

# Partnership Traps for the Unwary: What Happens When You Inadvertently Enter Into A Partnership?

by Carolyn R. Turnbull, CPA, MST  
Director of Tax, Associate Member  
Moore Stephens Tiller LLC  
[cturnbull@mstiller.com](mailto:cturnbull@mstiller.com)  
December 16, 2008



# What is a Partnership?

- Background
- A partnership includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of [Title 26 of the U.S. Code], a trust or estate or a corporation. [IRC §§761(a) and 7701(a)(2)]
  - Classification for federal tax purposes does not depend on whether the organization is recognized as an entity under local law.
  - A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation or venture and divide the profits there from.
  - Business entities are generally classified as either corporations or partnerships for federal tax purposes.
- A partner includes a member in such syndicate, group, pool, joint venture, or organization. [IRC §§761(b) and 7701(a)(2)]
  - Different types of partnership interests exist.
  - Family partnership rules under IRC §704(e)
- Check-the-box regulations

# Relationships That Are Not Partnerships

- Employment or independent contractor relationships
  - Intent to form a partnership can be a key factor.
- Purchaser-seller relationships
  - Look at whether the benefits and burdens of ownership have shifted from the seller to the buyer.
- Lender-borrower relationships
  - Factors to consider are whether there is a written debt instrument, how the relationship is characterized by the parties, and whether principal repayment is dependent upon the profitability of the debtor.
- Lessor-lessee relationships
  - Rev. Rul. 92-49
  - IRC §7701(e)(2) may recharacterize a partnership as a lease.
    - §7701 was enacted primarily to prevent avoidance of the tax-exempt leasing rules under §168.

# Relationships That Are Not Partnerships

- Co-ownership of property
  - Reg. §301.7701-1(a) – arrangements that do not create partnerships
    - A joint undertaking merely to share expenses
    - Mere co-ownership of property that is maintained, kept in repair, and rented or leased
      - Partnership is created, however, if co-owners of an apartment building lease space and, in addition, provide services to the occupants either directly or indirectly through an agent.
        - Rev. Rul. 74-374 held that the furnishing of customary services, such as heat, air conditioning, hot and cold water, unattended parking, normal repairs, trash removal, and cleaning of public areas furnished at no additional charge above the basic rent did not create a partnership.
      - Rev. Proc. 2002-22 specifies the conditions under which the IRS will consider a request for a ruling that an undivided fractional interest in rental real property (other than a mineral property under §614) is not an interest in a business entity.
- Qualified joint ventures between a husband and wife under §761(f)

## Election Out of Subchapter K

- IRC §761(a) provides that all members of an unincorporated organization may elect, as provided under regulations, to exclude the organization from the application of Subchapter K, provided the income of the members of the organization may be adequately determined without the computation of partnership taxable income and the organization is availed of –
  - For investment purposes only and not for the conduct of a trade or business;
  - For the joint production, extraction or use of property, but not for the purpose of selling services or property produced or extracted, or
  - By dealers in securities for a short period for the purpose of underwriting, selling or distributing a particular issue of securities.

# Election Out of Subchapter K

- Two methods of electing out of Subchapter K
  - Affirmative method – made by attaching a statement to a timely filed partnership return that all members are electing to be excluded from Subchapter K
    - The election will not be effective if within 90 days of the formation of the organization, any member
      - 1) notifies the Service that he desires Subchapter K to apply to the organization, and
      - 2) Also advises the Service that he has notified all other members of the organization by registered or certified mail.
  - Deemed election – made by demonstrating that the members intended at the time of the organization's formation to secure exclusion from all of Subchapter K beginning with the first year of the organization.
- Organization may also request partial exclusion from Subchapter K.
  - The Service will not consent to an election out certain provisions of Subchapter K, such as the basis limitations under §704(d) or the requirement to adopt the taxable year of all of the principal partners.
- Election is irrevocable unless the organization ceases to qualify for the election or the organization obtains the Service's consent to terminate the election.

# Consequences of Being Classified as a Partnership

- Partnership must adopt the taxable year of its principal partners.
- Most elections are made at the partnership level.
  - Examples
    - Accounting method(s)
    - §179
    - Cost recovery methods and lives under §168
    - Election to adjust the basis of partnership property under §§734(b) and 743(b) (i.e., the “§754 election”)
  - Exceptions
    - Elections related to discharge of indebtedness income under §§108(b)(5) and 108(c)(3).
    - Election relating to deduction and recapture of certain mining exploration expenses under §617.
    - Election to claim the foreign tax credit under §901.
- The extraordinarily complex rules under Subchapter K will apply to the taxation of the partnership and its members.

# Formation of the Partnership

- Start-up and organizational costs
- Contribution of property (§721)
  - Special treatment for investment partnerships
  - Partnership basis and holding period in contributed property
  - Partner's initial basis in partnership interest
- Contribution of services
  - Special treatment of contribution of services in exchange for a profits-only interest
- Treatment of built-in gain or loss under §704(c)
- Disguised sale rules under §§707(a)(2)(B), 704(c)(1)(B), and 737



# Operation of the Partnership

- Partnership allocations
  - Ability to make special allocations to partners
  - Allocations must have substantial economic effect
    - Capital account maintenance requirements
    - General prohibition against partner deficit capital accounts
    - Alternate tests for economic effect
  - Treatment of built-in gain or loss under §704(c)
    - Traditional method
    - Traditional method with curative allocations
    - Remedial allocation method
    - Other reasonable method

# Operation of the Partnership

- Partner's basis in partnership interest
  - Initial basis
  - Adjustments to basis
- Allocation of liabilities
  - Recourse debt
  - Nonrecourse debt
- Maintenance of partners' capital accounts
  - Initial basis
  - Annual adjustments
  - Revaluations

# Operation of the Partnership

- Limitations on ability of partners to deduct current losses
  - Basis limitations
  - At-risk limitations
  - Passive loss limitations

## Example – Basis and At Risk Limitations

Susan is a 10% owner in ABC LLC, which has elected to be treated as a partnership for federal income tax purposes. Her tax basis in the LLC is \$25,000, consisting of a \$10,000 capital contribution and \$15,000 of nonqualified nonrecourse debt. For 2008, Susan's distributive share of the LLC's loss is (\$32,000).

## Example – Basis and At Risk Limitations – cont.

<u>2008</u>	Basis Limitation	At Risk Limitation
Capital Contribution	10,000	10,000
Nonqualified Nonrecourse Debt	15,000	- 0 -
Loss Allowed for 2008	<u>(25,000)</u>	<u>(10,000)</u>
Balance – 12/31/08	<u>- 0 -</u>	<u>- 0 -</u>
Carryover to 2009	(7,000)	(15,000)

## Example – Basis and At Risk Limitations – cont.

ABC, LLC has positive income for 2009. Susan's distributive share is \$10,000.

<u>2009</u>	<b>Basis Limitation</b>	<b>At Risk Limitation</b>
LLC income for 2009	10,000	
Loss carryover from 2008	(7,000)	
Net income reported for 2009	3,000	3,000
Loss carryover from 2008	<u>- 0 -</u>	<u>(3,000)</u>
Balance -12/31/09	<u>3,000</u>	<u>- 0 -</u>
Carryover to 2010	- 0 -	(12,000)

## Example – Basis and At Risk Limitations – cont.

Susan sells her interest in ABC, LLC in 2010 for \$8,000 cash, plus assumption of her \$15,000 share of the LLC's nonqualified nonrecourse debt.

Susan will recognize a \$20,000 gain. This \$20,000 gain will trigger release of the (\$12,000) §465 carryforward from 2008.

# Operation of the Partnership

- Distributions
  - Comparison to guaranteed payments
  - Liquidating versus nonliquidating distributions
  - Treatment of “hot assets” under §751
  - Distributions of marketable securities
- Self-employment tax issues



# Termination of the Partnership and Partner Retirement Distributions

- Partnership terminations under §708
  - Termination under §708(b)(1)(A)
  - Termination under §708(b)(1)(B)
- Retirement distributions
  - Treatment of payments under §736(a) versus §736(b)
  - Self-employment tax implications

# Sale of an Interest in a Partnership

- Computation of partner's gain or loss
- Character of gain or loss

## Example – Sale of Partnership Interest with Appreciated Inventory

Acme LLC, which is classified as a partnership for federal income tax purposes, owns the following assets as of September 30, 2008:

On October 1, 2008, A sells her one-third interest to D for \$130,000. Her tax basis is \$70,000. Therefore she recognizes a \$60,000 gain on the sale. \$17,000 of the gain is ordinary income; the remaining \$43,000 is capital gain.

	Basis	FMV
Cash	15,000	15,000
Inventory	39,000	90,000
Capital Asset 1	56,000	125,000
Capital Asset 2	<u>100,000</u>	<u>160,000</u>
	210,000	390,000
Capital, A	70,000	130,000
Capital, B	70,000	130,000
Capital, C	<u>70,000</u>	<u>130,000</u>
	210,000	390,000

# Example – Sale of Partnership Interest Where Partner Recognizes Ordinary Income and a Capital Loss

BlueCo LLC, owns the following assets as of September 30, 2008:

On October 1, 2008, D sells her one-third interest to G for \$95,000. Her tax basis is \$80,000. Under §751(a), D must recognize her \$35,000 share of the built-in gain on the inventory and the §1245 property. Therefore she recognizes \$35,000 of ordinary income and a \$20,000 capital loss.

	<b>Basis</b>	<b>FMV</b>
Cash	15,000	15,000
Inventory	- 0 -	45,000
Equipment (original cost \$150,000)	45,000	105,000
Capital Asset 2	<u>180,000</u>	<u>120,000</u>
	240,000	285,000
Capital, D	80,000	95,000
Capital , E	80,000	95,000
Capital, F	<u>80,000</u>	<u>95,000</u>
	240,000	285,000

## Elections to Adjust the Basis of Partnership Property

- Adjustment for partnership distributions under §734(b)
- Adjustment for transfers of a partnership interest under §743(b)
- Mandatory basis adjustment required for substantial built-in loss under §743(d)

## Circular 230 Disclosure

These materials are intended for educational purposes only. To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or any other state or local law, or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.