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PARTNERSHIP TAXATION

January 2024 Supplement
to
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PARTNERSHIP TAXATION

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ADDITIONS, SUBSTITUTIONS AND INSERTIONS 1

CHAPTER 1: DEFINING PARTNERSHIPS AND PARTNERS FOR TAX PURPOSES

§ 1.03 CLASSIFYING PARTNERSHIPS FOR TAX PURPOSES

§ 1.07 AGGREGATE AND ENTITY THEORIES OF PARTNERSHIP TAXATION

§ 1.08 SERIES LLCS

§ 1.09 SIDE POCKETS AND ALTERNATIVE INVESTMENT VEHICLES

CHAPTER 2: FORMATION OF THE PARTNERSHIP

§ 2.02 TRANSFER OF PROPERTY TO PARTNERSHIP

CHAPTER 3: OUTSIDE BASIS AND ALLOCATIONS OF LIABILITIES

§ 3.04 EFFECT OF PARTNERSHIP LIABILITIES

§ 3.06 READING, QUESTIONS AND PROBLEMS

CHAPTER 4: CALCULATION OF PARTNERSHIP TAXABLE INCOME

§ 4.03 COMPUTING INCOME, GAIN, LOSS, DEDUCTIONS AND CREDITS OF PARTNERSHIP

§ 4.10 READING, QUESTIONS AND PROBLEMS

CHAPTER 5: ALLOCATION OF PARTNERSHIP INCOME AND LOSSES

§5.01 INTRODUCTION

§5.03 SUBSTANTIAL ECONOMIC EFFECT RULES

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

§ 5.07 ALLOCATIONS OF NONRECOURSE DEDUCTIONS

CHAPTER 6: DISPOSITIONS OF PARTNERSHIP INTERESTS

§ 6.03 CHARACTER OF GAIN OR LOSS

§ 6.07 OPTIONAL ADJUSTMENT TO BASIS OF PARTNERSHIP PROPERTY

CHAPTER 7: PARTNERSHIP DISTRIBUTIONS

§ 7.03 NONLIQUIDATING DISTRIBUTIONS OF PROPERTY

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

§ 8.04 GUARANTEED PAYMENTS

§ 8.06 DISGUISED SALES

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

§ 8.08D HOLDING PERIOD FOR PARTNERSHIP INTERESTS ISSUED FOR SERVICES

CHAPTER 9: BUSINESS COMBINATIONS

§ 9.02 PARTNERSHIP MERGERS

§ 9.05 PARTNERSHIP CONTINUATIONS

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

§ 12.02 FOREIGN PARTNERSHIPS

§ 12.03 U.S. PARTNERSHIPS WITH FOREIGN PARTNERS

§ 12.08 READING, QUESTIONS AND PROBLEMS

CHAPTER 14: FAMILY PARTNERSHIPS

§ 14.01 INCOME TAX ISSUES ON THE PARTNERSHIP'S FORMATION

§ 14.03 INCOME TAX ISSUES FOR VACATION/RENTAL HOMES

CHAPTER 15: DEATH OF A PARTNER

§ 15.02 TERMINATION OF A PARTNERSHIP

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CHAPTER 17: LEGISLATIVE UPDATES AND NON-SUB K PROVISIONS

§ 17.05 QUESTIONS AND PROBLEMS

CHAPTER 18: PARTNERSHIP DEBT WORKOUTS

§ 18.11. QUESTIONS AND PROBLEMS

ERRATA 16

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PARTNERSHIP TAXATION

ADDITIONS, SUBSTITUTIONS AND INSERTIONS

CHAPTER 1: DEFINING PARTNERSHIPS AND PARTNERS FOR TAX PURPOSES

§ 1.03 CLASSIFYING PARTNERSHIPS FOR TAX PURPOSES

B. The Classification of Domestic Business Entities

THE THIRD PARAGRAPH IS RESTATED AS FOLLOWS:

If a domestic business entity has more than one owner (for federal tax purposes), the entity may not be a disregarded entity. In other words, the entity must either be a corporation or a partnership. In general, under the check-the-box Regulations, whether a business entity with more than one owner is treated as a corporation or a partnership is determined by whether the entity has been formed as a corporation.[1] If a domestic entity is an unincorporated business entity with more than one owner, the default classification of the entity will generally be a partnership.[2]

D. Reclassifying Partnerships as Corporations

2. Publicly Traded Partnerships

Add at the end of the section:

The Regulations provide five exceptions from the treatment of trading on a secondary market.[3] First, a variety of transfers are ignored.[4] These include transfers at death, family transfers, block transfers, transfers pursuant to a closed end redemption plan (which is subject to a variety of restrictions), and a few other transactions.[5] Redemption and repurchase agreements are ignored if (i) the closing does not occur for 60 days of exercise of the redemption right, and either (ii) the price is not set for 60 days or (iii) the price is set not

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1. *Id.*

2. Treas. Reg. § 301.7701-2(b) provides a list of domestic business entities that are *per se* corporations that would be exceptions to this general rule: *(1)* a business entity organized under a federal or state statute, or under a statute of a federally recognized Native American tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic; *(2)* an association (as determined under Treas. Reg. § 301.7701-3); *(3)* a business entity organized under a state statute, if the statute describes or refers to the entity as a joint-stock company or joint-stock association; *(4)* an insurance company; *(5)* a state-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act, as amended, 12 U.S.C. 1811 et seq., or a similar federal statute; *(6)* a business entity wholly owned by a state or any political subdivision thereof, or a business entity wholly owned by a foreign government or any other entity described in Treas. Reg. § 1.892-2T; and *(7)* a business entity that is taxable as a corporation under a provision of the Internal Revenue Code other than section 7701(a)(3).

3. Treas. Reg. § 1.7704-1(c)(3).

4. Treas. Reg. § 1.7704-1(c)(3).

5. Treas. Reg. § 1.7704-1(e).

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more than four times per year.[6] A transfer is ignored if the transfer is pursuant to a "qualified matching service", which is subject to a 15-day signing delay and a 45-day closing delay.[7] The private placement exception (limiting the partnership to 100 holders) has been described above. Finally, the Regulations provide that interests in a partnership are not readily tradable on a secondary market if the sum of the percentage interests in partnership capital or profits transferred during the taxable year does not exceed two percent of the total interests in partnership capital or profits.[8]

3. Taxable Mortgage Pools

FOOTNOTE 39 IS RESTATED AS:

[39]. Treas. Reg. § 301.7701(i)-1(c)(2)(ii).

RESTATE THE PARAGRAPH AS:

Although TMPs are subject to tax as corporations, most transactions that would otherwise have been subject to the taxable mortgage pools rules are now formed as real estate mortgage investment conduits ("REMICs").[9] An entity that makes a valid REMIC election is not treated as a TMP.[10]

§ 1.07 AGGREGATE AND ENTITY THEORIES OF PARTNERSHIP TAXATION

The final paragraph is restated as follows:

Thus, in areas in which there is no existing authority as to whether the entity or aggregate approach should be applied, there is still substantial uncertainty as to what is the most appropriate approach. For example, in a decision addressing the taxpayer's motion for summary judgement, the Tax Court held that the hypothetical sale of assets treatment that occurs under I.R.C. § 751 when a partnership interest is sold (an aggregate treatment) applies not only for the purposes of characterizing the income as ordinary but also for the purpose of determining which source rules apply.[11]

§ 1.08 SERIES LLCS

Footnote 130 is restated as follows:

[130]. Series LLC statutes have been enacted in Alabama, Arkansas, Delaware, District of Columbia, Illinois, Iowa, Kansas, Missouri, Montana, Nebraska, Nevada, North Dakota, Ohio, Oklahoma, Tennessee, Texas, Utah, Virginia, Wyoming and Puerto Rico.

Footnote 152 is restated as follows:

[152]. 6 Del. Code. Ann 18-101(14). The Arkansas, Iowa, Nebraska and Virginia statutes provide that a protected series of a limited liability company is a person distinct from all of the following: (i) the

[6]. Treas. Reg. § 1.7704-1(f).
[7]. Treas. Reg. § 1.7704-1(g).
[8]. Treas. Reg. § 1.7704-1(j).
[9]. *See* I.R.C. § 860A and sections following. A discussion of real estate mortgage investment conduits is beyond the scope of this text.
[10]. I.R.C. § 7701(i)(A).
[11]. Rawat v. Commissioner, T.C. Memo 2023-14.

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company, (ii) another protected series of the company, (iii) a member of the company, (iv) a protected-series transferee of a protected series of the company, and (v) a transferee of a transferable interest of the company. AR Code § 4-37-103; Iowa Code § 489.12103; Neb. Rev. Stat. 21-503; Va. Code Ann. § 13.1-1089. These provisions are part of the Uniform Protected Series Act in which the provision appears at Section 103.

§ 1.09 Side Pockets and Alternative Investment Vehicles

Add after the second paragraph:

It may be worthy of note that in GCM 36866, the IRS concluded that once the partnership asserts that it is a single partnership, it cannot later assert that it is multiple partnerships.[12]

Add after the third paragraph:

The proposed partnership audit regulations included as a factual question whether multiple partnerships should be treated as a single partnership.[13] The preamble to the proposed regulations gave as an example a partnership in which profits and losses of its partners are determined by the profits and losses of another partnership.[14] However, the final regulations declined to clarify the circumstances under which multiple partnerships would be treated as a single partnership.[15]

CHAPTER 2: FORMATION OF THE PARTNERSHIP

§ 2.02 Transfer of Property to Partnership

B. What Constitutes Property

2. Contract Rights

a. Promissory Notes

ii. Third-Party Note

The paragraph is restated as follows:

In the context of I.R.C. § 721, what is usually meant by "property" when a promissory note is contributed is a third-party note. In other words, a note that arose when the contributing partner lent money to a third party and received a promissory note in return. If that note is contributed to the partnership, it constitutes property for the purposes of I.R.C. § 721(a).[16]

Add after 8. Recapitalizations:

9. Cryptocurrencies and Other Digital Assets

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12. GCM 36866 (Sept. 29 1976).

13. Prop. Reg. § 301.6241-6(b)(8)(iii).
14. REG-136118-15, 82 Fed. Reg. 27,334, 27,337 (June 14, 2017).
15. TD 9829, 83 Fed. Reg. 24,26 (Jan. 2, 2018).
16. *See, e.g.,* PLR 8117210 (Jan. 30, 1981).

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The IRS concluded in Notice 2014-21 that cryptocurrency is "property."[17] This would generally make cryptocurrencies eligible for contribution under I.R.C. § 721(a), subject to the discussion of transfers to investment companies, below.

For years after 2022, digital assets will be treated as "covered securities" and "specified securities" for the purposes of I.R.C. § 6045(g). For these purposes, a "digital asset" means any digital representation of value which is recorded on cryptographically secured distributed ledger or any similar technology specified by the Treasury.[18] It is questionable whether this definition is broad enough to include all types of digital assets (*e.g.*, non-fungible tokens),[19] but it is likely that both digital assets as defined in I.R.C. § 6045(g) and other digital assets will be teated as property for the purposes of I.R.C. § 721.

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

[18] I.R.C. § 6045(g)(3)(D).

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

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CHAPTER 3: OUTSIDE BASIS AND ALLOCATION OF LIABILITIES

§ 3.04 EFFECT OF PARTNERSHIP LIABILITIES

B. Definition of Recourse and Nonrecourse Liabilities

1. *Definition of Liability*

THE FIRST PARAGRAPH IS RESTATED AS FOLLOWS:

Before you can distinguish between a recourse liability and a nonrecourse liability, it is first necessary to know what is included in the term "liability." For purposes of I.R.C. § 752, an obligation is a liability to the extent that the incurring of the liability: (i) creates or increases the basis of the obligor's assets (including cash), (ii) gives rise to an immediate deduction to the obligor,[20] or (iii) gives rise to an expense that is not deductible and not properly chargeable to capital.[21] However, some obligations are not "liabilities" for the purposes of I.R.C. § 752. In Rev. Rul. 88-77,[22] 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]…."[23] Since the interest expense that was owed and the accounts payable did not increase the basis of assets and did not give rise to a deduction when incurred (but only when paid), they were not I.R.C. § 752 liabilities.

2. *Definition of Recourse Liability*

THE SECOND AND THIRD FULL PARAGRAPHS ARE RESTATED AS FOLLOWS:

First some basics: Economic risk of loss speaks to bottom-line obligation on a recourse debt, after taking into account all facts and circumstances, including rights of contribution among partners. Assume a general partnership, that is not a limited liability partnership, has two partners, one who holds a 60% interest and one who holds a 40% interest. Unsurprisingly, they will usually share the economic risk of loss on any partnership recourse debt 60/40. Now assume a limited partnership, where A is the general partner and B is the limited partner. Generally, on the basis of limited partnership law generally, the general partner has all of the economic risk of loss on any partnership recourse debt and the limited partner has none. It is possible for a limited partner to voluntarily take on some part of that economic risk of loss, however, by making an agreement to that effect with the lender, the partnership and/or the general partner. Limited partners often want to do this to increase their bases in their partnership interests, allowing them to deduct more losses,[24] to avoid recognizing gain,[25] or because the lender (or another party) insists upon it.

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

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

[21]. Treas. Reg. § 1.752-1(a)(4)(i).

[22]. 1988-2 C.B. 128.

[23]. *Id.*

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

[25]. *See* I.R.C. § 752(b), (d).

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each partner has a capital account. For now, think of a capital account as a measure of a partner's economic investment in the partnership. Generally, capital accounts are increased by money contributed, the (net) fair market value (not basis) of property contributed, and allocated income.[26] They are decreased by money distributed, the (net) fair market value of property distributed, and allocated losses.[27] Note that, unlike the calculation of tax basis, liabilities do not go into the calculation of capital accounts (other than reducing the value of contributed and distributed property). Accordingly, capital accounts can be negative, while a partner's outside basis can never be negative. One way capital accounts can become negative is if partnership debt increases a partner's outside basis. For a partner who, for example, contributes cash and is allocated partnership liabilities, initially, the partner's outside basis will exceed the partner's capital account. For example, assume A contributes $1,000 to a new partnership and is properly allocated $500 of partnership recourse liabilities that are incurred on formation of the partnership. Initially, A's outside basis is $1,500, but his capital account is $1,000. Deductions allocated to A, say for losses, reduce A's outside basis in the partnership interest and A's capital account. Since the outside basis was higher to begin with, the capital account will go negative before the tax basis is "used up." For example, if at the end of the first tax year A is allocated a net partnership loss of $1,100, A's outside basis is reduced to $400, and his capital account balance becomes negative ($100). Generally, partners may have negative capital accounts to the extent they have an obligation to pay to the partnership any negative balance no later than the liquidation of the partnership interest or when the partnership has allocated nonrecourse debt to the partner.[28] 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.[29]

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

Treas. Reg. § 1.752-2(c)(1) provides a general rule that a partner also bears the economic risk of loss for a partnership liability to the extent the partner or related person has made a nonrecourse[30] loan to the partnership and the economic risk of loss with respect to that loan is not borne by another partner.[31] Though the loan is nominally nonrecourse, the lending partner of course bears the economic risk of loss if the partnership fails to pay the debt. It sometimes occurs, however, that a commercial lender will take a (typically small) profits interest in the partnership in addition to being paid interest. In order to facilitate financial institutions making such loans, the Regulations contain a *de minimis* exception to the general rule. If the partner's interest in each item of partnership income, gain, loss, deduction, or credit for every taxable year is 10% or less, and that partner or a person related to that partner makes a loan to the partnership which constitutes qualified nonrecourse financing within the meaning of I.R.C. § 465(b) (determined without regard to the type of activity financed), then the partner is not deemed to bear the economic risk of loss.[32] 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

26. Treas. Reg. § 1.704-1(b)(2)(iv)(b).

27. *Id.*

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

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

30. "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.

31. 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).

32. Treas. Reg. § 1.752-2(d)(1).

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convertible debt.[33]

The first paragraph on page 89 is restated as follows:

Under current Regulations, a partner generally does *not* have the economic risk of loss on a "bottom dollar payment obligation."[34] Generally, a bottom dollar payment obligation exists unless a partner (or related person) has first dollar liability for all, a specified dollar amount or a specified percentage of the partner's payment obligation if any of the partnership's liability is unpaid.[35] In the example, for Small Partner to have economic risk of loss on the $10 guarantee, under the general rule Small Partner must be liable if any part of the $100 liability goes unpaid. If the $10 guarantee is a bottom dollar payment obligation, $10 of the debt is treated as nonrecourse debt and is allocated under the rules for nonrecourse debt discussed below.

D. Allocation of Nonrecourse Liabilities

THE EXAMPLE ON PAGE 99 IS RESTATED AS FOLLOWS:

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

Footnote 73 is restated as follows:

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

E. Contributions and Distributions of Encumbered Property

REPLACE THE LAST THREE PARAGRAPHS WITH THE FOLLOWING:

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[33]. I.R.C. § 465(b)(6)(A). The actual rule is more complex than we state in the text.
[34]. Treas. Reg. § 1.752-2(b)(3)(ii)(A).
[35]. Treas. Reg. § 1.752-2(b)(3)(ii)(C).

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When a property which is subject to a nonrecourse liability is contributed to a partnership, the allocation of that liability is far more complicated. The IRS has addressed this situation, however, in Rev. Rul. 95-41,[36] though to fully understand the Revenue Ruling you will need to have a solid understanding of Chapter 5. In Rev. Rul. 95-41, A contributes depreciable property with a fair market value of $10,000 to a partnership in exchange for a 50% interest in the partnership. The property is subject to a nonrecourse liability of $6,000, and A's basis for the property is $4,000. B contributes $4,000 in cash for the other 50% interest. The partnership agreement provides that each partner will be allocated a 50% share of all partnership items, though, as we will see, that agreement is not entirely controlling. The Revenue Ruling first notes that as a result of the contribution, A's individual liabilities decreased by $6,000. It is then necessary to run through the Regulation's three-tier allocation scheme to determine A's share of the partnership's nonrecourse liability. Minimum gain exists if the nonrecourse debt exceeds the property's book value.[37] Here the debt is $6,000, but the book value of the property is its fair market value, or $10,000. There is thus no minimum gain,[38] and no allocation under the first tier.

Under the second-tier allocation, if the property is disposed of for an amount equal to the amount of the liability, a $2,000 gain would be recognized ($6,000 — $4,000). (For book purposes, however, there would be a $4,000 loss, allocated $2,000 to each of the partners.) The manner in which the liability is allocated under the second tier depends upon the method used for purposes of I.R.C. § 704(c). If either the "traditional method" or the "traditional method with curative allocations" is used, $2,000 of the nonrecourse liability would be allocated to A under the second tier and we will assume that is the case. That leaves $4,000 of debt to allocate ($6,000 - $2,000).

As we discussed, the partnership may choose to allocate third tier excess nonrecourse liabilities in accordance with the partners' shares of partnership profits. The partners' interests in partnership profits are determined by taking into account all the facts and circumstances relating to the economic arrangement of the partners. Rev. Rul. 95-41 does not specify how excess nonrecourse liabilities under the stated facts would be allocated, but merely lays out the guiding principles. The Revenue Ruling provides that the partners' agreement to share the profits of the partnership equally is one fact to be considered in making this determination. Another fact to be considered is a partner's share of I.R.C. § 704(c) built-in gain to the extent that the gain was not taken into account in making an allocation of nonrecourse liabilities under the second tier. This built-in gain is one factor because, under the principles of I.R.C. § 704(c), this excess built-in gain, if recognized, would be allocated to A. (Under the facts, this amount would be $6,000 - $2,000 = $4,000.) The Revenue Ruling states that this is one factor, but not the only factor, to be considered in determining A's interest in partnership profits. Under the Revenue Ruling, it must be given an appropriate weight in light of all other items of partnership profit. For example, if it is reasonable to expect that the partnership will have items of partnership profit over the life of the partnership that will be allocated to B, the partnership may not allocate all of the excess nonrecourse liabilities to A. Rather, the remaining nonrecourse liabilities must be allocated between A and B in proportion to their interests in total partnership profits.

Further, the partnership agreement may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities, provided that the interests specified are reasonably consistent with allocations that have "substantial economic effect" under the I.R.C. § 704(b) Regulations of some other significant item of partnership income or gain. The partnership agreement provides that each partner will be allocated a 50% share of all partnership items. Assuming that such allocations have substantial economic effect, Rev. Rul. 95-41 provides that the partnership can choose to allocate the excess nonrecourse liabilities

[36]. 1995-1 C.B. 132.

[37]. *See* Treas. Reg. § 1.704-2(d)(3). *See also* Chapter 5.

[38]. Under the Regulations promulgated under I.R.C. § 704(b), when property is contributed to a partnership, the partner's capital account is credited with the fair market value of the property, not its basis. Treas. Reg. § 1.704-1(b)(2)(iv)(d)(1). Although the value added to a partner's capital account is the net fair market value (gross fair market value minus associated debt), the contributed property is carried on the partnership's tax books initially at gross fair market value (i.e., at book value, with the offsetting liability recorded separately).

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50% to each partner. Section 704(c) allocations, however, do not have substantial economic effect under the I.R.C. § 704(b) Regulations.[39] Accordingly, under this alternative, I.R.C. § 704(c) allocations cannot be used as a basis for allocating excess nonrecourse liabilities.

Finally, Rev. Rul. 95-41 provides that the partnership may choose to allocate the excess nonrecourse liabilities in accordance with the manner in which it is reasonably expected that the deductions attributable to the excess nonrecourse liabilities will be allocated. Because A and B have agreed to allocate all partnership items 50% to each partner, A and B each will be entitled to allocations of book depreciation of $5,000 each over the life of the contributed property. The contributed property, however, has an adjusted tax basis of $4,000 and, regardless of the method used by the partnership under I.R.C. § 704(c), the entire $4,000 of tax depreciation over the life of the contributed property must be allocated to B. Therefore, according to the Revenue Ruling, the partnership must allocate all of the excess nonrecourse liabilities to B if it chooses to allocate the excess nonrecourse liabilities in accordance with the manner that the deductions attributable to the excess nonrecourse liabilities will be allocated.

McKee disagrees with this last part of the Revenue Ruling, stating that:

> While the Service's position makes sense from a tax policy basis (it matches the allocation of excess nonrecourse liabilities with the manner in which gain could be allocated when recognized), such an approach is inconsistent with the § 752 Regulations. The Service's position focuses on tax deductions rather than § 704(b) book deductions, even though nonrecourse deductions and minimum gain are defined under the § 704(b) Regulations by reference to § 704(b) book value. The presence or absence of §704(c) gain should have no impact on the manner in which nonrecourse deductions are allocated…. In addition to being facially inconsistent with the language of the § 752 Regulations, determining a partner's share of profits by reference to noneconomic allocations under § 704(c) seems to be a trap for the unwary. Equal partners, for example, expect to share equally and are unlikely to think that they must make a special election to share excess nonrecourse liabilities equally.[40]

While the McKee concerns have merit, especially with regard to a possible trap for the unwary, it can no longer be said that Rev. Rul. 95-41 is inconsistent with the Regulations, as the Service reaffirmed the Revenue Ruling in a subsequent regulatory preamble to amendments to Treas. Reg. § 1.752-3 that were effective as of Oct. 31, 2000.[41] The Treasury and the IRS did caution, however, against double-counting excess I.R.C. § 704(c) gain noting that to the extent that a portion of the excess I.R.C. § 704(c) gain remains after a liability has been fully allocated, the remaining portion of the gain should be taken into account as one factor to be considered in determining a partner's interest in partnership profits.[42]

G. Sales of Partnership Interests

The first two paragraphs are restated as follows:

As indicated above, I.R.C. § 752(d) provides that in the case of a sale or exchange of a partnership interest, liabilities are treated in the same fashion as in the case of an exchange not involving a partnership interest. Outside of the partnership context, if a taxpayer sells property and the purchaser assumes a liability of the seller, or takes the property subject to a liability, the amount of the liability is part of the amount realized for purposes of computing gain or loss from the sale. Although a transfer of a partnership interest may not

[39]. *See* Treas. Reg. § 1.704-1(b)(2)(iv)(d).
[40]. *See* McKee, Nelson & Whitmire, Federal Taxation of Partnerships and Partners at § 8.03[4].
[41]. 65 FR 64888 (Oct. 31, 2000), 2000-2 C.B. 470, 2000-46 I.R.B. 470 (TD 8906).
[42]. 65 FR at 64889.

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directly result in the selling partner's liabilities being formally assumed, and the partnership interest itself may not be subject to liabilities, nevertheless the liabilities of the partnership must be taken into account. This is the purpose of I.R.C. § 752(d). Assume a 25% partner of a partnership has a basis for her partnership interest of $20,000 and her basis includes her 25% share of the $100,000 liabilities of the partnership (i.e., $25,000). Assume she sells her partnership interest for cash of $15,000. If the gain or loss recognized by the partner is simply the difference between her basis for her partnership interest and the amount of cash received, she would have a loss on the transaction (i.e., $20,000 − $15,000). The amount realized in this situation, however, includes her $25,000 former share of the partnership's liabilities for which she no longer has a share. Thus, the amount realized is $40,000 ($15,000 + $25,000) and a gain in the amount of $20,000 ($40,000 − $20,000) is recognized.[43]

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

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

The first paragraph is restated as follows:

In an effort to fight tax shelters, the IRS has issued Regulations relating to the inclusion of partnership liabilities in a partner's basis. Treas. Reg. § 1.752-7 is designed to prevent the acceleration or duplication of loss through the assumption of certain types of obligations.[44] Prior to the promulgation of Treas. Reg. § 1.752-7, taxpayers would transfer assets to a partnership and have the partnership assume a contingent liability (such as a potential environmental liability). The taxpayer would take the position that the assumed liability was not a liability for purposes of I.R.C. § 752 and, therefore, the taxpayer was not required to reduce the basis of the taxpayer's partnership interest to the extent the taxpayer was relieved of the liability (assume completely). The taxpayer would then sell the partnership interest to a third party for an amount which was significantly less than the taxpayer's basis (because the purchaser would take the liability into account) and claim a loss. When the liability was paid, the partnership would claim a deduction. Thus, the same liability would produce a double deduction.[45]

1. Assumption by Partnership

a. Transfer of Partnershp Interest

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

If the § 1.752-7 liability partner were to transfer her partnership interest prior to the satisfaction of the § 1.752-7 liability, the rule of Treas. Reg. § 1.752-7(c) would not prevent the § 1.752-7 liability partner from having an excessive basis. To eliminate this problem, Treas. Reg. § 1.752-7(e)(1) provides that if a § 1.752-7 liability partner disposes of her partnership interest, the basis of the § 1.752-7 liability partner's partnership interest is reduced immediately prior to the disposition. The amount of the reduction is referred to as the § 1.752-7 liability reduction. The § 1.752-7 liability reduction is equal to the lesser of (i) the excess of the

[43]. *See* § 6.02 for a discussion of the rules when a partner sells less than her entire interest in the partnership.
[44]. Treas. Reg. § 1.752-7(a).
[45]. *See* Notice 2000-44, 2000-2 C.B. 255.

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§ 1.752-7 liability partner's basis in the partnership interest over the adjusted value of that interest, or (ii) the remaining built-in loss associated with the § 1.752-7 liability.[46] The term "adjusted value" means the fair market value of the partnership interest increased by the partner's share of partnership liabilities under Treas. Reg. §§ 1.752-1 through 1.752-5.[47]

b. Assumption of § 1.752-7 Liability

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

There are two important exceptions to the rules of Treas. Reg. § 1.752-7(e), (f), and (g). First, those sections do not apply if a partnership assumes a § 1.752-7 liability as part of a contribution to the partnership of a trade or business with which the liability is associated and the partnership continues to carry on that trade or business after the contribution.[48]

§ 3.06 Reading, Questions and Problems

B. Questions and Problems

Question 3 is restated as follows;

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

[46]. Treas. Reg. § 1.752-7(b)(7)(i).
[47]. Treas. Reg. § 1.752-7(b)(2).
[48]. Treas. Reg. § 1.752-7(d)(2)(A).

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CHAPTER 4: CALCULATION OF PARTNERSHP TAXABLE INCOME

§ 4.03 COMPUTING INCOME, GAIN, LOSS, DEDUCTIONS AND CREDITS OF PARTNERSHIP

D. BOTTOM LINE PROFIT OR LOSS

The first paragraph is restated as follows:

After taking into account all of the items required to be separately stated, the remaining items of the partnership (i.e., items that do not have to be separately stated) are netted and the "bottom line" profit or loss flows through to the partners as a single number. For example, most ordinary and necessary business expenses do not have to be separately stated. They would be netted against partnership gross income when calculating bottom line profit or loss.[49] In computing partnership taxable income under I.R,C. § 703, all taxable items (separately stated or not) are netted.

§ 4.10 READING, QUESTIONS AND PROBLEMS

B. QUESTIONS AND PROBLEMS

Problem 1 is restated as follows:

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

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

[49] I.R.C. § 702(a)(8).

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Net Income	$66,000

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

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

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

CHAPTER 5: ALLOCATION OF PARTNERSHIP INCOME AND LOSSES§ 5.01 INTRODUCTION

ADD THE FOLLOWING AS THE LAST PARAGRAPH OF § 5.01:

The overall goal is for partnership allocations to have substantial economic effect. To have substantial economic effect, partnership allocations must reflect the actual division of income or loss among the partners when viewed from the standpoint of economic, rather than tax, consequences.[50] In other words, if there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden.[51] The current Regulations are heavily reliant on capital accounts for testing allocations, so we will start there.[52]

§ 5.03 SUBSTANTIAL ECONOMIC EFFECT RULES

C. Substantiality

2. Shifting and Transitory Allocations

FOOTNOTE 41 IS RESTATED AS FOLLOWS:

[41]. This example is based on Treas. Reg. § 1.704-1(b)(5), example 8(ii).

4. Tax Credits

THE LANGUAGE IN THE TEXT IS RESTATED AS FOLLOWS:

Partners' capital accounts are not generally adjusted for tax credits. Therefore, the allocation of tax credits cannot have economic effect. As we have discussed above, and will discuss below, if an allocation does not comply with the substantial economic effect safe harbor, it must be allocated in accordance with the "partners' interests in the partnership." Under the Regulations, if a partnership expenditure (whether or not deductible) that gives rise to a tax credit in a partnership taxable year also gives rise to valid allocations of partnership loss or deduction (or other downward capital account adjustments) for such year, then the partners' interests in the partnership with respect to such credit (or the cost giving rise thereto) shall be in the

[50] *Goldfine v. Commissioner*, 80 T.C. 843 (1983).

[51] Treas. Reg. § 1.704-1(b)(2)(ii)(a).

[52] *See Ogden v. Commissioner*, 788 F.2d 252, 261 (5th Cir. 1986)(noting the necessity of capital accounts in order for the distributive share allocation to have substantial economic effect).

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same proportion as such partners' respective distributive shares of such loss or deduction (and adjustments).[53] For example, if the property generating the tax credit also generates a depreciation deduction, the tax credit can be allocated in the same manner as the depreciation deduction. Note that a partner's share of loss or deduction may vary depending on the item, in which case the partnership has some flexibility as to how to allocate tax credits.

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

B. Partner's Interest in the Partnership, In General

Add after the list of factors in the Regulation:

The determination would require an analysis or determination of, inter alia, the partnership agreement, capital accounts maintained under general accounting practices, capital accounts maintained for tax purposes in cases where there is a difference, historical allocation of income and deduction items, implications of negative capital account balances, partners' liability for partnership debt, whether partnership debt is recourse or nonrecourse, partners' shares of profit and loss, and partners' shares of partnership assets upon liquidation of the partnership.[54]

D. Other Liquidation Models

Add after the second paragraph:

Similarly, when partners in an oral partnership had equal rights in liquidation, the Eighth Circuit Court of Appeals concluded that each partner had a 50% interest in the partnership.[55]

F. Avoiding Negative Capital Accounts as PIP

Add to the end of the section:

A recent Tax Court memorandum decision concluded that a qualified income offset provision that was included in an LLC agreement in respect of which the allocations lacked substantial economic effect reflected the partners' agreement that income should be shared in a manner that brought negative capital accounts up to zero and, thus, reflected the partners' interests in the partnership.[56]

§ 5.07 ALLOCATIONS OF NONRECOURSE DEDUCTIONS

C. Subsequent Nonrecourse Borrowing

Add to the end of the section:

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[53]. Treas. Reg. § 1.704-1(b)(4)(ii). This rule does not apply to the extent I.R.C. § 50(c)(1) requies a basis adjustment for a credit. This exception would apply to the rehabilitation tax credit, certain energy credits, and certain other credits.

[54] Tigers Eye Trading, LLC v. Commissioner, 138 TC 67 (2012), affirmed in part, reversed & remanded in part, Logan Trust v. Commissioner, 115 AFTR 2d 2015-228, 616 Fed Appx 426 (CA Dist Col, 6/26/2015).

[55] Estate of Ballantyne v. Commissioner, 341 F.3d 802 (8th Cir. 2003). The partners had also consistently reported the partners' interests as being 50/50.

[56] Clark Raymond & Co., PLLC v. Commissioner, T.C. Memo 2022-105 (Oct. 13, 2022).

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What if a partnership makes additional nonrecourse borrowings but neither invests the proceeds in the property nor distributes them to the partners? For minimum gain allocation purposes, the funds are effectively held in abeyance until one of those two events occurs.[57]

CHAPTER 6: DISPOSITIONS OF PARTNERSHIP INTERESTS

§ 6.03 CHARACTER OF GAIN OR LOSS

B. UNREALIZED RECEIVABLES AND INVENTORY ITEMS

3. Inventory Items

Add after the last paragraph:

In a decision addressing the taxpayer's motion for summary judgement, the Tax Court held that the hypothetical sale of assets treatment that occurs under I.R.C. § 751 when a partnership interest is sold (an aggregate treatment) applies not only for the purposes of characterizing the income as ordinary but also for the purpose of determining which source rules apply.[58]

§ 6.07 OPTIONAL ADJUSTMENT TO BASIS OF PARTNERSHIP PROPERTY

B. MAKING THE I.R.C. § 754 ELECTION

I.R.C. § 754 further provides that once an election is made, it applies to all applicable transfers of partnership interests during the taxable year in which the election is made, as well as for all subsequent taxable years. While an election under I.R.C. § 754 may be revoked, it may only be revoked with the consent of the IRS.[59]

Treas. Reg. § 1.754-1(b) provides that an election under I.R.C. § 754 is to be made in a written statement filed with the partnership return for the taxable year in which the transfer occurs. For the election to be valid, the return must be timely filed (including extensions). The statement must set forth the name and address of the partnership making the election and contain a declaration that the partnership elects under I.R.C. § 754 to apply the provisions of I.R.C. § 734(b) and I.R.C. § 743(b).[60] The IRS has provided in a Revenue Procedure, however, that an election filed within 12 months of the original due date for the election will be treated as timely if all affected taxpayers report their income consistently with the election for the election year and each subsequent year.[61] If a valid election under I.R.C. § 754 has been made and not revoked, a new election is not required to be made.[62]

As we discuss in § 7.07, an I.R.C. § 754 election can also apply to certain distributions. Once made, an I.R.C. § 754 election applies to all applicable distributions and all applicable transfers of partnership interests,

[57] *See* Treas. Reg. § 1.704-2(g), (h).
[58] Rawat v. Commissioner, T.C. Memo 2023-14.
[59]. *See* Treas. Reg. § 1.754-1(c).
[60] Treas. Reg. § 1.754-1(b). Note that effective August 5, 2022, Treas. Reg. § 1.754-1(b) was amended to remove the requirement that a partner must sign the I.R.C. § 754 election statement. TD 9963, 87 F.R. 150, 47931 (Aug. 5, 2022).
[61]. Rev. Proc. 92-85, § 4.01, 1992-2 C.B. 490, *as amended by* Rev. Proc. 93-28, 1993-2 C.B. 344.
[62] Treas. Reg. § 1.754-1(b)(1).

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it is not possible to make an election only with respect to distributions of partnership property, or only with respect to sales of partnership interests.

If a partnership wishes to revoke an election under I.R.C. § 754, it must file with the IRS an application setting forth the grounds on which the revocation is desired.[63] The application has to be filed not later than 30 days after the close of the partnership taxable year with respect to which the revocation is intended to apply.[64] The Regulations give as examples of situations that might result in a favorable response to an application for revocation: (i) a change in the nature of the partnership's business, (ii) a substantial increase in the assets of the partnership, (iii) a change in the character of partnership assets, or (iv) an increased frequency of retirements or shifts of partnership interests that would result in an administrative burden to the partnership. The Regulations make clear, however, that an application for revocation will not be approved where the revocation is intended primarily (in our current context) to permit a transferee partner to take advantage of preexisting losses.[65]

CHAPTER 7: PARTNERSHIP DISTRIBUTIONS

§ 7.03 NONLIQUIDATING DISTRIBUTIONS OF PROPERTY

C. Marketable Securities

Add the following to footnote 16:

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

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

§ 8.04 GUARANTEED PAYMENTS

THE FOLLOWING IS SUBSTITUTED FOR THE FIRST FULL SENTENCE:

I.R.C. § 707(c) guaranteed payments are made to a partner in a partner's capacity as a partner, but the amount to be paid is made without regard to partnership income (hence, they are "guaranteed" at least to the extent the partnership has the capacity to pay them).

ADD AFTER THE LAST FULL PARAGRAPH ON PAGE 327:

The fees were not actually paid. The partnerships were on the accrual method of accounting and the partners on the cash method. Apparently, the parties were trying to game the accrual and cash accounting systems at a time when I.R.C. § 267(a)(2), which would have prevented any deduction, had entered the Code.

[63]. Treas. Reg. § 1.754-1(c)(1).
[64]. *Id.*
[65]. *Id.*

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§ 8.06 DISGUISED SALES.

C. Payment for Services

THE SIXTH PARAGRAPH IS RESTATED AS FOLLOWS:

Whether an arrangement constitutes a disguised payment for services (in whole or in part) depends on all of the facts and circumstances.[66] The Proposed Regulations include six non-exclusive factors that may indicate that an arrangement constitutes a disguised payment for services. Of these factors, the first five factors generally track the facts and circumstances identified as relevant in the legislative history for purposes of applying I.R.C. § 707(a)(2)(A).[67] The sixth factor, which was not included in the legislative history, provides factual elements that indicate that an allocation/distribution is tied to particular services rather than the business of the partnership as a whole.[68] The first of the six factors, the existence of significant entrepreneurial risk, is accorded more weight than the other factors, and arrangements of allocations and distributions to the service provider that lack significant entrepreneurial risk are generally treated as disguised payments for services.[69] An arrangement in which allocations and distributions to the service provider are subject to significant entrepreneurial risk will generally be recognized as a distributive share, but the ultimate determination depends on the totality of the facts and circumstances.[70]

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

A. Limitations on Recognition of Losses

Add after the first paragraph at the top of page 354:

In 2023, the IRS released proposed Regulations under I.R.C. § 267 and I.R.C. § 707(b) dealing with transactions between related persons and partnerships. If finalized in the same form as proposed, the Regulations would resolve the ambiguity by removing current Treas. Reg. § 1.267(b)-1(b) and amending Treas. Reg. § 1.267(a)-1 to remove the application of Questions and Answers 2 and 3 in Treas. Reg. § 1.267(a)-2T(c) for tax years ending after the proposed Regulations are finalized. The proposed Regulations would also amend Treas. Reg. § 1.707-1(b).

§ 8.08D HOLDING PERIOD FOR PARTNERSHIP INTERESTS ISSUED FOR SERVICES

B. Short-Term Capital Gain

THE SECOND AND THIRD PARAGRAPHS ARE RESTATED AS FOLLOWS:

The 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.[71] 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 gain from the

66. Prop. Reg. § 1.707-2(c).
67. *See* S. Prt. No. 98-169 (Vol. 1), 98th Cong., 2d Sess. 223–32, at 227–28 (1984) ("S. Prt. 98-169").
68. Prop. Reg. § 1.707-2(c)(6).
69. Prop. Reg. § 1.707-2(c).
70. *Id.*
71. Treas. Reg. § 1.1061-4(a)(1).

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disposition of a partnership interest with a holding period of more than one year (after the application of the look-through rule).[72] As you might expect, an owner taxpayer's three-year gain has the same definition, substituting "three-year" for "one-year."[73]

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.[74] In addition, if the partnership interest has been held for more than three years, a special look-through rule applies if the service partner would have a holding period of three years or less if the period before any non-service partner is legally obligated to contribute substantial money or property to the partnership would be disregarded.[75] If the look-through rule applies, (i) the taxpayer includes the entire amount of capital gain recognized on the sale of the partnership in the taxpayer's one-year disposition amount, and (ii) the three year disposition amount would be the one year disposition amount reduced by the gain that would have had a three-year holding period if the partnership had sold its assets for fair market value (taking into account I.R.C. § 7701(g)) immediately prior to the taxpayer's transfer of the partnership interest.[76]

C. Applicable Partnership Interest

INSERT AFTER THE THIRD PARAGRAPH:

In order to qualify for the exclusion for capital interests, gains and losses allocated to the interest must be determined in a manner similar to the allocations with respect to capital interests held by non-service partners.[77] In determining whether the allocations are similar, the following factors are considered: The amount and timing of capital contributed, the rate of return on capital contributed, the terms, priority, type and level of risk associated with capital contributed, and the rights to cash or property distributions during the partnership's operations and on liquidation.[78] However, an allocation will not fail to qualify solely because the allocation is subordinated to allocations made to non-service partners, because an allocation to an service partner is not reduced by the cost of services provided by the service partner or a related person to the partnership, where the cost of services provided includes management fees or allocations, or because a service partner has a right to receive tax distributions while non-service partners do not, where such distributions are treated as advances against future distributions.[79]

In addition to being similar to other capital interest allocations, the allocations must be with respect to, and corresponding to, such partners' contributed capital that are separate and apart from allocations made to the service partner with respect to the interest received for services and the partnership's books and records must clearly demonstrate that this requirement is met.[80]

THE EXAMPLE IS RESTATED AS FOLLOWS:

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[72]. Treas. Reg. § 1.1061-4(a)(2)(i).
[73]. Treas. Reg. § 1.1061-4(a)(2)(ii).
[74]. Treas. Reg. § 1.1061-4(b)(8).
[75]. Treas. Reg. § 1.1061-4(b)(9).
[76]. Treas. Reg. § 1.1061-4(b)(9)(ii).
[77]. Treas. Reg. § 1.1061-3(c)(3)(i).
[78]. Treas. Reg. § 1.1061-3(c)(3)(ii)(A).
[79]. *Id*.
[80]. Treas. Reg. § 1.1061-3(c)(3)(ii)(B).

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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, so long as the allocations to Elinore's capital interest meet the similarity and separate identification requirements described above.[81] If Elinore additionally receives a profits interest for services, the profits interest could be an applicable partnership interest.

AFTER THE EXAMPLE INSERT:

For purposes of the Regulations, an allocation is not a capital interest allocation to the extent the allocation is attributable to the contribution of an amount of capital to a partnership that, directly or indirectly, results from, or is attributable to, any loan or other advance made or guaranteed, directly or indirectly, by the partnership, a partner in the partnership, or any related person with respect to such persons.[82] The rule in the preceding sentence does not apply if (i) the loan is fully recourse to the service partner, (ii) the service partner has no right to reimbursement from any other person, and (iii) the loan is not guaranteed by any other person.[83]

F. Capital Interest Disposition Amount

THE SECTION IS RESTATED AS FOLLOWS:

In the case of a disposition of a portion of a partnership interest, in general, Revenue Ruling 84–53[84] applies and basis must be equitably apportioned between the portion of the interest disposed of and the portion retained. However, Treas. Reg. § 1.1223–3 modifies the rules for determining a divided holding period when a partnership interest includes 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 profits interests, the Treas. Reg. § 1.1223-3(b)(5) modifies the timing of this determination as to that portion to the time of the disposition (as compared to the acquisition) of all or a part of the interest.[85] 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 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.[86] 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

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

[82]. Treas. Reg. § 1.1061-3(c)(v)(A).

[83]. Treas. Reg. § 1.1061-3(c)(v)(B).

[84]. 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.

[85]. Treas. Reg. § 1.1223-3(b)(5)(i).

[86]. Treas. Reg. § 1.1061-3(c)(4).

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steps of the calculation. The computation then proceeds as follows. First, the amount of long term 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).[87] 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).[88] 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 treated as gain other than from the sale of the capital interest (Step Three). 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 loss other than from the sale of a capital interest.[89]

If step three in the previous paragraph does not apply and long-term capital gain is recognized on the disposition of the partnership interest, the amount of long-term capital gain that the transferor of the partnership interest recognizes that is treated as a capital interest disposition amount is determined by multiplying long-term capital gain recognized on the disposition of the partnership interest by a fraction, the numerator of which is the amount of long-term capital gain determined under step two above, and the denominator of which is the amount of long-term capital gain determined under step one, with the percentage represented by the fraction limited to 100 percent.[90]

CHAPTER 9: BUSINESS COMBINATIONS

§ 9.02 PARTNERSHIP MERGERS

D. BUY-OUT RULE

THE LAST SENTENCE OF § 9.02 D IS DELETED.

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

§ 9.05 PARTNERSHIP CONTINUATIONS

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

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

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87. Treas. Reg. § 1.1061-3(c)(4)(ii)(A).
88. Treas. Reg. § 1.1061-3(c)(4)(ii)(B).
89. Treas. Reg. § 1.1061-3(c)(4)(ii)(C).
90. Treas. Reg. § 1.1061-3(c)(4)(ii)(D).

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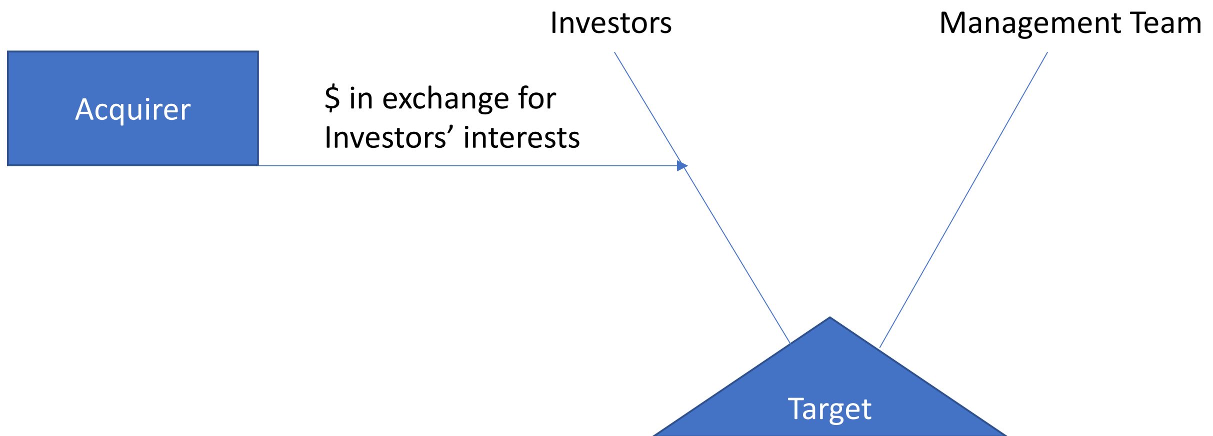
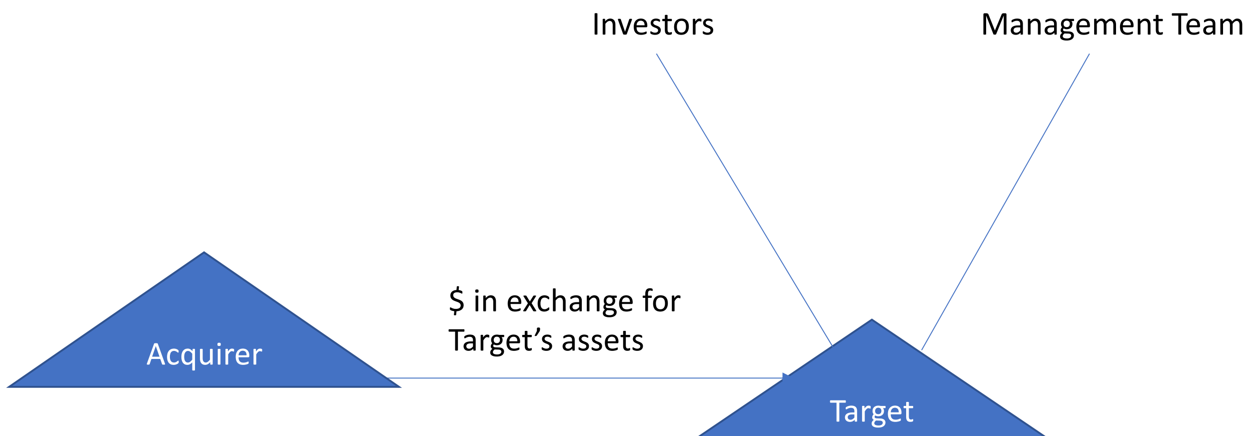


In this structure the Target would continue because the Management Team continues to carry on the business of Target in partnership form.

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



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

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

There are more questions than answers about the application of I.R.C. § 708(b)(1) in the context of acquisitions. Fortunately, the IRS has opened a guidance project that will hopefully answer some of the questions in this context.[91]

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

§ 12.02 FOREIGN PARTNERSHIPS

A. CLASSIFICATION

ADD AT THE END OF SUBSECTION ADD:

Once the non-U.S. entity has been classified as a partnership under the U.S. tax rules, the normal rules relating to Subchapter K apply. One of the Subchapter K rules that may not have made much difference in the purely domestic context is that the character of any item of income, gain, loss, deduction or credit that is required to be separately stated under I.R.C. § 702(a) is determined as if such item were realized directly from the source from which realized by the partnership.[92] Most significantly in the context of this Chapter, non-U.S. source income realized by a partnership retains its character as non-U.S. source income.

You will also recall that Subchapter K sometimes treats partnerships as entities and sometimes as aggregates. The entity and aggregate treatments are applied again in the international context, but now sections of the Code outside of Subchapter K are added to the provisions that balance the two approaches. Outside of Subchapter K, one needs to look at the purposes of a particular section to determine if the aggregate or entity approach should apply.[93]

B. FOREIGN TAX CREDIT RULES IN REGARD TO PARTNERSHIPS

1. Generally

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

[92] I.R.C. § 702(b)

[93] *See,* S. Rep't No. 1622, 83d Cong., 2d Sess. 89 (1954), and H.R. Conf. Rep't No. 2543, 83d Cong., 2d Sess. 59 (1954); Casel v. Commissioner, 79 T.C. 424 (1982)).

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SUBSECTION 1. IS RESTATED AS FOLLOWS:

One of the issues that becomes relevant in an international context is the treatment of non-U.S. taxes imposed on the income of the partnership. The United States employs a worldwide tax system under which U.S. individuals and domestic corporations generally are taxed on all income, whether derived in the United States or abroad. The foreign tax credit provided under I.R.C. § 901 allows some relief for U.S. taxpayers from double taxation of income generated (and taxed) outside of the U.S. Subject to certain limitations, a U.S. taxpayer is allowed to claim a credit against its U.S. income tax liability for the foreign income taxes that it pays or accrues. (It is also possible to instead deduct foreign taxes from income, but, if the credit is not limited, a credit provides a greater after-tax benefit.) A "foreign income tax" is any income, war profits, or excess profits tax paid or accrued to any foreign country or to any U.S. possession.[94] A "foreign income tax" includes any tax paid in lieu of such a tax within the meaning of I.R.C. § 903.

Although partnerships cannot benefit directly from the foreign tax credit, their partners potentially are entitled to do so. 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.[95] 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,[96] 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.

The Regulations contain separate rules for allocating foreign tax credits and the expenses related to the income associated with the taxes.[97] Allocations of creditable foreign taxes (and most other tax credits) do not have substantial economic effect within the meaning of the Regulations under I.R.C. § 704(b),[98] and, accordingly, such expenditures must be allocated in accordance with the partners' interests in the partnership.[99] An allocation of a creditable foreign tax expenditure ("*CFTE*") will be deemed to be in accordance with the partners' interests in the partnership if: (i) the CFTE is allocated (whether or not pursuant to an express provision in the partnership agreement) and reported on the partnership return in proportion to the distributive shares of income to which the CFTE relates; and (ii) allocations of all other partnership items that, in the aggregate, have a material effect on the amount of CFTEs so allocated to a partner are valid.[100]

If the partner is a corporation and the non-U.S. tax is attributable to a non-U.S. corporation owned in whole or in part by the partnership, the analysis is a bit more complex. 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.[101] 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

[94]. I.R.C. § 901(b)(1). Whether a tax is a creditable tax is determined under principles of U.S. law. Treas. Reg. § 1.901-2(a)(2)(i).
[95]. Treas. Reg. § 1.901-1(a). See discussion at 5.04 M.
[96]. 1971-1 C.B. 211.
[97]. Treas. Reg. § 1.861-8(e)(15); Prop. Reg. § 1.861-8(e)(6); Treas. Reg. § 1.960-3.
[98]. Foreign taxes taken as credits do not reduce capital accounts.
[99]. Treas. Reg. § 1.704-1(b)(4)(viii)(a).
[100]. *Id.*
[101]. I.R.C. § 960.

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during the taxable year of such foreign corporation.[102] Controlled foreign corporations are sometimes referred to as "CFCs."[103]

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 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.[104] 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).[105] 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.[106]

Under the so-called "technical taxpayer" rule of Treas. Reg. § 1.901-2(f)(1), the person by whom tax is considered to have been paid for purposes of I.R.C. §§ 901 and 903 is the person on whom foreign law imposes legal liability for the tax. This focus on legal liability applies even if another person, such as a withholding agent, actually remits the tax.[107] It also applies even if another person bears the economic burden of the tax, for example through a gross-up clause.[108]

Treas. Reg. § 1.901-2(f)(3) extends the technical taxpayer rule to situations in which more than one person is liable for a foreign income tax under the foreign law. That Regulation provides that if foreign income tax is imposed on the combined income of two or more related persons (such as a corporation and one or more of its subsidiaries) and they are jointly and severally liable for the tax under foreign law, the foreign law is considered to impose legal liability on each such person for the amount of the foreign income tax that is attributable to its portion of the base of the tax, regardless of which person actually pays the tax.

In 2007, in *Guardian Industries,* U.S. Court of Appeals for the Federal Circuit held that a U.S. company that wholly owned a foreign hybrid entity (a Luxembourg company treated as a disregarded entity for U.S. tax purposes, but as a corporation for Luxembourg tax purposes) was entitled to claim a direct foreign tax credit under I.R.C. § 901 for Luxembourg taxes paid by the hybrid entity on behalf of a consolidated group of companies of which it was the parent.[109] The other Luxembourg entities that were part of the consolidated group were operating companies treated as corporations for U.S. tax purposes. The income earned by those companies was not subpart F income, and the U.S. company consequently had no current income inclusions from those other group members. However, because the Luxembourg parent company was disregarded for U.S. tax purposes, the income and expenses of the Luxembourg parent were treated as income and expenses of the U.S. corporate owner. The Luxembourg taxes paid by the hybrid entity thus were available for credit against U.S. income tax imposed on other foreign source income derived by the U.S. company.

102. I.R.C. § 957.
103. *Id. See* Treas. Reg. § 1.901-1(a).
104. REG-105600-18, 83 Fed. Reg. 63200 (Dec. 7, 2018).
105. Treas. Reg. § 1.960-2(b)(4).
106. *See* Treas. Reg. § 1.960-3(b)(5).
107. *See* Norwest Corp. v. Commissioner, 69 F.3d 1404 (8th Cir. 1995); Continental Illinois Corp. v. Commissioner, 998 F.2d 513 (7th Cir. 1993); Nissho Iwai American Corp. v. Commissioner, 89 T.C. 765 (1987); Gleason Works v. Commissioner, 58 T.C. 464 (1972).
108. Treas. Reg. § 1.901-2(f)(2)(i); *cf.* Continental Illinois Corp. v. Commissioner, 998 F.2d at 516.
109. Guardian Industries Corp. v. United States, 477 F.3d 1368 (Fed. Cir. 2007).

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THE LAST PARAGRAPH BEFORE SUBSECTION C. IS DELETED.

C. U.S. Participation Exemption

SUBSECTION C. IS RESTATED AS FOLLOWS.

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 U.S. participation exemption comes in the form of a deduction for dividends received from non-U.S. corporations. The deduction has two parts: a deduction for dividends from U.S. source income and a deduction for dividends from non-U.S. source income.

Under I.R.C. § 245, a corporation may take a deduction in an amount equal to the percent of the U.S. source portion of a dividend from a qualified 10% owned non-U.S. corporation. The term "qualified 10% owned foreign corporation" means any foreign corporation (other than a passive foreign investment company) if at least 10 percent of the stock of such corporation (by vote and value) is owned by the taxpayer.[110] The U.S.-source portion of any dividend is an amount which bears the same ratio to such dividend as (A) the post-1986 undistributed U.S. earnings, bears to (B) the total post-1986 undistributed earnings.[111] No foreign tax credit is allowed with respect to the portion of a dividend for which the deduction under I.R.C. § 245 is allowed.

Similarly, under Section 245A, 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-U.S. source portion of any dividend received from the 10% owned non-U.S. corporation.[112] 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.[113] The non-U.S.-source portion of the dividends are dividends other than dividends attributable to a U.S. trade or business or dividends received from an 80% owned U.S. corporation.[114] The non-U.S. 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.[115]

If a U.S. 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 distributive share of the domestic partnership's inclusion under I.R.C. § 951(a) or I.R.C. § 951A(a) with respect to the CFC then, 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 or tested income included in gross income under I.R.C. § 951(a) or I.R.C. § 951A(a), respectively, includes such person's distributive share of the domestic partnership's pro rata share of the CFC's Subpart F income or tested income.[116] A person is an indirect partner with respect to a domestic partnership if the

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[110]. I.R.C. § 245(a)(2).
[111]. I.R.C. § 245(a)(3).
[112]. I.R.C. § 245A(a). A deduction for the U.S. source portion is separately available. I.R.C. § 245.
[113]. I.R.C. § 951(b): Conference Report to Accompany H.R. 1, 115 Cong. 1st Sess., Rep. 115-466, p. 597 (15 Dec. 2017).
[114]. I.R.C. § 245A(c).
[115]. I.R.C. § 245A(c)(3).
[116]. Treas. Reg. § 1.245A-5(g)(6).

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person indirectly owns the domestic partnership through one or more specified entities (other than a foreign corporation).[117]

D. Controlled Foreign Corporations and Partnerships

As was hopefully implied by the previous sections, part of the U.S. world-wide tax system includes the requirement that U.S. 10% shareholders of non-U.S. corporations include certain types of income in the shareholder's taxable income whether or not such income is distributed.

The income required to be included in the U.S. shareholder's income includes (among other things) insurance income, certain types of passive income (called foreign personal holding company income), foreign base company service income, and foreign base company sales income.[118]

Foreign personal holding company income includes (among other things) dividends, interest, royalties, rents, and annuities and the excess of gains over losses from the sale or exchange of property: (i) which gives rise to dividends, interest, royalties, rents, and annuities, (ii) which is an interest in a trust, partnership, or REMIC, or (iii) which does not give rise to any income.[119] In the case of any sale by a CFC of an interest in a partnership with respect to which such corporation is a 25% owner of an interest in the capital or profits of the partnership, such corporation is treated as selling the proportionate share of the assets of the partnership attributable to such interest.[120]

"Foreign base company services income" means income derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services that are performed on behalf of any related person, and are performed outside the country in which the CFC is organized.[121]

"Foreign base company sales income" means income derived in connection with: (a) (i) the purchase of personal property from a related person and its sale to any person, (ii) the sale of personal property to any person on behalf of a related person, (iii) the purchase of personal property from any person and its sale to a related person, or (iv) the purchase of personal property from any person on behalf of a related person, if (b) (i) the property so purchased or sold was not manufactured in the country in which the CFC is organized, and (ii) the property is purchased or sold for use, consumption, or disposition outside of the country in which the CFC is organized.[122]

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 the traditional 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.[123]

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 US shareholder

117. *Id.*
118. I.R.C. § 952.
119. I.R.C. § 954(c)(1).
120. I.R.C. § 954(c)(4)(A).
121. I.R.C. § 954(e).
122. I.R.C. § 954(d)(1).
123. I.R.C. § 951A(b)(1).

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over the aggregate of its pro rata share of the tested loss of each CFC with respect to which it is a US shareholder.[124] Pro rata shares are determined under the rules of I.R,C. § 951(a)(2).[125]

The tested income of a CFC means the excess (if any) of the gross income of the corporation—determined subject to certain exclusions—over deductions (including taxes) properly allocable to such gross income.[126] The exclusions to tested income are: (1) the corporation's income effectively connected with a U.S. trade or business 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)).[127]

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 US 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 allowable under I.R.C. § 167.[128] Specified tangible property means any property used in the production of tested income.[129] 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.[130]

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."

The aggregate approach to partnerships in the context of I.R.C. § 951(a) or I.R.C. § 951A(a) was further emphasized under the attribution rules of Subpart F. Under Treas. Reg. § 1.958-1(d)(1) for the purposes of I.R.C. § 951, I.R.C. § 951A and I.R.C. § 956(a), and for purposes of any provision that specifically applies by reference to any of such sections or the regulations under such sections, a domestic partnership is not treated as owning the stock of a foreign corporation. Instead, under I.R.C. § 958(a)(2), the partners are treated as owning the stock proportionately.[131] Although the partnership is still treated as owning the stock of the foreign corporation for the purposes of (i) determining whether any U.S. person is a United States shareholder, (ii) determining whether any non-U.S. coporation is a controlled foreign corporation, (iii) determining whether a pledge or a guarantee triggers a I.R.C. § 956 deemed dividend, (iv) applying I.R.C. § 1248 or (v) determining whether an U.S. shareholder is a controlling domestic shareholder,[132] The

[124]. I.R.C. § 951A(c).
[125]. I.R.C. § 951A(e)(1).
[126]. I.R.C. § 951A(c)(2)(A).
[127]. I.R.C. § 951A(c)(2)(A)(i).
[128]. I.R.C. § 951A(d)(1).
[129]. I.R.C. § 951A(d)(2)(A).
[130]. I.R.C. § 951A(d)(2)(B).
[131] Treas. Reg. § 1.958-1(d)(1).
[132]. Treas. Reg. § 1.958-1(d)(2)(iii).

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Regulations exclude partners from inclusions under I.R.C. § 951, I.R.C. § 951A and I.R.C. § 956(a) if the partner did not own directly or indirectly 10% or more of the stock of the CFC – even if the stock was owned through a partnership that did itself own more than 10% of the stock of the CFC. In other words, each individual partner is separately tested to determine if that partner owns more than 10% of the CFC directly or indirectly.

The Regulations illustrate this approach with the following example:

Example (1).

(A) Facts. USP, a domestic corporation, and Individual A, a United States citizen unrelated to USP, own 95% and 5%, respectively, of PRS, a domestic partnership. PRS owns 100% of the single class of stock of FC, a foreign corporation.

(B) Analysis.

(1) United States shareholder and CFC determinations. The determination of whether PRS, USP, and Individual A (each a United States person) are United States shareholders of FC, and whether FC is a controlled foreign corporation, is made without regard to Treas. Reg. § 1.958-1(d)(1). PRS, a United States person, owns 100% of the total combined voting power or value of the FC stock within the meaning of section 958(a). Accordingly, PRS is a United States shareholder under I.R.C. § 951(b), and FC is a controlled foreign corporation under I.R.C. § 957(a). USP is also a United States shareholder of FC because it owns 95% of the total combined voting power or value of the FC stock under I.R.C. § 958(b) and I.R.C. § 318(a)(2)(A). Individual A, however, is not a United States shareholder of FC because Individual A owns only 5% of the total combined voting power or value of the FC stock under I.R.C. § 958(b) and I.R.C. § 318(a)(2)(A).

(2) Application of I.R.C. § 951 and I.R.C. § 951A. Under Treas. Reg. 1.958-1(d)(1), for purposes of sections 951 and 951A, PRS is not treated as owning (within the meaning of I.R.C. § 958(a)) the FC stock; instead, for purposes of determining the persons that own the FC stock within the meaning of I.R.C. § 958(a), the FC stock is treated as if it were owned by a foreign partnership. Therefore, for purposes of I.R.C. § 951 and I.R.C. § 951A, USP is treated as owning 95% of the FC stock under I.R.C. § 958(a), and Individual A is treated as owning 5% of the FC stock under I.R.C. § 958(a). USP is a United States shareholder of FC, and therefore USP determines its income inclusions under I.R.C. § 951 and I.R.C. § 951A directly with respect to FC based on its ownership of FC stock under section 958(a). However, because Individual A is not a United States shareholder of FC, Individual A does not have an income inclusion under I.R.C. § 951 with respect to FC or a pro rata share of any amount of FC for purposes of I.R.C. § 951A. This is the case even though PRS is a United States shareholder of FC.[133]

If a CFC has investments in U.S. property at the end of any quarter, a proportionate part of any earnings and profits of the CFC that are not otherwise required to be included in the U.S. shareholders' income may be required to be included in the income of the U.S. shareholders up to such shareholders' pro rata shares of such investment.[134] For the purposes of determining whether a CFC has an investment in U.S. property, if a CFC is a partner in a partnership that owns property that would be U.S. property if owned directly by the CFC, the CFC is treated as holding an interest in the property equal to its interest in the partnership and such interest

[133]. Treas. Reg. § 1.958-1(d)(3). Ex. 1.

[134]. I.R.C. § 956(a). 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). See discussion of participation exemption, above. Regulations also deny a foreign tax credit for an I.R.C. § 956 inclusion. Reg. § 1.960-1(a)(1); TD 9882, 84 Fed. Reg. 69022, 69046 (Dec. 17, 2019).

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is treated as an interest in U.S. property.[135]

> *S*, a wholly owned Country *X* subsidiary of *P*, a domestic corporation, is a CFC. *S* reports its income on a calendar year basis. *S* is not engaged in any United States business activity and does not earn any income that is effectively connected with a United States trade or business. *PRS*, an entity classified as a partnership for United States Federal tax purposes, is organized under the laws of Country *X. S* owns a 25 percent interest in the capital and profits of *PRS*, which it purchased in 1987. The remaining 75 percent interest in *PRS* is owned by an unrelated Country *X* corporation. In 1988, *PRS* purchased undeveloped land in the United States. The land is not subject to any mortgages or other liabilities.
>
> For purposes of I.R.C. § 956, *S* is considered to hold on the last day of its 1988 taxable year, a 25 percent interest in the undeveloped land that is owned by *PRS* on such date. The amount taken into account, for purposes of I.R.C. § 956, with respect to *S*'s 25 percent interest in the undeveloped land will be 25 percent of *PRS*'s adjusted basis in the land, limited by *S*'s total basis in *PRS.* The result would be the same if *PRS* were a domestic partnership.[136]

The Treasury has also proposed regulations that would treat the non-subpart F income of a CFC as subpart F income under certain circumstances if a hybrid branch payment is made that reduces a foreign tax and falls within a category of foreign personal holding company income.[137] A hybrid branch payment means the gross amount of any payment (including an accrual) that under the tax laws of any foreign jurisdiction to which the payor is subject is regarded as a payment between two separate entities, but is regarded under U.S. income tax rules as not income to the recipient because the payment is treated as being made between two parts of a single entity.[138] The rules relating to hybrid branches may also apply to payments between a partnership and a hybrid branch under certain circumstances.[139]

Regulations treat property acquired by a partnership that is controlled by a CFC as U.S. property held indirectly by the CFC if the property would be U.S. property if it had been held directly by the CFC and a principal purpose of creating, organizing, or funding by any means (including through capital contributions or debt) the partnership is the avoidance of the application of I.R.C. § 956.[140] For such purposes, a CFC controls a partnership if the CFC and the partnership are related for the purposes of I.R.C. § 267(b) or I.R.C. § 707(b).

In addition, in general, for purposes of I.R.C. § 956, an obligation of a foreign partnership is treated as a separate obligation of each of the partners in the partnership to the extent of each partner's share of the obligation.[141] However, this rule does not apply if neither the lending CFC nor any person related to the lending CFC is a partner in the partnership.[142]

In some circumstances, branches of CFCs may be treated as separate corporations. If a CFC conducts sales or purchasing activity outside its country of organization through a branch, and the use of a branch for such operations has substantially the same effect as the use of a separate corporation, the branch is treated as if it were a separate corporation.[143]

Although, as just noted, the CFC rules may treat a branch as a separate entity in some circumstances, in

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135. Treas. Reg. § 1.956-2(a)(3); Rev. Rul. 90-112, 1990-2 C.B. 186.
136. Rev. Rul. 90-112, 1990-2 C.B. 186.
137. Prop. Treas. Reg. § 1.954-9(a).
138. Prop. Treas. Reg. § 1.954-9(a)(6).
139. Prop. Treas. Reg. § 1.954-9(a)(2)(ii).
140. Treas. Reg. § 1.956-1(b)(1)(iii).
141. Treas. Reg. § 1.956-4(c)(1).
142. Treas. Reg. § 1.956-4(c)(2).
143. I.R.C. § 954(d)(2).

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other situations the CFC rules apply an aggregate theory of partnerships. A CFC's distributive share of any item of partnership income must be included in the income of a U.S. shareholder if the income would have been required to be included in the U.S. shareholder's income if the income had been received directly by the CFC.[144] Similarly, to determine whether an entity is a related person and whether an activity occurred within or outside the country under the laws of which the CFC is created or organized, the determination is made by reference to the CFC and not by reference to a partnership in which the CFC is a partner.[145] Also, a sale to or purchase from a partnership by a CFC will be treated as a transaction with a related entity if the CFC purchases the property from or sells the property to a person that is related to the CFC other than the partnership. A transaction will also be treated as being made with a related entity in the case where the partnership purchases personal property from (or sells personal property on behalf of) the CFC and the branch rule of I.R.C. § 954(d)(2) applies to treat the income of the CFC from selling personal property that the CFC has manufactured to the partnership (or a third party) as foreign base company income.[146]

> *Example*: CFC, a CFC organized in Country A, is an 80 percent partner in MJK Partnership, a Country B partnership. CFC purchased goods from J Corp, a Country C corporation that is a related person with respect to CFC. CFC sold the goods to MJK Partnership. In turn, MJK Partnership sold the goods to P Corp, a Country D corporation that is unrelated to CFC. P Corp sold the goods to unrelated customers in Country D. The goods were manufactured in Country C by persons unrelated to J Corp. CFC's distributive share of the income of MJK Partnership from the sale of goods to P Corp will be treated as income from the sale of goods purchased from a related person for purposes of I.R.C. § 954(d)(1) because CFC purchased the goods from J Corp, a related person. Because the goods were both manufactured and sold for use outside of Country A, CFC's distributive share of the income attributable to the sale of the goods is foreign base company sales income. Further, CFC's income from the sale of the goods to MJK Partnership will also be foreign base company sales income.[147]

E. Special Source Rules

As mentioned above, the character of any item of income, gain, loss, deduction or credit that is required to be separately stated under I.R.C. § 702(a) is determined as if such item were realized directly from the source from which realized by the partnership.[148] Thus, non-U.S. source income realized by a partnership retains its character as non-U.S. source income.

In general, payments of interest by non-U.S. persons would be foreign source income.[149] Thus, a payment of interest by a non-U.S. partnership would be foreign source income, absent another rule. However, I.R.C. § 861 generally defines payments of interest by noncorporate residents to be from U.S. sources.[150] Residents, for these purposes, generally include a foreign partnership that at any time during its taxable year is engaged in a trade or business in the United States.[151] However, in the case of a foreign partnership that is predominantly engaged in the active conduct of a trade or business outside of the United States, any interest paid by such partnership that is not paid by a trade or business engaged in by the partnership in the United States, and is not allocable to income that is effectively connected (or treated as effectively connected) with the conduct of a

[144]. In other words, the test is applied as if the CFC owned the right to income directly rather than through the partnership. Treas. Reg. § 1.952-1(g)(1).
[145]. Treas. Reg. § 1.954-1(g)(1).
[146]. Treas. Reg. § 1.954-1(g)(2).
[147]. Treas. Reg. § 1.954-1(g)(3), example 3.
[148] I.R.C. § 702(b)
[149]. I.R.C. § 862.
[150]. I.R.C. § 861(a).
[151]. Treas. Reg. § 1.861-2(a)(2).

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trade or business in the United States, is not treated as being from U.S. sources.[152]

§ 12.03 U.S PARTNERSHIPS WITH FOREIGN PARTNERS

A. General Rules Relating to U.S. Taxation of Foreign Persons

ADD AFTER SECTION HEAD:

1. FDAP Income

THE LAST SENTENCE OF THE SECOND PARAGRAPH IS DELETED.

AFTER THE SECOND PARAGRAPH ADD THE FOLLOWING MATERIAL:

As to the withholding obligation on interest payments, the Code provides for a broad exception from withholding if the recipient of the interest is not a bank, a controlled foreign corporation related to the borrower or a 10% shareholder of the borrower.[153] The IRS and Treasury have clarified that for the purposes of the 10% shareholder rule, if the debt is held by a partnership, the 10% shareholder exclusion is tested at the level of the partner rather than the level of the partnership.[154] This means that a partnership that was widely held could theoretically own 100% of the stock of a borrower from the partnership and still qualify for the portfolio interest exception

2. FIRPTA

"FIRPTA" stands for Foreign Investment in Real Property Tax Act. Although the provisions in the Code have been substantially changed since the first provisions relating to the sale of real estate by non-U.S. persons were enacted, the concept is the same: the provisions are intended to cause non-U.S. persons to pay U.S. tax on sales of U.S. real estate.

In general, gains of non-U.S. persons that are not effectively connected with a U.S. trade or business are generally not included in U.S. income.[155] Congress created special provisions to cause gains from U.S. real estate to be subject to tax.

The provisions are primarily comprised of two sections: I.R.C. § 897 and I.R.C. § 1445.[156] The two sections have the same goal, but have different focuses. I.R.C. § 897 imposes a tax on the non-U.S. investor on the sale of a U.S real property interest (a "*USRPI*")[157] and I.R.C. § 1445 creates an obligation of the buyer of a USRPI to collect the tax and pay it over to the Service.

A USRPI naturally means an interest in real property in the United States.[158] An interest in real property includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or

[152]. I.R.C. § 861(a)(1)(C).
[153]. I.R.C. §§ 871(h), 881(c).
[154]. Treas. Reg. § 1.871-14(g)(3).
[155]. I.R.C. § 871(a)(2).
[156]. The non-U.S. investor may also have certain reporting requirements under I.R.C. § 6039C that are not discussed herein.
[157]. In general, I.R.C. § 897 defines gains from the sale of a USRPI as income that is effectively connected with a U.S. trade or business and, therefore, subject to U.S. tax.
[158]. I.R.C. § 897(c).

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improvements thereon, options to acquire land or improvements, and options to acquire leaseholds or improvements.[159]

A USRPI also includes any interest (other than an interest solely as a creditor)[160] in any domestic corporation, unless the taxpayer demonstrates that the corporation which not a United States real property holding corporation during the shorter of the period during which the taxpayer held the property or 5 years. A U.S. real property holding corporation includes any corporation if the aggregate fair market value of its USRPIs equals or exceeds 50 percent of the sum of the fair market values of the corporation's USRPIs, its interests in real property located outside the United States, plus any of its other assets which are used or held for use in a trade or business.

A USRPI does not include a corporation which has previously disposed of all of its U.S. real property interests in transaction in which gain was recognized, or because other corporations have ceased to be U.S. real property holding companies because such other corporations previously disposed of all of their USRPIs.[161]

Foreign corporations are considered U.S. real property holding corporations *only* for the purpose of determining if another corporation is a U.S. real property holding corporation.[162] Publicly traded corporations are not considered U.S. real property holding corporations in respect of shareholders holding 5 percent or less of the stock of such corporations.[163] Interests in publicly traded partnership are excluded under similar rules.[164] For the purposes, of determining whether a corporation is a U.S. real property holding corporation, assets held by partnerrships are treated as held proportionately by its partners.[165]

I.R.C. § 1445 requires any purchaser of a USRPI to withhold 15 percent of the amount realized on the disposition. A non-U.S. investor disposing of a USRPI may want to apply for a withholding certificate issued by the Service on or before the date of closing to reduce the total amount withheld to the actual U.S. tax due on the transaction. The withholding certificate will instruct the purchaser as to the amount of withholding that will be required.

If the non-U.S. seller applies for a withholding certificate before closing, but it has not been received by closing, the purchaser is required to withhold the full 15 percent but retain the funds in escrow until the withholding certificate is received.[166]

Withholding under the FIRPTA rules is not required if the seller is not a non-U.S. person or the interest being sold is not a USRPI. To determine if the seller is a U.S. person, the purchaser normally collects FIRPTA certificates from the seller.[167]

No withholding is required if one or more individual transferees acquire a USRPI for use as a residence and the amount realized on the transaction is $300,000 or less.[168]

Withholding is not required if the foreign investor gives notice to the transferee that the foreign investor is not required to recognize gain on the transaction due to the operation of a nonrecognition provision of the Code or a treaty. The transferee must file the notice with the Service within 20 days of the date of closing.[169]

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[159]. I.R.C. § 897(c)(6)(A).

[160] Any interest which includes a direct or indirect right to share in the appreciation in the value of, or in the gross or net proceeds or profits degenerated by the real property is considered an interest other than solely as a creditor. Treas. Reg. § 1.897-1(d)(3)(D).

[161]. I.R.C. § 897(c)(1)(B).

[162]. I.R.C. §§ 897(c)(1)(A)(ii), (c)(4)(A).

[163]. I.R.C. § 897(c)(3).

[164]. Treas. Reg. § 1.897-1(c)(2)(iv).

[165]. I.R.C. § 897(c)(4)(B).

[166]. Treas. Reg. § 1.1445-1(c)(2).

[167]. Treas. Reg. § 1.1445-2(b)(2).

[168]. Treas. Reg. § 1.1445-2(d)(1).

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A domestic or foreign partnership is required to withholding a tax of 15 percent of the fair market value (as of the time of the taxable distribution) of any U.S. real property interest distributed to a partner who is a non-U.S. person.[170] Domestic partnerships are required to withhold on the gain recognized on the disposition of a USRPI to the extent such gain is allocable to a non-U.S. partner.[171] However, publicly traded partnerships that comply with the withholding procedures under I.R.C. § 1446 will be deemed to have satisfied their withholding obligations under I.R.C. § 1445.[172]

3. ECI

THE LAST PARAGRAPH OF SUBSECTION A IS DELETED

SUBSECTION B IS DELETED

THE HEADING FOR SUBSECTION C IS DELETED

THE SECOND FULL PARAGRAPH ON PAGE 456 IS DELETED.

SUBSECTION D. IS RELABELED SUBSECTION B. BRANCH PROFITS TAX

SUBSECTON E. IS RELABELED SUBSECTION C. AND IS RESTATED AS FOLLOWS:

C. Disposition of Interests in U.S. Partnerships by Non-U.S. Persons

In general, the disposition of a partnership interest results in gain or loss treated as gain or loss from the sale or exchange of a capital asset, except as provided in I.R.C. § 751, relating to unrealized receivables and inventory items.[173] Gain or loss recognized by a nonresident, non-U.S. person is generally not subject to tax in the United States, unless the gain is effectively connected with a U.S. trade or business.[174]

1. Disposition of a Partnership Holding a U.S. Real Property Interest

In general, a USRPI includes an interest in a partnership to the extent that the fair market value of the interest is attributable to a USRPI held by the entity.[175] This means that the sale of an interest of U.S. real estate investment partnership by a non-U.S. person would also generally be subject to FIRPTA withholding, just as a sale of the underlying real estate would be subject to withholding. Although this may be self apparent for a venture focused on real estate, as LLCs and partnerships have gained in popularity for a variety of types of businesses, it should also be kept in mind that the sale of an interest in any entity treated as a partnership for U.S. tax purposes will be treated as the sale of a U.S. real property interest if the partnership holds a U.S. real property interest. For example, a manufacturing business formed as an LLC may own its own factory and, if not, is likely to hold a leasehold interest in the real estate. A sale of an interest in the LLC would be subject to the FIRPTA withholding rules to the extent attributable to the real estate.

An interest in a partnership in which, directly or indirectly, 50 percent or more of the value of the gross assets consist of U.S. real property interests, and 90 percent or more of the value of the gross assets consist of

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169. Treas. Reg. § 1.1445-2(d)(2).
170. I.R.C. § 1445(e)(4).
171. Treas. Reg. § 1.1445-5(a), (c).
172. Treas. Reg. § 1.1445-8(b)(2).
173. I.R.C. § 741; see Chapter 6.
174. I.R.C. §§ 871, 881. This rule is subject to some exceptions. For example, non-U.S. individuals who are present in the United States for 183 days or more are subject to U.S. tax on U.S. source gains.
175 I.R.C. § 897(g). Although the statute appears to be contingent upon Regulations, Notice 88-72, 1988-2 C.B. 383 indicates that the provision is self-effectuating.

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U.S. real property interests plus any cash or cash equivalents shall, for purposes of I.R.C. § 1445, be treated as entirely a U.S. real property interest.[176] Consequently, if a partnership meets the 50 percent test and the 90 percent test, a disposition of any portion of such partnership interest shall be subject to partial taxation under I.R.C. § 897(a) and full withholding under I.R.C. § 1445(a). For purposes of this paragraph, cash equivalent means any asset readily convertible into cash (whether or not denominated in U.S. dollars) including, but not limited to, bank accounts, certificates of deposit, money market accounts, commercial paper, U.S. and foreign treasury obligations and bonds, corporate obligations and bonds, precious metals or commodities, and publicly traded instruments.[177]

2. Disposition of a Partnership Engaged in a U.S. Trade or Business

Under Rev. Rul. 91-32, a foreign partner's gain or loss from the disposition of an interest in a partnership that is engaged in a trade or business through a fixed place of business in the United States will be effectively connected income, gain or loss to the extent such gain or loss is attributable to effectively connected income property of the partnership.[178] The gain or loss attributable to the effectively connected income property of the partnership is an amount that bears the same ratio to the gain or loss realized by the foreign partner from the disposition of its partnership interest as the foreign partner's distributive share of partnership net effectively connected income gain or loss would have borne to the foreign partner's distributive share of partnership net gain or loss if the partnership had itself disposed of all of its assets at fair market value at the time the foreign partner disposes of its partnership interest. In computing the foreign partner's distributive share of net gain or loss of the partnership, net effectively connected income gain or loss, and net non-effectively connected gain or loss are computed independently of one another. Thus, net non-effectively connected loss will not offset effectively connected gain, and net effectively connected loss will not offset net non-effectively connected gain.

In *Grecian Magnesite*, the Tax Court concluded in 2017 that Rev. Rul. 91-32 was invalid,[179] 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) effectively frustrates the conclusion of *Grecian Magnesite*.[180] 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.[181] The provision requires that any gain or loss from the hypothetical asset sale by the

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[176]. Treas. Reg. § 1.897-7T.

[177]. *Id*.

[178]. Rev. Rul. 91-32, 1991-1 C.B. 107. The rule established by Rev. Rul. 91-32 does not apply to effectively connected property that is a U.S. real property interest. Treas. Reg. § 1.864(c)(8)-1(d) provides a separate, more nuanced, coordination rule.

[179]. Grecian Magnesite Mining v. Commissioner, 149 T.C. 63 (2017), *aff'd*, 926 F.3d 819 (CA Dis. Col. 2019). The ruling has not been withdrawn. In a decision on the taxpayer's motion for summary judgment dealing with years before the amendment to I.R.C. § 864(c)(8), the Tax Court held that the hypothetical sale that results under I.R.C. § 751(b) on the sale of a partnership interest applies not only to recharacterize the income as ordinary but also to determine the relevant source rule. Rawat v. Commissioner, T.C. Memo 2023-14.

[180]. One could say that the Code provision "overruled" *Grecian Magnesite*, but the Code provision actually went beyond the position of Rev. Rul. 91-32, so "overruled" is probably not adequate in this situation.

[181]. Treas. Reg. § 1.864(c)(8)-1(b)(2)(ii).

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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.[182] 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) 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.

As to partnerships other than publicly traded partnerships, Regulations under I.R.C. § 1446(f) for six exceptions. First, if the transferee receives a certification that the transferor is a U.S. person, no withholding is required.[183] Second, if the transferee receives a certification that no gain will be realized, no withholding is required.[184] 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 (other than a partnership that is a transferee because it makes a distribution) receives a certificate that (i) the transferor was a partner of the partnership throughout the three preceding taxable years, (ii) the transferor's distributive share of gross effectively connected income from the partnership was less than $1 million for each of the preceding three taxable years, (iii) the share of income from the partnership for the three preceding taxable years was comprised of less than 10% income effectively connected to a U.S. trade or business, no withholding is required and (iv) all of the transferor's effectively connected income from the partnership has been property reported on a tax return and the tax has been paid, no withholding is required.[185] Fourth, no withholding is required if the transferee receives a certificate that (a) if partnership sold all of its assets as of the determination date either (i) the partnership would have no gain that would have effectively connected to a U.S. trade or business; (ii) the transferor would not have distributive share of net gain from the partnership that would have been effectively connected with a U.S. trade or business; or (iii) less than 10% of the gain would be was income effectively connected to a U.S. trade or business; or (b) the partnership was not engaged in a U.S. trade or business at any time during the taxable year of the partnership through the date of the transfer.[186] 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.[187] 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.[188]

The general rules for withholding on transfers of partnership interests do not apply to the transfers of interests in publicly traded partnerships.[189] However, the Regulations provide a separate set of rules for

182. Treas. Reg. § 1.6012-1, -2.
183. Treas. Reg. § 1.1446(f)-2(b)(2).
184. Treas. Reg. § 1.1446(f)-2(b)(3)(i).
185. Treas. Reg. § 1.1446(f)-2(b)(5)(i).
186. Treas. Reg. § 1.1446(f)-2(b)(4).
187. Treas. Reg. § 1.1446(f)-2(b)(6).
188. Treas. Reg. § 1.1446(f)-2(b)(7)(i).
189. Treas. Reg. § 1.1446(f)-1(a).

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publicly traded partnerships.[190] Under these rules, any broker that effects a transfer of a publicly traded partnership interest on behalf of a non-U.S. partner and receives the amount realized on behalf of the transferor is generally required to withhold a tax equal to 10 percent of the amount realized.

A broker is not required to withhold on a payment to a non-US broker if the paying broker is able to obtain documentation that the recipient broker is either a qualified intermediary (as defined in Treas. Reg. § 1.1441-1(e)(5)(ii)) that provides a valid qualified intermediary withholding certificate that states that the recipient broker assumes primary withholding responsibility for the payment or that the recipient broker is a U.S. branch of a non-U.S. person that provides a valid U.S. branch withholding certificate that states that the U.S. branch agrees to be treated as a U.S. person with respect to the payment.[191]

A broker is not required to withhold under I.R.C. § 1446(f), if the broker receives a certification that one of three exceptions is met, receives a qualified notice, or if the amount is separately subject to withholding under I.R.C. § 3406.

The first exception for which a broker may obtain a certification is the U.S. person exception. If the paying broker obtains a validly executed Form W-9, or substitute form, may generally rely upon the form unless the broker knows that it is false.[192] A broker may rely upon a certification from the transferor that states that the transferor 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 if certain requirements are met.[193] A broker may also rely upon a certification provided by the transferor that it is a dealer in securities and any gain from the transfer of the publicly traded partnership interest is already subject to tax by the United States as effectively connected income without regard to I.R.C. § 864(c)(8).[194]

A broker may rely on a qualified notice (as defined below) that states that the 10-percent exception applies.[195] The 10-percent exception applies to a transfer if, on the PTP designated date, (1) if the publicly traded partnership had sold all of its assets at fair market value, either (i) the amount of net gain that would have been effectively connected with the conduct of a trade or business within the United States would be less than 10 percent of the total net gain; or (ii) no gain would have been effectively connected with the conduct of a trade or business in the United States; or (2) the partnership was not engaged in a trade or business within the United States at any time during the taxable year of the partnership through the designated date.[196]

In a case in which a broker properly relies on a qualified notice that results in under withholding on a transfer of a publicly traded partnership interest, the partnership that issued the notice is solely liable for the under withheld tax under I.R.C. § 1461.[197] A partnership's liability applies only when the partnership fails to make a reasonable estimate of the amounts required for determining the applicability of the 10-percent exception.[198]

3. Coordination Between I.R.C. § 864(c)(8) and I.R.C. § 897

[190]. Treas. Reg. § 1.1446(f)-4(a)(1). The rules under the Regulations have been clarified and modified by Notice 2023-8, 2023-2 IRB 341 (Jan. 9, 2023).
[191]. Treas. Reg. § 1.1446(f)-4(a)(2)(ii).
[192]. Treas. Reg. § 1.1446(f)-4(b)(2).
[193]. Treas. Reg. § 1.1446(f)-4(b)(5).
[194]. Treas. Reg. § 1.1446(f)-4(b)(6).
[195]. Treas. Reg. § 1.1446(f)-4(b)(3)(i).
[196]. Treas. Reg. § 1.1446(f)-4(b)(3)(ii)(A).
[197]. Treas. Reg. § 1.1446(f)-4(b)(3)(i).
[198]. *Id.*

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Except as provided in Treas. Reg. § 1.864(c)(8)-1, the amount of any money, and the fair market value of any property, received by a nonresident non-U.S. individual or non-U.S. corporation in exchange for all or part of its interest in a partnership, trust, or estate will, to the extent attributable to U.S. real property interests, be considered as an amount received from the sale or exchange in the United States of such property.[199]

Under Treas. Reg. § 1.864(c)(8)-1, if a non-U.S. transferor transfers an interest in a partnership in a transfer that is subject to I.R.C. § 864(c)(8) without regard to any U.S. real property interests, then the non-U.S. transferor determines its effectively connected gain and effectively connected loss under I.R.C. § 864(c)(8), and not pursuant to I.R.C. § 897(g), even if the partnership holds U.S. real property interests.[200] However, Treas. Reg. § 1.864(c)(8)-1(c)(3) provides that a non-U.S. transferor's distributive share of deemed sale effectively connected gain or deemed sale effectively connected loss does not include any amount to which an exception under I.R.C. § 897 applies, such as I.R.C. § 897(k) (which provides special rules for REITs) or I.R.C. § 897(l) (which provides special rules for qualified foreign pension funds), provided that amount is not otherwise treated as effectively connected income under a provision of the Code.

Accordingly, in spite of the statutory language, with respect to a transfer that is subject to I.R.C. § 864(c)(8) because the partnership is engaged in a trade or business (without regard to gain on the disposition of U.S. real property interests), I.R.C. § 864(c)(8)(C) does not reduce the amount of gain or loss treated as effectively connected gain or loss under I.R.C. § 864(c)(8), other than to the extent of certain identified exceptions.[201] For a transfer not otherwise subject to I.R.C. § 864(c)(8) of an interest in a partnership that owns one or more United States real property interests, I.R.C. § 897(g) and the regulations thereunder govern.[202] If a non-U.S. transferor transfers an interest in a partnership in the manner described in one or more nonrecognition provisions of the Code, the transfer is treated as not subject to I.R.,C. § 864(c)(8) to the extent of the gain or loss that is not recognized; instead, if the partnership owns one or more United States real property interests at the time of transfer, the rules of I.R.C. § 897(g) and the regulations thereunder apply to the unrecognized gain or loss.

§ 12.08 Reading, Questions and Problems

B. Questions and Problems

Problem 9 is restated as follows:

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

CHAPTER 14: FAMILY PARTNERSHIPS

The introductory material of § 14.01 and subsection A are restated as follows:

§ 14.01 Income Tax Issues on the Partnership’s Formation

[199]. Treas. Reg. § 1.897-7(c).

[200]. Treas. Reg. § 1.84(c)(8)-1(d). See also, TD 9919, 85 Fed. Reg. 70958,

[201]. Treas. Reg. § 1.864-c-1(d).

[202]. *Id.*

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Entities are formed by families for a variety of reasons. The family is one of the basic units of business.

In addition to running a family business, some of the traditional reasons for forming an entity for the family were to provide a unified voting block for family held stock (similar to a voting trust), to provide a larger investment base to save money on investment advice and other fees, and to provide a mechanism for joint ownership of family assets. In addition, a family entity may be used to structure inter-generational transfers of assets efficiently.

The use of family limited partnerships and LLCs as inter-generatinal transfer tools re-introduces two factual issues, each with potentially significant tax consequences to the partners on the formation and termination of the partnership. First, it became much more likely that a significant portion of the assets of the partnership would be comprised of stock or other investment assets, not just of a family controlled corporation, but of a variety of issuers. Second, in contrast to the trend in partnerships generally after the introduction of the check-the-box Regulations,[203] family limited partnerships formed for estate planning purposes often either explicitly or implicitly would be assumed to terminate within a reasonable period of time after the older generation died.

Chapter 2 describes the rules relating to the formation of a partnership and the transfer of property to a partnership. It is generally assumed by taxpayers forming a partnership, including family members forming a family limited partnership or LLC, that the initial contribution of property to the partnership is eligible for tax-free treatment under I.R.C. § 721.

In general, I.R.C. § 721(a) provides that gain or loss is not recognized by a partner on a contribution of property to a partnership in exchange for an interest in the partnership. If, however, a partnership would be treated as an investment company for the purposes of I.R.C. § 351 if the partnership were a corporation, under I.R.C. § 721(b), gain (but not loss) may be recognized by a partner on contribution of property to a partnership in exchange for a partnership interest. For the purposes of I.R.C. § 351, a transfer is treated as a transfer to an investment company if:

1. The transfer results in diversification of the transferor's interests.
2. The transferee is (a) a regulated investment company (a "*RIC*"), (b) a real estate investment trust (a "*REIT*"), or (c) a corporation more than 80% of the value of whose assets is held for investment and include certain defined investment assets ("portfolio assets").[204]

A. Diversification

A transfer results in diversification of the transferor's interests if two or more persons transfer non-identical assets to the entity in the exchange.[205] If two or more persons transfer identical assets to a newly

[203]. Treas. Reg. §§ 301.7701-1, -2, -3. Prior to the check-the-box Regulations, the previous Regulations used the existence of a limited life as one of the characteristics that distinguished a partnership from an association taxable as a corporation. Under the check-the-box Regulations, partnerships are often perpetual.

[204]. Treas. Reg. § 1.351-1(c)(1). Under I.R.C. § 351(e)(1), the portfolio assets taken into consideration are: (1) all stock and securities; (2) money; (3) stocks and other equity interests in a corporation, evidences of indebtedness, options, forward or futures contracts, national principal contracts, and derivatives; (4) any foreign currency; (5) any interest in a REIT, a common trust fund, a RIC, a publicly traded partnership (as defined in I.R.C. § 7704(b)), or any other equity interest (other than in a corporation) which pursuant to its terms or any other arrangement is readily convertible into, or exchangeable for, any asset described in any preceding clause, this clause, or clause (6) or (9); (6) except to the extent provided in Regulations, any interest in a precious metal, unless such metal is used or held in the active conduct of a trade or business after the contribution; (7) except as otherwise provided in Regulations, interests in any entity if substantially all of the assets of such entity consist (directly or indirectly) of any assets described in any preceding clause or clause (9); (8) to the extent provided in Regulations, any interest in any entity not described in clause (6), but only to the extent of the value of such interest that is attributable to assets listed in clauses (1) through (6) or clause (9); or (9) any other asset specified in Regulations.

[205]. Treas. Reg. § 1.351-1(c)(5). It is common in a family limited partnership situation for a husband and wife who own non-

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organized entity, the transfer will generally be treated as not resulting in diversification (the "identical asset exception").[206]

One of the traditional uses of a family limited partnership applies the identical asset exception: the use of the partnership to create a unified voting block for stock in a closely held corporation.

For example, suppose Anna, who founded a corporation, Brilliant Ideas, Inc., dies and leaves some of the stock in Brilliant Ideas to her daughter, Edna, and her grandchildren, Bill, age 25, Charlotte, age 30, and Dudley, age 45. If Edna, who has been CEO of the business for the last 10 years, only has one-third of the stock of the company, and non-family members hold 20%, who the grandchildren vote with could determine whether Edna would still have control of the business. If Bill, Charlotte, Dudley, and Edna all contribute their stock in Brilliant Ideas, Inc. to Brilliant Holdings, LLC, no diversification is obtained (assuming the stock is the only asset contributed), and although stock is specifically identified as taken into consideration in I.R.C. § 351(e)(1), the transfer is not treated as a transfer to an investment company for the purposes of I.R.C. § 721(b) because no diversification is obtained.[207]

Cash, like other property, is taken into consideration for the purposes of the diversification test. In Rev. Rul. 87-9,[208] publicly traded stock was transferred to a newly formed corporation in exchange for 89% of the Newco stock. Cash was contributed in exchange for the remainder of the stock. Diversification was not obtained by the stock alone, because all of the stock contributed was of the same corporation. The IRS ruled, however, that the contribution of cash could not be ignored and did cause diversification for the purposes of the investment company exception. Thus, everyone who contributed stock to Newco recognized gain on that contribution to the extent that the value of the stock received in the exchange exceeded the basis of the stock contributed.

The determination of whether a transfer to a partnership is a transfer to an investment company for the purposes of I.R.C. § 721(b) is ordinarily made by reference to the circumstances in existence immediately after the contribution. However, where the circumstances change pursuant to a plan in existence at the time of the contribution, the determination of whether the contribution to a partnership is a contribution to an investment company is made by reference to the circumstances in existence after the planned change occurs.[209]

Thus, although cash is taken into consideration for purposes of the diversification test, if the cash is being contributed to the partnership to acquire identical (or fungible) property, no diversification will be obtained (if such assets are, in fact, acquired pursuant to the plan).

For example, if Edna contributed her stock in Brilliant Ideas, Inc. to Brilliant Holdings, LLC, but Bill, Charlotte and Dudley contributed cash, if at the time of the contribution, the purpose of the contribution of cash was to enable Brilliant Holdings, LLC to acquire additional stock in Brilliant Ideas (and such stock is purchased using all of the contributed cash), no diversification is obtained.

If the non-identical assets involved in an exchange constitute an insignificant portion of the total value of assets transferred, the non-identical nature of the assets is ignored for the purposes of determining whether a transfer is to be treated as a transfer to an investment company. As indicated above, 11% is more than an

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identical assets to equalize their assets (transfer a one-half interest in each asset to the other spouse) prior to contributing the assets to a family limited partnership if another exception to gain recognition is not available.

[206]. *Id.*

[207]. The legislative history to I.R.C. § 351(e) specifically notes that although Congress intended to expand the list of property taken into consideration for purposes of identifying a transfer to an investment company, Congress did not intend to change the requirement in the Regulations that the transfer must create diversification before the transfer is treated as a transfer to an investment company. H.R. Rep. 105-148, 105th Cong., at 447, 1997 U.S.C.C. & A.N. 841 (1997).

[208]. 1987-1 C.B. 133.

[209]. Treas. Reg. § 1.351-1(c)(2).

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insignificant portion. The Regulations provide an example in which 0.99% is viewed as an insignificant portion.[210] In the example, two stockholders contribute a total of $20,000 in publicly traded stock, and a third stockholder contributes $200 in cash. The example concludes that the contribution of the third stockholder should be ignored for purposes of determining whether diversification has occurred.

A transfer of stock or securities to a partnership does not result in diversification if each transferor transfers a diversified portfolio of stock and securities (the "*diversified portfolio exception*").[211] For these purposes, a portfolio will be considered diversified if not more than 25% of the value of each portfolio is invested in any one issuer and not more than 50% of the value of each portfolio is invested in the stock and securities of five or fewer issuers. Government securities are included in the denominator for the purposes of the test (*i.e.*, included in determining the total value of the portfolio), but are not treated as securities of an issuer.

The theory behind the diversified portfolio exception would seem to be that if a portfolio is already diversified, any incremental diversification by adding another diversified portfolio is not significant.

§ 14.03 INCOME TAX ISSUES FOR VACATION/RENTAL HOMES

ADD AT THE END OF THE SECTION:

As discussed below in § 14.05, expenses from activities not engaged in for profit, even if otherwise deductible under the hobby loss rules, are considered miscellaneous itemized deductions.[212] Thus, such expenses are not deductible for tax years 2018 through 2025.[213]

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

However, property taxes are subject to a separate limitation under I.R.C. § 164. Prior to 2026, an individual may not claim a deduction of more than $10,000 in the aggregate per year of certain taxes, including state and local income and property taxes ($5,000 in the case of a married individual filing a separate return).[214]

Investment interest expense is deductible to the extent of investment income of the taxpayer for the year.[215] Interest attributable to a passive activity is deductible to the extent of the passive activity income.[216] However, the deductibility of interest from a trade or business is subject to an overall limitation of 30% of the taxpayer's earnings before depreciation, amortization, interest and taxes (depreciation and amortization are backed out only for years before 2022), provided, generally, that the average annual gross receipts for the

[210]. Treas. Reg. § 1.351-1(c)(7), example 1. In at least one Private Letter Ruling, the IRS ruled that a non-identical transfer of less than 5% of the total assets was insignificant. *See* PLR 200006008 (Feb. 14, 2000).

[211]. Treas. Reg. § 1.351-1(c)(6).

[212]. Temp. Reg. § 1.67-1T(a)(1)(iv).

[213]. I.R.C. § 67(g).

[214]. I.R.C. § 164(b)(6).

[215]. I.R.C. § 163(d)(1).

[216]. Temp. Reg. § 1.469-2T(d)(3). The passive activity loss rules do not apply to a residence subject to I.R.C. § 280A(c)(5). *See* I.R.C. § 469(j)(10).

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taxpayer's three-year taxable period ending prior to the current taxable year exceed $25 million (adjusted for inflation).[217]

Personal interest is an allowable deduction only if it fits in certain specified preferred categories.[218] One of those categories is acquisition indebtedness for a qualified residence.[219] A "qualified residence" means the taxpayer's principal residence and one other residence of the taxpayer which is used by the taxpayer as a residence for the purposoes of I.R.C. § 280A(d)(1).[220] For years prior to 2026, the interest on no more than $750,000 ($375,000 in the case of a married individual filing separately) of acquisition indebtedness is deductible. After 2025, the limits go up to $1,000,000 and $500,000, respectively.

So one might asked, "What does all this have to do with a family limited partnership?" In Chapter 1 we talked about the entity and the aggregate theories. I.R.C. § 280A is applied to a partnership under the aggregate theory. Prop. Reg. § 1.280A-1(e)(3) provides that, for the purposes of I.R.C. § 280A, the partnership is treated as making personal use of property on any calendar day which any member of the partnership would be considered to have made personal use of the property.[221]

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

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

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

§ 14.05 is deleted and § 14.06 is renumbered § 14.05

CHAPTER 15: DEATH OF A PARTNER

§ 15.02 TERMINATION OF A PARTNERSHIP

THE FIRST PARAGRAPH IS RESTATED AS FOLLOWS:

I.R.C. § 708 provides that a partnership is considered as terminated only if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership. Death of the partner does not ordinarily result in the termination of the partnership under I.R.C. § 708(b)(1), unless the partnership is a two-person partnership. In such a case the death of the partner will cause the partnership to terminate unless the estate or other successor continues to share in the profits or

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[217]. I.R.C. §§ 163(j)(3), 448(c)(1), (4).
[218]. I.R.C. § 163(h)(1) and (2).
[219]. I.R.C. § 163(h)(3)(A)(i).
[220]. I.R.C. § 163(h)(4)(A).
[221]. *See also* S. Rept No. 94-938 (PL 94-455), Tax Reform Act of 1976, 1976-3 C.B. (Vol. 3) pp. 153-54 (June 10, 1976).

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losses of the partnership business.[222]

THE LAST PARAGRAPH OF § 15.02 IS DELETED

CHAPTER 17: LEGISLATIVE UPDATES AND NON-SUB K PROVISIONS

Add after 17.04 Qualified Opportunity Zone Funds:

§ 17.05 QUESTIONS AND PROBLEMS

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

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

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

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

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

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

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

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

[222]. Treas. Reg. § 1.708-1(b)(1)(i).

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B. Qualified Opportunity Zone Funds

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

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

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

c. What will Money Bags recognize in 2026?

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

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

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

CHAPTER 18: PARTNERSHIP DEBT WORKOUTS

Add after 18.10 Abandonment or Worthlessness of Partnership Interests:

§ 18.11. Questions and Problems

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

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

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

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successful, and after a few years Neighborhood Bank releases C from the guarantee. Does C have income from the release of the guarantee?

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

5. ABC, an LLC treated as a partnership, borrowed money from Neighborhood Bank to buy Strip Mall. ABC was a newly formed entity but had capitalization equal to 50% of the purchase price of Strip Mall. Neighborhood Bank extends ABC a recourse loan (for state law purposes) at 7% per annum. A, B and C do not have personal liability for the debt. Initially, the project does very well, and after a few years, ABC refinances the bank debt so that outstanding debt is $500, interest only nonrecourse. The neighborhood in which Strip Mall is located starts to decline. Strip Mall is not able to break even. Neighborhood Bank forecloses on the property. At the time of the foreclosure, the amount of the debt is $500 and the cash proceeds from the foreclosure sale from the Strip Mall are $100. ABC's basis in Strip Mall at the time of the foreclosure sale is $100. None of A, B or C are subject to the jurisdiction of the bankruptcy court. A had put every penny A had into the deal and is now approximately $2,000,000 insolvent. Neither B nor C are insolvent. Do A, B or C have income on the cancellation? Does ABC recognize gain on the foreclosure sale?

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

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

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ERRATA

PAGES 206 AND 207

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

PAGE 408

Footnote 36 should be restated as follows:

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

PAGE 517

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