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PARTNERSHIP TAXATION

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PARTNERSHIP TAXATION

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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]

THE THIRD PARAGRAPH ON PAGE 7 IS RESTATED AS FOLLOWS:

One exception to the general rule that domestic business entities with more than one owner may not be treated as disregarded entities is a spousal partnership. I.R.C. § 761(f) provides that a husband and wife who operate a joint venture as the only owners may elect not to treat the joint venture as a partnership; in other words, they may treat it as a disregarded entity. In order to qualify, both spouses must materially participate in the business of the entity, and they must file a joint return. Rev. Proc. 2002-69[3] also allows spousal partnerships to be disregarded in community property states without regard to the material participation standard.

[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]. 2002-2 C.B. 831.

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C. The Classification of Non-U.S. Business Entities

THE LAST SENTENCE OF FOOTNOTE 26 IS RESTATED AS FOLLOWS:

Many of the *per se* corporations under Treas. Reg. § 301.7701-2 are publicly traded and would have had all four factors under the old Kintner Regulations.

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.[4] First, a variety of transfers are ignored.[5] 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.[6] 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 more than four times per year.[7] 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.[8] 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.[9]

3. Taxable Mortgage Pools

FOOTNOTE 39 IS RESTATED AS:

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

RESTATE THE LAST PARAGRAPH OF THE SECTION 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").[10] An entity that makes a valid REMIC election is not treated as a TMP.[11]

[4]. Treas. Reg. § 1.7704-1(c)(3).
[5]. Treas. Reg. § 1.7704-1(c)(3).
[6]. Treas. Reg. § 1.7704-1(e).
[7]. Treas. Reg. § 1.7704-1(f).
[8]. Treas. Reg. § 1.7704-1(g).
[9]. Treas. Reg. § 1.7704-1(j).
[10]. *See* I.R.C. § 860A and sections following. A discussion of real estate mortgage investment conduits is beyond the scope of this text.
[11]. I.R.C. § 7701(i)(A).

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§ 1.04 DISTINGUISHING PARTNERSHIPS FROM OTHER CONTRACTUAL ARRANGEMENTS

A. Distinguishing Partnerships from Loans

Restate the first paragraph at the topic of page 13 as follows:

The analysis of *O'Hare* was affirmed in *ASA Investerings Partnership v. Commissioner.*[12] In *ASA Investerings Partnership*, the D.C. Circuit viewed the "basic inquiry" under *Culbertson* as "whether, all facts considered, the parties intended to join together as partners to conduct business activity for a purpose other than tax avoidance."[13] The court found that ABN's (the purported partner) interest was limited to a specified return (approximately LIBOR[14] plus 75 basis points) and that AlliedSignal (the other purported partner) effectively protected ABN from loss on the transaction. The court never actually reached the question of whether ABN's contribution constituted a loan. The court stated that whether an equity contribution or a loan was involved was "quite peripheral to the central issue of whether the parties entered into a bona fide partnership."[15] The court concluded that the parties lacked a nontax business purpose and that the partnership therefore was a sham.[16]

§ 1.05 Determining Who Is a Partner

Add at the end of the section:

In *YA Global*,[17] the Tax Court held that I.R.C. § 704(e)(1), as it applied before 2015, required the recognition as a partner one who holds a capital interest in a partnership even though the person would not be recognized as a partner under *Culbertson*'s intent test. This holding of *YA Global* could be read to be in conflict with the holding of the Second Circuit Court of Appeals in *TIFD III-E* that I.R.C. § 704(e)(1) does not apply to a person who is not a partner.[18] Although I.R.C. § 704(e)(1) was amended in 2015, the issue would continue as to interests acquired by gift under I.R.C. § 761(b).[19]

§ 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.[20]

§ 1.08 SERIES LLCS

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12. T.C.M. (RIA) ¶ 98,305 (1998), *aff'd*, 201 F.3d 505 (D.C. Cir. 2000), *cert denied*, 531 U.S. 871 (2000).
13. ASA Investerings Partnership, 201 F.3d 505, 513 (D.C. Cir. 2000).
14. LIBOR was the London Interbank Offered Rate. In the United States, LIBOR has generally been replaced by the Secured Overnight Financing Rate pursuant to the LIBOR Replacement Act. 12 USC 55.
15. *Id.* at 515.
16. *Id.* at 512.
17. YA Global v. Commissioner, T.C. Memo 2024-78.
18. *TIFD III-E Inc. v. United States, 459 F.3d 220 (2d Cir. 2006).*
19. See discussion of I.R.C. § 704(e) in § 1.08.B.5.
20. Rawat v. Commissioner, T.C. Memo 2023-14, rev'd, 134 AFTR 2d 2024-5131 (D.C. Cir. 2024).

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A. Introduction

Footnote 128 is restated as follows:

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

The second, third and fourth paragraphs are restated as follows:

The basic concept is that an LLC operating agreement may provide for segregated "series" to be established by the LLC. Each series may have its own liability shield. Thus, everything else being equal, a liability of a particular series may only be satisfied by the assets allocated to that series, and not by the assets of other series. Thus, not only does a series LLC have the LLC liability shield, but it can create multiple additional liability shields within itself. Why do that instead of just creating additional LLCs? It is mostly about convenience and possibly about cost. Creating a new series may not require an additional filing with the state and/or federal government. The additional fees that must be paid for new series, if any, may be less than the fees required for creating new LLCs. However, this varies by state, and the cost advantages may or may not be very significant, depending what the LLC and series are doing, what are the registration rules that they need to comply with, and the structure of filing fees for the various agencies with whom they must register.

Series LLCs have had mixed gains in popularity, in part because it is unclear whether the series liability shield will be respected by nonseries states[21] or in bankruptcy.[22] In some contexts, it is also unclear how series will be treated for regulatory, licensing, and nontax purposes. Further, it has been unclear how each series would be classified for federal income tax purposes. For a time, all we had for guidance was private letter rulings.[23] In the federal tax cases where series LLCs are present, the classification of the series has not been in issue.[24] We have guidance in the form of Proposed Regulations, discussed below. Although there are only proposed, not final Regulations, there is now a measure of certainty as to tax classification. This may induce more states to adopt series legislation, which, in turn, may make their use more widespread.[25] Until that happens, the questions on how a series will be treated in a nonseries state are almost endless. Here is a sampling: Will the series liability shield be respected? May a series by itself qualify to do business? Can a series contract in its own name? How will environmental liabilities be assessed? How will sales taxes be applied? How will employment laws be applied? How will state income taxes be applied? Can it be fraud on creditors to transfer an asset from one series to another? A similar list could be created at the federal level for bankruptcy law, pension law, and securities law.

To date, series LLCs have mostly been used by investment funds, insurance companies and in certain debt offerings, where the existence of the series liability shield is of little importance, where the applicable regulatory scheme is compatible and where authority for series investment trusts gave practitioners sufficient confidence about the tax classification. Investment funds, for example, like to use series LLCs because they can create series to house new funds while operating under a single registration under the Investment

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[21]. *See* GxG Management LLC v. Young Brothers and Co., Inc., 2007 U.S. Dist. LEXIS 12337 (D. Me. 2007); Butler v. Adoption Media, LLC, 2005 U.S. Dist. LEXIS 46208 (N.D. Cal. June 21, 2005) (both cases are unreported).

[22]. *See* Shannon Dawson, *Series LLC and Bankruptcy: When the Series Finds Itself in Trouble, Will It Need Its Parent to Bail It Out?*, 35 Del. J. Corp. L. 515 (2010).

[23]. *See* PLR 200733003 (Aug. 17, 2007); PLR 200803004 (Jan. 18, 2008);

[24]. *See* Callhan v. The Chicago Series of Lockton Co., 118 F. Supp. 3d 1008 (DC IL 2015); U.S. v Lawrence; 118 AFTR 2d 2016-5958 (DC FL 2016); In re Palmieri, 651 B.R. 349 (Bktcy Ct IL 2023);

[25]. *See* Michael Mcloughlin and Bruce Ely, *IRS Issues Long-Awaited Guidance on Series LLCs, Will the States Soon Follow?*, 20 J. Multistate Tax'n & Incentives 8 (2011).

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Company Act of 1940. Similarly, some real estate developer put their projects in series LLCs with each project in a separate series.

B. Tax Classification and the Proposed Regulations

3. Starting Gate

The first paragraph is restated as follows:

Treas. Reg. § 301.7701-1(a) provides that whether or not an organization is "an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law." But Prop. Reg. § 301.7701-1(a)(5)(i) contains a somewhat opaque provision that provides that whether or not a series is a "juridical person for local law purposes, it is treated as an entity formed under local law." Why do the Proposed Regulations feel obliged to make this reference? It may be an effort to invoke the presumptions of *Moline Properties, Inc. v. Commissioner.*[26] In *Moline Properties*, the Supreme Court noted that, so long as a corporation was formed for a purpose that is the equivalent of business activity, or the corporation actually carries on a business, the corporation remains a taxable entity separate from its shareholders. Thus, organizations that are recognized as separate entities under local law generally are also recognized as separate entities for federal tax purposes.[27] By treating a series as an entity formed under local law, the Proposed Regulations may be trying to provide further support for its position that a series can be recognized as a separate entity for federal tax purposes. It also sets up a subsequent provision of the Proposed Regulations that provides that whether a series that is "treated as a local law entity" under Prop. Reg. § 301.7701-1(a)(5)(i) "is recognized as a separate entity for federal tax purposes is determined under this section [i.e., Prop. Reg. § 301-7701] and general tax principles."[28] That in turn brings a series within the check-the-box Regulations. Under those rules, a series is classified as a disregarded entity if it has one owner or a partnership if it has two or more owners, unless it elects to be taxed as a corporation.[29] (Note, somewhat counter-intuitively, that separate entity status is a condition precedent to classification as a disregarded entity.)

The second and third paragraphs are deleted.

The fourth paragraph is restated as follows:

As noted previously, the Delaware statute provides that the series liability limitation provisions do not apply if the series does not maintain records adequately accounting for the assets associated with each series separately from the assets of the LLC or any other series. The Proposed Regulations provide that an election, agreement, or other arrangement that permits debts and liabilities of other series or the LLC to be enforceable against the assets of a particular series, or a failure to comply with the recordkeeping requirements for the limitation on liability available under the relevant series statute, will not prevent a series from meeting the definition of "series" in the Proposed Regulations.

Footnote 152 is restated as follows:

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26. 319 U.S. 436 (1943). The preamble to the Proposed Regulations includes a discussion of *Moline Properties* in the discussion of separate entity classification. REG-119921-09, 75 Fed. Reg. 55699, 55700 (Sept. 14, 2010).

27. A state law entity may be disregarded if it lacks business purpose or any business activity other than tax avoidance. *See* Chapter 1 and Bertoli v. Commissioner, 103 T.C. 501 (1994); Aldon Homes, Inc. v. Commissioner, 33 T.C. 582 (1959).

28. Prop. Reg. § 301.7701-1(a)(5)(iii).

29. Treas. Reg. §§ 301.7701-3(b)(1)(i), (ii), 301.7701-3(a), (c).

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[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 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.

4. Single Entity/Multiple Entities

The following is substituted for the second paragraph:

Where the answer is less certain is when the documentation treats groups of members as being associated with particular series, but there is a substantial overlap of the membership interest in the various series. Should the series LLC be seen as multiple entities or a single entity? This same issue exists under current law with entities other than series. The mere presence of common ownership does not generally cause multiple entities to be collapsed into a single entity for federal income tax purposes.[30] However, common ownership may increase the likelihood that taxpayers would forget to respect the structure that they have put in place – in which case, one or more of the entities may be ignored.[31]

For some purposes, tax authorities allow multiple entities to be combined as a single entity on an elective basis. For example, under the passive activity loss rules, multiple entities may be grouped as a single activity if they have sufficient common ownership.[32] Similarly, the Code allows corporations with sufficient common ownership to elect to file a consolidated return, which treats the included corporations as a single entity in some respects.[33] The Preamble to the check-the-box Regulations states that the issue of whether common ownership creates a single entity for federal income tax purposes was an issue when those Regulations were finalized.[34] It also provides that although the determination of whether an organization has more than one owner is based on all the facts and circumstances, the fact that some or all of the owners of an organization are under common control does not require the common parent to be treated as the sole owner.[35] Thus, the Proposed Regulations

[30]. *See* Southern Pacific Transportation Company v. Commissioner, 75 T.C. 497 (1980) (the mere fact of common ownership and operations would not justify disregarding distinct corporate entities).

[31]. *See, e.g.,* DJB Holding Corp. v. Commissioner, 803 F.3d 1014 (9th Cir. 2015).

[32]. Treas. Reg. § 1.469-4(c).

[33]. *See* Treas. Reg. § 1.1502-13(a)(2).

[34]. The Preamble indicates that some commentators, relying on Rev. Rul. 93-4, 1993-1 C.B. 225 (declared obsolete by Rev. Rul. 98-37, 1998-2 C.B. 133), suggested that if two wholly owned subsidiaries of a common parent were the owners of an organization, those owners would not be respected as bona fide owners and the organization would be treated as having only one owner (the common parent).

[35]. State law also may provide circumstances under which multiple entities may be disregarded or treated as a single entity with a common parent. One of the most common approaches to this issue under state law is "veil piercing." Delaware law provides requirements for veil piercing, and the case law reveals that to pierce the corporate veil based on an alter ego theory, a plaintiff must demonstrate a misuse of the corporate form along with an overall element of injustice or unfairness. NetJets Aviation, Inc. v. LHC Communications, LLC, 537 F.3d 168 (2d Cir. 2008) (citing Harco Nat'l Ins. Co. v. Green Farms, Inc., 1989 Del. Ch. LEXIS 114 (Sept. 19, 1989)). In short, the test applied under Delaware law is two pronged: (1) Whether the entities in question operated as a single economic entity, and (2) Whether there was an overall element of injustice or unfairness. *See id.*; Medi-Tec of Egypt Corp. v. Bausch & Lomb Surgical, 2004 Del. Ch. LEXIS 21 (Mar. 4, 2004) (citing *Mobil Oil Corp. v. Linear Films, Inc.*, 718 F. Supp. 260 (D. Del. 1989)); *cf.* Alberto v. Diversified Group, Inc., 55 F.3d 201 (5th Cir. 1995). This two-pronged test was recently described by the Second Circuit as follows: "Stated generally, the inquiry initially focuses on whether those in control of a corporation did not treat the corporation as a distinct entity; and, if they did not, the court then seeks to evaluate the specific facts with a standard of fraud or misuse or some other general term of reproach in mind, such as whether the corporation was used to engage in conduct that was inequitable, or prohibited, or an unfair trade practice, or illegal." *NetJets Aviation, Inc., supra* (internal citations and quotations omitted) (citing and quoting *Mobil Oil Corp. v. Linear Films, Inc., supra*; David v. Mast, 1999 Del. Ch. LEXIS 34 (Mar. 2, 1999); Martin v. D. B. Martin Co., 88 A 612 (Del. Ch. 1913)). Thus, both for state law and current federal tax purposes, commonality of

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do not provide a definitive answer, with each case being decided on its own facts and circumstances.

5. Who Are the Owners?

The second, third and fourth paragraphs are deleted.

§ 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.[36]

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.[37] 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.[38] However, the final regulations declined to clarify the circumstances under which multiple partnerships would be treated as a single partnership.[39]

The final paragraph is restated as follows:

So, on the one hand, the treatment of side pockets does not recognize the existence of a separate entity for tax purposes where segregated assets are not put into a separate state-law entity.[40] This creates tension with the fact the series LLCs are usually not separate legal entities. On the other hand, alternative investment vehicles are treated as separate entities if they are recognized as separate entities for state law purposes. This, again, puts the emphasis on the recognition of the state law series LLC rather than the economic units created by the series under the series LLC.

ownership does not generally cause multiple entities to be treated as a single entity.

[36]. GCM 36866 (Sept. 29 1976).

[37]. Prop. Reg. § 301.6241-6(b)(8)(iii).

[38]. REG-136118-15, 82 Fed. Reg. 27,334, 27,337 (June 14, 2017).

[39]. TD 9829, 83 Fed. Reg. 24,26 (Jan. 2, 2018).

[40]. In PLR 201248019 (Nov. 30, 2012), the IRS ruled that it was the partnership that was able to make a qualified electing fund election in respect of an asset held in a side pocket. It was not clear from the ruling whether the potential separate entity status of a side pocket was considered.

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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).[41]

Subsection 4 is restated as follows:

4. Assignment of Income

One of the bedrock principles of federal income tax law is that income must be taxed to the earner of the income and that an assignment of the right to the income will not transfer the incidence of taxation, the "assignment of income doctrine."42 Thus, there is a question as to whether the assignment of income doctrine would cause a taxpayer to be taxable if the taxpayer assigned to a partnership in exchange for a partnership interest accounts receivable of the taxpayer for services rendered or from the sale of property. In fact, however, accounts receivable have been recognized as property for I.R.C. § 721(a) purposes.[43] As to accrual basis accounts receivables, that only makes sense – the income should have already been recognized when the right to the income became fixed and determinable. As to cash basis accounts receivable, the issue may be triggered, but note that I.R.C. § 704(c)(1) mostly moots the assignment of income question. Under I.R.C. § 704(c)(1), when accounts receivable are collected or sold, income from contributed accounts receivable are typically allocated to the contributing partner.[44] We discuss I.R.C. § 704(c)(1) in detail in Chapter 5.

The first paragraph of Subsection 8 is restated as follows:

8. Recapitalizations

Often partnerships have different classes of interest. In a limited partnership, there are always at least two classes, the general partner and the limited partners. In many more complex partnership arrangements, there are often a variety of classes, each of which has different rights and preferences. If a partner changes the class of interest they own (*e.g.*, the general partner becomes a limited partner, or a Class A Member of an LLC becomes a Class C Member), or if the partnership recapitalizes and issues different classes of interest to its existing partners in exchange for the classes they previously held, if the interest received differs materially in kind or extent from the interest relinquished,[45] an issue arises as to whether these transactions are taxable transactions in which the transferring partner recognizes gain or loss. These transactions might be treated as exchanges under I.R.C. § 1001, which could result in gain and possibly loss being recognized if no statutory provision exempts gain and loss recognition.

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41. *See, e.g.,* PLR 8117210 (Jan. 30, 1981).

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

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

44. *See* discussion at § 5.05.

45. Treas. Reg. § 1.1001-1(a).

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Add after 8. Recapitalizations:

9. Cryptocurrencies and Other Digital Assets

The IRS concluded in Notice 2014-21 that cryptocurrency is "property."[46] 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.[47] It is questionable whether this definition is broad enough to include all types of digital assets (*e.g.*, non-fungible tokens),[48] but it is likely that both digital assets as defined in I.R.C. § 6045(g) and other digital assets will be treated as property for the purposes of I.R.C. § 721.

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

[47] I.R.C. § 6045(g)(3)(D).

[48]. *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

§ 3.02 RELEVANCE OF OUTSIDE BASIS

C. Effect of Distributions

2. Property Distributions

Add the following footnote to the last paragraph:

Fn#. See discussion of the application of I.R.C. 732(b) in the context of a partnership with related partner in Section 6.07. F.

§ 3.03 GENERAL RULES FOR COMPUTING BASIS

A. Starting Point

2. Purchase of a Partnership Interest

The paragraph is restated as follows:

If a person purchases a partnership interest from a third party who is already a member of the partnership, then the normal rule of I.R.C. § 1012 applies, namely that the purchasing partner's basis for his partnership interest is the cost of the partnership interest purchased.[49] As discussed below, the cost will include the purchasing partner's share of partnership liabilities.[50]

§ 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,[51] or (iii) gives rise to an expense that is not deductible and not properly chargeable to capital.[52] However, some obligations are not "liabilities" for the purposes of I.R.C. § 752. In Rev. Rul. 88-77,[53] 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

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[49]. I.R.C. § 742.

[50]. I.R.C. § 752(d); Crane v. Commissioner, 331 U.S. 1 (1947). The mere fact that the liability is secured only by the asset transferred, and that the purchaser otherwise has no personal liability will not alone prevent such liability from being included in the basis of property. Mayerson v. Commissioner, 47 T.C. 340 (1966).

[51]. 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.

[52]. Treas. Reg. § 1.752-1(a)(4)(i).

[53]. 1988-2 C.B. 128.

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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]…."[54] 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,[55] to avoid recognizing gain,[56] 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, 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.[57] They are decreased by money distributed, the (net) fair market value of property distributed, and allocated losses.[58] 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.[59] A partner may

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[54]. *Id.*
[55]. Under I.R.C. § 704(d), a partner cannot deduct losses in excess of his basis in his partnership interest.
[56]. *See* I.R.C. § 752(b), (d).
[57]. Treas. Reg. § 1.704-1(b)(2)(iv)(b).
[58]. *Id.*
[59]. *See* § 5.03.B. Negative capital accounts may occur in other circumstances as well.

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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.[60]

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[61] loan to the partnership and the economic risk of loss with respect to that loan is not borne by another partner.[62] 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.[63] Generally, qualified nonrecourse financing means financing by a person regularly engaged in the business of lending who is not a related person, or from a government or guaranteed by a governmental agency, which is secured by real property, with respect to which no person is personally liable for repayment and which is not convertible debt.[64]

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."[65] 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.[66] 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.

4. Assumption of Liability

As indicated above, a partner's assumption of a partnership liability is treated as a contribution of money by that partner to the partnership and the assumption by a partnership of an individual partner's liability is treated as a distribution of money to that partner. In general, a person is treated as assuming a liability to the extent that: (i) the assuming person is personally obligated to pay the liability and (ii) the creditor knows

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60. *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.

61. "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.

62. 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).

63. Treas. Reg. § 1.752-2(d)(1).

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

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

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

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of the assumption and can directly enforce the partner's (or related persons) obligation and no other partner or related person to another partner would bear the economic risk of loss for the liability immediately after the assumption.[67] This comes close to saying that the parties have to have a novation of the loan to have a recognized assumption. But there is a large exception to the general rule. In the case of property contributed by a partner to a partnership, or distributed by a partnership to a partner, which is subject to a liability, the transferee is treated as having assumed the liability, even if none of the regular assumption rules are met. This is only true to the extent the liability does not exceed the fair market value of the property at the time of the contribution or distribution.[68]

D. Allocation of Nonrecourse Liabilities

THIS SUBSECTION IS RESTATED AS FOLLOWS:

1. The Three-Tiered System

Much of what follows will be easier to understand once you have mastered the contents of Chapter 5. But to tide you over until then: Nonrecourse liabilities are allocated based upon a three-tier formula set forth in Treas. Reg. § 1.752-3(a). This is sometimes called a "stacking rule." Nonrecourse liabilities are allocated in the following order of priority:

Tier 1: First, there is allocated to the partners their respective shares of partnership "minimum gain." Minimum gain is determined in accordance with the rules of Treas. Reg. § 1.704-2(d)(1) and a partner's share of minimum gain is determined in accordance with Treas. Reg. § 1.704-2(g)(1). Generally, minimum gain is the amount by which a nonrecourse debt secured by a property exceeds the "book value" of property.[69] Book value, initially, is the fair market value of property at the time it is acquired by the partnership. Like tax basis, it can be increased for additional investments in the property and decreased, by, for example, depreciation deductions. Assume a partnership buys a property for $1,000, paying $200 and financing the balance with an $800 nonrecourse loan that secures the property. Initially there is no minimum gain, as the book value of $1,000 exceeds the nonrecourse debt of $800. Assume depreciation deductions reduce the book value to $700 and that the nonrecourse debt remains unchanged, only interest having been paid on the debt. Now there is $100 of minimum gain. We go over the rules for allocating minimum gain to the partners in Chapter 5.

Tier 2: Second, the nonrecourse liability is allocated to the partners to the extent of their shares of the taxable gain that would be allocated them under I.R.C. § 704(c) (or in the same manner as I.R.C. § 704(c) in the case of revalued partnership property) if the partnership disposed of the property that is subject to the nonrecourse liability in satisfaction of that liability and for no other consideration. If multiple properties are subject to a single nonrecourse liability, the partnership may allocate the liability among the multiple properties under any reasonable method.[70]

What does that mean in English? Well, to fully understand it, you will need to read Chapter 5. To get you by for now, we offer the following example:

Assume partner A contributes property to a partnership with a fair market value of $1,000, a tax basis of $100, and the property is subject to a nonrecourse debt of $400. There is no minimum gain here, as minimum

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[67]. Treas. Reg. § 1.752-1(d).

[68]. Treas. Reg. § 1.752-1(e).

[69]. Some theoretical issues arise if a debt meets the I.R.C. § 752 definition of a nonrecourse debt but is not secured by any property. See discussion of exculpatory liabilities, below.

[70]. The method is not reasonable, however, if the amount allocated, when added to other liabilities burdening a property, is in excess of the fair market value of the property. Treas. Reg. § 1.752-3(b)(1).

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gain only exists to the extent that the nonrecourse debt exceeds book value. Here book value is $1,000. Under the second tier of the allocations, however, $300 of the nonrecourse debt is allocated to partner A (i.e., the amount by which the nonrecourse debt exceeds tax basis, $400 − $100 = $300).

Tier 3: Third, there is allocated to the partners their share of the balance of the nonrecourse liabilities (referred to as "*excess nonrecourse liabilities*") in accordance with the partners' shares of partnership profits.

The partners' interest in profits is determined by taking into account all of the facts and circumstances relating to the partners' interests in the partnership. The Regulations allow the partnership agreement to specify the partners' interest in partnership profits for purpose of allocating excess nonrecourse liabilities so long as the interests are reasonably consistent with allocations that have substantial economic effect of some other significant item of partnership income or gain ("*significant item method*").[71]

The Regulations also permit excess nonrecourse liabilities to be allocated among the partners in accordance with the manner in which it is expected that nonrecourse deductions will be allocated (the "*alternative method*"). Finally, the Regulations permit excess nonrecourse liabilities to first be allocated to a partner to the extent of the built-in gain that is allocable to the partner under I.R.C. § 704(c)(2), or property for which reverse section 704(c) allocations are applicable, to the extent that gain exceeds the gain allocated to them in the second tier ("*the built-in gain method*"). If the partnership uses the built-in gain method but is not able to allocate all of the excess nonrecourse liabilities using that method, the balance of the excess nonrecourse liabilities must be allocated using one of the other methods.[72]

The following example illustrates the allocation of nonrecourse liabilities:

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. Note that basis and book value will be the same in this example.

During the first eight years, the basis of the property would be equal to or greater than the amount of the nonrecourse liability. This being the case, there is no minimum gain. Based upon the provisions of the Operating Agreement, the Tier 3/excess nonrecourse liabilities would be shared 40% by A and 60% by B.

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

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

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71. Treas. Reg. § 1.752-3(a)(3).

72. *Id.* The significant item method, alternative method, and built-in gain method do not apply for purposes of Treas. Reg. § 1.707-5(a)(2) involving disguised sales. *Id. See* § 8.06.

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2. Nonrecourse Debt Secured by Multiple Properties

Note that the calculation of partnership minimum gain for Tier 1 and the I.R.C. § 704(c) gain for Tier 2 require debt to be allocated to particular partnership properties.

If one nonrecourse liability is secured by multiple properties, for purposes of Tier 2 (the I.R.C. 704(c) gain) the partnership may allocate the liability among the multiple properties using "any reasonable method."[73] A method is not reasonable if it allocates to any item of property an amount of the liability that, when combined with any other liabilities allocated to the property, is in excess of the fair market value of the property at the time the liability is incurred.[74] The portion of the nonrecourse liability allocated to each item of partnership property is then treated as a separate loan. In general, a partnership may not change the method of allocating a single nonrecourse liability while any portion of the liability is outstanding. However, if one or more of the multiple properties subject to the liability is no longer subject to the liability, the portion of the liability allocated to that property must be reallocated among the properties still subject to the liability so that the amount of the liability allocated to any property does not exceed the fair market value of such property at the time of reallocation. [75]

3. Property Secured by Multiple Liabilities

Also, in our examples, there is one property subject to one secured liability. In real life, it is often not that simple. One property may secure multiple liabilities, perhaps even some recourse and some nonrecourse. As we have seen, it is vital to know how much tax basis and/or book value can be associated with a given nonrecourse liability. The Regulations provide rules for prioritizing adjusted tax basis allocations. While the Regulations speak in terms of adjusted tax basis, for now you can assume that adjusted tax basis and book value are equal, which they will be if the property is purchased by the partnership (and thus not contributed to the partnership by a partner). Indeed, the Regulations generally make this assumption, albeit with exceptions.[76] First, if a property is subject to two or more liabilities of equal priority, the property's adjusted tax basis is allocated among the liabilities in proportion to their outstanding balances. If property is subject to two or more liabilities of unequal priority, the adjusted tax basis is allocated first to the liability of the highest priority to the extent of its outstanding balance and then to each liability in descending order of priority to the extent of its outstanding balance, until fully allocated.[77] Note that these rules apply to recourse and nonrecourse liabilities. Thus, if a recourse liability has the highest priority, adjusted tax basis is allocated to it first, up to the amount of the liability. Only tax basis allocated to nonrecourse debt can be used to calculate minimum gain.[78] What if one of the liabilities is an exculpatory liability? We are aware of no authority, but we assume that for purposes of adjusted tax basis allocation, secured liabilities have priority over (unsecured) exculpatory liabilities.

4. Exculpatory Liabilities

As discussed above, a liability can be nominally recourse to an LLC or an LLP but be treated as a nonrecourse liability for I.R.C. § 752 purposes, because none of the (tax) partners have personal liability on the debt. These types of liabilities are sometimes called "exculpatory liabilities."[79] Unlike traditional

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[73]. Treas. Reg. § 1.752-3(b)(1).
[74]. *Id.*
[75]. *Id.*
[76]. *See* Treas. Reg. § 1.704-2(d)(3).
[77]. Treas. Reg. § 1.704-2(d)(2)(ii).
[78]. Treas. Reg. § 1.704-2(d)(2)(i).
[79]. *See* Karen C. Burke, *Exculpatory Liabilities and Partnership Nonrecourse Allocations*, 57 Tax Law. 33 (2003); Terrence Floyd Cuff, *Indebtedness of a Disregarded Entity*, 81 Taxes 303 (2003). "Exculpatory Liabilities" are used here to mean general unsecured obligations of the partnership (and for which no partner has personal liability). In an LLC, all of the general unsecured obligations of

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nonrecourse liabilities, they may not formally be secured by any particular partnership asset. Notwithstanding the fact that, with the advent of LLCs, exculpatory liabilities often play an important role, there is almost no authority on how to allocate them to partnership assets.[80] The Regulation discussed above for allocating a nonrecourse liability secured by multiple properties among the properties might provide an appropriate method for exculpatory liabilities, though the Regulation does not discuss exculpatory liabilities, as such. Allocating exculpatory liabilities to assets is vital, because in order for all portions of the I.R.C. § 752 Regulations' stacking rule to function, all nonrecourse debt, including exculpatory liabilities, have to be associated with partnership assets.

Fully explicating the complexities involved with exculpatory liabilities is beyond the scope of this text, but they are many. The following is just one example: An exculpatory debt is a nonrecourse debt for I.R.C. § 752 purposes, but in the view of many commentators a recourse debt for I.R.C. § 1001 purposes.[81] The I.R.C. § 1001 Regulations do not provide a comprehensive definition of recourse and nonrecourse liabilities, but if all of the assets of a debtor are available to pay a debt, which is typically the case for exculpatory liabilities of LLCs and LLPs, there is a good argument that for I.R.C. § 1001 purposes the liabilities should be treated as recourse (assuming the LLC or LLP is not a disregarded entity). If a given debt is recourse to a corporation, why should it not be recourse to an LLC or an LLP? The possible tax consequences of this distinction are important. For example, if a creditor forecloses on a property secured by a traditional nonrecourse liability, the amount realized includes the full amount of the liability, regardless of the fair market value of the property.[82] In traditional real estate ventures (a common scenario where nonrecourse debt would be used), any gain or loss typically is capital or I.R.C. § 1231 gain or loss. But if a creditor forecloses property to pay for an I.R.C. § 1001 recourse debt, the amount realized cannot exceed the fair market value of the property.[83] Any debt that is discharged that is in excess of the fair market value of the property is cancellation of indebtedness income (i.e., ordinary income). Thus, foreclosure of exculpatory liabilities of an LLC or an LLP has the potential to generate ordinary income, whereas the foreclosure of traditional nonrecourse liabilities typically does not.[84]

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the LLC would be exculpatory liabilities, unless a partner provided a guaranty. In a general partnership or a traditional limited partnership, a general unsecured obligation would be recourse to the general partners, so the liability would be a recourse obligation unless the lender released the general partners. Many state-law recourse obligations are secured by all of a debtor's property, in which case (if no partner has personal liability) the rules for liabilities secured by multiple properties would apply.

[80]. 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.

[81]. *See* Karen C. Burke, *Exculpatory Liabilities and Partnership Nonrecourse Allocations*, 57 Tax Law. 33 (2003); Terence Floyd Cuff, *Indebtedness of a Disregarded Entity*, 81 Taxes 303 (2003).

[82]. I.R.C. § 7701(g); Treas. Reg. § 1.1001-2(a).

[83]. Treas. Reg. § 1.1001-2(a); Aizawa v. Commissioner, 29 F.3d 630 (9th Cir. 1004).

[84]. Traditional nonrecourse debt is typically secured by real estate. If it is secured by personal property, a foreclosure could generate ordinary recapture income under I.R.C. § 1245. Cancellation of indebtedness income can be preferable if the taxpayer is bankrupt or to the extent insolvent, as I.R.C.§ 108(a)(1) then excludes it from income. I.R.C. § 108(d)(6), however, applies that rule in the case of (presumably all tax) partnerships at the partner level. *See* § 4.06.E.

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E. Contributions and Distributions of Encumbered Property

REPLACE THE LAST THREE PARAGRAPHS WITH THE FOLLOWING:

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,[85] 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.[86] 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,[87] 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

[85]. 1995-1 C.B. 132.

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

[87]. 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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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 50% to each partner. Section 704(c) allocations, however, do not have substantial economic effect under the I.R.C. § 704(b) Regulations.[88] Accordingly, under this alternative, I.R.C. § 704(c) allocations could not 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.[89]

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.[90] 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.[91]

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,

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88. *See* Treas. Reg. § 1.704-1(b)(2)(iv)(d).

89. *See* McKee, Nelson & Whitmire, Federal Taxation of Partnerships and Partners at § 8.03[4].

90. 65 FR 64888 (Oct. 31, 2000), 2000-2 C.B. 470, 2000-46 I.R.B. 470 (TD 8906). *See also* Treas. Reg. § 1.752-3(a)(3).

91. 65 FR at 64889.

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liabilities are treated in the same fashion as in the case of an exchange not involving a partnership interest. Outside of the partnership context, if a taxpayer sells property and the purchaser assumes a liability of the seller, or takes the property subject to a liability, the amount of the liability is part of the amount realized for purposes of computing gain or loss from the sale. Although a transfer of a partnership interest may not directly result in the selling partner's liabilities being formally assumed, and the partnership interest itself may not be subject to liabilities, nevertheless the liabilities of the partnership must be taken into account. This is the purpose of I.R.C. § 752(d). Assume a 25% partner of a partnership has a basis for her partnership interest of $20,000 and her basis includes her 25% share of the $100,000 liabilities of the partnership (i.e., $25,000). Assume she sells her partnership interest for cash of $15,000. If the gain or loss recognized by the partner is simply the difference between her basis for her partnership interest and the amount of cash received, she would have a loss on the transaction (i.e., $20,000 − $15,000). The amount realized in this situation, however, includes her $25,000 former share of the partnership's liabilities for which she no longer has a share. Thus, the amount realized is $40,000 ($15,000 + $25,000) and a gain in the amount of $20,000 ($40,000 – $20,000) is recognized.[92]

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 that might not otherwise be included as a partnership liability under Treas. Reg. § 1.752-1. Treas. Reg. § 1.752-7 is designed to prevent the acceleration or duplication of loss through the assumption of certain types of obligations.[93] 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.[94]

1. Assumption by Partnership

a. Transfer of Partnership Interest

The subparagraph is labeled as:

2. Transfer of Partnership Interest

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

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

If the § 1.752-7 liability partner were to transfer her partnership interest prior to the satisfaction of the § 1.752-7 liability, the rule of Treas. Reg. § 1.752-7(c) would not prevent the § 1.752-7 liability partner from having an excessive basis. To eliminate this problem, Treas. Reg. § 1.752-7(e)(1) provides that if a § 1.752-7 liability partner disposes of her partnership interest, the basis of the § 1.752-7 liability partner's partnership interest is reduced immediately prior to the disposition. The amount of the reduction is referred to as the § 1.752-7 liability reduction. The § 1.752-7 liability reduction is equal to the lesser of (i) the excess of the § 1.752-7 liability partner's basis in the partnership interest over the adjusted value of that interest, or (ii) the remaining built-in loss associated with the § 1.752-7 liability.[95] 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.[96]

b. Assumption of § 1.752-7 Liability

The subsection is relabeled as:

3. Assumption of § 1.752-7 Liability

The first two sentences of the last paragraph are 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.[97]

§ 3.05 TAX BASIS CAPITAL

THE SECTION IS RESTATED AS FOLLOWS:

A. Background

As we discussed briefly in § 3.04.B.2, and we will discuss in more detail in Chapter 5, capital accounts play an important role in determining the validity of allocations of income and deduction.

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

Starting in 2018, the IRS required the capital accounts to be recalculated as "tax basis capital accounts" rather than the capital accounts under I.R.C. § 704(b). In 2020, the IRS issued Notice 2020-43.[98] This Notice is, in part, in the form of a proposal that asks for comments and was issued in response to the difficulties many commentators said they would have in computing tax basis capital. The Notice then proposes two alternative methods that a partnership would be required to use to comply with the tax basis

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95. Treas. Reg. § 1.752-7(b)(7)(i).
96. Treas. Reg. § 1.752-7(b)(2).
97. Treas. Reg. § 1.752-7(d)(2)(A).
98. 2020-27 I.R.B. 1 (6/29/2020).

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capital reporting requirement: A partnership may report, for each partner, either (i) the partner's basis in its partnership interest, reduced by the partner's allocable share of partnership liabilities, as determined under I.R.C. § 752 ("modified outside basis method") or (ii) the partner's share of "previously taxed capital," as calculated under a modified version of Treas. Reg. § 1.743-1(d) ("modified previously taxed capital method"). We discuss previously taxed capital in Chapter 6. The latter calculation typically requires the partnership to determine the fair market value of its assets. The IRS acknowledges that some partnerships will not readily be able to determine fair market values, and allows partnerships to use other values for its assets, as long as done consistently, such as GAAP, I.R.C. § 704(b), or another basis set forth in the partnership agreement for purposes of determining what each partner would receive if the partnership were to liquidate. The Notice states that the IRS anticipates that the two proposed methods outlined will be the only methods that meet the tax capital reporting requirement for partnership taxable years ending on or after December 31, 2020.

Although the Notice seems to suggest that further guidance would be forthcoming, none has been issued to date. The current instructions to Schedule K-1 state that the partnership must report the partner's beginning capital account and ending capital account for the year using the tax-basis method, including the amount of capital the partner contributed to the partnership during the year, the partner's share of the partnership's current year net income or loss as computed for tax purposes, any withdrawals and distributions made to the partner by the partnership, and any other increases or decreases to partner's capital account determined in a manner generally consistent with figuring the partner's adjusted tax basis in its partnership interest (without regard to partnership liabilities), taking into account the rules and principles of I.R.C. §§ 705, 722, 733, and 742.

§ 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).

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CHAPTER 4: CALCULATION OF PARTNERSHP TAXABLE INCOME

§ 4.02 PASS-THROUGH NATURE OF PARTNERSHIP

FOOTNOTE 3 IS RESTATED AS FOLLOWS:

See Rev. Rul. 69-184, 1969-1 C.B. 256; *see also* Treas. Reg. § 301.7701-2(c)(2)(iv); IRS Gen. Couns. Mem. 34001 (Dec. 23, 1969); IRS Gen. Couns. Mem. 34173 (July 25, 1969); Riether v. United States, 919 F. Supp. 2d 1140 (NM 2012). This rule does not apply for some employee benefit purposes. *See* I.R.C. § I.R.C. § 401(c)(1)(A); I.R.C. § 129(e)(3); Amstrong v. Phinney, 394 F.2d 661 (5th Cir. 1968).

THE LAST TWO PARAGRAPHS ARE RESTATED AS FOLLOWS:

That said, the treatment of a secretary who has a 0.00001% profits interest in an LLC as a partner for income tax purposes strains credulity, although that is the logical outcome of the IRS' position in this area. To address this issue, some practitioners will create a separate entity (often also taxable as a partnership) to hold the profits interests for all of the individual employees (This also make good business sense, because it means that employees do not have a direct ownership interest in their employers, which is helpful if a dispute ever arises between the employer and the employee.). By using tiers, a tax practitioner may be able to achieve a result that could not be obtained directly. To date, however, there is no official sanction for this approach.[99]

Employers withhold federal payroll and other taxes from employees and are required to pay them to the federal government. If a business is in financial distress, it may be tempting to use this source of funds to keep the business afloat. It is unwise to do so, however. Penalties can apply, and if the taxes are ultimately unpaid, any person responsible for paying the taxes to the federal government becomes personally liable for the obligation.[100] Further, in a general partnership, the partners can be jointly and severally liable for this obligation as well, including those partners not charged with the responsibility for paying the withheld taxes to the federal government.

§ 4.03 COMPUTING INCOME, GAIN, LOSS, DEDUCTIONS AND CREDITS OF 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.[101] In computing partnership taxable income under I.R.C. § 703, all taxable items (separately stated or not) are netted.

[99]. In a related issue, the Tax Court in Renkemeyer, et alia, v Commissioner, 136 TC 137 (2011), held that the distributive share of partnership income were appropriately allocable to the partners that earned the income rather than to an S corporation owned by an employee stock ownership plan. The three partners that earned the income were members of the employee stock ownership plan.

[100]. I.R.C. § 6672.

[101]. I.R.C. § 702(a)(8).

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§ 4.06 CHARACTERIZATION

C. HOBBY LOSS RULES

FOOTNOTE 81 IS RESTATED AS FOLLOWS:

[81]. Podell v. Commissioner, 55 T.C. 429 (1970); Grove v. Commissioner, 54 T.C. 799 (1970); Barham v. United States, 301 F. Supp. 43 (M.D. Ga. 1969), *aff'd per curiam*, 429 F.2d 40 (5th Cir. 1970). However, if the partners do not have a profit motive the partnership may be disregarded as a sham. BCP Trading & Investments, LLC v. Commissioner, TC Memo 2017-151 aff'd 991 F.3d 1253 (D.C. Cir. 2021).

§ 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
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?

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CHAPTER 5: ALLOCATION OF PARTNERSHIP INCOME AND LOSSES

§ 5.01 INTRODUCTION

THE FOLLOWING IS SUBSTITUTED FOR THE SECOND PARAGRAPH:

Recall that in Subchapter K, the word "distributive" has nothing to do with distributions and is generally synonymous with "allocable." I.R.C. § 704(b) provides that a partner's "distributive share of income, gain, loss, and deduction, or credit . . . shall be determined in accordance with the partner's interest in the partnership . . . if" the partnership agreement does not provide for how a distributive share will be allocated *or* if the allocations do not have substantial economic effect. Thus, if an allocation *does* have substantial economic effect, it need not be in accordance with a partner's interest in the partnership. As we will learn, a partner's interest in the partnership is determined under a facts and circumstances test. The Regulations provide detailed and specific rules as to when allocations have substantial economic effect. These substantial economic effect rules provide a structure that is intended to be a safe harbor. If the partnership agreement complies with the rules, the partnership knows the transaction will be safe. Many practitioners will endeavor to comply with them if possible. It used to be that practitioners viewed compliance with the substantial economic effect rules as being virtually mandatory, but in recent years practitioners have been increasingly drafting agreements to come under the partners' "interest in the partnership" facts and circumstances test or the deemed partners' interest in the partnership rules for certain partnerships that liquidate in accordance with capital accounts. Indeed, in large, complex deals, the latter approach is likely the norm. However, only those with a firm grasp of the safe harbor should consider planning outside the safe harbor.

ADD THE FOLLOWING AS THE LAST PARAGRAPH OF § 5.01:

The overall goal (outside the partners' interests in the partnership approach) 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.[102] 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.[103] The current Regulations are heavily reliant on capital accounts for testing allocations, so we will start there.[104]

§ 5.02 CAPITAL ACCOUNTS

THE FOLLOWING IS SUBSTITUTED FOR THE FIRST PARAGRAPH

For an allocation to have substantial economic effect under the safe harbor, the capital accounts must be maintained in accordance with the rules in the Regulations.[105] As the name of the substantial economic effect test suggests, an allocation will meet the test if it has a genuine after-tax, economic effect on the partner to whom the allocation is made. The rules for maintaining the capital accounts help to fulfill this task. The capital accounts will also determine the partners' "interests in the partnership" if the partnership liquidates in accordance with capital accounts.[106] As the concern here is with the economic rather than tax impacts, the

[102]. *Goldfine v. Commissioner*, 80 T.C. 843 (1983).
[103]. Treas. Reg. § 1.704-1(b)(2)(ii)(a).
[104]. *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).
[105]. Treas. Reg. § 1.704-1(b)(2)(iv)(a).
[106]. Treas. Reg. § 1.704-1(b)(3)(iii).

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rules for keeping these "I.R.C. § 704(b)" capital accounts are quite different from the rules for computing tax basis. The rules for keeping I.R.C. § 704(b) capital accounts are also different than the rules for keeping tax basis capital accounts discussed in § 3.05. Do not conflate the two, though their calculation is in some ways similar. I.R.C. § 704(b) capital accounts focus on the fair market value of property, whereas tax basis capital accounts focus on the tax bases of property. But in neither case are liabilities part of the capital account. For the remainder of this chapter, the term capital account means an I.R.C. § 704(b) capital account.

§ 5.03 Substantial Economic Effect Rules

B. Economic Effect Rules

1. "Regular" Rules

Footnote 17 is restated as follows:

[17]. This requirement may exist for a general partnership under state law, depending upon how the negative capital account was created. For limited liability entities such as LLCs, the obligation to re-contribute a negative capital account would need to be contractually created. Contractually creating unlimited liability may be good tax planning in some circumstances, but it may not be consistent with business objectives.

2. Alternative Economic Effect Rules

The following is substituted for the second and third paragraphs at the top of page 167:

A partnership agreement contains a "qualified income offset" "if, and only if, it provides that a partner who unexpectedly receives an adjustment, allocation, or distribution described in (4), (5), or (6) above, will be allocated items of income and gain (consisting of a pro rata portion of each item of partnership income, including gross income, and gain for such year) in an amount and manner sufficient to eliminate such deficit balance as quickly as possible." Note that it is not an inevitability that a qualified income offset provision will be triggered. The partnership must have income and gain in that tax year that it can use for this purpose. If it does not, a partner is permitted to have a negative capital account without an immediate consequence and without affecting the validity of the allocations. Of course, most partnerships will have income and gain they can use currently, and it would be a rare partnership that never had available income or gain.

Returning to the example discussed above in the "Regular Rules," assuming there are no "reasonably expected" future events, if A has no deficit restoration obligation but the partnership agreement includes a qualified income offset provision, the allocations to her will still be effective as long as they do not cause her to have a negative capital account.

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).

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4. Tax Credits

THE LANGUAGE IN THE TEXT IS RESTATED AS FOLLOWS:

Partners' capital accounts are not generally adjusted for tax credits. If this is true, 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 same proportion as such partners' respective distributive shares of such loss or deduction (and adjustments).[107] 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.

Example:

Development Corp., a real estate developer, is a partner in a low-income housing partnership. The other partner is an investment partnership. Profits and losses are split 50/50, with the depreciation and low income housing credit specially allocated 99% to the investment partnership and 1% to Development Corp. The debt is recourse debt from an unrelated lender and both partners are general partners. Assume that the partnership's allocation of depreciation, 99% to the investment partnership, has substantial economic effect under Treas Reg. § 1.704-1.

Since a partnership expenditure that gives rise to the tax credit (the building's qualified basis) also gives rise to a valid allocation of partnership deduction (deprecation) which reduces the capital accounts, the allocation of tax credit 99% to the investment partnership partner will be respected.

Unlike the low-income housing tax credit, the rehabilitation tax credit does have an impact on the partners' capital accounts. The partnership must reduce the depreciable basis of the building by the amount of the rehabilitation tax credit.[108] Similarly, a partner must reduce his capital account by his ratable share of the rehabilitation tax credit.[109]

The rule for allocating the rehabilitation tax credit is found in Treas. Reg. § 1.46-3(f)(2). The general rule is that each partner's share of the rehabilitation costs is based on the general profit ratio of the partnership. This ratio should reflect the partners' real economic sharing arrangement.

The exception to the general rule is that a special allocation is possible if:

- All related items of income, gain, loss, and deduction with respect to the property are specially allocated in the same manner and

- Such allocation is either made in accordance with the partner's interest in the partnership or has substantial economic effect.

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[107]. Treas. Reg. § 1.704-1(b)(4)(ii).
[108]. I.R.C. § 50(c)(1).
[109]. MSSP Training Guide Chapter 21.

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Example 3 in Treas. Reg. § 1.46-3(f)(3) discusses a partnership engaged in the business of renting equipment whose costs qualified for the investment tax credit. Under the partnership agreement, the income, gain or loss on disposition, depreciation and other deductions attributable to the equipment are specially allocated 70% to one partner and 30% to the other partner. The conclusion is that if this allocation is made in accordance with the partners' interests in the partnership or has substantial economic effect, the cost of the equipment (and therefore the tax credit) will be taken into account 70% by one partner and 30% by the other partner.

Certain energy credits and clean electricity investments credits also affect the basis of the relevant property and would be eligible for the allocation rules just described.[110]

§ 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.[111]

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.[112]

F. Avoiding Negative Capital Accounts as PIP

Add to the end of the section:

A 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.[113]

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[110]. *See* I.R.C. § 50(c)(3). I.R.C. § 50(c)(1) indicates that any credit determined under Supart E of Part IV of Subchapter A of Chapter 1 of Subtitle A of the Code requires an adjustment to basis.

[111]. 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).

[112]. 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.

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

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L. Common Allocation Structures

2. Percentage Interests

b. Discussion

THE LAST PARAGRAPH IS RESTATED AS:

One shortcoming of the specific language used in the example is that it does not deal with the situation in which all partners have negative capital accounts. Allocations of losses in such a situation cannot have substantial economic effect and must be allocated in accordance with PIP, so it may be prudent to have some agreement in advance as to what the parties' understanding of PIP is.

3. Targeted Capital Account Approach

b. Discussion

THE FIRST PARAGRAPH IS RESTATED AS:

The targeted capital account approach, in a sense, inverts the substantial economic effect test. Rather than basing distributions on capital account balances, it bases allocations, and, thus, capital account balances, on intended distributions. The parties agree on how distributions will be made, and income and loss are allocated to the capital accounts to ensure that there is a sufficient balance in the capital account to cover the distribution (especially on liquidation of a partnership interest).[114] Some believe that the targeted capital account approach is preferable to the substantial economic effect safe harbor, because it is more likely to protect the deal of the parties; they believe that the Regulations should provide a safe harbor for the targeted capital account approach.[115]

§ 5.07 ALLOCATIONS OF NONRECOURSE DEDUCTIONS

A. Introduction

The following is substituted for the last paragraph:

In § 3.04 we introduced you to exculpatory liabilities, i.e., liabilities that are recourse to an LLC or an LLP (and typically unsecured), but not to the (tax) partners. While these liabilities are nonrecourse for I.R.C. § 752 purposes, as no partner bears the economic risk of loss, they may be recourse for I.R.C. § 1001 purposes, as all of the assets of the LLC or LLP may be used to pay them. It is not the case that partnership minimum gain is inevitably equal to *Tufts* gain. Treas. Reg. § 1.704-2(d)(1) clearly contemplates applying the I.R.C. § 752 approach rather than the I.R.C. § 1001 approach (other than as to partner nonrecourse debt) in its definition of minimum gain. As we discussed in § 3.04, the foreclosure of a property to pay an exculpatory liability might, under Treas. Reg. § 1.1001-2, generate both capital or I.R.C. § 1231 gain or loss and cancellation of indebtedness income. Arguably partnership minimum gain nets these together to offset a negative capital account. Thus, for example, assume a partner without an actual DRO has a $2,000 negative capital account attributable to I.R.C. § 752 nonrecourse debt that is an exculpatory liability. On a practical level, a partner

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114. *See* William G. Cavanagh, *Targeted Allocations Hit the Spot*, 2010 TNT 192-4; Todd D. Golub, *Target Allocations: The Swiss Army Knife of Drafting (Good for Most Situations — But Don't Bet Your Life on It,* Taxes, Mar. 2009; Terence Floyd Cuff, Some Selected Issues in Drafting Real Estate Partnership and LLC Agreements, in Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financing, Reorganizations & Restructurings (Louis S. Freemen ed., 2007); Stephen L. Whitmire et al., Structuring and Drafting Partnership Agreements: Including LLC Agreements, ¶ 5.05[2] (3d ed. 2003).

115. *See* Daniel Goldberg, *The Target Method for Partnership Special Allocations and Why It Should Be Safe-Harbored*, 69 Tax Law. 663 (2016); William G. Cavanagh, *Targeted Allocations Hit the Spot*, 2010 TNT 192-4.

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may often not have a negative capital account in excess of his share of partnership minimum gain. In calculating that partner's share of partnership minimum gain, it may be permissible to take into account both capital or § 1231 gain or loss and any cancellation of indebtedness income that would result from the foreclosure of partnership property to pay the exculpatory liability.[116]

B. Regulatory Safe Harbor

The following is substituted for footnote 161:

[161]. Treas. Reg. § 1.704-2(m), example 1(ii). Examples in Regulations are persuasive authority so long as they do not conflict with the Regulations themselves. Cook v. Commissioner, 269 F.3d 854 (7th Cir. 2001).

C. Subsequent Nonrecourse Borrowing

Add to the end of the section:

What if a partnership makes additional nonrecourse borrowings but neither invests the proceeds in the property nor distributes them to the partners? For minimum gain allocation purposes, the funds are effectively held in abeyance until one of those two events occurs.[117]

D. Partner Nonrecourse Deductions

The following is substituted for footnote 177:

[177]. Treas. Reg. § 1.704-2(b)(4). Note that an exculpatory liability would typically appear to be excluded from this definition, since an exculpatory liability is likely an I.R.C. § 1001 recourse (not nonrecourse) debt. If an exculpatory debt is guaranteed by a LLC member, similar issues to those addressed by the partner nonrecourse deduction rules exist. Nonetheless, the partner nonrecourse deduction rules apparently do not apply, and the matter would have to be addressed under the substantial economic effect rules (or the partners' interests in the partnership rules), an unsatisfying disjuncture. *See* Karen C. Burke, *Exculpatory Liabilities and Partnership Nonrecourse Allocations*, 57 Tax Law. 33 (2003).

The following is substituted for the example starting at the bottom of page 226 and carrying over to page 227:

AB LLC has two equal members, A and B. The LLC borrows $100 on a nonrecourse basis. The loan is used to buy a depreciable asset. A guarantees the debt (without a right or reimbursement), making the liability recourse to A under I.R.C. § 752 (and thus not covered by the partner*ship* nonrecourse deduction rules). Neither A nor B make any contributions to the LLC, but the LLC has other I.R.C. § 752 nonrecourse debt that gives both A and B sufficient bases in their partnership interests. The $100 of deductions from the depreciable property are (assume otherwise properly) allocated to B, giving B a $100 negative capital account. Assume B also has a $100 actual DRO, thus allowing his capital account to be negative by this amount under the economic effect Regulations and ordinarily permitting the allocation of the deductions to B. When the basis and fair market value of the property are zero, the LLC defaults on the debt and the creditor requires A to make payment on her guarantee, but the LLC agreement does not give A a capital account credit for the payment. Under these facts, B's DRO is illusory, since there is effectively no one to enforce it. The creditor has been paid and presumably would not be a third-party beneficiary of the DRO in any event, given that the debt was nonrecourse.[118] A has a zero capital account and so no reason or, typically, ability, to

[116]. *See* Karen C. Burke, *Exculpatory Liabilities and Partnership Nonrecourse Allocations,* 57 Tax Law. 33 (2003). *See* discussion in § 5.03B2.

[117]. *See* Treas. Reg. § 1.704-2(g), (h).

[118]. It is possible for someone to be a "third-party beneficiary" of a contract to which they are not a party, potentially giving them rights to enforce the contract. But that status must be intended by the parties to the contract. If the debt is nonrecourse to the LLC,

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enforce B's DRO, since restoring a deficit capital account is meant to provide funds to pay a creditor or a partner with a positive capital account, neither of which exists.[119] (And in any event, A was in cahoots with B or the deal would have been structured differently). The partner nonrecourse debt rules prevent this abuse from happening by requiring the deductions attributable to the debt A guarantees to be allocated to A.[120] Note, though, that the rules are over-broad. Had A's payment on the guaranty increased A's capital account, A would have had an incentive to enforce B's negative capital account and there would be no abuse. (Note in this case there would be no *Tufts* gain[121] that could potentially offset B's negative capital account as A has paid the debt.) Nonetheless, the partner nonrecourse deduction rules require the deductions attributable to the debt to be allocated to A.[122]

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there typically cannot be an intention to give a creditor third-party enforcement rights on the DRO, as that would have the effect of making the debt recourse. Note that the creditor's rights against A do not involve third-party beneficiary law, but a direct contract between A and the creditor. *See* Walter Schwidetzky, *The Negative Capital Account Maze*, 152 Tax Notes 1107 (2016).

119. A may have a guarantor's right of subrogation (*See*, e.g., Intergraph Corporation v. Commissioner, 106 T.C. 312 (1996)), but would only be able to enforce the DRO under the subrogation right if the creditor had the right to enforce it. *See, e.g.,* California Civil Code § 2848.

120. *See* Karen C. Burke, *Exculpatory Liabilities and Partnership Nonrecourse Allocations,* 57 Tax Law. 33, 54–56 (2003) (from which we derived the example); Christine Rucinski Strong and Susan Pace Hamill, *Allocations Attributable to Partner Nonrecourse Liabilities: Issues Revealed by LLCs and LLPs*, 51 Ala. L. Rev. 603, 649–655 (2000).

121. *See* § 5.07.A.

122. *Id.*

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CHAPTER 6: DISPOSITIONS OF PARTNERSHIP INTERESTS

§ 6.02 Recognition of Gain or Loss

A. Amount Realized

The following is substituted for the final paragraph:

It is possible that in certain circumstances there may not be any decrease in a partner's share of the partnership's liabilities by reason of the disposition of a portion of a partnership interest. For example, in the case of a limited partnership, if all of the partnership's liabilities are recourse to the partnership and the general partner is also a limited partner and sells a portion of her limited partner interest, by virtue of her still being the general partner of the partnership, there may be no reduction in her share of partnership liabilities.[123] In such case, the amount realized is only the cash and fair market value of property received by the selling partner. Another situation where this can occur is if a partner has guaranteed the indebtedness of the partnership or where the partner or related party is the lender to the partnership.

C. Capital Accounts

The following is substituted for the last paragraph:

What if, on the other hand, there is no actual DRO? The seller has a deficit capital account that he is not obligated to restore and that has, in turn, triggered a qualified income offset provision that has not yet been fully implemented at the time of the sale of the interest.[124] Possibly the seller has sold a "right" to future income. The allocable portion of the sales price could be income to the seller in the year of the sale of the same character as the income that would have been allocated to the seller had the qualified income offset provision been fully implemented.[125] If there is a triggered minimum gain chargeback for the seller at the time of the sale that has not yet been fully implemented, the answer should be the same as for a triggered qualified income offset provision. However, if the negative capital account is the result of a deemed DRO associated with partnership nonrecourse debt, where no minimum gain chargeback has been triggered, then the regular rules of I.R.C. § 752(d) should bring the seller's share of the partnership nonrecourse debt into the seller's amount realized and resolve the issue.[126]

§ 6.03 Character of Gain or Loss

B. Unrealized Receivables and Inventory Items

1. Ordinary Income Recognition

The following is substituted for the last paragraph:

I.R.C. § 741 generally may be thought of as an entity approach to partnerships, whereas I.R.C. § 751(a) may be thought of as the aggregate approach, but only to the extent that the partnership has unrealized receivables or

[123]. You will recall that in a limited partnership the general partners are usually jointly and severally liable for the liabilities of the partnership.

[124]. *See* § 5.03B2.

[125]. *See* Estate of Stranahan v. Commissioner, 472 F.2d 867 (6th Cir. 1973); Walter Schwidetzky, *The Negative Capital Account Maze,* 152 Tax Notes 1107 (2016).

[126]. *See* § 5.07. *See also* Walter Schwidetzky, *The Negative Capital Account Maze,* 152 Tax Notes 1107 (2016).

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inventory items.[127] The key, therefore, is determining whether an item is an unrealized receivable or an inventory item.

§ 6.07 Optional Adjustment to Basis of Partnership Property

A. I.R.C. § 743(b)

The first paragraph is restated as follows:

Three code sections interplay to address this problem. I.R.C. § 754 provides the election, I.R.C. § 743(b) provides the amount of the adjustment,[128] and I.R.C. § 755 provides rules for how the adjustment is allocated to the partnership assets. The adjustment provided by I.R.C. § 743(b) is only available in the case of a sale or exchange of a partnership interest or upon the death of a partner. Thus, the provisions of I.R.C. § 743(b) do not apply to partnership interests acquired directly from a partnership or acquired by gift.[129] However, it should be noted that the triggering requirement is a sale, exchange or death. There is not a requirement that the exchange be a taxable exchange. This means that a variety of non-taxable exchanges in the Code (e.g., I.R.C. § 368, I.R.C. § 351, I.R.C. § 721) could trigger an I.R.C. § 743(b) adjustment if an I.R.C. § 754 election is in place or if there is a substantial built-in loss.

In order for I.R.C. § 743(b) to be applicable (on a voluntary basis), the partnership must make an I.R.C. § 754 election. In fact, if an I.R.C. § 754 election has already been made, an adjustment is mandatory under I.R.C. § 743(b), and no longer optional. This is true even if there is a negative I.R.C. § 743(b) adjustment, because the partnership holds primarily loss assets, rather than a positive adjustment, as in our example. Of course, the transferee partner would not mind being allocated losses that occurred before his watch, but if an I.R.C. § 754 election has been made, he will not be able to take advantage of those losses.

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.[130]

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).[131] 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

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[127]. It is important to remember that I.R.C. § 751 does not create a literal aggregate approach but only applies the aggregate approach to the extent it affects character. For example, I.R.C. § 751 does not affect the source of income. *See* Rawat v. Commissioner, 134 AFTR 2d 2024-5131 (D.C. Cir. 2024).

[128]. *See* Treas. Reg. § 1.743(h)(2)(B)(iv) ex. (i)

[129]. In many instances, this same inequity resulting from a purchase of a partnership interest will not result in the case of a contribution to a partnership, either because the existing partners will be subject to tax on the appreciation by virtue of a revaluation of the partnership assets and the making of reverse section 704(c) allocations or because of a special allocation of the pre-contribution gain to the existing partners.

[130]. *See* Treas. Reg. § 1.754-1(c).

[131]. 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).

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subsequent year.[132] If a valid election under I.R.C. § 754 has been made and not revoked, a new election is not required to be made.[133]

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

If a partnership wishes to revoke an election under I.R.C. § 754, it must file with the IRS an application setting forth the grounds on which the revocation is desired.[134] 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.[135] 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.[136]

F. Additional Aspects of Adjustment

8. Partnerships with Related Parties[137]

On June 17th, 2024, the IRS released guidance on basis shifting in partnerships between related parties. The package contained three pieces: Rev. Rul. 2024-14,[138] Notice 2024-54,[139] and Prop. Reg. § 1.6011-18.[140] The main thrust of the package is to delay or disallow the benefits of an adjustment to basis in certain partnership transactions when the partnership includes related parties.

Rev. Rul. 2024-14 applies the economic substance doctrine to transactions in which IRC §§ 743, 734 or 732 operate to benefit a related party where the non-tax business purpose was insubstantial. An edited version of an example in the revenue ruling:

> C is a domestic corporation engaged in operating a trade or business. The C Subsidiaries include, among other entities, Sub 1, Sub 2, Sub 3, Partnership A, Partnership B, Partnership C, and Partnership D, each of which is indirectly owned by C through one or more C Subsidiaries. The C Subsidiaries own various depreciable or amortizable assets used in, and have incurred various liabilities as part of, the conduct of C's trade or business. C indirectly owns more than 50 percent of the stock of each of Sub 1, Sub 2, and Sub 3, all domestic corporations. Sub 1 and Sub 2 are the only partners in Partnership A with each holding a 50 percent interest in the capital, profits, and losses of Partnership A. Sub 1 and Sub 3 are the only partners in Partnership B with each holding a 50 percent interest in the capital, profits, and losses of Partnership B. Prior to Date 1, Partnership A had a valid election in place under

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132. Rev. Proc. 92-85, § 4.01, 1992-2 C.B. 490, *as amended by* Rev. Proc. 93-28, 1993-2 C.B. 344.
133. Treas. Reg. § 1.754-1(b)(1).
134. Treas. Reg. § 1.754-1(c)(1).
135. *Id.*
136. *Id.*
137. See also discussion at Section 7.10.
138. Rev. Rul. 2024-14, 2024-28 IRB 18 (June 17, 2024).
139. Notice 2024-54, 2024-28 IRB 24 (June 17, 2024).
140. REG-124593-23, 89 Fed. Reg. 51476 (June 18, 2024).

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> § 754. Also prior to Date 1, Sub 1's share of the adjusted tax basis of Partnership A's property (that is, Sub 1's share of Partnership A's inside basis) was equal to $20x and the adjusted tax basis of Sub 1's interest in Partnership A (that is, Sub 1's outside basis) was $100x. This $80x disparity between Sub 1's share of Partnership A's inside basis and Sub 1's outside basis in Partnership A prior to Date 1 resulted from Sub 1 and Sub 2 making contributions to Partnership A, and Partnership A making distributions to Sub 1 and Sub 2, of property with specific Federal income tax attributes, and the allocation of Federal income tax items in accordance with § 704(b) and (c). Such contributions, distributions, and allocations were undertaken with a view to creating a disparity between Sub 1's share of Partnership A's inside basis and Sub 1's outside basis in Partnership A. On Date 1, Sub 1 transfers its interest in Partnership A to Partnership B in a contribution that qualifies for nonrecognition of gain or loss under § 721(a) (Sub 1 Contribution). The stated business purpose for the Sub 1 Contribution is to achieve cost savings for C and the C Subsidiaries by cleaning up intercompany accounts, reducing administrative complexity, and achieving other administrative efficiencies. Immediately after the Sub 1 Contribution, Partnership B's outside basis in its interest in Partnership A is $100x under § 723 while its share of Partnership A's inside basis is $20x (without regard to § 743(b)). Under § 743(b), Partnership A increases the adjusted basis of its property by $80x (the excess of Partnership B's $100x outside basis over its $20x proportionate share of inside basis) with respect to Partnership B only. Partnership A allocates substantially all of this $80x basis increase to its depreciable or amortizable property (Basis-Adjusted Property) under § 755 and § 1.755- 1(b)(5). The Sub 1 Contribution on Date 1 was undertaken with a view to exploiting the disparity between Sub 1's share of Partnership A's inside basis and Sub 1's outside basis in Partnership A created before Date 1 and increasing Partnership B's share of Partnership A's inside basis in the depreciable or amortizable property. The cost savings resulting from the Sub 1 Contribution are insubstantial in relation to the reduction in the aggregate Federal income tax liability of the C Subsidiaries resulting from the $80x increase in Partnership A's basis in the Basis-Adjusted Property, which results in Partnership B being allocated increased amounts of deductions for depreciation or amortization or reduced amounts of gain (or increased amounts of loss) upon the sale of the Basis-Adjusted Property.

Notice 2024-54 announces the intent to publish proposed regulations which would suspend or deny the benefits of IRC §§ 743, 734 or 732 where they would operate to benefit a related party. The Notice announces proposed regulations that would be mechanical and apply without regard to the taxpayer's intent and without regard to whether the transactions would be abusive or lacking in economic substance.

While the example in the revenue ruling shows a potential abuse, there is a worry that the regulations could overreach. For example, imagine a real estate partnership held by a family that holds several parcels of developed real estate. Because the partnership has been in existence for a number of years, the real estate has been fully depreciated or nearly fully depreciated. If a member of the older generation dies, the IRC § 1014 basis adjustment on death would trigger IRC § 743 if the partnership had an IRC § 754 election in place. Notice 2024-54 (death is not excluded from Notice 2024-54) would suspend the benefit of IRC § 743 until the family becomes unrelated, which, since they are family, is likely to only occur on their own death. Yet there need be nothing abusive about making an IRC § 754 election in this scenario.

Even if the partnership did not have an IRC § 754 election in place on the death of the older generation, IRC § 1014 would still adjust the outside basis to fair market value. If one of the younger generation wanted to be redeemed out, IRC § 732(b) would kick in if the partnership made the redemption distribution in kind. Notice 2024-54 would suspend the benefits of IRC § 732(b), until the recipient is unrelated (without any dollar threshold). Again, where is the abuse?

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Some have also questioned whether there the government has the authority to issue the regulations.[141]

Prop. Reg. § 1.6011-18 would make such transactions (excluding death for these purposes) transactions of interest which would require all participants and all material advisors to disclose the transactions and keep records.

In addition, Prop. Reg. § 1.6011-18 may treat the redemption as a reportable transaction. Although Prop. Reg. § 1.6011-18 would exclude death from triggering transactions, it would not exclude a redemption if the basis of the property distributed is increased by $5 million or more. – even if the redemption is triggered by a death.

[141]. Monte Jackel, "Individual Finds Fault With Basis-Shifting Transaction Rules," 2024 TNTF 143-23 (June 18, 2024); Kristen A. Parillo, "Tax Pros Predict Rocky Road for Basis-Shifting Initiative," 183 Tax Notes Federal 2402 (June 24, 2024) (citing Monte A. Jackel).

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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.

§ 7.07 I.R.C. § 734(B) ADJUSTMENTS

ADD TO FOOTNOTE 51 IN THE TEXT:

See discussion of the application of I.R.C. 734(b) in the context of a partnership with related partner in Section 6.07. F and Section 7.10.

§ 7.09 LIQUIDATIONS OF PARTNERSHIPS AND PARTNERSHIP INTERESTS

B. Liquidations of the Partnership or of a Partnership Interest

ADD AFTER THE SECOND FULL PARAGRAPH ON PAGE 312:

In the case of a liquidating distribution, I.R.C. § 732(b) provides that the distributee partner's basis in distributed property (other than money) is equal to the adjusted basis of the distributee partner's partnership interest reduced by any money distributed to such partner in the same transaction. Under I.R.C. § 732(b), the distributee partner's basis in the distributed property is generally equal to the partner's outside basis immediately before the distribution. As a result, the distributed property's basis is increased by an amount equal to the excess of the distributee partner's outside basis over the partnership's basis in the distributed property.

> DEF Partnership is owned by partners D, E and F. The partners are related to each other within the meaning of Prop. Reg. § 1.6011-18(b)(8) and (b)(9)(i). D's outside basis is $7 million. E and F each have an outside basis of $1 million. DEF Partnership owns only two properties, Property 1 and Property 2, both of which it uses in its trade or business. For Federal income tax purposes, Property 1 is depreciable property and Property 2 is nondepreciable property. DEF Partnership has an adjusted basis in Property 1 of zero, and an adjusted basis in Property 2 is $9 million.
>
> DEF Partnership distributes Property 1 to D in liquidation of D's partnership interest. Under I.R.C. § 732(b), D's basis in distributed Property 1 is equal to $7 million. As a result, D claims depreciation deductions based on a $7 million basis in Property 1.[142]

Add before current 7.10 and renumber 7.10 as 7.11:

[142]. REG-124593-23, 89 Fed. Reg. 51476, 51484 Ex. 2. (June 18, 2024). Under the Proposed Regulations this would be a transaction of interest and a reportable transaction under I.R.C. § 6011. Under Notice 2024-54, 2024-28 IRB 24 (June 17, 2024), the benefit of the increase in basis would be suspended until D was no longer related to the other partners.

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§ 7.10 BASIS SHIFTING

Related parties have used the provisions of I.R.C. §§ 734(b), 743(b), and 732 to shift basis from nondepreciable assets to depreciable assets or to shift basis from assets that will continue to be held to assets that are going to be sold, all without the benefit of a taxable transaction or an investment. For example, assume Corporations X, Y, and Z are all wholly owned by Corporation W. Corporations X, Y, and Z from Partnership XYZ. Corporation X has a $1 million basis in its partnership interest. Partnership XYZ distributes land with a basis of $15 million to Corporation X while it had an I.R.C. § 754 election in effect. Under I.R.C. § 732(a)(2), Corporation X is limited to a $1 million basis in the land and assume the partnership may increase its basis in depreciable property by $14 million under I.R.C. § 734(b). The IRS understandably considers these transactions to be abusive. It is rumored that the same asset is often depreciated repeatedly, and taxpayers have often avoided large gains on the sale of assets ($867 million according to the IRS in a case currently before the Tax Court[143]). Recently, the IRS took the issue on, issuing Notice 2024-54[144] (which contained contemplated Proposed Regulations) and Revenue Ruling 2024-14.[145] The details are complex, but in the example, the I.R.C. § 734(b) adjustment typically would be held in abeyance under the Proposed Regulations until the land is sold to an unrelated party in a fully taxable transaction.

Section 6011(a) provides, in part: "When required by regulations prescribed by the Secretary any person made liable for any tax imposed by this title, or with respect to the collection thereof, shall make a return or statement according to the forms and regulations prescribed by the Secretary." Contemporaneously with the Notice and Revenue Ruling, Treasury issued Proposed Reg. 1.6011-18 on June 18, 2024.[146] These Proposed Regulations were finalized, and became effective, on January 14, 2025.[147] The Final Regulations identify four types of "partnership related party basis adjustment transactions" as "transactions of interest." We will not give a detailed review of these Regulations, but they generally require participants in related-party (or tax-indifferent party) basis shifting transactions to give notice to the IRS, which will tend to have a deterrent effect on basis shifting transactions. Participants who may be required to give notice include the partnerships, the related parties, and material advisors. Importantly, these Regulations provide that they apply if there is a basis shifting transaction where there is, in the aggregate, a basis increase that exceeds by at least $10 million the gain recognized from such transactions, without netting for basis decreases.[148]

The I.R.C. § 6011 Regulations can apply to transactions first entered into in prior tax years. The Final Regulations, however, limit the "lookback" period to 6 years and for lookback purposes increase the minimum threshold to $25 million.[149] Generally, the partnership, related parties, and material advisors are required to report a transaction by filing a disclosure statement with the Office of Tax Shelter Analysis within 90 calendar days of the relevant transaction.[150] An extension of an additional 90 days is possible for material advisors.[151]

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[143] For a current example in this latter regard, see the IRS Pre-Trial Memorandum in Otay Project LP, Oriole Management LLC Tax Matters Partner, currently before the Tax Court, Docket No. 6819-20 (hereinafter "Otay").

[144] Notice 2024-54, 2024-29 I.R.B. 24.

[145] Rev. Rul. 2024-14, 2024-28 I.R.B. 18.

[146] 89 FR 51476.

[147] 90 FR 2958.

[148] Treas. Reg. § 1.6011-18(c)(3)(i). This is an increase over the $5 million threshold in the Proposed Regulations.

[149] Treas. Reg. § 1.6011-18(c)(3)(ii).

[150] Treas. Reg. §§ 1.6011-4(e)(2)(i), 1.6011-4(c)(3), 1.6011-18(e),(f),(i).

[151] Treas. Reg. § 1.6011-18(h)(2).

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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.

§ 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.[152] 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).[153] 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.[154] 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.[155] 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.[156]

§ 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

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152. Prop. Reg. § 1.707-2(c).
153. *See* S. Prt. No. 98-169 (Vol. 1), 98th Cong., 2d Sess. 223–32, at 227–28 (1984) ("S. Prt. 98-169").
154. Prop. Reg. § 1.707-2(c)(6).
155. Prop. Reg. § 1.707-2(c).
156. *Id.*

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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.[157] 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 disposition of a partnership interest with a holding period of more than one year (after the application of the look-through rule).[158] As you might expect, an owner taxpayer's three-year gain has the same definition, substituting "three-year" for "one-year."[159]

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.[160] 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.[161] 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.[162]

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.[163] 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

[157]. Treas. Reg. § 1.1061-4(a)(1).
[158]. Treas. Reg. § 1.1061-4(a)(2)(i).
[159]. Treas. Reg. § 1.1061-4(a)(2)(ii).
[160]. Treas. Reg. § 1.1061-4(b)(8).
[161]. Treas. Reg. § 1.1061-4(b)(9).
[162]. Treas. Reg. § 1.1061-4(b)(9)(ii).
[163]. Treas. Reg. § 1.1061-3(c)(3)(i).

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partnership's operations and on liquidation.[164] 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.[165]

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.[166]

THE EXAMPLE IS RESTATED AS FOLLOWS:

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.[167] 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.[168] 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.[169]

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[170] 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

[164]. Treas. Reg. § 1.1061-3(c)(3)(ii)(A).
[165]. *Id*.
[166]. Treas. Reg. § 1.1061-3(c)(3)(ii)(B).

[167]. Conference Report to Accompany H.R. 1, 115 Cong. 1st Sess., Rep. 115-466, p. 420 (Dec. 15, 2017).
[168]. Treas. Reg. § 1.1061-3(c)(v)(A).
[169]. Treas. Reg. § 1.1061-3(c)(v)(B).
[170]. 1984–1 C.B. 159. Rev. Rul. 84-53 rules that when only part of a taxpayer's interest in the partnership is sold the basis must be allocated between the piece sold and the piece retained based on their relative fair market values.

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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.[171] 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.[172] Amounts that are treated as ordinary income under I.R.C. § 751(a) or (b) as a result of the disposition are excluded from all steps of the calculation. The computation then proceeds as follows. First, the amount of 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).[173] 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).[174] 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.[175]

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.[176]

171. Treas. Reg. § 1.1223-3(b)(5)(i).
172. Treas. Reg. § 1.1061-3(c)(4).
173. Treas. Reg. § 1.1061-3(c)(4)(ii)(A).
174. Treas. Reg. § 1.1061-3(c)(4)(ii)(B).
175. Treas. Reg. § 1.1061-3(c)(4)(ii)(C).
176. Treas. Reg. § 1.1061-3(c)(4)(ii)(D).

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CHAPTER 9: BUSINESS COMBINATIONS

§ 9.02 Partnership Mergers

D. Buy-Out Rule

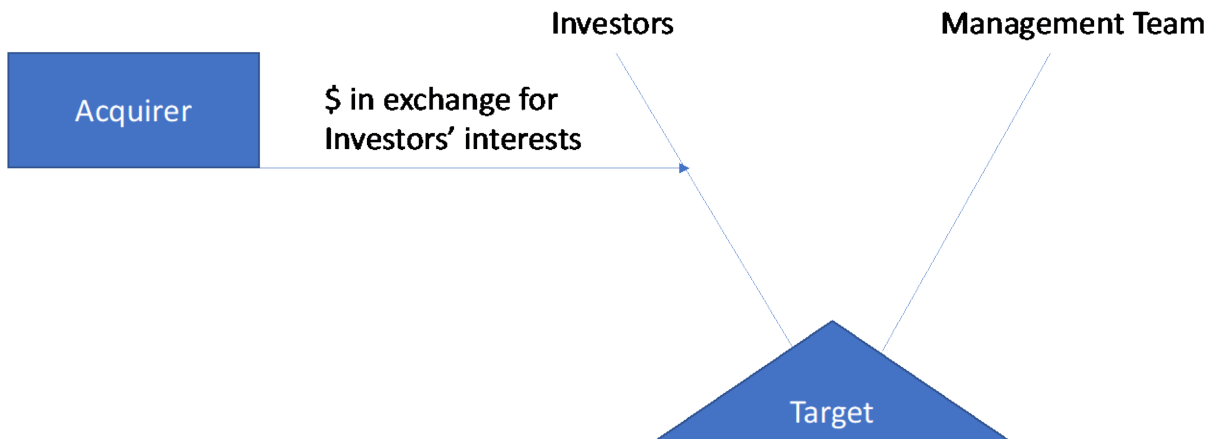
The last sentence of § 9.02 D is deleted.

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:



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

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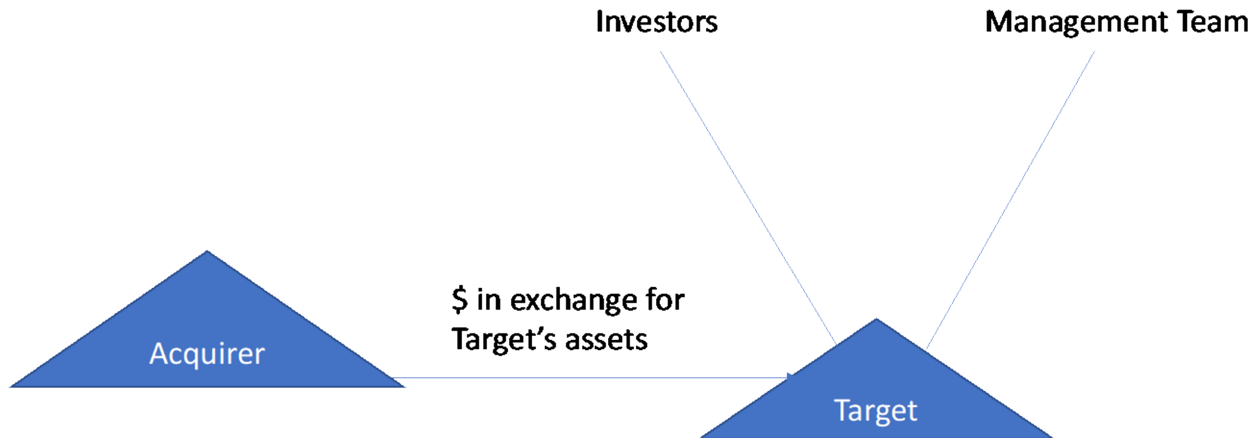
If the Acquirer is itself a partnership and the acquisition is in the form of an asset purchase, then the analysis is also relatively straightforward – unless the Acquirer requires the Management Team to contribute their interests to the Acquirer.



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

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

There are more questions than answers about the application of I.R.C. § 708(b)(1) in the context of acquisitions. Fortunately, the IRS has opened a guidance project that will hopefully answer some of the questions in this context.[177]

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

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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.[178] 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.[179]

B. FOREIGN TAX CREDIT RULES IN REGARD TO PARTNERSHIPS

1. Generally

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.[180] 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.[181] 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)

[178]. I.R.C. § 702(b)

[179]. *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)).

[180]. 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).

[181]. Treas. Reg. § 1.901-1(a). See discussion at 5.04 M.

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is made by each partner separately. In Rev. Rul. 71-141,[182] 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.[183] 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),[184] and, accordingly, such expenditures must be allocated in accordance with the partners' interests in the partnership.[185] 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.[186]

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.[187] Subpart F is the portion of the Code dealing with the conditions under which U.S. shareholders are required to currently include income recognized by a controlled foreign corporation. A controlled foreign corporation is a foreign corporation if more than 50% of (i) the total combined voting power of all classes of stock of such corporation entitled to vote, or (ii) the total value of the stock of such corporation, is owned or is considered as owned by United States shareholders on any day during the taxable year of such foreign corporation.[188] Controlled foreign corporations are sometimes referred to as "CFCs."[189]

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.[190] 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).[191] 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.[192]

Under the so-called "technical taxpayer" rule of Treas. Reg. § 1.901-2(f)(1), the person by whom tax is

182. 1971-1 C.B. 211.
183. Treas. Reg. § 1.861-8(e)(15); Prop. Reg. § 1.861-8(e)(6); Treas. Reg. § 1.960-3.
184. Foreign taxes taken as credits do not reduce capital accounts.
185. Treas. Reg. § 1.704-1(b)(4)(viii)(a).
186. *Id.*
187. I.R.C. § 960.
188. I.R.C. § 957.
189. *Id. See* Treas. Reg. § 1.901-1(a).
190. REG-105600-18, 83 Fed. Reg. 63200 (Dec. 7, 2018).
191. Treas. Reg. § 1.960-2(b)(4).
192. *See* Treas. Reg. § 1.960-3(b)(5).

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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.[193] It also applies even if another person bears the economic burden of the tax, for example through a gross-up clause.[194]

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.[195] 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.

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.[196] The

[193]. *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).

[194]. Treas. Reg. § 1.901-2(f)(2)(i); *cf.* Continental Illinois Corp. v. Commissioner, 998 F.2d at 516.

[195]. Guardian Industries Corp. v. United States, 477 F.3d 1368 (Fed. Cir. 2007).

[196]. I.R.C. § 245(a)(2).

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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.[197] 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.[198] 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.[199] 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.[200] 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.[201]

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.[202] A person is an indirect partner with respect to a domestic partnership if the person indirectly owns the domestic partnership through one or more specified entities (other than a foreign corporation).[203]

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.[204]

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.[205] 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

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197. I.R.C. § 245(a)(3).
198. I.R.C. § 245A(a). A deduction for the U.S. source portion is separately available. I.R.C. § 245.
199. I.R.C. § 951(b): Conference Report to Accompany H.R. 1, 115 Cong. 1st Sess., Rep. 115-466, p. 597 (15 Dec. 2017).
200. I.R.C. § 245A(c).
201. I.R.C. § 245A(c)(3).
202. Treas. Reg. § 1.245A-5(g)(6).
203. *Id.*
204. I.R.C. § 952.
205. I.R.C. § 954(c)(1).

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attributable to such interest.[206]

"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.[207]

"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.[208]

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.[209]

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 over the aggregate of its pro rata share of the tested loss of each CFC with respect to which it is a US shareholder.[210] Pro rata shares are determined under the rules of I.R,C. § 951(a)(2).[211]

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.[212] 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)).[213]

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.[214] Specified tangible property means any property used in the production of

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206. I.R.C. § 954(c)(4)(A).
207. I.R.C. § 954(e).
208. I.R.C. § 954(d)(1).
209. I.R.C. § 951A(b)(1).
210. I.R.C. § 951A(c).
211. I.R.C. § 951A(e)(1).
212. I.R.C. § 951A(c)(2)(A).
213. I.R.C. § 951A(c)(2)(A)(i).
214. I.R.C. § 951A(d)(1).

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tested income.[215] 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.[216]

I.R.C. § 951A(d)(3) (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.[217] 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. corporation 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,[218] The 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

215. I.R.C. § 951A(d)(2)(A).
216. I.R.C. § 951A(d)(2)(B).
217. Treas. Reg. § 1.958-1(d)(1).
218. Treas. Reg. § 1.958-1(d)(2)(iii).

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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.[219]

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.[220] 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 is treated as an interest in U.S. property.[221]

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.[222]

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.[223] 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

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219. Treas. Reg. § 1.958-1(d)(3). Ex. 1.

220. 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).

221. Treas. Reg. § 1.956-2(a)(3); Rev. Rul. 90-112, 1990-2 C.B. 186.

222. Rev. Rul. 90-112, 1990-2 C.B. 186.

223. Prop. Treas. Reg. § 1.954-9(a).

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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.[224] The rules relating to hybrid branches may also apply to payments between a partnership and a hybrid branch under certain circumstances.[225]

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.[226] 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.[227] 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.[228]

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.[229]

Although, as just noted, the CFC rules may treat a branch as a separate entity in some circumstances, in 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.[230] 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.[231] 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.[232]

> *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

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224. Prop. Treas. Reg. § 1.954-9(a)(6).
225. Prop. Treas. Reg. § 1.954-9(a)(2)(ii).
226. Treas. Reg. § 1.956-1(b)(1)(iii).
227. Treas. Reg. § 1.956-4(c)(1).
228. Treas. Reg. § 1.956-4(c)(2).
229. I.R.C. § 954(d)(2).
230. 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).
231. Treas. Reg. § 1.954-1(g)(1).
232. Treas. Reg. § 1.954-1(g)(2).

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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.[233]

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.[234] 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.[235] 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.[236] 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.[237] 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 trade or business in the United States, is not treated as being from U.S. sources.[238]

§ 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.[239] 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.[240] 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.

233. Treas. Reg. § 1.954-1(g)(3), example 3.
234. I.R.C. § 702(b)
235. I.R.C. § 862.
236. I.R.C. § 861(a).
237. Treas. Reg. § 1.861-2(a)(2).
238. I.R.C. § 861(a)(1)(C).
239. I.R.C. §§ 871(h), 881(c).
240. Treas. Reg. § 1.871-14(g)(3).

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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.[241] 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.[242] 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*")[243] 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.[244] An interest in real property includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements, and options to acquire leaseholds or improvements.[245]

A USRPI also includes any interest (other than an interest solely as a creditor)[246] 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.[247]

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.[248] 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.[249] Interests in publicly traded partnership are excluded under similar rules.[250] For the purposes, of determining whether a corporation is a U.S. real property holding corporation, assets held by partnerships are treated as held proportionately by its partners.[251]

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241. I.R.C. § 871(a)(2).

242. The non-U.S. investor may also have certain reporting requirements under I.R.C. § 6039C that are not discussed herein.

243. 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.

244. I.R.C. § 897(c).

245. I.R.C. § 897(c)(6)(A).

246 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).

247. I.R.C. § 897(c)(1)(B).

248. I.R.C. §§ 897(c)(1)(A)(ii), (c)(4)(A).

249. I.R.C. § 897(c)(3).

250. Treas. Reg. § 1.897-1(c)(2)(iv).

251. I.R.C. § 897(c)(4)(B).

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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.[252]

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.[253]

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.[254]

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.[255]

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.[256] 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.[257] 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.[258]

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

SUBSECTION 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

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252. Treas. Reg. § 1.1445-1(c)(2).
253. Treas. Reg. § 1.1445-2(b)(2).
254. Treas. Reg. § 1.1445-2(d)(1).
255. Treas. Reg. § 1.1445-2(d)(2).
256. I.R.C. § 1445(e)(4).
257. Treas. Reg. § 1.1445-5(a), (c).
258. Treas. Reg. § 1.1445-8(b)(2).

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inventory items.[259] 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.[260]

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.[261] 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 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.[262] 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.[263]

3. 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.[264] 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.

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259. I.R.C. § 741; see Chapter 6.

260. 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.

261. 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.

262. Treas. Reg. § 1.897-7T.

263. *Id.*

264. 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.

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In *Grecian Magnesite*, the Tax Court concluded in 2017 that Rev. Rul. 91-32 was invalid,[265] 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*.[266] 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.[267] The provision requires that any gain or loss from the hypothetical asset sale by the partnership be allocated to interests in the partnership in the same manner as nonseparately stated income and loss. This portion of the provision applies to dispositions of partnership interests after November 27, 2017.

As a result of I.R.C. § 864(c)(8), non-U.S. partners would be subject to a return filing requirement in the United States from the disposition of the partnership interest, and, potentially be subject to tax in the United States.[268] 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.[269] Second, if the transferee receives a certification that no gain will be realized, no withholding is required.[270] 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

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[265]. 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.

[266]. 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.

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

[268]. Treas. Reg. § 1.6012-1, -2.

[269]. Treas. Reg. § 1.1446(f)-2(b)(2).

[270]. Treas. Reg. § 1.1446(f)-2(b)(3)(i).

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been property reported on a tax return and the tax has been paid, no withholding is required.[271] 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.[272] 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.[273] 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.[274]

The general rules for withholding on transfers of partnership interests do not apply to the transfers of interests in publicly traded partnerships.[275] However, the Regulations provide a separate set of rules for publicly traded partnerships.[276] 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.[277]

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.[278] 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.[279] 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).[280]

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271. Treas. Reg. § 1.1446(f)-2(b)(5)(i).
272. Treas. Reg. § 1.1446(f)-2(b)(4).
273. Treas. Reg. § 1.1446(f)-2(b)(6).
274. Treas. Reg. § 1.1446(f)-2(b)(7)(i).
275. Treas. Reg. § 1.1446(f)-1(a).
276. 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).
277. Treas. Reg. § 1.1446(f)-4(a)(2)(ii).
278. Treas. Reg. § 1.1446(f)-4(b)(2).
279. Treas. Reg. § 1.1446(f)-4(b)(5).
280. Treas. Reg. § 1.1446(f)-4(b)(6).

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A broker may rely on a qualified notice (as defined below) that states that the 10-percent exception applies.[281] 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.[282]

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.[283] 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.[284]

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

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.[285]

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.[286] 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.[287] 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.[288] 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.

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281. Treas. Reg. § 1.1446(f)-4(b)(3)(i).
282. Treas. Reg. § 1.1446(f)-4(b)(3)(ii)(A).
283. Treas. Reg. § 1.1446(f)-4(b)(3)(i).
284. *Id.*
285. Treas. Reg. § 1.897-7(c).
286. Treas. Reg. § 1.84(c)(8)-1(d). See also, TD 9919, 85 Fed. Reg. 70958,
287. Treas. Reg. § 1.864-c-1(d).
288. *Id.*

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§ 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?

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CHAPTER 13: ANTI-ABUSE PROVISIONS

§ 13.02. JUDICIAL DOCTRINES

B. Substance Over Form

The following is substituted for the second full paragraph on page 486:

In 2010, Congress codified the "economic substance doctrine" in new I.R.C. § 7701(o). This code section can roughly be thought of as a codification of the substance over form doctrine. Under I.R.C. § 7701(o)(1), any transaction to which the economic substance doctrine is relevant will be treated as having economic substance only if (i) the transaction changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position, *and* (ii) the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into the transaction. For the purposes of both requirements, a profit potential for the transaction is taken into account only if the present value of the pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits from the transaction, if the transaction were respected.[289]

[289]. I.R.C. § 7701(o)(2)(A).

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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

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-generational 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,[290] 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").[291]

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[290]. 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.

[291]. 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

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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.[292] If two or more persons transfer identical assets to a newly organized entity, the transfer will generally be treated as not resulting in diversification (the "identical asset exception").[293]

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.[294]

Cash, like other property, is taken into consideration for the purposes of the diversification test. In Rev. Rul. 87-9,[295] 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.[296]

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

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other asset specified in Regulations.

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

293. *Id.*

294. 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).

295. 1987-1 C.B. 133.

296. Treas. Reg. § 1.351-1(c)(2).

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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 insignificant portion. The Regulations provide an example in which 0.99% is viewed as an insignificant portion.[297] 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*").[298] 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.[299] Thus, such expenses are not deductible for tax years 2018 through 2025.[300]

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).[301]

Investment interest expense is deductible to the extent of investment income of the taxpayer for the year.[302] Interest attributable to a passive activity is deductible to the extent of the passive activity income.[303]

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[297]. 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).

[298]. Treas. Reg. § 1.351-1(c)(6).

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

[300]. I.R.C. § 67(g).

[301]. I.R.C. § 164(b)(6).

[302]. I.R.C. § 163(d)(1).

[303]. 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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However, the deductibility of interest from a trade or business is subject to an overall limitation of 30% of the taxpayer's earnings before depreciation, amortization, interest and taxes (depreciation and amortization are backed out only for years before 2022), provided, generally, that the average annual gross receipts for the taxpayer's three-year taxable period ending prior to the current taxable year exceed $25 million (adjusted for inflation).[304]

Personal interest is an allowable deduction only if it fits in certain specified preferred categories.[305] One of those categories is acquisition indebtedness for a qualified residence.[306] 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 purposes of I.R.C. § 280A(d)(1).[307] 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 ask, "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.[308]

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

[304]. I.R.C. §§ 163(j)(3), 448(c)(1), (4).
[305]. I.R.C. § 163(h)(1) and (2).
[306]. I.R.C. § 163(h)(3)(A)(i).
[307]. I.R.C. § 163(h)(4)(A).
[308]. *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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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 losses of the partnership business.[309]

THE LAST PARAGRAPH OF § 15.02 IS DELETED

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

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CHAPTER 17: LEGISLATIVE UPDATES AND NON-SUB K PROVISIONS

Add after 17.04 Qualified Opportunity Zone Funds:

§ 17.05. PARTNERSHIP PROVISIONS IN THE CORPORATE ALTERNATIVE MINIMUM TAX

A. General Rules

For taxable years beginning after 2022,[310] in the case of an applicable corporation, the tentative minimum tax is the excess of 15% of the adjusted financial statement income ("AFSI") for the taxable year over the corporate alternative minimum tax ("CAMT") foreign tax credit.[311] The actual tax imposed would be the excess of the tentative minimum tax over the sum of the regular tax for the taxable year[312] plus the base erosion and anti-abuse tax ("BEAT").[313] A complete discussion of the CAMT is beyond the scope of this text, but the discussion below covers some issues related to partnerships under the CAMT.

The IRS has published proposed Regulations under the CAMT,[314] which, among other things adjust AFSI for applicable corporations that are partners in partnerships.

Prop. Treas. Reg. § 1.56A-5 would provide rules under I.R.C. § 56A(c)(2)(D) regarding a partner's distributive share of partnership AFSI. I.R.C. § 56A(c)(2)(D)(i) provides that if the taxpayer is a partner in a partnership, the AFSI of the taxpayer with respect to such partnership is adjusted to only take into account the taxpayer's distributive share of the AFSI of such partnership. I.R.C. § 56A(c)(2)(D)(ii) provides that, for the purposes of the CAMT, the AFSI of a partnership is the partnership's net income or loss set forth on the partnership's applicable financial statements ("AFS") adjusted under rules similar to the rules of I.R.C. § 56A.

B. Applicable Corporations

An "applicable corporation" is any corporation (other than an S corporation,[315] a regulated investment company,[316] or real estate investment trust[317]) which meets the average annual adjusted financial statement income test for one or more taxable years which are prior to the tested taxable year and end after December 31, 2021.[318]

[310]. PL 117-169 § 10101(f).
[311]. I.R.C. § 55(b)(2).
[312]. I.R.C. § 55(a).
[313]. I.R.C. § 55(a)(2). I.R.C. § 59A imposes an excise tax, the base erosion and anti-abuse tax ("BEAT"), on certain amounts paid by U.S. payors to certain related non-U.S. recipients if the amounts are deductible by the U.S. payor and if 10% of the modified taxable income of the US payor is greater than the regular tax liability reduced by certain credits.
[314]. REG-112129-23, 89 Fed. Reg. 75062 (Sept. 13, 2024).
[315]. An "S corporation" is a U.S. business entity treated as corporation and meeting certain requirements that has elected to be treated as a flow-through entity under I.R.C. § 1362.
[316]. A regulated investment company is a U.S. business entity treated as a corporation and meeting certain requirements that has elected to be treated as a regulated investment company under I.R.C. § 851. Under I.R.C. § 852, regulated investment companies are entitled to a dividends paid deduction, which means that normally a regulated investment company is not subject to an entity level tax.
[317]. A real estate investment trust is a U.S. business entity treated as a corporation and meeting certain requirements that has elected to be treated as a real estate investment trust under I.R.C. § 856. Under I.R.C. § 857, real estate investment trusts are entitled to a dividends paid deduction.
[318]. I.R.C. § 59(k)(1)(A).

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In general, the average annual AFSI test for the CAMT is met if the corporation has an average of AFSI for the 3-taxable year period in excess of $1 billion.[319] For the purpose of determining whether a corporation is an applicable corporation, all AFSI of persons treated as a single employer with such corporation under I.R.C. § 52(a) or (b) would be treated as AFSI of such corporation, and AFSI of such corporation would be determined without regard to I.R.C. § 56A(c)(2)(D)(i) and 56A(c)(11).[320]

I.R.C. § 52 generally applies to groups with a common parent directly or indirectly owning more than 50% of the vote or value of each subsidiary or a group with 50% or more of the vote or value of each corporation being owned by five or fewer individuals, estates or trusts.[321] For these purposes, partnerships are treated similarly to corporations.[322]

For the purpose of determining whether a taxpayer meets the U.S. average annual AFSI test, if a corporation is a member non-U.S. parented multinational group, the AFSI of such corporation includes the AFSI of all of the non-U.S. members.[323] Solely for this purpose, AFSI is determined without regard to: (i) the distributive share from partnerships; (ii) income from U.S. controlled non-U.S. corporations ("CFCs");[324] (iii) the principles of I.R.C. § 882 in regard to effectively connected income; and (iv) the adjustment for benefit plans.[325] For the purposes of the non-U.S. parented multinational group rules, if a non-U.S. corporation is engaged in a trade or business in the United States, such trade or business is treated as a separate U.S. corporation that is wholly owned by the non-U.S. corporation.[326] A non-U.S. parented multinational group means for such purposes two or more entities if at least one entity is a U.S. corporation and another entity is a non-U.S. corporation, such entities are included in the same applicable financial statement with respect to a relevant tax year, and either (i) the common parent of such entities is a non-U.S. corporation or (ii) the entities are treated as having a common parent which is a non-U.S entity.[327]

C. Distributive Shares

A partnership would calculate its AFSI and allocate each partner a "distributive share" of the partnership's AFSI.

A CAMT entity's distributive share of AFSI generally should be based on the income it reports for AFS purposes with respect to its partnership investment rather than the amount of its taxable income with respect to the partnership investment. Accordingly, under Prop. Reg. § 1.56A-5, a CAMT entity's distributive share of AFSI from a partnership investment generally would be based on the share of the partnership's financial statement income ("FSI") that the CAMT entity reports on its AFS with respect to such investment, rather than on the CAMT entity's allocations of partnership items for regular tax purposes. This rule comports with the structure of the CAMT, which generally imposes a tax that is based on book income with certain adjustments.

Prop. Reg. § 1.56A-5 would provide certain exceptions that would be consistent with the statute's adjustments to FSI.

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[319]. I.R.C. § 59(k)(1)(B)(i).
[320]. IRC § 59(k)(1)(D).
[321]. I.R.C. § 52(a) applying I.R.C. § 1563(a) but substituting 50% for 80% and making certain other modifications.
[322]. I.R.C. § 52(b).
[323]. I.R.C. § 59(k)(2)(A).
[324]. A CFC would be a non-U.S. corporation in respect of which U.S. shareholders own more than 50% of the vote or value. I.R.C. § 957.
[325]. I.R.C. § 59(k)(2)(A).
[326]. I.R.C. § 59(k)(2)(C).
[327]. I.R.C. § 59(k)(2)(B).

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Prop. Reg. § 1.56A-5(b) generally would provide that, if a CAMT entity is a partner in a partnership, its AFSI with respect to its partnership investment is adjusted as required under the applicable method in Prop. Reg. § 1.56A-5(c) and the rules in Prop. Reg. § 1.56A-20 (concerning AFSI adjustments to apply certain principles of subchapter K) to take into account its distributive share of the partnership's AFSI. A CAMT entity must use the applicable method described in Prop. Reg. § 1.56A-5(c) to determine its AFSI adjustment regardless of the CAMT entity's method used to account for its partnership investment for AFS purposes.

Under the applicable method in Prop. Reg. § 1.56A-5(c), a CAMT entity would compute its distributive share of AFSI with respect to its partnership investment by first disregarding any amount the CAMT entity reflects in its FSI with respect to that investment for the taxable year (for example, under the fair value method or the equity method), except as provided in Prop. Reg. § 1.56A-5(d).[328] The CAMT entity then would include its "distributive share amount" (as determined under Prop. Reg. § 1.56A-5(e)) for the taxable year in its AFSI with respect to its investment in the partnership.[329]

The statutory directive in I.R.C. § 56A(c)(2)(D) to take into account only the taxpayer's distributive share of a partnership's AFSI does not mean that a CAMT entity may disregard all amounts with respect to a partnership investment that are outside the scope of the "distributive share amount," as computed under Prop. Reg. § 1.56A-5(e), in determining its FSI with respect to that investment. I.R.C. § 56A(c)(2)(D) and the applicable method implementing this statutory provision address only a CAMT entity's AFSI amount based on a partnership's AFSI. FSI amounts resulting from transactions such as a transfer, sale or exchange, or deconsolidation of a partnership investment are not covered by I.R.C. § 56A(c)(2)(D). Accordingly, Prop. Reg. § 1.56A-5(d) would clarify the amounts of FSI with respect to the CAMT entity's partnership investment that may not be disregarded in applying the applicable method under Prop. Reg. § 1.56A-5(c).

Under Prop. Reg. § 1.56A-5(d), a CAMT entity may not disregard any FSI amounts attributable to a transfer, sale or exchange, contribution, distribution, dilution, deconsolidation, change in ownership, or any other transaction between any partners (including the CAMT entity) and the partnership, or between any partners (including the CAMT entity), that are not derived from, and included in, the partnership's FSI. As a result, such amounts are not excluded from a CAMT entity's AFSI under the applicable method. However, these amounts may be subject to adjustment under Prop. Reg. §§ 1.56A-1(d)(4) (concerning redetermination of FSI gains and losses) and 1.56A-20 (concerning AFSI adjustments to apply certain subchapter K principles).

The rules for computing the distributive share amount included in a CAMT entity's AFSI with respect to its partnership investment under Prop. Reg. § 1.56A-5(c)(2) are contained in Prop. Reg. § 1.56A-5(e). Prop. Reg. § 1.56A-5(e)(1) would provide that a CAMT entity's distributive share amount is computed for each taxable year based on the following four steps: (i) the CAMT entity determining its distributive share percentage; (ii) the partnership determining its modified FSI; (iii) the CAMT entity multiplying its distributive share percentage by the modified FSI of the partnership (as reported by the partnership); and (iv) the CAMT entity adjusting the product of the amount determined in (iii) for certain separately stated I.R.C. § 56A adjustments.

Prop. Reg. § 1.56A-5(e)(2) provides rules for how a CAMT entity determines its distributive share percentage. Determining a CAMT entity's distributive share percentage based on the amount of FSI it reports on its AFS with respect to its partnership the partnership's FSI for the taxable year plus the sum of any amounts reflected in the partnership's FSI that are treated as paid or accrued to the other partners for the partnership's taxable year.[330] In the case of a CAMT entity that uses any other method of accounting to account for its partnership investment, the denominator would be an amount determined under the principles

[328]. Prop. Reg. § 1.56A-5(c)(1).
[329]. Prop. Reg. § 1.56A-5(c)(2).
[330]. Prop. Reg. § 1.56A-5(e)(2)(iv).

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set forth in Prop. Reg. § 1.56A-5(e)(2)(i) and (ii) that is reasonable under the facts and circumstances and reflective of the proportionate amount of the partnership's FSI the CAMT entity is reporting for AFS purposes.[331]

It is possible for the distributive share percentage to be a negative number. This situation may arise if a partner is using the equity method to account for its partnership investment and the partnership's FSI is positive but the CAMT entity is reporting a negative FSI amount. In such cases, the negative distributive share percentage is multiplied by the partnership's modified FSI. If the distributive share percentage is negative and the partnership's modified FSI is positive, the result for the CAMT entity's share of modified FSI will be a negative amount. Similarly, if the distributive share percentage is negative and the partnership's modified FSI is negative, the result for the CAMT entity's share of modified FSI will be a positive amount. Examples under Prop. Reg. § 1.56A-5 would include illustrations on computing the distributive share percentage.[332]

The second step in the distributive share amount computation is for the partnership to determine its modified FSI. To facilitate this computation, Prop. Reg. § 1.56A-5(e)(3) would provide that a partnership starts with its FSI for its taxable year (as determined under Prop. Reg. § 1.56A-1(c)) and makes all AFSI adjustments provided for in the I.R.C. § 56A Regulations that are applicable to partnerships, with certain exceptions.

The third step in the distributive share amount computation is for the CAMT entity to multiply its distributive share percentage by the partnership's modified FSI, as reported by the partnership to the CAMT entity.[333]

The fourth and final step in the distributive share amount computation is for the CAMT entity to adjust the amount determined in the third step by certain AFSI items that are separately stated to the CAMT entity and not taken into account by the partnership in determining its modified FSI.[334] Separately stated AFSI items that adjust a CAMT entity's distributive share amount would include certain AFSI items with respect to basis adjustments under I.R.C. § 743(b) and Treas. Reg. § 1.1017-1(g)(2) attributable to I.R.C. § 168 property or qualified wireless spectrum and would be based on the CAMT entity's distributive share of the items for regular tax purposes.[335]

Also, separately stated AFSI items that adjust a CAMT entity's distributive share amount would include the CAMT entity's distributive share of deferred distribution gain or loss described in Prop. Reg. § 1.56A-20(d)(1)(ii), which would be equal to the CAMT entity's allocable share of the items as provided in Prop. Reg. § 1.56A-20(d)(2)(i), taking into account any acceleration event under Prop. Reg. § 1.56A-20(d)(1)(iii) and (d)(2)(ii).

Under Prop. Reg. §1.56A-5(e)(4)(iii), certain AFSI items would be separately stated by the partnership but would not be taken into account as adjustments to a CAMT entity's distributive share amount. Instead, these AFSI items would be taken into account by a CAMT entity in determining its AFSI. These AFSI items include items described in Prop. Reg. § 1.56A-4(c)(1)(ii) with respect to stock of foreign corporations owned by the partnership, as provided under Prop. Reg. § 1.56A-4(e); items described in Prop. Reg. §1.56A-6(c)(2)(iii) with respect to stock of foreign corporations owned by the partnership, as provided under Prop. Reg. § 1.56A-6(c)(2)(iv); items described in Prop. Reg. § 1.56A-8(c) with respect to creditable foreign tax expenditures of a partnership, as provided under Prop. Reg. § 1.56A-8(c); and the item described in Prop.

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331. Prop. Reg. § 1.56A-5(e)(2)(v).
332. Prop. Reg. § 1.56A-5(k).
333. Prop. Reg. § 1.56A-5(e)(1)(iii).
334. Prop. Reg. § 1.56A-5(e)(1)(iv) and (e)(4)(ii).
335. Prop. Reg. §§ 1.56A- 15(d)(2)(ii) and (iv) and 1.56A-16(d)(2)(ii) and (iv).

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Reg. § 1.56A-21(e)(2)(iii) with respect to discharge of indebtedness income reflected in the partnership's FSI, as provided under Prop. Reg. § 1.56A-21(e)(2)(ii).

Prop. Reg. § 1.56A-5(e)(5) would provide rules coordinating the effect of equity method basis adjustments for AFS purposes with a CAMT entity's adjustments to a partnership's modified FSI under the applicable method. If a CAMT entity includes in its FSI amortization of an equity method basis adjustment with respect to a partnership investment that is attributable to I.R.C. § 168 property or qualified wireless spectrum held by the partnership, and if the CAMT entity has a basis adjustment under I.R.C. § 743(b) with respect to the same property that affects the CAMT entity's distributive share amount, then the CAMT entity adjusts its AFSI to disregard any such FSI amortization. The rule in Prop. Reg. §1.56A-5(e)(5) is intended to remove the potential for a duplicative reduction to AFSI for an equity method basis adjustment and I.R.C. § 743(b) basis adjustment that relates to the same property.

Prop. Reg. § 1.56A-5(e)(6)(i) would provide rules for determining a CAMT entity's distributive share amount if the partnership treats as its AFS its income tax return pursuant to Prop. Reg. § 1.56A-2(c)(6). In such case, a CAMT entity's distributive share amount with respect to its partnership investment would be equal to the amount of FSI disregarded under Prop. Reg. § 1.56A-5(c)(1) of the applicable method further adjusted to disregard any items described in Prop. Reg. §§ 1.56A-4(b)(1) and 1.56A-8(b) that are reflected in such amount. Additionally, the AFSI items described in Prop. Reg. § 1.56A-5(e)(4)(iii)(A) through (C) would still apply to determine the CAMT entity partner's AFSI, but not the AFSI item described in Prop. Reg. § 1.56A-5(e)(4)(iii)(D) since the AFSI item in Prop. Reg. § 1.56A-5(e)(4)(iii)(D) is dependent on the partnership's FSI and, pursuant to Prop. Reg. § 1.56A-5(e)(6)(i), the partnership effectively does not have an FSI amount if it treats as its AFS its Federal income tax return.[336]

D. Contributions

For contributions of property by a partner to a partnership to which nonrecognition treatment under I.R.C. § 721 applies in whole, section 3 of Notice 2023-7[337] provides that any FSI resulting for AFS purposes to a partnership or a contributing partner is not taken into account in the partnership's or the partner's AFSI (partnership contribution rule). For distributions of property by a partnership to a partner to which nonrecognition treatment under I.R.C. § 731 applies in whole, section 3 of Notice 2023-7 provides that any FSI resulting for AFS purposes to a partnership or a partner to a transaction is not taken into account in the partnership's or the partner's AFSI (partnership distribution rule; together with the partnership contribution rule, the partnership covered nonrecognition rules).

Prop. Reg. § 1.56A-20(a)(2) would provide that the rules in Prop. Reg. § 1.56A-20 apply to contributions to or distributions from a partnership, but not with respect to stock of a foreign corporation except in the limited circumstance of the effect on the CAMT basis of a partnership investment for a distribution of foreign stock that is distributed in the same transaction as other property. Prop. Reg. § 1.56A-20(b) would provide a general operating rule for transactions between a CAMT entity and a partnership in which it holds an investment. This general operating rule would require each of the CAMT entity, any other partners in that partnership, and the partnership itself to include in its AFSI any income, expense, gain, or loss reflected in its FSI as a result of the transaction, except as otherwise provided in Prop. Reg. § 1.56A-20 (which would apply after the application of Prop. Reg. § 1.56A-1(c) and (d)).

The Proposed Regulations would adopt a deferred sale method for contributions of property to a partnership. More specifically, proposed Prop. Reg. § 1.56A- 20(c)(1) generally would provide that, if property (other than stock in a foreign corporation) is contributed by a CAMT entity (contributor) to a partnership in a transaction to which I.R.C. § 721(a) applies (subject to special rules in Prop. Reg. § 1.56A-

[336]. Prop. Reg. § 1.56A- 21(e)(2)(iii).
[337]. Notice 2023-7, 2023-3 IRB 390, modified by Notice 2023-64, 2023-40 IRB 974 and Notice 2024-10, 2024-3 IRB 406..

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20(e) and (f) for determining I.R.C. § 721(a) treatment), any gain or loss reflected in the contributor's FSI from the property transfer is included in the contributor's AFSI in accordance with the deferred sale approach set forth in Prop. Reg. § 1.56A-20(c)(2). The deferred sale approach would not apply to disregard any other FSI amount resulting to the contributor or the partnership from the transaction (for example, FSI gain or loss resulting from a deconsolidation or a dilution) for purposes of determining AFSI.[338]

Under Prop. Reg. § 1.56A-20(c)(2)(i), a contributor would be required to include the amount of gain or loss reflected in its FSI (deferred sale gain or loss) resulting from the contribution of the property to a partnership in a transaction described in Prop. Reg. § 1.56A-20(c)(1) (deferred sale property) in its AFSI ratably, on a monthly basis, over the applicable recovery period beginning on the first day of the month that the deferred sale property is contributed to the partnership, unless the special rule in Prop. Reg. § 1.56A-20(c)(2)(i)(E) would apply to the timing of the inclusion. If the contribution is treated as a sale for AFS purposes, the gain or loss resulting from the transaction would be redetermined by reference to the contributor's CAMT basis in the deferred sale property at the time of the contribution rather than the contributor's AFS basis in the deferred sale property.[339] For example, if the FSI resulting from the contribution is calculated for AFS purposes by subtracting the AFS basis of the deferred sale property from its fair market value, the result would be redetermined by reference to the CAMT basis of the deferred sale property rather than the contributed property's AFS basis.

The applicable recovery period for the deferred sale property would depend on the type of deferred sale property contributed to a partnership. For deferred sale property that is I.R.C. § 168 property or qualified wireless spectrum and placed in service by the contributor in a taxable year prior to the taxable year in which the property becomes deferred sale property, the applicable recovery period would be the full recovery period that was assigned to the property by the contributor in the taxable year such property was placed in service for purposes of depreciating or amortizing the property for regular tax purposes.[340] For deferred sale property that is I.R.C. § 168 property or qualified wireless spectrum and that is either placed in service and contributed to the partnership in the same taxable year it is placed in service, or is contributed and placed in service by the partnership in the same taxable year as the contribution, the applicable recovery period would be the recovery period used by the partnership to depreciate or amortize the deferred sale property for regular tax purposes.[341]

For deferred sale property subject to depreciation or amortization for AFS purposes that is not I.R.C. § 168 property or qualified wireless spectrum in the hands of the contributor or the partnership, the applicable recovery period would be the recovery period used by the partnership to depreciate or amortize the deferred sale property for AFS purposes.[342] For deferred sale property that is I.R.C. § 168 property or qualified wireless spectrum but is not subject to depreciation because it has not been placed in service before it is contributed to the partnership, but is placed in service by the partnership in the immediately subsequent taxable year and recovery period for regular tax purposes used by the partnership in the immediately subsequent taxable year, and the inclusion of the deferred sale gain or loss by the contributor would begin in the first month of that subsequent taxable year.[343] For property that is not described in proposed §1.56A-20(c)(2)(i)(B) through (E), the applicable recovery period would be 15 years.[344]

Under Prop. Reg. § 1.56A-20(c)(2)(ii), a contributor would accelerate a portion of its deferred sale gain or loss into its AFSI upon the occurrence of certain events. If a contributor's distributive share percentage in

338. Prop. Reg. § 1.56A-20(c)(1).
339. Prop. Reg. § 1.56A-20(c)(2)(i)(A).
340. Prop. Reg. § 1.56A-20(c)(2)(i)(B).
341. Prop. Reg. § 1.56A-20(c)(2)(i)(C).
342. Prop. Reg. § §1.56A-20(c)(2)(i)(D).
343. *See* Prop. Reg. § 1.56A-20(c)(2)(i)(E).
344. *See* Prop. Reg. § 1.56A-20(c)(2)(i)(F).

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the partnership decreases by more than one-third following its contribution of the deferred sale property (whether by sale or exchange, liquidation of all or a part of the contributor's interest in the partnership, dilution, deconsolidation, or otherwise), the contributor would include in its AFSI for the taxable year in which the decrease occurs an amount of the remaining deferred sale gain proportionate to the percentage change in the contributor's distributive share percentage. Any remaining deferred sale gain would continue to be included in the contributor's AFSI ratably on a monthly basis over the remaining applicable recovery period of the deferred sale property.[345] Under Prop. Reg. §1.56A-20(c)(2)(ii), a contributor's deferred sale loss would not be accelerated into its AFSI upon a decrease in its distributive share percentage unless the decrease is the result of the contributor disposing of its entire investment in the partnership. In contrast, if the partnership sells, distributes, or otherwise disposes of the deferred sale property (including by distribution to the contributor or the partnership's contribution of the deferred sale property to another CAMT entity in a recognition or nonrecognition transaction), the contributor would accelerate all of the remaining deferred sale gain or loss into its AFSI for the taxable year of the disposition.[346]

If a contribution of property to a partnership would result in I.R.C. § 721(a) not applying (and, thus, would result in the recognition of gain or loss for regular tax purposes (for example, under I.R.C., § 721(b) or (c)), then the CAMT entity would include in its AFSI in the taxable year of contribution all FSI resulting from the contribution. However, if the CAMT entity defers gain upon a contribution to which I.R.C. § 721(c) applies in accordance with the gain deferral method described in Treas. Reg. § 1.721(c)-3, then the deferred sale approach in Prop. Reg. § 1.56A-20(c)(2) would apply.

Prop. Reg. § 1.56A-20(c)(3) would provide basis rules for contributions of property. Prop. Reg. § 1.56A-20(c)(3)(i) would provide that the partnership's initial CAMT basis in contributed property would be the partnership's initial AFS basis in the contributed property at the time of contribution, regardless of whether I.R.C. § 721(a) applies, in whole or in part, to the contribution.

Prop. Reg. § 1.56A-20(c)(3)(ii) would provide that the contributor's initial CAMT basis in its partnership investment upon a contribution of property to the partnership to which I.R.C. § 721(a) applies is the contributor's AFS basis in the acquired partnership investment, decreased by any deferred sale gain or increased by any deferred sale loss that is required to be included in the contributor's AFSI in accordance with the deferred sale approach. The contributor's initial CAMT basis in the acquired partnership investment would be subsequently increased or decreased: (i) on the last day of each taxable year during the applicable recovery period by an amount equal to the deferred sale gain or loss, respectively, required to be included in AFSI in such year in accordance with the deferred sales approach (without duplication of any increases or decreases to CAMT basis described in the following clause (ii)); or (ii) immediately prior to an event causing all or a portion of the deferred sale gain to be accelerated into AFSI in accordance with Prop. Reg. § 1.56A-20(c)(2)(ii) by an amount equal to the sum of (A) the deferred sale gain that accrued during the taxable year prior to the acceleration event, and (B) the amount required to be included in AFSI under Prop. Reg. § 1.56A-20(c)(2)(ii).

E. Distributions

The Proposed Regulations would adopt a deferred distribution gain or loss approach (similar to the rules for contributions of property in Prop. Reg. § 1.56A-20(c)(2)) to the gain or loss recognized by the partnership on a distribution of property to which I.R.C. § 731(b) applies. The Proposed Regulations would not alter the AFS results to a partner using the principles of I.R.C. § 731(a) because importing I.R.C. § 731(a) into the CAMT also would require importing the carryover basis rules under I.R.C. § 732(a)(2) and (b) and, thus, the basis adjustment rules under I.R.C. § 734(b). As such, the timing or amount of any FSI resulting to a CAMT entity partner from a distribution of partnership property would not be affected by these rules, except to the

[345]. *See* Prop. Reg. § 1.56A-20(c)(2)(ii)(D).
[346]. *See* Prop. Reg. § 1.56A- 20(c)(2)(iii).

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extent of the CAMT entity's distributive share amount of any deferred distribution gain or loss resulting from the distribution.

Prop. Reg. § 1.56A-20(d)(1)(i) generally would provide that, except as provided in Prop. Reg. § 1.56A-20(f), if a partnership distributes property to a partner in a transaction to which I.R.C. § 731(b) applies, any gain or loss reflected in the partnership's FSI resulting from the distribution of property is disregarded for purposes of determining the partnership's modified FSI (as defined in Prop. Reg. § 1.56A-5(e)(3)). Instead, any such gain or loss would be included by the partners in their distributive share amounts (as defined in Prop. Reg. § 1.56A-5(e)) in accordance with the deferred distribution gain or loss approach in Prop. Reg. § 1.56A-20(d)(1)(ii) and (iii) and (d)(2). The deferred distribution gain or loss approach would not apply to disregard any other FSI amount resulting from the transaction (for example, FSI gain or loss to a partner resulting from a deconsolidation or dilution) for purposes of determining AFSI.[347]

Under Prop. Reg. § 1.56A-20(d)(1)(ii), the amount of gain or loss reflected in the partnership's FSI (deferred distribution gain or loss) resulting from the distribution of property (deferred distribution property) (i) would be allocated among the partners in proportion to their distributive share percentages for the taxable year in which the distribution occurs (as determined under Prop. Reg. § 1.56A-20(d)(2)(i)) (a partner's allocable share of deferred distribution gain or loss), and (ii) would be included by each partner in their respective distributive share amounts ratably, on a monthly basis, over the applicable recovery period for the deferred distribution property beginning on the first day of the month in which the distribution occurs.

If the distribution is treated as a sale for AFS purposes, the partnership would redetermine the amount of deferred distribution gain or loss by reference to the partnership's CAMT basis in the deferred distribution property at the time of the distribution rather than its AFS basis in the deferred distribution property.[348] For example, if the FSI resulting from the distribution is calculated for AFS purposes by subtracting the AFS basis of the deferred distribution property from its fair market value, the AFS basis would be replaced with the CAMT basis of the deferred distribution property.

The applicable recovery period for the deferred distribution property would depend on the type of property. For deferred distribution property that is I.R.C. § 168 property or qualified wireless spectrum and that was placed in service by the partnership in a taxable year prior to the taxable year in which the property becomes deferred distribution property, the applicable recovery period would be the full recovery period that was assigned to the property by the partnership in the taxable year such property was placed in service for purposes of depreciating or amortizing the property for regular tax purposes.[349] For deferred distribution property that is I.R.C. § 168 property or qualified wireless spectrum and that is either placed in service by a partnership and distributed by the partnership to a partner in the same taxable year it is placed in service, or is distributed by the partnership to a partner and placed in service by the partner in the same taxable year as the distribution, the applicable recovery period would be the recovery period used by the partner to depreciate or amortize the property for regular tax purposes.[350]

For deferred distribution property subject to depreciation or amortization for AFS purposes that is not I.R.C. § 168 property or qualified wireless spectrum, the applicable recovery period would be the recovery period for newly placed in service property that was used by the partnership to depreciate or amortize the deferred distribution property for AFS purposes.[351] For deferred distribution property that is I.R.C. § 168 property or qualified wireless spectrum that is not placed in service in the same taxable year it is distributed to the partner but is placed in service by the partner in the immediately subsequent taxable year, the applicable

347. Prop. Reg. § 1.56A- 20(d)(1)(i).
348. Prop. Reg. § 1.56A-20(d)(1)(ii)(A).
349. Prop. Reg. § 1.56A-20(d)(1)(ii)(B).
350. Prop. Reg. § 1.56A- 20(d)(1)(ii)(C).
351. Prop. Reg. § 1.56A-20(d)(1)(ii)(D).

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recovery period would be the recovery period for regular tax purposes that is used by the partner for the deferred distribution property in the immediately subsequent taxable year.[352] For deferred distribution property that is not described in Prop. Reg. § 1.56A-20(d)(1)(ii)(B) through (E), the applicable recovery period would be 15 years.[353]

Under Prop. Reg. § 1.56A-20(d)(1)(iii), a partner would accelerate the remaining amount of its allocable share of deferred distribution gain or loss into its AFSI upon the occurrence of certain events. If a partnership (i) terminates under I.R.C. § 708(b)(1) as a result of a dissolution or liquidation, (ii) sells or exchanges all or substantially all of its assets, or (iii) merges or consolidates with one or more partnerships and is not the resulting partnership for regular tax purposes (as determined under Treas. Reg. § 1.708-1(c)), then for the taxable year in which the acceleration event occurs, each partner must include in its distributive share amount the amount of the partner's allocable share (if any) of deferred distribution gain or loss that has yet to be included in its distributive share amount as of the date immediately before the acceleration event.

Similarly, if a partner disposes of its entire investment in the partnership, including through a liquidating distribution by the partnership, the partner must include in its distributive share amount for the partner's taxable year in which the disposition occurs the amount of the partner's allocable share (if any) of deferred distribution gain or loss that has yet to be included in the partner's distributive share amount as of the disposition date.[354]

If a distribution of property or money from a partnership to a partner results in any gain, loss, or other amount being reflected in the partner's FSI, that amount would be redetermined using the relevant CAMT basis, if applicable, and included in the partner's AFSI in the year of the distribution. If the relevant CAMT basis is the partner's CAMT basis in its partnership investment, Prop. Reg. § 1.56A-20(d)(2)(iii) would provide that (A) money distributed in the same transaction as property is treated as reducing CAMT basis, if applicable, prior to any distribution of property, (B) stock in a foreign corporation distributed in the same transaction is treated as reducing CAMT basis prior to any distribution of property other than stock in a foreign corporation, and (C) principles similar to Treas. Reg. § 1.731-1(a)(1)(ii) apply for purposes of calculating the effect of the distribution on the CAMT entity's AFSI.

If any partner of the distributing partnership is a partnership for Federal tax purposes, then Prop. Reg. § 1.56A-20(d)(2)(iv) would provide that the deferred distribution gain or loss included in the partner's distributive share amount under Prop. Reg. § 1.56A- 20(d)(2)(i) is included in its partners' respective distributive share amounts (whether or not the partners were partners in the partnership at the time of the distribution) in proportion to their distributive share percentages for the taxable year, as determined under Prop. Reg. § 1.56A-5(e)(2).

Prop. Reg. § 1.56A-20(d)(3)(i) would provide that a partner's initial CAMT basis of property distributed by a partnership is the partner's initial basis of the property for AFS purposes, determined immediately after the distribution. Prop. Reg. § 1.56A-20(d)(3)(ii) would provide that the CAMT basis of a partner's investment in a partnership following the partnership's distribution of property is increased or decreased (i) at the end of each taxable year during the applicable recovery period, by the amount required to be included in the partner's distributive share amount in each taxable year in accordance with Prop. Reg. § 1.56A-20(d)(1)(ii), and (ii) immediately prior to an acceleration event described in Prop. Reg. § 1.56A-20(d)(1)(iii) or (d)(2)(ii), by the amount of deferred distribution gain or loss not previously included in the partner's distributive share amount.

F. Liabilities

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[352]. Prop. Reg. § 1.56A-20(d)(1)(ii)(E).
[353]. Prop. Reg. § 1.56A-20(d)(1)(ii)(F).
[354]. Prop. Reg. § 1.56A-20(d)(2)(ii).

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Prop. Reg. § 1.56A-20(e)(1) generally would provide that the treatment of partner and partnership liabilities for purposes of determining a partner's or partnership's AFSI is based on the treatment of such liabilities for AFS purposes and not how such liabilities are treated under I.R.C. § 752.

With regard to the treatment of liabilities upon a contribution or distribution of property to or from a partnership, Prop. Reg. § 1.56A-20(e)(2) would provide that I.R.C. § 752 is inapplicable in determining the amount of gain or loss to be included in the AFSI of the partner or partnership. Accordingly, any rules relating to liabilities for regular tax purposes, such as those under Treas. Reg. §§ 1.707-5 and 1.707-6, would not apply for purposes of the CAMT. For example, if I.R.C. § 707 or I.R.C. § 752 would provide that gain or loss is not recognized for regular tax purposes upon a contribution of encumbered property, that rule would be disregarded in determining whether I.R.C. § 721(a) or 731(b) applies to a transaction for purposes of the CAMT.

G. Partial Deferral

Prop. Reg. §1.56A-20(f) would provide that, if a transfer of property by a partner to a partnership, or by a partnership to a partner, is not a nonrecognition transaction for regular tax purposes, in whole or in part, under I.R.C. § 721(a) or I.R.C. § 731(b), respectively (or would not be a nonrecognition transaction under those Code sections for regular tax purposes considering the application of Prop. Reg. § 1.56A-20(e)), then the partner or partnership, as applicable, must include an amount in its AFSI for the taxable year of the transfer. The amount to be included is an amount (if any) of the FSI reflected on the partner's or partnership's AFS resulting from the transaction that (i) bears the same ratio to the total amount of gain or loss reflected in the partner's or partnership's FSI resulting from the transaction, as (ii) the taxable gain or loss that would be recognized on the transfer without the application of I.R.C. § 752 and the exceptions in Treas. Reg. §§ 1.707-5 and 1.707-6 bears to the taxable gain or loss realized on the transfer for regular tax purposes. Any FSI resulting from the transaction must be calculated using the CAMT basis of the property and not the AFS basis of the property. Any resulting FSI that is not included in AFSI in the taxable year of the transfer under the rule described in Prop. Reg. § 1.56A-20(f) would be subject to the deferred sale approach or the deferred distribution gain or loss approach.

§ 17.06 *Loper Bright*

As should have been clear by this point in the text, partnership taxation is heavily dependent upon a number of very complex, sometimes controversial Regulations.

No discussion of a Regulation would be complete without a brief mention of the recent *Loper Bright* decision by the U.S. Supreme Court.[355] In *Loper Bright*, the U.S. Supreme Court overturned the standard of deference courts were to pay to regulations promulgated by U.S. administrative agencies as established in *Chevron U.S.A. Inc*.[356] Under *Loper Bright,* the courts must exercise independent judgment in determining the meaning of statutory provisions. According to the decision, judges need only fulfill their obligations under the U.S. Administrative Procedures Act[357] to independently identify and respect any delegations of authority, police the outer statutory boundaries of those delegations, and ensure that agencies exercise their discretion consistent with the APA. Thus, under *Loper Bright,* the courts would respect, but not defer to, the positions of U.S. administrative agencies as expressed in regulations. Where the statute expressly delegates authority to the Treasury to promulgate Regulations, there will be an additional issue as to whether the delegation is Constitutional.

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[355]. *Loper Bright Enterprises v. Raimondo*, No. 22-451, 603 U.S. ___ (June 28, 2024).
[356]. *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc*. 467 U.S. 837 (1984).
[357]. Administrative Procedure Act, 5 U.S.C. § 551, *et seq*. ("APA")

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The decision is too recent to judge its practical impact, but it seems reasonable to say at this point that all new regulations, including U.S. Treasury Regulations, are subject to challenge to the extent that they include interpretive material that goes beyond the statute.

For taxpayers whose main focus is planning with certainty, the current environment does not provide a positive atmosphere. Taxpayers are required to comply with Regulations until they are determined to be invalid.[358]

§ 17.07 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 be 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?

[358]. *See* I.R.C. § 6011(a).

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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?

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CHAPTER 18: PARTNERSHIP DEBT WORKOUTS

Add after 18.10 Abandonment or Worthlessness of Partnership Interests:

§ 18.11. QUESTIONS AND PROBLEMS

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

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

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

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

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

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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).

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