



Understanding Partnership Taxation: Types of Basis, Contributions, and Distributions

PTB4/26/F1



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A Quick Word on Policy vs. Politics

- Many times when discussing accounting, tax and finance policy issues, it can be difficult to divorce the politics from the policy
- Today, when discussing the various issues we will encounter over the next several hours, let's agree to keep our own view of politics out of the application of the policy and focus on doing the very best we can for all our clients
- This goes for religious/faith views as well



Learning Objectives

- Calculate Inside Basis, Outside Basis, and 704(b) Basis
- Recognize the concept of Substantial Economic Effect
- List the three requirements that need to be present for an allocation to be deemed to have Economic Effect
- Calculate the reallocation of items of gains and loss under IRC 704(b) when a qualified income offset is present
- Recognize the tax effects of transferring cash, property, and services to a partnership
- Recall the tax effects of contributing assets to a partnership that are encumbered by debt



Learning Objectives

- List the key rules of thumb to remember when dealing with distributions
- State the ordering rules for calculating a partner's tax basis
- Describe the key differences between liquidating and non-liquidating distributions
- Determine any applicable tax gains and losses of cash and property distributions
- State the ordering rules for hybrid distributions that involve both cash and property



Capital vs. Basis – What's the Difference?

- We tend to use the terms capital and basis interchangeably
- We generally mean one of three things:
 - Inside Basis
 - Outside Basis
 - 704(b) Basis

Inside Basis



- Partner's share of the assets of the partnership on a tax basis
- Basically "Tax Basis Equity"
- Does not include Debt

Outside Basis



- AKA – Tax Basis or just Basis
- Basically "Tax Basis Equity Plus Debt"
- Basis we use if you sell a partnership interest



704(b) Basis



- AKA – Book Basis
- Basically “Equity” using FMV
- Concerned with Economics – not tax basis!



Contributions of Property – In General

- IRC 721(a) — *No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership*
- IRC 722 — *The basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under section 721(b) to the contributing partner at such time*
- IRC 723 — *The basis of property contributed to a partnership by a partner shall be the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under section 721(b) to the contributing partner at such time*



Example 1

Alice contributes a building to a partnership with a basis of \$100,000 and a fair market value of \$250,000 in exchange for an interest in a partnership. What is her inside basis, outside basis, and 704(b) basis immediately after the transfer?



Example 1

Alice's share of the inside basis of the assets is \$100,000. She would take an outside basis of \$100,000 and 704(b) basis of \$250,000.

The partnership also has a tax basis in the building of \$100,000. It would show the asset at \$250,000 on its 704(b) balance sheet.



Why Even Have 704(b) Capital Accounts?



- Can we make special allocations?
- Substantial Economic Effect
- If there is no substantial economic effect, then we go back to the default → partnership interest



Economic Effect

- Under 704(b), three requirements to have economic effect:
 1. Maintain books and records in accordance with IRC 704(b)
 2. Partners must be entitled to positive balances in their capital account upon liquidation/retirement
 3. Partners must be obligated to restore negative balances upon liquidation (or there must be a qualified income offset – see next slide)



Deficit Restoration or Qualified Income Offset

- If you do not have a deficit restoration requirement, you need to have a qualified income offset in order to have economic effect
- A qualified income offset says that if a deficit is created or increased that is not otherwise required to be restored, it must be offset or reallocated by profits or gain



Example 2

Ben and Cynthia are partners in a partnership. They share everything equally, except Ben receives 100% of the depreciation expense since he contributed a building to the partnership for his partnership interest. They each have a beginning balance in their 704(b) capital accounts of \$10,000. The partnership had income before depreciation during the year of \$20,000 and depreciation expense of \$30,000. The partnership agreement does not contain a deficit restoration requirement, but it does contain a qualified income offset.



Example 2

Ignoring the Qualified Income Offset:

	<u>Ben</u>	<u>Cynthia</u>
Beginning Balance	\$10,000	\$10,000
Net Income	\$10,000	\$10,000
Depreciation	<u>(\$30,000)</u>	<u>\$0</u>
Ending	(\$10,000)	\$20,000



Example 2

With the Qualified Income Offset (50% of everything is reallocated, so Ben does not go below zero – partial economic effect under the alternate test):

	<u>Ben</u>	<u>Cynthia</u>
Beginning Balance	\$10,000	\$10,000
Net Income	\$5,000	\$15,000
Depreciation	<u>(\$15,000)</u>	<u>(\$15,000)</u>
Ending	\$0	\$10,000

[Reg. 1.704-1(b)(2)(ii)(d)]



In English, What Does This All Mean?

- No paper gains and losses → Need to feel it
- Gains have to truly add value
- Losses have to hurt



Substantiality

- Allocations must be “meaningful and relatively long-lasting”
- Three Tests:
 1. Shifting Tax Consequences Test (Reg 1.704-1(b)(2)(iii)(b))
 2. Transitory Allocations Test (Reg 1.704-1(b)(2)(iii)(c))
 3. Overall Tax Effects Test (Reg 1.704-1(b)(2)(iii)(a))



Example 3

- Beatrice contributes machinery (basis: \$50,000, FMV: \$100,000) and cash of \$50,000 in exchange for a 50% interest in a partnership at formation
- Cindy contributes land (basis: \$75,000, FMV: \$150,000) in exchange for a 50% interest in a partnership at formation
- Calculate each partner's share of inside basis, outside basis, and 704(b) basis in the partnership immediately after the transfer



Example 3

Balance Sheet

	<u>Tax Basis</u>	<u>704(b) Basis</u>
Cash	\$50,000	\$50,000
Machine	\$50,000	\$100,000
Land	<u>\$75,000</u>	<u>\$150,000</u>
Total	\$175,000	\$300,000
Capital – Beatrice (50%)	\$100,000	\$150,000
Capital – Cindy (50%)	<u>\$75,000</u>	<u>\$150,000</u>
Total	\$175,000	\$300,000



Example 3

	<u>Beatrice</u>	<u>Cindy</u>
<i>Inside Basis</i>	\$100,000	\$75,000
<i>Outside Basis</i>	\$100,000	\$75,000
<i>704(b) Basis</i>	\$150,000	\$150,000

Why is inside basis equal to outside basis in this instance?



What If the Property Is Encumbered by Debt?

- IRC 752(a) — *Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a **contribution of money** by such partner to the partnership*
- IRC 752(b) — *Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a **distribution of money** to the partner by the partnership*



Example 4

- Beatrice contributes machinery (basis: \$50,000, FMV: \$100,000) and cash of \$50,000 in exchange for a 50% interest in a partnership at formation
- Cindy contributes a building (basis: \$75,000, FMV: \$200,000) in exchange for a 50% interest in a partnership at formation. The building is encumbered by a \$50,000 mortgage.
- The partnership will assume the mortgage
- Calculate each partner's share of inside basis, outside basis, and 704(b) basis in the partnership immediately after the transfer



Example 4

Balance Sheet

	<u>Tax Basis</u>	<u>704(b) Basis</u>
Cash	\$50,000	\$50,000
Machine	\$50,000	\$100,000
Building	<u>\$75,000</u>	<u>\$200,000</u>
Total	<u>\$175,000</u>	<u>\$350,000</u>
Mortgage Debt	\$50,000	\$50,000
Capital – Beatrice (50%)	\$100,000	\$150,000
Capital – Cindy (50%)	<u>\$25,000</u>	<u>\$150,000</u>
Total	<u>\$175,000</u>	<u>\$350,000</u>



Example 4

	<u>Beatrice</u>	<u>Cindy</u>
<i>Inside Basis</i>	\$100,000	\$25,000
<i>Outside Basis</i>	\$125,000	\$50,000
<i>704(b) Basis</i>	\$150,000	\$150,000

Why is 704(b) Basis still the same?



What If Debt Exceeds Basis?



- Inside Basis → Okay
- 704(b) Basis → Okay
- Outside Basis → Not okay, must recognize a gain (IRC 705(a)(2))



Example 5

- Beatrice contributes machinery (basis: \$50,000, FMV: \$100,000) and cash of \$50,000 in exchange for a 50% interest in a partnership at formation
- Cindy contributes a building (basis: \$75,000, FMV: \$250,000) in exchange for a 50% interest in a partnership at formation. The building is encumbered by a \$100,000 mortgage.
- The partnership will assume the mortgage
- Calculate each partner's share of inside basis, outside basis, and 704(b) basis in the partnership immediately after the transfer



Example 5

Balance Sheet

	<u>Tax Basis</u>	<u>704(b) Basis</u>
Cash	\$50,000	\$50,000
Machine	\$50,000	\$100,000
Building	<u>\$75,000</u>	<u>\$250,000</u>
Total	\$175,000	\$400,000
Mortgage Debt	\$100,000	\$100,000
Capital – Beatrice (50%)	\$100,000	\$150,000
Capital – Cindy (50%)	<u>(\$25,000)</u>	<u>\$150,000</u>
Total	\$175,000	\$400,000



Example 5

	<u>Beatrice</u>	<u>Cindy</u>
<i>Inside Basis</i>	\$100,000	(\$25,000)
<i>Outside Basis</i>	\$150,000	\$25,000
<i>704(b) Basis</i>	\$150,000	\$150,000

Why doesn't Cindy have to recognize a gain?

- ***It is okay for inside basis to fall below zero***
- ***She got back 50% of the debt she was relieved of***



Example 6

- Beatrice contributes machinery (basis: \$50,000, FMV: \$100,000) and cash of \$50,000 in exchange for a 50% interest in a partnership at formation
- Cindy contributes a building (basis: \$75,000, FMV: \$350,000) in exchange for a 50% interest in a partnership at formation. The building is encumbered by a \$200,000 mortgage.
- The partnership will assume the mortgage
- Calculate each partner's share of inside basis, outside basis, and 704(b) basis in the partnership immediately after the transfer



Example 6

<u>Balance Sheet</u>		
	<u>Tax Basis</u>	<u>704(b) Basis</u>
Cash	\$50,000	\$50,000
Machine	\$50,000	\$100,000
Building	<u>\$75,000</u>	<u>\$350,000</u>
Total	<u>\$175,000</u>	<u>\$500,000</u>
Mortgage Debt	\$200,000	\$200,000
Capital – Beatrice (50%)	\$100,000	\$150,000
Capital – Cindy (50%)	<u>(\$125,000)</u>	<u>\$150,000</u>
Total	<u>\$175,000</u>	<u>\$500,000</u>



Example 6

	<u>Beatrice</u>	<u>Cindy</u>
Inside Basis	\$100,000	(\$125,000)
Outside Basis	\$200,000	(\$25,000)
704(b) Basis	\$150,000	\$150,000

Cindy will recognize a \$25,000 gain on her income tax return (outside basis will then be zero)



A Few Last Things on Debt

- Debt is allocated to partners based on:
 - Partner Type – Limited vs. General
 - Type of Debt – Recourse vs. Non-Recourse
- Recourse Debt – Allocated based on a Constructive Liquidation Scenario
- Non-Recourse Debt – Several rules for allocation but usually comes down to profit sharing percentages



Example 7

ABC Partnership obtains a loan from the bank that is only backed by the reputation and creditworthiness of the entity itself. In order to obtain a more favorable interest rate, the loan is guaranteed by Katie (who is a limited partner).

This is a recourse debt since Katie has guaranteed the loan. This is true based on the totality of the circumstances – even if Katie is a limited partner. It is true even if the note were to say that it is a nonrecourse debt.



Practitioner Point

- Agreements existing outside of the loan documents should be scrutinized to determine the allocation and proper character of a debt
- For example, if the operating agreement states that partner A will reimburse the other partners for any amounts they owe in the event of default by a partnership, this would be a recourse debt to partner A. Partner A's outside basis should be increased for this debt.
- What the loan document says is not important. Look at the totality of the circumstances to determine the type of debt!



Constructive Liquidation Scenario (Reg. 1.752-2)

Steps in a Constructive Liquidation Scenario:

1. Assume all the assets of the partnership become worthless
2. Allocate the loss on the assets among the partners based on the loss sharing percentages described in the partnership agreement
3. Using the 704(b) capital accounts, figure out how much of the debt each partner would be on the hook for
4. The recourse debt should be allocated among the partners based on who would ultimately be on the hook (the results from step 3). This would generally be whoever has a negative 704(b) capital account after the loss allocation from step 2.



Example 8

Assume that a partnership has a recourse debt on its balance sheet for \$100,000. The 704(b) basis balance sheet for the partnership is presented on the next slide. Assume that partners A and B each share all items 50/50, except for losses. Losses are shared 60% to Partner A and 40% to Partner B. Assume that this special allocation has substantial economic effect. Additionally, assume that both partners are general partners.



Example 8 – 704(b) Balance Sheet

704(b) Basis

Total Assets

\$200,000

Recourse Debt

\$100,000

Capital – Partner A (60% Losses)

\$50,000

Capital – Partner B (40% Losses)

\$50,000



Example 8 – 704(b) Balance Sheet

Step 1 – Assume all assets become worthless

	<u>704(b) Basis</u>
Total Assets	\$0
Recourse Debt	\$100,000
Capital – Partner A (60% Losses)	\$50,000
Capital – Partner B (40% Losses)	\$50,000

Note: We have a \$200,000 loss that must be allocated to the partners



Example 8 – Loss Allocation

Step 2 – Allocate loss among the partners

	<u>704(b) Basis</u>
Total Assets	\$0
Recourse Debt	\$100,000
Capital – Partner A (60% Losses)	$\$50,000 - \$120,000 = (\$70,000)$
Capital – Partner B (40% Losses)	$\$50,000 - \$80,000 = (\$30,000)$

Note: Both partners would be required to restore a portion of the debt in the event of liquidation



Example 8 – Debt Allocation

Step 3 and 4 – Allocate the debt among the partners

Partner A's outside basis should be increased by \$70,000 for their share of the recourse debt. Partner B's outside basis should be increased by \$30,000.

This is how much both partners would be on the hook for in the event of liquidation.

Note: The debt is NOT allocated 60/40. It is allocated based on what each partner would ultimately be on the hook for in the event of liquidation. This allocation could change if the balance were to change in each partner's 704(b) capital account!



Discussion

What would have happened if one of the partners was a limited partner?

You would need to look at what would happen in the event of liquidation. In general, limited partners are not on the hook for anything but their amount invested in the event of liquidation. Therefore, they are not normally allocated recourse debt. An exception to this would be if the limited partner were to guarantee the debt. This would create a recourse debt that would be allocated to that limited partner!



Nonrecourse Debt

- Nonrecourse debt is allocated based on a 3-tier system described in Reg. 1.752-3:
 1. Minimum Gain in Accordance with Sec 704(b)
 2. Gains attributable under Sec 704(c)
 3. Profit Sharing Percentages
- A limited partner would be allocated nonrecourse debt since such a debt would be serviced using partnership profits. (General partners would also be allocated nonrecourse debt.)



What About Excess Nonrecourse Debt?

Partnerships may choose to allocate “excess” nonrecourse debt in accordance with:

- The way other “significant items” of partnership income or gain are allocated; or
- The way in which partners are reasonably expected to share in future deductions attributable to such nonrecourse liabilities (the way in which nonrecourse deductions are expected to be allocated in future); or
- The way the remaining built-in gain might still be allocable to the partner on a sale of Section 704(c) property. (Built-in gain property must be subject to the nonrecourse liability being allocated.)



What Is a 704(b) Minimum Gain?

- A minimum gain is primarily created through nonrecourse deductions
- Nonrecourse deductions are primarily depreciation deductions that reduce the adjusted basis of a property below its associated debt (on a 704(b) basis). To have nonrecourse deductions, there must be no remaining partner or member capital, or recourse debt, to absorb the partnership loss.
- It essentially represents the amount that would need to be declared as a gain (on a 704(b) basis) if the taxpayer were to just walk away from the debt



Contribution of Services – IRC 83

- Services are NOT property or cash
- Treated like “compensation” or a “guaranteed payment”
- Timing of recognition is based on risk of forfeiture





Contribution of Services – IRC 83

- Generally deductible to the partnership
- Timing of the deduction depends on the timing of income recognition
- Profits-only interests generally are valued at zero



Notice 2020-43

- For tax years ending on or after December 31, 2020, there are two choices to report capital on the Schedule K-1:
 - Modified Outside Basis Method; or
 - Modified Previously Taxed Capital Method
- Essentially, this is meant to eliminate other options to report basis that are not tax basis



Modified Outside Basis Method

- Modified O/S Basis = Outside Basis – Share of Partnership Liabilities
- Basically the equity share of a partner on a tax basis
- Includes:
 - IRC 705 (determination of basis of partnership interest)
 - IRC 722 (basis of contributing partner's interest)
 - IRC 733 (basis of distributee partner's interest)
 - IRC 742 (basis of transferee partner's interest)



Modified Previously Taxed Capital Method

- Cash partner would receive if they liquidated after selling all assets in a fully taxable transaction for cash equal to the fair market value of the assets

Plus

- Tax loss determined without taking into account any Section 743(b) basis adjustments (including any remedial allocations) that would be allocated to the partner following such a liquidation (treating all liabilities as nonrecourse)

Minus

- Tax gain determined without taking into account any Section 743(b) basis adjustments (including any remedial allocations) that would be allocated to the partner following such a liquidation (treating all liabilities as nonrecourse)



Schedule K-1 – Beginning Capital for 2020

- If tax basis method was used in 2019, the partner's ending capital account as determined for 2019 is entered on the line for the beginning capital account for 2020
- If a different amount is reported as a beginning balance for 2020 (compared to ending balance in 2019), an explanation should be attached
- Transactional method should be used to determine beginning balance for 2020 (basically a summation of all items on a tax basis without debt)



Schedule K-1 – Beginning Capital for 2020

- If a partnership did not prepare Schedules K-1 under the tax basis method in 2019, but did maintain tax basis capital account records (for purposes of reporting negative capital accounts), each partner's beginning balance for 2020 may be determined using any of the following:
 - Modified Outside Basis Method (*just discussed*)
 - Modified Previously Taxed Capital Method (*just discussed*)
 - IRC 704(b) Method (*see next slide*)



IRC 704(b) Method

- IRC 704(b) Basis – 704(c) Built-In Gain + 704(c) Built-In Loss
- 704(c) built-in gains/losses occur when there is a difference between fair market value and tax basis
- Essentially, the formula just backs into reportable basis by removing appreciation/depreciation



Takeaways – Basis and Contributions

- Three Different Types of Capital/Basis – Inside, Outside, and 704(b)
- 704(b) basis is concerned with economics
- No gain/loss on property contributions unless debt is involved



Distributions – General Rules

- Generally, carryover basis going in, carryover basis going out for tax purposes
- FMV going in, FMV going out for 704(b) purposes
- Generally, only recognize gains or losses when cash is involved**

**Several exceptions: IRC 704(c)(1)(B), IRC 707, IRC 737, IRC 751(b), etc.



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Distributions – General Rules

- Unlike an S-Corporation, partnership distributions do **NOT** have to be pro-rata
- Basis Calculations are usually made once per year – At the end of the year
- Tax rules generally favor tax-free distributions



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Partnership Basis Calculation – IRC 705

Beginning Basis

- + Taxable income
- + Tax-exempt income
- + The excess of the deductions for depletion over the basis of the property subject to depletion
- Nontaxable distributions
- Tax-deductible losses
- Non-deductible expenses
- Amount of the s/h's deduction for depletion for any oil and gas property held by the partnership to the extent such deduction does not exceed basis
- = **Ending Basis**



Partnership Basis Calculation – Dave's Summary

Beginning Basis

- +Increases (Gains & Contributions)
- Distributions
- Deductible Decreases
- Non-deductible Decreases
- = **Ending Basis**





Distributions

- **Two Types of Distributions:**

- 1) *Non-Liquidating/Current* – Partnership interest still exists after the distribution (may be zero)
- 2) *Liquidating* – No partnership interest left after the distribution

- With liquidating distributions, you **must** have outside basis of zero after the distribution!



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What About a Disproportionate Distribution?

- A disproportionate distribution occurs when an actual or constructive distribution to a partner changes the partner's proportionate interest in unrealized receivables (including 1245 recapture property) or substantially appreciated inventory
- When this happens, ordinary income must be recognized under IRC 751(b)

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Non-Liquidating Distributions

IRC 731(a) – *In the case of a distribution by a partnership to a partner—*

- 1) *Gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution; and*
- 2) *Loss shall not be recognized to such partner, except that upon a distribution in liquidation of a partner's interest in a partnership where no property other than that described in subparagraph (A) or (B) is distributed to such partner, loss shall be recognized to the extent of the excess of the adjusted basis of such partner's interest in the partnership over the sum of—*
 - A. *Any money distributed; and*
 - B. *The basis to the distributee, as determined under section 732, of any unrealized receivables (as defined in section 751(c)) and inventory (as defined in section 751(d)).*

Any gain or loss recognized under this subsection shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner.



Non-Liquidating Distributions

- IRC 731(b) – Partnership does not recognize gain or loss on distribution of property
- Several exceptions: IRC 704(c)(1)(B), IRC 707, IRC 737, IRC 751(b), etc.



Non-Liquidating Distributions

- IRC 731(a) – Non-cash distributions generally do not trigger recognition of gain to recipient partner
- IRC 732(a)(1) – *The basis of property (other than money) distributed by a partnership to a partner other than in liquidation of the partner's interest shall, except as provided in paragraph (2), be its adjusted basis to the partnership immediately before such distribution*
- IRC 732(a)(2) – *The basis to the distributee partner of property to which paragraph (1) is applicable shall not exceed the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction*



Example 9

- Derek has an outside basis in his partnership interest of \$100,000
- He takes a \$70,000 cash distribution
- This is a non-liquidating distribution
- Calculate his resulting outside basis as well as any gains and losses



Example 9

Beginning Basis: \$100,000

Distribution: (\$70,000)

Ending Basis: \$30,000

Gain/Loss: No gain or loss



Example 10

- Derek has an outside basis in his partnership interest of \$100,000
- He takes a \$120,000 cash distribution
- This is a non-liquidating distribution
- Calculate his resulting outside basis as well as any gains and losses



Example 10

Beginning Basis:	\$100,000
Distribution:	<u>(\$120,000)</u>
Ending Basis:	\$0

Gain/Loss: \$20,000 Gain



Example 11

- Derek has an outside basis in his partnership interest of \$100,000
- He takes a distribution of capital gain property (Basis: \$70,000/FMV: \$120,000)
- This is a non-liquidating distribution
- Calculate his resulting outside basis as well as any gains and losses



Example 11

Beginning Basis: \$100,000

Distribution: (\$70,000)

Ending Basis: \$30,000

Gain/Loss: No gain or loss

Basis of the Property in Derek's Hands: \$70,000



Example 12

- Derek has an outside basis in his partnership interest of \$100,000
- He takes a distribution of capital gain property (Basis: \$120,000/FMV: \$150,000)
- This is a non-liquidating distribution
- Calculate his resulting outside basis as well as any gains and losses



Example 12

Beginning Basis:	\$100,000
Distribution:	<u>(\$100,000)</u>
Ending Basis:	\$0

Gain/Loss: No gain or loss

Basis of the Property in Derek's Hands: \$100,000



What If I Receive Both Cash and Property?

- IRC 732(a)(2): *The basis to the distributee partner of property to which paragraph (1) is applicable shall not exceed the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction*
- Ordering Rules
 - Cash First
 - Ordinary Assets Second
 - Capital Assets Last
- Remember: Only recognize gain if cash is received in excess of basis!



Example 13

- Derek has an outside basis in his partnership interest of \$100,000
- He takes a distribution of \$50,000 in cash and capital gain property (Basis: \$70,000/FMV: \$100,000)
- This is a non-liquidating distribution
- Calculate his resulting outside basis as well as any gains and losses



Example 13

Beginning Basis:	\$100,000
Cash Distribution:	(\$50,000)
Property Distribution:	<u>(\$50,000)</u>
Ending Basis:	\$0

Gain/Loss: No gain or loss

Basis of the Property in Derek's Hands: \$50,000



Example 14

- Derek has an outside basis in his partnership interest of \$100,000
- He takes a distribution of \$100,000 in cash and capital gain property (Basis: \$70,000/FMV: \$100,000)
- This is a non-liquidating distribution
- Calculate his resulting outside basis as well as any gains and losses



Example 14

Beginning Basis:	\$100,000
Cash Distribution:	(\$100,000)
Property Distribution:	<u>(\$0)</u>
Ending Basis:	\$0

Gain/Loss: No gain or loss
Basis of the Property in Derek's Hands: \$0



Liquidating Distributions

IRC 731(a)—

In the case of a distribution by a partnership to a partner—

- 1) Gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution; and
- 2) Loss shall not be recognized to such partner, except that upon a distribution in liquidation of a partner's interest in a partnership where no property other than that described in subparagraph (A) or (B) is distributed to such partner, loss shall be recognized to the extent of the excess of the adjusted basis of such partner's interest in the partnership over the sum of—
 - A. Any money distributed; and
 - B. The basis to the distributee, as determined under section 732, of any unrealized receivables (as defined in section 751(c)) and inventory (as defined in section 751(d)).

Any gain or loss recognized under this subsection shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner.



Liquidating Distributions

- IRC 732(b) – *The basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction*
- IRC 735(b) – Partnership's holding period tacks onto partner's holding period for distributed property
- IRC 735(a) – Inventory retains its character for five years as ordinary income property. (Accounts Receivable technically always retains its character.)



Example 15

- Derek has an outside basis in his partnership interest of \$100,000
- He takes a \$70,000 cash distribution
- This is a liquidating distribution
- Calculate his resulting outside basis as well as any gains and losses



Example 15

Beginning Basis: \$100,000

Distribution: (\$70,000)

Ending Basis: \$0

Gain/Loss: \$30,000 loss



Example 16

- Derek has an outside basis in his partnership interest of \$100,000
- He takes a \$120,000 cash distribution
- This is a liquidating distribution
- Calculate his resulting outside basis as well as any gains and losses



Example 16

Beginning Basis:	\$100,000
Distribution:	<u>(\$120,000)</u>
Ending Basis:	\$0

Gain/Loss: \$20,000 Gain



Example 17

- Derek has an outside basis in his partnership interest of \$100,000
- He takes a distribution of capital gain property (Basis: \$70,000/FMV: \$120,000)
- This is a liquidating distribution
- Calculate his resulting outside basis as well as any gains and losses



Example 17

Beginning Basis:	\$100,000
Distribution:	<u>(\$100,000)</u>
Ending Basis:	\$0

Gain/Loss: No gain or loss

Basis of the Property in Derek's Hands: \$100,000



Example 18

- Derek has an outside basis in his partnership interest of \$100,000
- He takes a distribution of capital gain property (Basis: \$120,000/FMV: \$150,000)
- This is a liquidating distribution
- Calculate his resulting outside basis as well as any gains and losses



Example 18

Beginning Basis:	\$100,000
Distribution:	<u>(\$100,000)</u>
Ending Basis:	\$0

Gain/Loss: No gain or loss

Basis of the Property in Derek's Hands: \$100,000



Takeaways – Distributions

- Two types of distributions – Liquidating and Non-Liquidating
- Tax rules make it difficult to recognize a gain or loss on a distribution
- If it is a liquidating distribution, basis **MUST BE ZERO** when you are done
- Losses will usually only result from a liquidating distribution

Understanding
Partnership
Taxation:
Types of Basis,
Contributions,
and Distributions

Review Questions



Review Question #1

The biggest difference between a partner's inside basis and their outside basis is that outside basis:

- a) Does not include debt
- b) Includes debt
- c) Is based on Fair Market Value
- d) Is based on Generally Accepted Accounting Principles (GAAP)



Review Question #1

Answer choice B is correct. The key difference between inside basis and outside basis is that outside basis includes debt.



Review Question #2

704(b) basis is also referred to as:

- a) Book Basis
- b) Client Basis
- c) Modified Adjusted Basis
- d) Outside Basis



Review Question #2

Answer choice A is correct. Some practitioners refer to 704(b) basis as book basis. This is not normally what the client gives us from their accounting system though.



Review Question #3

On the contribution of property not encumbered by debt, for tax purposes, a partnership will generally take a basis in the asset equal to:

- a) Its FMV, and recognize no gain
- b) Its FMV, and may recognize a gain
- c) Its tax basis, and recognize no gain
- d) Its tax basis, and recognize a gain



Review Question #3

Answer choice C is correct. For tax purposes, IRC 721, 722, and 723 generally work together. The partnership takes the asset at its carryover tax basis, and no gain or loss is recognized.



Review Question #4

In addition to meeting the other requirements, in order for an allocation to have substantial economic effect, there must be a deficit restoration requirement. If there is no deficit restoration requirement, you can still have substantial economic effect if you have a:

- a) Debt ceiling
- b) Economic Income Agreement
- c) Qualified Income Offset
- d) Coinsurance Clause



Review Question #4

Answer choice C is correct. A qualified income offset essentially makes it so basis cannot go negative or more negative, thus serving a similar purpose to a deficit restoration requirement.



Review Question #5

In example 2, we reallocated Ben's depreciation allocation in accordance with a qualified income offset. If we had not done that:

- a) Ben would have faced a tax penalty
- b) Ben would have had a negative 704(b) capital account and no obligation to restore it
- c) The partnership would lose its status as a partnership for tax purposes
- d) Ben would have had to recognize a gain



Review Question #5

Answer choice B is correct. In other words, it would have just been a meaningless negative number.



Review Question #6

If a special allocation is deemed not to have Substantial Economic Effect:

- a) The special allocation is disallowed
- b) The company may be subject to fines and penalties
- c) A 50/50 allocation is made
- d) The special allocation is allowed



Review Question #6

Answer choice A is correct. If an item does not have substantial economic effect, the special allocation is disallowed, and the item is normally allocated using the partners' respective interests.



Review Question #7

According to IRC 752, the assumption of debt by a partnership is treated by the partner as:

- a) A contribution of money
- b) A distribution of money
- c) A taxable loss
- d) A nondeductible expense



Review Question #7

Answer choice B is correct. This transaction would be like the partnership paying the debt of the partner.



Review Question #8

According to IRC 752, the assumption of partnership debt by a contributing partner is treated by the partner as:

- a) A contribution of money
- b) A distribution of money
- c) A taxable gain
- d) A taxable loss



Review Question #8

Answer choice A is correct. Assuming partnership debt is almost like an “I owe you” to the partnership. Therefore, it is treated as a contribution of money.



Review Question #9

Recourse debt is usually allocated to the general partners based on:

- a) A qualified income offset
- b) A constructive liquidation scenario
- c) Profit sharing percentages of the partners
- d) Tax Basis Equity



Review Question #9

Answer choice B is correct. Recourse debt is allocated based on who is ultimately responsible for paying it. This is determined through a constructive liquidation scenario.



Review Question #10

When services are contributed to a partnership in exchange for a partnership interest:

- a) No gain or loss is recognized
- b) It is treated similarly to a guaranteed payment or compensation under IRC 83
- c) A loss is recognized
- d) The partner may be subject to fines and penalties



Review Question #10

Answer choice B is correct. Services are generally income to the extent of the fair market value of the partnership interest to the partner and deductible to the partnership.



Review Question #11

Beginning with the 2020 tax year, partner basis must be shown as:

- a) 704(b) Basis
- b) Modified Inside Basis
- c) Previously Taxed Income Basis
- d) One of two different basis types available



Review Question #11

Answer choice D is correct. Firms can generally choose between the Modified Outside Basis Method or the Modified Previously Taxed Capital Method.



Review Question #12

Which of the following is correct in regard to partnership distributions?

- a) Partnership distributions do not have to be made pro-rata
- b) Partnership distributions have no effect on basis
- c) Partnership distributions normally result in taxable gains or losses
- d) Basis calculations are usually made immediately after the distribution



Review Question #12

Answer choice A is correct. Unlike S-Corporations, partnership distributions do not have to be made pro-rata. One partner may take a distribution while the others do not.



Review Question #13

When calculating a partner's tax basis, which of the following is generally the correct ordering?

- a) Add Increases, Subtract Non-deductible Expenses, Subtract Deductible Expenses, Subtract distributions
- b) Add Increases, Subtract Distributions, Subtract Non-deductible Expenses, Subtract Deductible Expenses
- c) Add Increases, Subtract Distributions, Subtract Deductible Expenses, Subtract Non-deductible Expenses
- d) Subtract Distributions, Subtract Non-deductible Expenses, Subtract Deductible Expenses, Add Increases



Review Question #13

Answer choice C is correct. Distributions are considered immediately after increases in order to give the highest chance possible for a tax-free distribution (basis is as high as it can be before the distribution).



Review Question #14

A distribution of cash in excess of outside basis in a non-liquidating distribution generally results in:

- a) A taxable gain to the partner
- b) A taxable loss to the partner
- c) Neither gain nor loss to the partner
- d) A tax penalty imposed on the partner



Review Question #14

Answer choice A is correct. Distributions in excess of outside basis result in a taxable gain to the partner. The gain is recognized, and the partner's basis in the partnership is zero.



Review Question #15

Which of the following correctly shows the ordering rules for hybrid distributions?

- a) Capital Assets, Ordinary Income Assets, Cash
- b) Cash, Capital Assets, Ordinary Income Assets
- c) Cash, Ordinary Income Assets, Capital Assets
- d) Ordinary Income Assets, Cash, Capital Assets



Review Question #15

Answer choice C is correct. This ordering stays in-line with the overall spirit of the code, which is to largely not recognize gains or losses on distributions.



Review Question #16

Which of the following will generally result in a taxable loss being recognized by a partner?

- a) Cash received in excess of outside basis in a non-liquidating distribution
- b) Cash received in excess of outside basis in a liquidating distribution
- c) Cash received in an amount less than outside basis in a non-liquidating distribution
- d) Cash received in an amount less than outside basis in a liquidating distribution



Review Question #16

Answer choice D is correct. In a liquidating distribution, if cash received is less than basis, this will result in a taxable loss being recognized. Basis must be zero after a liquidating distribution.



Review Question #17

If a partner with zero basis receives a liquidating distribution of capital property, what is the tax basis of that property in the partner's hands?

- a) Partner's basis is the same as the partnership's basis in the property before the distribution
- b) Partner's basis is zero
- c) Partner's basis is the fair market value of the asset
- d) Partner's basis is the liquidation value of the asset



Review Question #17

Answer choice B is correct. Since the partner's basis immediately before the distribution is zero, the basis in the property must be zero as well. No gain or loss would be recognized.

Thank you!