New partnership outline12:07 AM

Partnership Outline

1) Choice of law
   a) Applicability of subchapter K
      i) Unincorporated Entities with multiple members will be governed under the subchapter K regulations, unless it opts out by checking the box, or it is per se ineligible
         (1) General criteria
            (a) Must be at least two members
            (b) Must be unincorporated (or incorporated under an LLC statute)
            (c) Election out
               (i) for investment purposes and not for active conduct of a business[1]
               (ii) joint production extraction or use of property but not for selling whatever was done on the property[2]
                  1. e.g. joint venturers drilling for oil
               (iii) securities dealers who engage in joint ventures to underwrite, sell, or distribute securities[3]
         (2) must have some elements of joint venture
            (a) A **contract** (express or implied) showing that it was the intent of the parties that a business venture be established[4]
            (b) An **agreement for joint control** and proprietorship [5]
               (i) whether or not they exercise much managerial control is irrelevant[6]
            (c) A **contribution** of money, property, or services, by the venturers[7]
               (i) note: holding a non-recourse note, in which the creditor can exercise some management may convert a debtor-creditor relationship into a joint venture
               (ii) a convertible non-recourse loan might be characterized as a joint venture[8]
               (iii) note: services will not result in nonrecognition of gain when a partner contributes services in exchange for an interest in the partnership[9]
            (d) Sharing of profits (but not necessarily of losses)[10]
               (i) all parties must have a profit motive[11]

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[1] See n. 15
[2] See n. 15
[3] See n. 15
[4] Podell
[5] Podell
[6] Podell
[7] Podell
[8] 72-350: Held, in the situation described above, the so-called 'loan' is not a bona- fide debt but is, in reality, capital placed at the risk of the venture by B. Therefore, the funds advanced represents B's equity interest in the venture and the amount of the advance constitutes the basis to B for such interest. Thus, the bases of the partnership interests of the other parties under § 705 are not affected.
[9] Proposed Reg. 1.721-1(b)
[10] Podell

1. according to the 7th circuit that profit motive might not necessarily be cash[12] -- **but they need to be all working towards the same goal**

(ii) tenants in common are not *per se* joint venturers

(iii)no need to share risk of loss

(3) holding property

(a) "mere co-ownership"[13] tenants in common (must be sufficient activity to convert it into a joint venture)

(i) if the venturers hold the land together and manage it, the land is incidental to their joint venture

(ii) so, if the partners subdivide the land, there probably is sufficient activity to call it a joint venture

(b) expense sharing arrangements in an office:

1. by regulation an expense-sharing arrangement is not a separate entity for tax purposes[14]

b) Changing status

i) Changing status by election: Eligible entities may change their classification to partnership under § 761(a)[15] – and that election is good for 60 months[16]

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[11] Allison

[12] Madison

[13] 301.7701-1(a)(2): (2) Certain joint undertakings give rise to entities for federal tax purposes. A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes. Similarly, mere co- ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes.

[14] See n. 13

[15] § 761(a): Partnership. For purposes of this subtitle, the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate. Under regulations the Secretary may, at the election of all the members of an unincorporated organization, exclude such organization from the application of all or part of this subchapter, if it is availed of—

(1) for investment purposes only and not for the active conduct of a business,

(2) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted, or

(3) by dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities,

[16] 301.7701-3(c)(1)(iv): (iv) Limitation. If an eligible entity makes an election under paragraph (c)(1)(i) of this section to change its classification (other than an election made by an existing entity to change its classification as of the effective date of this section), the entity cannot change its classification by election again during the sixty months succeeding the effective date of the election. However, the Commissioner may permit the entity to change its classification by election within the sixty months if more than fifty percent of the ownership interests in the entity as of the effective date of the subsequent election are owned by persons that did not own any interests in the entity on the

(1) Service can waive the 60 month requirement if ½ of the people were not there
(2) If there is an election to be treated as a partnership, the parties are treated as having formed a newly formed partnership and contributing their money to it
(3) Up to 75 days before, or 12 months after election is filed, signed by either member of the electing entity). Exception: can make other election if 50% of the ownership interests were not owned when election was made

ii) Automatic changes

(1) Changes in form

§ 301.7701-3(g)	Old	New	effect
(i)	**Partnership**	**Association (corporation)**	The partnership contributes all of its assets and liabilities to the association in exchange for stock in the association, and immediately thereafter, the partnership liquidates by distributing the stock of the association to its partners
(ii)	**Association**	**partnership**	The association distributes all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership.
(iii)	**Association**	**disregarded entity**	The association distributes all of its assets and liabilities to its single owner in liquidation of the association.
(iv)	Disregarded entity	association	The owner of the eligible entity contributes all of the assets and liabilities of the entity to the association in exchange for stock of the association.

(2) Changes in number of members : in the number of members will generally not have an impact upon classification, unless the number of members is reduced to one[17]

filing date or on the effective date of the entity's prior election. An election by a newly formed eligible entity that is effective on the date of formation is not considered a change for purposes of this paragraph (c)(1)(iv).

[17] 301.7701-3(f)(2): (2) Partnerships and single member entities. An eligible entity classified as a partnership becomes disregarded as an entity separate from its owner when the entity's membership is reduced to one member. A single member entity disregarded as an entity separate from its owner is classified as a partnership when the entity has more than one member. If an elective classification change under paragraph (c) of this section is effective at the same time as a membership change described in this paragraph (f)(2), the deemed transactions in paragraph (g) of this section resulting from the elective change preempt the transactions that would result from the change in membership.

Entity type	Characteristics and tax profile
Joint ventures	Must be profit-sharing But can't be just expense sharing[18]
Subchapter C corporations	*Per se* not eligible, because subchapter C entities because owners are not liable for debts[19] • There is a list of *per se* foreign corporations (otherwise they are eligible entities which can elect) • Look to see whether the foreign eligibility entity with one member should be treated as a corporation if it has limited liability or disregarded if there is no limited liability • Look to see if a foreign eligible entity with more than one member should be treated as a corporation or not
LLCs	With more than one member who do not elect to be taxed as a corporation • All members not liable for the entity's debts and obligations • LLC members may participate in management and not forfeit liability
LLP and RLLP	Can be taxed under subchapter K • Members are not liable for certain kinds of partnership debts • Members not liable for things done by individual partners (e.g. negligence) • Usually not liable for contribution
LP	To be eligible to be treated as a partnership, **must have at least on GP** that is **responsible** for the debts • Limited partners are similar to shareholders – they can't directly manage the businesses affairs • Limited partners can't bind the partnership
Partnerships	default position is that entities organized under state tax rules are taxed as partnerships • must be profit sharing (but not necessarily expense sharing by all partners) • need not be in writing, unless they wish to avail themselves of safe harbors for substantial economic effect
Publicaly traded partnerships	deemed by statute to be corporations[20]

[18] See n. 13

[19] § 7701(a)**(3) Corporation.--**The term "corporation" includes associations, joint-stock companies, and insurance companies.

[20] § 7704: (a) General rule. For purposes of this title, except as provided in subsection (c), a publicly traded partnership shall be treated as a corporation.

(b) Publicly traded partnership. For purposes of this section, the term "publicly traded partnership" means any partnership if—

1. interests in such partnership are traded on an established securities market, or

real estate investment company	*Per se* ineligible
S corporations	**Can elect S-corporation status at inception or convert later** • Income, deductions, gains, and losses are not subject to taxation at the corporation level – pass though to the shareholders who report. • Limited to 75 shareholders – all US citizens
Trusts	Ordinary trusts: created to take title to protect property for beneficiaries – under subchapter J[21] Business trusts: to carry on a business for profit – can be taxed under subchapter J[22] (substance over form) Investment trusts are not trusts
Unincorporated co-ownership	These are not taxed as partnerships, and each member can make their own elections for everything! Different tax year, etc.

2. interests in such partnership are readily tradable on a secondary market (or the substantial equivalent thereof).

[21] 301.7704-4(a): Ordinary trusts. In general, the term "trust" as used in the Internal Revenue Code refers to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. Usually the beneficiaries of such a trust do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. However, the beneficiaries of such a trust may be the persons who create it and it will be recognized as a trust under the Internal Revenue Code if it was created for the purpose of protecting or conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them. Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it **can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit**.

[22] 301.7701(b): Business trusts. There are other arrangements which are known as trusts because the legal title to property is conveyed to trustees for the benefit of beneficiaries, but which are not classified as trusts for purposes of the Internal Revenue Code because they are not simply arrangements to protect or conserve the property for the beneficiaries. These trusts, which are often known as business or commercial trusts, generally are created by the beneficiaries simply as a device to carry on a profit-making business which normally would have been carried on through business organizations that are classified as corporations or partnerships under the Internal Revenue Code. However, the fact that the corpus of the trust is not supplied by the beneficiaries is not sufficient reason in itself for classifying the arrangement as an ordinary trust rather than as an association or partnership. **The fact that any organization is technically cast in the trust form, by conveying title to property to trustees for the benefit of persons designated as beneficiaries, will not change the real character of the organization if the organization is more properly classified as a business entity under** § 301.7701- 2.

2) Contributions: protected by § 721(a)[23] – no gain or loss recognized on **contributions** (not purchase of an interest from a partner) of **property** to a partnership in exchange for an interest. Exception: contributions to investment company will result in recognition of gain.
   a) Anything that results in the transfer of property back to the contributing partner will be treated as gain from the sale or exchange of property.
   b) To get protection of § 721 – there is no control requirement as in Sec. 351
      i) Defining property
         (1) Things that are property
            (a) Money
            (b) Goodwill
            (c) Accounts payable, receivable, patents, knowledge, etc.
         (2) Things that are not property
            (a) Not promissory notes,[24] but it is an open question as to whether promissory notes are even relevant for PIP standards. These are generally treated as a sale or exchange.
               (i) Notes tradable on an exchange are contributions of property
               (ii) Sold by the partnership
               (iii)Principle payments made[25]
            (b) Not services[26]: compensation for services rendered is not deductible by partnership, and causes a realization under § 61

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[23] 721(a): No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

[24] 1.721-1(a): … Thus, if the transfer of property by the partner to the partnership results in the receipt by the partner of money or other consideration, including a promissory obligation fixed in amount and time for payment, the **transaction will be treated as a sale or exchange under section 707 rather than as a contribution under section 721**. For the rules governing the treatment of liabilities to which contributed property is subject, see section 752 and § 1.752-1.

[25] 1.704-1(b)(2)(iv)(d)(2): … if a promissory note is distributed to a partner by a partnership that is the maker of such note, such partner's capital account will be decreased with respect to such note only when there is a taxable disposition of such note by the partner or when the partnership makes principal payments on the note. The previous sentence shall not apply if a note distributed to a partner by a partnership who is the maker of such note is readily tradable on an established securities market. Furthermore, the capital account of a partner whose interest in a partnership is liquidated will be reduced to the extent of (i) the fair market value, at the time of distribution, of any negotiable promissory note (of which such partnership is the maker) that such partnership distributes to the partner on or after the date such partner's interest is liquidated and within the time specified in paragraph (b)(2)(ii)(b)(2) of this section, and (ii) the fair market value, at the time of liquidation, of the unsatisfied portion of any negotiable promissory note (of which such partnership is the maker) that such partnership previously distributed to the partner. For purposes of the preceding sentence, the fair market value of a note will be no less than the outstanding principal balance of such note, provided that such note bears interest at a rate no less than the applicable federal rate at time of valuation.

[26] 1.721-1(b): Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) whether made at the formation of the partnership or subsequent thereto. To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an

ii) Defining contribution
(1) Can't be a purchase of an interest from a partner
(2) General rule: cannot be partial interest
(3) Court of Claims says that is possible for a partner to contribute a license of intellectual property[27]
c) Results of protection of § 721
i) No recognition of gain
(1) no recapture necessary under § 1231
(2) No recognition of gain on installment notes (overrides 453B(a))[28]
ii) Holding periods
(1) Capital assets or § 1231 assets: carry over to the partnership[29]
(2) Cash or ordinary assets: new holding period on date of exchange
(a) This means that most accounts receivable will not count
(3) Mix of assets: holding period in partnership interest is fragmented in proportion to the fair market value of the interest received[30] (recapture gain under § 1231 is treated separately
(a) Holding period of X% of the: **partnership interest = fair market value of the item with that holding period / value of the hold interest**
iii) Character in the hands of the partnership of contributed property
(1) unrealized receivables: is defined as rights to payment: **always ordinary**[31]

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interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61. The amount of such income is the fair market value of the interest in capital so transferred, either at the time the transfer is made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services. The time when such income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of such interest. To the extent that an interest in capital representing compensation for services rendered by the decedent prior to his death is transferred after his death to the decedent's successor in interest, the fair market value of such interest is income in respect of a decedent under section 691.

(2) To the extent that the value of such interest is: (i) Compensation for services rendered to the partnership, it is a guaranteed payment for services under section 707

[27] Dupont

[28] 1.721-1(a)(first sentence): (a) No gain or loss shall be recognized either to the partnership or to any of its partners upon a contribution of property, including installment obligations, to the partnership in exchange for a partnership interest.

[29] 1223(2): (2) In determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held by any other person, if under this chapter such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

[30] 1.1223-3(a)(2),(b)(1): (b) The holding period of property in the hands of a taxpayer shall include the period during which the property was held by any other person, if such property has the same basis in whole or in part in the hands of the taxpayer for determining gain or loss from a sale or exchange as it would have in the hands of such other person. For example, the period for which property acquired by gift after December 31, 1920, was held by the donor must be included in determining the period for which the property was held by the taxpayer if, under the provisions of section 1015, such property has, for the purpose of determining gain or loss from the sale or exchange, the same basis in the hands of the taxpayer as it would have in the hands of the donor.

(2) inventory items: any inventory or something that would not be a capital item in the hands of the partner: **will be tainted under 724(b)** as ordinary up to five years after the contribution to the partnership[32]
   (a) a like-kind exchange will not remove the taint (substituted basis)
(3) capital loss property:[33]
   (a) any capital asset held by contributing partners that had an adjusted basis in excess of its fair market value before it was contributed – built in loss will retain character for give years afterwards[34]
   (b) a like-kind exchange will not remove the taint (substituted basis)

iv) bases
   (1) Outside basis: Partner's basis: contributing partner takes a basis in partnership interest of ∑ adjusted basis in property contributed cash contributed
      (a) If any boot is recognized, the basis is increased
      (b) This means that a partner can't avoid recognition by selling his partnership interest before the partnership disposes of the property
   (2) Inside basis: **The term "inside basis" means tax basis of the property held by the partnership, and the term "outside basis" means a partner's basis in her partnership interest in the partnership**

v) Contributions of encumbered property (follow three step process and recharacterize as a cash transaction): **basis of contributing partner's interest is adjusted basis of such property at the time of contribution increased by amount of gain recognized**
   (1) to contributing partner
      (a) basis of contributing partner's interest is adjusted basis of such property at the time of contribution increased by amount of gain

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[31] 724(a): (a) Contributions of unrealized receivables.--In the case of any property which--
(1) was contributed to the partnership by a partner, and
(2) was an unrealized receivable in the hands of such partner immediately before such contribution, any gain or loss recognized by the partnership on the disposition of such property shall be treated as ordinary income or ordinary loss, as the case may be

[32] 724(b) Contributions of inventory items.--In the case of any property which--
(1) was contributed to the partnership by a partner, and
(2) was an inventory item in the hands of such partner immediately before such contribution, any gain or loss recognized by the partnership on the disposition of such property during the 5-year period beginning on the date of such contribution shall be treated as ordinary income or ordinary loss, as the case may be.

[33] 724(c): (c) Contributions of capital loss property.--In the case of any property which--
(1) was contributed by a partner to the partnership, and
(2) was a capital asset in the hands of such partner immediately before such contribution,
any loss recognized by the partnership on the disposition of such property during the 5-year period beginning on the date of such contribution shall be treated as a loss from the sale of a capital asset to the extent that, immediately before such contribution, the **adjusted basis of such property in the hands of the partner exceeded the fair market value of such property.**

[34] 723; The basis of property contributed to a partnership by a partner shall be the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under section 721(b) to the contributing partner at such time.

recognized[35] **--** this ensures that the contributing partner may not avoid recognition by selling his interest before the partnership disposes of the property

(b) to the extent that a contributing partner is relieved of liability he is treated as having received a distribution from the partnership

(c) if there is boot it is immediately recognized, and then the basis is increased

(2) distributions of property will reduce the outside basis of the contributing partner – but not below zero[36]

(3) to other partners: other partner's basis are increased

(a) recourse

(i) normally (when liabilities are less than basis):

1. reduce cotrnibuting partner's basis by share of debt relieved (remember, if he ends still being subject to part of the debt, this amount will not reduce his basis)
2. increases other partner's share by their share of debt relieved

(ii) under water (liabilities more than adjusted basis)

1. if there is a negative basis that amount is treated as an immediate gain[37] -- that is treated as a distribution from the partnership

(b) nonrecourse

(i) normal: basis greater than encumberances: partners can allocate so long as the allocation has substantial economic effect (come back to)

(ii) under water: before the flexible non-recourse rule can be applied, the partner must first be allocated his portion of the gain if the property were sold at the time of contribution for an amount equal to the liabilitybefore the flexible non-recourse rule can be applied, the partner must first be allocated his portion of the gain if the property were sold at the time of contribution for an amount equal to the liability

(iii)if a partnership has non-recourse liabilities, these are allocated between the partners in accordance with each partner's share in

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[35] 722: The basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under section 721(b) to the contributing partner at such time.

[36] 731, 733

733: In the case of a distribution by a partnership to a partner other than in liquidation of a partner's interest, the adjusted basis to such partner of his interest in the partnership shall be reduced (but not below zero) by--

(1) the amount of any money distributed to such partner, and

(2) the amount of the basis to such partner of distributed property other than money, as determined under section 732.

[37] 731(a)(1): gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution, and

partnership PROFITS[38] (cash contributed + share of non-recourse debt), unless there is a special allocation

Accounting cheat-sheet

Assets	Partnership's Adjusted Basis	Book Value (historical cost to last buyer)[39]
Cash	For cash, AB=BV +proceeds from debt	
Securities		
Property	Fair market value at time	

Capital Accounts		
	AB	Book value
Parntership's debt		+debt
Partner		
A	+personal liability on debt + money or property contributed to partnership (using fair market value, not basis, unlike outside basis) fair market value will be respected if the parties have adverse interests, and it appears to be an arms-length transaction + allocations of partner of income or gain (including tax-exempt income)	

[38] 1.752-3(a): (a) In general. A partner's share of the nonrecourse liabilities of a partnership equals the sum of paragraphs (a)(1) through (a)(3) of this section as follows--

(1) The partner's share of partnership minimum gain determined in accordance with the rules of section 704(b) and the regulations thereunder;

(2) The amount of any taxable gain that would be allocated to the partner under section 704(c) (or in the same manner as section 704(c) in connection with a revaluation of partnership property) if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities and for no other consideration; and

(3) The partner's share of the excess nonrecourse liabilities (those not allocated under paragraphs (a)(1) and (a)(2) of this section) of the partnership as determined in accordance with the partner's share of partnership profits. The partner's interest in partnership profits is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners. The partnership agreement may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities provided the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain. Alternatively, excess nonrecourse liabilities may be allocated among the partners in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated. Additionally, the partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on section 704(c) property (as defined under § 1.704- 3(a)(3)(ii)) or property for which reverse section 704(c) allocations are applicable (as described in § 1.704-3(a)(6)(i)) where such property is subject to the nonrecourse liability to the extent that such built-in gain exceeds the gain described in paragraph (a)(2) of this section with respect to such property. This additional method does not apply for purposes of § 1.707- 5(a)(2)(ii). To the extent that a partnership uses this additional method and the entire amount of the excess nonrecourse liability is not allocated to the contributing partner, the partnership must allocate the remaining amount of the excess nonrecourse liability under one of the other methods in this paragraph (a)(3). Excess nonrecourse liabilities are not required to be allocated under the same method each year.

[39] The term "book value" in the partnership context is commonly understood to mean a value of property determined at the time of contribution of the property

				–distributions to partners of money or property – allocations which are not properly charagable to a capital account	
			B		
			N		

- d) partnerships borrowing money:
  - i) treated as if the partners 1) borrowed the money themselves and 2) contributed it to the partnership, thereby 3) increasing their basis in the partnership[40]
- e) General rules for economic effect of **special allocations**
  - i) General rule: if the the allocation is nonetheless respected if it is in accordance with partnership interest, it will be respected
    - (1) Checklist
      - (a) Economic effect
        - (i) Capital account
        - (ii) Distribution on liquidation
        - (iii)DRO/Alternate test (QIO)
      - (b) Substantial: shifting or transitory
  - ii) Safe harbors
    - (1) Two part test for substantial economic effect
      - (a) **Part I: economic effect:** in general, the economic benefit or burden corresponding to an allocation must be born by the partner receiving the allocation[41] -- there are three possible tests for economic effect (basic, alternate, and economic equivalence test)
        - (i) basic: look to written or oral partnership agreement[42]
          - 1. **capital accounts** are properly maintained in accordance with regulations
            - a. + money or property contributed to partnership (using fair market value, not basis, unlike outside basis)
              - i. fair market value will be respected if the parties have adverse interests, and it appears to be an arms-length transaction
            - b. + allocations of partner of income or gain (including tax-exempt income)
            - c. – distributions to partners of money or property
            - d. – allocations which are not properly charagable to a capital account

[40] 752(a): (a) Increase in partner's liabilities.--Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

[41] 1.704-1(b)(2)(ii)(A): (ii) Economic effect--(a) Fundamental principles. In order for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. This means that in the event 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.

[42] 1.704-1(b)(2)(ii)(H)

2. on **liquidation**, the partnership agreement specifies that distributions will be made in accordance with the positive account balances of the partners
3. **deficit restoration**: if a partner has a deficit capital account balance after all adjustments for the year, he has to restore the deficit by the end of the partnership taxable year in order to pay partnership creditors
   a. promissory notes, which might not be treated as property will constitute a partial deficit restoration obligation to the extent that they are outstanding [43]
   b. but a promisorry note that isn't paid on will trigger a basis limitation issue

(ii) alternate test for economic effect (often used for limited partnerships because they don't want to have to restore deficit balances -- usually used for LLCs
1. **capital accounts** are properly maintained in accordance with regulations see above
2. on **liquidation**, the partnership agreement specifies that distributions will be made in accordance with the positive account balances of the partners
3. **allocation will be respected to the extend that it doesn't cause a deficit in the capital account** based on what is "reasonably expected" – the balance is allocated according to the parties interests[44]
   a. allocations of recourse debt: partner's share of minimum gain is an increase in the obligation to restore a deficit[45]d
   b. dealing with events
      i. must take into account events that are reasonably expected: must take into account **reasonably expected** events
      ii. distributions at the end of the year must be taken into account in the agreement in order to have their allocation respected
      iii. this means that the agreement must specify that things that are almost certain to occur will not cause a capital account deficit
      iv. borrowing money, secured by partnership property, and distributing it to the partners will be reasonably expected (and result in a reduction of capital accounts)[46]

[43] 1.704-1(b)(2)(ii)(c)(1)
[44] 1.704-1(b)(2)(ii)(C)
[45] 1.704-2(g)(1)
[46] 1.704-1(b)(2)(ii)(d)(6)

v. in determining what distributions are expected, value will be presumed to equal basis[47]
vi. e.g. since there is a presumption of value equaling basis, any "what-if" scenario in which value does not equal basis will be not reasonably expected, and therefore the allocation will be respected
vii. surprise events: must have **Qualified Income Offsets** language in the partnership agreement: if there is a deficit capital account balance as a result of one of these (check this) events, partner will be allocated items of income or gain in an amount that will eliminate the deficit[48]

c. **event that a basis is reduced below zero (deficit), because of depreciation and a limited partner is**

[47] 1.704-1(b)(2)(ii)(d)(6)

[48] 1.704-1(b)(2)(ii)(D) **qualified income offsets**

(3) The partnership agreement contains a "qualified income offset," such allocation will be considered to have economic effect under this paragraph (b)(2)(ii)(d) to the extent such allocation does not cause or increase a deficit balance in such partner's capital account (in excess of any limited dollar amount of such deficit balance that such partner is obligated to restore) as of the end of the partnership taxable year to which such allocation relates. In determining the extent to which the previous sentence is satisfied, such partner's capital account also shall be reduced for –

(4) Adjustments that, as of the end of such year, reasonably are expected to be made to such partner's capital account under paragraph (b)(2)(iv)(k) of this section for depletion allowances with respect to oil and gas properties of the partnership, and

(5) Allocations of loss and deduction that, as of the end of such year, reasonably are expected to be made to such partner pursuant to section 704(e)(2), section 706(d), and paragraph (b)(2)(ii) of § 751-1, and

(6) Distributions that, as of the end of such year, reasonably are expected to be made to such partner to the exent they exceed offsetting increases to such partner's capital account that reasonably are expected to occur during (or prior to) the partnership taxable years in which such distributions reasonably are expected to be made (other than increases pursuant to a minimum gain chargeback under paragraph (b)(4)(iv)(e) of this section or under § 1.704-2(f); however, increases to a partner's capital account pursuant to a minimum gain chargeback requirement are taken into account as an offset to distributions of nonrecourse liability proceeds that are reasonably expected to be made and that are allocable to an increase in partnership minimum gain).

For purposes of determining the amount of expected distributions and expected capital account increases described in (6) above, the rule set out in paragraph (b)(2)(iii)(c) of this section concerning the presumed value of partnership property shall apply. The 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. Allocations of items of income and gain made pursuant to the immediately preceding sentence shall be deemed to be made in accordance with the partners' interests in the partnership if requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied. See examples (1)(iii), (iv), (v), (vi), (viii), (ix), and (x), (15), and (16)(ii) of paragraph (b)(5) of this section.

unwilling to contribute any more money, the gain will be allocated by the partner's interst in the property

i. **manner in which distributions would be made if property were sold at book value after the partnership**
ii. **manner in which distributions would be made if all partnership proper were sold at book value**

d. may take into account a promissory note issued by the parties

(iii)economic effect equivalence

1. will respect allocations if at the end of the taxable year, they would produce the same results as the economic effects test[49]

(b) part II: substantial[50]: the allocation will reasonably cause a change in the dollar amount received by a partner (other than tax consequences)[51]

(i) defining substantiality

1. in general: one partner would benefit (in present value terms) more than if the provision were not in the partnership agreement **and NO** partner would suffer (in present value terms) if it were not in the partnership agreement
2. specific cases of insubsubtantiality
   a. shifting allocations are not substantial
      i. if when the partnership agreement was written, there was a strong likelihood that the total **increases and decreases in capital accounts** would not differ **and the tax liability would be reduced** if the provisions were not added to the agreement [52]
      ii. e.g. an agreement that an exempt part would get 50% of the profits, but would have the same capital account[53]
      iii. but, if they could be predicted, it would appear that there is no real economic effect[54]
      iv. presumption: if at the end of the year this is so, then the allocation is presumed to be shifting
      v. "flip-flop" shifts that shift with time (e.g. when all of the deductions are used up). According to the Court of claims in *Hamilton* (under the old regs), these were considered to have substantial economic effect. – but under the new regs. These might be considrerd to be "transitory"

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[49] 1.704-1(b)(2)(ii)(I)
[50] 1.704-1(b)(2)(i)
[51] 1.704-1(b)(2)(iii)(a)
[52] 1.704-1(b)(2)(iii)(b)
[53] 1.704-1(b)(5)
[54] 1.704-1(b)(5), ex. 7(i)

vi. **safe harbor for cost recovery**: adjusted basis of property is assumed to be its fair market value.[55] As a result, it is presumed that any gain on disposition was unlikely, therefore any "gain chargeback" provisions do have substantial effect (so, any depreciation that is allocated to one partner, and then charged back on disposition is considered to be valid)

vii. this means that it is possible to allocate all of the cost recovery to one partner, so long as their capital accounts are reduced[56]

b. transitory allocations: same as shifting allocations, but if the benefit form the allocation doesn't occur within five years, the presumption evaporates, and the allocations will not be considered to be substantial[57]

i. safe harbor for cost recovery: adjusted basis of property is assumed to be its fair market value.[58] As a result, it is presumed that any gain on disposition was unlikely, therefore any "gain chargeback" provisions do have substantial effect

ii. "flip-flop" shifts that shift with time (e.g. when all of the deductions are used up). According to the Court of claims in *Hamilton* (under the old regs), these were considered to have substantial economic effect. – but under the new regs. These might be considrerd to be "transitory"

3. specific cases of substantiality

a. gain chargeback provisions: it is considered to be substantial to have a provision that provides that any gain on disposition is allocated to the capital account of a partner who was previously allocated a depreciation deduction (provided that the accounts are properly maintained)[59] -- this is because the "**value equals basis**" presumption assumes that any deductions allocated due to depreciation to one parter (in the partnership agreement) are due to a decline in value in the property, and in the event that any more is realized than the adjusted basis of the property upon disposition, it is proper to allocate it back to the partner who took the deductions due to their decrease in basis

) **Allocation rules for gain realized from contributed property upon the partnership's disposition of it**: income, gain, and loss with respect to

04-1(b)(2)(ii)(C)
04-1(b)(2)(ii)(b)
04-1(b)(2)(iii)(C)
04-1(b)(2)(ii)(C)
04-1(b)(2)(iii)(c), 1.704-1(b)(5) ex 1(vi), (xi)

contributed property that has a book value (commonly understood to mean a value of property determined at the time of contribution of the property) that is different from the adjusted basis of the contributing partner (a.k.a. § 704(c) property or property with built-in gain that is subject to mandatory allocation rules) should first be allocated to the partner from which it came[60]

i) Defining § 704(c) Property
   (1) it has built-in gain or loss at the time of contribution. Property has built-in gain or loss at the time of contribution if the contributing partner's tax basis in the property at the time of contribution is more or less than its fair market value.
   (2) Property that has a tax basis that is equal to its book value at the time of contribution is not section 704(c) property, regardless of whether the property subsequently appreciates.
ii) If the property is 704(c) property, its allocation must pass three hurdles: 1) the ceiling rule, or an exception; 2) substantial economic effect; 3) at risk rules; [61] passive activity loss rules[62]; 4) partnership basis rules;[63] 5) "more accurately reflect rules"
iii) **Allocations of precontribution gain** are presumed to be without substantial economic effect. They will be disregarded. Instead the portion of the gain allocable to the contributing partner will be first allocated to him. Any remainder will be split up between the parties.
iv) Limits: *Various allocation methods circumvent the ceiling rule by allowing the partnership to borrow similar deductions from other partnership property (curative allocations) or by allowing the partnership to create otherwise nonexistent tax items for the sole purpose of equalizing book and tax capital accounts (remedial method allocations).*
   (1) Traditional Method with ceiling rule: General rule is the "**ceiling rule**" total gain allocated, loss, or deduction to a partner with respect to property with built in gain may not be greater than the total partnership income, gain, loss or deduction with regard to that property.[64]
      (a) This will apply when ***Adjusted basis < Selling price < book value***

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[60] 704(c)(1)(A): income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution, and

[61] 465

[62] 469

[63] 704(d): Limitation on allowance of losses.--A partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred. Any excess of such loss over such basis shall be allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership.

[64] 1.704-3(b)(1) … the total income, gain, loss, or deduction allocated to the partners for a taxable year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the taxable year (the ceiling rule). If a partnership has no property the allocations from which are limited by the ceiling rule, the traditional method is reasonable when used for all contributed property.

(2) **Traditional method with curative allocations** (to get around ceiling rule): allocations of tax items that are actually realized may be allocated to account for ceiling rule distortions[65]
   (a) Purpose: if a partner has built in gain or loss on a property, and the partnership disposes of the property, the amount that that partner realizes is limited to the amount that any other partner realizes. This method gets around this problem.
   (b) Requirements to be reasonable
      (i) Must be made with respect to property with *similar character*
      (ii) Cannot exceed the amount necessary to avoid the effect of the ceiling rule[66]
      (iii) Must be either in the same taxable year, or a prior taxable year if 1) within a reasonable amount of time; and 2) they were authorized by the partnership agreement in effect for that year[67]
      (iv) Must be made with respect to other property of similar character[68]
      (v) Can't be larger than what would be produced by the ceiling rule
   (c) Procedure
      (i) Not reflected in capital accounts, because there is no economic effect
      (ii) If the partnership later disposes of property with similar character, some of the gain can be reallocated to the partner that lost out due to the ceiling rule
(3) **Remedial method**: (when not enough tax items are available under the curative method)
   (a) The remedial method eliminates the ceiling rule distortions by creating fictional tax items that exactly offset the deficiency created by the ceiling rule both in amount and in character.[69]

[65] 1.704-3(c)(3)(ii): Built-in gain and built-in loss. The built-in gain on section 704(c) property is the excess of the property's book value over the contributing partner's adjusted tax basis upon contribution. The built-in gain is thereafter reduced by decreases in the difference between the property's book value and adjusted tax basis. The built-in loss on section 704(c) property is the excess of the contributing partner's adjusted tax basis over the property's book value upon contribution. The built-in loss is thereafter reduced by decreases in the difference between the property's adjusted tax basis and book value.

[66] 1.704-3(c)(3)(i): A curative allocation is not reasonable to the extent it exceeds the amount necessary to offset the effect of the ceiling rule for the current taxable year or, in the case of a curative allocation upon disposition of the property, for prior taxable years.

[67] 1.704-3(c)(3)(ii) Timing. The period of time over which the curative allocations are made is a factor in determining whether the allocations are reasonable. Notwithstanding paragraph (c)(3)(i) of this section, a partnership may make curative allocations in a taxable year to offset the effect of the ceiling rule for a prior taxable year if those allocations are made over a reasonable period of time, such as over the property's economic life, and are provided for under the partnership agreement in effect for the year of contribution..

[68] 1.704-3(c)(3)(ii)… curative allocation of income from another statutory grouping to the contributing partner generally is not reasonable, although a curative allocation of income from the same statutory grouping and of the same character is reasonable.

[69] 1.704-3(d)(1): A partnership may adopt the remedial allocation method described in this paragraph to eliminate distortions caused by the ceiling rule. A partnership adopting the remedial allocation method eliminates those distortions by creating remedial items and allocating those items to its partners. Under the remedial allocation method, the partnership first determines the amount of

(b) Requirements: Cannot change a partner's tax liability from that which the ceiling rule created[70]

(c) Procedure

(i) No effect on capital accounts

(4) If neither the traditional or remedial method works, the traditional method with the ceiling method is mandatory.

g) Allocation of depreciations of property that is held by the partnership: A corollary to the allocation of precontribution gain or loss is a rule that requires a **noncontributing partner to have a priority in depreciation claims over the claims of the contributing partner** - to force the contributing partner to recognize the precontribution gain as soon as possible.

i) Requirement: book and tax depreciation must be calculated using the same method[71]

ii) Traditional method of allocating depreciation

(1) Allocate deprecation to noncontributing partner in an amount equal to his share of book depreciation (e.g. value that property was contributed to the partnership * share of property * noncontributing partner's share)

(a) Book depreciation = depreciable % per year * fair market value at contribution[72]

(b) Tax depreciation = depreciable % per year * adjusted basis of property when the contributor held it[73]

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book items under paragraph (d)(2) of this section and the partners' distributive shares of these items under section 704(b). The partnership then allocates the corresponding tax items recognized by the partnership, if any, using the traditional method described in paragraph (b)(1) of this section. If the ceiling rule (as defined in paragraph (b)(1) of this section) causes the book allocation of an item to a noncontributing partner to differ from the tax allocation of the same item to the noncontributing partner, the partnership creates a remedial item of income, gain, loss, or deduction equal to the full amount of the difference and allocates it to the noncontributing partner. The partnership simultaneously creates an offsetting remedial item in an identical amount and allocates it to the contributing partner.

[70] 1.704T-3T(d)(3)

[71] 1.704-1(b)(2)(iv)(g)(3)

[72] 1.704-3(b)(1): --(1) In general. This paragraph (b) describes the traditional method of making section 704(c) allocations. In general, the traditional method requires that when the partnership has income, gain, loss, or deduction attributable to section 704(c) property, it must make appropriate allocations to the partners to avoid shifting the tax consequences of the built-in gain or loss. Under this rule, if the partnership sells section 704(c) property and recognizes gain or loss, built-in gain or loss on the property is allocated to the contributing partner. If the partnership sells a portion of, or an interest in, section 704(c) property, a proportionate part of the built-in gain or loss is allocated to the contributing partner. For section 704(c) property subject to amortization, depletion, depreciation, or other cost recovery, the allocation of deductions attributable to these items takes into account built-in gain or loss on the property. For example, tax allocations to the noncontributing partners of cost recovery deductions with respect to section 704(c) property generally must, to the extent possible, equal book allocations to those partners. However, the total income, gain, loss, or deduction allocated to the partners for a taxable year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the taxable year (the ceiling rule). If a partnership has no property the allocations from which are limited by the ceiling rule, the traditional method is reasonable when used for all contributed property.

[73] 1.704-3(b)(1)

(c) Noncontributing partners get deprecation equal to their share of book depreciation
(d) Ceiling rule: The ceiling limitation rule is the maximum amount of income, gain, deduction, or loss that can be taken into account by the partnership
(i) calculate how much depreciation contributing partner is entitled to based on his adjusted basis
(ii) calculate how much non-contributing partners are entitled to based on the book value of the property at the time of contribution – this is the ceiling
(iii)allocate depreciation, first to noncontributing partners – but only up to the amount of the tax depreciation (a.k.a. the depreciation that the contributing partner would be entitled to)

(2) traditional method with curative allocations of reallocating depreciation: The curative method looks to any other tax items of the partnership that differ from the allocation of corresponding book items to close the gap between the book value and tax basis of contributed property
(a) if the ceiling rule limits depreciation (causes a noncontributing partner to be allocated less tax depreciation than book deprecation), the partnership can allocate tax depreciation from another item of partnership property to make up the difference

(3) remedial method of allocating dereciation –eliminates the ceiling rule distortions by creating fictional tax items that exactly offset the deficiency created by the ceiling rule both in amount and in character
(a) The noncontributing partner's basis for depreciation is bifurcated between a portion that relates to the carryover basis to the extent of the ceiling rule, and the portion that represents the excess over the ceiling rule, which is considered the "purchased" amount
(b) if the agreement provides for it, depreication will be
(i) book depreciation as to whatever the book value is
(ii) tax depreciation as to the excess of tax over book – but starting anew (there is a new recovery period)[74]

3) Rules regarding the **contribution of services** in exchange for a partnership interest. Unlike contributions of cash or property, they are not protected
a) Contributions of services in exchange for a capital interest (earnings and underlying assets)
i) Character and amount: These “service partners” receives ordinary income (less amount, if any paid for the interest). Services are treated as a payment of cash followed by a purchase of a partnership. So, they are treated as having received ordinary income[75]

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[74] 1.704-3(d)(2)

[75] § 83: (a) General rule.--If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of--
(1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over

ii) Timing: § 83
    (1) To the recipient
        (a) Timing: If no restrictions, realized on receipt (even for past services)
            (i) Amount is the fair market value of the interest
        (b) Amount is **Fair market value of interest** (at the time of vesting of unrestricted interest) is included in income when restrictions lapse or not subject to a substantial risk of forfeiture[76][77] (see special election)
            (i) It is possible for these partners to defer recognition by simply not triggering the conditions (so, for example, provision that an interest is forefieted unless the recipient continues to manage the partnership can defer until that restriction lapses)
            (ii) So, if the interest is compensation for past services, there will be immediate recognition – and will be ordinary income[78]
            (iii)**Special election**: can elect to include the value of the property at the time it was received (with restrictions) under § 83(b) (and 83(b) election)
                1. if they make the election, there is no deduction if the property is forefeited – apart from any cash paid[79]
    (2) to the partnership (and the partners)
        (a) character of any possible deductions
            (i) if it the services are of a nature that should be expensed an ordinary income deduction would be inappropriate
            (ii) if the service are of a nature that are a current expense (e.g. ongoing management deductions)[80], they can be taken as a deduction
                1. deductions would be divided up between the other two partners based on their partnership interests
                2. results in deduction to their outside basis[81] in this amount
        (b) partnership might recognize gain: if the service-provider receives a partnership interest
            (i) must treat the transaction in two steps (this is the majority view, but commentators say that this is unfair because stock issued for services does not result in a recognition of gain[82])
                1. 1/3rd undivided interest in the property owned by the partnership is transferred to the service provider (at its appreciated value, so the partnership recognizes gain)[83]

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(2) the amount (if any) paid for such property,

[76] 83(a)
[77] 83(c)(1), (2)
[78] 1.721-1(b)(1)
[79] 1.83-2(a)
[80] 162(a)(1)
[81] 705(a)(2)(A)
[82] Willis Treatist 4.05[5][A], McKee 5.08[2][b] the minority view is in Gunn 47 Tax Notes 699 (May 7, 1990)
[83] 1.83-6(b): (b) Recognition of gain or loss. Except as provided in section 1032, at the time of a transfer of property in connection with the performance of services the transferor recognizes gain to the

a. transferor can take a deduction in that amount[84]

2. manager then contributes that interest back as a property provider (this part is tax free) under § 723
   a. the partnership takes a basis in this amount equal to what the transferor received the partner received in the transaction[85]

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extent that the transferor receives an amount that exceeds the transferor's basis in the property. In addition, at the time a deduction is allowed under section 83(h) and paragraph (a) of this section, gain or loss is recognized to the extent of the difference between (i) the sum of the amount paid plus the amount allowed as a deduction under section 83(h), and (ii) the sum of the taxpayer's basis in the property plus any amount recognized pursuant to the previous sentence.

[84] McDougal

[85] McDougal

Contribution of Services in exchange for a partnership interest (TM p. 22)

Service provider	Recognition	Service provider	Partnership	Partners
Past services	Yes. 721 inapplicable	Step 1: Realizes fair market value of interest received at present fair market value Step 2: takes a outside basis in the property equal the fair market value of his share of the property at the time he received it. (AB=BV)	Step 3 partnership recognizes gain (based on the percentage amount of the basis of the value of the interest dispersed) – but one commentator disagrees gain recognized to partnership = (fair market value – adjusted basis) * share of partnership disbursed New Book value is old book value minus amount given as compensation to service provider. Book value of assets will take on two basis – one for amount given to service provider, and the original one. If the service provider produces a capital item, there is an initial adjusted basis in that item, and there must be a special allocation under § 704(c) Options: no authority	Step 4 partners split up this gain in proportion to their former interests – and immediately recognize. 705(a)(1)(A) effect on partner's capital new outside basis of old partners is out outside basis minus amount given to service provider plus amount realized $AB_{old\ partners}$= $AB_{old\ partners}$ – their share of interest given to provider + share of gain recognized $AB_{new\ parter}$= fair market value of interest $BV_{old\ partners}$= fair market value of interest Note: if the services produces a capital item, there needs to be a special allocation under § 704(b). The partners adjusted basis are not initially decreased.
Future services without	Occurs at point in which	Step 1: Realizes fair market value	Same analysis, but with higher values Step 2: partnership recognizes gain on	Same analysis, but with higher (or lower) values

83(b) election	interest vests	of share of interest at time of vesting. Takes outside basis equal to that value	amount of interest disbursed (minus their initial basis) times their share of profits Options: no authority	
Forfeited interest		No deduction	Partnership must include value of deduction in gross income 1.83-6(c)	

b) Contributions of services in exchange for a profits interest (share of future earnings, but no current right to underlying assets)

  i) Diamond: they are taxable as they are earned[86]

    (1) Valuation: can be valued by amount of money that they were sold for[87]

    (2) **Rev. proc. 93-27** – determine whether interest is vested at time the interest is granted[88] **-- but not entitled to this protection if it is disposed of in two years** (value at sale price)

      (a) General rule: no income to service partner with only a profits interest

        (i) However, if the partnership treats him as an owner and takes into account the distributive share of his gain, there will be a gain to the partner[89]

      (b) exceptions

        (i) if a profits interest is received in return for services as an employee (e.g. in the past) or in a non-partner capacity the service will attempt to value it

          1. if there is a risk of forfeiture, there will still be no taxation at the time the risk of forfeiture lapses

        (ii) But if it is ascertainable, there is income (and partnership gets a § 162 deduction, or an amortizable capital deduction)

        (iii) If the partner disposes of the income for money there is income

          1. Rev. proc. 93-27 – determine whether interest is vested at time the interest is granted[90] **-- but not entitled to this protection if it is disposed of in two years** (value at sale price)

        (iv) If it is a publicly traded partnership, there is income

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[86] 1.183-3(e): (e) Property. For purposes of section 83 and the regulations thereunder, the term "property" includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future. The term also includes a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor, for example, in a trust or escrow account. See, however, § 1.83-8(a) with respect to employee trusts and annuity plans subject to section 402(b) and section 403(c). In the case of a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, only the cash surrender value of the contract is considered to be property. Where rights in a contract providing life insurance protection are substantially nonvested, see § 1.83-1(a)(2) for rules relating to taxation of the cost of life insurance protection.

[87] Diamond

[88] 2001-43: This revenue procedure clarifies that, for purposes of Rev. Proc. 93-27, where a partnership grants an interest in the partnership that is substantially nonvested to a service provider, the service provider will be treated as receiving the interest on the date of its grant, provided that:

> .01 The partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant and the service provider takes into account the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest;
> .02 Upon the grant of the interest or at the time that the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation, or otherwise) for the fair market value of the interest; and
> .03 All other conditions of Rev. Proc. 93-27 are satisfied.

[89] 2001-43 See n. 88

[90] 2001-43 See n. 88

        ii) Consequences to the partnership
            (1) Same as if it were a current assignment (in the year the amount is realized) 1) allocation according to interest; 2) character
            (2) Could also view as an assignment of future income
                (a) Would require a special allocation
                (b) Would take a basis in the value of services
                (c) Would recover profits interst tax free until to the extent of basis
4) Deduction of organizational expenses
    a) General rule: not deductible
    b) Exception under 709(b)[91]: can deduct over 60 months (or more)
        i) Expenses incident to the creation of the partnership
            (1) Fees for establishing an accounting system
            (2) Filing fees
        ii) Chargable to capital account
        iii) Of a character, if exoebded to create a partnership having an ascertainable life, would be amortizable over that life
    c) Specific exclusions
        i) Expenses connected with acquiring assets
5) Income from partners changing partnerships: if income is not earned by a partner until he is in a new partnership, it may be possible to report the income as part of the new partnership
6) Exceptions to aggregate approach: what a partnership must elect to do and report on its information return
    a) Characterization is determined at partnership level[92] -- this means that some things must be separately stated to preserve their unique characteristics
        i) E.g. election to avoid recognition made by partnership[93]
    b) Partnership tax years
        i) Tax year (determined by formula or by business purpose)[94]
            (1) Must use taxable year of partners who have more than a 50% interest in the partnership.[95]
            (2) If the partners that own more than 50% don't have the same taxable year, then partnership must use the taxable year of the PRINCIPAL PARTNERS (e.g. the ones who own more than 5%)[96]

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[91] § 709(b): (1) Deduction.--Amounts paid or incurred to organize a partnership may, at the election of the partnership (made in accordance with regulations prescribed by the Secretary), be treated as deferred expenses. Such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the partnership (beginning with the month in which the partnership begins business), or if the partnership is liquidated before the end of such 60-month period, such deferred expenses (to the extent not deducted under this section) may be deducted to the extent provided in section 165.

[92] 68-79

[93] Demirijian

[94] 706(b)(1)(A): Partnership treated as taxpayer.--The taxable year of a partnership shall be determined as though the partnership were a taxpayer.

[95] 706(b)(1)(B)(i): the majority interest taxable year (as defined in paragraph (4)),

[96] 706(b)(1)(B)(ii): if there is no taxable year described in clause (i), the taxable year of all the principal partners of the partnership

Adequate non-tax deferral purpose for alternative tax year?
Every three years look at majority interest – see if there is one with over 50%
Principle parter's tax year (over 5%)
Least aggregate tax year

(3) otherwise, use the taxable year that results in the **"least aggregate deferral of income: The "least aggregate deferral" for a particular year is the sum of the products of -- the months of deferral for each partner generated by that tax year multiplied by * each partner's interest in partnership profits for that year.**

(4) Alternatively, the partnership can convince the service that its taxable year is its "natural business year"[97] The service accept as a natural business year in the last two years, the last two months of the proposed taxable year accounted for 25% of its gross income.

   (a) Alternatively: can select whatever tax year it wants, if the year selected results in no more than three months of deferral, and it makes "required payments" to offset whatever tax deferral there is[98]

c) 1033 elections for involuntary conversions[99]

d) Deductions that pass directly though to the partners and so the partnership cannot take them

   i) Personal exemptions

   ii) Alimony

   iii) NOLs

e) Things required to be separately stated by partnership (from 702(a))

	Nonseperately stated
STCG/STCL	435 elections
LTCG/LTCG	
§ 1231 property	
Charitable contributions (because each partner has different limits to deductibility)	
Dividends eligible for DRD	
Foreign taxes paid	
Other things[100]	

[97] 706(b)(1)(C): Business purpose.--A partnership may have a taxable year not described in subparagraph (B) if it establishes, to the satisfaction of the Secretary, a business purpose therefor. For purposes of this subparagraph, any deferral of income to partners shall not be treated as a business purpose.

[98] § 7519. Required payments for entities electing not to have required taxable year
(a) General rule.--This section applies to a partnership or S corporation for any taxable year, if--
(1) an election under section 444 is in effect for the taxable year, and
(2) the required payment determined under subsection (b) for such taxable year (or any preceding taxable year) exceeds $500.
(b) Required payment.--For purposes of this section, the term "required payment" means, with respect to any applicable election year of a partnership or S corporation, an amount equal to--
(1) the excess of the product of--
(A) the applicable percentage of the adjusted highest section 1 rate, multiplied by
(B) the net base year income of the entity, over
(2) the net required payment balance.

[99] 1033(1)(2): (2) Taxpayers to which subsection applies.--This subsection shall apply to--…
(B) a partnership in which 1 or more C corporations own, directly or indirectly (determined in accordance with section 707(b)(3)), more than 50 percent of the capital interest, or profits interest, in such partnership at the time of the involuntary conversion, and

…things that might have a different effect for that partner if not taken into account separately[101] after 2002	
Passive activity income or losses (including interest on margin accounts)	
Tax exempt interest	
Recoveries from bad debts	

f) Limits on partnership losses passed to partners (remember, can get around a lot of these limitations by contributing money to the partnership)
   i) **Basis limits**: A partner can only deduct things to the extent of his basis at the end of the taxable year in which the loss occurred[102] -- anything else must be deferred
      (1) Can increase basis by contributing, or by increasing share of liabilities
      (2) Non-recourse liabilities will increase basis
      (3) Pro-rate basis limitation by the characteristics of the losses
   ii) **Passive loss** limitations for people who are not really involved in the partnership management of § 469

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[100] 1.702-1(a)(8)(i): Each partner shall take into account separately, as part of any class of income, gain, loss, deduction, or credit, his distributive share of the following items: Recoveries of bad debts, prior taxes, and delinquency amounts (section 111); gains and losses from wagering transactions (section 165(d)); soil and water conservation expenditures (section 175); nonbusiness expenses as described in section 212; medical, dental, etc., expenses (section 213); expenses for care of certain dependents (section 214); alimony, etc., payments (section 215); amounts representing taxes and interest paid to cooperative housing corporations (section 216); intangible drilling and developments costs (section 263(c)); pre-1970 exploration expenditures (section 615); certain mining exploration expenditures (section 617); income, gain, or loss to the partnership under section 751(b); and any items of income, gain, loss, deduction, or credit subject to a special allocation under the partnership agreement which differs from the allocation of partnership taxable income or loss generally.

[101] 1.702-1(a)(8)(ii): (ii) Each partner must also take into account separately the partner's distributive share of any partnership item which, if separately taken into account by any partner, would result in an income tax liability for that partner, or for any other person, different from that which would result if that partner did not take the item into account separately. Thus, if any partner is a controlled foreign corporation, as defined in section 957, items of income that would be gross subpart F income if separately taken into account by the controlled foreign corporation must be separately stated for all partners. Under section 911(a), if any partner is a bona fide resident of a foreign country who may exclude from gross income the part of the partner's distributive share which qualifies as earned income, as defined in section 911(b), the earned income of the partnership for all partners must be separately stated. Similarly, all relevant items of income or deduction of the partnership must be separately stated for all partners in determining the applicability of section 183 (relating to activities not engaged in for profit) and the recomputation of tax thereunder for any partner. ***This paragraph (a)(8)(ii) applies to taxable years beginning on or after July 23, 2002.***

[102] 704(d): Limitation on allowance of losses.--A partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred. Any excess of such loss over such basis shall be allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership.

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(1) Applied at the partner by **partner level**, and so a partner (and not the partnership) might only be able to avail himself of the partnership losses when he cashes out

(a) Active participation safe harbors from 1.469-5T for "facts and circumstances the individual participates in the activity on a regular, continuous, and substantial basis during such year.[103]

(i) The individual participates in the activity for more than **500 hours** during such year

(ii) The individual's participation in the activity for the taxable year constitutes **substantially all** of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year;

(iii) The individual participates in the activity for more than **100 hours** during the taxable year, and such individual's participation in the activity for the taxable year **is not less than the participation in the activity of any other individual** (including individuals who are not owners of interests in the activity) for such year;

(iv) The activity is a **significant participation activity** for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours;[104]

(v) The individual **materially participated** in the for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;

1. special rules for limited partners – they materially participate if
    a. more than 500 hours per year
    b. material participation for 5 of the last 10 years
    c. it's a personal service activity

(vi) The activity is a **personal service activity** (and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year; orbbb

(b) exceptions for small-time real estate

(2) like corporate tax, portfolio income can be handled separately

iii) At risk limitations

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[103] § 1.469-5T (a)(7): Based on all of the facts and circumstances (taking into account the rules in paragraph (b) of this section), the individual participates in the activity on a regular, continuous, and substantial basis during such year.

[104] (c) Significant participation activity—

(1) In general. For purposes of paragraph (a)(4) of this section, an activity is a significant participation activity of an individual if and only if such activity--

(i) Is a trade or business activity (within the meaning of § 1.469-1T(e)(2)) in which the individual significantly participates for the taxable year; and

(ii) Would be an activity in which the individual does not materially participate for the taxable year if material participation for such year were determined without regard to paragraph (a)(4) of this section.

(2) Significant participation. An individual is treated as significantly participating in an activity for a taxable year if and only if the individual participates in the activity for more than 100 hours during such year.

(1) Losses are limits to cash contributions + property contributions + amounts borrowed that they are personally liable for (under state law)
  (a) Non-recourse liabilities won't help
  (b) Exception: qualified recourse financing will increase at risk amount
    (i) Commercial or government debt that is not convertible, acquired with respect to real estate, an unrelated person who regularly lends money. Must be unrelated or on the same terms as an unrelated person
(2) Limited partners who have to make additional contributions can be considered at risk with respect to those liabilities[105]
(3) Note: Callahan – if the partners can elect out when the partnership is solvent they are not really at risk (even if they are on the hook in insolvency)[106]

g) ELPs (electing large partnerships) over over 100 partners
h) Effects of having to report partnership income
  i) Partners outside basis increased for **taxable and tax-exempt income**
    (1) **Tax exempt income results in a basis increase** to prevent a double-taxation when the partnership share is sold
  ii) Decreased for distributions, shares of partnership loss, shares of expenditures that are not deductible[107] (but not below zero)

7) allocating partnership liabilities
  a) recourse (bearing an economic risk of loss – to the extent that they would ultimately have to pay the debt if it the partnership was liquidated): allocated with respect to proporation of partners respective shares of partnership losses
    i) limited partners won't be allocated beyond their liability
    ii) allocation
      (1) partner's share of non-recourse liabilities is sum of
        (a) partners share of minimum gain under 704(b) regulations in the property
          (i) distribution of proceeds of nonrecourse loan
          (ii) built in gain in an asset
        (b) if the nonrecourse is secured by contributed property, the amount that the partner would recognize under 704(c) if the partnership disposed of it in full satisfaction and with no other consideration[108]

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105 Pritchett

106 Callahan

107 705(a)(2): decreased (but not below zero) by distributions by the partnership as provided in section 733 and by the sum of his distributive share for the taxable year and prior taxable years of--
(A) losses of the partnership, and
(B) expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account; and

108 1.752-3 (a) In general. A partner's share of the nonrecourse liabilities of a partnership equals the sum of paragraphs (a)(1) through (a)(3) of this section as follows--
(1) The partner's share of partnership minimum gain determined in accordance with the rules of section 704(b) and the regulations thereunder;
(2) The amount of any taxable gain that would be allocated to the partner under section 704(c) (or in the same manner as section 704(c) in connection with a revaluation of partnership property) if the partnership disposed of (in a taxable transaction) all partnership property subject to one or

(c) partners share of excess nonrecourse liabilities determined in accordance with share of the profits (this is what most nonrecoruse liabilities are made from) is defined as nonrecourse liabilities are allocated in accordance with the partner's interest in the partnership
   (i) alternatively they can be allocated the way deductions will be allocated

b) non-recourse: allocated with respect to respective shares of partnership profits on the assumption that if paid they will come from the assets of the partnership[109]

8) admission of new partners
   a) if an asset with built in gain is sold it, in general, must be allocated to the old partners unless there is substantial economic effect in the partnership agreement that allocates it to a new partner

9) policy problems
   a) allocations of nonrecourse debt can be allocated however the partners want because it doesn't have economic significance, provided that the allocation corresponds to allocation of some other partnership item

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more nonrecourse liabilities of the partnership in full satisfaction of the liabilities and for no other consideration; and

(3) The partner's share of the excess nonrecourse liabilities (those not allocated under paragraphs (a)(1) and (a)(2) of this section) of the partnership as determined in accordance with the partner's share of partnership profits. The partner's interest in partnership profits is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners. The partnership agreement may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities provided the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain. Alternatively, excess nonrecourse liabilities may be allocated among the partners in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated. Additionally, the partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on section 704(c) property (as defined under § 1.704- 3(a)(3)(ii)) or property for which reverse section 704(c) allocations are applicable (as described in § 1.704-3(a)(6)(i)) where such property is subject to the nonrecourse liability to the extent that such built-in gain exceeds the gain described in paragraph (a)(2) of this section with respect to such property. This additional method does not apply for purposes of § 1.707- 5(a)(2)(ii). To the extent that a partnership uses this additional method and the entire amount of the excess nonrecourse liability is not allocated to the contributing partner, the partnership must allocate the remaining amount of the excess nonrecourse liability under one of the other methods in this paragraph (a)(3). Excess nonrecourse liabilities are not required to be allocated under the same method each year.

[109] See n. 109

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