## Update Info

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Page No.</th>
<th>Source</th>
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</tr>
</thead>
<tbody>
<tr>
<td>18</td>
<td>352</td>
<td>Final Regs.</td>
<td>Regulations §1.706-0, 1.706-1, 1.706-2, 1.706-3, 1.706-4, and 1.706-5) were finalized August 3, 2015, providing method for determining a partner's distribute share of partnership items in any year where there is a change in partner's interest.</td>
</tr>
<tr>
<td>18</td>
<td>352</td>
<td>Final Reg.</td>
<td>Reg. 1.706-4 substantially changes allocation rules when partnership interest change during the year.</td>
</tr>
</tbody>
</table>
II. Economic Substance Required for Partnership Transactions

AUDIT GUIDELINES: During 2011 the IRS issued LB&I Control No: LB&I-4-0711-015 “Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties” that identifies circumstances in which the application of the economic substance doctrine may be appropriate.

- Transaction is promoted/developed/administered by tax department or outside advisors
- Transaction is highly structured
- **Transaction includes unnecessary steps**
- Transaction is not at arm’s length with unrelated third parties
- **Transaction creates no meaningful economic change** on a present value basis (pre-tax)
- Taxpayer’s potential for gain or loss is artificially limited
- **Transaction accelerates a loss or duplicates a deduction**
- Transaction generates a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset)
- **Transaction has no significant risk of loss**
- Tax benefit is artificially generated by the transaction
- Transaction is pre-packaged
- **Transaction is outside the taxpayer’s ordinary business operations**

This guidance can be found at: https://www.irs.gov/irm/part4/irm_04-046-004.html#d0e1219.
III. Understanding the Effect the Partnership Agreement Has on Allocations

A. In the **absence of an partnership agreement** all allocations will be made **based on ownership interests** – Most small partnerships

B. Tax law does not have the authority to govern how partners deal with economic results.

C. IRS will always **look to the partnership agreement**, lacking the same **default to the ownership interests**
III. Understanding the Effect the Partnership Agreement Has on Allocations

Best Practice demands asking for copy of agreement
A partnership return should not be prepared without

D. When reviewing a partnership agreement to determine the economic arrangement between the partners, it is important to look at all sections that impact the actual dollars to be contributed by or distributed to the partners. Special attention should be given to sections of the agreement dealing with:

1. Capital contributions,
2. Capital calls,
3. Distributions of cash from operations,
4. Requirements for funding deficits,
5. Responsibility for partnership liabilities, and
III. Understanding the Effect the Partnership Agreement Has on Allocations

F. When do changes to the partnership agreement need to be made?

- Modifications can be made up to the original due date of the return

- Any change or modification must always be attuned to the issue of substantial economic effect
IV. The Substantial Economic Effect

Safe Harbor Rules

At the end of the day for every benefit there must be a cost or vice versa.

EXAMPLE 3: Dick and Jane each contribute $5,000 to Buzzbee, a general partnership. The partnership agreement calls for allocation of 90% of losses to Dick, and 10% to Jane. As to profits, it first calls for an allocation of all profits to Dick up to the specially allocated losses, with the remainder of profits split 50/50.

The partnership agreement also requires maintenance of book capital accounts, liquidation by book capital accounts, and capital deficit restoration requirements. This situation meets the safe harbor rules, and is, therefore, a qualified safe harbor agreement for unequal allocations.
IV. The Substantial Economic Effect
Safe Harbor Rules

If there is no non-tax cost (Dick) to the benefiting partner there is no substantial economic benefit.

**EXAMPLE 4:** Dick and Jane each contribute $5,000 to Buzzbee, a general partnership, and consider themselves equal partners. During 2016, the partnership has a $50,000 short-term capital gain. Normally, the partners would split this gain equally, but this year Dick has a personal $40,000 capital loss.

The partners agree to allocate the capital gain 80% to Dick ($40,000) and 20% to Jane. This treatment would not be considered substantial and would cause the allocation to flunk the substantial economic effect safe harbor rules, resulting in a reallocation of the capital gain 50/50 to the partners upon examination.

Why does it flunk the safe harbor rules? Because the allocation of 80% of the capital gain to Dick does not have an offsetting cost to Jane.

How could this be remedied? The partnership agreement could be modified to reflect cash distributions at liquidation will follow economic allocations: e.g., at liquidation, Jane would get a larger distribution at a substantial cost to Dick.
V. How Allocations are Made According to Partners Interest in the Partnership (PIP)

The pain of failure to follow the PIP rules in the absence of a partnership agreement.

NOTE: In a real-life illustration of how the PIP principle is applied, consider the case of two brothers who were partners in a farming partnership. In the *Estate of James R. Tobias, et al. v. Comm.*, TC Memo 2001-37, James and Darwin orally agreed to operate an animal farm business as partners but never reduced their agreement to writing. The relationship between the brothers grew strained with James evicting Darwin from the farm in 1986. A Pennsylvania court later found that capital contributions from the partners amounted to $1,001,558 for James and $2,320 for Darwin. After the falling out, James filed partnership returns showing a 50/50 split of taxable income. The IRS later reallocated all the income to James. The tax court agreed with the IRS and used the PIP capital account approach in allocating income; the court allocated all the profit to James.
VI. Allocations of Current Year Tax Items When Ownership Interests Change

A. With the finalized regulations, all tax years beginning after 08/03/2015 must adhere to the rules – TD 9728 – allocating partnership items.

B. On 08/03/2015 proposed regs. were issued which will address the determination of distributive shares.

These rules are meant to bring the regulations into agreement with changes made by the 1997 Taxpayer Relief Act and before
VIII. Allocations of Current Year Tax Items When Ownership Interests Change for Tax Years Beginning After August 2, 2015

The partnership taxable year does not close as a result of the following:

➢ Death of a Partner
➢ Entry of a New Partner
➢ Liquidation of a Partner’s entire interest
➢ Sale of a Partner’s interest

Unless – There is a technical termination, i.e. greater than 50% change in ownership of the partnership – See Chapter 21
VIII. Allocations of Current Year Tax Items When Ownership Interests Change for Tax Years Beginning After August 2, 2015

However – The partner’s year closes with respect to the interest in the partnership.

IRC 706(c) and Regulation 1.706-1(c) Section 2 and 3 apply to any “change”

New regulations are an attempt to unify the processes from taxpayer to taxpayer.
VIII. Allocations of Current Year Tax Items When Ownership Interests Change for Tax Years Beginning After August 2, 2015

F. Determination will first be made if the partnership is eligible for one of two exceptions:
   a. Contemporaneous events – Those events that occurred during the same period, there are exceptions to the contemporaneous rule:
      ▪ Contribution of money or property.
      ▪ Distribution of money or property.
      ▪ Allocations do not violate the rules of 704(b)
   b. Service partnerships can use any reasonable method
VIII. Allocations of Current Year Tax Items When Ownership Interests Change for Tax Years Beginning After August 2, 2015

2. Extraordinary Items cannot be prorated as they are subject to day of event:
   a. Items from disposition or abandonment.
   b. Capital assets dispositions or abandonment.
   c. Assets converted in a like kind exchange.
   e. Discharges of indebtedness.
   f. Settlements of tort actions.
VIII. Allocations of Current Year Tax Items When Ownership Interests Change for Tax Years Beginning After August 2, 2015

2. Extraordinary Items cannot be prorated as they are subject to day of event:
   
g. Credits due to the preceding events.

h. An item that partners have agreed to treat as an extraordinary event.

i. Events that have been identified as extraordinary by Internal Revenue Bulletin.
VIII. Allocations of Current Year Tax Items When Ownership Interests Change for Tax Years Beginning After August 2, 2015

3. Choose the method:

✓ Proration Method – An allocation method that can only be done by agreement of the partners

OR

✓ Interim Closing Method – The default method that will be used absent an agreement to use the proration method by the partners.

Different methods can be used for different events during a partnership year.
VIII. Allocations of Current Year Tax Items When Ownership Interests Change for Tax Years Beginning After August 2, 2015

4. Choose the convention:
   a. Calendar Day
   b. Semi-Monthly – Occurring between the 1st and 15th it is deemed occur on the last day of the preceding month. The 16th thru the last day of the month are deemed to occur on the 15th of the month.
   c. Monthly – Events occurring between the 1st and the 15th are deemed to be the last day of the prior month. The 16th until month end are deemed to occur on the end of the month.
VIII. Allocations of Current Year Tax Items When Ownership Interests Change for Tax Years Beginning After August 2, 2015
VIII. Allocations of Current Year Tax Items When Ownership Interests Change for Tax Years Beginning After August 2, 2015

5. Optional Regular or Monthly Closings:

- Is there an agreement in place by the partners to perform regular interim closings monthly or semi-monthly?

-Absent an agreement by the partners then the closing will be based on the date of the occurrence if the partnership is using the interim method.
VIII. Allocations of Current Year Tax Items When Ownership Interests Change for Tax Years Beginning After August 2, 2015

6. Segments are the periods created by the closing of the partnership books.

7. Apportion applicable book/tax items among the segments.
   
a. While the partnership could have a capital loss for the year a specific segment could have a capital gain.

   b. Any annual limitations are first applied and each segment will receive its allocable share, i.e. calculate IRC 179 then apply each segment its allocable share.
VIII. Allocations of Current Year Tax Items When Ownership Interests Change for Tax Years Beginning After August 2, 2015

8. Proration Periods – Look at the dates, each succeeding period begins when the prior one ends.

9. Prorate the Items – Apply the respective amounts in each segment.

10. Determine the partner’s distributive shares under IRC 702(a).

G. Partnerships using the proration methods MUST USE THE CALENDAR DAY METHOD
### Allocating Income and Loss to Partners

**Partner Info, Basis - Partner Info and Partner Basis**
- Screen K1Misc
  - AMT: Total depreciation
  - ACE: Post-1993 Property

**Rent & Royalty - Rental or Royalty Income and Expenses - 2621 Jacksboro Hwy.**
- Screen Rent - Rent and Royalty Properties
  - 2621 Jacksboro Hwy.
  - Screen SepK - Separately Stated Income and Expenses
  - Depreciation adjustment post-1986 property

**Rent & Royalty - Rental or Royalty Income and Expenses - 5115 Stanley Keller Rd.**
- Screen Rent - Rent and Royalty Properties
  - 5115 Stanley Keller Rd.

**Rent & Royalty - Rental or Royalty Income and Expenses - 3300 Cooper St.**
- Screen Rent - Rent and Royalty Properties
  - 3300 Cooper St.

**Rent & Royalty - Rental or Royalty Income and Expenses - 5609 Parker Henderson**
- Screen Rent - Rent and Royalty Properties
  - 5609 Parker Henderson
VIII. Allocations of Current Year Tax Items When Ownership Interests Change for Tax Years Beginning After August 2, 2015

Putting this stuff into action will like make you a little crazy.

Good News – Most partnerships do not change frequently.

**EXAMPLE 6** [See worksheet that follows]: At the beginning of the year, PRS, a calendar year partnership, has three equal partners, Abe, Bill, and Charley. On April 16th, Abe sells 50% of his interest to new partner Dave. On August 6, Bill sells 50% of his interest to new partner Ed.
VIII. Allocations of Current Year Tax Items When Ownership Interests Change for Tax Years Beginning After August 2, 2015

EXAMPLE 6 [See worksheet that follows]: At the beginning of the year, PRS, a calendar year partnership, has three equal partners, Abe, Bill, and Charley. On April 16th, Abe sells 50% of his interest to new partner Dave. On August 6, Bill sells 50% of his interest to new partner Ed.

During the year, PRS earned $75,000 of ordinary income, incurred $33,000 of ordinary deductions, earned $12,000 of capital gain in the ordinary course of its business, and sustained $9,000 of capital loss in the ordinary course of its business. Within that year, PRS earned $60,000 of ordinary income, incurred $24,000 of ordinary deductions, earned $12,000 of capital gain, and sustained $6,000 of capital loss between January 1st and July 31st, and PRS earned $15,000 of gross ordinary income, incurred $9,000 of gross ordinary deductions, and sustained $2,000 of capital loss between August 1st and December 31st. None of PRS’s net income-producing factor shares of Abe, Bill, Charley, Dave, and Ed were materially altered.

First, PRS determines that no service partners apply because the variation is the result of a change in ownership.

Second, PRS determines that no allocation on the date of occurrence applies.

Third, the partners of PRS agree to the August 6th variation and PRS accepts the August 6th variation.

Fourth, PRS determines the deemed date of the variations based upon PRS’s selected convention. Because PRS applied the proration method to the April 16th variation, PRS must use the calendar day convention with respect to it. Therefore Abe’s sale to Dave on April 16th is deemed to occur at the end of the day on April 16th. Further, the partners of PRS agree to apply the semi-monthly convention to the August 6th variation. Therefore, the August 6th variation is deemed to occur at the end of the day on July 31st.

Fifth, the partners of PRS do not agree to perform regular semi-monthly or monthly closings. Therefore, PRS will have only one interim closing for the year, occurring at the end of the day on July 31st.

Sixth, PRS determines that it has two segments for the year. The first segment commences January 1st and ends at the close of the day on July 31st. The second segment commences at the beginning of the day on August 1st and ends at the close of the day on December 31st.
VIII. Allocations of Current Year Tax Items When Ownership Interests Change for Tax Years Beginning After August 2, 2015

Seventh. PRS determines that during the first segment of its taxable year (beginning January 1st and ending July 31st), it had $60,000 of ordinary income, $24,000 of ordinary deductions, $12,000 of capital gain, and $6,000 of capital loss. PRS determines that during the second segment of its taxable year (beginning August 1st and ending December 31st), it had $15,000 of gross deductions, and $3,000 of capital loss.

Eighth. PRS determines that it has two proration periods, the first proration period begins January 1st and the second proration period begins April 31st.

Ninth. PRS prorates its income from these proration periods. Because each proration period contains $30,000 gross ordinary income, $60,000 capital gain, and $3,000 capital loss.

Tenth. PRS calculates each partner’s distribution of the prorata income.

1st Segment:

1st Proration: Because Abe, Bill, and Charley were equal partners during the first proration period, each is allocated one-third of the partnership’s items attributable to that proration period. Thus, Abe, Bob, and Charley are each allocated $10,000 gross ordinary income, $4,000 gross ordinary deductions, $2,000 capital gain, and $1,000 capital loss for the first proration period. For combined total income of $7,000 each. (Please note that total income is shown for illustration purposes only).

2nd Proration: For the second proration period, Abe and Dave each had a one-sixth interest in PRS and Bill and Charley each had a one-third interest in PRS. Thus, Abe and Dave each allocated $5,000 gross ordinary income, $2,000 gross ordinary deductions, $1,000 capital gain, and $500 capital loss, or total income of $3,500 each. While Bill and Charley who each own a one-third interest are allocated $10,000 gross ordinary income, $4,000 gross ordinary deductions, $2,000 capital gain, and $1,000 capital loss for the second proration period for a total of $7,000 each.

2nd Segment:

For the second segment of PRS’s taxable year, Abe, Bill, Dave, and Ed each had a one-sixth interest and Charley had a one-third interest in PRS. Thus, Abe, Bill, Dave, and Ed are each allocated $2,500 gross ordinary income, $1,500 gross ordinary deductions, and $500 capital loss for total income of $500 each. Charley is allocated $5,000 gross ordinary income, $3,000 gross ordinary deductions, and $1,000 capital loss for the second segment for a total income of $1,000.
### Worksheet Analysis for Previous Example

#### Segment

<table>
<thead>
<tr>
<th>Segment</th>
<th>First Segment (1/1/2017 to 7/31/17)</th>
<th>Second Segment (08/1/17 to 12/31/17)</th>
<th>Total for Year</th>
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</thead>
<tbody>
<tr>
<td>Ordinary Income</td>
<td>$60,000</td>
<td>$15,000</td>
<td>$75,000</td>
</tr>
<tr>
<td>Ordinary Deductions</td>
<td>$(24,000)</td>
<td>$(9,000)</td>
<td>$(33,000)</td>
</tr>
<tr>
<td>Cap Gain in course of business</td>
<td>$12,000</td>
<td>$-</td>
<td>$12,000</td>
</tr>
<tr>
<td>Cap Loss in course of business</td>
<td>$(6,000)</td>
<td>$(3,000)</td>
<td>$(9,000)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$42,000</td>
<td>$3,000</td>
<td>$45,000</td>
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#### 1st Segment

<table>
<thead>
<tr>
<th>Variation Method Convention</th>
<th>1st Pro-ration Period 01/01/17 to 04/16/17</th>
<th>2nd Pro-ration Period 04/17/17 to 07/31/17</th>
<th>Total First Segment 08/1/17 to 12/31/17</th>
<th>Total for Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abe sells 50% to Dave</td>
<td>106</td>
<td>106</td>
<td>$21,000.00</td>
<td>$45,000.00</td>
</tr>
<tr>
<td>Bill sells 50% to Ed</td>
<td>106</td>
<td>106</td>
<td>$21,000.00</td>
<td>$45,000.00</td>
</tr>
</tbody>
</table>

#### Partner Allocation Percentage

<table>
<thead>
<tr>
<th>Partner</th>
<th>1st Segment</th>
<th>2nd Segment</th>
<th>Total for Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abe</td>
<td>33.33%</td>
<td>16.67%</td>
<td>16.67%</td>
</tr>
<tr>
<td>Bill</td>
<td>33.33%</td>
<td>33.33%</td>
<td>16.67%</td>
</tr>
<tr>
<td>Charley</td>
<td>33.33%</td>
<td>33.33%</td>
<td>33.34%</td>
</tr>
<tr>
<td>Dave</td>
<td>0.00%</td>
<td>16.67%</td>
<td>16.66%</td>
</tr>
<tr>
<td>Ed</td>
<td>0.00%</td>
<td>0.00%</td>
<td>16.67%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>100.00%</td>
<td>100.00%</td>
<td>100.00%</td>
</tr>
</tbody>
</table>

#### Total Amount of Income Allocated

<table>
<thead>
<tr>
<th>Partner</th>
<th>1st Segment</th>
<th>2nd Segment</th>
<th>Total for Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abe</td>
<td>$7,000</td>
<td>$3,500</td>
<td>$11,000</td>
</tr>
<tr>
<td>Bill</td>
<td>$7,000</td>
<td>$7,000</td>
<td>$14,500</td>
</tr>
<tr>
<td>Charley</td>
<td>$7,000</td>
<td>$7,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Dave</td>
<td>$-</td>
<td>$3,500</td>
<td>$4,000</td>
</tr>
<tr>
<td>Ed</td>
<td>$-</td>
<td>$-</td>
<td>$500</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$21,000</td>
<td>$21,000</td>
<td>$45,000</td>
</tr>
</tbody>
</table>
**VIII. Current Distributions to Partners**

Distributed Property – What is the receiving partner’s basis?

**EXAMPLE 7:** Betty has an adjusted outside basis in Grable’s Fables, LLC of $100,000. She receives a current distribution of property worth $200,000 with an adjusted basis of $150,000. She recognizes no IRC Sec. 731 gain on the distribution. Her basis in the building is $100,000. If she had instead received $200,000 in cash or marketable securities, she would have had a recognized gain of $100,000 ($200,000 less $100,000 outside basis).

<table>
<thead>
<tr>
<th>Property</th>
<th>Partnership Basis</th>
<th>FMV</th>
<th>Betty’s Basis in Partnership</th>
<th>Betty’s Basis in Asset</th>
<th>Taxable Gain</th>
</tr>
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<tbody>
<tr>
<td>Building</td>
<td>$150,000</td>
<td>$200,000</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$0</td>
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<tr>
<td>Cash</td>
<td>$200,000</td>
<td>$200,000</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

But if the partner gets money
VIII. Current Distributions to Partners

Distributed Property – What is the receiving partner’s basis?

**EXAMPLE 8:** Lucy has an **adjusted basis of $60,000** in her partnership interest. She receives a current distribution of **property** with an **adjusted basis of $40,000** (partnership’s inside basis), and **cash of $8,000**.

The **basis of the property in Lucy’s hands will be $40,000**. The basis of her partnership interest will be **$12,000** ($60,000 less $8,000 cash, less $40,000 property basis).

<table>
<thead>
<tr>
<th>Property</th>
<th>Partnership Basis</th>
<th>FMV</th>
<th>Lucy’s Basis in Partnership</th>
<th>Lucy’s Basis in Asset</th>
<th>Lucy’s Taxable Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$8,000</td>
<td>$16,000</td>
<td>$60,000</td>
<td>$8,000</td>
<td>$0</td>
</tr>
<tr>
<td>Property</td>
<td>$40,000</td>
<td>?</td>
<td>$52,000</td>
<td>$40,000</td>
<td>$0</td>
</tr>
<tr>
<td>Remaining Basis in Partnership</td>
<td>$12,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
VIII. Current Distributions to Partners

E. There is no recognition of gain/loss by the distribution of property by the partnership to a partner except for IRC 751 assets.

The rules of IRC 751

When the partner receives IRC 751 (Hot Assets – Receivables and Appreciated Inventory (FMV or Inventory ≥ 120% of carrying value))

- The actual receivables or assets
- Their attributed share of those assets
VIII. Current Distributions to Partners

How does all that cold assets for hot assets stuff work?

3. Assume first that a partnership has “IRC Sec. 751 assets.” In the event that a partner receives a distribution of “cold” assets in excess of his pro rata share, it stands to reason the partner received less than his pro rata share of “hot” assets. In that case, the partnership is deemed to have distributed to the partner his pro rata share of “hot” assets, and the partner is deemed to have sold them back to the partnership, in a series of hypothetical transactions.

What this means is if you try to get “clever” to get rid of a partner without tax and the partnership has “hot assets” you lost...