas. Reg. § 1.1400Z2(a)-1(b)(11)(vi)(B).
438 Treas. Reg. § 1.1400Z2(a)-1(b)(11)(vi)(A)(2),(B).

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substantial diminution of the taxpayer's risk of loss from holding any position with respect to personal property by reason of the taxpayer's holding one or more other positions with respect to actively traded personal property (whether or not of the same kind).[439] A mixed straddle is a straddle (i) all of the positions of which are held as capital assets, (ii) at least one (but not all) of the positions of which is a I.R.C. § 1256 contract, (iii) for which an election under I.R.C. § 1256(d) has not been made[440] and (iv) which is not part of a larger straddle.[441]

The Regulations impose an additional requirement that the gain be subject to U.S. federal income tax in order to be eligible for the deferral.[442] This means that gain that is realized, but not recognized under another Code provision could not be rolled over in QOZ transaction in order to get the 10-year step up in basis.

3. The Investment Required

I.R.C. § 1400Z-2(a)(1)(A) makes reference to an investment in a QOZ fund in order to qualify for the deferral. The Regulations clarify that the investment must be an equity investment, so either stock in a corporation or a partnership interest.[443] If more than one eligible gain may have been deferred with respect to an investment in a QOF for which a deferral election has been made, then the taxpayer is treated as making the investment in the QOF first with respect to the earliest realized eligible gain, followed by the next earliest eligible gain and any other eligible gains in order of the date of their realization.[444]

B. TECHNICAL REQUIREMENTS

1. Requirements for Qualified Opportunity Zone Funds

A QOF is a partnership or a corporation that holds at least 90% of its assets in QOZ property, which is measured every 6 months during the life of the fund.[445] QOZ property includes QOZ stock, QOZ partnership interests or QOZ business property.[446]

QOZ stock means stock acquired by the QOF from the corporation after 2017 for cash.[447] The corporation must either be a QOZ business or be newly formed and organized to be a QOZ business.[448] Also, during at lease 90% of the QOF's holding period for the corporation's stock, the corporation must qualify as a QOZ business.[449]

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[439] I.R.C. § 1092(c)(2)(A). A position that is not part of an identified straddle will not be treated as an offsetting position with respect to a position that is part of an identified straddle. I.R.C. § 1092(c)(2)(B).

[440] The election under I.R.C. § 1256(d) would allow a taxpayer not to apply I.R.C. § 1256 to a contract that is (or would otherwise be) part of a mixed straddle.

[441] Treas. Reg. § 1.1092(b)-5T(e).

[442] Treas. Reg. § 1.1400Z2(a)-1(b)(11)(i)(B).

[443] Treas. Reg. § 1.1400Z2(a)-1(b)(12)(i).

[444] Treas. Reg. § 1.1400Z2(a)-1(c)(1)(C)(1).

[445] I.R.C. § 1400Z-2(d)(1).

[446] I.R.C. § 1400Z-2(d)(2).

[447] I.R.C. § 1400Z-2(d)(2)(B).

[448] Treas. Reg. § 1400Z2(a)-1(c)(2)(i)(B).

[449] Treas. Reg. § 1400Z2(a)-1(c)(2)(i)(C)(1).

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QOZ partnership interest similarly means a partnership interest acquired by the fund from the partnership after 2017 for cash.[450] Again, the partnership must either be a QOZ business or be newly formed and intend to be a QOZ business.[451] Also, during at lease 90% of the QOF's holding period for the partnership interest, the partnership qualified as a QOZ business.[452]

A QOZ business is a business in respect of which at least 70 percent of the property is QOZ business property and which is engaged in an active business.[453] Less than 5% of the property of the business may be financial property.[454] To be QOZ business property, the property must be acquired by purchase after 2017, the original use must begin with the business or the property must be substantially improved, and substantially all of the use of the property must be in the opportunity zone.[455]

2. Acceleration of Inclusion

Section 1400Z-2(b)(1) provides that all gain to which I.R.C. § 1400Z-2(a)(1)(A) deferral applies must be included in income in the taxable year that includes the earlier of the date on which a QOF investment is sold or exchanged or December 31, 2026. The statute would appear to create a cliff for recognition: if an investment is sold, the gain is recaptured. The Regulations clarify that transactions described as inclusion events result in a reduction or termination of a qualifying investments status as a qualifying investment to the extent of the reduction or termination, except as otherwise provided in other provisions of the Regulations. An inclusion event is a transaction that reduces or terminates the QOF investor's direct (or, in the case of partnerships, indirect) qualifying investment for Federal income tax purposes or, in the case of distributions, constitutes a "cashing out" of the eligible taxpayer's qualifying investment in the QOF.

The Regulations allow a second deferral if an interest in an opportunity zone fund is sold and the proceeds are rolled into another fund. The Regulations adopt the position that gain arising from an inclusion event is eligible for deferral under I.R.C. § 1400Z-2(a) even though the taxpayer retains a portion of its qualifying investment after the inclusion event. Although such gain relates in part to gain from a sale or exchange for which there was a prior election in effect, it is no longer subject to that prior election within the meaning of I.R.C. § 1400Z-2(a)(2)(A) as soon as the inclusion event triggers an income inclusion. Therefore, if an inclusion event relates only to a portion of a taxpayer's qualifying investment in the QOF, (i) the deferred gain that otherwise would be required to be included in income (inclusion gain amount) may be invested in a different QOF, and (ii) the taxpayer may make a deferral election under I.R.C. § 1400Z-2(a) with respect to the inclusion gain amount, so long as taxpayer satisfies all requirements for a deferral election on the inclusion gain amount.

To satisfy the requirements under I.R.C. § 1400Z-2(a) and Regulations § 1.1400Z2(a)-1(b)(11)(iv), the eligible taxpayer must treat the inclusion gain amount to be deferred as if it were originally realized as a result of the inclusion event.

C. ROLES OF PARTNERSHIPS

1. Partnership as Taxpayer

450 I.R.C. § 1400Z-2(d)(2)(C)(i).
451 Treas. Reg. § 1400Z2(a)-1(c)(3)(i)(B).
452 Treas. Reg. § 1400Z2(a)-2(c)(2)(i)(C)(1).
453 Treas. Reg. § 1.1400Z2(d)-1(d).
454 Treas. Reg. § 1.1400Z2(d)-1(d)(3)(iv).
455 Treas. Reg. § 1.1400Z2(d)-2(b).

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A partnership could have three potential roles in regard to I.R.C. § 1400Z-2 deferals. The partnership could be the "taxpayer" that makes the election to defer gain. The partnership could be a QOF into which an eligible investment is made. Or a partnership could be a QOZ business into which a QOF makes an investment.

I.R.C. § 1400Z-2 references the term "taxpayer," which I.R.C. § 7701(a)(14) defines as "any person subject to any internal revenue tax." In turn, I.R.C. § 7701(a)(1) defines the term "person" to include "an individual, a trust, estate, partnership, association, company or corporation." Under the Regulations, an eligible taxpayer, i.e., a taxpayer eligible to make the deferral election, is a person that is required to report the recognition of gains during the taxable year under U.S. federal income tax accounting principles.[456] Thus, for example, eligible taxpayers include individuals; C corporations, including RICs and REITs; organizations subject to tax under I.R.C. § 511; and partnerships, S corporations, trusts, and decedents' estates.

In other words, a partnership is generally an eligible taxpayer and may make an election to defer recognition of gain under I.R.C. § 1400Z-2.[457] However, the partnership is also a passthrough entity, and the partners of the partnership would also be required to report the recognition of gains recognized by the partnership and reported out to the partners on Form K-1.

As mentioned above, in general, the gain in respect of which a deferral election may be made must otherwise be subject to U.S. federal income tax.[458] It would not generally be possible for a partnership to determine if gain it allocates to its partners is subject to U.S. federal income tax because partnerships do not generally have sufficient information about the tax treatment and positions of their partners to perform this analysis. Thus, in the case of partnerships, the Regulations provide an exception to the general requirement that gain be subject to U.S. federal income tax in order to constitute eligible gain if the partnership does the reinvestment of such gains in a QOF.[459]

If a partnership is formed or availed of with a significant purpose of avoiding the requirement that a gain be otherwise subject to federal income tax in order to be an eligible gain, the partnership will be disregarded in whole or in part for purposes of I.R.C. § 1400Z-2 to prevent the creation of a qualifying investment by the partnership with respect to any partner or partners that would not otherwise satisfy such requirements.[460]

2. Partner as Taxpayer

If a partnership does not elect to defer all of its eligible gain, the partner may elect to treat the partner's own 180-day period regarding the partner's distributive share of that gain as being the same as the partnership's 180-day period.[461]

In general, the partner's 180-day period begins on the last day of the partnership taxable year in which the gain is taken into account.[462] However, a partners may not know that the 180-day period is running until the partner receives the partner's Form K-1. As a result, the Regulations provide partners of a

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456 Treas. Reg. § 1.1400Z2(a)-1(b)(13).
457 Treas. Reg. § 1.1400Z2(a)-1(c)(7).
458 Treas. Reg. § 1.1400Z2(a)-1(b)(11)(i)(B).
459 Treas. Reg. § 1.1400Z2(a)-1(b)(11)(ix)(B).
460 Treas. Reg. § 1.1400Z2(f)-1(c)(2)(ii).
461 Treas. Reg. § 1.1400Z(a)-1(c)(8).
462 Treas. Reg. § 1.1400Z(a)-1(c)(8)(iii)(A).

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partnership, with the option to treat the 180-day period as commencing upon the due date of the entity's tax return, not including any extensions.[463]

If a taxpayer has held a qualifying investment in a QOF partnership for at least 10 years, and the QOF partnership or any partnership that is owned directly, or indirectly solely through one or more partnerships, by the QOF partnership sells or exchanges property, the taxpayer may make an election to exclude from the taxpayer's income all gains and losses allocable to the qualifying investment that arise from all such sales or exchanges for the QOF partnership's taxable year.[464] If any partner of a QOF partnership makes an election to exclude the gain on disposition, the taxpayer is treated as receiving a distribution of cash from the QOF partnership at the end of the QOF partnership's taxable year and immediately recontributing the cash to the QOF partnership in exchange for a non-qualifying investment in the QOF partnership.[465]

If a QOF partner's basis in a qualifying QOF partnership interest is adjusted under I.R.C. § 1400Z-2(c) upon the disposition of a qualifying investment, then the basis of the QOF partnership interest is adjusted to an amount equal to the net fair market value of the interest, plus the QOF partner's share of QOF partnership indebtedness under I.R.C. § 752 with respect to that interest, and immediately prior to the sale or exchange, the bases of the assets of the QOF partnership and of any partnership owned directly or indirectly by the QOF partnership solely through one or more partnerships are also adjusted with respect to the disposed-of qualifying investment.[466] For these, I.R.C. § 7701(g) will apply in determining the value of a qualifying investment in a QOF partnership (so the fair market value well be deemed to be at least equal the amount of any non-recourse debt attributable to the interest). The adjustments are calculated in a manner similar to the I.R.C. § 743(b) adjustments that would have been made if the transferor QOF partner had purchased its interest in the QOF partnership for cash equal to the fair market value of the interest immediately prior to the sale or exchange, assuming that valid I.R.C. § 754 elections had been in place with respect to the QOF partnership and any partnerships directly or indirectly owned by the QOF partnership, whether or not an actual I.R.C. § 754 election is in place for any of the partnerships.

CHAPTER 18: PARTNERSHIP DEBT WORKOUTS[467]

§ 18.01 INTRODUCTION

Debt workouts tend to be front and center during difficult economic times, such as those created by the Covid 19 pandemic. This chapter will review debt workouts in the partnership context. While our focus is on partnership taxation, much of the relevant law takes place outside of Subchapter K, and consequently so will much of this chapter. But it is not our intention to cover the entire waterfront of debt workouts,[468] but rather concentrate on those areas most relevant to partnerships. Outside of the debt for equity exchanges, our

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463 Treas. Reg. § 1.1400Z(a)-1(c)(8)(iii)(B).
464 Treas. Reg. § 1.1400Z(c)-1(b)(2)(ii)(A).
465 Treas. Reg. § 1.1400Z(c)-1(b)(2)(ii)(B).
466 Treas. Reg. § 1.1400Z2(c)-1(b)(2)(i).
467 This chapter is a modestly revised version of the following article: Walter D. Schwidetzky, Partnership Debt Workouts During a Pandemic, 169 Tax Notes 259 (2020).
468 For a fine, still fairly current article that does just that, see Martin J. McMahon Jr. and Daniel L. Simmons, A Field Guide to Cancellation of Debt Income, 63 Tax Law. 415 (2010) (hereinafter "Field Guide").

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primary focus will be on the debtor, but it should be noted that a creditor who goes unpaid typically will have either a bad debt deduction or a business loss.[469]

Whenever we use the term partnership, a tax partnership is meant, which, as your learned in Chapter 1, includes LLCs with two or more members under the regulatory default rule.[470] While we do discuss the tax consequences for bankrupt partners and partnerships, for space reasons, we do not provide a review of relevant, substantive bankruptcy law. But that law can have important tax and nontax consequences. Mastery of this area, or access to someone with mastery, it vital for workouts involving bankrupt partners and partnerships.[471]

§ 18.02. OVERVIEW OF (MOSTLY) THE FUNDAMENTALS

As the Supreme Court has famously observed, a taxpayer has gross income whenever the taxpayer has an undeniable accession to wealth.[472] When a taxpayer borrows money, the borrowed money, in a sense, gives the taxpayer an accession to wealth, but the loan is not considered to be income because the taxpayer is required to repay it.[473] If the loan is forgiven or becomes uncollectible due to the expiration of the statute of limitations,[474] however, the taxpayer has an undeniable accession to wealth and gross income, as she received the benefit of the loan proceeds, but no longer has an obligation to repay them.[475] This type of income is usually called "discharge of indebtedness income" or "cancellation of indebtedness income," and commonly abbreviated "CODI," and is now codified in I.R.C. § 61(a)(11)[476]

A. DISPUTED LIABILITIES

Neither the code nor the Regulations define the term "indebtedness." A former Regulation under I.R.C. § 108 defined "indebtedness" as "an obligation, absolute and not contingent, to pay on demand or within a given time, in cash or another medium, a fixed amount."[477] Courts have effectively adopted this definition.[478] A genuinely disputed debt is neither absolute nor "not contingent." If there is a bona fide dispute between the debtor and creditor as to the amount of the debt, a settlement of the dispute for a lesser

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469 Losses incurred in a business or investment (other than bad-debt deductions) are deductible under I.R.C. § 165. Bad debts arising from a trade or business are deductible under I.R.C. § 166. See Bittker, McMahon, & Zelenak: Federal Income Taxation of Individuals, (hereinafter "BMZ") at ⁋⁋ 16.1-16.7, 17.1-17.8.

470 Treas. Reg. § 301.7701-3.

471 *See* Richard M. Lipton, Tax Planning for Noncorporate Bankruptcies, Taxes (Oct. 1992).

472 Commissioner v. Glenshaw Glass Co, 348 US 426 (1955).

473 Commissioner v. Tufts, 461 U.S. 300, 307 (1983); see BMZ supra note 547 at ⁋ 4.01 and Field Guide supra note 546 at 417.

474 *See* In re Higgins, 403 B.R. 537 (Bankr. E.D. Tenn. 2009), Carl T. Miller Trust v. Comm'r, 76 T.C. 191 (1981); Estate of Emelil Bankhead, 60 T.C. 535 (1973). Apparently, it makes no difference if the debt is, as such, extinguished, or if the claim is merely barred, see Securities Co. v. U.S., 85 F. Supp. 532 (S.D.N.Y. 1948).

475 Commissioner v. Kirby Lumber Co, 284 US 1 (1931) and I.R.C. § 61(a)(11). For a discussion of the theoretical underpinnings of Kirby, see Field Guide supra note 546 at 419-425. Also see Dallas Transfer & Terminal Warehouse Co. v. C.I.R. 70 F.2d 95 (5th Cir. 1934) distinguishing Kirby and holding, pre-I.R.C. § 108 (enacted in 1954), that an insolvent taxpayer could not have income from debt forgiveness.

476 Some abbreviate it as CODI or refer to CODI. At least one case held that the debtor can avoid COD if the debt forgiveness was a gift. Bosse v. Commissioner, T.C. Memo. 1970-355 (cancellation of debt treated as a gift); but see Dosek v. Commissioner, T.C. Memo. 1971-160 (no donative intent). But see Treas. Reg. § 1.1001-2(a)(4)(iii). If debt is forgiven subject to an improbable contingency, likely the "gross" forgiveness is income at the time of the foregiveness and does not await the resolution of the contingency. *See* Jelle v. Commissioner, 116 T.C. 63 (2001).

477 Former Treas. Reg. § 1.108(b)-1(c) (issued under § 108(b), repealed in 1976), removed by TD 8787, 1998-2 CB 621.

478 *See* BMZ supra note 547 at at ⁋ 4.05[3][c].

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payment than the creditor would have preferred does not create CODI.[479] For example, if the taxpayer hires a car mechanic to rebuild his car's engine for $10,000 and the taxpayer makes a bona fide claim that the rebuild was not done properly, if the parties settle for a payment to the mechanic of $8,000, there is no CODI. Sometimes this type of debt is called an "unliquidated debt," because the amount owed is up for debate. Normally, if it is "liquidated debt," i.e. the amount owed is known and not legitimately in dispute, and it is retired for less than the liquidated amount, CODI is created.[480]

B. PURCHASE PRICE ADJUSTMENT

If a buyer and seller wish to adjust the purchase price of the property, one might think that this would fall under the disputed liability doctrine. While disputed liabilities and purchase price adjustments could be thought of as cousins, a purchase price adjustment has a specific code section on point, I.R.C. § 108(e)(5). The IRS and the 10th Circuit have taken the position that it is the exclusive purchase price adjustment exception to (what is now) I.R.C. § 61(a)(11).[481] Nothing in the literal language of the statute mandates that. That said, I.R.C. § 108(e)(5) was enacted to resolve disputes between the IRS and taxpayers as to when a true purchase price adjustment has occurred and when true debt forgiveness is involved.[482] If I.R.C. § 108(e)(5) is not exclusive, it really has not resolved disputes between the IRS and taxpayers, arguing for exclusivity.[483] Under I.R.C. § 108(e)(5), if a seller of property carries back the financing, and the debt owed by the purchaser to the seller is reduced, and the reduction does not occur in bankruptcy or because the purchaser is insolvent, then the reduction is treated as a "purchase price adjustment." It does not create CODI, provided the reduction would be treated as CODI to the purchaser, but for I.R.C. § 108(e)(5). Normally, I.R.C. § 108(d)(6) provides that the I.R.C. § 108 applies at the partner, not the partnership level. There is a TAM that suggests,

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479 *See* BMZ supra note 547 at ¶ 4.05[3][c]; Zarin v. Commissioner, 916 F.2d 110 (3d Cir. 1990), rev'g 92 T.C. 1084 (1989); N. Sobel, Inc. v. Commissioner, 740 B.TA. 1263, 1265 (1939). In Zarin , the 3rd Circuit refused to find CODI for a nominal gambling debt that was unenforceable from the outset under New Jersey law. While at least some of your authors find the case cogently reasoned, others do not. See, e.g., Theodore P. Seto, Inside Zarin, 59 SMU L. Rev. 1761 (2006); I. Jay Katz, Did Zarin Have a Tufts Day at a Casino Made Out of Kirby Lumber?, 26 U.C. Davis L. Rev. 261, 265 (1993) (wins award for best article title); Daniel Shaviro, The Man Who Lost Too Much: Zarin v. Commissioner and the Measurement of Taxable Consumption, 45 Tax L. Rev. 215 (1990). While the facts of the case were rather different, the 10th Circuit rejected Zarin in Preslar v. Commissioner, 167 F3d 1323 (10th Cir. 1999). The 10th Circuit stated that "The mere fact that a taxpayer challenges the enforceability of a debt in good faith does not necessarily mean he or she is shielded from discharge-of-indebtedness income upon resolution of the dispute. To implicate the contested liability doctrine, the original amount of the debt must be unliquidated [*i.e.*, a bona fide dispute as to what is owed]. A total denial of liability is not a dispute touching upon the amount of the underlying debt." Id. at 1328.

480 *See* Preslar v. Commissioner, 67 F3d 1323, 1328 (10th Cir. 1999) and Rood v. Commissioner, T.C. Memo. 1996-248 at 255 ("disputed debt" exception did not apply because taxpayer failed to prove existence of any bona fide dispute"), aff'd per curiam, 122 F3d 1078 (11th Cir. 1997); Melvin v. Commissioner, 98 TCM 159 (2009) (no evidence that the debt was disputed before it was compromised). It is possible for the debtor to have income that does not constitute COD, a unfortunate occurrence if the income would otherwise have been excluded under I.R.C. § 108. For example, in United States v. Centennial Sav. Bank FSB, 499 U.S. 573 (1991), a savings and loan association realized deductible losses when it exchanged its interest in one group of residential mortgage loans for another lender's interest in a different group of residential mortgage loans. It also collected penalties for premature withdrawal of federally insured certificates of deposit. These penalties were not COD, because, in the Court's view, "Congress did not intend to extend the benefits of [section] 108 beyond the setting in which a creditor agrees to release a debtor from an obligation assumed at the outset of the relationship. Id. at 583.

481 At the time of the ruling, the discharge of debt rule was in I.R.C. § 61(a)(12); see Rev. Rul. 92-99, 1992-2 C.B. 35 and Preslar v. CIR, 167 F3d 1323 (10th Cir. 1999).

482 S. Rep. No. 96-1035 (1980) at 16.

483 There is a suggestion in the legislative history, that I.R.C. § 108(e)(5) was intended as a safe harbor. See S. Rep. No. 96-1035, 96th Cong., 2d Sess (1980), at 20 n.24: "A purchase price adjustment (whether or not described in new sec. 108(e) (5) of the Code, as added by this bill) continues to constitute an adjustment for purposes of the investment credit rules of the Code." Richard M. Lipton, Planning for Noncorporate Debt Workouts Outside of Bankruptcy, Taxes (May 1992) (hereinafter "Lipton I") argues for this position.

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however, that the rules of I.R.C. § 108(e)(5) apply at the partnership level.[484] I.R.C. § 108(e)(5) does not, by its literal terms, require the purchaser to reduce the basis of the property by the amount that the debt is reduced, but that result seems inescapable under I.R.C. § 1016 principles, most practitioners believe that such a basis reduction is required, and the Service has said as much in a TAM.[485] The scope of I.R.C. § 108(e)(5) is fairly narrow. The legislative history indicates that the negotiation must occur between the buyer and the seller and the debt cannot be reduced because of factors not involving direct agreements between the buyer and the seller, such as the running of the statute of limitations on enforcement of the obligation.[486] I.R.C. § 108(e)(5) does not apply to a debt reduction by a third-party lender.

C. GUARANTORS

Interestingly, in *Payne v. CIR*, [487] the Tax Court has held that a guarantor of a debt does not have CODI when the debt is compromised, even if the guarantor is active in settling the guaranteed debt for a reduced amount. At first blush, this holding may seem dubious, but it actually makes sense. A guarantor steps into the shoes of the creditor, i.e. is subrogated to the creditor, when he makes a payment on the debt, and can seek to be reimbursed by the primary debtor. If the debtor cannot pay, then the guarantor should have a bad debt deduction or a business loss. The primary debtor, however, has CODI if the guarantor waives his subrogation rights or if the statute of limitation expires before the guarantor can collect on his claim.[488] If the guarantor were given CODI, there would be the risk of double counting, as the debtor also could have CODI. If the debtor transfers property to satisfy a debt, his amount realized can include the amount of any discharged debt.[489] There are two conflicting Tax Court cases with regard to guarantors. In *Friedland*, [490] there was a cooperative transfer by the guarantor of pledged stock. The court concluded that the relevant liabilities were not included in the guarantor's amount realized. But two years later in *Medlin*,[491] the Tax Court distinguished Payne and concluded that on a foreclosure sale, liabilities of which the guarantor is relieved can be included in the guarantor's amount realized. The fact that *Medlin* involved a foreclosure sale rather than, essentially, a voluntary transfer of *Friedland* does not provide a cogent basis for a different holding. Given how guaranteed liabilities are treated generally, *Friedland* would seem to have the better argument. Also, the *Medlin* case was a very lengthy, the guarantor liability issue was one issue among many and received fairly short shrift, and *Medlin* did not discuss *Friedland*. *Friedland* is the better reasoned opinion, and it is possible that the *Medlin* case should be seen as anomalous.

D. PPP LOANS

There is one more CODI exclusion provision that is not in I.R.C. § 108, but instead is in Coronavirus Aid, Recovery, and Economic Security Act ("CARES").[492] Section 1102 of CARES established a "Paycheck Protection Program"("PPP"). Under this program, the SBA will guarantee loans taxpayers borrow from participating lenders. A recipient of a covered loan may use the proceeds to pay (1) payroll costs, (2) certain employee benefits relating to healthcare, (3) interest on mortgage obligations, (4) rent, (5)

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484 See TAM 8429001 (March 2,1984).

485 See Lipton I supra note 561 and TAM 8429001.

486 S. Rep. No. 96-1035, at 7031-7032(1980). It is possible that non-CODI could be created, such as compensation income when a note between an employer and employee is reduced. See Rev. Rul. 2004-37, 2004-1 CB 583.

487 Payne v. Commissioner, T.C. Memo. 1998-227, *rev'd on other grounds* 224 F.3d 415, (5th Cir. 2000).

488 See Miller v. Commissioner, 291 TCM 1267 (2006).

489 See infra notes 77-79 and accompanying text.

490 See Friedland v. Commissioner, 82 TCM 492 (2001) and Treas. Reg. § 1.1001-2(a)(1).

491 Medlin v. CIR, T.C. Memo. 2003-224.

492 P.L. 116-136.

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utilities, and (6) interest on any other existing debt obligations.[493] Under section 1106(b), loan proceeds that are being used for the following purposes may be forgiven: Payroll costs, mortgage interest payments (but not payments on the principal), rent, and utilities. If the loan is forgiven, section 1106(i) of the CARES excludes the loan forgiveness from income. Because I.R.C. § 108 does not generate the income exclusion, there is no requirement to reduce tax attributes. I.R.C. § 108(b)(1) expressly limits its application to exclusions under I.R.C. § 108. But there is a potential downside. CARES does not expressly address the tax treatment of expenses paid with the forgiven funds.

In Notice 2020-32,[494] the Service took the position that existing tax law intends to prevent a double benefit. The Notice states that otherwise deductible business expenses that are paid with forgiven PPP funds are not deductible, in fact. This conclusion surprised some in Congress, and there is pending bipartisan legislation that would overrule the Notice. But, until that happens, the conclusion the Notice drew is arguably inescapable. I.R.C. § 265 generally provides that no deduction is allowed for expenses that are allocable to exempt income.[495] Of course, the expenses paid with forgiven PPP loans are allocable to exempt income since CARES excludes the CODI from income. It appears, therefore, that only Congressional legislation could make the expenses paid with forgiven PPP loans deductible.[496]

§ 18.03 THE I.R.C. § 108 EXCLUSIONS

I.R.C. § 108 excludes CODI from income under some circumstances. I.R.C. § 108 is a long and complex statute. We will focus on the parts most relevant to partnership debt workouts. Before we address the important exclusions, a minor one deserves brief mention. Under I.R.C. § 108(e)(2), no CODI is realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction. This makes sense, inasmuch as if CODI were recognized it would have been zeroed out by the deduction. Presumably, I.R.C. § 108(e)(2) applies even if the deduction is postponed under the at-risk rules in I.R.C. § 465 or the passive loss limitation under I.R.C. § 469.[497]

The most important I.R.C. § 108 exclusions for purposes of this discussion are for bankruptcy, insolvency, and for the discharge of qualified real property business indebtedness.[498] A taxpayer is insolvent to the extent his liabilities exceed the fair market value of his assets immediately before the discharge, and the I.R.C. § 108 insolvency exclusion only applies to the extent of the insolvency.[499]

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493 See section 7(a)(36)(F) of the Small Business Act; see also Q&A 2.r. in Part III of the interim final rule, Business Loan Program Temporary Changes; Paycheck Protection Program, Docket No. SBA-2020-0015, 85 Fed. Reg. 20811, 20814 (April 15, 2020).

494 2020-21 I.R.B. 837.

495 Other than interest, to which other statutes apply.

496 For a proposal to liberalize the rules for exclusion of COD, see Donald B. Susswein, Ryan P. McCormick, Congress, Covid, and COD, Tax Notes Federal (July 27, 2020).

497 See Lipton I supra note 561.

498 I.R.C. § 108(a)(1)(A),(B), (D) and 108(a)(3). Before the enactment of I.R.C. § 108, there were judicially crafted exceptions. For the most part, these have gone the way of the Dodo bird, and I.R.C. § 108 is typically seen as providing the exclusive exceptions to COD inclusion. See Gitlitz v. Commissioner, 531 U.S. 206, 215 (2001) (stating that I.R.C. § 108 provides exclusive insolvency exception); Preslar v. Commissioner, 167 E3d 1323, 1332-33 (10th Cir. 1999) (I.R.C. § 108(e)(5) provides exclusive purchase price reduction exception).

499 I.R.C. §§ 108(d)(3), 108(a)(3); assets which are exempt from the reach of the taxpayer's creditors under state law are not included in determining the fair market value of the taxpayer's assets, see Davis v. Corn., 69 TC 814, 831-33 (1978); Hunt v. Com., 57 TCM 919, 947-48 (1989).

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A. BANKRUPTCY

Determining whether a taxpayer is in bankruptcy usually is straight forward, but there is one special case that deserves attention. The literal language of I.R.C. § 108(a)(1)(A) does not actually require the taxpayer to be bankrupt, merely that "the discharge occurs in a title 11 case." The vast majority of the time, that is an unimportant distinction. But in *Gracia v. CIR*,[500] it allowed a nonbankrupt general partner to exclude CODI. To qualify for the bankruptcy exception, I.R.C. § 108(d)(2) requires that the taxpayer be under the jurisdiction of the Bankruptcy Court and that the discharge of indebtedness be granted by the court or be pursuant to a plan approved by the court. The taxpayer was a general partner who had personally guaranteed a portion of the partnership debt. Subsequently, the partnership initiated a bankruptcy case by filing a voluntary chapter 11 bankruptcy petition in the U.S. Bankruptcy Court. The bankruptcy trustee reached a negotiated settlement with some of the general partners, including the taxpayer, whereby in exchange for paying agreed-upon sums to the partnership's bankruptcy estate, the contributing partners would be discharged from liability. The Bankruptcy Court approved the settlement and discharged and released the taxpayer from all liability to the trustee, the bank, and all other creditors that might have claims arising from or relating to the partnership, petitioner's status as a general partner in the partnership, and the personal guaranty agreement. Importantly, the bankruptcy court explicitly asserted its jurisdiction over the taxpayer for this purpose. In a surprising decision, the Tax Court stated:

> "Giving due regard to principles of judicial comity, we discern no reason to second-guess the bankruptcy court's assertion of jurisdiction over petitioner in the partnership's chapter 11 bankruptcy case….We conclude that petitioner's debts in question were discharged "in a title 11 case" within the meaning of section 108(d)(2). Accordingly, we hold that petitioner's discharge of indebtedness income is excludable from gross income pursuant to section 108(a)(1)(A)."

Interestingly, the case did not discuss the *Payne* case which held that guarantors do not have CODI when debt is forgiven. A reason may be that inasmuch as general partners are jointly and severally liable for the debts of the partnership, regardless, the taxpayer had primary liability with the guarantee being more a case of belts and suspenders. (LLPs did not yet exist in the late 1980s, when the relevant transactions took place.) Assuming the general partner in *Gracia* indeed would have had CODI, the result in *Gracia* was doubtless not intended by Congress. On the face of it, *Gracia* seems to create a loophole of Mack Truck proportions, and the IRS did issue a nonacquiescence, though oddly not until almost 11 years after *Gracia* was decided.[501] The IRS fairly noted that the Tax Court's ruling was inconsistent with the structure of I.R.C. § 108 and underlying Congressional intent, which focused on excluding CODI income from the debtor's income so that "the debtor coming out of bankruptcy . . . is not burdened with an immediate tax liability."[502]

While the IRS's reasoning is cogent, if bizarrely late, there may be more smoke than fire here. *Gracia* is probably just a case with anomalous facts. Section 1126 of the Bankruptcy Code requires approval of each class of creditors if the class is "impaired." Under section 1124, a class is impaired unless the plan pays the creditors 100% of what they are owed. Accordingly, the creditors could have refused the deal in *Gracia*. Under section 303 of the Bankruptcy Code, debtors can be forced into Chapter 7 bankruptcy. Further, section 723 of the Bankruptcy Code authorizes the Trustee to recover any deficiency from all general

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500 T.C. Memo. 2004-147.

501 AOD- 2015-02 (IRS AOD), 2015 WL 461750.

502 S. Rep. No. 96-1035, supra, at 10, 1980-2 C.B. at 624; while not overruling Gracia, Treas. Reg. § 1.108-9(a)(2) (2016 WL 3197270) does push back a bit and provides that I.R.C. § 108(a)(2) does not apply If a grantor trust or a disregarded entity is under the jurisdiction of the court in a title 11 case as the title 11 debtor, but the owner of the grantor trust or the owner of the disregarded entity is not.

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partners and the personal assets of the general partners can be reached by the Chapter 7 Trustee. For some reason in *Gracia*, the creditors were decidedly cooperative, but one suspects that is not the norm.[503]

B. INSOLVENCY

I.R.C. § 108's insolvency exception can become complex when the debt is nonrecourse, assuming the typical scenario where the debt is secured by property. (Later we will address the complexities in determining whether debt is recourse or nonrecourse, particularly in the LLC context.) Since the taxpayer has no personal liability on the debt, it is not necessarily appropriate to include the full amount of the nonrecourse debt in the taxpayer's liabilities when calculating the taxpayer's insolvency. Revenue Ruling 92-53[504] addresses this issue.

A slightly tweaked example from the Revenue Ruling: In 1988, individual A borrowed $1,000,000 from C and signed a note payable to C for $1,000,000 that bore interest at a fixed market rate payable annually. The note was secured by an office building valued in excess of $1,000,000 that A acquired from B with the proceeds of the note. A was not personally liable on the note. By 1989, the value of the office building had dropped to $800,000 and the outstanding principal on the note was still $1,000,000. The Revenue Ruling calls the difference between the original debt and the value of the property "excess nonrecourse debt." In the IRS's view, excess nonrecourse debt that is not discharged should not be treated as a liability in determining the amount of insolvency as it does not affect a taxpayer's ability to pay a current tax resulting from the discharge of another debt (whether recourse or nonrecourse) as there is no personal liability on the debt. C agreed to modify the terms of the note by reducing the note's principal amount to $825,000. The modified note bore adequate stated interest. Thus, under the facts of the ruling, $175,000 of A's $200,000 excess nonrecourse debt was discharged, and the ruling therefore concludes that $175,000 of the excess nonrecourse debt should be taken into account in determining whether, and to what extent, A was insolvent within the meaning of I.R.C. § 108, not the full $200,000. Or saying the same thing in a different way, $975,000 of the nonrecourse liability counted toward A's insolvency calculation.

Rev. Rul. 92-53 was followed in this century by Rev. Rul. 2012-14, which applied the reasoning of Rev. Rul. 92-53 to partnerships. In Rev. Rul. 2012-14, X, an investor other than a partnership, and Holdco, a corporation, were equal partners in PRS, a partnership for federal tax purposes. In Year 1, PRS borrowed $1,000,000 from Bank and signed a note payable to Bank for $1,000,000 that bore interest at a fixed market rate payable annually. The note was secured by real estate valued in excess of $1,000,000 that PRS acquired from Seller, in part with the proceeds of the note. The note was a nonrecourse liability within the meaning of Treas. Reg. § 1.752-1(a)(2). Thus, neither PRS nor its partners (X and Holdco) were personally liable on the note.

In Year 2, when the value of the real estate was $800,000 and the outstanding principal on the note was $1,000,000, Bank agreed to modify the terms of the note by reducing the note's principal amount to $825,000. At the time that the Bank reduced the note's principal amount, PRS had no partnership minimum gain with respect to the note under Treas. Reg. § 1.704-2(d)(1). The PRS partnership agreement provided for income to be allocated equally to X and Holdco under § 704(b) and its Regulations. X and Holdco shared PRS nonrecourse liabilities equally under Treas. Reg. § 1.752-3. At the time of the modification of the note, the ruling states that X and Holdco (rather unrealistically) had no assets or liabilities other than their partnership interests in PRS. PRS's sole asset was the real estate subject to the note, and PRS's sole liability was the note. The Revenue Ruling concludes that in order to properly apply Rev. Rul. 92-53 in a partnership context, the partnership's discharged excess nonrecourse debt should be associated with the partner who in the absence of the insolvency or other I.R.C. § 108 exclusion would be required to pay the tax liability arising from the discharge of that debt. Therefore, a partnership's discharged excess nonrecourse debt is treated as a

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503 Thanks go to Prof. Scott Ehrlich who explained the relevant bankruptcy law to me.

504 1992-2 C.B. 48.

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liability of the partners for purposes of measuring the partners' insolvency under § 108(d)(3) based upon how the CODI income with respect to that portion of the debt would be allocated among the partners under I.R.C. § 704(b) and its Regulations. Bank had canceled $175,000 of PRS's $200,000 excess nonrecourse debt, generating $175,000 of CODI income. PRS's $175,000 CODI income was allocated equally between X and Holdco. (I will revisit the topic of discharges of nonrecourse debt and CODI below.) For purposes of measuring the insolvency of the partners, PRS's discharged excess nonrecourse debt was treated as a liability of its partners based upon the CODI income allocation. Thus, X treated $87,500 of PRS's debt as a liability of X, and Holdco treated $87,500 of PRS's debt as a liability of Holdco (and not in either case $100,000). In this case, the value of X's and Holdco's partnership interests in PRS was zero. As X and Holdco had no assets or liabilities other than their partnership interests in PRS, immediately before Bank discharges the indebtedness, X's liability exceeded the value of X's partnership interest by $87,500, and similarly Holdco's liability exceeded the value of Holdco's partnership interest by $87,500. Therefore, X and Holdco were each insolvent to the extent of $87,500 under I.R.C. § 108(d)(3). Accordingly, X and Holdco each excluded $87,500 of CODI from income under § 108(a)(1)(B).[505]

Note that if the nonrecourse debt of the partnership were owed to a partner, under the general rule it is treated as recourse debt, because the lending partner has the economic risk of loss on the debt.[506] If the lending partner forgives the debt, the other partners would have CODI, and the lending partner should have a bad debt deduction under I.R.C. § 166.[507]

It is unclear for insolvency calculation purposes how one should treat contingent liabilities. It is also unclear how to treat liabilities for which the taxpayer has joint and several liability. Likely the Service and the courts would be guided by the likelihood of payment.[508] For example, if a taxpayer has joint and several liability, but is the only debtor with meaningful assets, it will be easier to make the case that the liability should be included in his insolvency calculation. Conversely, it would be harder to make this case for debtors with few assets.

C. Reduction of Tax Attributes

I.R.C. § 108's exclusion for bankruptcy or insolvency potentially comes at a price.[509] The taxpayer is required to reduce certain tax attributes, if the taxpayer has them, by the amount of the exclusion. The exclusion happens regardless of whether or not the taxpayer has the attributes. The attributes are, in brief, net operating losses ("NOLs"), general business credits, minimum tax credits, capital loss carryovers, under limited circumstances basis in taxpayer assets, passive activity loss and credit carryovers, and foreign tax credit carryovers.[510] These attributes are reduced in the order listed.[511] Under I.R.C. § 108(b)(4)(A), these reductions are applied after the taxpayer determines his federal income tax liability for the taxable year, so

505 See Richard M. Lipton, Nonrecourse Debt, Insolvency, and Partnerships, the Service Deals with a Volatile Mix, J. of Tax'n (August 2012).

506 Treas. Reg. § 1.752-2(c)(1). There is an exception if the partner holds an interest of 10% or less in all partnership items. Treas. Reg. § 1.752-2(d)(1).

507 See James B. Sowell, Good News Regarding Partnership Debt and Partner Insolvency, Tax Notes (July 3, 2012).

508 *See* Merkel v. CIR, 192 F.3d 844 (9th Cir. 1999), which takes this position. *But also see* Treas. Reg. § 1.752-7, which seems to suggest that all liabilities, contingent or not, can be valued. *See* Richard M. Lipton and Todd D. Golub, Taxation Meets Bizarro World, Passthroughs and Debt Workouts, Taxes-The Tax Magazine (May 2010) at 337 (hereinafter "Bizarro").

509 While not a subject of this chapter, tax attribute reduction is also required for the discharge of "qualified farm indebtedness."

510 I.R.C. § 108(b). If the taxpayer has more than one of the attributes, the reduction occurs in to the attributes in the order listed. I.R.C. § 108(b)(2).

511 I.R.C. § 108(b)(2).

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that a taxpayer, for example, may offset gain from sales with existing NOLs before reducing them and other attributes as a result of excluded CODI. Under I.R.C. § 1017(b)(2), in the case of a discharge where the taxpayer in bankrupt or insolvent, the basis reduction only occurs to the extent of the excess of the aggregate of the bases of property held by the taxpayer immediately after the discharge over the aggregate of the liabilities of the taxpayer immediately after the discharge. Under the Regulations, taxpayer must make permissible basis reductions in the following order (but not below zero), based on the adjusted bases of property held on the first day of the taxable year following the taxable year that the taxpayer excluded CODI: (1) Real property used in a trade or business or held for investment, other than real property described in I.R.C. § 1221(1), that secured the discharged indebtedness immediately before the discharge; (2) Personal property used in a trade or business or held for investment, other than inventory, accounts receivable, and notes receivable, that secured the discharged indebtedness immediately before the discharge; (3) Remaining property used in a trade or business or held for investment, other than inventory, accounts receivable, notes receivable, and real property described in I.R.C. § 1221(1); (4) Inventory, accounts receivable, notes receivable, and real property described in I.R.C. § 1221(1); and (5) Property not used in a trade or business nor held for investment.[512]

If a taxpayer has CODI attributable to more than one discharged indebtedness, the rules for basis reduction must be applied allocating the tax-attribute reductions among the debts in proportion to the amount of CODI income attributable to each discharged indebtedness. For example, if a taxpayer excludes $20 of CODI income attributable to secured indebtedness A and excludes $80 of CODI income attributable to unsecured indebtedness B (a total exclusion of $100), and if the taxpayer reduces tax attributes by $40 under sections 108(b)(2)(A) through (D) (i.e. NOLs, general business credits, minimum tax credit and capital loss carryovers), for basis reduction purposes, the taxpayer must reduce the amount of CODI income attributable to secured indebtedness A to $12 ($20−($20 / $100 x $40)) and must reduce the amount of CODI income attributable to unsecured indebtedness B to $48 ($80−($80 / $100 x $40)).

Under I.R.C. § 108(b)(5), in lieu of reducing other tax attributes, the taxpayer may elect to apply any portion of the reduction in tax attributes under I.R.C. §§ 108(b)(2)(A) through (D) to the reduction under I.R.C. § 1017 of the basis of the depreciable property of the taxpayer, but now without the I.R.C. § 1017(b)(2) limitation. Note that it is not all or nothing. One can make the election for only part of the tax attribute reduction and have the rest follow the primary rules. Applying I.R.C. § 108(b)(5) and the related I.R.C. § 1017 rules in the partnership context comes with some challenges. We discuss these rules below after the discussion of I.R.C. § 108(c) and qualified acquisition indebtedness. Ordinarily, taxpayers would not want to make a I.R.C. § 108(b)(5) election, because the I.R.C. § 1017(b)(2) limitation means that excluded CODI in excess of the limit disappears and cannot reduce tax attributes further, unless that taxpayer has passive loss or foreign tax credit carryforwards (attributes that are reduced after the basis reduction). Still, there are times when other tax attributes could be more valuable and worth the election, especially NOLs.[513] Note that even if a I.R.C. § 108(b)(5) election is made, other tax attributes might still need to be reduced if there is not enough depreciable basis to cover all of the excluded CODI.

If a taxpayer is required to reduce tax attributes, he no longer receives a true exclusion, but rather, effectively, a deferral. For example, assume a taxpayer has $10,000 of NOLs that are reduced to zero under the discussed rules. That means that $10,000 of future income of the taxpayer will be taxable that would not have been taxable but for the attribute reduction. In a true exclusion (such as that for gifts under I.R.C. § 102), the excluded amount is never part of income and never taxed. But in the example, the taxpayer did not get a true exclusion of $10,000 of CODI. Instead, he was able to avoid taxation of the CODI currently, but later can have $10,000 income he would not otherwise have had. Thus, the taxpayer "only" received a

512 Treas. Reg. § 1.1017-1(a).

513 *See* Treas. Reg. § 1.1017-1(c)(1) which can allow the taxpayer to only reduce the basis of certain assets.

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deferral of the tax on $10,000, assuming the taxpayer earns that amount of otherwise taxable income at some point down the road.[514]

As discussed above, under I.R.C. § 108(d)(6), in almost all cases I.R.C. § 108 applies at the partner level and not the partnership level. Thus, a bankrupt or insolvent partner may make use of I.R.C. § 108's exclusions for bankruptcy or insolvency, but a bankrupt or insolvent partnership may not. Attribute reduction also happens at the partner level.

Rev. Proc. 92-92,[515] on the other hand, provides an exception of sorts to the general rule. The Revenue Procedure holds that in the case of a partnership that is either bankrupt or insolvent, the Service will not challenge the partnership's treatment of a reduction (in whole or in part) of an indebtedness owed by such partnership as a purchase price adjustment (and thus not CODI) if (1) the transaction would qualify as a purchase price adjustment within the meaning of I.R.C. § 108(e)(5) but for the bankruptcy or insolvency of the partnership, and (2) no partner takes an inconsistent position.

D. Qualified Real Property Business Indebtedness

As we will discuss, if there is a foreclosure of property, it can make a significant difference whether the debt is recourse debt or nonrecourse debt. But that is not true in the case of straight forgiveness of debt without a foreclosure. Recourse or nonrecourse, the amount forgiven normally is CODI.[516] There is one exception, however, for certain debt secured by real estate. During the 1990s, real estate prices took a tumble. It is worth recalling that banks are in the money lending business, not the real estate business. Banks did not want to have large real estate portfolios and during this real estate crisis were often open to forgiving some portion of the debt. But the CODI rules often proved to be an obstacle. Often the debt was nonrecourse and the borrowers were neither bankrupt nor insolvent. Debtors did not want the ordinary income attendant with CODI. And in foreclosure, nonrecourse debtors could typically avoid ordinary income (see below), which sometimes encouraged foreclosure. In response, Congress enacted I.R.C. §§ 108(a)(1)(D), which provides the exclusion, and 108(c), which provides the rules for the election. Under these provisions, the forgiveness of a certain amount of "qualified real property business indebtedness" ("QRPBI") is not CODI. QRPBI is debt that was incurred or assumed by the taxpayer in connection with real property used in a trade or business, which is secured by the real property. Real property held for sale does not qualify for this exclusion.[517] Further, the indebtedness must be incurred or assumed to acquire, construct, reconstruct, or substantially improve such property, i.e. the debt must generate basis at the time it was incurred or assumed.[518] Thus, for example, if a partnership borrows against real property and distribute the proceeds to its partners, the debt is not QRPBI. There is no requirement that the debt be nonrecourse, but it commonly is. What if part of the debt qualifies as QRPBI and part does not, because, for example, the taxpayer refinanced the debt and pocketed a portion of the proceeds? PLR 200953005 ruled that the entire debt need not constitute qualified real property business indebtedness in order to rely on I.R.C. § 108(c). Under the PLR, the taxpayer must use a "reasonable allocation method" in determining the portion of a debt instrument that is QRPBI the portion that is not.

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514 Currently, NOLs may be carried forward indefinitely. *See* I.R.C. § 172. Of course, if the taxpayer dies before he could have taken advantage of the NOL, a true exclusion could exist. There was a time when there was a limit on how many years an NOL could be carried forward. In that case, as well, an exclusion would in fact have occurred, if the NOL expired before the taxpayer could have taken advantage of it.

515 1992 C.B. 505.

516 *See* I.R.C. § 108(d)(1).

517 *See* Rev. Rul. 2016-15, 2016-26 I.R.B. 1060.

518 *See* PLR 200953003.

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The fact that the debt must be secured by real property can pose problems, especially in the LLC context. If debt is secured by an interest in a single-member LLC ("SMLLC") that is a disregarded entity and owns real property, is that sufficient? Revenue Procedure 2014-20 provides that if the following five requirements are satisfied, debt secured by a 100 percent ownership interest in a disregarded entity holding real property will be treated as indebtedness that is "secured by real property" for these purposes:

(1) The taxpayer or a wholly owned disregarded entity of the taxpayer ("Borrower") incurs indebtedness.

(2) Borrower directly or indirectly owns 100 percent of the ownership interest in a separate disregarded entity owning real property ("Property Owner"). Borrower is not the same entity as Property Owner.

(3) Borrower pledges to the lender a first priority security interest in Borrower's ownership interest in Property Owner. Any further encumbrance on the pledged ownership interest must be subordinate to the lender's security interest in Property Owner.

(4) At least 90 percent of the fair market value of the total assets (immediately before the discharge) directly owned by Property Owner must be real property used in a trade or business and any other assets held by Property Owner must be incidental to Property Owner's acquisition, ownership, and operation of the real property.

(5) Upon default and foreclosure on the indebtedness, the lender will replace Borrower as the sole member of Property Owner.

While not free from doubt, it appears that only one level of debt can be secured by a disregarded entity. In large real estate businesses that own numerous parcels of real estate, it is not unusual to see many levels of subordinated junior debt secured by interests in disregarded entities. The fact that under requirement (3) borrower must pledge to the lender a first priority security interest suggests that a multi-layered structure (outside of the top layer) will not qualify under the Revenue Procedure. While the Revenue Procedure does not meet the needs of many complex real property structures, it at least has the value of simplicity. Tracing debt through many layers would be both a complex process and one that would be difficult for the Service to monitor.

Under I.R.C. § 108(c)(2)(A), the amount of CODI that is excluded cannot exceed the excess of (i) the outstanding principal amount of the indebtedness (immediately before the discharge), over (ii) the fair market value of the real property reduced by the outstanding principal amount of any other QRPBI secured by such property. In other words, the amount that can be excluded is that amount by which the real property is under water. To the extent the discharge creates equity, it does not qualify for the exclusion.

Chief Counsel Advice 201623009 addressed the application of the equity limitation where the taxpayer owned two properties, Property A and Property B. Both debts were secured by both properties, although one debt ("Debt A") was used solely to acquire and construct Property A and the other debt ("Debt B") was used solely to acquire and construct Property B. Debt A was reduced. Should the equity limitation be applied by reference to both Debts A and B and all property securing those debts or instead by reference only to the Debt A and Property A? The Service chose the latter option, concluding that the equity limitation should apply by comparing the amount of Debt A, determined immediately before the discharge, to the fair market value of Property A.

Under I.R.C. § 108(c)(1)(A) and its Regulations, the amount excluded from gross income reduces the basis of the *all depreciable* real property of the taxpayer beginning first with the real property securing the

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debt which lead to the exclusion.[519] I.R.C. § 108(c)(2)(B) further provides that the amount excluded may not exceed the aggregate adjusted bases of *depreciable* real property held by the taxpayer immediately before the discharge (other than depreciable real property acquired in contemplation of such discharge). While it appears the forgiven debt could be secured by unimproved real property, the fact that the excluded amount cannot exceed the aggregate bases of depreciable real property makes the exclusion of limited value in this regard. Again, the basis reduction provisions mean that the exclusion can provide an income deferral, but, the nomenclature notwithstanding, not a true income exclusion, as less basis means more gain or less loss down the road when the property is sold.[520] Further, gain on the sale of the property is taxed as ordinary income under I.R.C. § 1017(d) to the extent of the basis reduction.

There is some tension between the QRPBI rule and I.R.C. § 108(d)(6). The determination of whether a debt is QRPBI is made at the partnership level, and the fair market value limitation on the amount of the I.R.C. § 108(c) exclusion is also applied at the partnership level.[521] But the election to have I.R.C. § 108(c) apply, nevertheless, is made at the partner level.[522] This two-level approach makes life needlessly complex and can create many additional complexities, some of which are discussed below. Particularly in light of the fact that it would be rare to not take advantage of the exclusion, it would have been simpler to allow the partnership to make the election and apply the exclusion at the partnership level, with the partnership adjusting the basis of the relevant real property. Only in the rare case where the adjustment exceeds the partnership's depreciable real property basis would the partners be required to proportionately reduce the basis in depreciable real property held outside the partnership. The amount excluded under the QRPBI rules should count at tax-exempt income and be allocated to the partners, as such, with a concomitant increase in their bases in their partnership interests under I.R.C. § 705. That likely would be mostly offset by the deemed distribution under I.R.C. § 752(b) for the debt reduction. We review I.R.C. § 752(b) issues in more detail below. We discussed I.R.C. § 752(b) in detail in Chapter 3.

E. BASIS ADJUSTMENTS

I.R.C. § 1017(b)(3)(C) provides that any interest of a partner in a partnership shall be treated as depreciable property (and thus could be reduced under the I.R.C. § 1017 general rules) to the extent of such partner's proportionate interest in the depreciable property held by such partnership. But it also states that this rule shall apply only if there is a corresponding reduction in the partnership's basis in depreciable property with respect to such partner.

The Regulations flush this out by providing that if a partner makes an election under I.R.C. § 108(c) or 108(b)(5), the partner must treat his partnership interest as depreciable property (or depreciable real property) to the extent of the partner's proportionate share of the partnership's basis in depreciable property (or depreciable real property), *provided* that the partnership consents to a corresponding reduction in the

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519 A taxpayer who elects to apply I.R.C. § 108(c) may reduce only the adjusted basis of property described in I.R.C. § 108 (a)(1) and (3) of this and, within paragraphs (a)(1) and (3) of this section, may reduce only the adjusted bases of depreciable real property. Treas. Reg. § 1.1017-1(c)(1). The amount excluded from gross income may not exceed the aggregate adjusted bases of all depreciable real property held by the taxpayer immediately before the discharge (other than depreciable real property acquired in contemplation of the discharge) reduced by the sum of any depreciation claimed for the taxable year the taxpayer excluded discharge of indebtedness from gross income under I.R.C. § 108(a)(1)(D); and reductions to the adjusted bases of depreciable real property required under I.R.C. § 108(b) or I.R.C. § 108(g) for the same taxable year. I.R.C. § 108(c)(2)(B); Treas. Reg. § 1.108-6(b).

520 See Treas. Reg. § 1.1017-1(c)(1) for an ordering rule. If depreciable real property is disposed of prior to the end of the tax year, the basis of the property is reduced immediately before disposition if earlier that the time under I.R.C. § 1017(a), i.e. at the beginning of the taxable year following the taxable year in which the discharge occurs. I.R.C. § 1017(b)(3)(F)(iii).

521 See HR Rep. No. 111, 103d Cong., 1st Sess. 186 (1993); Priv. Ltr. Rul. 9426006 (Mar. 25, 1994); McKee, Nelson & Whitmire, Federal Taxation of Partnerships and Partners, ⁋ 9.02[2][a][ii][A] (hereinafter "McKee").

522 Id. See HR Rep. No. 111, 103d Cong., 1st Sess. 186 (1993). See I.R.C. §§ 108(d)(6), 703(b)(1); Priv. Ltr. Rul. 9426006 (Mar. 25, 1994). See also Reg. § 1.1017-1(g)(2)(i).

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partnership's basis in depreciable property (or depreciable real property) with respect to such partner. Subject to exceptions discussed below, the partnership may grant or withhold consent in its sole discretion.[523] Even the partner's request of the partnership is not always mandated. Subject to exceptions discussed below, the Regulations provide that a partner *may* choose whether or not to request that a partnership reduce the inside basis of its depreciable property (or depreciable real property) with respect to the partner.[524] If either the partner does not make a request or the partnership declines it, this adjustment is not made, and the partner is required to make basis reductions to the partner's other assets (excluding assets held through the partnership).[525] That said, given the limitation in I.R.C. § 108(c)(2)(B) that the QRPBI exclusion cannot exceed the aggregate basis of the taxpayer's depreciable real property, to maximize the exclusion a partner may have an incentive to seek to treat the partnership interest as depreciable real property.

If circumstances arise under which the partner indeed requests consent, the partner must do so before the due date (including extensions) for filing the partner's Federal income tax return for the taxable year in which the partner has CODI that is excluded.[526] There are exceptions to the discretion given partners and their partnerships, however. A partner *must* request a partnership's consent to reduce inside basis if, at the time of the discharge, the partner owns (directly or indirectly) a greater than 50 percent interest in the capital and profits of the partnership.[527] Similarly, a partnership must consent to reduce its partners' shares of inside basis with respect to a discharged indebtedness if consent is requested with respect to that indebtedness by (1) partners owning (directly or indirectly) an aggregate of more than 80 percent of the capital and profits interests of the partnership *or* by five or fewer partners owning (directly or indirectly) an aggregate of more than 50 percent of the capital and profits interests of the partnership.

These rules are perhaps easiest to apply to forgiven debt held by the partner outside of a given partnership. In their treatise, William S. McKee, William F. Nelson, and Robert L. Whitmire provide a helpful QRPBI example, where the action takes place within a partnership. Here is the example, lightly edited, and I've put an addition in brackets.

> A and B are equal partners in the AB general partnership. AB owns depreciable real property X used in its business. Property X has a value of $800, an adjusted basis of $200, and is subject to a $1,000 nonrecourse encumbrance, which is a QRPBI. Each partner has a basis of $100 in his partnership interest. AB and the lender agree to reduce the principal amount of the debt to $800.
>
> The debt reduction generates $200 of CODI to the partnership, $100 of which is allocated to each partner. Applying I.R.C. § 108(c) at the partnership level, the debt is QRPBI and the FMV limitation is satisfied. A elects to exclude his share of discharge income under I.R.C. § 108(c), but B does not. The basis of each partner's partnership interest is increased by a $100 allocable share of CODI, and is reduced by a $100 reduction in the liabilities allocated to him under I.R.C. § 752. Therefore, there is no net change in either the basis of B's partnership interest or B's proportionate share of the partnership's basis in real property X. Because of A's I.R.C. § 108(c) election, [A is required to reduce the basis of depreciable real property under sections 108(c)(1) and 1017(b)(3)], A's outside basis in the partnership is treated as depreciable real property and is reduced by a further $100 under I.R.C. § 1017, as is A's share of the partnership's basis in property X. Thus, A winds up with a zero basis for his partnership interest and his share of the basis of property X is also reduced to zero.

523 *See* Treas. Reg. § 1.1017-1(g)(2)(i).
524 *See* Treas. Reg. § 1.1017-1(g)(2)(i),(ii).
525 *See* Bizarro *supra* note 586 at 114.
526 Treas. Reg. § 1.1017-1(g)(1)(ii).
527 Treas. Reg. § 1.1017-1(g)(2)(ii)(B).

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A reduction in the basis of partnership property is specific to the partner (A in the McKee, Nelson, and Whitmire example) and does not reduce the common basis of a partnership's assets. These basis adjustments are treated in the same manner and have the same effect as basis adjustments under I.R.C. § 743(b).[528]

T.D. 8787 (preamble) contains an example which helps explain why under some circumstances the partner's request and the partnership consent are mandatory. In the example, if there is a cancellation of partnership indebtedness that is secured by real property, and if partners owning (in the aggregate) 90 percent of the capital and profits interests of the partnership elect to exclude the CODI under I.R.C. § 108(c), the partners must request the consent, and the partnership must accede to it, making the appropriate reductions in those partners' shares of inside basis. The likely objective here is to prevent taxpayers from contributing depreciable property to a partnership and then not making an election in order to block a basis adjustment for the contributed property. It seems doubtful that this would be a frequent issue in the real property context, because, as discussed above, under I.R.C. § 108(c)(2)(B) the QRPBI exclusion cannot exceed the basis of the taxpayer's depreciable real property. That said, a taxpayer could have a preference for which bases are reduced depending on the facts and might attempt to protect a given property by contributing it to the partnership.

Although it is hard to imagine a circumstance when one would not want to make the I.R.C. § 108(c) election, it is not hard to imagine a circumstance where a financially struggling partnership would have uncooperative, disgruntled partners (or simply clueless or poorly advised ones). It thus would be wise to address the I.R.C. § 108(c) election up front in the partnership agreement. The agreement might provide that all partners must make the I.R.C. § 108(c) election, and the partnership must cooperate in that regard, unless 75% of the partners affirmatively vote to the contrary.

A problem that sometimes arises is that after the debt has been renegotiated, the partners and the partnership still cannot make a go of it and are forced to sell the underlying property in the near term. Due to the application of the basis reduction rules, the sale can generate a large gain, which I.R.C. § 1017(d) could tax as ordinary income. Consequently, partners want to think through downstream sales ahead of time. If the financial problems have not gotten completely out of hand, a solution might be not to sell the property at all, but to bring in equity partners who can put the partnership in better economic shape and continue to operate the property.

F. MINIMUM GAIN CHARGEBACKS

If a partner's share of nonrecourse debt is forgiven, that partner's share of minimum gain can drop, triggering a "minimum gain chargeback," under which income is allocated to the partner to offset the drop in minimum gain. These rules do not necessarily pose a major problem in the debt workout context, because the partners' elections under I.R.C. §§ 108(b)(5) and 108(c) have no effect on the book values of partnership assets, which remain unchanged by any of the adjustments relating to the debt reduction. The book income generated by the discharge of indebtedness is equal to the amount of the discharge regardless of these elections.[529] Thus, the minimum gain chargeback should be met by the book income from the discharge, which usually should be exactly adequate for this purpose. Although this area surely has its complexities, it typically should not cause problems with the minimum gain chargeback rules.[530]

For example, assume the partnership AB has two equal partners A and B. A and B share all allocations equally. AB borrows $100,000 on a nonrecourse basis and buys a building on leased land for $100,000. It is the partnership's only asset. Market interest is paid annually, but no principal payments are

528 Treas. Reg. § 1.1017-1(g)(2)(v).
529 *See* McKee supra note 599 at ⁋ 9.02[2][a][ii][C].
530 *Id.*

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due for ten years. The debt constitutes QBPRI. Initially, the building has a $100,000 tax basis and book value. Assume further that the partners and partnership comply with all of the relevant regulatory rules. At the end of Year 6, assume the partnership's basis and book value in the building are reduced to $70,000 and there is $30,000 of minimum gain. If A and B made no contributions to the partnership, their outside bases will be $35,000 each and each will have a permissible negative capital account of $15,000.[531] The creditor forgives $10,000 of the debt. The resulting $10,000 of CODI could be excluded for tax purposes (with all of the basis, etc. issues discussed above), assuming the property's fair market value has dropped to $90,000 (or less) and that the I.R.C. § 108(c) election is made. Here our focus, however, is on the minimum gain issues. The drop in the debt triggers a minimum gain chargeback of $10,000, $5,000 of which must be allocated to each of A and B, increasing their capital accounts to a negative $10,000 each. The source of the revenue for the chargeback is the CODI itself which constitutes not only taxable income but also book income. As discussed earlier, even if the CODI is tax exempt, it should still be partnership income for basis and capital account calculation purposes.

Sometimes a debt workout involves that is commonly called a "squeeze down." For example,[532] the old partners, Dick and Jane, own equal interests in partnership DJ, which has a building with an adjusted basis and book value of $40 that is subject to nonrecourse debt of $100 from an unrelated lender, and is qualified nonrecourse financing for I.R.C. § 465 purposes. Dick and Jane have claimed deductions of $30 each, which reduces their basis in their partnership interests to $20 each. Furthermore, because the debt is nonrecourse, Dick and Jane have each been allocated $30 of minimum gain and under the third tier another $20 given their equal profit shares, for a total debt share of $50 each. If Dick and Jane lost their interests in the partnership, they would have a $30 minimum gain chargeback and a I.R.C. § 752(b) distribution of $50 each, creating $30 of capital gain under I.R.C. § 731(a)(1) (absent I.R.C. § 751, which we will assume does not apply for purposes of this chapter). Assume that the fair market value of the building is less than its debt, but another individual, Sally, is willing to invest $50 into the partnership which will be used for improvements; however, because the partnership has no net equity, Sally insists that she must "own" the building. The adverse tax consequences to Dick and Jane can be reduced, if they keep a small interest in the partnership. For example, the partnership agreement could be amended to reduce their partnership interests to ½ percent each, so that Sally would own 99 percent of the partnership. The debt of the partnership would remain at $100, and Dick and Jane would each be allocated $30 of the $100 liability under the Regulations as their minimum gain has not changed.[533] The reduction in their partnership interests does not change their shares of minimum gain under the Regulations, which tracks prior allocations of nonrecourse deductions.[534] As a result, Dick and Jane would each have a I.R.C. § 752(b) deemed distribution of $20 instead of $50 (($50 original share minus $30 remaining "minimum gain" share, ignoring the tiny profit share they kept), which would reduce their basis in their partnership interests to $0 but would not result in I.R.C. § 731(a)(1) gain. To state the obvious, this technique works best if the debt of the partnership is not reduced.

If partners want to limit the impact of a minimum gain chargeback, one possibility is to do a book up, if the book values of the partnership assets are below their fair market values. In a book up, which has no tax impact, the book values of the assets and the partners' capital accounts are restated at fair market value. The Regulations permit the partnership to book up capital accounts at the time of the admission of a new partner.[535] Furthermore, in making such adjustments, the fair market value of the property of a partnership that is encumbered by nonrecourse debt is deemed to be equal to the amount of such liability.[536] Of course, if a partnership is underwater, it is unlikely that the fair market values of the partnership assets exceed book

531 *See* § 5.07A.

532 We borrow this example from Lipton I *supra* note 561 and are indebted to Lipton I for much of the discussion.

533 Treas. Reg. §1.752-3(a)(1).

534 *See* Treas. Reg. § 1,704-2(c).

535 Treas. Reg. § 1.704-2(b)(2)(iv)(f).

536 I.R.C. § 7701(g) and Treas. Reg. §1.704-1(b)(2)(iv)(f)(1).

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value. But, if a new partner is admitted or the old partners make a significant capital contribution which is used to purchase additional property that is again subject to nonrecourse debt, it may increase the overall value of the partnership assets so that a book up if possible. A book up will reduce minimum gain (because the amount by which the liability exceeds "book basis" will be reduced), but under the Regulations the reduction will be ignored in applying the minimum gain chargeback rules as long as the reduction in minimum gain is caused solely by the book up.[537] For this technique to work, the total amount of nonrecourse debt should not be decreased, because then the decrease in minimum gain would not be caused solely by the book up and a minimum gain chargeback would thus be triggered.

For example,[538] assume that partnership LS has two partners, Les and Sandy, and LS owns a building with an adjusted basis of $40 that is subject to a nonrecourse debt of $100. As a result, Les and Sandy each have $30 of minimum gain and a basis in their partnership interests of $20. In order to obtain new capital, LS agrees to admit Rich as a 50% partner in exchange for a capital contribution of $20, which funds are used to make capital improvements to an asset that is subject to the partnership's liabilities. If the partnership does not "book up" capital accounts, the amount of partnership minimum gain will be decreased by $20, resulting in a $20 minimum gain chargeback to Les and Sandy, because the book value (and tax bases) of the asset would be increased by $20 for the additional investment in the asset. On the other hand, if the partnership were to book up as a result of the admission of a Rich before his funds are invested, the minimum gain allocated to Les and Sandy would be eliminated because the fair market value of the property of LS would be deemed to be equal to its remaining debt ($100),[539] and the decrease in minimum gain to zero was caused solely by the book up.[540] As a result, even though a new partner was admitted to the partnership and the amount of minimum gain decreased, Les and Sandy would not suffer a minimum gain chargeback. Since the minimum gain is already reduced to zero, the investment of Rich's funds has no untoward effects in this regard.

§ 18.04. FORECLOSURE

The plot thickens a bit when there is a foreclosure of property subject to debt. In the case of foreclosure or its equivalent, it can make a dramatic difference if the debt is recourse or nonrecourse. The different rules are perhaps best understood by way of an example: Debtor borrows $80,000 on which only interest was owed for five years. Debtor uses the borrowed funds and $20,000 of cash to purchase land for $100,000, with the land securing the debt. By year 4, the land drops in value to $80,000 and debtor gives the bank a deed in lieu of foreclosure (it would make no tax difference if an actual foreclosure occurred). All interest was paid when due, and throughout the debt remains at $80,000 and the basis in the property remains at $100,000. If the debt is recourse, the amount considered paid by the debtor on foreclosure, and therefore the debtor's amount realized, is limited to the fair market value of the property, i.e. $80,000, which less the $100,000 basis generates a $20,000 capital or I.R.C. § 1231 loss to the taxpayer.[541] The reason that the amount paid is limited to $80,000 is because the lender can sue to recover the other $20,000 of unpaid debt, sometimes called "suing on a deficiency." If the lender forgives the $20,000 unpaid debt, the debtor has CODI in that amount. Having CODI can be a good thing if the debtor can take advantage of one of the I.R.C. § 108 exclusions, and typically a bad thing if the debtor cannot. Assuming no CODI exclusion, note that there is a potential character mismatch. There is $20,000 of ordinary income CODI, which will not be offset by the $20,000 loss, if the loss is a capital loss or a I.R.C. § 1231 loss that is treated as a capital loss, in light

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537 Treas. Reg. § 1.704-2(d)(4).

538 We borrow this example from Lipton I *supra* note 561 and are indebted to Lipton I for much of the discussion.

539 I.R.C. § 7701(g) and Treas. Reg. §1.704-1(b)(2)(iv)(f)(1).

540 Treas. Reg. § 1.704-2(d)(4).

541 Treas. Reg. § 1.1001-2. *See* Gehl v. Comm'r, 95-1 USTC & 50,191 (unpublished, 8th Cir. 1995) and Aizawa v. Comm'r, 99 T.C. 197 (1992); *also see* Deborah Geier, Tufts and the Evolution of Debt - Discharge Theory, 1 Fla. Tax Rev. 115 (1992) (hereinafter "Geier").

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of I.R.C. § 1211(b). But, if it is a I.R.C. § 1231 loss that is treated as an ordinary loss, the two will offset, but for the following five years $20,000 of any net I.R.C. § 1231 gains will be recaptured as ordinary income under I.R.C. § 1231(c).

On the other hand, if the debt is nonrecourse, the debtor has no personal liability on the obligation, and the debt is effectively deemed paid in full when the debtor gives the lender the deed in lieu of foreclosure. Under Tufts, the debtor's amount realized is $100,000 less the $100,000 basis for no gain or loss realized or recognized.[542] Note that if the basis in the land had been less than $100,000, the debtor would have had capital gain or I.R.C. § 1231 gain on the foreclosure, but no CODI because in a foreclosure none of the nonrecourse debt is forgiven, as such.[543] For obvious reasons, nonrecourse debtors generally try to avoid foreclosure because of the lack of available exclusions. The gain has been known exceed the value of the property. But if foreclosure cannot be avoided and the nonrecourse debtors are neither bankrupt nor insolvent, they typically will be better off than recourse debtors, because usually there is a lower tax rate on the gains than on CODI, assuming no application of I.R.C. § 1017(d) from prior debt forgiveness.

If a taxpayer has NOLs, he may use them to offset either the COD income or the gain recognized under I.R.C. § 1001. Although I.R.C. § 108(b)(2)(A) requires that the NOL attribute be reduced in the case of CODI exclusions, I.R.C. § 108(b)(4)(A) provides that a taxpayer does not reduce tax attributes until after he has determined the tax that would otherwise be imposed for the tax year in question. Thus, any NOL can be used, unreduced, for the tax year of the discharge. If a taxpayer has NOLs, is insolvent, and owes both recourse and nonrecourse debt, a planning opportunity may exist, though it requires cooperative creditors. In Year 1 allow the property subject to nonrecourse debt to be foreclosed and use the NOLs to offset the gain. In Year 2, allow the property subject to recourse debt to be foreclosed, and use the insolvency rule to exclude any CODI (assuming, of course, that the taxpayer remains insolvent). If the income from foreclosure is passive under I.R.C. § 469 and the taxpayer has a passive activity loss (i.e. a passive loss carryforward from prior years), the same planning opportunity exists. In principle, these approaches should also work in bankruptcy, but query whether the trustee could be persuaded to cooperate.[544]

Note that partners can have decidedly divergent preferences on how income is classified. If one of the I.R.C. § 108 exclusions is available to a partner, the partner will prefer having more CODI. If not, typically the partner will prefer having more capital or I.R.C. § 1231 gain. To the extent that partner buy-in is necessary to reach an agreement with the lender and/or to make necessary modifications to the partnership agreement, the divergent preferences of the partners can pose a substantial hurdle. Further, even if partner buy-in is not required, a general partner in a limited partnership or a managing member in a manager-managed LLC must make sure he does not violate any fiduciary duties that he has to the partners or members in reaching an agreement with the creditor.

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[542] Tufts v. CIR, 461 U.S. 300 (1983); see Crane v. CIR, 331 U.S. 1, 11 (1947).

[543] Treas. Reg. § 1.1001-2. The Regulations provide that relief from acquisition indebtedness is not included in amount realized "to the extent that such liability was not taken into account in determining the transferor's basis in such property." Treas. Reg. § 1.1001-2(a)(3). *See* Erik M. Jensen, The Unanswered Question in Tufts: What Was the Purchaser's Basis?, 10 VA. Tax Rev. 455 (1991).

[544] Some, including no less than Justice Sandra Day O'Connor, have argued that this divergence in treatment between recourse and nonrecourse debt should not exist, and that nonrecourse debt should be treated the same as recourse debt (thus generating higher taxed ordinary income COD instead of typically lower-taxed capital or I.R.C. § 1231 gain). *See* Commissioner v. Tufts, 461 US 300 (1983), 318-320 O'Connor concurrence, arguing for the alternative treatment, but acknowledging that it was too late to change it (hereinafter "Tufts"). Inasmuch as this topic has received substantial coverage in the literature, we will not reengage it here, other than to note that the current treatment is hardly irrational and there seems to be no prospect of this rule changing. *See, e.g.*, Alice Cunningham, Payments of Debt with Property, the Two-Step Analysis After Commissioner v. Tufts, 38 Tax Law. 575 (1985); Daniel N. Shaviro, Risk and Accrual: The Tax Treatment of Nonrecourse Debt, 44 Tax L. Rev. 401 (1989); Fred T. Witt, Jr. & William H. Lyons, An Examination of the Tax Consequences of Discharge of Indebtedness, 10 Va. Tax Rev 1 (1990), and Geier *supra* note 619.

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§ 18.05. PARTNERSHIP ALLOCATION OF CODI

In a "straight up" partnership (i.e. one in which partners' allocations of items of income and deduction do not change), allocating the CODI should not prove to be a challenge. But if the partnership has complex allocation provisions, such as waterfalls (where different classes of partners have different rights to income and distribution depending on the aggregate earnings and losses of the partnership), it may not be a straight-forward matter as to how to allocate CODI. Ideally, how CODI should be allocated would be contained in the original partnership agreement. If not, it could be wise to amend the partnership agreement to specifically address the allocation of CODI. It may be difficult for all of the partners to agree on how the partnership agreement should be amended during a debt workout, hence the preference for having the agreement anticipate the problems initially. Of course, any allocation of CODI must comply with I.R.C. § 704(b) and its Regulations, meaning that the allocation must either have substantial economic effect or be in accordance with the partners interests in the partnership.

This is not the place for a deep dive into these highly complex I.R.C. § 704(b) rules, but it is important to tread carefully. It may not, for example, be possible to allocate all of CODI to partners for whom it would be excluded under I.R.C. § 108 (and not to partners for whom it would not be excluded) due to the lack of substantiality under the substantial economic effect safe harbor.[545] On the other hand, if all of the partners could exclude CODI income, but one of the partners wanted to increase his capital account and tax basis in order to increase the amount of losses allocated to that partner in the future, the special allocation of the "extra" CODI to that partner might be respected. Working through the analysis gets even more challenging if tiers of partnerships are involved, which in larger deals are the norm. It can be challenging to track through the tiers to determine where the CODI allocation ultimately lands, a very big deal if some partners are entitled to a I.R.C. § 108 exclusion.

An unanswered question is how allocations of CODI interact with the new interest deduction limitation of I.R.C. § 163(j). I.R.C. § 163(j) is incredibly complex in the partnership context.[546] Add in I.R.C. § 108, and it is the stuff of nightmares. Can CODI increase adjusted taxable income, thereby potentially increasing the interest deduction and affecting possible carryforwards of excess business interest at the partner level? If a partner has "excess business interest," i.e. unused partnership interest expenses he is carrying forward, what happens if the underlying debt is canceled? One positive aspect: I.R.C. § 163(j) carryforwards are not on the list of attributes subject to reduction under I.R.C. § 108(b)(2).

Depending on how carefully a partnership agreement is drafted, how CODI is allocated need not necessarily be consistent with the allocation of the discharged debt under I.R.C. § 752, which can lead to both pleasant and unpleasant surprises.[547] For example, a partner's share of debt under I.R.C. § 752 might drop by 5% of the debt, with that amount deemed distributed to the partner under I.R.C. § 752(b). But if the partnership agreement does not have a specific provision for allocating CODI, the allocation of the CODI could fall under a general allocation rule which might allocate more than 5% of the CODI to the same partner. That could be a good thing for the partner if the CODI is excludable under I.R.C. § 108, less good if it is not. But note that the CODI increases the outside basis of the partner's partnership interest, making it impossible in this example for the deemed I.R.C. § 752(b) distribution to exceed the outside basis and cause I.R.C. § 731(a) gain, assuming no other deemed or actual distributions. That might also create a downstream capital loss for the partner if the partner has positive outside basis and the partnership liquidates without sufficient proceeds to pay the partner an amount equal to the outside basis, though ordinary CODI and a capital loss are a suboptimal combination. Or it could be the other way around, with a 5% share of CODI and a 10% debt reduction for the partner. Now the CODI will not be sufficient to offset the deemed I.R.C. § 752(b)

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545 *See* Treas. Reg. § 1.704–1(b)(2)(iii), (b)(5), Exps. 5 and 9.

546 *See* Walter D. Schwidetzky, Complexity Cubed: Partnerships, Interest, and the Proposed Regulations, 165 Tax Notes 1113 (2019).

547 *See* Rul. 92-97, 1992-2 C.B. 124; also see Rev. Rul. 99-43, 1999-2 C.B. 506.

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distribution, and the greater deemed distribution under I.R.C. § 752(b) could exceed the partner's outside basis triggering gain under I.R.C. § 731(a)(1). The Service's view is that this gain is not excludable under I.R.C. § 108 even if the partner is bankrupt or insolvent.[548] Technically, the Service has the better argument, albeit one likely not intended by Congress.[549] It would create fewer disjunctures if the partnership agreement mandates that the allocation of CODI must be in the same ratio as the discharged debt is shared among the partners. Such an allocation should be valid under I.R.C. § 704(b). Indeed, some have said this "CODI chargeback" should be mandatory, though that likely would require an act of Congress.[550]

§ 18.06. The Elephant in the Room: When is debt recourse or nonrecourse?

Given how important the distinction between recourse and nonrecourse debt can be, one would think the law in this regard would be well-settled and clear.[551] Sadly, that is not the case, particularly in the LLC context.

The Code and regulations do not define recourse and nonrecourse for purposes of I.R.C. § 1001. Under *Raphan*, [552] it is generally said that whether a debt is recourse or nonrecourse depends on whether a creditor's right of recovery is limited to a particular asset (or assets) of the borrower; if so, the liability is said to be nonrecourse. On the other hand, if a creditor's right of recovery extends to all assets of a taxpayer, the liability is said to be recourse.[553] Further, procedure and administration regulations provide that the status of debt as recourse or nonrecourse should be determined at the partnership level.[554]

But I.R.C. § 752 and its Regulations see matters rather differently. I.R.C. § 752 generally includes a partner's share of partnership liabilities in the partner's basis in the partnership interest. How partners share liabilities depends on whether the debt is recourse or nonrecourse. Treas. Reg. §§ 1.752-1(a)(1) and (2) provide that a partnership liability is recourse to the extent that any partner or related person bears "the economic risk of loss" for that liability under Treas. Reg. § 1.752-2, and a partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss. Once a debt's status and recourse of nonrecourse has been established, each partner needs to know her share of the relevant liability. Unsurprisingly, a partner shares in recourse debt to the extent of her economic risk of loss on the debt.[555]

How a partner shares in nonrecourse debt under I.R.C. § 752 can be quite complex. It is based on a three-part stacking rule: The partner's share of the partnership's minimum gain determined in accordance with I.R.C. § 704(b) (i.e. nonrecourse debt in excess of book value); plus (ii) The amount of any taxable gain that would be allocated to the partner who contributed the relevant property to the partnership under I.R.C. § 704(c) if the partnership disposed of all partnership property subject to one or more nonrecourse liabilities in full satisfaction of the liabilities and for no other consideration; plus (iii) The partner's share of the excess

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548 *See* TAM 9619002 and McKee supra note 599 at ⁋ 9.02[2][a][ii][B]. Before the Bankruptcy Tax Act of 1980, the Service took the opposite view in Rev. Rul. 71-301, 1971-2 C.B. 256, declared obsolete in Rev. Rul. 95-2, 1995-11 I.R.B. 4.

549 *See* McKee supra note 599 at ⁋ 9.02[2][a][ii][B].

550 *See* Mckee supra note 599 at ⁋ 9.02[2][a][ii][B].

551 For a discussion of the tax consequences when the character of debt changes, *see* Kenneth C. Weil, Recourse and Nonrecourse Debt: What Are the Federal Income Tax Consequences When the Character of Debt Changes, 74 Tax Lawyer 141 (2020) (hereinafter "Weil").

552 Raphan v. United States, 759 F.2d 879, 885 (Fed. Cir. 1985).

553 *Id.*; Great Plains Gasification Associates v. Commissioner, T.C. Memo 2006-276. Would it make a difference if it was all assets but one? We are aware of no case on point, but substance over form principles should limit game playing.

554 Treas. Reg. § 301.6231(a)(3)- 1(a)(1)(i) and (v).

555 Treas. Reg. § 1.752-2(a). *See* § 3.04.

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nonrecourse liabilities of the partnership, commonly shared based on the partner's share of partnership profits.[556]

It is difficult to come up with a principled reason why recourse and nonrecourse debt should be defined one way for I.R.C. § 1001 and another way for I.R.C. § 752. Of course, in this context, the end points are different, with I.R.C. § 1001 focusing on whether or not there is gain and I.R.C. § 752 on the calculation of the partners' bases in their partnership interests. But that simply describes the what of it, not the why of it. And indeed, the dichotomy upon occasion causes confusion.

A good example is *Great Plains Gasification Associates v. CIR*[557] ("*Great Plains*"), which involved a fairly novel fact pattern. The parties formed a "traditional" general partnership. At the time, LLPs did not yet exist. Normally, that would be thought of as foolish, but even today one sometimes sees large publicly traded corporations form general partnerships/joint ventures that are not LLPs. The liability shield is not a priority because of the economic size of the partners. That was not the case in *Great Plains*, however, but the partners were nobody's fools. In *Great Plains*, the partners were contractually exculpated from personal liability. Thus, they were effectively in a position similar to the one they would have been in with an LLC or LLP today. The lender had access to all the assets of the partnership, but not to the personal assets of the partners.

The *Great Plains* facts are very complex and involve guarantees by the U.S. Department of Energy, contested foreclosure proceedings, an appeal to the 8th Circuit over redemption rights, among other items. But the bottom line is straight forward. The partnership defaulted on the loan and ultimately the partnership assets securing the loan went into foreclosure. The question is what tax treatment the foreclosure should receive for I.R.C. § 1001 purposes, and that, of course, would vary depending on the classification of the debt as recourse or nonrecourse. Since the creditor had access to all of the assets of the partnership, under *Raphan* one would think that this would make the debt recourse for I.R.C. § 1001 purposes and limit the amount realized on the foreclosure to the fair market value of the assets subject to foreclosure. But that is not how the Tax Court saw it. The Tax Court noted the rules of Raphan for when debt is recourse and nonrecourse. But immediately followed that observation with a discussion of I.R.C. § 752 Regulations, stating: "For indebtedness incurred by a partnership, Treasury regulations that were in effect at relevant times defined a nonrecourse liability as one with respect to which 'none of the partners have any personal liability.'"[558] The Tax Court did not explicate its use of two sets of rules that apply in two different contexts, but at the end of the day concluded that the debt was nonrecourse because:

> "the partnership's liability on the debt was effectively limited to the project assets that collateralized the indebtedness, and the partners' liabilities were effectively limited to their interests in those project assets. In these circumstances, the debt was in substance nonrecourse against the partnership and the partners. We do not believe that the partners should be considered to have had any personal liability for the partnership's debt within the meaning of the then-applicable regulations."[559]

The Tax Court did not state which "then-applicable regulations" it was referring to, but in the context of the case it seems clear that it was the I.R.C. § 752 Regulations. One interpretation of the case is that the Tax Court was confused as to the applicable law and the case has limited precedential value. Another

556 Treas. Reg. § 1.752-3(a). Treas. Reg. § 1.704-2(d)(ii) states: If property is subject to two or more liabilities of equal priority, the property's adjusted tax basis is allocated among the liabilities in proportion to their outstanding balances. If property is subject to two or more liabilities of unequal priority, the adjusted tax basis is allocated first to the liability of the highest priority to the extent of its outstanding balance and then to each liability in descending order of priority to the extent of its outstanding balance, until fully allocated.

557 T.C. Memo. 2006-276.

558 *Id.* at 300.

559 *Id.* at 301.

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interpretation is that notwithstanding *Raphan*, the I.R.C. § 752 Regulations are applied to determine whether a debt is nonrecourse in the I.R.C. § 1001 context (i.e. the foreclosure sale), which would be a major law change.

The latter interpretation troubled the Service, and in CCA 201525010 the Service claimed on the one hand that "[t[he Tax Court did not decide *Great Plains* by reference to the regulations under § 752," a statement that, as the discussion of *Great Plains* above shows, is at least a highly dubious gloss, and arguably naked false. But the Service also stated that:

> "The implication created by *Great Plains* is erroneous. The regulations under § 752 are limited to determining the partners' basis in the partnership. The definition of a recourse liability found in § 1.752-1(a)(1) is limited to issues under § 752, rather than a definition intended to extend to issues under §§ 61 and 1001. The primary authority for this conclusion is found in the regulatory text of § 1.752-1(a) which states, prefacing the definition of 'recourse liability,' 'nonrecourse liability,' 'related person,' and 'liability,' that the definitions found in this paragraph apply "for purposes of § 752…"

The Service's statements with regard to the I.R.C. § 752 Regulations are nakedly true. While the Service's approach was awkward, it has effectively nonacquiesced in the Tax Court's in *Great Plains*. And the Service clearly has the better argument based on the current state of the law, but that leaves the question of whether the current state of the law makes any sense and whether the dichotomy between sections 1001 and 752 is defensible.

At least one of us believes the dichotomy, in fact, does not make sense and there is no coherent reason to classify debt differently under I.R.C. § 1001 and I.R.C. § 752. Subchapter K has always been a little schizophrenic as to when a partnership should be treated as an entity apart from its partners, and when it should not be seen that way, but as an aggregate of its partners. But in a flow-through entity like a partnership, where taxation happens not at the entity level but at the partner level (with rare exceptions), it will yield the most consistent results to address the issue at the partner level, i.e. under the I.R.C. § 752 Regulations. As just one example, in *Great Plains* the partnership was engaged in a single project and all of the assets securing the debt were part of that project. The creditor had access to all of the assets of the partnership, but there would have been no substantive difference if the loan had been formally nonrecourse and secured by the same assets. To say the debt in *Great Plains* could be recourse for I.R.C. § 1001 and nonrecourse for I.R.C. § 752, is to make a distinction without a difference, and may be what caused the Tax Court to put more focus on I.R.C. § 752. At the end of the day, the creditor could not pursue any partner for payment of the debt, and could only have access to the assets of the partnership to pay off the debt, assets that also secured the debt. It is hard to see how the debt should be seen as anything but nonrecourse.

Admittedly, things look a bit different if, for example, an LLC operates multiple businesses and a creditor of any of those businesses can pursue the other businesses' assets to collect the debt. But the Service does not distinguish between these two types of fact patterns. Further, if a single LLC is operating multiple businesses, it is probably the result of legal malpractice. The typical structure is that a "mothership" LLC is formed, in the partnership context with multiple members. The mothership then forms SMLLCs for each business. Each SMLLC is a disregarded entity for tax purposes, but that does not affect liability to the creditor. Barring guarantees, other contractual overrides, or a veil piercing claim, the creditor of one of the SMLLCs only has access to that SMLLC's business assets and not the assets of the other SMLLC businesses. If there is no liability on the part of the members, it is hard to see why this should not be nonrecourse debt. In fact, the Service has taken that position itself in the SMLLC context, albeit not in a public ruling. The Service has stated that any debt of the SMLLC is nonrecourse if the member has not guaranteed it, notwithstanding the fact that the creditor has access to all of the assets of the SMLLC.[560] It is hard to see how the Service

560 *See* IRS Field Attorney Advice 20150301F.

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could reach a different outcome in a public ruling. And if that is true, why should adding a member and having an LLC taxed as a partnership change this result?

In truth, it is often unclear whether the I.R.C. § 1001 or the I.R.C. § 752 definition of recourse debt should control if property is retransferred to the lender as part of a workout. Well known tax practitioners have come down on both sides of the question.[561] This is the direct result of having two classification systems that generate different answers. Allowing I.R.C. § 752 to reign supreme over I.R.C. § 1001 would answer these questions and eliminate most of the uncertainty.

§ 18.07. Modification of Debt Instruments, Sections 108(e)(10), 1271-1274, and 1286

Significant modifications of debt instruments can generate *both* a taxable exchange of the debt instrument and CODI. There is perhaps no area in the debt workout arena more fraught with peril and traps for the unwary. The Regulations in this area were promulgated in response to the Supreme Court decision in *Cottage Savings Ass*'n,[562] in which the Supreme Court held that the exchange two mortgage portfolios by two savings and loans was a taxable event, notwithstanding the lack of meaningful economic difference between the portfolios. A critique of the Regulations is that they go well beyond the facts of *Cottage Savings*, which involved the exchange of two different mortgage portfolios. The Regulations create a taxable exchange not only *under Cottage Savings*-like facts, but also provide that when there has been a "significant modification" of a debt instrument, it results in a taxable exchange of the original debt instrument for the modified one.[563] Inescapably, if the modification is not significant, there is no deemed exchange.[564]

A modification means any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise.[565] Alterations occurring by operation of the terms of the original debt instrument, such as an automatically adjusting interest rate or a requirement to substitute collateral if the value of the original collateral drops in value, generally do not count as a modification for these purposes (and thus cannot create a significant modification), but there are exceptions, most of which are discussed below.[566] The failure of the debtor to perform its obligations under a debt instrument is not itself a modification.[567] Nor is the failure to exercise an option to change a term of an instrument (such as to increase the interest rate).[568] On the other hand, an alteration that results from the exercise of an option provided to an issuer or a holder to change a term of a debt instrument is a modification (and depending on the facts can be a significant modification) unless the option is unilateral and the exercise of the option does not result in a deferral of, or a reduction in, any scheduled payment of interest or principal.[569] An agreement by the lender to stay collection or temporarily waive an acceleration clause or similar default right (including such a waiver following the exercise of a right to demand payment in full) is not a modification unless and until the forbearance remains in effect for a period that exceeds two years following the issuer's initial failure to perform *plus* any additional period during which the parties conduct

561 *See* Bizarro supra note 586 at 115.
562 499 US 554 (1991).
563 Treas. Reg. § 1.1001-3(b).
564 Treas. Reg. § 1.1001-3(b).
565 Treas. Reg. § 1.1001-3(c)(1).
566 Treas. Reg. § 1.1001-3(c)(1), (d) Exp. 2. One exception not discussed below deals with an alteration that results from the exercise of an option provided to an issuer or a holder to change a term of a debt instrument. That can count as a modification unless certain requirements are met. *See* Treas. Reg. § 1.1001-3(c)(2)(iii).
567 Treas. Reg. § 1.1001-3(c)(4)(i).
568 Treas. Reg. § 1.1001-3(c)(5).
569 Treas. Reg. § 1.1001-3(c)(2)(iii).

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good faith negotiations or during which the debtor is in bankruptcy ("forbearance exception").[570] While surely better than nothing, this two-year window is not as generous as it might seem. Often, debt workouts are a rolling process, where the debtor move from default to default. As a consequence, the two-year might never close unless the earlier defaults are completely cured, though the Regulations do not address this issue specifically.[571]

The general "catch-all" rule is that a modification is significant if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant. In making this determination, modifications normally are considered collectively, so that a series of such modifications may be significant when considered together although each modification, if considered alone, would not be significant.[572] The Regulations do not contain an explicit definition of economic significance, which suggests that the general rule is based on a subjective assessment of the modification's expected economic effect.[573] But, a modification that adds, deletes, or alters customary accounting or financial covenants is not a significant modification.[574]

The Regulations consider the following modifications to be significant:[575]

1. A change in the yield of a debt instrument if the yield computed under the Regulations varies from the annual yield on the unmodified instrument (determined as of the date of the modification) by more than the greater of ¼ of one percent or 5 percent of the annual yield of the unmodified instrument. A yield change is thought to be the most common modification.[576]

2. Subject to exceptions, a modification that changes the timing of payments (including any resulting change in the amount of payments) due under a debt instrument if it results in the material deferral of scheduled payments. Examples include deferral of payments due before maturity and an extension of the final maturity date. Materiality, as such is not defined, but the Regulations provide that the materiality of the deferral depends on all the facts and circumstances, including the length of the deferral, the original term of the instrument, the amounts of the payments that are deferred, and the time period between the modification and the actual deferral of payments. One exception is the forbearance rule discussed above. The other exception applies if the deferred payments are unconditionally payable no later than at the end of the "safe-harbor period." The safe-harbor period begins on the original due date of the first scheduled payment that is deferred and extends for a period equal to the lesser of five years or 50 percent of the original term of the instrument. Note that this test can overlap with yield change rules if there is a deferral that includes a yield change.

3. The substitution of a new obligor on a *nonrecourse* debt instrument is not a significant modification. But, even if pursuant to the original debt instrument, the substitution of a new obligor on a *recourse* debt instrument is a significant modification, but again there are a number of exceptions. In the context of this chapter, the important exception is that the substitution of a new obligor is not a significant modification if the new obligor acquires substantially all of the assets of the original obligor, the transaction does not result in a change in payment expectations, and the transaction does not result in some other

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570 Treas. Reg. § 1.1001-3(c)(4)(ii).
571 *See* Bizarro *supra* note 586 at 99.
572 Treas. Reg. § 1.1001-3(e)(1).
573 *See* Friedemann Thomma, Rebecca M. Chappell, Molly M. Schneider, Misha Goodwin, Borrower Beware: Debt Restructuring During the COVID-19 Crisis, Tax Notes (August 10, 2020) (hereinafter "Borrower Beware").
574 Treas. Reg. § 1.1001-3(e)(6)).
575 *See* Treas. Reg. § 1.1001-3(e).
576 *See* Borrower Beware, supra note 651.

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significant alteration. Further, the filing of a bankruptcy proceeding does not, in and of itself, result in the substitution of a new obligor.

4. The addition or deletion of a co-obligor on a debt instrument is a significant modification if the addition or deletion of the co-obligor results in a change in payment expectations. If the addition or deletion of a co-obligor is part of a transaction or series of related transactions that results in the substitution of a new obligor, however, the transaction is treated as a substitution of a new obligor (and is tested under those rules) rather than as an addition or deletion of a co-obligor.

5. In the case of recourse debt, a modification that releases, substitutes, adds or otherwise alters the collateral for, a guarantee on, or other form of credit enhancement is a significant modification if the modification results in a change in payment expectations. In the case of nonrecourse debt, a modification that releases, substitutes, adds or otherwise alters a *substantial amount* of the collateral for, a guarantee on, or other form of credit enhancement is also a significant modification. (Note that the "substantial amount" language does not apply to recourse debt.) A substitution of collateral is not a significant modification, however, if the collateral is fungible or otherwise of a type where the particular units pledged are unimportant (for example, government securities or financial instruments of a particular type and credit quality). In addition, the substitution of a similar commercially available credit enhancement contract is not a significant modification, and an improvement to the property securing a nonrecourse debt instrument does not result in a significant modification.

6. A change in the priority of a debt instrument relative to other debt of the issuer is a significant modification if it results in a change in payment expectations.

7. Even if pursuant to the original debt instrument, a modification of a debt instrument that results in an instrument or property right that is not debt for Federal income tax purposes is a significant modification.

8. Generally, a change in the nature of a debt instrument from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse) is a significant modification, even if pursuant to the terms of the original loan document.[577] But, this rule does not apply if the instrument continues to be secured only by the original collateral and the modification does not result in a change in payment expectations. For this purpose, if the original collateral is fungible or otherwise of a type where the particular units pledged are unimportant (for example, government securities or financial instruments of a particular type and credit quality), replacement of some or all units of the original collateral with other units of the same or similar type and aggregate value is not considered a change in the original collateral. A change in the nature of the debt instrument from nonrecourse (or substantially all nonrecourse) to recourse (or substantially all recourse) is a significant modification. Counter-intuitive though it is, it can make sense to convert nonrecourse debt to recourse (or not to convert recourse to nonrecourse), if it enables the taxpayer to take advantage of a CODI exclusion. Whether this strategy works is very fact specific, but it certainly is worthy of consideration when the facts fit.

The debt modification rules are not likely to pose a major hurdle to getting a workout done from the perspective of the lender. Typically, the lender's debt instrument will be worth less after the modification than before. If that modification is significant and generates a deemed exchange, the lender may be able to recognize a loss under I.R.C. § 165 or receive a bad debt deduction under I.R.C. § 166--but not always. Under I.R.C. § 1274(a) (discussed below), the lender's basis in the new and old debt instruments may be the same, i.e. the face amount as long as the interest rate is above the applicable federal rate. But at least there would be no gain. That said, normally, the problem child on a deemed exchange is going to be the debtor.

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577 *See* Weil *supra* note 629.

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Understanding these debt exchange rules is important. As we discuss below, a deemed exchange can create CODI. But if the deemed exchange can be avoided, it may also be possible to avoid CODI. For example, if the forbearance exception discussed above applies, it may be possible to give the taxpayer some breathing room without creating CODI. Also, once partners are outside of the list of 8 deemed significant changes, it may be hard to judge whether there has been a significant modification under the catch-all rule. For example, how should a contingent change be treated where the contingency has not yet been triggered? For example, assume debtor owes creditor $1,000,000 and creditor agrees to take $800,000 and forgive the balance, but only if the $800,000 is paid by a date certain.[578] Until the payment is made, debtor still owes $1,000,000. Does one measure significance when the contingent agreement is made (which could also trigger CODI to the debtor) or when the contingency is met? Contingent changes fall under the general facts and circumstances test,[579] and it could be a close call if the contingent change itself is significant.

A complaint about these Regulations is that they simply go too far. The mere extension of a term of a debt instrument is thin grounds on which to create a taxable exchange. Both borrowers and lenders are more focused on the principal and the yield than the term of the loan.[580] Where there is not fundamental change to the economic relationship of the parties, a taxable exchange should not be triggered.

The original issue discount ("OID") rules play an important role is this area. This is not the place for a deep dive into the OID rules, but it is important to have command of them as they can play an important role in the debt workout context. Some basics: The OID rules generally are designed to get at interest that is accruing but not being paid annually. Generally, OID exists if the "stated redemption price at maturity" exceeds the "issue price."[581] These are both deceptively complex terms of arts. The stated redemption price at maturity is sum of *all* payments provided by debt instrument, regardless of when they are to be made, other than qualified stated interest. Qualified stated interest is stated interest that is unconditionally payable or that will be constructively received *at least annually* based on a fixed rate.[582] Note that the OID rules do not require a minimum interest rate. They just force the lender and borrower to take all interest into account annually. Thus, for example, if A lends B $800,000 and B agrees to pay A $1,000,000 in three years, there is $200,000 of OID (i.e. this represents the interest on the loan). Rather than having the interest paid and taken into account in year 3, the parties must calculate what the interest would be if it were payable annually and take it into account for tax purposes annually, typically with the debtor getting a deduction for the deemed interest payments each year, and the lender having a corresponding amount of interest income. Thus, assuming none of the exceptions to the OID rules apply, from a tax perspective it is pointless to delay the payment of interest, as the OID rules will force the taxpayers to take it into account annually.

Under I.R.C. § 108(e)(10), if a debtor is considered to issue a new debt instrument in satisfaction of an old indebtedness (including under the deemed exchange rules of the I.R.C. § 1001 Regulations discussed above), the debtor is treated as having satisfied the old indebtedness with an amount of money equal to the issue price of the new debt instrument. The definition of issue price can be complex and different definitions apply in different circumstances. But for nonpublicly traded debt instruments issued for nonpublicly traded property, it will be the stated redemption price at maturity; in the debt workout context that commonly is the

578 We borrow this example from Bizarro *supra* note 586 at 104.

579 Treas. Reg. § 1.1001-3(f)(1)(ii).

580 *See* Bizarro supra note 586 at 117.

581 I.R.C. § 1273(a)(1). There is a de minimis exception. If OID is less than .0025 times the stated redemption price at maturity times number of years to maturity, OID is treated as $0. I.R.C. § 1273(a)(3).

582 I.R.C. § 1273(a)(2). A variable rate loan can be treated as having a fixed interest rate. *See* Treas. Reg. § 1.1275–5(e). Applying the OID rules to variable rate loans can be very challenging, and Treasury Department struggled for over a decade to promulgate regulations dealing with such instruments. If payments to be received under an debt instrument are contingent, it is impossible accurately to compute the OID at the time the obligation is issued, because the stated redemption price at maturity is not fixed. *See* BMZ *supra* note 547 at ⁋ 42.02[4].

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face amount of the new debt obligation.[583] Thus, in the simplest case, where none of the debt is publicly traded, the original debt is not in arrears, and I.R.C. § 1274 is not triggered, if the old debt had an issue price of $2,000,000 and the lender and debtor agree to reduce the debt to $1,500,000, the issue price of the new debt is also $1,500,000 and the debtor has CODI of $500,000.[584]

But it can be trickier than that if there is OID is in the mix. For example,[585] assume that the face amount of the old debt instrument is $2,000,000 and carries a 6% interest rate. Assume the lender and debtor do not reduce the principal of the note but agree to extend its due date and increase the interest rate to 7%. Further assume the debt is publicly traded and the old debt instrument is quoted as available for sale or for purchase at a price $1,500,000. Under the I.R.C. § 1001 Regulations, this constitutes a significant modification and there would be a deemed exchange of obligations. Due to the public market, the issue price of the new debt instrument is not its stated redemption price at maturity, but its fair market value of $1,500,000,[586] and the debtor realizes $500,000 of CODI ($2,000,000-$1,500,000). But, $2,000,000 is still, in fact, owed on the new debt instrument. To keep things (relatively) simple, assume the debt is interest only until maturity and interest is paid annually. Under these facts, the stated redemption price at maturity is $2,000,000, the issue price is $1,500,000, and there is also OID of $500,000 that will have to be taken into account under the OID rules over the remaining term of the loan. In this example, CODI and OID are equal, and they often will be when the loan terms are simple. As the loan terms get more complex, with, e.g., different interest rate applying at different times and various amount of principal due at various times, CODI and OID can diverge. We will spare you the details. But note that during challenging economic times, the odds of a taxpayer's publicly traded debt having an issue price that is significantly lower than the face amount is fairly high.[587] And as shown in the above example, a taxpayer may have CODI even though the principal amount of the debt obligation has not been reduced.

Also, one heads up: The definition of publicly traded under Treas. Reg. § 1.1273-2(f) is very broad and sometimes a taxpayer can be seen to have publicly traded debt instruments in unexpected ways. An "indicative quote" can be enough, *i.e.*, a price quote that is available from at least one broker, dealer, or pricing service.[588] A saving grace is a fairly large exemption. A debt instrument will not be treated as traded on an established market if at the time the determination is made the outstanding stated principal amount of the issue that includes the debt instrument does not exceed $100 million.[589]

Subject to some exceptions, I.R.C. § 1274 applies to debt instruments issued for property and generally will impute interest if the interest provided in the debt instrument is less than the applicable federal rate at the time it was created.[590] A deemed exchange of debt instruments can trigger I.R.C. § 1274, as one debt instrument (the old one) can be seen as being exchanged for property, *i.e.,* the new debt instrument.[591]

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583 I.R.C. § 1273(b)(4), which provides for this treatment if the debt instrument is issued for property. Note that the exchange of debt instruments should constitute an exchange of property for these purposes. *See* Field Guide *supra* 2 note at 443.

584 *See* BNA 535-1st, Time Value of Money, OID and Imputed Interest, IIIG; Borrower Beware *supra* note 651; I.R.C. § 1273(b)(4), which is applied by reducing the stated redemption price of any instrument by the portion of such stated redemption price which is treated as interest (hereinafter "BNA").

585 Much of this example is borrowed from Field Guide supra note 546 at 443-444.

586 Treas. Reg. § 1.1273-2(c).

587 We are told by practitioners (including some of our co-authors) that during the Great Recession, because of market disruptions, there were numerous instances of debt that was technically publicly traded but in respect of which the price a willing buyer would pay was $0.

588 Treas. Reg. § 1.1273-2(f)(1),(4).

589 Treas. Reg. § 1.1273-2(f)(6).

590 If I.R.C. § 1274 does not apply, I.R.C. § 483 (which can also impute interest) may, but the parties are left on their own methods of accounting, and the OID rules should not apply.

591 *See* BNA *supra* note 662 at IIIG.

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I.R.C. § 1274 will not apply if enough interest is charged and is paid annually. But if either condition is not met, the application of I.R.C. § 1274 can create OID. For example, assume property is sold to an arm's-length, unrelated buyer. The nominal purchase price is $1,500,000, with the seller carrying back financing of $1,000,000. The loan is interest only for five years and charges a 2% interest rate at a time when the relevant AFR rate is 5%, and no exceptions to the application of I.R.C. § 1274 or the OID rules apply. We will spare you the calculations, but even if the 2% is qualified stated interest, OID would have to be created, because a combination of I.R.C. § 1274 and the OID rules require interest at the 5% rate to be taken into account annually, and the payments actually being made under the debt instrument are less than that.

Add a few more variables, and it becomes apparent that determining the issue price and therefore how the OID rules should apply can be mathematically challenging and the potential for error great. Accordingly, it is best to avoid unduly complex terms in any debt workout. It will not always be possible or even desirable to avoid their application of the OID rules or I.R.C. § 1274, but tread carefully.

If a debt instrument is assumed by a buyer of property (typically recourse debt), or the buyer takes the property subject to a debt instrument (typically nonrecourse debt), and the terms of the debt instrument are significantly modified as part of the sale or exchange, as discussed above, there will be a deemed taxable exchange of the debt instrument under I.R.C. § 1001. The modification is treated as a separate transaction taking place immediately *before* the sale or exchange of the underlying property and is attributed to the seller of the property.[592] For these purposes, a debt instrument is not considered to be modified as part of the sale or exchange unless the seller knew or had reason to know about the modification.[593] Alternatively, however, the seller and buyer may jointly elect to treat the transaction as one in which the buyer first assumed the original (unmodified) debt instrument and then subsequently modified the debt instrument. For this purpose, the modification is treated as a separate transaction taking place immediately *after* the sale or exchange. Under the primary rule, any CODI or basis reduction under I.R.C. § 108(e)(5) or sections 108(a)(1)(D) and 108(c) occurs with respect to the seller. Under the election, of course, any such CODI or basis reduction occurs with respect to the buyer. [594]

§ 18.08. RELATED PARTY ACQUISITIONS

Under I.R.C. § 108(e)(4), if debt is acquired by a party related to the debtor from someone not so related, it is treated as if it were acquired by the debtor. Related party for these purposes includes persons related under sections 267(b) or 707(b)(1), except that the family of an individual consists of the individual's spouse, children, grandchildren, and parents, and any spouse of the individual's children or grandchildren. Further, two entities which are treated as a single employer under subsection (b) or (c) of I.R.C. § 414 are treated as bearing a relationship to each other which is described in I.R.C. § 267(b).

This acquisition of debt by the related party can create CODI to the debtor, typically to the extent the purchase price of the debt is less than the amount owed on it.[595] Thus if partner A owes an unrelated creditor $10,000 and a partnership which is owned 100% by A, her husband, and her children purchases the debt for $6,000, A has CODI of $4,000. (Note I.R.C. § 108(e)(4) speaks in terms of "acquisition;" an actual purchase is not required.) Going forward, the debt is treated as new indebtedness issued by the debtor to the related holder on the acquisition date (the "deemed issuance"). And, to add insult to injury, the debtor can be kicked into the OID rules. The new indebtedness is deemed issued with an issue price equal to the amount paid by

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592 Treas. Reg. § 1.1274-5(b)(1).

593 *Id.*

594 There are a few other code sections in this area which we do not discuss, because we think it is unlikely they will apply in a debt workout. I.R.C. § 1286 can create OID, when a third party buys the debt instrument severed from some or all of the rights to interest payments. Sections 1276 and 1278 also can apply when a third party acquires the debt instrument if it is a so-called "market discount bond; *see* BMZ *supra* note 547 at ¶ 42.04.

595 Treas. Reg. § 1.108-2(f).

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the related party.[596] In the example, there is OID inasmuch as the $10,000 face amount of the debt exceeds its $6,000 cost, That in turn means that over the remaining term of the debt, the debtor may get a deduction for the "OID interest" paid (assuming it is deductible) and the related party creditor will have "OID income." There is an important exception. If the related party acquired the debt within one year of its stated maturity date, and the debt is in fact retired by then, there is no CODI or arguably OID.[597]

Applying I.R.C. § 707(b)(1) in this context can be a major challenge. I.R.C. § 707(b)(1) applies to a partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest, or the profits interest, in the partnership, or two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests. That may sound straight forward, but in real life can be anything but that. In complex partnerships, it can be quite challenging to determine whether or not the over-50% standard is met. For example, what if a partner holds a 48% profits interest, but it will increase to 70% on the occurrence of certain future events. Does one just use the current 48% share, or does one have to factor in potential for the future increase, and factor in the probability of it happening? Or what if there are two possibly related partnerships, both with many partners, some direct, some indirect, with some of the partners being other partnerships. In can be very difficult to simply gather the information necessary to make a decision. And a lot could be riding on the outcome.

I.R.C. § 267(c)(3) provides that an individual owns (otherwise than by the application of I.R.C. § 267(c)(2)) any stock in a corporation owned, directly or indirectly, by or for his partner. This enormously broad rule can tag small investors in a partnership with stock owned by larger investors. Thus, a 1% partner could be deemed to own all of the stock of a corporation if one of his partners owns all of the stock. It may be possible to plan around I.R.C. § 267(c)(3) by using upper and lower tier partnerships, with the smaller investors only involved in the upper tier, perhaps avoiding attribution from partners in the lower tier, but that often require careful advance planning, when no one may be contemplating, say, a pandemic. Getting into the weeds of the single employer test of I.R.C. § 414 is also no walk in the park.

Under the I.R.C. § 108 Regulations, the related party acquisition rules can apply not only if the indebtedness is acquired directly by a person related to the debtor in a direct acquisition, but also if a holder of indebtedness becomes related to the debtor in an "indirect acquisition."[598] An indirect acquisition is a transaction in which a holder of outstanding indebtedness becomes related to the debtor, if the holder acquired the indebtedness "in anticipation" of becoming related to the debtor.[599] This latter test is a facts and circumstances test and it can be difficult to know whether the standard is met or not.[600] Is the lack of discussion of becoming related to the debtor enough to be safe? Many would say not. Further, a holder of indebtedness is treated as having acquired the indebtedness in anticipation of becoming related to the debtor if the holder acquired the indebtedness less than 6 months before the date the holder becomes related to the debtor.[601] Thus, even if there was no actual intent, one can stumble into these rules accidentally. This latter rule can prove a major due diligence challenge for advising tax practitioners. There is also a disclosure rule for a potential indirect acquisition.[602]

596 Treas. Reg. § 1.108-2(g)(1).

597 *See* Treas. Reg. § 1.108-2(e)(1), IRC § 1272(a)(2)(C), and Treas. Reg. §§ 1.1272-1(f). There is no OID if the purchase by the related party counts as the "date of issue."

598 Treas. Reg. § 1.108-2(a).

599 Treas. Reg. § 1.108-2(c)(1).

600 Treas. Reg. § 1.108-2(c)(2).

601 Treas. Reg. § 1.108-2(c)(3).

602 *See* Treas. Reg. § 1.108-2(c)(4).

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§ 18.09. DEBT FOR PARTNERSHIP EQUITY EXCHANGES

What if a partnership cannot pay a given debt and reaches an agreement with the creditor to exchange the debt for an equity interest in the partnership? It could bring I.R.C. § 108(e)(8) and its Regulations into play, which, as we will discuss, can create CODI if the value of the partnership interest is less than the debt owed.

The starting point is I.R.C. § 721(a), which in most contexts treats an exchange of property for a partnership interest as a nontaxable event, i.e. no gain or loss is recognized. This rule usually also applies to debt for equity exchanges.[603]

I.R.C. § 108(e)(8) was amended by the American Jobs Creation Act of 2004 to include discharges of partnership indebtedness occurring after October 21, 2004 (prior to that, the Code I.R.C. § only applied to corporations).[604] I.R.C. § 108(e)(8) provides that for purposes of determining CODI of a debtor partnership, the partnership is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the capital or profits interest transferred to the creditor. The amount by which the indebtedness exceeds the fair market value of the transferred partnership interest is the amount of CODI. I.R.C. § 108(e)(8) requires any such CODI to be allocated to the taxpayers who were partners in the partnership immediately before the discharge. See the discussion of allocations of CODI above.

Note that there has been no foreclosure, so CODI can arise whether the underlying indebtedness is recourse or nonrecourse. In terms of calculating CODI, it is no different than if the lender had been paid cash equal to the value of the partnership interest and forgave the rest of the debt. For example, if the debt is $1,000 and the value of the partnership interest received in exchange for the debt is $300, there will be $700 of CODI whether the debt is recourse or nonrecourse. If the debt is nonrecourse, it would be important to consider whether it would make more sense to allow the underlying property to go into foreclosure. For solvent partners, this of course could yield a superior tax result (likely I.R.C. § 1231 or capital gain instead of CODI). For insolvent partners, the answer likely would be the exact opposite.

It is worth recalling that tax consequences are not everything (though it sometimes seems that way), and it could make economic sense to do a debt for equity exchange even if the tax consequences are suboptimal, depending on the prospects of the partnership. A real estate partnership with a successful history, but having cash flow problems due to the pandemic, might be worth supporting

Of course, the most important hurdle in implementing a debt for equity exchange is determining the fair market value of the partnership interest that the creditor receives. Treas. Reg. § 1.108-8(b)(2) provides an important safe harbor in this regard. Under the Regulation, the fair market value of a debt-for-equity interest is deemed to be equal to the liquidation value of the debt-for-equity interest (defined below), if the following four requirements are satisfied—

> (A) The creditor, debtor partnership, and its partners treat the fair market value of the indebtedness as being equal to the liquidation value of the debt-for-equity interest for purposes of determining the tax consequences of the debt-for-equity exchange;
>
> (B) If, as part of the same overall transaction, the debtor partnership transfers more than one debt-for-equity interest to one or more creditors, then each creditor, debtor partnership, and its partners treat the fair market value of each debt-for-equity interest transferred by the debtor partnership to such creditors as equal to its liquidation value;

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603 Treas. Reg. § 1.721-1(d)(1).

604 For a thoughtful article that discusses the state of the law before this change to I.R.C. § 108(e)(8), see Karen C. Burke, Partnership Debt-Equity Exchanges: Kirby Lumber and Subchapter K, 47 Tax Law. 13 (1993).

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(C) The debt-for-equity exchange is a transaction that has terms that are comparable to terms that would be agreed to by unrelated parties negotiating with adverse interests; and

(D) Subsequent to the debt-for-equity exchange, the debtor partnership does not redeem the debt-for-equity interest, and no person bearing a relationship to the debtor partnership or its partners that is specified in I.R.C. § 267(b) or I.R.C. § 707(b) purchases the debt-for-equity interest, as part of a plan at the time of the debt-for-equity exchange that has as a principal purpose the avoidance of CODI income by the debtor partnership.

The Regulation defines liquidation value in the debt for equity context as an amount equal to the amount of cash that the creditor would receive with respect to the debt-for-equity interest if, immediately after the exchange, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles) for cash equal to the fair market value of those assets and then liquidated.[605] The involvement of related parties does not affect the availability of the safe harbor, as such, but note the anti-abuse rule in requirement four.

Of course, the partnership agreement must align with these rules. We are not aware of any hard data, but we suspect the most common method for implementing these provisions is for the partnership to maintain capital accounts, establish the lender's capital account at liquidation value, and provide that a partner is paid the balance of any positive capital account upon liquidation of that interest.[606]

In the case of a debt-equity swap, it is important to review carefully the partnership agreement to ensure that allocations and capital accounts provisions comply with the Regulations, or the Treas. Reg. § 1.108-8(b)(2) safe harbor may not be available. And, of course, any well-advised creditor will want its liquidation rights to be both valid and clearly spelled out and will typically have the bargaining power to make sure that objective is achieved.

Note that if the partnership is "under water," the value of a capital account given the creditor may be zero, irrespective of the "balance" given to the creditor-now-partner's capital account. For example, assume a partnership with debts of $500,000 and assets worth $400,000. If a creditor exchanges a $50,000 debt for a partnership interest, the creditor may ask that she be given a capital account balance of $50,000. A literal reading of the Regulations, however, would limit the creditor to a capital account equal to the fair market value of the debt, in this example zero, since even after the debt is reduced by the $50,000, the partnership is still under water. [607] We are aware of no other authorities that address this issue. Further, there will also be CODI of $50,000 that must be allocated to the taxpayers who were partners immediately before the debt-equity exchange, because the debt dropped by $50,000 without transferring anything of value to the creditor. Note that a creditor could also be an existing partner in the partnership. That in turn could mean that the creditor could be allocated some part of the CODI, which in turn could make negotiations with the creditor more challenging.

As discussed above, the reduction in the partnership debt creates a deemed distribution of money under I.R.C. § 752(b). If that distribution exceeds a given partner's basis in the partnership interest, the partner will also have capital gain under I.R.C. § 731(a) to the extent of the excess. A distribution under I.R.C. § 752(b) is deemed to occur on the last day of the tax year.[608] This can be a plus if the partnership has

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605 Treas. Reg. § 1.108-8(b)(2)(iii).

606 Note though that there is no requirement in the I.R.C. § 108 Regulations that capital accounts be maintained. The earlier Proposed Regulations contained such a requirement, but it was removed in the final Regulations. *See* Richard M. Lipton, Final Regulations on COD Income Under Section 108(e)(8) Make Few Changes, 116 J. of Tax'n 7 (Jan. 2012).

607 *See* Treas. Reg. § 1.704-1(b)(2)(iv)(a).

608 Rev. Rul. 94-4, 1994-1 C.B. 195.

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net income, which increases basis before the deemed distribution.[609] Net business income may not be all that likely for a partnership involved in a debt workout, but CODI can often cause there to be positive net income, even if the CODI is excluded from income under I.R.C. § 108.[610] If the partnership operates at a loss, it can make matters worse, as the loss reduces basis before the deemed distribution.

One way to possibly improve the value of what the creditor receives, and one the creditor will often insist upon, is to give the creditor a preferred interest in the partnership. For example, the creditor-now-partner might be entitled to a 5% cumulative preferred return on its interest before income is allocated to other partners. If the partnership is fully underwater, this might not have an impact on valuation, because the value of creditor's interest might still be zero. But if things are not quite that dire, depending upon where the creditor is in the debt hierarchy, using some kind of preferred interest could be an effective way of pushing more value to the creditor (immediately after the debt for equity exchange), and thus generating less CODI to the partners.

The general rule of I.R.C. § 721(a) will not apply to the creditor to the extent the transfer of the partnership interest to the creditor is in exchange for the partnership's indebtedness for unpaid rent, royalties, or interest (including OID) that accrued on or after the beginning of the creditor's holding period for the indebtedness.[611] The reason for this exception is that the creditor is receiving a partnership interest for what would have been an ordinary income item had the creditor been paid with cash (and indeed, if on the accrual method, the creditor may have already included the relevant item in income). This may or may not pose a major hurdle, depending on the value of what the creditor is receiving. The Regulations provide that even though I.R.C. § 721(a) does not apply, the debtor partnership will not recognize gain or loss upon the transfer of a partnership interest to a creditor in a debt-for-equity exchange for unpaid rent, royalties, or interest (including OID).[612]

To the extent that I.R.C. § 721(a) does apply, the creditor will not be allowed to recognize a loss on the exchange, whereas if the creditor foreclosed or simply wrote the debt off, it would be entitled to a loss deduction under I.R.C. § 165 or 166. However, the creditor's basis in the partnership interest under I.R.C. § 722 will be its basis in the contributed debt instrument. Thus, the loss would be preserved in the partnership interest, but there would normally be a character difference. A commercial creditor would receive an ordinary trade or business bad debt deduction under I.R.C. § 166. Conversely, any downstream loss on the partnership interest would be a capital loss. It seems unfair that the continuing partners may have COD income or gain, but the creditor is not allowed a loss. What is good for the goose should be good for the gander. To the extent COD income is possible for the debtor partnership, so should a loss deduction be possible for the creditor. The lack of a loss deduction also may make it harder to get workouts done in situations in which the creditor can sell the debt obligation and recognize a loss.

Would it be possible for the creditor to first write off part of the debt and contribute the balance of the debt to the partnership? We are not aware of a case or ruling on point, but if this happens as part of a larger negotiation with the partnership debtor, it is hard to see how it would survive a substance-over-form attack. That said, at least one commentator thinks it could be possible.[613] If it is possible to separate the bad debt deduction and the debt-for-equity exchange significantly in time, the two-step approach would have a better chance of succeeding.

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609 *Id.*

610 *See* I.R.C. § 705(a)(1).

611 Treas. Reg. § 1.721-1(d)(2).

612 *Id.*

613 *See* Lipton, "Final Regulations on Partnership COD Income Under I.R.C. § 108(e)(8) Make Few Changes," 116 *J. Tax'n* 5, 8 (Jan. 2012).

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Substance-over-form issues would also exist if the creditor contributes cash to the partnership in exchange for a partnership interest, followed by the partnership using the cash to pay the debt. This "around-the-horn" form probably would not hold, because the IRS would be able to use the likely brief time between the contribution of cash and the payment on the debt to collapse the transaction and treat it as a contribution of debt for equity.

A single-member LLC ("SMLLC") that is treated as a disregarded entity can become a partnership if a creditor is issued a membership interest in exchange for the LLC's debt to the creditor.[614] The analysis should be the same as noted above. If the value of the interest issued to the creditor is worth less than the debt, the erstwhile single member should have CODI to the extent of the difference. It would be possible to structure the transaction as a transfer by the member of part of her SMLLC interest to the creditor in exchange for cancellation of the debt. Revenue Ruling 99-5[615] treats this as a sale by the member of a proportionate share of the assets. Here the rules discussed under foreclosures should apply. The tax consequences should thus make a difference if the debt is recourse (typically due to the fact that the member guaranteed the debt) or nonrecourse.[616]

§ 18.10. Abandonment or Worthlessness of Partnership Interests

If all else fails, perhaps a partner's best move is simply to walk away from her partnership interest. The first question is how does the taxpayer abandon a partnership interest? There is no clear, unequivocal guidance, but generally a partner must show and communicate abandonment to all interested parties. There must be both the intent to abandon and some affirmative act demonstrating that abandonment has occurred.[617] A letter to the general partner or managing LLC member might suffice.

What are the tax consequences of an abandonment? The taxpayer should receive a loss equal to his basis in the partnership interest at the time of abandonment. Under Rev. Rul. 93-80,[618] a loss incurred on the abandonment of a partnership interest is an ordinary loss under I.R.C. § 165 if sale or exchange treatment does not apply. If there is an actual or deemed distribution to the partner, however, a sale or exchange is considered to exist, and the partner's loss is capital. And, of course, that deemed distribution will be triggered by I.R.C. § 752(b) when the partner's share of nonrecourse debt drops as a consequence of the abandonment. Under the ruling, even a de minimis I.R.C. § 752(b) distribution gives the partner capital loss treatment.[619]

Rev. Rul. 93-80 is most relevant in the nonrecourse debt context, though nothing precludes it from applying to recourse debt. To the extent a partner has liability on partnership recourse debt, however, abandonment may not seem all that practical, because abandoning the partnership interest does not affect the partner's recourse liability. That said, if there are no nonrecourse liabilities in the mix, an abandonment of the partnership interest may not trigger a I.R.C. § 752(b) distribution because the partner's share of partnership recourse liabilities may not change. Arguably, the loss should be ordinary as there has been no deemed distribution. The ruling also states that the tax treatment of abandonment and worthlessness are the same where a partner has a share of partnership debt. This view is dubious, for reasons discussed below, and has not met with uniform acceptance.

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614 *See* Rev. Rul. 99-5, 1999-1 C.B. 434.

615 *Id.*

616 *See* Field Guide *supra* note 546 at 448.

617 *See* Citron v. Commissioner; 97 T.C. 200 (1991).

618 Rev. Rul. 93-80, 1993-2 C.B. 239.

619 *See* Citron v. CIR, 97 TC 200 (1991).

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In *Pilgram's Pride*[620] the Tax Court held that I.R.C. § 1234A could apply to the abandonment of corporate stock. I.R.C. § 1234A provides that gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation (other than a securities futures contract, as defined in I.R.C. § 1234B) with respect to property which is a capital asset in the hands of the taxpayer, shall be treated as gain or loss from the sale of a capital asset. The question is whether I.R.C. § 1234A can be read broadly enough to cover an abandonment of a partnership interest. *Pilgram's Pride* appears to be the first case on I.R.C. § 1234A. I.R.C. § 165(g), which treats worthless securities as sold or exchanged on the last day of the tax year in which they became worthless, did not apply in *Pilgram's Pride* because the securities had substantial value. The stock had a basis to the taxpayer of almost $100 million. A third-party purchaser was in fact available to buy the stock for about $20 million. An ordinary loss on abandonment of almost $100 million was more valuable from a tax perspective than the capital loss that would have arisen on a sale. The Tax Court case was a reviewed decision, which makes it embarrassing lack of cogent reasoning even more surprising. There is no discussion of the history of I.R.C. § 1234A or why it should apply in this context, when nothing in its literal language suggests that.

The Tax Court was rightly reversed by the 5th Circuit,[621] which observed that I.R.C. § 1234A was enacted in 1981 as part of the Economic Recovery Tax Act of 1981 to address tax straddles, which are transactions in which taxpayers acquire offsetting contractual positions to obtain tax benefits without any economic risk. That obviously had nothing to do with the abandonment of stock. The 5th Circuit, supplying the reasoning missing from the Tax Court case, stated:

> The primary question in this case is whether § 1234A(1) applies to a taxpayer's abandonment of a capital asset. The answer is no. By its plain terms, § 1234A(1) applies to the termination of rights or obligations with respect to capital assets (e.g. derivative or contractual rights to buy or sell capital assets). It does not apply to the termination of ownership of the capital asset itself. Applied to the facts of this case, [the taxpayer] abandoned the Securities, not a "right or obligation ... with respect to" the Securities. 26 U.S.C. § 1234A(1)…… Congress does not legislate in logic puzzles, and we do not "tag Congress with an extravagant preference for the opaque when the use of a clear adjective or noun would have worked nicely."[622]

As to I.R.C. § 165(g), the 5th Circuit stated:

> Although the parties stipulated that the Securities were worth at least $20 million when [the taxpayer] abandoned them, the Commissioner argues that the Securities were "worthless" because they had no value to [the taxpayer]. In the Commissioner's view, a security becomes "worthless" when it is "useless" to its owner, regardless of its market value.[623]

The Service's reasoning was, to put it mildly, dubious and inconsistent with precedent. But in the Service's defense, it was trying to make the best of a bad hand, albeit one it dealt itself. But all of the litigation was a waste of taxpayer money. Also note that if I.R.C. § 1234A were read to be broad enough to cover the abandonment of a stock or partnership interest, it could apply to virtually any intangible capital asset, gutting I.R.C. § 165, which could hardly have been Congress's intent. That said, I.R.C. § 165(g) does not apply to worthless interests in tax partnerships.

620 Pilgrim's Pride Corporation v. CIR, 141 T.C. 533, *rev'd* 779 F.3d 311 (5th Cir. 2015).
621 Pilgrim's Pride Corporation v. CIR, 779 F.3d 311 (5th Cir. 2015).
622 *Id.* at 317.
623 *Id.*

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The question that remains is if the Tax Court, which is not bound by the Tax Court decision outside the 5th Circuit,[624] will try its I.R.C. § 1234A reasoning again in a later case. The answer appears to be no, based on a 2019 case discussed below.[625]

Echols v. CIR[626] addressed both abandonment and worthlessness of partnership interests. The partnership owed nonrecourse debt, so under Rev. Rul. 93-80, ordinary loss treatment on an abandonment of a partnership interest would have been unavailable. Further, the underlying property was worth less than that debt. At the trial level, the Tax Court held that because there was no overt manifestation of abandonment in the relevant tax year, the taxpayers was not entitled to the capital loss they sought pursuant to I.R.C. § 165(a) in that year.[627] Inexplicably, even though the issue had been raised, the Tax Court did not discuss worthlessness. The 5th Circuit reversed on the abandonment issue, noting that that the Tax Court looked to the acts of the partnership to determine if it had abandoned the relevant property rather than looking to the acts of the partners to see if they had abandoned their interests in the partnership. In holding for the taxpayers, who had been 75% owners of the partnership, the 5th Circuit noted that the taxpayers had stated in the relevant tax year that they would contribute no further funds to the partnership, a clear and unequivocal indication to the other partners and the world that the taxpayers were "'walking' from their ownership interest in the Partnership. And they kept that vow, never thereafter to return to acts of ownership toward or contributions to the Partnership."[628]

On the issue of worthlessness, the 5th Circuit held:

> More precisely, the test for worthlessness is a mixed question of objective and subjective indicia. Admittedly, a property cannot be treated as worthless for tax loss purposes if at the time it, objectively, has substantial value. But the more important question of when a property is worthless for purposes of a loss deduction under I.R.C. § 165(a) is, like beauty, largely in the eyes of the beholder. The instant case is a good example. Emphasizing again that the asset being tested for worthlessness is not the Land but the Taxpayers' 75% interest in the Partnership which owned the Land, we must determine subjectively just when it was that the Taxpayers deemed their Partnership interest worthless, then determine objectively whether that interest was valueless at such time.[629]

Importantly, the court went on to say:

> For, unlike abandonment, the timing of worthlessness is largely a judgment call by a taxpayer based on his own particular, highly personal set of economic factors, including tax effects. That the asset in question may have become virtually valueless in a prior year, or that the value may have been restored unexpectedly after being deemed worthless by the taxpayer, are not determinative of the "when" of worthlessness for that particular taxpayer.[630]

Thus, unlike abandonment, worthlessness in part looks at the subjective opinion of the taxpayer. But the court, doubtless wary of abuse, also noted that a taxpayer must demonstrate his subjective determination of worthlessness in a given year, coupled with a showing that in such year the asset in question is actually valueless. The fact that another taxpayer might not find the interest to be valueless is not controlling, as long as the taxpayer's assessment in bona fide. Further, unlike with abandonment, no affirmative act by the

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624 *See* Golsen v. Commissioner of Internal Revenue, 54 T.C. 742 (1970).
625 *See* infra notes 692-696 and accompanying text.
626 93 T.C. 553 (1989), *rev'd* 935 F.2d 703 (5th Cir. 1991), *rehearing denied*, 950 F.2d 209 (1991).
627 93 T.C. 553 (1989).
628 935 F.2d 703 (1991), at 707.
629 *Id.*
630 *Id.* at 708.

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taxpayer is required. The court concluded that the taxpayers were alternatively entitled to a deduction for worthlessness. \

An issue the court did not address is whether worthlessness would have entitled the taxpayer to an ordinary loss instead of a capital loss. The taxpayers initially only sought a capital loss and may have been barred from claiming an ordinary loss. As we will discuss, below, ordinary loss treatment may be available in the case of a worthlessness deduction when it would not be in the case of abandonment.

Treas. Reg. § 1.165-1(b) provides that for a loss to be allowable as a deduction under I.R.C. § 165(a), the loss "must be evidenced by closed and completed transactions, fixed by identifiable events, and [except for disaster losses] actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss." There is not necessarily any tension between the Regulation and Echols, as the taxpayer's subjective assessment of worthlessness can be seen as an "identifiable event" that gives rise to a closed transaction. Note that if something beyond that were required to have a "closed and completed transaction," it would be almost impossible to establish a deduction for worthlessness short of some sort of formal, possibly costly appraisal, which seems like an undue burden on the taxpayer. Further, in light of the fact that the Code allows deductions for worthlessness, reading the Regulation in light of Echols is the more sensible approach.[631] The Tax Court now seems to agree, citing Echols in holding for the taxpayer in *MCM Investment Management, LLC v. CIR* ("*MCM*"),[632] which we discuss next.

An important, but in some ways frustrating, aspect of MCM, a 2019 case, is that the parties stipulated that the taxpayer was entitled to an ordinary loss if successful on the merits. It is a curious stipulation in light of the reasoning in Rev. Rul. 93-80, which *MCM* did not discuss. Rev. Rul. 93-80 claims that the loss treatment for abandonment and worthlessness deduction are the same. While, as we will discuss, there may have been a solid basis for the stipulation, given the importance of the issue and Rev. Rul. 93-80, some discussion would have been helpful. Another oddity is that the decision does not discuss the relevance of recourse versus nonrecourse debt. The debt appears to be recourse at the entity level, and it could be an important basis for the court's conclusion since, as discussed earlier, partners can stay liable on recourse debt and possibly avoid I.R.C. § 752 distribution treatment whether they abandon a partnership interest or treat it as worthless. But the court did not discuss this issue in any meaningful way. Further, given the structure, discussed below, it seems clear that no individual had any personal liability on any debt.

The facts of the case are complex. In 1960 Macey L. McMillin, Jr. (Corky), entered into the home building and remodeling industry. By 2009, the year at issue, MCM Investment Management LLC ("MCMIM") consisted of more than 110 entities beneficially owned by Macey L. McMillin Jr. and his immediate family. McMillin Cos. LLC ("Companies") was the largest entity, a tax partnership, and operated real estate development and sales businesses in Texas and California. Companies initially was owned by four S corporations organized under California law, which in turn were owned by trusts which, the court stated, were "owned" initially by Corky, his wife, and their children. By 2009, Corky had died. In the interim, the S corporations were replaced by eight LLCs which in turn were owned by trusts owned by the McMillin children. MCMIM also owned an interest in Companies and was its manager. The precise ownership of MCMIM is a bit opaque but it was owned by family trusts. Given this structure, note that any I.R.C. § 752(b) distribution should only go as far as the trusts and not to the beneficiaries of the trusts.

During 2009, Companies was involved in three distinct lines of real estate development: single-family homebuilding, master-planned communities, and commercial development and management. Like many other real estate businesses, Companies was hit by the subprime mortgage crisis beginning in 2007. Before that,

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631 *See* Proesel v. CIR, 77 T.C. 992 (1981) for how to measure worthlessness.

632 T.C. Memo. 2019-158. For a helpful summary of the case, see Emily L. Foster, LLC Allowed Loss Deduction for Worthless Partnership Interest, (Tax Notes Federal, December 16, 2019).

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Companies had borrowed over $100 million, much of which was guaranteed by the owners of Companies; there was no suggestion of liability on the part of individual family members.

Companies made various efforts to come to terms with its creditors, including a debt for equity swap with one creditor, and various other complex restructurings, but ultimately, Companies had more debt that it could repay. The home building and real estate market worsened considerably in early 2009. The continued decline in property values prompted lenders to issue notices of default. During 2009 at least seven notices of default and/or demands for loan repayment were issued to 10 of the 73 project entities. By the end of 2009, Companies' owners decided to wind down the entity. On its 2009 partnership tax return, MCMIM reported an ordinary loss of $41,488,446 from “Worthless Ptrship Interest - McMillin Companies.” Importantly, the parties stipulated that MCMIM did not abandon its interest in Companies.

The Tax Court framed the question as whether, in 2009, MCMIM’s partnership ceased to have liquidating value and potential future value. It stated that to be allowable as a deduction under I.R.C. § 165(a), a worthlessness loss must be demonstrated by closed and completed transactions, fixed by identifiable events, and actually sustained during the tax year. Citing Echols, the court noted that assessing worthlessness involves a mix of subjective and objective factors. The court stated that the subjective determination of the taxpayer, while not conclusive, is entitled to great weight. The Tax Court further stated that a taxpayer asserting that its equity interest in a company is worthless need not prove that every asset held by the company is worthless. The court addressed extensively the various arguments made by the parties, but ultimately concluded that looking at subjective and objective factors, MCMIM’s interest in Companies indeed became worthless in 2009.

Importantly, the Tax Court distinguished this case from its holding in *Tucker v. CIR*.[633] In *Tucker* the Tax Court held that real property held by a taxpayer's S corporation did not become worthless before a foreclosure sale occurred because the real property was encumbered by recourse debt. The S corporation, Paragon, owned real estate for development. The real estate served as collateral for a number of recourse mortgage loans. When the real estate market declined in 2007 and 2008, Paragon was in default on many of its recourse mortgages, and it wrote down the value of its real estate holdings in 2008 as a result, arguing that they had become worthless. The Tax Court explained that Paragon was personally liable for the mortgage loans regardless of whether it could pay. This meant that the banks could go after Paragon for the remainder of the debt if the proceeds from foreclosure were inadequate to cover Paragon's debt obligations. Even so, in the Tax Court’s view a taxpayer's equity in mortgaged property for which the taxpayer is personally liable is not worthless before a foreclosure sale because “the property continues * * * to have some value which, when determined by the sale, bears directly upon the extent of the owner's liability for a deficiency judgment.”[634] Therefore, the Tax Court concluded that Paragon's properties continued to have value before their respective foreclosure sales in 2009 and 2010 even if, as petitioner claims, Paragon had no additional funds to reimburse its lenders.

We do not find the Tax Court’s reasoning in *Tucker* to be persuasive. If a property is underwater, it is worthless to the taxpayer, and assuming no change in values, waiting until foreclosure does not change that fact. But in the context of MCM, the important point is that the Tax Court stated that Tucker did not preclude a finding of worthlessness in MCM. In Tucker, the court had considered the worthlessness of the underlying real property, not the taxpayer's equity interest in the entity that held the real property. But, by contrast, the issue in MCM was exactly that, the worthlessness of MCMIM’s partnership interest itself.

MCM is an important case and the Tax Court would have been justified in issuing it as a reviewed opinion. Important take aways from the case are first, that the Tax Court clearly accepted the 5th Circuit’s decision in Echols. Second, the Tax Court fully acknowledged the ability of a taxpayer to get a deduction for

633 TC Memo 2015-185.

634 *Id.* at 190, citing CIR v. Green, TC Memo 1997-469, aff’d 188 F.3d 866 (7th Cir. 1999).

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a worthless partnership interest, in light of Tucker not an absolute given. Third, both the Tax Court and the Service seem to take it as a given that the taxpayer was entitled to an ordinary loss deduction and not the capital loss deduction that arguably would have been available on an abandonment, though since *MCM* involved recourse debt on which the parties remained liable and not nonrecourse debt, as discussed above distribution treatment need not be triggered. Fourth, *MCM* doubtless had sophisticated tax counsel who did not flip a coin when deciding between abandonment and worthlessness. They too apparently concluded that worthlessness could generate an ordinary loss where abandonment possibly could not.

State law could play an important role in determining the relevant tax treatment. Abandoning a partnership interest should terminate the partner's interest in the partnership for state law purposes, which again should trigger a I.R.C. § 752(b) distribution at least with regard to partnership nonrecourse debt. Abandonment in turn should be seen as a dissociation by the partner. State law on dissociation varies, but the provisions in RULLCA, RUPA, and ULPA (2001) are likely typical. Under these uniform acts, a member of an LLC, a general partner in a general partnership, and a general or limited partner in a limited partnership have an absolute power to dissociate, even if it is in breach of the operating agreement.[635] And the steps which trigger abandonment for tax purposes should trigger dissociation for state law purposes, though we are not aware of any cases on point. But a partner should remain a partner in the partnership, and an LLC member should remain a member of the LLC, if a worthlessness deduction is taken, because the mere fact of the deduction, by itself, is not act that can trigger dissociation. In turn, nothing therefore has occurred that could trigger a debt shift under I.R.C. § 752(b). Down the road, there likely will be foreclosures or their equivalent of the entity's assets, possibly triggering capital gain or I.R.C. § 1231 gain with their favorable tax rates. But in the current year, under the reasoning in MCM, the taxpayer should be able to receives an ordinary deduction and substantial tax savings by taking a worthlessness deduction. This reasoning could apply whether the partnership debt is recourse or nonrecourse, though the totality of the law around nonrecourse debt could make it a heavier lift. In effect, *MCM* may sanction generous tax arbitrage, an ordinary deduction now in exchange for favorably taxed capital and/or I.R.C. § 1231 gains down the road.

MCM is great news for taxpayers with important caveats. The partner has to both prove the partnership interest is worthlessness and the year in which it became worthless, easier said than done. *MCM* involved sophisticated taxpayers with sophisticated tax counsel who knew how to get their ducks in a row. Not all taxpayers, of course, will be so fortunate. The case would have been still more helpful to taxpayers had the court clearly discussed why ordinary loss treatment was allowed, rather than just relying on the parties' stipulation. The inference that it could be based on a lack of distribution treatment, of course, is not as good as a court's express holding to that effect.

All of that said, we do not believe the differing tax consequences between abandonment and a worthlessness deduction cannot be justified from a tax policy perspective. The differing tax consequences are not based on substantive economic differences. In both cases, the taxpayer is effectively walking away from his partnership interest. Well advised taxpayers may get a tax bonus, less well-advised taxpayers will not, and the tax bonus is not defensible. To fix this dichotomy likely will take Congressional action or possibly new Regulations. Horizonal equity requires that abandonment losses and worthlessness losses have the same tax consequences.

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[635] *See* RULLCA, § 601(a), RUPA § 601(1), ULPA (2001) §§ 601(b)(1), 603(1); *also see* Carter G. Bishop & Daniel S. Kleinberger, Limited Liability Companies: Tax And Business Law (Warren Gorham & Lamont, 1994; Supp. 2020-1) [WL database wgl-llc], ¶ 8.03[1][b] Power Versus Right to Dissociate Voluntarily

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ERRATA

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The reference to "1.1245(f)" should be deleted.