Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

PARTNERSHIP TAXATION

February 2016 Update
to
THIRD EDITION

RICHARD M. LIPTON, ESQ.
Partner, Baker & McKenzie LLP
PAUL CARMAN, ESQ.
Partner, Chapman and Cutler LLP
CHARLES FASSLER, ESQ.
Of Counsel, Bingham Greenebaum Doll LLP
WALTER D. SCHWIDETZKY
Professor of Law
University of Baltimore School of Law

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

PARTNERSHIP TAXATION

February 2016 Update to THIRD EDITION

ADDITIONS AND INSERTIONS..1

CHAPTER 1: DEFINING PARTNERSHIPS AND PARTNERS FOR TAX PURPOSES

§ 1.05 DETERMINING WHO IS A PARTNER

CHAPTER 2: FORMATION OF THE PARTNERSHIP

§ 2.11 ORGANIZATION AND SELLING EXPENSES

§ 2.12 READING, QUESTIONS AND PROBLEMS

CHAPTER 3: OUTSIDE BASIS AND ALLOCATION OF LIABILITIES

§ 3.04 EFFECT OF PARTNERSHIP LIABILITIES

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

§ 4.05 Accounting Method

§ 4.10 PARTNERSHIP LEVEL LIABILITY ON AUDITS

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

§ 5.03 SUBSTANTIAL ECONOMIC EFFECT RULES

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

§ 5.08 GIFTED PARTNERSHIP INTERESTS

§ 5.09 CHANGES IN PARTNERSHIP INTERESTS DURING THE TAX YEAR

CHAPTER 6: DISPOSITION OF PARTNERSHIP INTERESTS

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

§ 6.05 INSTALLMENT SALES

§ 6.06 DISPOSITIONS OTHER THAN SALES OR EXCHANGES

§ 6.07 OPTIONAL ADJUSTMENT TO BASIS OF PARTNERSHIP PROPERTY

§ 6.08 ALLOCATION OF INCOME AND LOSS

§ 6.09 TERMINATION OF PARTNERSHIPS

CHAPTER 7: PARTNERSHIP DISTRIBUTIONS

§ 7.08 SHIFTS IN ORDINARY INCOME PROPERTY

§ 7.09 LIQUIDATIONS OF PARTNERSHIPS & PARTNERSHIP INTERESTS

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

§ 8.04 GUARANTEED PAYMENTS

§ 8.06 DISGUISED SALES

§ 8.08A ISSUANCE OF A PARTNERSHIP INTEREST IN EXCHANGE FOR SERVICES

§ 8.08B COMPENSATORY INTEREST PROPOSED REGULATIONS

§ 8.08D ISSUANCE OF A PARTNERSHIP INTEREST SUBJECT TO A SUBSTANTIAL RISK OF FORFEITURE

CHAPTER 10: PARTNERSHIP OPTIONS

§ 10.01 INTRODUCTION

§ 10.02 BACKGROUND FOR NONCOMPENSATORY OPTIONS

§ 10.03 SCOPE OF REGULATIONS ON NONCOMPENSATORY OPTIONS

§ 10.04 ISSUANCE, LAPSE, AND STRAIGHT-FORWARD EXERCISE OF NONCOMPENSATORY OPTIONS

§ 10.05 COMPLICATIONS ON THE EXERCISE OF NONCOMPENSATORY OPTIONS

§ 10.06 OPTION HOLDER TREATED AS PARTNER

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

§ 12.02 FOREIGN PARTNERSHIPS

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

§ 12.08 FATCA

CHAPTER 13: ANTI-ABUSE PROVISIONS

§ 13.02 JUDICIAL DOCTRINES

§ 13.04 MIXING BOWL TRANSACTIONS

CHAPTER 14: FAMILY PARTNERSHIPS

§ 14.02 WHO ARE THE PARTNERS OF FAMILY LIMITED PARTNERSHIPS?

ERRATA 65

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

PARTNERSHIP TAXATION

ADDITIONS AND INSERTIONS

CHAPTER 1: DEFINING PARTNERSHIPS AND PARTNERS FOR TAX PURPOSES

§ 1.05 DETERMINING WHO IS A PARTNER

In the paragraph that begins "Although the Supreme Court in *Tower*", there is a discussion of former I.R.C. § 704(e)(1). That provision has now been moved to I.R.C. § 761(b) and now refers only to interests transferred by gift.

Add after the second paragraph:

On the other hand, if a service provider enters into a revenue sharing agreement with a partnership to share the profits of a partnership, and both he and the partnership act as if the service provider is a partner, the service provider is treated as a partner for federal income tax purposes even though he never signed the partnership agreement.[1]

Substitute the following for the last paragraph of the section:

The Regulations contain a new Treas. Reg. § 1.761-3 that provides tests to determine whether a noncompensatory option should be treated as an interest in a partnership. These Regulations will be discuss in greater detail in Chapter 10.

Even assuming that a partner would otherwise be treated as a partner under the analysis above, if a capital interest held by a partner is subject to a substantial risk of forfeiture, the partner may not be treated as a partner unless the partner makes an election to be taxed on the grant of the partnership interest.[2] In general, a service provider is not treated as the owner of property subject to a substantial risk of forfeiture unless an election under I.R.C. § 83(b) is filed within 30 days of the grant.[3] However, this rule does not apply to a profits interest granted to a service provider for services to the issuing partnership if all parties have consistently treated the recipient as a partner.[4]

§ 1.08 Series LLCs

B. Tax Classification and the Proposed Regulations

---

1 Cahill v. Commissioner, 2013 RIA TC Memo ¶2013-220 (9/18/2013).

2 Crescent Holdings, LLC v Commissioner, 141 T.C. No. 15 (2013).

3 Treas. Reg. § 1.83-1(a)(1).

4 Rev. Proc. 2001-43, 2001-2 C.B. 191.

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

5. Who are the Owners.

The third paragraph has a discussion of former I.R.C. § 704(e)(1). That provision has now been moved to I.R.C. § 761(b) and now refers only to interests transferred by gift.

CHAPTER 2: FORMATION OF THE PARTNERSHIP

§ 2.02 TRANSFER OF PROPERTY TO PARTNERSHIP

E. Stock of Corporate Partners

Add at the end of the subsection:

Under the Regulations, an I.R.C. § 337(d) transaction may occur if (i) a corporate partner contributes appreciated property to a partnership that owns stock of the corporate partner; (ii) a partnership acquires stock of the corporate partner, (iii) a partnership that owns stock of a corporate partner distributes appreciated property to a partner other than the corporate partner, (iv) a partnership distributes stock of a corporate partner to the corporate partner, or (v) a partnership agreement is amended in a manner that increases a corporate partner's interest in the stock of the corporate partner.[5] If a partnership engages in an I.R.C. § 337(d) transaction, the corporate partner must recognize gain.[6] The basis of the corporate partner's interest in the partnership is increased by the amount of gain recognized.[7] Similarly, the partnership's basis in the stock contributed is increased by the amount of gain that the corporate partner recognized.[8]

§ 2.11 ORGANIZATION AND SELLING EXPENSES

B. Organization Expenses

Add to footnote 71:

However, a technical termination under I.R.C. § 708(b)(1)(B) will not trigger the unamortized expenses. Treas. Reg. §§ 1.708-1(b)(6); 1.709-1(b)(3)(ii).

C. Start-Up Expenses

Add at the end of the subsection:

If a partnership disposes of its trade or business before the end of the amortization period, any unamortized start-up expenses may be deducted to the extent allowed under I.R.C. § 162.[9]

---

5 Temp. Reg. § 1.337(d)-3T(c)(3).

6 Temp. Reg. § 1.337(d)-3T(d)(1).

7 Temp. Reg. § 1.337(d)-3T(d)((4)(i).

8 Temp. Reg. § 1.337(d)-3T(d)((4)(ii).

9 I.R.C. § 195(b)(2).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

If a partnership that has elected to amortize start-up expenditures under I.R.C. § 195(b) terminates in a transaction or series of transactions described in I.R.C. § 708(b)(1)(B), the termination is not treated as resulting in a disposition of the partnership's trade or business for the purposes of I.R.C. § 195(b)(2).[10] Instead, the new partnership must continue to amortize the remaining unamortized expenditures of the terminating partnership over the remaining portion of the amortization period of the terminating partnership.[11]

§ 2.12 Reading, Questions and Problems

2. A and B form AB Partnership in 2012. The partners contributed the following:

a. Land which A had been selling as a residential subdivision. Approximately 60% of the original land owned by A has already been sold.

b. Cash which will be used to construct a strip mall on the land.

i. If the strip mall is sold in 2016, will the gain be ordinary income or I.R.C. § 1231 gain?

ii. If the strip mall is sold in 2026, will the gain be ordinary income or I.R.C. § l231 gain?

CHAPTER 3: OUTSIDE BASIS AND ALLOCATION OF LIABILITIES

§ 3.04 Effect of Partnership Liabilities

B. Definition of a Recourse and Nonrecourse Liabilities

2. Definition of Recourse Liability

Add after the first paragraph at the top of page 79:

Under Proposed Regulations, an obligation of a partner or related person to make a payment with respect to a partnership liability is not recognized unless all of the following requirements are satisfied:

(A) The partner or related person is—

(1) Required to maintain a commercially reasonable net worth throughout the term of the payment obligation; or

(2) Subject to commercially reasonable contractual restrictions on transfers of assets for inadequate consideration.

---

10 Treas. Reg. § 1.195-2(a).

11 Treas. Reg. § 1.708-1(b)(6).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

(B) The partner or related person is required periodically to provide commercially reasonable documentation regarding the partner's or related person's financial condition.

(C) The term of the payment obligation does not end prior to the term of the partnership liability.

(D) The payment obligation does not require that the primary obligor or any other obligor with respect to the partnership liability directly or indirectly hold money or other liquid assets in an amount that exceeds the reasonable needs of such obligor.

(E) The partner or related person received arm's length consideration for assuming the payment obligation.

(F) In the case of a guarantee or similar arrangement, the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied. The terms of a guarantee or similar arrangement will be treated as modified by any right of indemnity, reimbursement, or similar arrangement regardless of whether that arrangement would be recognized. However, the preceding sentence does not apply to a right of proportionate contribution running between partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable.

(G) In the case of an indemnity, reimbursement agreement, or similar arrangement, the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the indemnitee's or other benefitted party's payment obligation is satisfied. The indemnity, reimbursement agreement, or similar arrangement only satisfies this requirement if, before taking into account the indemnity, reimbursement agreement, or similar arrangement, the indemnitee's or other benefitted party's payment obligation is recognized or would be recognized if such person were a partner or related person. The terms of an indemnity, reimbursement agreement, or similar arrangement will be treated as modified by any further right of indemnity, reimbursement, or similar arrangement regardless of whether that further arrangement would be recognized. However, the preceding sentence does not apply to a right of proportionate contribution running between partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable.[12]

In addition to the requirements just mentioned, the Proposed Regulations would also require that in determining the extent to which a partner or related person other than an individual or a decedent's estate bears the economic risk of loss for a partnership liability other than a trade payable, a payment obligation is recognized only to the extent of the net value of the partner or related person as of the allocation date. This rule also applies to a payment obligation of a partner or related person that is disregarded as an entity separate from its owner or is a grantor trust, even if the owner of the disregarded entity is an individual or a decedent's estate. A

---

12 Prop. Treas. Reg. § 1.752-2(b)(3)(ii).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

partner or related person that is not a disregarded entity is treated as a disregarded entity for purposes of determining the net value of the partner or related person.[13]

C. Allocation of Recourse Liabilities

Modify Example (1) as follows:

Example (1). Assume that A and B are equal partners in a general partnership that has not elected under state law to be a limited liability partnership. Each of the partners contribute $10,000 to the partnership and the partnership borrows $80,000 to purchase a $100,000 building.

Add at the end of the subsection:

Sometimes more than one partner may have economic risk of loss in respect of a partnership liability. In such a case, the economic risk of loss borne by each partner with respect to such a liability will equal the amount determined by multiplying:

(i) the amount of such liability (or portion thereof) by

(ii) the fraction obtained by dividing the amount of the economic risk of loss that an individual partner is determined to bear with respect to that liability (or portion thereof) by the sum of such amounts for all partners.[14]

D. Allocation of Nonrecourse Liabilities

Add at the end of the last full paragraph on page 83:

Proposed Regulations would eliminate the ability of partnerships to allocate nonrecourse liabilities consistently with a significant item. Under the Proposed Regulations, the partnership agreement may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities provided the interests so specified are in accordance with the partners' liquidation value percentages. A partner's liquidation value percentage, which is determined upon the formation of a partnership and redetermined upon any event described in Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5), irrespective of whether the capital accounts of the partners are adjusted, is the ratio (expressed as a percentage) of the liquidation value of the partner's interest in the partnership divided by the aggregate liquidation value of all of the partners' interests in the partnership. Any change in the partners' shares of partnership liabilities as a result of an event described in Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5) is taken into account in determining the tax consequences of the event that gave rise to such change. The liquidation value of a partner's interest in a partnership is the amount of cash the partner would receive with respect to the interest if, immediately after the formation of the partnership or the occurrence of an event described in Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5), as the case may be, the partnership sold all of its assets for cash equal to the fair market value of such assets (taking into account

---

13 Prop. Treas. Reg. § 1.752-2(b)(3)(iii)(B).

14 Prop. Treas. Reg. § 1.752-2(a)(2).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

I.R.C. § 7701(g)), satisfied all of its liabilities (other than those described in Treas. Reg. § 1.752-7), paid an unrelated third party to assume all of its Treas. Reg. § 1.752-7 liabilities in a fully taxable transaction, and then liquidated.[15]

E. Contributions and Distributions of Encumbered Property.

The first paragraph is modified as follows:

As indicated in §3.04(A), an increase in a partner's share of partnership liabilities is treated as a contribution of money by the partner to the partnership, and a decrease in a partner's share of partnership liabilities is treated as a distribution of money to that partner. If a partner contributes property to a partnership and the partnership assumes liabilities of the contributing partner, or if the property contributed is subject to a liability, there may be both deemed money distributions to the partner, as well as deemed money contributions by the partner. Similarly, if a partnership distributes property to a partner and a partner assumes a partnership liability, or the property distributed is subject to debt, there can be deemed money contributions and distributions.

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

§ 4.05 ACCOUNTING METHOD

A. C Corporation Is Partner

1. Farming Business

Add at the end: However, I.R.C. § 447, discussed below, can trump and require a farming business to use the accrual method.

§ 4.09 PARTNERSHIP LEVEL LIABILITY ON AUDITS

Under the partnership audit rules, effective in 2018, the default position will be that a partnership (and not the partners) is required to pay any federal tax deficiency arising from an audit (the "*imputed underpayment*"), unless an alternative to the default position is elected as described below.[16] Partnership audit adjustments will no longer be assessed and collected at the partner level, but will instead be assessed to, and the tax collected directly from, the partnership. Under the default approach, partners in the year in which the assessment is finalized (the "*adjustment year*") will bear the cost of the partnership adjustment from a prior year (the "*reviewed year*"). This is the case even if a partner was not a partner in the partnership during the reviewed year.

15 Prop. Treas. Reg. § 1.752-3(a)(3).

16 I.R.C. § 6225.

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

When the IRS issues a Notice of Proposed Partnership Adjustment at the close of a partnership audit, the notice will net the partnership adjustments and will calculate the imputed underpayment for the adjustment year at the highest marginal federal tax rate in effect for the reviewed year.[17] In general, the tax calculation will not take into consideration the extent that any adjustment reallocates partnership items from one partner to another partner, such adjustment will not take into account any decrease in any item of income or gain, and any increase in any item of deduction, loss or credit.[18] In other words, if an income reallocation were made from one partner to another partner resulting in a partnership tax due to an increase in income to one partner, such assessment will not take into consideration any reduction in income to the other partner.

As an alternative to the default position discussed above, a partnership may elect to have adjustments from a partnership-level audit reflected on adjusted Schedules K-1 (which are provided to both the partners as well as the IRS) and paid at the partner level by those partners that were partners in a reviewed year (the "*Passthrough Adjustment Election*").[19] The Passthrough Adjustment Election must be made no later than 45 days after the date of the issuance of the Notice of Final Partnership Administrative Adjustment, and once made, the Passthrough Adjustment Election is revocable only with the consent of the IRS. The partners would be required to take the adjustments into account on their own tax returns in the adjustment year.

Certain partnerships may opt out of the new partnership audit rules altogether, but they must elect to do so every year. Eligible partnerships are those that issue fewer than 100 Schedules K-1 a year and only have individuals, C corporations (including comparable foreign entities), S corporations, or an estate of a deceased partner as partners.[20] Each S corporation shareholder is counted for purposes of the 100-Schedule K-1 limit. Partnerships that have another partnership as a partner (i.e., tiered partnership structures) cannot opt out.

---

17 I.R.C. § 6225(b).

18 I.R.C. § 6225(b)(2).

19 I.R.C. § 6226.

20 I.R.C. § 6221.

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

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

§ 5.03 SUBSTANTIAL ECONOMIC EFFECT RULES

B. Economic Effect Rules.

3. Economic Effect Equivalence.

The third alternative provided in the Regulations to meet the economic effect test is the "economic effect equivalence test." Allocations made to a partner that do not otherwise have economic effect under the rules discussed above can nevertheless be deemed to have economic effect under this test. The economic effect equivalence test is met provided that a liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic results to the partners as would occur if the formal economic effect test were met, regardless of the economic performance of the partnership.[21] For example, assume A and B contribute $ 75,000 and $ 25,000, respectively, to the AB partnership. Assume further that the partnership maintains no capital accounts and the partnership agreement provides that all income, gain, loss, deduction, and credit will be allocated 75% to G and 25% to H. G and H are ultimately liable (under a state law right of contribution) for 75% and 25 %, respectively, of any debts of the partnership. Although the allocations do not satisfy the requirements of the economic effect rules discussed above, the allocations have economic effect under the economic effect equivalence test.[22]

C. Substantiality.

1. General Rules.

Footnote 20. P. 130. The *de minimus* rule has been withdrawn for years after Dec. 28, 2012. TD 9607, 77 FR 76380 (Dec. 28, 2012).

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

Add in the bullet point list associated with footnote 90:

- In connection with the issuance by the partnership of a noncompensatory option (other than an option for a *de minimus* partnership interest); or

§ 5.08 GIFTED PARTNERSHIP INTERESTS

C. I.R.C. 761(b) and 704(e)

---

21 Treas. Reg. § 1.704-1(b)(2)(ii)(i).

22 This example is based on Treas. Reg. § 1.704-1(b)(5), example 4(ii).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

Congress ultimately stepped in and enacted I.R.C. § 761(b) and I.R.C. § 704(e). I.R.C. § 761(b) provides that the determination of whether a person shall be recognized as a partner if she owns a capital interest in a partnership in which capital is a material income-producing factor, shall be determined without regard to whether such interest was derived by gift from any other person.[23] Accordingly, I.R.C. § 761(b) trumps the assignment of income doctrine, at least as it was interpreted in the partnership context in early case law. Income may be allocated to a donee partner in a partnership in which capital is a material income-producing factor even if the partner contributed nothing to the partnership.[24]

When is capital a material income-producing factor? While this can sometimes be difficult to ascertain, usually it is not, and generally means what you would expect. For example, a partnership that derives its income mainly from an apartment building will meet the test. A partnership that derives its income from the performance of services (e.g. a partnership of accountants or lawyers) will not. Note that when capital is not a material income-producing factor, I.R.C. § 761(b) does not apply, and we must rely on the *Tower/Culbertson* line of cases in determining whether a person's partnership status is to be respected.

There are other ways to game the system. One would be to underpay the donor partner for services she renders to the partnership. In response, I.R.C. § 704(e)(1) requires that the partnership pay the donor partner reasonable compensation for her services. It also effectively requires that the rate of return on the donee's capital not exceed the rate of return on the donor's capital.

I.R.C. §§ 761(b) and 704(e)(1) can apply even if one family member acquires the partnership interest from another family member by purchase. I.R.C. 704(e)(2) provides that under these circumstances the transferred partnership interest shall be considered to be gifted from the seller, "and the fair market value of the purchased interest shall be considered to be the donated capital." Thus, the assignment of income principles can potentially even apply to the purchase by one family member of another family member's partnership interest, unless capital is an income producing factor. While I.R.C. § 704(e)(2) seems to provide an irrebuttable rule, the Regulations in fact provide exceptions.[25]

I.R.C. § 704(e) does not apply in the context of a services partnership in respect of which capital is not a material income producing factor. For such partnerships, the early assignment of income cases are still relevant.

§ 5.09 CHANGES IN PARTNERSHIP INTERESTS DURING THE TAX YEAR

A. General Rules

---

23 I.R.C. § 761(b).

24 I.R.C. § 704(e)(1).

25 *See* Treas. Reg. § 1.704-1(e)(4)(ii).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

I.R.C. § 706(a) provides that a partner is required to include the partner's distributive share of the income, gain, loss, deduction, or credit of the partnership for the taxable year of the partnership ending within or with the taxable year of the partner. The partnership's tax year as to a given partner will close early if the partner's entire interest in the partnership is sold, exchanged or liquidated.

Further, a partner's interest in the partnership can, of course, change during the tax year. A partner's percentage interest in the partnership can vary during a tax year if, for example, part of his or another partner's interest is sold or redeemed, if he or another partner contributes new capital to the partnership, or if new partners enter the partnership.

I.R.C. § 706 and its Regulations address how partnership items of income, gain, loss, deduction or credit are to be allocated when partnership interests change.

B. Closing of Partnership Taxable Year

I.R.C. § 706(c)(1) sets forth the general rule that the taxable year of the partnership is not closed as the result of the death of a partner, the entry of a new partner, the liquidation of a partner's interest in the partnership or the sale or exchange of a partner's interest in the partnership. This is true, whether or not any of such transactions result in the partnership being dissolved or liquidated for state law purposes.[26] I.R.C. § 706(c)(2) provides, however, significant exceptions to the general rule.

I.R.C. § 706(c)(2)(A) provides that the taxable year of the partnership indeed closes with respect to a partner whose entire interest in the partnership terminates. The closing of the partnership's taxable year is only with respect to the partner disposing of her interest, not the other partners. It does not matter whether the partner's interest terminates because of sale or exchange, death, liquidation, or otherwise.[27] I.R.C. § 706(c)(2)(B), however, provides that the partnership's taxable year does not close with respect to a partner who sells or exchanges less than his entire interest in the partnership.

C. Requirement to Account for Varying Interests

I.R.C. § 706(d)(1) sets forth the general rule that if there is any change in a partner's partnership interest during the year, each partner's distributive share of the items of income, gain, loss, deduction or credit of the partnership for that taxable year is determined by taking into account the varying interests of the partners during the year. Treas. Reg. § 1.706-1(c)(2)(i) provides that in the case of a sale or exchange of a partner's entire partnership interest, liquidation of the entire partnership interest, or the death of a partner, the partner includes in her taxable income for her taxable year within or with which her membership interest in the partnership ends, her distributive share of the items of income, gain, loss, deduction or credit, and any guaranteed payments under I.R.C. § 707(c). Recall that her partnership taxable year ends with the date of such sale or exchange or liquidation.

---

26 Treas. Reg. § 1.706-1(c)(1).

27 For a discussion of the closing of a taxable year upon the death of a partner, please see Chapter 15.

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

If, on the other hand, the partner's partnership tax year does not close, then the partner needs to take into account her varying share of partnership items as discussed below.

D. Methods of Allocation

The partnership has two options for allocating partnership items when the partners' interests change during the year if a partner terminates his entire interest in the partnership: It can do an "interim closing of the books" or it can prorate the partnership items to the partners based on their varying interests in the partnership during the year.[28] Specifically, Treas. Reg. § 1.706-4(a)(3)(iii) provides that in order to avoid an interim closing of the partnership's books, the terminating partner's distributive share of such items may, if agreed to by the partners[29], be estimated by taking into account her pro rata share of the amount of such items that would have been included in her taxable income had she remained a partner until the end of the partnership's taxable year. If such alternative method is used, the transferee also includes in her taxable income a pro rata share of the amount of the items that would have been included in her income had she been a partner from the beginning of the taxable year. The pro rata portions that are included in the transferor and transferee partners' income must be determined in the same fashion.

For example, assume in the equal ABC partnership, B sells his interest (one-third interest in the partnership) to D on October 1.[30] If the interim closing of the books method is used, the partnership would calculate what its income and expenses were for the first three-quarters of the year and allocate one-third of those amounts each to A, B and C. It would make the same calculation for the final quarter and allocate one-third to A, C and D.

Closing the books in this fashion and determining exactly what was incurred when can be challenging and expensive. Partnerships thus often prefer the pro rata method. The pro rata method is based on the period of time a partner held a particular percentage interest in the partnership, without regard to when a partnership item was actually incurred. Continuing with the above example, under the pro rata method, A and C each would be allocated one-third of all partnership items for the year. B would be allocated 1/3 x 9/12[31] of partnership items with respect to the portion of the year he was a partner. Finally, D would be allocated 1/3 x 3/12 of partnership items with respect to the portion of the year he was a partner.[32]

---

28 *See* Treas. Reg. § 1.706-1(c)(2)(ii).

29 The term "agreement of the partners" means either an agreement of all the partners to select the method, convention or extraordinary item in a dated, written statement or a selection of the method, convention or extraordinary item made by a person authorized to make that selection, either under state law or under the partnership agreement. Treas. Reg. § 1.706-4(f).

30 *See Partnership Taxation* at ¶ 9.06[7]; this assumes the partnership is on a calendar year, as would typically be the case.

31 *I.e.*, 9 months divided by 12 months.

32 Treas. Reg. § 1.706-1(c)(2)(ii).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

Where the tax year of a partner does not close, the same principles should apply.[33] For example, assume in the equal AB partnership, B sells one-half of his interest (a one-quarter interest in the partnership) to C on October 1, so that after that date A has a one-half interest, and B and C each have a one-quarter interest. If the interim closing of the books method is used, the partnership would calculate what its income and expenses were for the first three quarters of the year and allocate half of those amounts each to A and B. It would make the same calculation for the final quarter and allocate one-half to A and one-quarter each to B and C. Under the pro rata method, A would be allocated half of all partnership items for the year. B would be allocated ½ x 9/12 of partnership items with respect to the portion of the year he was a one-half partner and 1/4 x 3/12 of partnership items with respect to the portion of the year he was a one-quarter partner. Finally, C would be allocated 1/4 x 3/12 of partnership items with respect to the portion of the year he was a partner.

Cash method partnerships could take advantage of the rules as discussed to this point. Assume in the example where B sold his entire interest that when D became a partner, the partnership used the cash basis and has a $60,000 expense that it has incurred, but not paid. Under the pro rata method, D's share of that expense would be 1/3 x 1/4 x $60,000, or $5,000. If, however, the cash method partnership used the interim closing of the books method, then paid the expense after D became a partner, D would be entitled to a full one-third share or $20,000, double what the result would be if the pro rata method were used.[34]

I.R.C. § 706(d)(2)(a) for the most part has stopped this ploy, and applies whenever a partner's interest in the partnership changes, not only when it terminates as in the example. Cash method partnerships must now allocate listed "cash basis items" to the time during the taxable year to which these items are attributable, regardless of whether or not the partnership uses the interim closing of the books method or the pro rata method. The listed items are treated, therefore, as if the partnership were on the accrual method of accounting. The allocable cash basis items are interest, taxes, payments for services or for the use of property, and any other item specified in the Regulations (though to date the Regulations have not specified any). Thus, in the example where B sold his entire interest, if the $60,000 expense were for services and was attributable to a time before D became a partner, D could be allocated none of it. It would have to be allocated entirely to A, B and C. If, on the other hand, the $60,000 expense was not an allocable cash basis item (a judgment against the partnership, for example), it should still be possible to close the books and allocate a portion to D. Note that the rules for allocating cash basis items cover most of the waterfront and thus will typically be the rule that applies whether a partner's interest in the partnership terminates or is merely changed.

Of course, as you now know, I.R.C. § 704(b) permits the partnership to make allocations other than based on strict partnership ownership percentages. But what I.R.C. § 706(d) does not permit, and in this regard it trumps I.R.C. § 704(b), is for the partnership to make a retroactive

33 Treas. Reg. § 1.706-4(a); S. Rep. No. 938, 94th Cong., 2d Sess. 98 (1976); accord H.R. Rep. No. 658, 94th Cong., 1st Sess. 124 (1975).

34 The partnership successfully used this technique in *Richardson v. Commissioner*, 76 T.C. 512 (1981), *aff'd on other issues* 693 F.2d 1189 (5th Cir. 1982).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

allocation to a partner of deductions and losses that the partnership incurred prior to that person becoming a partner.[35]

E. Additional details

Treas. Reg. § 1.706–1(c)(2)(ii) provides that, under the pro rata method, the partnership's income and losses may be prorated based on the portion of the taxable year that has elapsed prior to the date upon which the partners' interests varied, or "under any other method that is reasonable." These other reasonable methods have become known as conventions.

In 1984, the IRS issued a news release[36] announcing that partnerships using the interim closing method were permitted to use a semi-monthly convention. Under a semi-monthly convention, partners entering during the first 15 days of the month are treated as entering on the first day of the month, and partners entering after the 15th day of the month (but before the end of the month) are treated as entering on the 16th day of the month (except to the extent that I.R.C. § 706(c)(2)(A) applies). This is known as the semi-monthly convention.[37] Alternatively, the Regulations also provide for a calendar day convention and a monthly convention. Under the calendar day convention, each variation is deemed to occur for purposes of the Regulations at the end of the day on which the variation occurs.[38] Under the monthly convention, each variation is deemed to occur, either (i) in the case of a variation occurring on the 1st through the 15th day of a calendar month, at the end of the last day of the immediately preceding calendar month; or (ii) in the case of a variation occurring on the 16th through the last day of a calendar month, at the end of the last day of that calendar month.[39]

The Regulations provide that most partnerships that use the pro ration method for a variation may only use the calendar day convention for the variation.[40] On the other hand, partnerships that use the closing of the books method may use any of the three conventions. Publicly traded partnerships, however, may use any of the three conventions even if they use the pro ration method.

Treas. Reg. § 1.706-4(e) requires a partnership using the proration method to allocate extraordinary items among the partners in proportion to their interests at the time of the day on which they are taken into account. For this purpose, an extraordinary item is (i) any item from the disposition or abandonment (other than in the ordinary course of business) of a capital asset

---

35 *See* Staff of the Joint Committee on Taxation, *General Explanation of Tax Reform Act of 1976*, 94th Cong., 2d Sess. 91-94 (1976).

36 IR–84–129 (*http://www.irs.gov/puv/irs-drop/ir-84–129.pdf*) (Dec. 13, 1984).

37 Treas. Reg. 1.706-4(c)(ii).

38 Treas. Reg. § 1.706-4(c)(i).

39 Treas. Reg. § 1.706-4(c)(iii).

40 Treas. Reg. § 1.706-4(c)(3)(i).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

as defined in I.R.C. § 1221 (determined without the application of any other rules of law); (ii) any item from the disposition or abandonment of property used in a trade or business (other than in the ordinary course of business) as defined in I.R.C. § 1231(b) (determined without the application of any holding period requirement); (iii) any item from the disposition or abandonment of an asset described in I.R.C. §§ 1221(a)(1), (3), (4), or (5), if substantially all the assets in the same category from the same trade or business are disposed of or abandoned in one transaction (or series of related transactions); (iv) any item from assets disposed of in an applicable asset acquisition under I.R.C. § 1060(c); (v) any I.R.C. § 481(a) adjustment; (vi) any item from the discharge or retirement of indebtedness (for example, if a debtor partnership transfers a capital or profits interest in such partnership to a creditor in satisfaction of its recourse or nonrecourse indebtedness, any discharge of indebtedness income recognized under I.R.C. § 108(e)(8) must be allocated among the persons who were partners in the partnership immediately before the discharge); (vii) any item from the settlement of a tort or similar third-party liability; (viii) any credit, to the extent it arises from activities or items that are not ratably allocated (for example, the rehabilitation credit under I.R.C. § 47, which is based on placement in service); (ix) any additional item if the partners agree to consistently treat such items as an extraordinary item for that taxable year;[41] and (x) any item which, in the opinion of the IRS, would, if ratably allocated, result in a substantial distortion of income in any consolidated return or separate return in which the item is included. If all the items in a particular class of extraordinary items are less than five percent of the partnership's gross income, the partnership may treat the items as not being extraordinary items for the taxable year.[42] Proposed Regulations would also treat amounts subject to withholding under Treas. Reg. § 1.1441-2(a) or Treas. Reg. § 1.1473-1(a) as an extraordinary item for publicly traded partnerships if the partnership agree to treat all such items as extraordinary items for the taxable year.[43] In addition, the Proposed Regulations would treat deductions for the transfer of partnership equity in connection with the performance of services as an extraordinary item for all partnerships.[44]

CHAPTER 6: DISPOSITIONS OF PARTNERSHIP INTERESTS

§ 6.05 INSTALLMENT SALES

Add to footnote 6, page 187:

See also Mingo v. Commissioner, 2013 RIA TC Memo ¶2013-149 (6/12/2013).

§ 6.06 DISPOSITIONS OTHER THAN SALES OR EXCHANGES

F. Transfers to Partnerships

---

41 This alternative is not available would result in a substantial distortion in any partner's return.

42 Treas. Reg. § 1.706-4(e)(3).

43 Prop. Treas. Reg. § 1.706-4(e)(2)(ix).

44 Prop. Treas. Reg. § 1.706-4(e)(2)(x).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

For example, assume that A is a 25% partner of partnership ABCD, that A's basis for A's partnership interest is $10,000 and that A's share of the $60,000 of nonrecourse liabilities of ABCD is $15,000. If A were to transfer A's partnership interest in ABCD to a newly formed partnership AZ, which has no other liabilities and of which A was a 50% partner, A's share of the liabilities ABCD would now be $7,500 and there would have been a decrease in A's share of ABCD's liabilities of $7,500. Since this is less than A's basis for his partnership interest in ABCD, no gain or loss would be recognized by A on the transfer.[45] A's basis in AZ would be $2,500.

If AZ has liabilities, those liabilities would need to be taken into consideration in determining the net result to A. As discussed in Chapter 3, Treas. Reg. § 1.752-1(f) provides that where the same transaction produces both an increase and decrease in a partner's share of partnership liabilities, only the net increase is treated as a contribution of money by the partner and only the net decrease is treated as a distribution of money to the partner. If we assumed that AZ had $5,000 of nonrecourse liabilities in addition to those attributable to A's contribution of A's interest in ABCD, then A's 50% of the additional liabilities would have to be included in the calculation of the impact to A. A's share of the liabilities of ABCD would be $7,500, and A's share of the additional liabilities of AZ would be $2,500. So the net distribution to A on the contribution of A's interest in ABCD to AZ would be $5,000. A's basis in AZ would also be $5,000 under these facts.

§ 6.07 Optional Adjustment to Basis of Partnership Property

F. Additional Aspects of Adjustment

4. Contribution of Property to a Corporation

If a partnership contributes an asset to a corporation in a transaction to which I.R.C. § 351 applies with respect to which a partner of the transferring partnership has a special basis adjustment, the corporation's basis for such property generally includes the basis adjustment.[46] If any gain is recognized by the contributing partnership in such transaction, the contributing partnership determines the amount of gain without regard to the basis adjustment, but when allocating the gain to the transferee partner having the basis adjustment, the basis adjustment is taken into account.[47] The partnership's basis in the stock of the corporation is determined without regard to the I.R.C. § 743(b) adjustment, but the transferee partner has an I.R.C. § 743(b) adjustment with respect to the stock.[48]

---

45 *See* Rev. Rul. 79-205, 1979-2 C.B. 255; Rev. Rul. 77-309, 1977-2 C.B. 216; and Rev. Rul. 87-120, 1987-2 C.B. 161.

46 Treas. Reg. § 1.743-1(h)(2)(i).

47 Treas. Reg. § 1.743-1(h)(2)(ii).

48 Treas. Reg. § 1.743-1(h)(2)(iii).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

§ 6.08 ALLOCATION OF INCOME AND LOSS

We discussed in Chapter 5 the conditions under which the partnership taxable year may close as a result of the transfer of a partnership interest.[49] As discussed there, a partnership generally has a choice between two methods: the closing of the books method and the pro rata method. The Code does place a limit on the types of income for which the pro rata method may be used, and Proposed Regulations would expand the types of income for which the pro rata method may not be used.

§ 6.09 TERMINATION OF PARTNERSHIPS

A. What Transactions Are Taken in Account

The third sentence in the first paragraph on page 207 should be replaced with:

A transfer of a partnership interest by gift, bequest or inheritance and the liquidation of a partnership interest are not treated as a sale or exchange for the purposes of I.R.C. § 708(b)(1)(B).

The text associated with footnote 87 should be replaced with:

If a partnership is terminated by a sale or exchange of an interest in the partnership, an I.R.C. § 754 election (including an I.R.C. § 754 election made by the terminated partnership on its final return) that is in effect for the taxable year of the terminated partnership in which the sale occurs, applies with respect to the incoming partner.[50] Therefore, the bases of partnership assets are adjusted pursuant to I.R.C. §§ 743 and 755 prior to their deemed contribution to the new partnership. A partner with a basis adjustment in property held by a partnership that terminates under I.R.C. § 708 (b)(1)(B) will continue to have the same basis adjustment with respect to property deemed contributed by the terminated partnership to the new partnership under Treas. Reg. § 1.708-1(b)(1)(iv), regardless of whether the new partnership makes an I.R.C. § 754 election.[51] Proposed Regulations suggest that the deemed liquidation in an I.R.C. § 708(b)(1)(B) termination could also result in an adjustment if the resulting partnership makes an I.R.C. § 754 election for its first year.[52]

CHAPTER 7: PARTNERSHIP DISTRIBUTIONS

§ 7.08 SHIFTS IN ORDINARY INCOME PROPERTY

---

49 The issues related to the transfer of a partnership interest by the death of a partner are discussed in Chapter 15.

50 Treas. Reg. § 1.708-1(b)(5).

51 Treas. Reg. § 1.743-1(h)(1).

52 Prop. Reg. § 1.755-1(c)(2)(vi).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

C. Nuts and Bolts.

We gave brief examples earlier illustrating why Congress put I.R.C. § 751(b) into the Code. Now let's take a more detailed look. Assume that A, B, and C are equal partners in the ABC partnership. The partnership has the following balance sheet:

P/S Assets	Adj. Basis	F.M.V.	Partners	Adj. Basis	F.M.V.
Cash	$30,000	$30,000	A	$18,000	$30,000
Inventory	$18,000	$30,000	B	$18,000	$30,000
Cap. Asset	$6,000	$30,000	C	$18,000	$30,000
Total	$54,000	$90,000		$54,000	$90,000

Assume that partner C receives the inventory in liquidation of his interest. It is of no particular significance that it is a liquidating as opposed to an operating distribution; we have made it a liquidating distribution in order to make the numbers easier to follow. Note that the inventory is substantially appreciated. The fair market value of $30,000 exceeds 120% of the basis of $18,000 (120% of $18,000 is $21,600). Also, assume that the capital asset has been held for over one year. If I.R.C. § 751(b) did not exist, C would receive the inventory with a basis of $18,000 and a fair market value of $30,000 and his basis in his partnership interest would be reduced to zero.[53] There is $12,000 of gain inherent in the inventory in C's hands. There is $24,000 of gain inherent in the capital asset the partnership continues to hold, or $12,000 each for A and B. Thus, all the partners have the same *amount* of gain that they had before C's interest was liquidated. But, the *character* of the gain has changed. If the partnership had sold all of its assets before C's interest was liquidated, each partner would have had $4,000 of ordinary income and $8,000 of long-term capital gain. If the partnership sells all of its assets and C sells the inventory after C's interest is liquidated, A and B each have $12,000 of long-term capital gain and C has $12,000 of ordinary income.[54] A and B have shifted their shares of the ordinary income that was inherent in the inventory to C; that is, A and B have converted ordinary income into capital gains. I.R.C. § 751(b) stops this, though as we will see, it does not always do so perfectly. While it prevents partners from converting ordinary income into capital gains, it does not always prevent partners from shifting ordinary income amongst themselves.[55]

---

53 I.R.C. §§ 731(a), 732(b), (c)(1)(A).

54 I.R.C. § 735(a)(2).

55 *See* Monte Jackel and Avery Stok, *Blissful Ignorance: Section 751(b) Uncharted Territory*, 98 Tax Notes 1557 (2003).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

The mechanics of I.R.C. § 751(b) are complex. The starting point of I.R.C. § 751(b) is that each partner has, in effect, an undivided interest in the assets that constitute I.R.C. § 751 property and I.R.C. § 741 property. The examples in the Regulations under I.R.C. § 751(b) determine a partner's interest in I.R.C. § 751 property by reference to the partner's share of the gross value of the partnership's assets (the "gross value" approach), not by reference to the partner's share of the unrealized gain or loss in the property.[56] If an interest in one class is swapped for an interest in the other class, a taxable event has occurred. Note that partners (or LLC members) are generally not considered to have an ownership interest in partnership (or LLC) property for state law purposes.[57] I.R.C. § 751(b) creates a fiction to avoid ordinary income shifting. From the perspective of I.R.C. § 751(b), C held a one-third interest in the partnership assets consisting of:

Assets	Adjusted Basis	F.M.V.
Cash	$10,000	$10,000
Inventory	$6,000	$10,000
Capital Asset	$2,000	$10,000
Total	$18,000	$30,000

C effectively exchanged his interest in the cash and the capital asset (the I.R.C. § 741 assets) for the "extra" two-thirds of the inventory (the I.R.C. § 751(b) asset). I.R.C. § 751(b) requires C and the partnership (now A and B) to treat what is a liquidation distribution in substance as a taxable exchange for tax purposes.[58]

The partnership is deemed to have made a phantom distribution of the I.R.C. § 741 assets to C. The partners may actually choose which I.R.C. § 741 assets are deemed to have been distributed to C. The partners could, for example, choose just the cash or just the capital asset. If there is no specific agreement, as we will assume here, C is deemed to receive a pro rata share of each I.R.C. § 741 asset.[59] Thus, the partnership is deemed to have made a phantom distribution to C of one-third of the cash and the capital asset. The "regular" distribution rules apply to this phantom distribution. C will thus first reduce his $18,000 basis for the $10,000 of cash deemed received, leaving him with a basis of $8,000 in the partnership interest. C will then reduce his basis by the partnership's $2,000 basis in the capital asset and take a full carryover

---

56 See, for example, Treas. Reg. § 1.751-1(g), Example 2.

57 *See* Revised Uniform Partnership Act ("RUPA") § 203.

58 Treas. Reg. § 1.751-1(b)(2)(i).

59 Treas. Reg. § 1.751-1(g), example 4(c).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

basis in that asset, leaving C with a $6,000 basis in his partnership interest. Under I.R.C. § 731, C recognizes no gain or loss.

C now enters into a phantom, taxable exchange with the partnership, as follows:

C		Partnership
Cash $10,000 and		Inventory
Capital Asset	For	F.M.V. $20,000
F.M.V. $10,000		Basis $12,000
Basis $2,000		

C will recognize $8,000 of capital gain on the capital asset and the partnership will recognize $8,000 of ordinary income on the inventory.[60] Logically enough, the Regulations require that the partnership's ordinary income be allocated to A and B.[61] Note that at this point A and B have recognized the pro rata shares of the ordinary income inherent in the inventory and each will increase his basis in his partnership interest by the $4,000 of income recognized.[62] C will take a fair market basis of $20,000 in two-thirds of the inventory, and the partnership will take a fair market value basis of $10,000 in one-third of the capital asset.[63]

After the phantom exchange (but prior to the distribution of one-third of the inventory to C), the balance sheet of the partnership is as follows:

Assets	Adj. Basis	F.M.V.	Partners	Adj. Basis	F.M.V.
Cash	$30,000	$30,000	A	$22,000	$30,000
Inventory	$6,000	$10,000	B	$22,000	$30,000
Cap. Asset	$14,000	$30,000	C	$6,000	$10,000
Total	$50,000	$70,000		$50,000	$70,000

60 I.R.C. §§ 1001(a), (c).

61 Treas. Reg. §§ 1.751-1(b)(2)(ii), (b)(3)(ii).

62 I.R.C. § 705(a)(1)(A).

63 I.R.C. § 1012.

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

The regular operating rules are now back in effect, and the final one-third of the inventory is deemed distributed to C. C takes a basis of $6,000 in the one-third of the inventory, his partnership interest basis is reduced to zero, and he recognizes no gain on the distribution.[64] C thus now holds the inventory with a total basis of $26,000 (fair market value basis of $20,000 in two-thirds of the inventory plus $6,000 under I.R.C. § 732(b) for the final one-third of the inventory considered distributed). Assuming its value does not change, when C sells the inventory for $30,000, he recognizes $4,000 of ordinary income. This is what his share of ordinary income inherent in the inventory was to begin with when the partnership held it, and all is right with the world.

The balance sheet of the partnership after completion of the transaction is as follows:

Assets	Adj. Basis	F.M.V.	Partners	Adj. Basis	F.M.V.
Cash	$30,000	$30,000	A	$22,000	$30,000
Cap. Asset	$14,000	$30,000	B	$22,000	$30,000
Total	$44,000	$60,000		$44,000	$60,000

Note that in order for I.R.C. § 751(b) to apply, an interest in the I.R.C § 751 property must be swapped for an interest in the I.R.C. § 741 property. If C had simply received a distribution with a value of $30,000 consisting of his proportionate one-third share of I.R.C. § 751(b) property plus cash and/or a portion of the capital asset to make up the difference, no deemed swap would have occurred, and I.R.C. § 751(b) would not have applied. Further, I.R.C. § 751(b) will not apply to a distribution of property that the distributee contributed to the partnership.[65] I.R.C. § 751(b) also will not apply to I.R.C. § 736(a) payments[66] (discussed below), draws or advances that a partner receives against his distributive share of partnership income, or to gifts, payments for services, or use of capital.[67]

D. Associated Issues

[64] I.R.C. §§ 731(a)(1), 732(b) and 733(2). Technically, because it is a liquidating distribution, C does not take a carryover basis in the one-third of the inventory, as would be the case if it had been an operating distribution. Instead, his basis in his partnership interest of $6,000 becomes the basis in this part of the inventory. Note that if it had been an operating distribution, C's carryover basis would have been the same $6,000. Further, a partner is never permitted to take a greater basis than that which the partnership had in inventory and unrealized receivables, regardless of the type of distribution involved. I.R.C. § 732(c)(1).

[65] I.R.C. § 751(b)(2)(A).

[66] I.R.C. § 751(b)(2)(B).

[67] Treas. Reg. § 1.751-1(b)(i)(ii).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

In the example just above, assume that C purchased his interest in the partnership from X for $24,000 and that since the time of the purchase both the value of the partnership assets and their bases are as stated above. Assume further that no I.R.C. § 754 election is in effect and more than two years has elapsed since C's purchase. C would in effect have paid $8,000 of the purchase price for an indirect one-third interest in the equipment. Nonetheless, C will have to recognize the same amount of ordinary income as in the example above because no I.R.C. § 754 election was made. If, on the other hand, C's share of the equipment is distributed to C within two years of C's purchase of the interest, then I.R.C. § 732(d), discussed above, would provide relief and for purposes of the distribution give C the equivalent of an I.R.C. § 754 election.[68]

Insert after D:

E. Proposed Regulations

The Proposed Regulations under I.R.C. § 751(b) establish an approach for measuring partners' interests in section 751 property, provide new rules under I.R.C. § 704(c) to help partnerships compute partner gain in I.R.C. § 751 property more precisely, and describe how basis adjustments under I.R.C. §§ 734(b) and 743(b) affect the computation of partners' interests in I.R.C. § 751 property.

The first step in computing the effect of I.R.C. § 751(b) is to measure the partners' interests in I.R.C. § 751 property. The hypothetical sale approach requires a partnership to compare: (1) the amount of ordinary income (or ordinary loss) that each partner would recognize if the partnership sold its property for fair market value immediately before the distribution with (2) the amount of ordinary income (or ordinary loss) each partner would recognize if the partnership sold its property, and the distributee partner sold the distributed assets, for fair market value immediately after the distribution.[69] The Proposed Regulations adopt the hypothetical sale approach as the method by which the partners must measure their respective interests in I.R.C. § 751 property for the purpose of determining whether a distribution reduces a partner's interest in the partnership's I.R.C. § 751 property. (A distribution that reduces a partner's interest in the partnership's I.R.C. § 751 property is referred to as an "I.R.C. § 751(b) distribution.")

Because the hypothetical sale approach relies on the principles of I.R.C. § 704(c) to preserve a partner's share of the unrealized gain and loss in the partnership's I.R.C. § 751 property, the Proposed Regulations make several changes to the Regulations under I.R.C. § 704(c). Specifically, the Proposed Regulations revise Treas. Reg. § 1.704-1(b)(2)(iv)(f), regarding revaluations of partnership property, to make its provisions mandatory if a partnership distributes money or other property to a partner as consideration for an interest in the partnership, and the partnership owns I.R.C. § 751 property immediately after the distribution. (A partnership that does not own I.R.C. § 751 property immediately after the distribution may still revalue its property under the existing Regulation , but is not required to do so under these Proposed

68 *See* Treas. Reg. § 1.751-1(b)(2)(iii), (b)(3)(iii).

69 Prop. Reg. § 1.751-1(b)(2).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

Regulations.) If a partnership does not maintain capital accounts in accordance with Treas. Reg. § 1.704-1(b)(2)(iv), the partnership must comply with this requirement by computing each partner's share of gain or loss in each partnership asset prior to a distribution, and making future allocations of partnership items in a manner that takes these amounts into account (making subsequent adjustments for cost recovery and other events that affect the property basis of each such asset).[70]

While I.R.C. § 704(c) revaluations generally preserve partners' interests in I.R.C. § 751 property upon a partnership distribution, certain basis adjustments under I.R.C. § 732(c) or 734(b) may alter partners' interests in I.R.C. § 751 property following the distribution. Accordingly, the Proposed Regulations provide rules on the effect of these basis adjustments on the computation of partners' interests in I.R.C. § 751 property.

If a distribution of capital gain property results in a basis adjustment under I.R.C. § 734(b), that basis adjustment is allocated to capital gain property of the partnership under Treas. Reg. § 1.755-1(c)(1). However, some property that is characterized as capital gain property for purposes of I.R.C. § 755 can also result in ordinary income when sold. For example, I.R.C. § 1231 property is characterized as a capital asset for purposes of I.R.C. § 755, but selling the property can also result in ordinary income from recapture under I.R.C. § 1245(a)(1). The Regulations under I.R.C. § 755 do not differentiate between the capital gain aspect of the property and the ordinary income aspect of the property for this purpose. Accordingly, allocating an I.R.C. § 734(b) positive basis adjustment to such property as capital gain property may reduce the amount of ordinary income that would result on a sale of the property. Under the Proposed Regulations, that reduction in ordinary income would constitute a reduction in the partners' shares of unrealized gain in the partnership's I.R.C. § 751 property, which could trigger I.R.C. § 751(b) in situations in which I.R.C. § 751(b) would not have otherwise applied.[71] A similar reduction in I.R.C. § 751 property could occur if the basis of the distributed property increases under I.R.C. § 732.

The Proposed Regulations provide that a basis adjustment under I.R.C. § 732(c) or I.R.C. § 734(b) (as adjusted for recovery of the basis adjustment) that is allocated to capital gain property and that reduces the ordinary income (attributable, for example, to recapture under I.R.C. § 1245(a)(1)) that the partner or partnership would recognize on a taxable disposition of the property, is not taken into account in determining (1) the partnership's basis for purposes of I.R.C. §§ 617(d)(1), 1245(a)(1), 1250(a)(1), 1252(a)(1), and 1254(a)(1), and (2) the partner or partnership's respective gain or loss for purposes of I.R.C. §§ 995(c), 1231(a), and 1248(a).[72]

Under the Proposed Regulations, if I.R.C. § 751(b) applies to a distribution, each partner must generally recognize or take into account currently ordinary income equal to its "I.R.C. § 751(b) amount."[73] If a partner has net I.R.C. § 751 unrealized gain both before and after the

---

70 Prop. Reg. § 1.751-1(b)(2)(iv).

71 Prop. Reg. § 1.751-1(b)(3)(ii)(A).

72 Prop. Reg. § 1.732-1(c)(2)(iii).

73 Prop. Reg. § 1.751-1(c)(3)(i).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

distribution, then the partner's I.R.C. § 751(b) amount equals the partner's net I.R.C. § 751 unrealized gain immediately before the distribution less the partner's net I.R.C. § 751 unrealized gain immediately after the distribution.[74] If a partner has net I.R.C. § 751 unrealized loss both before and after the distribution, then the partner's I.R.C. § 751(b) amount equals the partner's net I.R.C. § 751 unrealized loss immediately after the distribution, less the partner's net I.R.C. § 751 unrealized loss immediately before the distribution.[75] If a partner has net I.R.C. § 751 unrealized gain before the distribution and net I.R.C. § 751 unrealized loss after the distribution, then the partner's I.R.C. § 751(b) amount equals the sum of the partner's net I.R.C. § 751 unrealized gain immediately before the distribution and the partner's net I.R.C. § 751 unrealized loss immediately after the distribution.[76]

The Proposed Regulations also provide an anti-abuse rule that requires taxpayers to apply the rules set forth in the Proposed Regulations in a manner consistent with the purpose of I.R.C. § 751, and that allows the I.R.S. to recast transactions for federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of I.R.C. § 751.[77]

The Proposed Regulations provide a list of situations that are presumed inconsistent with the purpose of I.R.C. § 751. Under this list, a distribution is presumed inconsistent with the purpose of I.R.C. § 751 if I.R.C. § 751(b) would apply but for the application of I.R.C. § 704(c) principles, and one or more of the following conditions exists: (1) a partner's interest in net I.R.C. § 751 unrealized gain is at least four times greater than the partner's capital account immediately after the distribution, (2) a distribution reduces a partner's interest to such an extent that the partner has little or no exposure to partnership losses and does not meaningfully participate in partnership profits aside from a preferred return for the use of capital, (3) the net value of the partner (or its successor) becomes less than its potential tax liability from I.R.C. § 751 property as a result of a transaction, (4) a partner transfers a portion of its partnership interest within five years after the distribution to a tax-indifferent party in a manner that would not trigger ordinary income recognition in the absence of this anti-abuse rule, or (5) a partnership transfers to a corporation in a nonrecognition transaction I.R.C. § 751 property other than pursuant to a transfer of all property used in a trade or (excluding assets that are not material to a continuation of the trade or business).[78] In addition, the Proposed Regulations provide that an amendment to the partnership agreement that results in a reduction in a partner's interest in I.R.C. § 751 property is also presumed inconsistent with the purpose of I.R.C. § 751.[79] A partnership or a partner taking a position on its return that I.R.C. § 751 does not apply to a

74 Prop. Reg. § 1.751-1(c)(2)(i)(A).

75 Prop. Reg. § 1.751-1(c)(2)(i)(B).

76 Prop. Reg. § 1.751-1(c)(2)(i)(C).

77 Prop. Reg. § 1.751-1(c)(4)(i).

78 Prop. Reg. § 1.751-1(c)(4)(i)(A).

79 Prop. Reg. § 1.751-1(c)(4)(i)(B).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

transaction that meets one or more of these situations must disclose its position on Form 8275-R, Regulation Disclosure Statement.[80]

The Proposed Regulations require a distributee partner to recognize capital gain to the extent necessary to prevent the distribution from triggering a basis adjustment under I.R.C. § 734(b) that would reduce other partners' shares of net unrealized I.R.C. § 751 gain or loss.[81]

The Proposed Regulations also allow distributee partners to elect to recognize capital gain in certain circumstances to avoid decreases to the basis of distributed I.R.C. § 751 property.[82] Elective capital gain recognition is appropriate to eliminate a negative I.R.C. § 732(a)(2) or (b) basis adjustment to the asset or assets received in the distribution if, and to the extent that, the distributee partner's net I.R.C. § 751 unrealized gain would otherwise be greater immediately after the distribution than it was immediately before the distribution (or would cause the distributee partner's net I.R.C. § 751 unrealized loss to be less immediately after the distribution than it was immediately before the distribution). For example, elective capital gain recognition is appropriate if a partner with zero basis in its partnership interest receives a distribution of partnership I.R.C. § 751 property with a basis in the hands of the partnership equal to its value, and the distribution otherwise increases the distributee partner's net I.R.C. § 751 unrealized gain.

I.R.C. § 751(b)(2)(A) provides that I.R.C. § 751(b) does not apply to a distribution of property that the distributee contributed to the partnership ("previously contributed property exception"). Unlike other provisions in subchapter K that include similar previously contributed property exceptions, the current Regulations under I.R.C. § 751(b) do not contain successor rules for purposes of applying the I.R.C. § 751(b) previously contributed property exception. The Proposed Regulations add successor rules to I.R.C. § 751(b) similar to the successor rules contained in other previously contributed property exceptions within subchapter K.

§ 7.09 Liquidations of Partnerships & Partnership Interests

C. I.R.C. § 736 Payments

3. I.R.C. § 736(b) Payments

Add to footnote 85:

There is currently no authority as to whether a member of an LLC that is active in the business of the LLC should be treated as a general partner for these purposes.

The last paragraph should be changed to:

---

80 Prop. Reg. § 1.751-1(c)(4)(ii).

81 Prop. Reg. § 1.751-1(c)(3)(ii)(A).

82 Prop. Reg. § 1.751-1(c)(3)(ii)(B).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

The distribution rules discussed earlier in this chapter apply to I.R.C. § 736(b) payments. Thus, the relevant Code sections are I.R.C. §§ 731, 741, and 751(b). We address these rules in detail below.

4. Allocating and Taxing I.R.C. § 736 Payments

On page 242, first full paragraph, change the fourth sentence to read:

Under this method, any loss recognition is postponed until the final payment is received (and the retiring partner has partnership interest basis left over).[83]

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

§ 8.04 Guaranteed Payments

Add to footnote 3:

The results of the Pratt decision would be largely reversed by the Proposed Regulations on disguised sales of services. See § 8.06(c), below.

Add to the end of the discussion:

Current Treas. Reg. § 1.707-1(c) would treat a guaranteed minimum payment as a guaranteed payment to the extent the payment is not matched by an allocation of income.[84] Proposed Regulations would change the result of this example so that the guaranteed minimum amount would always be a guaranteed payment.[85] The preamble to the Proposed Regulations concludes that the treatment of the arrangements described in current Example 2 is inconsistent with the concept that an allocation must be subject to significant entrepreneurial risk to be treated as a distributive share under section 704(b).[86]

§ 8.06 Disguised Sales

A. The Disguised Sale of Assets

Add to footnote 44:

Proposed Regulations would require that this test be applied on a property by property basis. Prop. Treas. Reg. § 1.707-4(d)(1)(ii)(B).

---

83 Treas. Reg. § 1.731-1(a)(2).

84 Treas. Reg. § 1.707-1(c) ex. 2.

85 Prop. Reg. § 1.707-1(c) ex. 2.

86 REG-115452-14, at 43655.

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

Add to footnote 47:

Proposed Regulations would eliminate the requirement that the liability be secured by the assets. Prop. Treas. Reg. § 1.707-4(d)(2).

Add following the sentence associated with footnote 50:

For an anticipated loan reduction to be taken into consideration, Proposed Regulations would add the requirement that the anticipated reduction not be subject to the entrepreneurial risks of partnership operations.[87] If within two years of the partnership incurring the liability, a partner's share of the liability is reduced due to a decrease in the net value of the partner or a related person for the purposes of Treas. Reg. § 1.752-2(k), Proposed Regulations would create a presumption that the reduction is anticipated, unless the facts and circumstances clearly establish that the decrease in the net value was not anticipated.[88]

Add the following paragraph at the end of 8.06.A.

The Regulations provide that rules similar to those in Treas. Reg. § 1.707-5 (for disguised sales of property by a partner to a partnership) apply to determine the extent to which an assumption of, or taking property subject to, a liability by a partner, in connection with a transfer of property by a partnership, is considered part of a sale.[89] More specifically, the Regulations provide that if the partner assumes or takes property subject to a liability that is not a qualified liability, the amount treated as consideration transferred to the partnership is the amount that the liability assumed or taken subject to by the partner exceeds the partner's share of that liability immediately before the transfer.[90] Thus, if a transferee partner had a 100 percent share of a liability immediately before a transfer in which the transferee partner assumed the liability, then no sale is treated as occurring between the partnership and the partner with respect to the liability assumption, irrespective of the period of time during which the partnership liability is outstanding and the period of time in which the partnership liability is allocated to the partner.[91]

B. The Disguised Sale of Partnership Interests

Add at the beginning of the section:

I.R.C. § 741 provides that in the case of a sale or exchange of a partnership interest, gain is recognized by the transferring partner. Treas. Reg. § 1.741-1(b) provides that I.R.C. § 741

---

87 Prop. Reg. § 1.707-5(b)(2)(iii)(A)(2).

88 Prop. Reg. § 1.707-5(b)(2)(iii)(B).

89 Treas. Reg. § 1.707-6.

90 Treas. Reg. § 1.707-6(b)(1).

91 REG-119305-1, 79 Fed. Reg. 4826, 4828 (Jan. 30, 2014). The IRS and Treasury have indicated that they are studying the issue of whether it is appropriate to take into account whether the transferee partner had economic exposure. *Id*.

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

applies (i) to the transferor in a 2-man partnership when he sells his interest to the other partner, and (ii) to all the members of a partnership when they sell their interests to one or more persons outside the partnership. If I.R.C. § 741 applies, the purchase is a purchase of a capital asset, and the purchaser is not entitled to deduct the purchase price against partnership income.[92]

On the other hand, if the partnership chooses to "liquidate" a withdrawing partner's interest, I.R.C. § 736 applies. Treas. Reg. § 1.736-1(a)(1)(i) provides that I.R.C. § 736 applies to payments made to a retiring partner in liquidation of such partner's entire interest in the partnership. The Regulations further provide that I.R.C. § 736 applies to payments made by the partnership and not to transactions between the partners.

I.R.C. § 736 applies to transactions between the withdrawing partner and the partnership, while I.R.C. § 741 deals with transactions between the partners as individuals.[93] Where the obligation to purchase is on the remaining partners individually, the substance of the transaction is a sale between the partners.[94]

Add after the third paragraph on page 261:

Sloan v. Commissioner established a three part test to determine if a transaction was a sale of a partnership interest under I.R.C. § 741 or a liquidation of a partnership interest under I.R.C. § 736. The first factor is the form of the transaction as set up by the parties. The second factor is whether the obligation to make the payment is an obligation of the partnership or of the remaining partners in their individual capacities. The third factor is the intent of the parties as demonstrated by the circumstances surrounding the agreement and the negotiations preceding the withdrawal.

Although a contract may use the language of a sale or exchange, the language itself is not determinative of whether the contract is in respect of the liquidation of the partnership interests. In *Mason v. Commissioner*,[95] the contract was called a "sales contract." However, the court held that contract contemplated liquidating distributions from the partnership.

The parties may determine the nature of the transaction (i.e., a liquidation of an interest or a sale of the interest to another partner or a person outside the partnership, and then the tax consequences will be determined based upon that characterization.[96] The intent of the parties is strongly relevant in determining the appropriate characterization of the transaction.[97]When one

---

92 Sloan v. Commissioner, TC Memo 1981-641.

93 Champlin v. Commissioner, TC Memo 1977-196.

94 Foxman v. Commissioner, 352 F.2d 466 (3rd Cir. 1965).

95 Mason v. Commissioner, TC Memo 1988-273.

96 Miller v. United States, 181 Ct. Cl. 331 (1967).

97 Bolling v. Patterson, 7 AFTR 2d 1464 (DC AL 1961).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

or more partners are coming into a partnership at the same time as one or more partners are leaving a partnership, the transaction may be subject to scrutiny as to whether it is a disguised sale of a partnership interest.

C. The Disguised Sale of Services

Proposed Regulations promulgated in July of 2015 provide guidance regarding transactions involving disguised sales of services under section 707(a)(2)(A). The effective date of the Proposed Regulations will generally be after the publication of the final Regulations in the Federal Register.

Prop. Reg. § 1.707–2(b) provides that an arrangement will be treated as a disguised payment for services if (i) a person (service provider), either in a partner capacity or in anticipation of being a partner, performs services (directly or through its delegate) to or for the benefit of the partnership; (ii) there is a related direct or indirect allocation and distribution to the service provider; and (iii) the performance of the services and the allocation and distribution when viewed together, are properly characterized as a transaction occurring between the partnership and a person acting other than in that person's capacity as a partner.

An arrangement that is treated as a disguised sale of services under the Proposed Regulations will be treated as a payment for services for all purposes of the Code.[98] Thus, the partnership must treat the payments as payments to a non-partner in determining the remaining partners' shares of taxable income or loss.

The preamble to the Proposed Regulations indicates that the Treasury and the IRS believe that I.R.C. § 707(a)(2)(A) generally should not apply to arrangements that the partnership has reasonably characterized as a guaranteed payment under I.R.C. § 707(c).[99]

The Proposed Regulations characterize the nature of an arrangement at the time at which the parties enter into or modify the arrangement and without regard to whether an allocation and distribution are made in the same taxable year.[100]

Whether an arrangement constitutes a disguised sale of services (in whole or in part) depends on all of the facts and circumstances.[101] The Proposed Regulations include six non-exclusive factors that may indicate that an arrangement constitutes a disguised sale of services. Of these factors, the first five factors generally track the facts and circumstances identified as relevant in the legislative history for purposes of applying section 707(a)(2)(A).[102] The sixth

98 Prop. Reg. § 1.707-2(b)(2)(i).

99 REG-115452-14, 80 Fed. Reg. 43652, 43654 (July 23, 2015) (the "*REG-115452-14*").

100 Prop. Reg. § 1.707-2(b)(2)(i).

101 Prop. Reg. § 1.707-2(c).

102 *See* S. Prt. No. 98-169 (Vol. 1), 98th Cong., 2d Sess. 223–32, at 227-28 (1984) ("S. Prt. 98-169").

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

factor, which was not included in the legislative history, provides factual elements that indicate that an allocation/distribution are tied to particular services rather than the business of the partnership as a whole. The first of the six factors, the existence of significant entrepreneurial risk, is accorded more weight than the other factors, and arrangements that lack significant entrepreneurial risk are generally treated as disguised payments for services.[103] An arrangement in which allocations and distributions to the service provider are subject to significant entrepreneurial risk will generally be recognized as a distributive share but the ultimate determination depends on the totality of the facts and circumstances.[104]

Whether an arrangement lacks significant entrepreneurial risk is based on the service provider's entrepreneurial risk relative to the overall entrepreneurial risk of the partnership.[105] For example, a net profits interest in a partnership that invests in high-quality debt instruments may have entrepreneurial risk relative to the overall risk of the partnership investment strategy, even though that risk might be less than a net profits interest in a partnership that invests in volatile or unproven businesses.

Prop. Reg. Section 1.707–2(c)(1)(i) through (v) lists types of arrangements that create a presumption that a lack of entrepreneurial risk exists. The presumption may be overcome if other facts and circumstances can establish the presence of significant entrepreneurial risk by clear and convincing evidence. The examples of arrangements listed describe circumstances in which the risk to the service provider has been reduced so that there is a high likelihood that the service provider will receive an allocation regardless of the overall success of the business operation. The arrangements listed include (i) capped allocations of partnership income if the cap would reasonably be expected to apply in most years,[106] (ii) allocations for one or more years under which the service provider's distributive share of income is reasonably certain,[107] (iii) allocations of gross income items,[108] (iv) allocations (under a formula or otherwise) that are predominantly fixed in amount, reasonably determinable under all the facts and circumstances, or designed to assure that sufficient net profits are highly likely to be available to make the allocation to the service provider (for example, if the partnership agreement provides for an allocation of net profits from specific transactions or accounting periods and this allocation does not depend on the long-term future success of the enterprise),[109] and (v) arrangements in which a service provider either waives its right to receive payment for the future performance of services

---

103 Prop. Reg. § 1.707-2(c).

104 *Id*.

105 Prop. Reg. § 1.707-2(c)(1).

106 Prop. Reg. § 1.707-2(c)(1)(i).

107 Prop. Reg. § 1.707-2(c)(1)(ii).

108 Prop. Reg. § 1.707-2(c)(1)(iii).

109 Prop. Reg. § 1.707-2(c)(1)(iv).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

in a manner that is non-binding or fails to timely notify the partnership and its partners of the waiver and its terms.[110]

The analysis for a capped allocation of gross income is illustrated by Example 1 of the Proposed Regulations. Under the example, Partnership ABC constructed a building that is projected to generate $100,000 of gross income annually. A, an architect, performs services for partnership ABC for which A's normal fee would be $40,000 and contributes cash in an amount equal to the value of a 25 percent interest in the partnership. In exchange, A will receive a 25 percent distributive share for the life of the partnership and a special allocation of $20,000 of partnership gross income for the first two years of partnership's operations. The ABC partnership agreement satisfies the requirements for economic effect contained in Prop. Reg. § 1.704–1(b)(2)(ii), including requiring that liquidating distributions are made in accordance with the partners' positive capital account balances. Under Prop. Reg. § 1.704-1(c), whether the arrangement is treated as a payment for services depends on the facts and circumstances. The special allocation to A is a capped amount and the cap is reasonably expected to apply. The special allocation is also made out of gross income.[111]

Under paragraphs Prop. Reg. § 1.704-1(c)(1)(i) and (iii), capped allocations of income and gross income allocations are presumed to lack significant entrepreneurial risk. No additional facts and circumstances in the example indicate that the arrangement does in fact have entrepreneurial risk by clear and convincing evidence. Thus, the special allocation lacks significant entrepreneurial risk. Accordingly, the special allocation provides for a disguised sale of services as of the date that A and ABC enter into the arrangement and, pursuant to Prop. Reg. § 1.707-2(b)(2)(ii), should be included in income by A in the time and manner required under applicable law as determined by applying all relevant sections of the Code to the arrangement.

One fact that is considered in determining whether an allocation is dependent upon the long-term success of a partnership is that the value of partnership assets is not easily ascertainable and the partnership agreement allows the service provider or a related party in connection with a revaluation to control the determination of asset values, including by controlling events that may affect those values (such as timing of announcements that affect the value of the assets). Example 3, in the Proposed Regulations, illustrates the application of this issue in a structure that may be very familiar.

In Example 3, M performs services for which a fee would normally be charged to new partnership ABC, an investment partnership that will acquire a portfolio of investment assets that are not readily tradable on an established securities market. M will also contribute $500,000 in exchange for a one percent interest in ABC's capital and profits. In addition to M's one percent interest, M is entitled to receive a priority allocation and distribution of net gain from the sale of any one or more assets during any 12-month accounting period in which the partnership has overall net gain in an amount intended to approximate the fee that would normally be charged for the services M performs. A, a company that controls M, is the general partner of ABC and

---

110 Prop. Reg. § 1.707-2(c)(1)(v).

111 Prop. Reg. § 1.707-2(d). ex. 1.

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

directs all operations of the partnership consistent with the partnership agreement, including causing ABC to purchase or sell an asset during any accounting period. A also controls the timing of distributions to M including distributions arising from M's priority allocation. Given the nature of the assets in which ABC will invest and A's ability to control the timing of asset dispositions, the amount of partnership net income or gains that will be allocable to M under the ABC partnership agreement is highly likely to be available and reasonably determinable based on all facts and circumstances available upon formation of the partnership. A will be allocated 10 percent of any net profits or net losses of ABC earned over the life of the partnership. A undertakes an enforceable obligation to repay any amounts allocated and distributed pursuant to this interest (reduced by reasonable allowances for tax payments made on A's allocable shares of partnership income and gain) that exceed 10 percent of the overall net amount of partnership profits computed over the life of the partnership (a "clawback obligation"). It is reasonable to anticipate that A could and would comply fully with any repayment responsibilities that arise pursuant to this obligation. The ABC partnership agreement satisfies the requirements for economic effect contained in Treas. Reg. § 1.704–1(b)(2)(ii), including requiring that liquidating distributions are made in accordance with the partners' positive capital account balances.[112]

The arrangement with respect to A creates significant entrepreneurial risk under Prop. Reg. § 1.707-2(c)(1). The allocation to A is of net profits earned over the life of the partnership. The allocation is subject to a clawback obligation, and it is reasonable to anticipate that A could and would comply with this obligation. Finally, the allocation is neither reasonably determinable nor highly likely to be available. There are no other facts present that would suggest that A lacks entrepreneurial risk. Thus, the arrangement with respect to A does not constitute a disguised sale of services for purposes of Prop. Reg. § 1.707-2(b)(1).

However, the priority allocation to M is an allocation of net profit from any 12-month accounting period in which the partnership has net gain, and thus it does not depend on the overall success of the enterprise. Moreover, the sale of the assets by ABC, and hence the timing of recognition of gains and losses, is controlled by A, a company related to M. Taken in combination, the facts indicate that the allocation is reasonably determinable and that sufficient net profits are highly likely to be available to make the priority allocation to the service provider. As a result, under Proposed Regulations Section 1.707-2(c)(1)(ii), a presumption is created that the allocation lacks significant entrepreneurial risk. In the absence of other facts clearly establishing entrepreneurial risk, the arrangement provides for a Disguised Sale of Services as of the date M and ABC enter into the arrangement and, pursuant Proposed Regulations Section 1.707-2(b)(2)(ii) of this section, should be included in income by M subject to other applicable timing rules.

Another fact that impacts entrepreneurial risk is if the service provider or a related party controls the entities in which the partnership invests, including controlling the timing and amount of distributions by those controlled entities. However, these two facts by themselves do not, however, necessarily establish the absence of significant entrepreneurial risk. Example 4 assumes the same facts as in Example 3, except that ABC's investment assets are securities that are readily tradable on an established securities market, and ABC is in the trade or business of

112 Prop. Reg. § 1.707-2(d) ex. 3.

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

trading in securities and has validly elected to mark-to-market under section 475(f)(1). In addition, M is entitled to receive a special allocation and distribution of partnership net gain attributable to a specified future 12-month taxable year. Although it is expected that one or more of the partnership's assets will be sold for a gain, it cannot reasonably be predicted whether the partnership will have net profits with respect to its entire portfolio in that 12-month taxable year.

Under the facts of Example 4, the special allocation to M is allocable out of net profits, the partnership assets have a readily ascertainable market value that is determined at the close of each taxable year, and it cannot reasonably be predicted whether the partnership will have net profits with respect to its entire portfolio for the year to which the special allocation would relate. Accordingly, the special allocation is neither reasonably determinable nor highly likely to be available because the partnership assets have a readily ascertainable fair market value that is determined at the beginning of the year and at the end of the year. Thus, the arrangement does not lack significant entrepreneurial risk. Absent other facts that would suggest that the arrangement is properly characterized as a disguised sale of services, the arrangement does not constitute a disguised sale of services.

The distinction between Example 3 and Example 4 is that the priority distribution is assigned to a specified future period, but the mark-to-market election means that gains occurring between now and the future period will already have been taken in to income, so would not be included in the calculation of the priority distribution. This combination creates sufficient uncertainty so that A's control over the partnership is counterbalanced.

Prop. Reg. §§ 1.707–2(c)(2) through (6) describe additional factors of secondary importance in determining whether or not an arrangement that gives the appearance of significant entrepreneurial risk constitutes a disguised sale of services. The weight given to each of the other factors depends on the particular case, and the absence of a particular factor is not necessarily determinative of whether an arrangement is treated as a payment for services.[113] The first four factors are (i) that the service provider holds, or is expected to hold, a transitory partnership interest or a partnership interest for only a short duration,[114] (ii) that the service provider receives an allocation and distribution in a time frame comparable to the time frame that a non-partner service provider would typically receive payment,[115] (iii) that the service provider became a partner primarily to obtain tax benefits which would not have been available if the services were rendered to the partnership in a third party capacity,[116] and (iv) that the value of the service provider's interest in general and continuing partnership profits is small in relation to the allocation and distribution.[117]

---

113 Prop. Reg. § 1.707-2(c).

114 Prop. Reg. § 1.707-2(c)(2).

115 Prop. Reg. § 1.707-2(c)(3).

116 Prop. Reg. § 1.707-2(c)(4).

117 Prop. Reg. § 1.707-2(c)(5).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

§ 8.08A ISSUANCE OF A PARTNERSHIP INTEREST IN EXCHANGE FOR SERVICES

A. Potential Income to Partner and Gain to Partnership

Replace the second full paragraph on page 264 with:

As discussed in Chapter 2, under I.R.C. § 721, neither the partnership nor a partner recognizes gain or loss when contributing property or money to the partnership in exchange for a partnership interest. I.R.C. § 721, however, does not apply to the contribution of services in exchange for a partnership interest.

B. Receipt of Profits Interests by Service Partners

Add to the end of the third full paragraph on page 266:

The preamble to recent Proposed Regulations indicates that the Treasury Department and the IRS plan to issue a revenue procedure providing an additional exception to the safe harbor in Rev. Proc. 93–27.[118] The additional exception will apply to a profits interest issued in conjunction with a partner forgoing payment of an amount that is substantially fixed (including a substantially fixed amount determined by formula, such as a fee based on a percentage of partner capital commitments) for the performance of services, including a guaranteed payment under section 707(c) or a payment in a non-partner capacity under section 707(a).

§ 8.08B COMPENSATORY INTEREST PROPOSED REGULATIONS

B. Explanation of the Provisions of the Compensatory Interest Proposed Regulations

Add at the end of the section:

Forfeiture allocations are allocations of gross income and gain or gross deduction and loss (to the extent such items are available) to the service partner that offset prior distributions and allocations of partnership items with respect to the forfeited partnership interest. Forfeiture allocations may be made out of the partnership's items for the entire taxable year, whether or not the forfeiting partner was a partner for the entire taxable year.[119] The formula for forfeiture allocations is (i) the excess (which cannot be less than zero) of (a) the amount of distributions (including deemed distributions and the adjusted tax basis of any property distributed) to the partner with respect to the forfeited interest (to the extent such distributions were not taxable under I.R.C. § 731) over (b) the amount paid for the interest (including any deemed

118 REG-115452-14, 80 Fed. Reg. 43652, at 43656 (July 23, 2015).

119 Prop. Reg. § 1.706-3(b).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

contributions) and the adjusted basis of property contributed, minus (ii) the cumulative net income or loss allocated to the partner with respect to the forfeited partnership interest.[120]

§ 8.08D ISSUANCE OF A PARTNERSHIP INTEREST SUBJECT TO A SUBSTANTIAL RISK OF FORFEITURE

We discussed in Chapter 1 when a partner is recognized as a partner under general common law rules and in Chapter 14 we discuss when a partner is recognized as a partner in a partnership where capital is a material income producing factor. A person that holds an interest in a partnership for state law purposes may also not be treated as a partner under tax rules related to the transfer of property in connection with services.

I.R.C. § 83 requires that, in general, if property is issued in connection with the performance of services, the excess of the value of the property over the amount paid for the property is included in the gross income of the service provider in the first year the rights of the recipient of the property are transferable or not subject to a substantial risk of forfeiture.[121] Special rules are provided for an election to recognize income in respect of property subject to a substantial risk of forfeiture in the year the property is transferred to the service provider rather than the year of vesting[122] and for the general treatment of the income in respect of options without a readily ascertainable fair market value[123] as being at the time of exercise of the options rather than the time of transfer to the service provider or the time of vesting.[124]

A substantial risk of forfeiture exists where rights in property that are transferred are conditioned, directly or indirectly, on the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if that condition is not satisfied.[125] The

---

120 Prop. Reg. § 1.704-1(b)(4)(xii)(c). For these purposes, items of income and gain are reflected as positive amounts, and items of deduction and loss are reflected as negative amounts. Prop. Reg. § 1.704-1(b)(4)(xii)(d).

121 I.R.C. § 83(a). Becoming transferable or the lapsing of a substantial risk of forfeiture is sometimes herein referred to as "vesting."

122 I.R.C. § 83(b). The rights of a person in property are subject to a substantial risk of forfeiture if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual. I.R.C. § 83(c)(1).

123 The value of an option is ordinarily not treated as having a readily ascertainable value unless the option is actively traded on an established market. Treas. Reg. § 1.83-7(b)(1). If the option is not actively traded, it does not have a readily ascertainable fair market value unless its fair market value can otherwise be measured with reasonable accuracy. Treas. Reg. § 1.83-7(b)(2).

124 I.R.C. § 83(e)(3).

125 Treas. Reg. § 1.83-3(c).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

rights of a person in property are transferable if that person can transfer any interest in the property to any person other than the transferor of the property, but only if the rights in that property are not subject to a substantial risk of forfeiture.[126]

Under I.R.C. § 83(f), the holding period of transferred property to which I.R.C. § 83(a) applies begins just after the property is substantially vested. However, if the person who has performed the services in connection with which property is transferred has made an election under I.R.C. § 83(b), then the holding period of such property begins just after the date on which the property is transferred.[127]

If property is transferred in connection with the performance of services but is not vested, the transferee is not treated as the owner of the property until such property becomes substantially vested, unless the recipient files a I.R.C. § 83(b) election.[128]

"Property," for purposes of I.R.C. § 83, includes real and personal property other than money or an unfunded and unsecured promise to pay money in the future.[129] Partnership interests have been recognized as property separate from the underlying assets of the partnership.[130] Under I.R.C. § 83, absent the application of exceptions, a compensatory transfer of a capital interest results in taxable income to the transferee to the extent that the fair market value of the interest exceeds the amount paid for the interest, if the interest is not subject to a substantial risk of forfeiture.[131]

If a capital interest is subject to a substantial risk of forfeiture at the time of grant, the partner does not recognize income on the grant,[132] but the partner is also not recognized as a partner unless a I.R.C. § 83(b) election is made.[133] This means that no amounts may be allocated to the partner until the interest vests.

However, this rule does not apply to a profits interest granted to a service provider for services to the issuing partnership if all parties have consistently treated the recipient as a

---

126 Treas. Reg. § 1.83-3(d).

127 See Treas. Reg. § 1.83-4(a).

128 Treas. Reg. § 1.83-1; Treas. Reg. § 1.1361-1(b)(3).

129 Treas. Reg. § 1.83-3(e).

130 See, e.g., Safford v. U.S., 216 F. Supp. 226 (E.D. Wis. 1954). See also William R. Welke, Olga A. Loy, "Compensating the Service Partner with Partnership Equity: Code §83 and Other Issues," 79 Taxes 94 (2001).

131 Larson v. Commissioner, TC Memo 1988-387.

132 I.R.C. § 83(a).

133 Crescent Holdings, LLC v. Commissioner, 141 T.C. No. 15 (2013).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

partner.[134] The IRS has ruled that a profits interest that is excluded from income under Rev. Proc. 93-27, is excluded both at the time of the grant and, if subject to a substantial risk of forfeiture, at the time of vesting.[135]

CHAPTER 10: PARTNERSHIP OPTIONS[136]

§ 10.01 INTRODUCTION

It has become increasingly common for partnerships to issue options. There was historically a dearth of authority on the federal tax treatment of options to acquire interests in partnerships. In this context, there are two main categories of options, "compensatory options" and "noncompensatory options." Compensatory options, unsurprisingly, are options to acquire partnership interests where the option is received in exchange for services. Noncompensatory options cover the rest of the waterfront.[137] The simplest version of the latter would be partnership analog to "normal" options found outside the partnership context: The option holder pays an "option premium" to acquire an option to purchase a partnership interest sometime in the future for a fixed price. The IRS has promulgated proposed regulations for compensatory options and final regulations for noncompensatory options. The proposed Regulations for compensatory options were promulgated in 2005[138] and the noncompensatory final Regulations in 2013. We will take a non-detailed look at those Regulations and associated issues.

§ 10.02 BACKGROUND FOR NONCOMPENSATORY OPTIONS

Assuming an option is recognized as an option for federal income tax purposes, the basic principles that apply to the taxation of the issuance and exercise of noncompensatory options have been clear for some time. They are contained in I.R.C. § 1234 and various pronouncements of the Courts and the IRS:[139]

---

134 Rev. Proc. 2001-43, 2001-2 C.B. 191.

135 *Id*.

136 Portions of this Chapter are derived from Professor Schwidetzky's article *The Proposed Regulations on Noncompensatory Options, A Light at the End of the Tunnel*, 21 Journal of Taxation of Investments 155 (2004). As Professor Schwidetzky noted in the article, he is indebted to the "Options Group," composed of members of the Partnerships, Real Estate, and Employee Benefits Committees of the ABA Section of Taxation. The Options Group, of which three of the authors were members, submitted extensive recommendations to the IRS on the taxation of partnership options both before and after the IRS promulgated proposed Regulations. Paul Carman headed the group when it commented on the proposed Regulations. The resulting recommendations are entitled "Comments in Response to REG-1003580-02" (hereinafter "ABA Comments").

137 *See* Treas. Reg. § 1.721-2(f).

138 REG-105346-03, 70 FR 29675 (May 24, 2005).

139 Palmer v. Commissioner, 302 U.S. 63 (1937), Rev. Rul. 58-234, 1958-1 C.B. 279 (as clarified in Rev. Rul. 68-151, 1968-1 C.B. 363), Rev. Rul. 78-182, 1978-1 C.B. 265; *see* ABA Comments at IIID1.

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

i. Option contracts are generally treated as open transactions[140] until exercise or expiration.

ii. There is no federal income tax consequence on account of either the receipt or the payment of the option premium by either the issuer or the option holder until the option is exercised or terminated.[141]

iii. Under I.R.C. § 1234(a), if the option goes unexercised, the option holder is treated as having a loss from the sale or exchange of property which has the same character as the property to which the option relates. Thus, if the option relates to a capital asset, the loss will be a long-term or short-term capital loss depending on how long the option holder has held the option. Regardless of how long the option is outstanding, the option issuer's gain on the lapse is short-term capital gain under I.R.C. § 1234(b).

iv. Upon exercise, both the issuer and the option holder use the total of the option premium and the exercise price to determine the amount realized on the sale and the cost basis of the property acquired, respectively. and

v. The exercise of an option at a time when the value of the relevant property had risen above the exercise price of the option does not cause the option holder to have income. The Regulations depart from this principle in a limited way, as we will discuss.

If the option holder disposes of the option before exercise, it is treated like any other disposition of property. Gain or loss is recognized under I.R.C. § 1001 unless an exclusionary rule applies. The character of the gain or loss is a function of the character of the property to which the option relates in the hands of the option holder.[142]

When an entity issues interests in itself, it can raise tax issues in addition to those discussed above. Normally, when a taxpayer satisfies an obligation with appreciated property, the taxpayer recognizes gain to the extent of the excess of the fair market value of the property over the basis of the property transferred.[143] Until the IRS finalized the noncompensatory option Regulations, there was no precedential guidance in the partnership context, but there has been guidance for some time with regard to corporations. I.R.C. § 1032(a) provides that a corporation recognizes no gain or loss on the lapse or acquisition of an option to buy or sell its stock. The actual exercise of the option is not taxable to the corporation either, as I.R.C. § 1032(a) also

---

140 "An open transaction" generally means that no tax consequences apply while it is "open." In this context, there are usually no tax consequences until the option is exercised or lapses, thereby closing the open transaction.

141 This assumes the premium is paid in cash. If property is transferred in exchange for the option, I.R.C. § 1001 would require gain or loss recognition on the property transfer.

142 I.R.C. § 1234(a)(1).

143 U.S. v. Davis, 370 U.S. 65 (1962). Similarly, the exercise of an option is normally a taxable event to the seller of the referenced property. *See* Converse v. Earle, 43 AFTR 1308 (DC Or 1951).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

provides that a corporation recognizes no gain or loss on the receipt of money or other property for its stock. The treatment of the option holder is covered by the regular rules discussed above.

Partnerships are very different tax (and nontax) creatures than corporations, and when they issue options they raise different tax issues. Most of the issues that arise relate to the fact that unlike C corporations, partnerships are not taxable entities, and income is taxed to, and losses are deducted by, the partners. Appreciation in partnership property and undistributed income typically inures in part to the benefit of the option holder. How should the partnership keep track of that benefit? Since the economics of a partner's investment in the partnership are generally measured by the partner's capital account, a corollary question is how should capital accounts be kept when an option is outstanding? If a new partner acquires a partnership interest while an option is outstanding, how should the existence of the option be taken into account? There are times when an option holder should be treated as a partner. If there were no anti-abuse rules, taxpayers could give option holders so many rights that they would have all the economic benefits of being a partner without actually being treated as a partner. High bracket taxpayers would buy options, avoid taxable ordinary income on the partnership earnings, through the option economically benefit from undistributed earnings, and then sell the option at a long-term capital gain and receive preferential tax rates. The Regulations address these and other issues.

Another piece of the puzzle is I.R.C. § 721. As you now know, it provides that no gain or loss is recognized to a partnership or its partners in the case of a contribution of property to the partnership in exchange for a partnership interest. A major question is when and how I.R.C. § 721 applies in the options context. To the extent it does apply, the transaction becomes nontaxable, the tax equivalent of the promised land. In the typical, nonabusive case, the Regulations sensibly take the view that an option holder is not a partner. Accordingly, the issuance of the option is not within the purview of I.R.C. § 721 (though the issuance of an option usually is still nontaxable). I.R.C. § 721 usually literally applies to the exercise of the option, however, inasmuch as then a partnership interest is being received for cash or property.

A final issue involves the potential for capital account shifts between the partners. Indeed, there may be no single issue more important than this one. When an option holder exercises an appreciated option, it may be necessary to shift capital from the continuing partners to the option holder/partner to give her the appropriate interest in the partnership. The form of this would be a transfer of a portion of the capital account balances from the continuing partners to the option holder/partner. The fear has been that this "capital shift" could be seen as a taxable transfer of partnership property by the continuing partners to the option holder/partner to the extent of the transfer. If the continuing partners transferred 5% of partnership capital to the option holder/partner, could they have made a taxable disposition of 5% of the partnership assets and have to recognize the associated gain or loss? If so, it would obviously inhibit option (and other) transactions, at least where gain would be recognized. No case ever held that such a capital shift was a taxable transaction to the continuing partners, but academics and practitioners have spilt a lot of ink speculating on this possibility. The Regulations generally put the fear to rest in the partnership options context. A capital shift is not treated as a taxable transfer of the

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

underlying partnership property, though there can be an income tax effect to the option holder/partner, as we will discuss.[144]

§ 10.03 Scope of Regulations on Noncompensatory Options

The Regulations on noncompensatory options only cover noncompensatory options issued by partnerships.[145] In addition to "standard" options, the Regulations also apply to warrants, convertible debt, and convertible preferred equity, though we will focus on traditional options.

§ 10.04 Issuance, Lapse, and Straight-Forward Exercise of Noncompensatory Options

In line with the existing nonpartnership authority, it is apparent from the Regulations that the issuance of the option usually is treated as an open transaction for the issuer (while outside the scope of I.R.C. § 721). The option holder is seen as having made a capital expenditure to acquire an option that is neither taxable to the partnership nor deductible to the holder. The Regulations never explicitly state this, however, though there is language in the Preamble and in an example to this effect.[146]

The Regulations illustrate that, consistent with general rules of taxation, if the holder exchanges property for the option, there has been a taxable disposition of the property.[147] Gain or loss is recognized.

The Regulations provide limited coverage of the tax treatment of a lapse of an option. The Regulations themselves merely state the obvious: That a lapse is outside the scope of I.R.C. § 721.[148] It would have to be outside the scope of I.R.C. § 721 inasmuch as the erstwhile option holder has not contributed property to the partnership in exchange for an interest in the partnership. The Preamble then observes that, consistent with general tax principles, the lapse of a noncompensatory option generally results in the recognition of income by the partnership and the recognition of loss by the former option holder. Under the general principles of I.R.C.

---

144 *See* McDougal v. Commissioner, 62 T.C. 720 (1974), where a transfer was taxable where the court deemed the sequence to be the transfer of property to a service provider followed by the formation of the partnership.

145 Treas. Reg. § 1.721-2(f); the Regulations do not apply to any interest on convertible debt that has been accrued by the partnership (including original issue discount). Treas. Reg. § 1.721-2(e)

146 TD 9612, 78 FR 7997 (Feb. 5, 2013).

147 Treas. Reg. § 1.721-2(h).

148 Treas. Reg. § 1.721-2(c).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

§ 1234, there should be short-term capital gain to the partnership in the amount equal to the option premium and a (typically capital) loss of the same amount to the option holder.[149]

The Regulations generally apply I.R.C. § 721 to the exercise of the option, making it a nontaxable transaction to the partners and the partnership. The option holder is viewed as contributing money or property in the form of the exercise price and option premium to the partnership and receiving a partnership interest in exchange. Thus, if in the exercise of the option the option holder transfers property to the partnership, no gain or loss is recognized to the option holder or the partnership. The partnership takes a carryover basis in any contributed property under I.R.C. § 723. The option holder takes a substituted basis in the partnership interest under I.R.C. § 722.

The Regulations contain some highly important rules for computing capital accounts. An option holder, not being a partner, has no capital account.[150] When the option holder becomes a partner upon exercise of the option, the option holder's initial capital account is equal to the option premium and option exercise price paid, including the fair market value of any contributed property. Typically, the value of the partnership interest received will be different from the total amount paid by the option holder. Of course, what commonly induces an option holder to exercise an option is the belief that what she is receiving is worth more than what she is paying. If true, this would mean that the option privilege itself would have value inherent in it. Since the option exercise is a nontaxable event, the gain is not recognized on exercise (neither would be the loss in the less likely event the option holder exercises the option even though the exercise price exceeds the value of the option). In principle, the option privilege is an asset with built-in gain or loss that should be allocated to the option holder under I.R.C. § 704(c). The difficulty is that the option privilege is not in fact contributed to the partnership, but rather disappears on exercise. Accordingly, the value of the option privilege itself does not increase the capital account. To get to the right result, the Regulations generally substitute gain or loss inherent in the partnership's assets for gain or loss inherent in the option privilege. This is done by first requiring the partnership to revalue its property immediately after the exercise of the option. Allowable revaluations were previously, and still are generally, optional. Under the Regulations, however, revaluations in this context are mandatory.[151] As we discussed in Chapter 5, a "revaluation" restates the property and the capital accounts of the partners at fair market value. The tax basis in the property is unaffected and there is no tax consequence to the revaluation. Revaluations are only allowed in certain circumstances, including on contributions in exchange for a partnership interest or distributions in exchange for a partnership interest. Under the "regular" rules, once a revaluation is made, I.R.C. § 704(c) principles have to be followed in allocating the tax gain or loss. Any tax gain or loss inherent in the assets at the time

---

149 On the same day that the noncompensatory option Regulations were finalized, the IRS proposed Regulations that would coordinate the lapse of a noncompensatory option with I.R.C. § 1234 by including partnership interests in the term securities for the purposes of such section.

150 This assumes the option holder does not also hold a partnership interest. It also assumes the recharacterization rules we discuss below do not apply.

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

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

of the revaluation must be allocated to the continuing partners based on the shares they would have received had the partnership properties been sold at the time of the revaluation.[152]

Under the Regulations, any unrealized gain or loss from the revaluation is first allocated to the option holder to the extent necessary to reflect the holder's right to share in partnership capital under the partnership agreement. Thereafter, the gain or loss is allocated to the historic partners to reflect the manner in which they would be allocated among them if there were a taxable disposition of the partnership property.[153] I.R.C. § 704(c) principles are then used to make sure that tax gain or loss tracks the book gain or loss. This is perhaps easiest to understand by way of an example.

Example 1[154]

(i) In Year 1, Jacob and Ginger each contribute cash of $9,000 to LLC, a newly formed limited liability company classified as a partnership for federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase a nondepreciable property, Property A, for $18,000. Later in Year 1, at a time when Property A is valued at $20,000, LLC issues an option to Lolly. The option allows Lolly to buy 100 units in LLC for an exercise price of $15,000 in Year 2. Lolly pays $1,000 to LLC to purchase the option. Assume that the LLC agreement satisfies the requirements of Treas. Reg. § 1.704-1(b)(2) and requires that, on the exercise of a noncompensatory option, LLC comply with the rules of Treas. Reg. § 1.704-1(b)(2)(iv)(s). Also assume that Lolly's option is a noncompensatory option under Treas. Reg. § 1.721-2(f), and that Lolly is not treated as a partner with respect to the option. Under Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5)(iv), LLC revalues its property in connection with the issuance of the option. The $2,000 unrealized gain in Property A is allocated equally to Jacob and Ginger under the LLC agreement. In Year 2, Lolly exercises the option, contributing the $15,000 exercise price to the partnership. At the time the option is exercised, the value of Property A is $35,000.

	Basis	Value
Year 1 After Issuance of the Option		
Assets:		
Cash Premium	$ 1,000	$ 1,000
Property A	18,000	20,000
	--------	-------
Total	19,000	21,000
	=======	=======
Liabilities and Capital:		

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

153 Treas. Reg. §§ 1.704-1(b)(2)(iv)(s)(1), (2).

154 Based upon Treas. Reg. § 1.704-1(b)(5), Example 31.

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

Option Liability	1,000	1,000
Jacob	9,000	10,000
Ginger	9,000	10,000
Total	19,000	21,000

Year 2 After Exercise of the Option

Assets:		
Property A	18,000	35,000
Premium, Cash	1,000	1,000
Exercise Price, Cash	15,000	15,000
Total	34,000	51,000
Liabilities and Capital:		
Jacob	9,000	17,000
Ginger	9,000	17,000
Lolly	16,000	17,000
Total	34,000	51,000

(ii) In lieu of revaluing LLC's property under Treas. Reg. § 1.704-1(b)(2)(iv)(f) immediately before the option is exercised, under Treas. Reg. § 1.704-1(b)(2)(iv)(s)(1), LLC must revalue its property under the principles of Treas. Reg. § 1.704-1(b)(2)(iv)(f) immediately after the exercise of the option. Under Treas. Reg. §§ 1.704-1(b)(2)(iv)(b) and (b)(2)(iv)(d)(4), Lolly's capital account is credited with the amount paid for the option ($1,000) and the exercise price of the option ($15,000). Under the LLC agreement, however, Lolly is entitled to LLC capital corresponding to 100 units of LLC (1/ 3 of LLC's capital). Immediately after the exercise of the option, LLC's properties are cash of $16,000 ($1,000 premium and $15,000 exercise price contributed by Lolly) and Property A, which has a value of $35,000. Thus, the total value of LLC's property is $51,000. Lolly is entitled to LLC capital equal to 1/3 of this value, or $17,000. As Lolly is entitled to $1,000 more LLC capital than Lolly's capital contributions to LLC, the provisions of Treas. Reg. § 1.704-1 (b)(2)(iv)(s) apply.

(iii) Under Treas. Reg. § 1.704-1(b)(2)(iv)(s)(2), LLC must increase Lolly's capital account from $16,000 to $17,000 by, first, revaluing LLC property in accordance with the principles of Treas. Reg. § 1.704-1(b)(2)(iv)(f). The unrealized gain in LLC's property (Property A) which has not been reflected in the capital accounts previously is $15,000 ($35,000 value less $20,000 book value). Under Treas. Reg. § 1.704-1(b)(2)(iv)(s)(2), the first $1,000 of this gain must be allocated to Lolly, and the remaining $14,000 of this gain is allocated equally to Jacob and Ginger in accordance with the LLC agreement. Because the revaluation of LLC property under Treas. Reg. § 1.704-1(b)(2)(iv)(s)(2) increases Lolly's capital account to the amount agreed on by the members, LLC is not required to make a capital account reallocation under Treas. Reg. § 1.704-1(b)(2)(iv)(s)(3). The $17,000 of unrealized booked gain in Property A ($35,000 value

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

less $18,000 basis) is shared $8,000 to each of Jacob and Ginger, and $1,000 to Lolly. Under Treas. Reg. § 1.704-1(b)(2)(iv)(f)(4), the tax items from the revalued property must be allocated in accordance with I.R.C. § 704(c) principles.

	Jacob		Ginger		Lolly	
	Tax	Book	Tax	Book	Tax	Book
Capital account after exercise	$9,000	$10,000	$9,000	$10,000	$16,000	$16,000
Revaluation amount	0	7,000	0	7,000	0	1,000
Capital account after revaluation ..	9,000	17,000	9,000	17,000	16,000	17,000

Summary. The properties are booked-up on the issuance of the option and immediately after the option is exercised. In the book-up immediately after exercise, un-booked appreciation is allocated to the option holder until the option holder's capital account reflects the economic arrangement. Because there is sufficient appreciation in the assets between the issuance and the exercise to cause the capital account of the option holder after exercise to reflect the economic arrangement of the parties, no further action needs to be taken.

§ 10.05 COMPLICATIONS ON THE EXERCISE OF NONCOMPENSATORY OPTIONS

A. New Partner Enters While Option Outstanding

The Regulations provide rules for doing the revaluation math if a partnership revalues its assets while an option is outstanding.[155] The fair market value of partnership property is adjusted for any outstanding options. There are two components to the adjustment.

> *The first component*: The fair market value of partnership property is reduced by the option premium paid to the partnership.[156] This reduction occurs because the value of the option premium in a sense belongs to the option holder, and the option holder will be able to increase the option holder's capital account by the amount of the premium if the option holder exercises the option.

155 Logically, these rules should apply even if a new partner is not entering the partnership, but the partnership interests change due to additional capital contributions from some of the existing partners while an option is outstanding.

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

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

The second component: If the fair market value of the outstanding option exceeds the premium payable by the option holder, then the fair market value of partnership property is reduced by the excess value to the extent of unrealized appreciation in partnership property that has not previously been reflected in the capital accounts. The reduction is allocated only to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation. This adjustment insures that gain economically attributable to the option holder is not allocated to the partners. If the option premium payable by the option holder exceeds the fair market value of the option, then the value of partnership property is increased by that excess to the extent of the unrealized depreciation in partnership property not previously reflected in the capital accounts. The increase is allocated only to properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation.[157] This adjustment insures that a loss economically attributable to the option holder is not allocated to the partners. If the option ultimately lapses, as would be likely where the value of what is to be received is less than the option exercise price, I.R.C. § 1234 will trigger short-term capital gain to the partnership in the amount of the option premium and a corresponding loss to the option holder. At that point, the adjustments discussed above would no longer be appropriate. The Regulations do not address this issue, but presumably the partnership would have to await a subsequent revaluation to get the numbers right again.

Example 2[158]
(i) In Year 1, Jacob and Ginger each contribute cash of $10,000 to LLC, a newly formed limited liability company classified as a partnership for federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase two nondepreciable properties, Property A and Property B, for $10,000 each. Also in Year 1, at a time when Property A and Property B are still valued at $10,000 each, LLC issues an option to Lolly. The option allows Lolly to buy 100 units in LLC for an exercise price of $15,000 in Year 2. Lolly pays $2,000 to LLC to purchase the option. Assume that the LLC agreement satisfies the requirements of Treas. Reg. § 1.704-1(b)(2) and requires that, on the exercise of a noncompensatory option, LLC comply with the rules of Treas. Reg. § 1.704-1(b)(2)(iv)(*s*). Also assume that Lolly's option is a noncompensatory option under Treas. Reg. § 1.721-2(f), and that Lolly is not treated as a partner with respect to the option.

	Basis	**Value**
End of Year 1		
Assets:		
Premium, Cash	$2,000	$2,000
Property A	10,000	10,000

157 Treas. Reg. §§ 1.704-1(b)(2)(iv)(f)(1), (h)(2).

158 Based upon Treas. Reg. § 1.704-1(b)(5), Example 33.

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

Property B	10,000	10,000
Total	22,000	22,000
Liabilities and Capital:		
Option Liability	$2,000	$2,000
D	10,000	10,000
E	10,000	10,000
Total	22,000	22,000

(ii) In year 2, prior to the exercise of Lolly's option, Matt contributes $18,000 to LLC for 100 units in LLC. At the time of Matt's contribution, Property A has a value of $32,000 and a basis of $10,000, Property B has a value of $5,000 and a basis of $10,000, and the fair market value of Lolly's option is $3,000. In year 2, LLC has no items of income, gain, loss, deduction, or credit.

(iii) Upon Matt's admission to the partnership, the capital accounts of Jacob and Ginger (which were $10,000 each prior to Matt's admission) are, in accordance with Treas. Reg. § 1.704-1(b)(2)(iv)(*f*), adjusted upward to reflect their shares of the unrealized appreciation in the partnership's property. Property A has $22,000 of unrealized gain and Property B has $5,000 of unrealized loss. Under Treas. Reg. § 1.704-1(b)(2)(iv)(*f*)(*1*), the adjustments must be based on the fair market value of LLC property (taking I.R.C. § 7701(g) into account) on the date of the adjustment, as determined under Treas. Reg. § 1.704-1(b)(2)(iv)(*h*). The fair market value of partnership property must be reduced by the excess of the fair market value of the option as of the date of the adjustment over the consideration paid by Lolly to acquire the option ($3,000 - $2,000 = $1,000) (under Treas. Reg. § 1.704-1(b)(2)(iv)(*h*)(*2*)), but only to the extent of the unrealized appreciation in LLC property that has not been reflected in the capital accounts previously ($22,000). This $1,000 reduction is allocated entirely to Property A, the only asset having unrealized appreciation not reflected in the capital accounts previously. Therefore, the book value of Property A after the revaluation is $31,000. Accordingly, the revaluation adjustments must reflect only $16,000 of the net appreciation in LLC's property ($21,000 of unrealized gain in Property A and $5,000 of unrealized loss in Property B). Thus, Jacob's and Ginger's capital accounts (which were $10,000 each prior to Matt's admission) must be adjusted upward (by $8,000) to $18,000 each. The $21,000 of built-in gain in Property A and the $5,000 of built-in loss in Property B must be allocated equally between Jacob and Ginger in accordance with I.R.C. § 704(c) principles.

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

	Basis	Value	Option adjustment	704(b) Book
Assets:				
Property A	$10,000	$32,000	($1,000)	$31,000
Property B	10,000	5,000	0	5,000
Cash	2,000	2,000	0	2,000
Subtotal	22,000	39,000	(1,000)	38,000
Cash Contributed by Matt ..	18,000	18,000	0	18,000
Total	40,000	57,000	(1,000)	56,000

	Tax	Value	704(b) Book
Liabilities and Capital:			
Option Liability	$ 2,000	$ 3,000	$ 2,000
Jacob	10,000	18,000	18,000
Ginger	10,000	18,000	18,000
Matt	18,000	18,000	18,000
Total	40,000	57,000	56,000

(iv) In year 2, after the admission of Matt, when Property A still has a value of $32,000 and a basis of $10,000 and Property B still has a value of $5,000 and a basis of $10,000, Lolly exercises the option. On the exercise of the option, Lolly's capital account is credited with the amount paid for the option ($2,000) and the exercise price of the option ($15,000). Under the LLC agreement, however, Lolly is entitled to LLC capital corresponding to 100 units of LLC (1/4 of LLC's capital). Immediately after the exercise of the option, LLC's properties are worth $72,000 ($15,000 contributed by Lolly, plus the value of LLC property prior to the exercise of the option, $57,000). Lolly is entitled to LLC capital equal to 1/4 of this value, or $18,000. As Lolly is entitled to $1,000 more LLC capital than Lolly's capital contributions to LLC, the provisions of Treas. Reg. § 1.704-1(b)(2)(iv)(*s*) apply.

(v) Under Treas. Reg. § 1.704-1(b)(2)(iv)(*s*), LLC must increase Lolly's capital account from $17,000 to $18,000 by, first, revaluing LLC property in accordance with the principles of Treas. Reg. § 1.704-1(b)(2)(iv)(*f*) and allocating the first $1,000 of unrealized gain to Lolly. The total unrealized gain which has not been reflected in the capital accounts previously is $1,000 (the difference between the actual value of Property A, $32,000, and the book value of Property A, $31,000). The entire $1,000 of book gain is allocated to Lolly under Treas. Reg. § 1.704-1(b)(2)(iv)(*s*)(*2*). Because the revaluation of LLC property under Treas. Reg. § 1.704-1(b)(2)(iv)(*s*)(*2*) increases Lolly's capital account to the amount agreed on by the members, LLC is not required to make a capital account reallocation under Treas. Reg. § 1.704-1(b)(2)(iv)(*s*)(*3*). The ($5,000) of unrealized booked loss in Property B has been allocated ($2,500) to each of

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

Jacob and Ginger, and the $22,000 of unrealized booked gain in Property A has been allocated $10,500 to each of Jacob and Ginger, and $1,000 to Lolly. Under Treas. Reg. § 1.704-1(b)(2)(iv)(*f*)(*4*), the tax items from Properties A and B must be allocated in accordance with I.R.C. § 704(c) principles.

	Jacob		Ginger	
	Tax	Book	Tax	Book
Capital account after admission of Matt	$10,000	$18,000	$10,000	$18,000
Capital account after exercise of Lolly's option............	10,000	18,000	10,000	18,000
Revaluation	0	0	0	0
Capital account after revaluation	10,000	18,000	10,000	18,000

	Matt		Lolly	
	Tax	Book	Tax	Book
Capital account after admission of Matt	$18,000	$18,000	0	0
Capital account after exercise of Lolly's option....	18,000	18,000	17,000	17,000
Revaluation	0	0	0	1,000
Capital account after revaluation	18,000	18,000	17,000	18,000

Obviously, these rules are highly complex. They accomplish one very useful objective. They hold out of the capital account adjustments the appreciation (and less importantly depreciation) attributable to the outstanding option, as well as the option premium itself. If this were not done, the capital accounts of the continuing partners and entering partners would tend to be overstated upon a revaluation, assuming the partnership property had appreciated while the option was outstanding. That is because some of the increased value of the property would really "belong" to the option holder who would be allocated it as soon as the option was exercised. Moreover, the more appreciation there would be, the more likely it would be that the option would be exercised, making it increasingly pointless to allocate the appreciation to anyone

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

other than the option holder. Further, if the option is ignored in these circumstances, and upon a revaluation (while the option is outstanding) all of the value is allocated to the new and existing partners, when the option is exercised and a revaluation is again done, a portion of the capital accounts of the existing partners would have to be allocated to the option holder/partner unless there was sufficient appreciation in the partnership's assets. Yet economically, the relevant gain belonged to the option holder all along. The Regulations solve this problem by pulling the appreciation attributable to the option holder–as well as the option premium--out of the revaluation equation (although the issue arises again for curative allocations, as we discuss below).

There is one practical problem with the approach of the Regulations. When doing a revaluation, the Regulations[159] require the partnership to restate the book values of the partnership properties at their fair market at the time of the revaluation. The capital accounts of the partners are in turn also restated to their fair market values, and the balance of the capital accounts is what partners would generally receive if the partnership were liquidated.[160] The practical problem is that the values of the partnership properties in real life in most instances will not be knowable with precision without going to the often great expense of an appraisal. In most cases, that will not be an economically viable option.

Partnerships, when doing revaluations, commonly do not attempt to independently determine the fair market values of the partnership properties. Rather, they "reverse engineer" the value of the partnership properties based on the value of the cash and/or property contributed by the new partner and the percentage interest that partner will have in the partnership. Thus, if an entering partner pays $10,000 for a 10% interest, it is assumed that the partnership property (inclusive of the $10,000) is worth $100,000. Thus, ultimately the revaluation is not based on the value of the partnership property, but on the value of the partnership interest being acquired.[161]

Typically, a reverse-engineered revaluation will yield values of partnership properties that are less than the amount for which they could be sold and capital accounts that are less than the liquidation value of the partnership interest. This is because an incoming partner will often discount what he will pay for the partnership interest to take into account economic realities. These realities could include the facts that the interest is not marketable, that it represents a minority interest in the enterprise, and, therefore, does not have control, and/or other relevant discounting considerations.[162] Thus, in the example above, where the entering partner paid

---

159 *See* Treas. Reg. § 1.704-1(b)(2)(iv)(f).

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

161 *See* ABA Comments supra note 1 at IVD2; this approach is most workable where a straight percentage is acquired. However, often a partner does not acquire a "10% interest," but instead acquires an interest that varies depending on partnership performance.

162 There is ample case law supporting the use of discounts. *See, e.g.*, Gross v. Commissioner, 272 F.3d 333 (6th Cir. 2001); Church v. Commissioner, 268 F.3d 1063 (5th Cir. 2001); but see Estate of Strangi v. Commissioner, 115 T.C. 478 (2000), *aff'd in part and rev'd in part* 293 F.3d 279 (5th Cir. 2002), on remand

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

$10,000 for a 10% partnership interest, the actual value of the partnership property on a sale might be $120,000, but the entering partner might have discounted the value by 20% to take into account the lack of marketability and the fact that he is receiving a minority interest. In that circumstance, the revaluation based on reverse engineering will generate capital accounts that will be lower than what the partners would receive on a liquidation of the partnership and book values of partnership properties that will be lower than the amount the partnership could receive on their sale.

It would be best if the Regulations were amended to take this real-world approach into account. If it is not done and a partnership (perhaps foolishly given the low risk of audit) wanted to comply literally with the Regulations, the results would be anomalous. In the example, upon the revaluation the entering partner arguably could be given a capital account of $12,000 notwithstanding the fact he only paid $10,000, which in addition to being aesthetically unpleasing, will cause a lot of confusion. Taxpayers will wonder why their capital accounts are different than their contribution, and many legal and accounting advisors will not understand the rules and make the capital account $10,000 regardless. Further, there is no real harm done by formally permitting the real-world approach as everything will come out in the wash on an actual liquidation. The Regulations require the partnership to recognize any book gain or loss inherent in the assets at that time.[163] Without regulatory authorization, however, a less than wise IRS auditor might claim the partnership is not keeping capital accounts properly and launch a full-blown attack on an otherwise allowable allocation regime.[164] Further, it would create disjunctures with other rules. If the new partner gifts the interest, the gift will have a value of $10,000, not the $12,000 in the capital account. The same is true with regard to the amount realized on a sale.

The Regulations are internally inconsistent and do not base capital accounts on liquidation values in one important respect. As we discuss in the above examples, in calculating the capital accounts of the partners in the case of a new partner entering the partnership while an option is outstanding, an adjustment is made for the "fair market value" of the outstanding option.[165] That fair market value is presumably the value an independent third party would pay for the option, not the "liquidation profit" that would be generated if the option were exercised and the partnership were immediately liquidated.[166] Using the actual fair market value of the

---

2003 T.C.M. (RIA) ¶ 2003-145, *aff'd* 417 F.3d 468 (5th Cir. 2005). Sometimes a premium is paid for "going concern value."

163 Treas. Reg. § 1.704-1(b)(2)(iv)(e)(1). This rule also requires book gain or loss to be recognized on a nonliquidating distribution of property.

164 In order to meet the "substantial economic effect" safe harbor for allocations of income and loss among the partners, capital accounts must be maintained as provided in the Regulations. Treas. Reg. §§ 1.704-1(b)(2)(ii)(b), -1(b)(2)(iv)(b). *See* Chapter 5.

165 Treas. Reg. §§ 1.704-1(b)(2)(iv)(f)(1), (h)(2).

166 In Treas. Reg. § 1.704-1(b)(5), Example 31, the Regulations assume the fair market value of the option is equal to the liquidation profit, but in real life that will not necessarily be the case.

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

option can create unnecessary problems with the corrective allocations rules (that we discuss immediately below). By using the fair market value, rather than liquidation profit, to value the outstanding option, the Regulations will tend to overstate the capital accounts of the existing partners. This is because the fair market value of the option will likely be less than the liquidation profit due to economic realities associated with minority interests, lack of marketability, and other factors, considerations the Regulations otherwise ignore. When the option is exercised, if the continuing partners have overstated capital accounts, the option holder/partner will need a larger capital account than would otherwise be the case, increasing the chance that a corrective allocation will be necessary.

B. Corrective Allocations

In some cases, the built-in gain or loss in the option will exceed the unrealized appreciation or depreciation in the partnership's assets. As a consequence, a disparity will remain after all of the unrealized appreciation or depreciation in the partnership's assets have been allocated to the option holder after the revaluation. In this case, the Regulations shift capital between the historic partners and the option holder so that the option holder has the economically correct capital account balance. In a controversial move, the Regulations require the partnership to make corrective allocations of gross income or loss to the partners so as to take into account this disparity.[167] This can mean, for example, that the option holder can incur taxable income on exercise of the option. Allocations under the partnership agreement will not be considered to have substantial economic effect unless the agreement complies with these rules.

Example 3[168]

(i) Assume the same facts as in Example 1, except that, in Year 2, before the exercise of the option, LLC sells Property A for $40,000, recognizing gain of $22,000. LLC does not distribute the sale proceeds to its partners and it has no other earnings in Year 2. With the proceeds ($40,000), LLC purchases Property B, a nondepreciable property. Also assume that Lolly exercises the noncompensatory option at the beginning of Year 3 and that, at the time Lolly exercises the option, the value of Property B is $41,000. In Year 3, LLC has gross income of $3,000 and deductions of $1,500.

Year 2 After Purchase of Property B		
Assets:		
Cash Premium	$ 1,000	$ 1,000
Property A	40,000	40,000
Total	41,000	41,000

167 Treas. Reg. § 1.704-1(b)(2)(iv)(s)(3).

168 Based upon Treas. Reg. § 1.704-1(b)(5), Example 32.

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

Liabilities and Capital:		
Option Liability	1,000	1,000
Jacob	20,000	20,000
Ginger	20,000	20,000
	-------	-------
Total	41,000	41,000

Year 3 After Exercise of the Option

Assets:		
Property B	40,000	41,000
Cash	16,000	16,000
	-------	-------
Total	56,000	57,000
	=======	=======
Liabilities and Capital:		
Jacob	20,000	19,000
Ginger	20,000	19,000
Lolly	16,000	19,000
	-------	-------
Total	56,000	57,000

(ii) Under Treas. Reg. §§ 1.704-1(b)(2)(iv)(b) and (b)(2)(iv)(d)(4), Lolly's capital account is credited with the amount paid for the option ($1,000) and the exercise price of the option ($15,000). Under the LLC agreement, however, Lolly is entitled to LLC capital corresponding to 100 units of LLC (1/3 of LLC's capital). Immediately after the exercise of the option, LLC's properties are $16,000 cash ($1,000 option premium and $15,000 exercise price contributed by Lolly) and Property B, which has a value of $41,000. Thus, the total value of LLC's property is $57,000. Lolly is entitled to LLC capital equal to 1/3 of this amount, or $19,000. As Lolly is entitled to $3,000 more LLC capital than Lolly's capital contributions to LLC, the provisions of Treas. Reg. § 1.704-1(b)(2)(iv)(s) apply.

(iii) In lieu of revaluing LLC's property under Treas. Reg. § 1.704-1(b)(2)(iv)(f) immediately before the option is exercised, under Treas. Reg. § 1.704-1(b)(2)(iv)(s)(1), LLC must revalue its property under the principles of Treas. Reg. § 1.704-1(b)(2)(iv)(f) immediately after the exercise of the option. Under Treas. Reg. § 1.704-1(b)(2)(iv)(s), LLC must increase Lolly's capital account from $16,000 to $19,000 by, first, revaluing LLC property in accordance with the principles of Treas. Reg. § 1.704-1(b)(2)(iv)(f), and allocating all $1,000 of unrealized gain from the revaluation to Lolly under Treas. Reg. § 1.704-1(b)(2)(iv)(s)(2). This brings Lolly's capital account to $17,000.

(iv) Next, under Treas. Reg. § 1.704-1(b)(2)(iv)(s)(3), LLC must reallocate $2,000 of capital from the existing partners (Jacob and Ginger) to Lolly to bring Lolly's capital account to $19,000 (the capital account reallocation). As Jacob and Ginger shared equally in all items from Property

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

A, whose sale gave rise to the need for the capital account reallocation, each member's capital account is reduced by 1/ 2 of the $2,000 reduction ($1,000).

(v) Under Treas. Reg. § 1.704-1(b)(2)(iv)(s)(4), beginning in the year in which the option is exercised, LLC must make corrective allocations so as to take into account the capital account reallocation. In Year 3, LLC has gross income of $3,000 and deductions of $1,500. Under Treas. Reg. § 1.704-1(b)(2)(x)(c), LLC must allocate the book gross income of $3,000 equally among Jacob, Ginger, and Lolly, but for tax purposes, however, LLC must allocate all of its gross income ($3,000) to Lolly. LLC's book and tax deductions ($1,500) will then be allocated equally among Jacob, Ginger, and Lolly. The $1,000 unrealized booked gain in Property B has been allocated entirely to Lolly. Under Treas. Reg. § 1.704-1(b)(2)(iv)(f)(4), the tax items from Property B must be allocated in accordance with I.R.C. § 704(c) principles.

	Jacob		Ginger		Lolly	
	Tax	Book	Tax	Book	Tax	Book
Capital account after exercise	$20,000	$20,000	$20,000	$20,000	$16,000	$16,000
Revaluation	0	0	0	0	0	1,000
Capital account after revaluation ..	20,000	20,000	20,000	20,000	16,000	17,000
Capital account reallocation	0	(1,000)	0	(1,000)	0	2,000
Capital account after capital account reallocation	20,000	19,000	20,000	19,000	16,000	19,000
Income allocation (Yr. 3)	0	1,000	0	1,000	3,000	1,000
Deduction allocation (Yr. 3)	(500)	(500)	(500)	(500)	(500)	(500)
Capital account at end of year 3	19,500	19,500	19,500	19,500	18,500	19,500

Summary. Unlike Example 1, the initial book-up on exercise does not allow the capital account of the option holder to reflect the economic arrangement of the parties. In order to force the capital accounts to reflect the economic arrangement, a capital account reallocation is require. Because a capital account reallocation is made, the option holder is required to receive corrective allocations as quickly as possible.

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

§ 10.06 OPTION HOLDER TREATED AS PARTNER

Generally, the Regulations treat an option as such and not as a partnership interest. Accordingly, the Regulations do not normally require the partnership to take an outstanding option into account when making partnership allocations of income and loss. There are exceptions, however, and they are necessary. If every option were blindly respected, it would be easy for high-bracket taxpayers to avoid partnership income while effectively owning an interest in the partnership. Rather than acquire a partnership interest, they would buy an option. The terms of the option and the partnership agreement could be written so they fully benefit from partnership profits. The terms might provide that the partnership may not make distributions or, more likely, only make limited distributions to cover partner tax liabilities. Since the profits will mostly stay in partnership solution, the option will increase in value, giving the option holder the benefit of partnership income without being taxed on it. Down the road, the option holder could even sell the option at a capital gain, which typically would only be taxed at a 20% rate rather than ordinary income rates of up to 39.6% on a partner's share of operating profits.[169] Further, had the option holder sold a partnership interest instead of the option, I.R.C. § 751 would have required him to recognize ordinary income to the extent of ordinary income inherent in partnership receivables and inventory.[170] Even before the noncompensatory Regulations were finalized, the IRS has ruled, and the courts have held, that under the right facts options can be viewed as ownership interests.[171] The Regulations would have fallen far short if they had not addressed this issue.

The Regulations treat an option holder as a partner if two tests are met. The option holder's rights must be substantially similar to the rights afforded a partner ("substantially similar test").[172] Additionally, as of the date that the option is issued, transferred, or modified, there must be a strong likelihood that the failure to treat the option holder as a partner would result in a substantial reduction in the present value of the partners' and the option holder's aggregate tax liabilities ("strong likelihood test").[173]

If an option is "reasonably certain" to be exercised, then the holder of the option ordinarily has rights that are "substantially similar" to the rights afforded to a partner.[174] The

---

169 I.R.C. §§ 1(h), (i)(2). A 3.8% tax on net investment income may also apply I.R.C. § 1411.

170 That said, a well-advised purchaser of the option is likely to discount the price paid for the option for the associated I.R.C. § 751 tax liabilities she will be assuming on exercise of the option. Note that an I.R.C. § 754 election could not solve this problem if the option is respected as an option since there has been no sale or exchange of a partnership interest.

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

172 Treas. Reg. § 1.761-3(a)(1)(i).

173 We borrow these descriptive terms from the ABA Comments supra note 1 at IVE1. *See* Treas. Reg. § 1.761-3(a)(1)(ii).

174 Treas. Reg. § 1.761-3(d)(2)

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

Regulations list a series of factors that are relevant in determining whether or not an option is reasonably certain to be exercised.

i. The fair market value of the partnership interest that is the subject of the option;

ii. The exercise price of the option;

iii. The term of the option;

iv. The volatility, or riskiness, of the partnership interest that is the subject of the option;

v. Anticipated distributions by the partnership during the term of the option;

vi. Any other special option features, such as an exercise price that declines over time or declines contingent on the happening of specific events;

vii. The existence of related options, including reciprocal options; and

viii. Any other arrangements (express or implied) affecting the likelihood that the option will be exercised.[175]

The Regulations provide two objective safe harbors, which are similar to two of the safe harbors in Treas. Reg. § 1.1504-4 and Treas. Reg. § 1.1361-1(l).[176] However, these safe harbors apply only to the determination of whether a noncompensatory option is reasonably certain to be exercised, and not to the determination of whether a noncompensatory option holder possesses partner attributes.

The first safe harbor provides that a noncompensatory option is not considered reasonably certain to be exercised if it may be exercised no more than 24 months after the date of the applicable measurement event and it has a strike price equal to or greater than 110% of the fair market value of the underlying partnership interest on the date of the measurement event. The second safe harbor provides that a noncompensatory option is not considered reasonably certain to be exercised if the terms of the option provide that the strike price of the option is equal to or greater than the fair market value of the underlying partnership interest on the exercise date. For purposes of these safe harbors, an option whose strike price is determined by a formula is considered to have a strike price equal to or greater than the fair market value of the underlying partnership interest on the exercise date if the formula is agreed upon by the parties when the option is issued in a bona fide attempt to arrive at the fair market value on the exercise date and is to be applied based on the facts and circumstances in existence on the exercise date.

---

175 Treas. Reg. § 1.761-3(d)(2).

176 Treas. Reg. § 1.761-3(d)(2)(ii).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

The safe harbors do not apply, however, if the parties to the noncompensatory option had a principal purpose of substantially reducing the present value of the aggregate federal tax liabilities of the partners and the noncompensatory option holder.[177]

The failure of an option to satisfy one of the safe harbors does not affect the determination of whether the option is treated as reasonably certain to be exercised. Thus, options that do not satisfy the safe harbors may still be treated as not reasonably certain to be exercised under the facts and circumstances.

The determination of whether a noncompensatory option holder possesses partner attributes is based on all the facts and circumstances, including whether the option holder, directly or indirectly, through the option agreement or a related agreement, is provided with voting or managerial rights in the partnership.[178] An option holder has partner attributes if (1) the option holder is provided with rights (through the option agreement or a related agreement) that are similar to rights ordinarily afforded to a partner to participate in partnership profits through present possessory rights to share in current operating or liquidating distributions with respect to the underlying partnership interest; or (2) the option holder, directly or indirectly, undertakes obligations (through the option agreement or a related agreement) that are similar to obligations undertaken by a partner to bear partnership losses.[179]

A noncompensatory option holder will not ordinarily be considered to possess partner attributes solely because the noncompensatory option agreement significantly controls or restricts, or the noncompensatory option holder has the right to significantly control or restrict, a partnership decision that could substantially affect the value of the underlying partnership interest. In particular, the following rights of the option holder will not be treated as partner attributes: (1) the ability to impose reasonable restrictions on partnership distributions or dilutive issuances of partnership equity or options while the noncompensatory option is outstanding; and (2) the ability to choose the partnership's I.R.C. § 704(c) method for partnership properties.[180]

To aid in determining whether there is a strong likelihood that the failure to treat a noncompensatory option holder as a partner would result in a substantial reduction in the present value of the partners' and the option holder's aggregate federal tax liabilities, the Regulations provide that all facts and circumstances should be considered in making this determination, including: (1) the interaction of the allocations of the issuing partnership and the partners' and noncompensatory option holder's federal tax attributes (taking into account tax consequences that result from the interaction of the allocations with the partners' and noncompensatory option holder's federal tax attributes that are unrelated to the partnership); (2) the absolute amount of the

177 Treas. Reg. § 1.761-3(d)(2)(ii)(C).

178 Treas. Reg. § 1.761-3(d)(3)(i).

179 Treas. Reg. § 1.761-3(d)(3)(ii).

180 Treas. Reg. § 1.761-3(d)(3)(iii)(C).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

federal tax reduction; (3) the amount of the reduction relative to overall federal tax liability; and (4) the timing of items of income and deductions.[181]

Additionally, to more specifically address the application of the strong likelihood test when a look-through entity (as defined in Treas. Reg. § 1.704-1(b)(2)(iii)(d)(2)) is a party, such as a partnership or an S corporation, then the tax attributes of that entity's ultimate owners (that are not look-through entities) will be taken into account in determining whether there is a strong likelihood of a substantial tax reduction.[182] The Regulations also provide that, if a partner is a member of a consolidated group, then tax attributes of the consolidated group and of another member with respect to a separate return year will be taken into account in determining whether there is a strong likelihood of a substantial tax reduction.

The characterization rule will be applied upon the occurrence of a measurement event with respect to the noncompensatory option. The Regulations define a measurement event as: (1) issuance of the noncompensatory option; (2) an adjustment of the terms (modification) of the noncompensatory option or of the underlying partnership interest (including an adjustment pursuant to the terms of the noncompensatory option or the underlying partnership interest); or (3) transfer of the noncompensatory option if either (A) the term of the option exceeds 12 months, or (B) the transfer is pursuant to a plan in existence at the time of the issuance or modification of the noncompensatory option that has as a principal purpose the substantial reduction of the present value of the aggregate federal tax liabilities of the partners and the noncompensatory option holder.[183]

The Regulations do not treat the following events as measurement events: (1) a transfer of the noncompensatory option that would otherwise be a measurement event if the transfer is at death or between spouses or former spouses under I.R.C. § 1041, or in a transaction that is disregarded for federal tax purposes; (2) a modification that neither materially increases the likelihood that the option will be exercised nor provides the option holder with partner attributes; or (3) a change in the strike price of a noncompensatory option, or in the interests in the issuing partnership that may be issued or transferred pursuant to the option, made pursuant to a bona fide, reasonable adjustment formula that has the intended effect of preventing dilution of the interests of the option holder.[184]

The Regulations provide that once a noncompensatory option is treated as a partnership interest, in no event may it be characterized as an option thereafter.[185]

---

[181] Treas. Reg. § 1.761-3(e)(1).

[182] Treas. Reg. § 1.761-3(e)(2).

[183] Treas. Reg. § 1.761-3(c)(1).

[184] Treas. Reg. § 1.761-3(c)(2).

[185] Treas. Reg. § 1.761-3(a)(4).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

Because the rules in the Regulations are intended to supplement rather than supplant general tax principles, general tax principles continue to apply, in addition to the characterization rule of the Regulations. Thus, an option that is not treated as a partnership interest under the Regulations may still be treated as a partnership interest under general principles of law.[186] For example, if upon the issuance of a noncompensatory option, the option in substance constitutes a partnership interest under general tax principles, then the option will be treated as a partnership interest for federal tax purposes, even if it is unlikely that the aggregate tax liabilities of the option holder and partners would be substantially reduced by the failure to treat the option holder as a partner.

If the option holder is considered to be a partner, she is allocated her allocable share of partnership income or loss based on her interest in the partnership. Computing her interest in the partnership is the hard part. The Regulations do not provide a lot of guidance in this regard beyond noting that an option holder may have contributed less than other partners, making her economic interest in the partnership smaller.[187] Many different factors might go into calculating the allocable share, including the amount of the option premium paid, future rights to current profits if they cannot be currently distributed, and rights on liquidation, if any.

There are other complexities that can arise when an option holder is required to be treated as a partner. The biggest problems will occur when the partnership does not treat an option holder as a partner when it should have. Any audit that would detect the mistake may come years after the fact. In the interim, the other partners may have been allocated too much income, while the option holder will have been allocated none. That will all have to be undone, assuming the statute of limitations has not expired on the personal tax returns of the partners. The problem gets worse if, for example, the option holder is a tax-exempt organization with a strong aversion to partner status and its associated unrelated business taxable income[188] or a non-U.S. person that would be come subject to U.S. tax on effectively connected income if treated as a partner.[189] If any partners have come or gone during the period an option holder should have been treated as a partner but was not, the complexities of setting it all right reach Kafkaesque proportions.

Those same problems exist in reverse if the option holder is treated as a partner only to discover he was not one. Another complication in this regard is if the option holder/partner who is considered a partner allows the option to lapse. Now what? Presumably it would be treated as an abandonment of the partnership interest, generating possible debt shifts and deemed cash

---

186 Treas. Reg. § 1.761-3(a)(2).

187 The partnership agreement itself may be silent on the manner in which allocations are made to the option holder causing the allocations to the option holder to be made in accordance with the partners' interests in the partnership. I.R.C. § 704(b).

188 This income is taxed to the tax-exempt organization at regular tax rates. *See* I.R.C. §§ 511, 512. The issues related to partnerships with exempt organizations as partners are discussed in Chapter 12.

189 *See* I.R.C. § 875. The issues related to partnerships with non-U.S. partners are discussed in Chapter 12.

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

distributions under I.R.C. §§ 752 and 731, basis adjustments under I.R.C. § 734 if an I.R.C. § 754 election is in effect, and hot asset problems under I.R.C. § 751.[190]

One of the most problematic areas in the rules is the fact that the option is tested to determine whether or not it constitutes a partnership interest not only when the option is issued, but also when it is transferred or modified. It is not clear when a transaction qualifies as a modification or transfer. Modifications to the terms of options are not uncommon. It is important that the final Regulations make clear what is a modification that triggers a recharacterization review and what is not, so that taxpayers have adequate guidance.

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

§ 12.02 FOREIGN PARTNERSHIPS

C. Controlled Foreign Corporations as Partners in Foreign Partnerships

Add at the end of the section:

The Treasury and the IRS have promulgated Temporary Regulations that treat property acquired by a partnership that is controlled by a CFC as U.S. property held indirectly by the CFC if the property would be U.S. property if it had been held directly by the CFC and a principal purpose of creating, organizing or funding by any means (including through capital contributions or debt) the partnership is the avoidance of the application of I.R.C. § 956.[191] For such purposes, a CFC controls a partnership if the CFC and the partnership are related for the purposes of I.R.C. § 707(b).

In addition, an obligation of a foreign partnership that is held by a CFC is treated as an obligation of a partner in the partnership when (a) the foreign partnership distributes an amount of money or property to the partner, (b) the foreign partnership would not have made the distribution but for a funding of the partnership through the obligation and (c) the partner is related to the CFC within the meaning of I.R.C. § 956(d)(3).[192] The amount that is treated as the obligation of the distributee partner is equal to the lesser of (i) the amount of the partnership distribution that would not have been made but for the funding of the partnership or (ii) the amount of the obligation of the foreign partnership that is held by the CFC.[193]

§ 12.08 FATCA

---

190 *See* ABA Comments at IVE1.

191 Temp. Reg. § 1.956-1T(b)(4)(i)(C).

192 Temp Reg. § 1.956-1T(b)(5)(i).

193 Temp. Reg. § 1.956-1T(b)(5)(ii).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

Replace the final paragraph in the section with:

I.R.C. §§ 1471 and 1472 on their face would generally apply to payments made after December 31, 2012, but no withholding is required in respect of obligations outstanding on March 18, 2012. However, Notice 2013-43 delayed the withholding obligations and the grandfather rules under FATCA until July 1, 2014[194] in regard to U.S.-source FDAP payments.[195] FATCA withholding will begin in regard to gross proceeds from the sale or other disposition of any property of a type that can produce interest or dividends from sources within the United States on January 1, 2016. Foreign financial institutions will be treated as participating foreign financial institutions (and not subject to the withholding) if they have registered as participating foreign financial institutions and entered into agreements with the IRS. The withholding obligations of participating foreign financial institutions in regard to passthru payments will begin no earlier than January 1, 2016. The IRS provided further transitional relief for during 2014 and 2015 for taxpayers that are making good faith efforts to put the new due diligence procedures into place.[196]

CHAPTER 13: ANTI-ABUSE PROVISIONS

§ 13.02 JUDICIAL DOCTRINES

E. Failure to Form a Valid Partnership for Tax Purposes

Add at the end of the section:

On remand, the District Court found that that the banks were partners because they held a capital interest in a partnership for which capital was a material income producing factor,[197] but the Second Circuit concluded that the banks were not partners because their interest was not in the nature of a partnership interest.[198] Although the Second Circuit had held that the 20% accuracy penalty against the U.S. taxpayer could apply, on further hearing by the District Court, the trial court concluded that the taxpayer had a reasonable basis for its position and that the negligence penalty would not apply.[199]

---

194 2013-31 IRB 113.

195 "FDAP payments" include any payments of interest (including original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments and other fixed or determinable annual or periodic gains, profits and income if such payment is from sources within the United States.

196 Notice 2014-33, 2014-21 IRB 1.

197 660 F. Supp. 2d 367 (D. Conn. 2009).

198 666 F.3d 836 (2d Cir. 2012).

199 113 AFTR 2d 2014-1557 (D. Conn. 2014).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

§ 13.04 MIXING BOWL TRANSACTIONS

A. Introduction

Add at the end of the section:

In June of 2105 the Treasury and the IRS released final and temporary Regulations that addressed the May Company transaction.[200] Under the Regulations, an I.R.C. § 337(d) transaction may occur if (i) a corporate partner contributes appreciated property to a partnership that owns stock of the corporate partner; (ii) a partnership acquires stock of the corporate partner, (iii) a partnership that owns stock of a corporate partner distributes appreciated property to a partner other than the corporate partner, (iv) a partnership distributes stock of a corporate partner to the corporate partner, or (v) a partnership agreement is amended in a manner that increases a corporate partner's interest in the stock of the corporate partner.[201] If a partnership engages in an I.R.C. § 337(d) transaction, the corporate partner must recognize gain.[202]

CHAPTER 14: FAMILY PARTNERSHIPS

§ 14.02 WHO ARE THE PARTNERS OF FAMILY LIMITED PARTNERSHIPS?

As noted in § 5.08, the question of whether certain individuals were partners in a family partnership resulted in extensive litigation.[203] In reaction to the continuing litigation, the statute and the Regulations were clarified to provide rules as to who is treated as a partner in a partnership in which capital is a material income-producing factor.

I.R.C. § 761(b) provides that whether a person should be recognized as a partner for purposes of federal income taxes if the person owns a capital interest in a partnership in which capital is a material income-producing factor is determined without regard to whether or not such interest was derived by gift from any other person. I.R.C. § 704(e)(1) provides that the distributive share of the donee must be included in the donee's gross income. Treas. Reg. § 1.704-1(e)(1)(iii) provides that a donee or purchaser of a capital interest in a partnership is not recognized as a partner under the principles of I.R.C. § 704(e)(1) unless such interest is acquired in a bona fide transaction, not a mere sham for tax avoidance or evasion purposes, and the donee is the real owner of such interest. To be recognized, a transfer must vest dominion and control of the partnership interest in the transferee. The existence of such dominion and control in the donee is to be determined from all the facts and circumstances. A transfer is not recognized if the transferor retains such incidents of ownership that the transferee has not acquired full and complete ownership of the partnership interest. The Regulations also indicate that transactions

---

200 TD 9722, 80 Fed. Reg. 33402 (June 12, 2015).

201 Temp. Reg. § 1.337(d)-3T(c)(3).

202 Temp. Reg. § 1.337(d)-3T(d)(1).

203 *See also* Paul Carman and Colleen Kushner, "The Uncertain Certainty of Being a Partner: Partner Classification for Tax Purposes," 109 *Journal of Taxation* 165 (Sept. 2008).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

between members of a family will be closely scrutinized, and the circumstances, not only at the time of the purported transfer, but also during the periods preceding and following it, will be taken into consideration in determining whether the purported gift or sale should be recognized.

Treas. Reg. § 1.704-1(e)(1)(iv) provides, in part, that for purposes of I.R.C. § 704(e)(1)[204], capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business conducted by the partnership. Capital is ordinarily a material income-producing factor if the operation of the business requires substantial inventories or a substantial investment in plant, machinery, or other equipment. In general, capital is not a material income-producing factor where the income of the business consists principally of fees, commissions, or other compensation for personal services performed by members or employees of the partnership.[205]

Treas. Reg. § 1.704-1(e)(1)(i) begins with the statement that the production of income by a partnership is attributable to the capital or services, or both, contributed by the partners. In *Carriage Square, Inc. v. Commissioner*,[206] the partners contributed a small amount of capital and then the partnership borrowed the funds to do its business (with a guarantee by a non-partner). The court concluded that capital was not a material income-producing factor of the partnership because the capital used was not provided by the partners.

Treas. Reg. § 1.704-1(e)(1)(v) provides that for purposes of I.R.C. § 704(e), a capital interest in a partnership means an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership. The mere right to participate in the earnings and profits of a partnership is not a capital interest in the partnership.

Whether a person claiming to be a partner who is a donee of a capital interest in a partnership is the real owner of such capital interest, and whether the donee has dominion and control over such interest, must be determined from all the facts and circumstances of the particular case.[207] Isolated facts are not determinative; the reality of the donee's ownership must be determined in the light of the transaction as a whole. The execution of legally sufficient and irrevocable deeds or other instruments of gift under state law is a factor to be taken into account, but is not determinative of ownership by the donee for the purposes of I.R.C. § 704(e). The reality of the transfer and of the donee's ownership of the property attributed to the donee are to be determined from the conduct of the parties with respect to the claimed gift and not by any mechanical or formal test.

---

204 This should now be read as a reference to I.R.C. § 761(b)

205 However, goodwill may be a significant income producing capital factor. *See Bateman v. U.S.*, 490 F.2d 549 (9th Cir. 1973) (a brokerage firm may rely upon I.R.C. § 704(e) where goodwill is a significant income producing factor).

206 69 T.C. 119 (1977).

207 Treas. Reg. § 1.704-1(e)(2)(i).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

Treas. Reg. § 1.704-1(e)(2)(ii) lists a series of factors to be considered in determining whether a partner is, in fact, the real owner of a capital interest in a partnership. The factors to be considered, which are illustrative rather than exhaustive, break down into five categories: retained controls (including retention of control of assets essential to the business), indirect controls, participation in management, income distributions, and conduct of partnership business. The first two factors indicate lack of ownership, while the last three factors indicate ownership.

Retention of control by the donor of the distribution of amounts of income or restrictions on the distributions of amounts of income (other than amounts retained in the partnership annually with the consent of the partners, including the donee partner, for the reasonable needs of the business) would be a factor indicating that the donor may be more appropriately treated as having dominion and control.[208] If there is a partnership agreement providing for a managing partner or partners, then amounts of income may be retained in the partnership without the acquiescence of all the partners if such amounts are retained for the reasonable needs of the business.

If the donor limits the right of the donee to liquidate or sell the donor's interest in the partnership at the donor's discretion without financial detriment, such a limitation would be a factor indicating that the donor may be more appropriately treated as having dominion and control.[209]

If the donor retains control of assets essential to the business, such controls would be a factor indicating that the donor may be more appropriately treated as having dominion and control.[210] For example, if the donor of a partnership interest owned the real property upon which the partnership had its manufacturing facility, and the lease was terminable at will by the donor without penalty, the donor has essentially retained the ability to take control of the assets of the partnership at any time.

If the donor retains management powers inconsistent with normal relationships among partners, such powers would be a factor indicating that the donor may be more appropriately treated as having dominion and control.[211] Retention by the donor of control of business management or of voting control, such as is common in ordinary business relationships, is not by itself inconsistent with normal relationships among partners, provided the donee is free to liquidate the donee's partnership interest at the donee's discretion without financial detriment. The donee will not be considered free to liquidate the donor's partnership interest unless the donee is independent of the donor and has such maturity and understanding of donor's rights as to be capable of deciding to exercise, and capable of exercising, the donee's right to withdraw the donee's capital interest from the partnership.

208 Treas. Reg. § 1.704-1(e)(2)(ii)(a).

209 Treas. Reg. § 1.704-1(e)(2)(ii)(b).

210 Treas. Reg. § 1.704-1(e)(2)(ii)(c).

211 Treas. Reg. § 1.704-1(e)(2)(ii)(c).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

Substantial participation by the donee in the control and management of the business (including participation in the major policy decisions affecting the business) is strong evidence of a donee partner's exercise of dominion and control over his interest.[212] Such participation presupposes sufficient maturity and experience on the part of the donee to deal with the business problems of the partnership.

In determining the reality of the donee's ownership of a capital interest in a partnership, whether the donee is actually treated as a partner in the operation of the business must be taken into consideration. Whether or not the donee has been held out publicly as a partner in the conduct of the business, in relations with customers, or with creditors or other sources of financing, is of primary significance.

While the Regulations under I.R.C. § 704(e) set forth certain rules for establishing the ownership of interests in a family partnership and the allocation of partnership income, the common thought projected throughout the Regulations is that each case must be decided on its own particular facts and surrounding circumstances.

In *U.S. v. Ramos*,[213] an alleged family partnership was found to be invalid where the taxpayer-parents retained the complete interests in the operating assets of a ranch, and the children contributed neither property nor services (other than bookkeeping services) for which compensation was paid. The failure of the parents to transfer title to the property to the partnership was one of the most important factors in the court's decision not to recognize the partnership. Although capital was a material income-producing factor to the business, the children received no interest in the capital of the business.

The recognition of an assignee's interest in a limited partnership will depend, as in the case of other donated interests, on whether the transfer of property is real and on whether the donee has acquired dominion and control over the interest purportedly transferred to him. To be recognized for federal income tax purposes, a limited partnership must be organized and conducted in accordance with the requirements of the applicable state limited partnership law.[214] The absence of services and participation in management by a donee in a limited partnership is immaterial if the limited partnership meets all the other requirements of Treas. Reg. § 1.704-1(e).

Thus, the question of whether the assignee obtains dominion and control of the assigned partnership interest is crucial to the determination of the tax consequences of the assignment. The courts have recognized the dominion and control test as being the deciding factor in

---

212 Treas. Reg. § 1.704-1(e)(2)(iv).

213 393 F. 2d 618 (9th Cir. 1968), *cert. denied*, 393 U.S. 983 (1968).

214 Reg. 1.704-1(e)(2)(ix). It should be noted that this statement out of context would appear to conflict with Treas. Reg. 301.7701-1(a)(1), which provides that the recognition of an entity for federal income tax purposes is not a question of local law. One way of reconciling the two provisions would be to read the provision in Treas. Reg. § 1.704-1(e)(2)(ix) to be introduced by the phrase "For the purposes of this paragraph," but other methods of reconciliation may also apply.

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

attributing the earning of partnership income or loss to a particular individual in partnerships in which capital is a material income-producing factor.[215] In *Pflugradt*, the court states:

> To be recognized for tax purposes, a transfer of a partnership interest must vest dominion and control in the transferee. ... [This] includes not only control with respect to the partnership business, which in this case is non-existent because the general partner had sole control of the business, but also control of the interest as a property right.

The Seventh Circuit subsequently decided another case applying the test of ownership of a capital interest to the assignment of a general partnership interest. *Evans v. Commissioner*[216] relies on Treas. Reg. § 1.704-1(e) to conclude that the assignee of a general partnership interest, and not the assigning general partner himself, was the "partner" for purposes of reporting partnership distributive shares. In *Evans*, the taxpayer sold his entire beneficial interest in a partnership to his closely held corporation, without the knowledge or consent of his equal partner in the business. The taxpayer continued to perform the same work for the partnership as before, but the court found that this was done in his capacity as an officer and director of the assignee corporation, not as a partner. As a fiduciary of the corporation, the taxpayer would have been required to exercise his remaining partnership powers in the interest of the corporation. Under these unique facts, the court held that the corporation (the assignee) and not the taxpayer (the assignor) was taxable on the partnership distributive share.

While all the facts and circumstances must be taken into consideration, note that the rights of the parties may be designed to intentionally meet the five factors of Treas. Reg. § 1.704-1(e)(2).

[215] *See, e.g., Pflugradt v. U.S.*, 310 F.2d 412 (7th Cir. 1962), where the court refused to recognize certain purported transfers of limited partnership interests to minor children (whose ages ranged from one to three and one-half years).

[216] 447 F.2d 547 (7th Cir. 1971), *aff'g* 54 T.C. 40 (1970).

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

ERRATA

PAGE 64

The last sentence of the second paragraph should read:

If the partnership is liquidated before the end of such 180-month period, the expenses which have not as yet been amortized may be deducted as a loss to the extent provided in I.R.C. § 165.

PAGE 112

Second full paragraph, 9th line: "…under local law, the IRS issued Proposed Regulations…

PAGE 120

Problem 8.

> P is a partner of a partnership. P has a 25% profit interest and a 100% loss interest. …

PAGE 163

In the second line, change "nonrecourse deductions" to "nonrecourse debt".

PAGE 220

First line: There should be an "is" after the "but".

PAGE 221

First full paragraph of § 7.05, three lines from the bottom. The sentence should end with "disposition of partnership property."

PAGE 222

Last line of § 7.05. The sentence should end with "enactment."

PAGE 216

In the first line of the third full paragraph, the reference should be to I.R.C. § 731 rather than to I.R.C. § 732.

PAGE 239

Six lines from the bottom of the first paragraph, change "his or her" to "her".

PAGE 413

Copyright © 2016 Carolina Academic Press, LLC. All rights reserved.

In the sentence accompanying footnote 10, change “partnership receives” to “partner receives”.