

Partnership Income Taxation

Fifth Edition

William H. Lyons and James R. Repetti



Foundation Press

PARTNERSHIP INCOME TAXATION

FIFTH EDITION

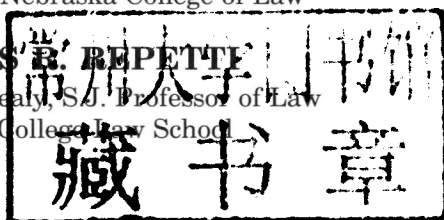
By

WILLIAM H. LYONS

Richard H. Larson Professor of Tax Law
University of Nebraska College of Law

JAMES B. REPETTE

William J. Kenealy, S.J. Professor of Law
Boston College Law School



CONCEPTS AND INSIGHTS SERIES®

FOUNDATION PRESS
2011



THOMSON REUTERS™

This publication was created to provide you with accurate and authoritative information concerning the subject matter covered; however, this publication was not necessarily prepared by persons licensed to practice law in a particular jurisdiction. The publisher is not engaged in rendering legal or other professional advice and this publication is not a substitute for the advice of an attorney. If you require legal or other expert advice, you should seek the services of a competent attorney or other professional.

Nothing contained herein is intended or written to be used for the purposes of 1) avoiding penalties imposed under the federal Internal Revenue Code, or 2) promoting, marketing or recommending to another party any transaction or matter addressed herein.

© 1991, 1995, 1999 FOUNDATION PRESS

© 2005 THOMSON REUTERS/FOUNDATION PRESS

© 2011 By THOMSON REUTERS/FOUNDATION PRESS

1 New York Plaza, 34th Floor
New York, NY 10004
Phone Toll Free 1-877-888-1330
Fax 646-424-5201
foundation-press.com

Printed in the United States of America

ISBN 978-1-59941-382-2

Mat #40638385

*To Karen, Ginger, Kevin, Andy, Rachel, Jeanette
and Bill
W.H.L.*

*To Susan, Jane, Tom, Caroline, Cleo and Memore
J.R.R.*

PREFACE

This book attempts the simplest possible introduction to an intricate body of law. Any “simplified” description of the rules of partnership taxation would be so misleading as to be useless. We have therefore tried to make the subject accessible not by paraphrasing the rules, but by including numerous illustrations that are as straightforward as possible. The text focuses on simple partnerships holding few assets and engaging in routine transactions. It places the rules in context by pointing out the purposes of the statute and regulations and presenting background information about practical matters such as how partnerships maintain capital accounts and how nonrecourse financing works. Using many examples, it then shows the operation of the rules in everyday cases encountered by practitioners.

This is not a reference book: many interesting and difficult issues have been ignored. Some matters, such as the application of § 736 to noncash distributions and tiered partnerships, are not discussed at all, and some problems, like mandatory basis adjustments under § 732(d), receive only passing mention. Most of the points that are dealt with are, however, discussed at considerable length. Our goal has been to give students background material and illustrations so that they can begin to understand and work with a statute that was drafted for (and by) experienced practitioners.

Most chapters end with a section comparing the tax treatment of partners with that of the shareholders of S corporations. Many students encountering partnership taxation for the first time have already studied subchapter S. We expect that an examination of some of the basic differences between subchapters S and K should help those students understand both subjects.

We thank our previous coauthor, Alan Gunn, for all of his contributions to this book. We greatly benefitted from Alan’s invaluable insights about partnership taxation and his good humor. He is a masterful teacher to whom we owe much. We also thank James E. Tierney and Larry D. Ward for helpful comments on previous editions.

Lastly, William Lyons gratefully acknowledges the generous support for a portion of this project provided by the McCollum Fund at the University of Nebraska College of Law and James

PREFACE

Repetti gratefully acknowledges support provided by the Paulus Endowment for Tax.

The cover picture is John Tenniel's drawing of the mad tea party. It seems a perfect match for a subject that has grown so intricate as to have become, in practice, almost a legal fiction.

William H. Lyons
Lincoln, Nebraska

James R. Repetti
Newton, Massachusetts

January 2011

PARTNERSHIP INCOME TAXATION

FIFTH EDITION

TABLE OF CONTENTS

PREFACE	v
Chapter One: Choice of Entity: Taxation of Partnerships, C Corporations and S Corporations	1
A. INTRODUCTION	1
B. THE FLOW-THROUGH FEATURE OF PARTNERSHIPS AND S CORPORATIONS.....	2
Chapter Two: The Pass-Through Principle of Partnership Taxation	6
A. INTRODUCTION	6
B. ILLUSTRATION	7
C. THE TIMING OF PARTNERSHIP INCOME.....	9
D. THE DURATION OF A PARTNERSHIP	10
E. PARTNERS AS SELF-EMPLOYED TAXPAYERS.....	10
F. PARTNERS AND SOCIAL SECURITY AND MEDICARE TAX- ES.....	12
G. THE “ANTI-ABUSE” REGULATIONS	12
H. COMPARISON WITH SUBCHAPTER S	14
Chapter Three: An Introduction to Partnership Basis and Limits on Losses	16
A. THE TAX BASIS OF PARTNERSHIP INTERESTS AND PARTNERSHIP PROPERTY.....	16
B. THE EFFECTS OF PARTNERSHIP DEBT TRANSACTIONS UPON BASIS	18
C. LIMITS ON THE DEDUCTIBILITY OF PARTNERSHIP LOSSES.....	19
1. Section 704(d)	20
2. The At-Risk Rules of Section 465.....	20
3. The Passive-Loss Rules of Section 469.....	22
D. COMPARISON WITH SUBCHAPTER S	23
Chapter Four: Contributions to Partnerships	24
A. CONTRIBUTIONS OF PROPERTY	24
1. The Statutory Pattern	24
2. Holding Periods.....	25
3. Contributions of Encumbered Property.....	26
4. Depreciation Recapture	27
5. Character Issues: Section 724	28

TABLE OF CONTENTS

B. CONTRIBUTIONS OF SERVICES	28
1. Receipt of an Interest in Partnership Capital	29
2. Receipt of an Interest in Partnership Profits	31
C. CONTRIBUTIONS DISTINGUISHED FROM OTHER TRANS- ACTIONS	38
1. Contribution vs. Sale to Partnership	38
2. Contribution vs. Sale or Exchange Between Partners	41
D. COMPARISON WITH SUBCHAPTER S	42
Chapter Five: Allocations of Partnership Income, Deduc- tions, and Credits: An Introduction	44
A. AN OVERVIEW OF THE CODE AND REGULATIONS	44
B. THE “SUBSTANTIAL ECONOMIC EFFECT” TEST	45
1. Introduction	45
2. Capital Accounts	46
3. The “Simple” Capital Account Test for Substantial Econom- ic Effect: Orrisch v. Commissioner	49
4. The “Substantial Economic Effect” Regulations	53
a. Determining “Economic Effect” When Capital Account Deficits Need Not Be Repaid	54
b. The “Substantiality” Rules	56
c. Some Special Problems	60
i. Depreciation	60
ii. Deductions Attributable to Nonrecourse Debt	63
iii. Interaction of Nonrecourse Deductions With the Al- ternate Test for Economic Effect Test	68
iv. Allocating Credits	69
C. COMPARISON WITH SUBCHAPTER S	70
Chapter Six: Allocations Attributable to Contributed Property: Section 704(c)	71
A. ALLOCATIONS OF GAIN OR LOSS	71
B. ALLOCATIONS OF DEPRECIATION	74
1. The Traditional Method	75
2. The Traditional Method With Curative Allocations	77
3. The Remedial Allocation Method	79
C. “REVERSE SECTION 704(c) ALLOCATIONS” UNDER SEC- TION 704(B)	82
D. DISTRIBUTIONS OF SECTION 704(c) PROPERTY	83
E. DISTRIBUTIONS OF PROPERTY TO A PARTNER WHO HAS CONTRIBUTED SECTION 704(c) ASSETS	85
F. COMPARISON WITH SUBCHAPTER S	86
Chapter Seven: Partnership Allocations: Assignment-of- Income Problems	87
A. FAMILY PARTNERSHIPS	87
B. LAST-MINUTE PARTNERS: SECTION 706(d)	90

TABLE OF CONTENTS

C. ASSIGNMENTS OF INCOME NOT DEALT WITH BY SPECIFIC CODE PROVISIONS: THE ANTI-ABUSE REGULATIONS.....	91
D. COMPARISON WITH SUBCHAPTER S	95
Chapter Eight: Allocation of Partnership Debt	96
A. INTRODUCTION	96
B. WHAT IS A PARTNERSHIP LIABILITY UNDER SECTION 752?	96
C. THE DEFINITION OF RECOURSE AND NONRECOURSE DEBT	97
1. Introduction.....	97
2. Economic Risk of Loss and Constructive Liquidation	98
D. ALLOCATION OF RECOURSE LIABILITY	100
1. In General	100
2. Effect of Guarantees and Indemnifications of Recourse Debt	102
3. Contributions of Property Encumbered by Recourse Debt	103
E. ALLOCATION OF NONRECOURSE LIABILITY	104
1. The First Tier of Nonrecourse Debt Allocation.....	104
a. Sufficient Basis for Nonrecourse Deductions	104
b. Refinancing.....	105
2. The Second Tier of Nonrecourse Debt Allocation.....	106
a. No Gain Recognized When Contributing Property Encumbered by Nonrecourse Debt.....	106
3. The Third Tier of Nonrecourse Debt Allocation.....	106
4. Effects of Guarantees of Nonrecourse Debt	108
F. OBLIGATIONS THAT ARE NOT “LIABILITIES” UNDER § 752.....	109
G. COMPARISON WITH SUBCHAPTER S	112
Chapter Nine: Transactions Between Partnerships and Their Partners	113
A. INCOME-RELATED PAYMENTS: DISTRIBUTIVE SHARES AND SECTION 707(a) PAYMENTS	115
B. FIXED PAYMENTS: GUARANTEED PAYMENTS AND SECTION 707(a) PAYMENTS	117
C. DETERMINING WHETHER A “PARTNER CAPACITY” PAYMENT IS A DISTRIBUTIVE SHARE OR A GUARANTEED PAYMENT.....	118
1. Minimum Payments.....	118
2. Payments Measured by a Partnership’s Gross Income.....	121
D. SOME OTHER ASPECTS OF TRANSACTIONS BETWEEN PARTNERS AND PARTNERSHIPS	121
E. COMPARISON WITH SUBCHAPTER S	122

TABLE OF CONTENTS

Chapter Ten: Sales of Partnership Interests	123
A. TAXATION OF THE SELLER.....	123
1. The Seller's Amount Realized.....	123
2. Section 751(a)	124
3. Taxation of Look-through Gains Under Section 1(h)	128
B. THE BUYER'S OUTSIDE AND INSIDE BASES	129
1. The Buyer's Outside Basis	129
2. Inside Basis Adjustments Under Section 743(b)	130
a. Determining the Transferee's Share of Inside Basis	131
b. Allocating Section 743(b) Adjustments to Particular Assets	133
c. Using the Section 743(b) Adjustment	137
d. The Section 754 Election and Adjustments Required Without a 754 Election for Substantial Built-in Loss	138
3. Basis Adjustments Under Section 732(d)	139
C. COLLATERAL EFFECTS OF A SALE OF A PARTNERSHIP INTEREST	140
D. COMPARISON WITH SUBCHAPTER S	141
1. Calculating Gain on the Sale of Stock	141
2. Character of Gain and Inside Basis Adjustments Upon Transfers of Interests	141
3. Termination by Sale.....	143
 Chapter Eleven: Partnership Distributions: An Introduction	144
A. THE GENERAL PRINCIPLE OF NONRECOGNITION.....	145
B. CASES IN WHICH GAIN OR LOSS IS RECOGNIZED	151
1. Gain Recognition	151
2. Liquidating Distributions on Which Loss Is Recognized.....	152
3. "De Minimis" Distributions of Property	154
4. Distributions of Section 704(c) Property.....	155
5. Distributions Taxed Under Section 737.....	155
C. TAX TREATMENT OF THE PARTNERSHIP	156
D. COMPARISON WITH SUBCHAPTER S	157
 Chapter Twelve: Distributions Subject to Section 751(b)	158
A. LIQUIDATING DISTRIBUTIONS OF ASSETS OTHER THAN SECTION 751 ASSETS.....	161
B. LIQUIDATING DISTRIBUTIONS OF SECTION 751 PROPERTY	164
C. SECTION 751(b) AND CURRENT DISTRIBUTIONS.....	167
D. THE SCOPE OF SECTION 751(b): AN EXAMPLE	168
E. COMPARISON WITH SUBCHAPTER S	170
 Chapter Thirteen: Payments to Retiring Partners: Section 736 and Related Problems	171
A. INTRODUCTION	171
1. Interpreting Section 736—In General	172
2. Payments by Service Partnerships to Retiring General Partners	173

TABLE OF CONTENTS

B. HOW SECTION 736 PAYMENTS ARE TAXED	176
C. EXAMPLES	178
D. SOME COMPLICATIONS.....	181
1. The Relationship Between Section 736 and Section 751(b)....	181
2. A Refinement in the Definition of Section 736(a) Payments ..	182
3. Liquidation of an Entire Partnership.....	183
E. SALES AND RETIREMENT PAYMENTS DISTINGUISHED ...	183
F. PROBLEMS OF “FORM” AND “SUBSTANCE”	186
G. COMPARISON WITH SUBCHAPTER S	187
Chapter Fourteen: Basis Adjustments Under Section 734 ...	188
A. ADJUSTMENTS UNDER SECTION 734	189
1. Distributions That Change the Basis of the Distributed Property.....	189
2. Distributions on Which Gain or Loss Is Recognized	190
3. Allocating the Adjustment to Particular Assets	192
4. Adjustments Required Without a Section 754 Election: Sub- stantial Basis Reductions	194
B. SECTION 734 AND THE ANTI-ABUSE REGULATIONS.....	195
C. COMPARISON WITH SUBCHAPTER S	196
Chapter Fifteen: The Death of a Partner.....	198
A. INCOME IN RESPECT OF A DECEASED PARTNER.....	198
1. Introduction.....	198
2. The Basis of an Inherited Partnership Interest	199
B. CLOSING THE PARTNERSHIP’S TAXABLE YEAR UPON THE DEATH OF A PARTNER	203
C. SALE OR LIQUIDATION OF A DECEASED PARTNER’S IN- TEREST	204
D. COMPARISON WITH SUBCHAPTER S	204
Chapter Sixteen: What Is a Partnership?	206
A. CO-OWNERSHIP OF PROPERTY.....	207
B. COST-SHARING AND EMPLOYMENT ARRANGEMENTS ...	208
C. PARTNERSHIP VS. CORPORATION.....	210
D. ELECTION OUT OF SUBCHAPTER K	212
E. PUBLICLY TRADED PARTNERSHIPS.....	213
F. ELECTING LARGE PARTNERSHIPS.....	215
TABLE OF CASES	217
TABLE OF INTERNAL REVENUE CODE SECTIONS	219
TABLE OF TREASURY REGULATIONS AND RULINGS	223
INDEX	225

Chapter One

CHOICE OF ENTITY: TAXATION OF PARTNERSHIPS, C CORPORATIONS AND S CORPORATIONS

A. INTRODUCTION

The central principle underlying the federal income taxation¹ of partners is that the existence of the partnership should matter as little as possible. As an American Law Institute study put it, “the ideal mode for taxing partnership earnings is to tax each partner as though he were directly conducting his proportionate share of the partnership business.”² This mode of taxation is usually referred to as the “aggregate” approach because it treats the partnership as an aggregate of individuals, each conducting her share of the partnership’s business. The ALI emphasized, however, that this principle controls only in the absence of countervailing factors.³ A “countervailing factor” that often makes it undesirable to try to tax partners as if they were conducting their shares of the business as sole proprietors is administrative convenience. Administrative convenience normally suggests that the partnership be treated as an entity separate from the partners, i.e. that the “entity” approach be used.⁴

To illustrate the considerations raised above, think about a laundry business conducted by Alice and Bill as equal partners. Each of them contributed equal amounts of cash, each does identical work, and each takes the same amount of money out of the business. In this very simple case, it is easy to apply the aggregate approach and tax Alice and Bill as if each were conducting half of the business: Each of them can include in income half of the income of the laundry.

Treating the partnership as an “aggregate,” as in the example above, is not always practical; sometimes an “entity” approach must be used. Suppose that the laundry building burns down, and that Alice wants to reinvest the insurance proceeds in a new building, electing nonrecognition of gain under § 1033. Bill (who has a large, deductible

1. This discussion focuses on federal income taxation of partnerships and partners. State taxation of partnerships and partners may differ from the federal income tax rules.

2. American Law Institute, Federal Income Tax Project, Subchapter K, 5 (1984).

3. Id. (emphasis omitted).

4. Indeed, concerns about administrative convenience prompted the drafters of the Revised Uniform Partnership Act (1997) to recommend that states use the entity approach in formulating laws that govern the conduct of partnerships so that partnerships can own property as an entity, contract as an entity and be sued as an entity.

loss from another activity) would prefer that the gain be recognized. Can both partners get the tax treatment they want? No: Section 703(b) adopts the entity approach and allows nonrecognition only if the partnership itself makes the election and replaces the building. Section 703(b), with three exceptions, provides that elections affecting the computation of partnership income must be made by the partnership, and § 1033(a)(2)(A) allows nonrecognition only if “the taxpayer” which realized the gain (in this case, the partnership) purchases qualifying replacement property.

As a rule, the amount and character of a partnership’s income are calculated using an “entity” approach. The income, however, is taxed to the partners, not to the entity, using the “aggregate” approach. For example, if a partnership realizes gain of \$10,000 from the sale of an asset, the entity approach causes the character of that gain to be determined at the partnership level. The gain will be capital gain if the partnership does not hold the property for sale to customers in the ordinary course of business and the other exceptions for capital asset treatment in § 1221 are inapplicable. The aggregate approach will then cause that gain to be taxable to the partners regardless of whether the gain is actually distributed to them.

B. THE FLOW-THROUGH FEATURE OF PARTNERSHIPS AND S CORPORATIONS

Application of the aggregate method to partnership income is one of the most attractive features of partnerships because it results in a single tax being applied to partnership income. When a partnership recognizes taxable income, such income is taxed directly to the partners. The partnership, itself, does not pay a tax on its income.⁵ In addition, the subsequent distribution of that income to the partners does not usually trigger an additional tax liability because the aggregate method treats each partner as though she had directly conducted her share of the rental business and had already received her share of the income.

This single-tax approach stands in stark contrast to the double taxation of income of a corporation subject to the tax regime contained in Subchapter C of the Internal Revenue Code.⁶ (Corporations subject to the double-tax regime of Subchapter C are often referred to as “C corporations.”) Income realized by a C corporation is taxable to the corporation because the corporation is treated for all purposes as an entity separate from its stockholders. When the corporation distributes

5. Although a partnership will not pay federal income tax on its income, a partnership that has employees will be subject to various federal and state employment taxes.

6. Subchapter C consists of §§ 301 through 385.

that income to its stockholders, the stockholders also recognize taxable income.

Example 1-1: Andrew and Rachel are considering whether they should organize a real estate investment business as either a limited liability company (LLC), which is taxable as a partnership, or as a corporation, which is subject to the double-tax regime of Subchapter C. They anticipate that their real estate investments in land will generate rental income of approximately \$500,000 per year. Andrew and Rachel have significant income from other sources and are subject to tax at the maximum marginal rates. They have asked their attorney which entity they should use.

Their attorney has advised them of the following tax consequences. If they place their land into an LLC, the \$500,000 rental income will be recognized by Andrew and Rachel and they will pay a federal tax of \$175,000 (35% of \$500,000). No further tax liability will be incurred when the LLC distributes the rental income to Andrew and Rachel since the aggregate principle treats them as having directly conducted the rental business. In contrast, if they place their land into a C corporation, the income will be taxable to the corporation and will be taxed again when distributed to them. This will result in a total tax of \$223,750, since a tax of \$175,000 is incurred at the corporate level (35% of \$500,000) and an additional tax of \$48,750 is incurred when the income remaining after payment of the corporate tax is distributed to Andrew and Rachel (15%⁷ of \$325,000).

Clearly, application of the aggregate method causes an entity taxable as a partnership to be an attractive alternative for conducting a profitable business. In addition, the aggregate method often causes a partnership to be the preferred choice where the business will hold assets that are likely to appreciate in value. The aggregate method means that when a partnership distributes appreciated assets to its partners, neither the partnership nor the partners recognize taxable income. The logic is that since the aggregate method treats each partner as though he holds his share of partnership assets, nothing changes as the result of an actual distribution of those assets. In contrast, when a C corporation distributes appreciated assets to its stockholders, both the distributing corporation and its stockholders recognize taxable income since the corporation is treated as an entity separate from its stockholders. The distribution of an appreciated asset is a realization event for the corporation, triggering

7. Section 1(h)(11) provides that “qualified dividend income” received by an individual will be taxed at a rate of not more than 15 percent.

the corporation's recognition of income. Similarly, receipt of the property also results in income recognition by the stockholders.

Example 1-2: The land that Andrew and Rachel's entity purchased in Example 1-1 for \$500,000 has appreciated in value to \$1,500,000. If Andrew and Rachel formed the real estate entity as an LLC, the LLC may distribute the land to Andrew and Rachel and neither Andrew and Rachel nor the LLC will recognize taxable income. In contrast, if Andrew and Rachel formed the entity as a C corporation, the corporation will recognize the \$1,000,000 difference between the land's tax basis and its fair market value as gain, and the stockholders will also recognize income upon their receipt of the land.

This favorable treatment of the distribution of appreciated assets from a partnership usually leads tax advisors to recommend that assets likely to appreciate in value not be placed into a C corporation. For example, a person considering purchasing a farm or marina should consider placing the farm's or marina's real property into a limited liability company that would be taxed as partnership, not a corporation.

If all the stockholders of a corporation elect to have the corporation subject to the provisions of Subchapter S of the Internal Revenue Code,⁸ instead of Subchapter C, a different approach applies. A corporation subject to taxation under Subchapter S, (an "S corporation") has some, but not all of the advantages of an entity taxable as a partnership. Like a partnership, income of an S corporation is taxable to its owners, i.e. to its stockholders, not to the corporation. However, unlike a partnership, taxable income is recognized when an S corporation distributes property that has appreciated in value. Thus, the S corporation provides less flexibility than a partnership.

Example 1-3: The facts are the same as in Examples 1-1 and Example 1-2 except that Andrew and Rachel are conducting their real estate investment business in the form of an S corporation. The \$500,000 rental income collected by their S corporation is not taxable to the S corporation. Instead, Andrew and Rachel are each taxed on their share of the corporation's income.

If the S corporation distributes the land that has appreciated in value to \$1,500,000, it recognizes \$1,000,000 of gain (the difference between the \$1,500,000 value and \$500,000 tax basis). This gain flows out to and is recognized by the S corporation stockholders on their individual tax returns. The stockholders normally do not also recognize additional taxable income as a result of receiving the distribution. Thus, only one level of tax

8. Subchapter S consists of §§ 1361 through 1379.

is usually assessed as a result of an S corporation's distribution of appreciated property. This means that the S corporation is preferable to C corporation, which is subject to a double tax, but not to a partnership, which would generate no tax.

Similar to income, expenses of a partnership and an S corporation also flow out to partners and stockholders. The ability of partners and S corporation stockholders to obtain immediate tax benefits from such expenses, however, may be significantly affected by limitations discussed in Section C of Chapter 3.