

# 2022 NATIONAL INCOME TAX WORKBOOK

CHAPTER 7:  
CURRENT PARTNERSHIP TAX ISSUES



1. Partnership Profits Interest
2. Partnership Elections
3. Basis in a Partnership interest
4. Tax implications of the sale of a business as an equity sale or an asset sale
5. Corporate Reorganizations

- **Capital Interest:** Amount to be distributed if partnership is liquidated for the FMV of its assets
- **Profits Interest:** An interest only in future income and gain. It has no liquidation value at the time of grant.

PARTNERSHIP INTEREST  
IN EXCHANGE FOR SERVICE (I.R.C. §83)

P. 254

- General rule is FMV of property received for services is taxable income
- Granting an interest with current liquidation value (capital interest) is therefore taxable
- Granting a profits interest is generally nontaxable

## VESTED INTERESTS (REV. PROC. 93-27)

P. 255

- Rev. Proc. 93-27 is the basis for prior comments
- Deals with vested interests (no strings attached)
- ▣ Partnership Agreement to document capital account balances and liquidation in accordance with them
- 3 Exceptions to the general rule

## 3 EXCEPTIONS TO THE GENERAL RULE

P. 255

The transfer is taxable if

- Substantially certain stream of income
- Disposition of interest within 2 years
- Limited interest in a publicly traded partnership

- Profits interest test is applied at the time of grant
- The existence of vesting requirements is not relevant
- The future event that causes vesting is not a taxable event
- There is no need for an election under I.R.C. §83(b)

## THREE REQUIREMENTS UNDER REV. PROC. 2001-43

PP. 255-256

1. Partnership and service partner
  - Recognize service provider as owner of the interest
  - Service provide reports distributive share of P/S activity
2. Neither P/S or any partner deducts any amount for the FMV of the interest (i.e., at the time of vesting)
3. All underlying conditions of Rev. Proc. 93-27 are met



## PROPOSED CHANGES

P. 256

- Notice 2005-43 and Prop. Reg. § 1.83-3(l)
- Elective safe harbor to value profits interest at liquidation value at time of transfer
- Otherwise, value is determined when interest vests
- Causes valuation at time of transfer
- Planning Pointer: Consider making a § 83 election at time of transfer if vesting is delayed

## TAX EFFECT OF SHIFT IN LIABILITIES

P. 256

- I.R.C. §752 controls the allocation of liabilities
- Transferring a profits interest can change the allocation of liabilities
- A reduction in liabilities is considered a distribution:
  - Could trigger gain if distribution exceeds outside basis
  - Could trigger ordinary gain from a deemed sale of “hot assets” under I.R.C. §751

## PARTNER SHARE OF RECOURSE LIABILITIES

PP. 256-257

- Measured by partner's economic risk of loss
- Constructive liquidation
  1. Debts are due
  2. Partnership assets have zero value
  3. Partnership disposes of all assets in a taxable transaction
  4. Resulting loss is allocated per operating agreement
  5. Partnership liquidates
- Who pays the creditors? All facts and circumstances

## PARTNER SHARE OF NONRECOURSE LIABILITIES

P. 257

- General rule is that nonrecourse liabilities are shared based on profit share percentages
- Special allocations change the general rule

## DEEMED SALE OF SECTION 751 PROPERTY

PP. 257-258

- Hot assets include unrealized receivables and inventory
- Gain triggered by “disproportionate distributions” of either hot assets or other property (including cash)
- Ex. 7.4 Henry and Grover
  - Plenty of outside basis but \$40k of hot assets
  - Transfer of 10% profits interest
  - Deemed distribution of \$5k ( $\$50k \text{ debt share} \times 10\%$ )
  - \$2k deemed sale of hot assets ( $\$40k \div 2 \times 10\%$ )

## RECOURSE LIABILITIES

P. 257

- Ex. 7.5 Debbie does not sign on debt
- No debt transfer, no deemed distribution, no ordinary income
- ☒ Partner flexibility in agreement to share economic risk of loss
  - Applies only to recourse liabilities
  - “Commercially reasonable expectation”
  - Controls outside basis and deemed distributions

## CARRIED INTERESTS

PP. 258-259

- TCJA added I.R.C. § 1061 for tax years after 12/31/2017
- Recipient of “applicable partnership interest” reports certain long-term capital gains as short-term
- API is received in connection with providing services
- Applicable trade or business: raising and returning capital by investing in (disposing of), identifying, or developing specified assets

## SPECIFIED ASSETS

P. 259

- Securities
- Commodities
- Real estate held for rental or investments
- Cash or cash equivalents



## EXCEPTIONS

P. 259

- Interests held by a C corporation
- Capital interest based on contribution or value taxed under I.R.C. §83
- Gain attributable to any asset not held as portfolio investment for third party
- Ex. 7.6 Hardware store excluded although owning real estate

## SECTION 1061 WORKSHEET A

P. 260

- Lines 2 and 3 remove the exceptions
- Lines 5 & 6 apply the 3-year holding period rule
- Line 7 will be the net gain that will not be eligible for LTCG treatment
- Ex. 7.7 \$55,000 long term capital gain allocation but \$35,000 Section 1061 adjustment on Form 8949
- ☐ Section 1061 adjustment does not apply to Sec. 1231 transactions, Sec. 1256 transactions, qualified dividends

## ISSUE 2: PARTNERSHIP ELECTIONS

P. 262

- Elect out of all or part of subchapter K
- Numerous tax elections under the entity concept
- Basis recovery election for retiring partner
- Section 754 election to adjust inside basis
- Section 732(d) basis adjustment election

## BENEFITS OF ELECTING OUT OF SUBCHAPTER K

- Gives owners election flexibility
- No coordination with other owners on tax planning issues
- No Partnership tax returns filed

## DETRIMENTS OF ELECTING OUT OF SUBCHAPTER K

- The co-owners want to make special allocations of tax items such as deductions for intangible drilling costs or depreciation
- The organization is unsure whether it qualifies to elect out
- The organization wants to use accounting methods different from those of its co-owners.

- Investing purposes – not an active trade or business
- joint production, extraction, or use of property – not selling the services or property
- Members must be able to determine income without computing partnership taxable income

## INVESTING PARTNERSHIPS

P. 262

- Hold the property as co-owners
- Reserve the right to separately take or dispose of their shares of any property
- No active conduct of business or authorize some person to act as representative in the buying, selling, or exchange of the investment property
  - Temporary exception for each individual participant

## OPERATING AGREEMENT (JOINT UNDERTAKING) P. 262

- Own the property as co-owners
- Reserve the right to take property produced in kind
- Do not sell jointly – but each separate participant may delegate this authority on a temporary basis



- Election by statement
- Attached to timely filed Form 1065 for first year of exclusion
- Statement details in workbook
- ☐ Deemed election based on intent and proper reporting of each owner's share – **CAUTION** -

## ☰ QUALIFIED JOINT VENTURE

P. 262

- Unincorporated business jointly held by married couple generally a partnership
- Can elect out if filing a joint return
- See 2017 workbook for details

## ENTITY-LEVEL ELECTIONS

PP. 263-264

- Since the partnership is a separate entity . . .
  - Fresh start!
  - Separate and apart from the choices of the owners
- List in text – many regarding depreciation
- Sec. 179
  - Limits at entity level
  - Statutory and business income limits apply again at owner level

## ELECTION TO RECOVER BASIS RATABLY

P. 264

- General rule for both current and liquidating distributions is to recover basis first before recognizing gain
- Recipient of fixed-sum liquidating payments can elect to recover basis ratably
- The election does not affect recognition of ordinary gain under section 751 (but see note for alt. view)
- Recipient partner makes the election by statement

- ☰ Basis recovery election under section 736 affects the timing of adjustments under a section 754 election
- Inside Basis: basis of partnership's assets
- Outside Basis: basis of a partner's interest
- Generally, total of all partners' outside bases = inside basis
- If not, a section 754 election adjusts inside basis to match

# MANDATORY INSIDE BASIS ADJUSTMENT

P. 265

## ☰ Practitioner Note

- Must reduce inside basis after a transfer containing a substantial built-in loss
  - Inside basis exceeds FMV of assets by more than \$250K; or
  - Loss allocable to transferee partner if partnership disposed of all assets at FMV would exceed \$250K

## WHEN TO MAKE THE ELECTION

PP. 266-267

Sec. 754 election can be made when

1. Partnership interest transfers by sale, exchange, or death and outside basis exceeds partner's share of inside basis (I.R.C. §743)
2. Distributions of cash in excess of outside basis triggers gain or distribution of property where asset basis is limited by outside basis (I.R.C. §734)
3. Contributions of property where partner recognizes gain due to liabilities in excess of basis (I.R.C. §734)

## TRANSFER AT DEATH

P. 266

- Outside basis adjusted to FMV at date of death (or alternate valuation date)
- Sec. 754 election can be used to adjust inside basis to match outside basis
- Cross Reference (page 267): Items of IRD do not receive a basis adjustment even when included in a decedent's partnership interest



# COMPUTATION OF ADJUSTMENT

P. 267

- Partnership increases its adjusted basis in the partnership assets by the excess of the transferee's outside basis over the transferee's share of inside basis; or
- decreases its adjusted basis in the partnership assets by the excess of the transferee's inside basis over the transferee's outside basis
- A transferee partner's inside basis is equal to the sum of his or her share of partnership liabilities plus his or her share of the partnership's previously taxed capital
  - Generally, previously taxed capital will be reflected in the partner's tax basis capital account on Schedule K-1
  - Also calculated using 3 steps in workbook

## ALLOCATING THE OPTIONAL BASIS ADJUSTMENT P. 269

- Separate partnership assets into 2 classes
  1. Capital gain property (including Sec. 1231)
  2. Ordinary income property (including depreciation recap)
- Allocate adjustment amount first to ordinary income class
- Any remaining adjustment is allocated to capital gain class
- Allocate within each class to reduce built-in gain or loss

## DIFFERENT RULES FOR DISTRIBUTIONS

PP. 271-272

- Any adjustment is allocated to remaining assets of similar character
- Any adjustment due to recognition of gain from a cash distribution goes to capital gain property
- Increases first go to reduce unrealized appreciation (prorata) and any remainder prorated by FMV
- Decreases first go to increase unrealized depreciation (prorata) and any remainder prorated by ATB

## SECTION 754 ELECTION

P. 272

- It is an election, not automatic
- When in effect, the adjustments must be made whenever there is a sale, exchange, death, distribution, that results in taxable gain or loss of basis
- Filed by extended due date of return for year of transfer or distribution
- 12-month automatic extension available for this only

## REPORTING REQUIREMENTS

P. 272

- Attach election statement
- Check box on Form 1065, Schedule B
- Attach calculations of adjustment amount and allocations – include transferee's name and TIN
- Transferee must notify partnership within 30 days
  - Extended to 1 year from date of death for inherited interest
  - Details on handling failure to notify partnership

## EFFECT OF SEC. 743 ADJUSTMENTS

PP. 272-273

- Adjustments affects transferee
- Adjustments may be to expense, COGS, depreciation, or gain upon future sale of the asset by the P/S
- ☐ The adjustment would qualify for section 179 expensing or bonus depreciation, if the underlying asset would qualify
- ☐ Excess adjustment over UBIA would increase UBIA

## REVOCACTION OF ELECTION

P. 273

- Revocation requires IRS approval
- File Form 15254 within 30 days of tax year end
- 4 reasons IRS may approve revocation
- Will not approve if revocation is to avoid downward basis adjustment

## TRANSFEEE'S BASIS ELECTION

P. 274

- Normally distributions have carryover basis
- Election available for distributions within 2 years of purchase of partnership interest
- Allows transferee to make a section 743(b) adjustment to the distributed property
- Does not apply to distributions taxed under section 751 (b)
- Transferee makes the election by statement with calculations
- Mandatory adjustment to transferee in certain cases



## ISSUE 3: BASIS OF PARTNERSHIP INTEREST

P. 275

- Target of IRS compliance campaign
- Outside basis limits a partner's ability to
  - deduct a loss allocated by the partnership
  - receive a distribution of cash without recognizing gain

## INITIAL BASIS

P. 275

- General rules apply if acquired by purchase, gift, inheritance
- Substituted basis rules apply when received in exchange for contributing assets
- I.R.C. §752 provides guidance on partnership liabilities
  - Assuming partnership debt is a deemed cash contribution
  - Contributing debt is a deemed cash distribution

## GAIN RECOGNIZED ON CONTRIBUTION

PP. 275-276

- Generally, no gain under the substituted basis rules
- However, gain is triggered if boot is received in excess of ATB of assets contributed
- Contributed debt is considered boot received
- Partnership debt assumed is a reduction in boot received
- Any gain recognized will increase outside basis

# ADJUSTMENTS TO OUTSIDE BASIS

PP. 276-277

**FIGURE 7.14**  
**Adjustments to Outside Basis**

**Increases to basis:**

- Adjusted tax basis of additional contributions (including cash)
- Increased share of partnership liabilities
- Share of partnership income or gain (including tax-exempt income)

**Decreases to basis:**

- Cash distributions and adjusted tax basis of property distributions
- Decreased share of partnership liabilities
- Share of losses (including capital losses) and deductions
- Share of nondeductible expenses

- ☰ Timing of Basis Adjustments
  - Contributions and distributions change basis on the date they occur
  - At year end:
    - First, add income
    - Then, subtract losses

## TRACKING BASIS

P. 277

- Outside basis has no affect on partnership reporting
- Responsibility of partner to track basis
- No IRS requirement to report basis
- Worksheet provided in Form 1065, Schedule K-1 instructions (see Fig. 7.15)
- Different reporting rules for S corp. shareholders

## OUTSIDE BASIS VS. TAX BASIS CAPITAL ACCOUNT

P. 279

- Most partnerships must report tax basis capital accounts (see Form 1065, Schedule B for exceptions)
- Tax Basis Capital Accounts
  - Do not include partner share of partnership liabilities
  - Can be negative
- See *2021 National Income Tax Workbook*

## UNITARY BASIS

PP. 283-284

- Partner may have more than one partnership interest
- For outside basis calculations, all interests are combined
- Ex. 7.16 basis of purchased limited partnership interest combined with that of initial partnership interest
  - Income due to limited interest simply adds to unitary basis
  - Unitary basis is apportioned when limited interest is sold
- ☹️ More gain than expected

## SCHEDULES K-2 AND K-3

P. 284

- Practitioner Note
- New for 2021 tax return
- Also applies to S corps
- Intended to improve international tax information reporting



## **ISSUE 4**: SALE OF A BUSINESS

P. 151

Most sellers prefer stock sale

Most buyers prefer asset sale

Review both for C corporation, S corporation and partnership

# C CORPORATION STOCK

PP. 151-152

## Sale of stock of C corporation

- Corporation
  - Not a taxable event
- Shareholder
  - Compute gain. Long- or short-term based on holding period
  - Net investment income tax potential
- The new owner basis in stock = purchase price

# C CORPORATION ASSET

PP. 152-153

## C corporation sale of assets

- Corporation
  - Gain or loss on sold asset
  - Liquidating distributions to the shareholder
- Shareholder
  - Gain or loss using the liquidating distributions as the sale price against the stock basis
  - Long- or short-term based on holding period
  - Net investment income tax potential
- New owner has new basis in all assets/ new depreciable life

# S CORPORATION STOCK

PP. 153-154

## Sale of S corporation stock

- S Corporation
  - Not a taxable event
- Shareholder
  - Compute gain. Long- or short-term based on holding period
  - Net investment income tax potential
- The new owner basis in stock = purchase price

# S CORPORATION ASSET

PP. 154-155

## S corporation Sells Assets

- S Corporation
  - Gain or loss on sold asset passed through to shareholder via Schedule K-1
  - Liquidating distributions to the shareholder
- Shareholder
  - Gain if liquidating distributions exceed stock basis
  - Long- or short-term based on holding period
  - Net investment income tax potential
- New owner has new basis in all assets/new depreciable life

# PARTNERSHIP INTEREST

PP. 155-156

## Partner Sells Partnership Interest

- Partnership
  - Not a taxable event
  - Computes short period income/loss for split Schedules K-1
  - Note - Partnership can make an I.R.C. 754 election
- Partner
  - Allocable share of “hot assets” taxed as ordinary income
  - Gain or loss using the remaining value against partnership basis
  - Long- or short-term based on holding period
  - Net investment income tax potential

# PARTNERSHIP ASSET

PP. 156-157

## Partnership Sale of Assets

- Partnership
  - No entity level tax as gains / losses flow through to the partners
  - Allocate sale price among asset classes to determine tax treatment
- Partner
  - Gain or loss based on partnership basis
  - Long- or short-term based on holding period
  - Net investment income tax potential

# ALLOCATION PRIORITIES

P. 157

<b>Asset</b>	<b>Seller Priority</b>	<b>Buyer Priority</b>
Land	High	Low
Buildings	Medium-low	Medium-low
Accounts receivable	No preference	No preference
Inventory	Low	High
Equipment	High (up to tax basis)	High
Goodwill	High	Low



# REPORTING REQUIREMENTS – ASSET SALES

PP. 158-159

The buyer and seller must complete Form 8594, Asset Acquisition Statement Under Section 1060, and the statements should match. The sale price is allocated between seven different classes:

- Class I – cash and general deposit accounts
- Class II – CD's, foreign currency, gvt. securities, publicly traded stock
- Class III – accounts receivable, mark-to-market items, debt instruments
- Class IV – inventory, stock in trade
- Class V – assets not identified in other categories – furniture/fixtures, bldgs., land, vehicles, equip
- Class VI – Section 197 intangibles excluding goodwill and going concern
- Class VII – Goodwill and going concern

# REPORTING REQUIREMENTS – EQUITY SALES

P. 159

## Equity Sales

Corporation (C or S) – shareholder reports on Form 8949

- Partnership – partner reports on Form 8949
  - Hot Assets – the selling partner must report the sale to the partnership
  - Partnership files Form 8308

## CASE STUDY

PP. 160-167

Woods Bay Tax, Inc. is a comprehensive case study of an S corporation asset sale

- Agree on allocation
- Part capital gain and part ordinary income
- See completed forms and closing letter

## ISSUE 4: CORPORATE REORGANIZATIONS

PP. 105-113

- No gain or loss in a divisive reorganization
- Two types of divisive reorganizations
  - Spin-off
  - Split-Off

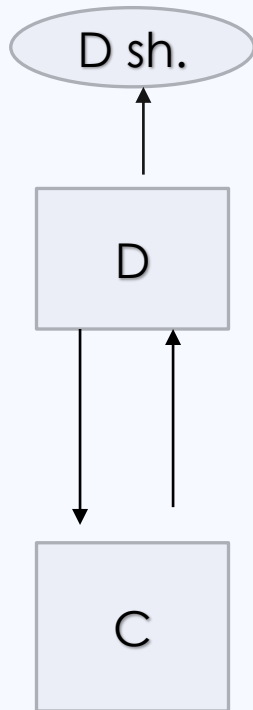
## SPIN-OFF

P. 105

- Historic corporation
  - Creates a subsidiary corporation
  - Contributes assets to subsidiary in exchange for all stock
  - Distributes stock to historic shareholders
- Shareholders now own stock in the two separate corporations

# SPIN-OFFS

PP. 105-106



step one: distributing (D) creates a subsidiary controlled (C)

step two: D distributes C stock to D shareholders

result: D shareholders own D and C

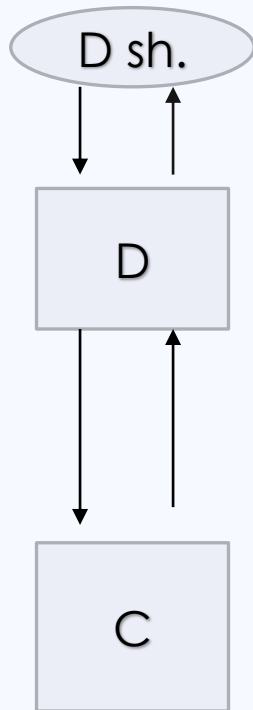
## SPLIT-OFF

P. 105

- Historic corporation:
  - Creates a subsidiary corporation
  - Contributes assets to subsidiary in exchange for all stock
  - Distributes stock to some of the historic shareholders in exchange for their shares in the historic corporation
- Some of the historic shareholders now own stock solely in the new corporation
- Remaining historic shareholders retain historic corporation

# SPLIT-OFFS

PP. 105-106



step one: distributing (D) creates a subsidiary controlled (C)

step two: D distributes C stock to one or more D shareholders in exchange for their shares in D

result: One or more D shareholders own D and one or more D shareholders own C



## SPLIT-OFF REQUIREMENTS

PP. 105-108

- I.R.C. §368 requires execution of a plan under which one or more of the original corporation's shareholders receive control of the newly formed corporation by a qualifying stock distribution from the original corporation
- I.R.C. §355 provides one set of qualifying rules
  - Distributing corporation has control of subsidiary
  - Distributing corporation distributes all subsidiary stock
  - Both corporations are engaged in active trade or business
  - Transactions are not a device to distribute E&P

## CONTINUITY OF BUSINESS ENTERPRISE

P. 106

- I.R.C. §355 also requires that the controlled corporation either
  - continues the distributing corporation's historic business or
  - uses a significant portion of the distributing corporation's historic business assets in a business
- Ex. 3.26 logging and farming corp splits - okay

## CONTINUITY OF PROPRIETARY INTEREST

P. 106

- In addition, I.R.C. §355 requires that one or more of the original shareholders retains a proprietary interest in the reorganized enterprise
- One or more original owners own, in aggregate, 50% of more of the stock in each corporation after separation
- IRS goal is to prevent use as a disguised sale

## BUSINESS PURPOSE

PP. 107-108

- A business purpose must exist for the split
- For both the transfer of assets to the subsidiary and the distribution of the subsidiary's stock
- Rev. Proc. 96-30 provides guidance – “Fit and Focus”

## ACTIVE TRADE OR BUSINESS

P. 108

- Generally, a facts and circumstances test
- I.R.C. §355: 5-year requirement for distributing corporation
- Holding land or other property for investment is not an active trade or business

## TAX CONSEQUENCES

P. 108

- Considered mere change in form when subsidiary is formed
  - Generally, tax-free unless boot received exceeds basis of contributed assets
  - Watch for debts transferred in excess of ATB of assets
- I.R.C. §355 provides for the tax-free exchange of stock to shareholders

## COMPREHENSIVE EXAMPLE

PP. 108-112

- More than 5 years active trade or business
- Management (family) disagreements
- Brother wants to expand orchard with a hard cider operation
- Risk concerns
- Goal: separate farm and orchard businesses

*Any Questions?*