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Mechanics Toolbox Series – Fundamentals of Partnership Tax Operations

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Learning objectives

1. Describe situations in which contributions to and distributions from a partnership may be taxable
2. Discuss complexities with basis tracking and depreciation computations as a result of certain partnership transactions
3. Identify the tax impact liability allocations can have on partners

Agenda

1. Taxable Partnership Contributions & Distributions
2. Basis Tracking & Depreciation Complexities
3. Liability Allocations

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Taxable Partnership Contributions & Distributions

Taxable Partnership Contributions & Distributions

Disguised sale of property

- Contributions & distributions of property are generally treated as tax-free exchanges under section 721(a) & section 731(a)
- Disguised sale of property is a common exception to the non-recognition treatment under the general rule
- What is or what could be a disguised sale?
    - Transfer of property to a partnership and a corresponding transfer by a partnership to a partner
    - In some situations, a contribution of property and a related distribution to the same partner could be treated as a sale between the partnership and the partner
- Transfers that are a disguised sale are treated as a sale for all purposes of the Code, and are not treated as a contribution and distribution

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Taxable Partnership Contributions & Distributions

Disguised sale of property

- Treas. Reg. Sec. 1.707-3(b)(1) – Facts and circumstances based two-part test
  - Part 1: one transfer would not have been made but for the other, and
  - Part 2: non-simultaneous transfers are not dependent upon the entrepreneurial risks of partnership operations
- Look at the facts and circumstances surrounding each transfer
- Key point – is the partner acting in a capacity other than as a member of the partnership?

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Taxable Partnership Contributions & Distributions

Presumption of disguised sale

- 2-year rebuttable presumption (Treas. Reg. Sec. 1.707-3(c) & (d)):
    - Transfers made within 2 years of each other: presumed part of a sale
    - Transfers made more than two years apart: presumed not to be part of a sale
- Presumption can be rebutted only if the relevant facts and circumstances clearly establish the contrary

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Taxable Partnership Contributions & Distributions

Disguised sale of partnership interest

- Proposed regulations on disguised sales of partnership interests were published in 2004; then withdrawn in 2009
- Look to statutory language, guidance provided in legislative history, and case law
- Contributions to and distributions from a partnership would be examined to determine whether they should be treated as related, thus re-characterized as a disguised sale in whole or in part of a partnership interest
- K-1 reporting may look different than expected
  - Cash paid will not show as a contribution
  - Section 743(b) adjustment available if partnership has made a section 754 election

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Taxable Partnership Contributions & Distributions

Disguised sale of partnership interest example

- Private Equity Company ("PE") is a partner in Partnership ABC, LLC
- During 2018 PE enters into a redemption agreement with Partnership ABC, LLC whereby Partnership ABC will redeem 15,095.4902 of PE's Class A units
- Per the redemption agreement, the company will deliver an amount of cash equal to $1,590,549.02 to PEG
- Also per the redemption agreement, the Class A units will automatically be cancelled upon the redemption
- Facts continued on next slide

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Taxable Partnership Contributions & Distributions

Disguised sale of partnership interest example continued

- Separate from the Redemption agreement, Partnership ABC, LLC provided subscription agreements for new and existing partners for 15,095.4902 Class A units.
- Some of the subscription agreements are dated March 18 and others are Dated March 22.
- The subscription agreements specify Partnership ABC, LLC is offering the subscriber to subscribe and purchase Class A units of Partnership ABC, LLC.
- The subscription amount of the units equals $100 per unit, so total subscription amount for all units equals $1,509,549.02.
- The subscription agreements specify that the Partnership ABC, LLC shall use the subscription amount for working capital, capital expenditures, repurchases of equity from certain members (including PE) and other corporate purposes.
- The audited financial statements and GAAP equity rollforward do not show a distribution to PE or contributions from the subscribers.

Taxable Partnership Contributions & Distributions

Disguised sale of partnership interest example continued

Questions:

- Should the redemption and subscription be treated as separate events, or should this be treated as a disguised sale of partnership interest?
- What factors should be considered in making this determination?

Taxable Partnership Contributions & Distributions

Disguised sale of partnership interest example continued

- Selected factors to consider when determining whether a transaction may be treated as a disguised sale (this is not an all inclusive list):
  - Is there language in any legal document associated with the transaction that specify how the transaction can, or should, be treated?
  - Do the legal documents associated with the transaction provide guidance on how subscription amounts can, or should, be used?
  - Are the dates listed in the respective redemption & subscription agreements the same or similar? Even though the redemption and subscription may not all happen on the same day, that may not necessarily preclude the ability to be a purchase across the top if the dates are close in proximity.

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Taxable Partnership Contributions & Distributions

Disguised sale of partnership interest example continued

- Selected factors to consider when determining whether a transaction may be treated as a disguised sale (this is not an all inclusive list) continued:
  - Are the redemption and subscription amounts shown as distributions and contributions on the audited financial statements or GAAP equity rollforward?
  - If the partnership has a section 754 election in effect, are the partners who subscribe to the partnership expecting a section 743(b) step-up?

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Taxable Partnership Contributions & Distributions

Disguised sale of partnership interest example continued

- Selected factors to consider when determining whether a transaction may be treated as a disguised sale (this is not an all inclusive list) continued:
  - Were the funds merely funneled into the partnership and immediately sent back out to effectuate the redemption?
  - Is the redemption reliant upon the contribution amounts? Would the company redeem the partner without having the new contributions come in?

If it looks like a purchase and sale, it probably is.

Taxable Partnership Contributions & Distributions

Mixing bowl rules

- Section 704(c)(1)(B) general rule
  - Distribution of previously contributed property to a noncontributing partner within 7 years of contribution triggers built-in gain or loss to the contributing partner
    - Treated as a sale of the contributed property by partnership to the distributee partner on the date of distribution
    - Applies only to any remaining section 704(c) built-in gain or loss on the property at the time of distribution
    - Character of gain or loss determined at the partnership level
  - Only affects contributing partner

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Taxable Partnership Contributions & Distributions

Mixing bowl rules

- Section 737(a) general rule
  - In the case of any distribution (other than money) by a partnership to a partner, such partner shall be treated as recognizing gain in an amount equal to the lesser of
    - Excess distribution (other than money), OR
    - The net precontribution gain of the partner

Excess Distribution:

FMV Received

<u>- Basis in Partnership Interest</u>

Excess Distribution

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Taxable Partnership Contributions & Distributions

Other taxable partnership contributions & distributions

- Contributions of services in exchange for a capital interest in the partnership
  - Income to the partner who contributed services
- Distributions in excess of outside basis
  - Liability allocations increase outside basis
  - Decrease in share of partnership liabilities can create an inadvertent taxable distribution
- Section 751(b)
  - Alteration of interests in “hot assets”
  - Potential gain at the partnership & partner level

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Basis Tracking & Depreciation Complexities

Basis Tracking & Depreciation Complexities

Revenue Ruling 99-5

- Revenue Ruling 99-5 – Guidance when a DRE becomes a partnership
- Situation 1 & Situation 2
- In both situations:
    - Single Member LLC is treated as a DRE
    - All assets are capital assets & the LLC has no liabilities

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Basis Tracking & Depreciation Complexities

Revenue Ruling 99-5 Situation 1

- B purchases 50% of A's ownership interest in the LLC for $5,000
- A does not contribute any portion of the $5,000 to the LLC
- A & B continue to operate the business of the LLC as co-owners of the LLC

Basis Tracking & Depreciation Complexities

Revenue Ruling 99-5 Situation 1

- LLC is converted to a partnership when B purchases an interest in the DRE from A
- B's purchase of 50% of A's ownership interest in LLC is treated as the purchase of a 50% interest in each of the LLC's assets
- Immediately thereafter, A and B are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership
- **<u>Bifurcated basis of assets</u>**
- Potential Forward section 704(c) for A
    - Bonus depreciation considerations for B under final regulations

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Basis Tracking & Depreciation Complexities

Revenue Ruling 99-5 Situation 2

- B contributes $10,000 to the LLC in exchange for a 50% ownership interest in the LLC
- The LLC uses all of the contributed cash in its business
- A & B continue to operate the business of the LLC as co-owners of the LLC

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Basis Tracking & Depreciation Complexities

Revenue Ruling 99-5 Situation 2

- LLC converted from a DRE to a partnership when B contributes cash to the LLC.
- B's contribution is treated as a contribution to a partnership in exchange for an ownership interest in the partnership.
- A is treated as contributing all of the assets of the LLC to the partnership in exchange for a partnership interest.
- Potential Forward 704(c) for A

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Basis Tracking & Depreciation Complexities

Termination of a partnership

- The general rule under section 708(a) provides that a partnership continues to exist for the purposes of Subchapter K unless it is terminated.
- Section 708(b)(1) provides that a partnership shall be considered as terminated only if:
  - No part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership
  - For partnership taxable years beginning after 12/31/2017 – TCJA removed technical terminations under section 708(b)

Basis Tracking & Depreciation Complexities

Revenue Ruling 99-6

- The termination occurs either through
  - An existing partner purchasing all of the interests owned by the other partners
  - or through an outside investor purchasing all of the interests in the partnership.
- Rev. Rul. 99-6 transactions result in a termination of the partnership.
- Situation 1 – Sale from A to B
- Situation 2 – Sale from C & D to E

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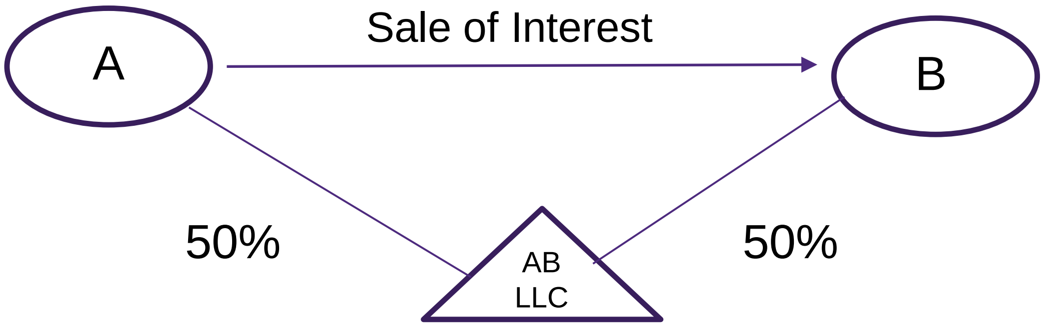
Basis Tracking & Depreciation Complexities

Revenue Ruling 99-6 Situation 1 – Sale from A to B



- A sells all of its interest in AB to B
- Afterward, the business is continued on by the LLC
- The partnership terminates under section 708(b)(1)(A)

Basis Tracking & Depreciation Complexities

Revenue Ruling 99-6 Situation 1 – Sale from A to B

- LLC terminates under former section 708(b)(1)(A).
- A treats the transaction as the sale of a partnership interest under section 741.
- For purposes of determining the tax treatment of B, LLC is treated as making a liquidating distribution of all of its assets to A and B, and following this distribution, B is treated as acquiring the assets deemed to have been distributed to A in liquidation of A's interest in LLC.
- With respect to assets deemed acquired from A:
  - B's basis in the assets is cost of acquisition under section 1012(a)
  - B takes a new holding period
- With respect to assets deemed distributed to B:
  - B must recognize gain or loss, if any, on the deemed distribution under section 731(a)
  - B's basis in the assets is determined under section 732(b)
  - B's holding period for the assets includes LLC's holding period under section 735(b)

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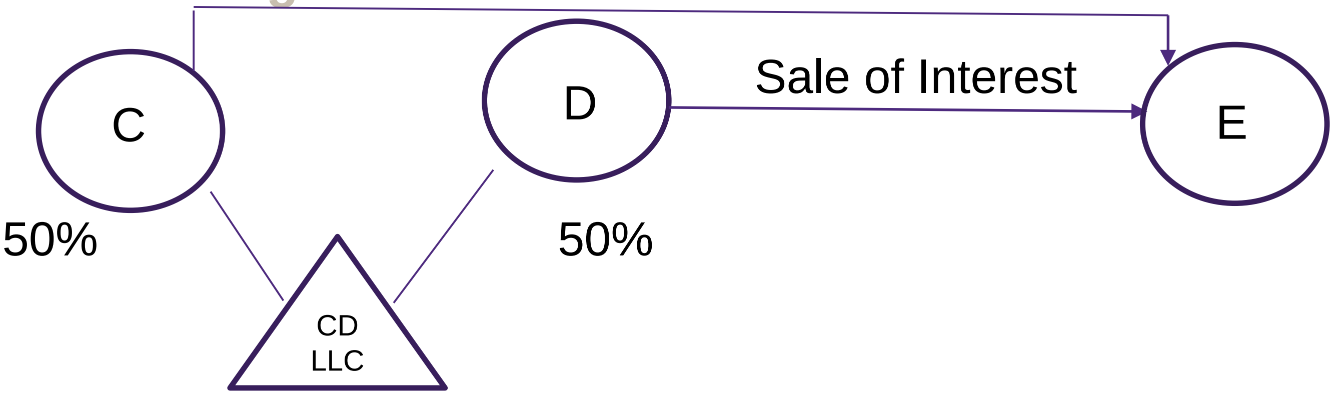
Basis Tracking & Depreciation Complexities

Revenue Ruling 99-6 Situation 2 – Sale from C and D to E



- C and D sell all their interests to E
- Afterward, the business is continued on by the LLC
- The partnership terminates under former section 708(b)(1)(A)

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Basis Tracking & Depreciation Complexities

Revenue Ruling 99-6 Situation 2 – Sale from C and D to E

- C and D are treated as selling their LLC interests and must report gain or loss under section 741
- For purposes of classifying the acquisition by E, CD partnership is deemed to make a liquidating distribution of its assets to C and D, and E is deemed to purchase those assets from C and D
- E is treated as purchasing all of the former partnership's assets from C & D, obtaining a new holding period for all assets beginning on the day immediately following the date of the sale.
- E's basis in the assets equals the amount of E's purchase price pursuant to section 1012
- E must complete Form 8594 if purchased assets constitute a trade or business

Basis Tracking & Depreciation Complexities

Section 734(b)

- Section 734(b) adjustments are triggered by distributions, in which:
  - Gain or loss is recognized by the distributee partner under section 731(a)(1) or (2),
  - Distributed property takes a substituted basis in the hands of the distributee under section 732(a) or (b) but basis in distributee's hands differs from the basis in the partnership's hands, or
  - There is a substantial basis reduction: section 731(a)(2) loss exceeds $250,000 or distributee's basis of distributed property exceeds partnership's basis of such property by more than $250,000
- Section 734(b) adjusts basis of remaining partnership property for all remaining partners ("common" basis adjustment)
  - Including distributee partner in a non-liquidating distribution

Basis Tracking & Depreciation Complexities

Section 734(b)

- In the event there is an allocation of section 734(b) adjustment to property, to which section 168 applies, cost recovery is to be adjusted as follows:
  - Increases (Treas. Reg. Sec. 1.734-1(e)(1)):
    - Treated as newly purchased recovery property placed in service when the distribution occurs
    - Any applicable recovery period and method may be used with respect to the increased portion, but no change is made to the legacy basis
  - Decreases (Treas. Reg. Sec. 1.734-1(e)(2)):
    - Accounted for over the remaining recovery period of the property beginning with the recovery period for which the basis is decreased
    - Taken in proportion to remaining basis recovery
- Section 734(b) basis adjustments are not eligible for the additional first year depreciation deduction

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Basis Tracking & Depreciation Complexities

Section 743(b)

- **Section 743(b)** – the basis of partnership assets is adjusted to equal the initial basis of a partnership interest acquired by sale or exchange or upon the death of a partner
  - Adjustments apply solely to the transferee-partner

- **Goal of section 743(b) is to make the transferee have an inside basis in the partnership assets equal to the amount he would have had if he had purchased an undivided interest in the partnership assets**

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Basis Tracking & Depreciation Complexities

Section 743(b)

- General rule: for purposes of section 168, the increased portion of the basis is taken into account as if it were newly-purchased depreciable property placed in service when the transfer occurs. Treas. Reg. Sec. 1.743-1(j)(4)(i)(B)(1)
  - Any applicable recovery period and method may be used to determine the depreciation allowance with respect to the increased portion of the basis
  - Does not affect holding period in the assets

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Basis Tracking & Depreciation Complexities

Section 743(b)

- TCJA - Bonus depreciation is generally allowed on section 743(b) adjustments
  - Including the portion that is attributable to section 704(c) built-in gain (BIG) using the Remedial method (change from proposed regulations)
- A separate election out of bonus depreciation is needed for section 743(b) basis adjustments
- If Remedial section 704(c) method is used & bonus depreciation is NOT taken
  - Section 743(b) basis increase attributable to BIG is recovered over the remaining recovery period for the partnership's excess section 704(b) book basis

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Liability Allocations

Liability Allocations

Recourse vs. Non-Recourse Liabilities

- Liabilities are allocated under section 752 based on whether they are "recourse" versus "nonrecourse"
  - Recourse liability: a partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss
  - Nonrecourse liability: a partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss

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Liability Allocations

Recourse Liabilities

- Economic risk of loss –
  - If a partnership is liquidated, the partner or related person would be obligated to pay the debt (or make a contribution to the partnership) if the partnership could not pay and the partner or related person is not entitled to reimbursement by another partner or related person
  - Based on the partnership agreement and other legal obligations
- Constructive liquidation test (events must occur simultaneously) –
  - Partnership liabilities become payable in full
  - All partnership assets, including cash, have a value of zero
  - Partnership disposes of all property for no consideration
  - All items of income, gain, loss, or deduction are allocated among the partners
  - The partnership liquidates

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Liability Allocations

Recourse Liabilities

- Items to look for in debt agreements and questions to ask
  - Is any partner (or related party) the lender?
  - Has the loan been made through a DRE or subsidiary of a partner?
  - Has any partner (or related party) guaranteed the debt?
  - Is a partner who guaranteed a loan entitled to be reimbursed for any amounts paid on the guarantee?
  - Have the terms of the debt been modified during the year?

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Liability Allocations

Non-Recourse Liabilities

- Non-Recourse liability to extent that no partner bears the economic risk of loss with respect to liability
- Allocated among partners in accordance with respective shares of partnership profits
  - Allow partners to claim nonrecourse deductions (“NRDs”)
  - Prevent gain recognition at formation
- 3 tier allocation – Nonrecourse debt is the sum of three items
  - First tier – share of partnership minimum gain
  - Second tier – section 704(c) minimum gain
  - Third tier – excess liabilities not allocated under first two tiers
    - Tier 3 Kicker

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Liability Allocations

Why do liability allocations matter?

- Recourse & Nonrecourse liabilities increase a partner's outside basis
  - Increased ability to deduct loss at partner level
  - Reduced likelihood of distributions in excess of basis if liabilities included in outside basis
- Important to track Outside Basis
  - Partner responsibility, not partnership
- Some flexibility in liability allocations if certain partners are close to having negative outside basis
  - Discussion point with service provider

Liability Allocations

Why do liability allocations matter?

- Recourse liabilities (and qualified nonrecourse liabilities) increase a partner's amount at risk in the partnership for purposes of section 465
  - Impacts ability to take losses at the partner level
- Increased scrutiny on liability allocations as a result of BBA
  - $1 misallocation of liabilities or misclassification between recourse and nonrecourse is treated similar to $1 of misallocation of income
- Increased scrutiny on negative tax basis capital accounts
  - Are there liabilities to cover the partner's negative tax basis capital?

Any final questions?

Q&A

Speakers

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