## Update Info

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<td>TC Memo 2014-182</td>
<td>Recent case contribution of personal note did not increase partner's basis.</td>
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<td>Reg. 1.752-2(b)(1)</td>
<td>New regulations expand testing for determination of recourse liabilities to include facts and circumstances at the time of determination.</td>
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<td>AM 2016-001 and CCA 201606027</td>
<td>New announcement addressing concerns generated in CCA 201606027 dealing with &quot;bad boy&quot; guarantees of nonrecourse and qualified nonrecourse debt.</td>
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</table>
II. Understanding Basis

The primary difference between partnerships and S-Corporations is DEBT:

- Partnership debt will be part of the basis.
- If partner is at risk then the basis can be used to absorb losses
III. Calculating Initial Basis

Contributions to the partnership will be easy.

Simply determine the contributing partner’s basis.

**EXAMPLE 1:** Woodrow acquires a 50% interest in an LLC in exchange for contributing realty with a FMV of $155,000. The property is not subject to any liabilities and the LLC has no other liabilities on the contribution date. Woodrow purchased the property for $105,000 and has claimed $8,716 in allowable depreciation. Therefore, Woodrow's adjusted tax basis in his LLC interest (i.e., his outside basis) is $96,284; the same as his adjusted tax basis in the property he contributed. The LLC's tax basis (i.e., inside basis) in the property is also $96,284.

**NOTE:** While Woodrow does not recognize taxable income on the contribution of the property, the partnership is required to track the built-in-gain or the excess of the FMV of the property over its basis of $58,716. See “Chapter 17 Formation of Partnerships” for “Contribution of Property with Built-In Gain or Loss” for more information.

In most situations the partner’s and partnership’s basis will be identical.
III. Calculating Initial Basis

The partner recognizes gain on the contribution of property due to:

B. Relief from liabilities – IRC 752

C. Distribution of property to another partner that had built in gain – IRC 704(c)

D. Investment Company Rule – IRC 721(b)
III. Calculating Initial Basis

Net Debt does not exceed basis

**EXAMPLE 2**: Brad contributes land worth $155,000, with an adjusted tax basis of $105,000. There is an $84,000 mortgage on the contributed realty that will be assumed by the LLC (along with personal guarantees). Brad's adjusted tax basis (outside basis) in the LLC interest is:

Adjusted tax basis of property contributed
Less: First mortgage assumed by the LLC
Plus: Brad's 1/2 share of first mortgage debt

\[
\begin{align*}
\text{Adjusted tax basis of property contributed} & \quad $105,000 \\
- \text{First mortgage assumed by the LLC} & \quad (84,000) \\
+ \text{Brad's 1/2 share of first mortgage debt} & \quad 42,000 \\
\hline \\
\text{Adjusted tax basis of Brad's LLC interest} & \quad $63,000
\end{align*}
\]

**EXAMPLE 2 (Continued)**: Brad's Schedule K-1 tax basis capital account analysis reflects $21,000 of capital contributed during the year. In addition, the Schedule K-1 shows $42,000 as his share of qualified nonrecourse debt in Item K. The sum of Brad's $21,000 capital account balance and $42,000 in allocated LLC debt is equal to his $63,000 LLC outside basis.
III. Calculating Initial Basis

Net Debt exceeds basis

EXAMPLE 3: Assume the same facts as in the prior example, except the land has a tax basis prior to the contribution of only $20,000. Brad's adjusted tax basis in the LLC interest is:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted tax basis of property contributed</td>
<td>$20,000</td>
</tr>
<tr>
<td>Less: First mortgage assumed by the LLC</td>
<td>$(84,000)</td>
</tr>
<tr>
<td>Plus: Brad's ½ share of LLC debt</td>
<td>$42,000</td>
</tr>
<tr>
<td>Subtotal</td>
<td>$(2,000)</td>
</tr>
<tr>
<td>Plus: Gain recognized [IRC Sec. 731(a)]</td>
<td>$2,000</td>
</tr>
<tr>
<td>Adjusted tax basis of Brad's LLC interest</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

Brad's Schedule K-1 tax basis capital account analysis reflects a negative $64,000 capital account balance. Item K of Schedule K-1 reflects a $42,000 share of LLC debt. This is a good example of why tax practitioners should NOT just depend on the tax capital amount reported on Schedule K-1 as the member's outside basis.
III. Calculating Initial Basis

EXAMPLE 3: Assume the same facts as in the prior example, except the realty has a basis prior to the contribution of only $20,000. Brad's adjusted tax basis in the LLC interest is:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted tax basis of property contributed</td>
<td>$20,000</td>
</tr>
<tr>
<td>Less: First mortgage assumed by the LLC</td>
<td>(84,000)</td>
</tr>
<tr>
<td>Plus: Brad's ½ share of LLC debt</td>
<td>42,000</td>
</tr>
<tr>
<td>Subtotal</td>
<td>(22,000)</td>
</tr>
<tr>
<td>Plus: Gain recognized [IRC Sec. 731(a)]</td>
<td></td>
</tr>
<tr>
<td>Adjusted tax basis of Brad's LLC interest</td>
<td></td>
</tr>
</tbody>
</table>

The $22,000 of taxable gain Brad is required to report is an individual gain that should not be included on his Schedule K-1. The LLC should provide a separate schedule to Brad along with his Schedule K-1 that shows the amount of gain he is required to report after contributing the mortgaged property. This gain should be reported on his Form 1040 Schedule D or Form 4797 as appropriate.
EXAMPLE 3: Assume the same facts as in the prior example, except the land has a tax basis prior to the contribution of only $20,000. Brad's adjusted tax basis in the LLC interest is:

Adjusted tax basis of property contributed $ 20,000
Less: First mortgage assumed by the LLC (84,000)
Plus: Brad's ½ share of LLC debt 42,000
Subtotal (22,000)
Plus: Gain recognized [IRC Sec. 731(a)] 22,000
Adjusted tax basis of Brad's LLC interest 0

The $22,000 of taxable gain Brad is required to report is an individual gain that should not be included on his Schedule K-1. The LLC should provide a separate schedule to Brad, along with his Schedule K-1, that shows the amount of gain he is required to report after contributing the mortgaged property. This gain should be reported on his Form 1040, Schedule D or Form 4797 as appropriate.

Debt Exceeds Basis
III. Calculating Initial Basis

Pre-Existing Liabilities can create basis for an entering Partner – Now NO TAXABLE GAIN

EXAMPLE 4: Assume the same facts as in the prior example, except the LLC has $150,000 of other recourse liabilities at the time of Brad's admission. Brad's adjusted tax (outside) basis is:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted tax basis of property contributed</td>
<td>$20,000</td>
</tr>
<tr>
<td>Less: First mortgage assumed</td>
<td>(84,000)</td>
</tr>
<tr>
<td>Plus: Brad's 1/2 share of the mortgage</td>
<td>47,000</td>
</tr>
<tr>
<td>Plus: Brad's 1/2 share of pre-existing debt</td>
<td>25,000</td>
</tr>
<tr>
<td>Adjusted tax basis of Brad's LLC interest</td>
<td>$58,000</td>
</tr>
</tbody>
</table>

Brad's Schedule K-1 reflects a negative $64,000 balance. However, he receives basis from the $117,000 of qualified non recourse debt in Item K for a total adjusted tax basis of $53,000.
### III. Calculating Initial Basis

**EXAMPLE 5:** Assume that Angie contributes $25,000 for a 1/3 interest in a partnership owned equally by two partners. The balance sheet of the partnership prior to her investment is below. The other partners had a tax basis (outside basis) of $5,000 (negative capital of $45,000 plus $50,000 share of partnership debt). When Angie enters the partnership, the partners are treated as receiving a $16,667 cash distribution because their respective share of liabilities has been reduced by that amount. Accordingly, each of the original partners has a potential $11,667 gain with the admittance of Angie to the partnership.

<table>
<thead>
<tr>
<th>Tax Basis</th>
<th>FMV</th>
<th>50%</th>
<th>33.33</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Real estate</strong></td>
<td>$10,000</td>
<td>$175,000</td>
<td>$5,000</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>10,000</td>
<td>175,000</td>
<td>5,000</td>
</tr>
<tr>
<td><strong>Recourse mortgage</strong></td>
<td>100,000</td>
<td>100,000</td>
<td>50,000</td>
</tr>
<tr>
<td><strong>Partner capital</strong></td>
<td>(90,000)</td>
<td>(75,000)</td>
<td>(45,000)</td>
</tr>
<tr>
<td><strong>Total liabilities and capital</strong></td>
<td>$10,000</td>
<td>$175,000</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

Somebody wins and somebody loses.
III. Calculating Initial Basis

When is a contribution of capital not really capital?

COURT CASE: In *VisionMonitor Software*, a partner contributed his own note to a partnership in exchange for his partnership interest. The Tax Court ruled that the contribution of a personal note is not the equivalent of a contribution of cash ("I will gladly pay you Tuesday for a hamburger today"), and therefore will not increase a partner's basis in his partnership interest.

The above fact pattern applied to all of the “investors” and none of the potential partners had any basis in the notes they had contributed. Until the notes were paid, they served as only contractual obligations to the LLC and did not constitute property. *[VisionMonitor Software, LLC, TC Memo. 2014-182]*.
IV. Calculating Outside Basis

B. The ordering rules of basis under Regulation § 1.704-1(d)(2)

1. All positive adjustments
2. Reduced by current year distributions
   - Deemed to have occurred on last day of tax year
   - Cash is deemed to have been distributed before property
   - Distributions will not reduce basis below ZERO
3. Reduced by share of losses (deductions) for year
   - Losses that reduce basis below ZERO will be suspended until basis is restored on a pro-rata basis
IV. Calculating Outside Basis

Some thoughts regarding outside basis

While a partner’s capital account can be less than ZERO, a partner’s outside basis can never be less than ZERO.

A partner receiving distributions in excess of their outside basis will have taxable gain.

How can you prepare a return for an individual without calculating outside basis when they have a loss or distributions?
V. Basis and Debt Allocations

Partner Capital

Non-Recourse Debt

Recourse Debt

Qualified Non-Recourse Debt

Partner's share of liabilities at year end:

- Nonrecourse: $_______________
- Qualified nonrecourse financing: $_______________
- Recourse: $_______________
VI. Old Rules and the More Recent Rules
For Allocating Liabilities to Partners

Attempt by IRS to bring definition of recourse debt in line with the real world.

NOTE: The biggest issue with the newly proposed IRC Sec. 752 regulations is that they change the way allocation of debt has been handled by partnerships for the last 25 years. In the past, whenever a partner has an obligation to repay all or a portion of a debt the bias was towards treating the debt as a recourse liability. Under the new proposed regulations, the bias is towards disregarding partner-level obligations or guarantees in determining whether debt is recourse or nonrecourse except when a full recourse liability is assumed by the relevant partner. They also would require a new "liquidation value method" to determine a partner's interest in a partnership's profits. The proposed regulations also were intended to respect only guarantees that reflect commercial reality, but their requirements are not consistent with the "real world" and simply create a new set of hoops for taxpayers to jump through to be able to treat debt as recourse.

But attempt just created a new set of confusing rules that taxpayers will struggle with. Welcome to the debt bomb.
VII. Allocation of Recourse Debt

To be recourse debt:

A. Allows lender to collect from debtor and their assets in the event of default.

B. A partner or related person bears economic risk.

C. Recourse debt is shared by partners based on their “share” of economic risk.
On July 7, 2017 IRS reported that its new regulations for allocating recourse liabilities was:

A. A great step forward.
B. Unduly burdensome or complex.
C. Made taxes great again.
VIII. Determining a Partners Share of Recourse Liabilities Under the New 2016 Regulations

A. A facts and circumstances test has replaced prior regulations – Based on time of determination.

B. If the partnership liability would not be recognized under the regulations it does not exist.

C. All statutory and contractual obligations are considered. (Look thru rules)
VIII. Determining a Partners Share of Recourse Liabilities Under the New 2016 Regulations

These things are convoluted and difficult.

**Example 1: Payment Obligations**

If a partner guarantees a partnership recourse debt, but the guarantee isn’t legally binding under applicable state law, the purported guarantee won’t be recognized as a payment obligation. Therefore, the guarantee will have no impact on how that debt was allocated to that partner under the Sec. 752 rules.

THE NEW PARTNERSHIP DEBT REGULATIONS – Many believe it will turn into a series of I gotcha – others say no real change.
VIII. Determining a Partners Share of Recourse Liabilities Under the New 2016 Regulations

Flash Update – The rules apply to all debt incurred or assumed by partnership after 10/05/2016

BUT

IRS, as instructed by Treasury has identified unduly burdensome rules, the outcome was

THE NEW PARTNERSHIP DEBT REGULATIONS
IX. Determining a Partners Economic Risk of Loss

**EXAMPLE 6:** Assume Moe and Larry are general partners in Slap Happy Partners and each contributes $20,000 to the partnership. The partnership then borrows $60,000 on a recourse basis and purchases property for $100,000. **Losses are allocated 90% to Moe and 10% to Larry** under the partnership agreement. Under applicable state law governing general partnerships, both Moe and Larry are liable for the full amount of the liability. State law also requires a general partner to restore any deficit capital account balance.

Under the no value liquidation rules, the partnership's assets are deemed worthless and disposed of in a fully taxable transaction, and all liabilities are deemed payable in full. Applying these assumptions, the partnership has a $100,000 taxable loss allocated $90,000 to Moe and $10,000 to Larry. Moe's capital account becomes a negative $70,000, while Larry's capital account is a positive $10,000, as shown in the following capital account analysis. Under his deficit capital account restoration obligation, Moe would be required to contribute $70,000 to the partnership. Thus, the entire $60,000 recourse liability is allocated to Moe. The basis from the liability is not allocated 90/10 or 50/50 as might be expected. The other $10,000 of Moe's contribution obligation relates to the $10,000 positive capital account owed by the partnership to Larry.

<table>
<thead>
<tr>
<th></th>
<th>Moe</th>
<th>Larry</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>contribution</td>
<td>$20,000</td>
<td>$20,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Loss</td>
<td>(90,000)</td>
<td>(10,000)</td>
<td>(100,000)</td>
</tr>
<tr>
<td>accounts</td>
<td>(70,000)</td>
<td>10,000</td>
<td>(60,000)</td>
</tr>
</tbody>
</table>

19 - Basis and At Risk Rules for Partnerships
IX. Determining a Partners Economic Risk of Loss

Purchase Costs

- Moe 20% - $20,000
- Larry 20% - $20,000
- Debt 60% - $60,000
IX. Determining a Partners Economic Risk of Loss

Hypothetical Liquidation Loss

Partnership Agreement Provides Tax Losses

- Moe 90%
- Larry 10%
IX. Determining a Partners Economic Risk of Loss

Capital in Excess of Investment at Risk

- Moe $70,000 - 100%
- Larry $0 - 0%
By definition limited partners do not share recourse liabilities however if they do bear that risk they would have basis to the extent of the debt:

**EXAMPLE 7:** Groucho and Harpo, equal general partners, each contribute $1,000 to form Marx Partnership. Chico, the sole limited partner, contributes $18,000. The partnership uses $10,000 for miscellaneous expenses and borrows $90,000 to purchase partnership property. Assume the loan is a recourse debt and Groucho and Harpo are personally liable for it. The remaining $10,000 is used to pay start-up costs.

Under a constructive no value liquidation, Groucho and Harpo as general partners, are obligated to contribute $45,000 each to satisfy the recourse liability and are therefore each allocated $45,000 of the liability for basis purposes. As a limited partner, Chico is not obligated to make any contribution to pay the recourse debt and is therefore not allocated any of the debt for basis purposes.
IX. Determining a Partners Economic Risk of Loss

F. Direct non-recourse loans by limited partners will be treated as recourse to the limited partner

G. When there is a special allocation of loss it is likely that some surprising “no value liquidation” numbers can result

WARNING: Basis allocation from partnership recourse liabilities can be tricky, especially when there are special allocations. All agreements among the partners and third parties (including agreements outside the partnership agreement) must be analyzed on a liability-by-liability basis in determining the partners’ true economic risk of loss for each partnership liability. However, if there are several partnership liabilities for which the partners’ obligations are identical, the liabilities can be lumped together for purposes of performing the no value liquidation analysis.
X. Allocation of Nonrecourse Liabilities

The process of debt allocation can be exceedingly complex but due to the nature of a non-recourse loan, economic risk of loss cannot be looked at to determine issues of basis.

B. Can be allocated among partners in proportion to their profits interest

E. Reg. § 1.752-3(a) provides a three tier formula
   1. Amount that debt that exceeds basis in assets
   2. Amount of gain that would be allocated under IRC 704(c)
   3. The remaining debt not allocated by applying the rules of Steps 1 and 2
X. Allocation of Nonrecourse Liabilities

First-tier Allocation: There is no partnership minimum gain, because the property's book basis ($100,000) exceeds the nonrecourse debt ($60,000). Therefore, there is no first-tier IRC Sec. 752 allocation to be made.

Second-tier Allocation: The second-tier IRC Sec. 752 allocation equals the partners' shares of the partnership's capital account.

**EXAMPLE 8:** Seth and Paul form a 50/50 partnership. In exchange for his partnership interest, Seth contributes depreciable property with a $40,000 tax basis and a $100,000 FMV. The property is burdened with a $60,000 nonrecourse liability. Paul contributes $40,000 cash.

The partnership agreement provides for 50/50 allocations of all partnership items of income, gain, deduction, and loss. In addition, the partnership maintains capital accounts in accordance with the IRC Sec. 704(b) safe harbor rules. Using the three-tiered system of Reg. §1.752-3(a) the nonrecourse debt would be allocated as follows:

Third-tier Allocation: The third-tier IRC Sec. 752 allocation is whatever basis from nonrecourse debt remains after making the first and second-tier allocations. The remainder is termed the excess nonrecourse liability amount. The excess amount depends on the IRC Sec. 704(c) gain allocation method used by the partnership. Using the traditional method, the remaining debt of $40,000 would be split evenly by the partners.
X. Allocation of Nonrecourse Liabilities

Coordinate the interplay of IRC 704(b) & 752

**OBSERVATION:** Coordinating the IRC Sec. 704(b) nonrecourse loss safe harbor allocation rules and the IRC Sec. 752 nonrecourse debt basis allocation rules is important for two reasons. First, the partner allocated the loss also needs to be allocated the corresponding basis from debt to ensure the loss's deductibility. Second, since the partner's basis is increased by the liability allocation and then decreased by the loss allocation, any subsequent shifting of the liability allocation for basis purposes to another partner could cause gain recognition because of the constructive cash distribution resulting from the reduction in liabilities allocable to the partner.
XI. Determining A Partner’s Share of Nonrecourse Liabilities Under the New 2016 Regulations

A. Excess nonrecourse liabilities to the extent of built in gains – Remains the same.

B. Partnership agreement may specify partner allocation of nonrecourse liabilities.

C. Excess can be allocated based on reasonable expectation of expense allocations.

NOTE: Excess nonrecourse liabilities are not required to be allocated under the same method each year and the above methods do not apply for purposes of determining disguised sales under Reg. 1.707-5(a)(2).

NOTE: Exculpatory debts, debts that are not secured by specific partnership or LLC property and for which no partner or member has personal liability for them are covered in the Chapter 15: Limited Liability Companies (LLCs).
XII. Guarantees of Debt

B. In most situations that we deal with a guarantee of a partnership loan simply moves the partner guarantor into the creditor’s shoes allowing the partner to collect from the other partners.

C. In the event the guarantee eliminates the risk on the part of other partner(s) then debt basis allocations must reflect that change.

E. A contractual obligation that substantially eliminates the creditors risk will be treated as a guarantee as well.
XIII. Understanding At Risk Rules

At Risk will be:
+ Cash Contributions
+ Basis of Property Contributed
+ Cumulative Share of Income and Gains
+ Partners Share of Debt (Liable For)
+ Partners Share of Qualified Nonrecourse Liabilities
- Cumulative Distributions
- Cumulative Share of Losses and Deductions
= AT RISK
XIII. Understanding At Risk Rules

Debt will be at risk except for nonrecourse loans with an exception for qualified nonrecourse loans

G. The effect of debt on amount at-risk:

1. Nonrecourse loans used to finance an activity are not amounts at-risk. See the exception for qualified nonrecourse financing below.

2. A partner’s amount at-risk is increased by the amount of any direct loan made to the partnership (Prop. Reg. §1.465-7).

3. Recourse debts are amounts at risk. Recourse debts that become nonrecourse are at-risk during the period of time that they are recourse.

4. Qualified nonrecourse debt does increase at-risk (see discussion below).
XIII. Understanding At Risk Rules

H. Not every guarantee will increase amounts at risk:

1. The guarantee is absolute and unconditional
2. There is no right of subrogation, contribution or collection from another entity
3. The guarantor bears the ultimate responsibility for the debt
XIII. Understanding At Risk Rules

Proposed Reg. § 1.465-6(d) places limits on when a guarantee does in fact place the guarantor at risk.

WARNING: Proposed Reg. §1.465-6(d) provides that guarantees do not increase at-risk basis until the taxpayer actually pays the guarantee and there is no further right to reimbursement from the partnership or other partners. These proposed regulations were issued in 1979 in an attempt to curb abusive tax shelters and have yet to be finalized. The Tax Court, however, has been willing to look at the economic issues involved in deciding whether or not basis should be increased for guarantees. *Abramson vs. Comm.*, 86 TC 360; *Gefen vs. Comm.*, 87 TC 1471; *Bennion vs. Comm.*, 88 TC 684)
XIII. Understanding At Risk Rules

Be careful of loans from individuals who are partners or related to a partner.

J. A loan from someone who has an interest in a partnership or is related to a person with an interest in a partnership other than that of creditor is not at risk (Reg. §1.465-8):

1. The borrower is not at risk for the loan.

2. The lender is also not considered at risk, because the lender has not contributed the funds to the partnership and may also be protected from loss by enforcement of the debt against the borrower.

K. Property that is not used in the at-risk activity but is pledged to secure partnership debt is considered at-risk to the extent of its FMV [IRC Sec. 465(b)(2)(B)].
XIV. Qualified Nonrecourse Debt

A. A taxpayer engaged in the activity of holding real property can increase his outside and at-risk basis by his share of the partnership’s qualified nonrecourse financing. Qualified nonrecourse debt is any financing [IRC Sec. 465(b)(6)(B)]:

1. Borrowed by the taxpayer with respect to the activity of holding real property after 1986.

2. Borrowed from a qualified person or a federal, state, or local governmental entity. A qualified person is actively and regularly engaged in the business of lending money (such as a bank or commercial credit company) and is not related to the taxpayer, a person from whom the property was acquired, nor a person who receives a fee with respect to the investment in the property (e.g., a broker or a person related to a broker).

3. For which no person is personally liable for repayment, and

4. For which the debt is not convertible.

B. Qualified nonrecourse financing is allocated in proportion to the partners’ profits interest. Reg. § 1.465-27(b)(4) states that the personal liability of any partnership for repayment of the qualified nonrecourse financing is disregarded, providing certain stipulations are met.
XIV. Qualified Nonrecourse Debt

Issue: For an LLC most debt will be considered non-recourse as state law limits personal liability.

EXAMPLE 10: MudHut, LLC files as a partnership for federal tax purposes. MudHut, LLC engages only in the activity of holding real property.

The LLC borrows $1,000 to use in the activity. The LLC is personally responsible on the financing, but no member or any other person is responsible for repayment under state law. The lender may proceed against MudHut’s assets should it default on the mortgage but not against the members.

Under the regulations, the personal liability of MudHut, LLC is disregarded. Provided the other caveats are met, the financing will be treated as qualified nonrecourse financing secured by real property.

This is good news because now the LLC members will share in the qualified nonrecourse financing based on their profits percentages for outside and at-risk basis purposes.
EXAMPLE 11: Taxpayer not engaged in the activity of holding real property

Pearl and Opal are equal partners in Jewels, a partnership. Pearl is a general partner while Opal is a limited partner. Jewels is an investment company. At the end of the year, the basis and at-risk amounts are calculated as follows:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th>GP—Pearl</th>
<th></th>
<th>LP—Opal</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tax Capital Accounts</strong></td>
<td>$100</td>
<td>$50</td>
<td></td>
<td>$50</td>
</tr>
<tr>
<td><strong>Liabilities:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>400</td>
<td>400</td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>Mortgage/Nonrecourse</td>
<td>2,000</td>
<td>1,000</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total Tax Basis</strong></td>
<td>$2,500</td>
<td>$1,450</td>
<td>$1,050</td>
<td></td>
</tr>
<tr>
<td><strong>At-Risk</strong></td>
<td></td>
<td>$450</td>
<td></td>
<td>$50</td>
</tr>
</tbody>
</table>

For outside basis purposes, Pearl would be allocated the accounts payable because, as the general partner, she is ultimately responsible for the debt. The nonrecourse mortgage is allocated using their partnership interest.

Opal would not be considered at-risk for the accounts payable.

Note that because Jewels was not formed for the purpose of holding real estate, the mortgage would not meet the requirement of qualified nonrecourse debt.
XIV. Qualified Nonrecourse Debt

**EXAMPLE 12:** Limited partnership formed to hold real estate

Same facts but Jewels was formed to hold real estate. At the end of the year the basis and at-risk amounts are calculated as follows:

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>GP—Pearl</th>
<th>LP—Opal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Capital Accounts</td>
<td>$ 100</td>
<td>$ 50</td>
<td>$ 50</td>
</tr>
<tr>
<td>Liabilities:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>400</td>
<td>400</td>
<td>0</td>
</tr>
<tr>
<td>Mortgage/Nonrecourse</td>
<td>2,000</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Total Tax Basis</td>
<td>$ 2,500</td>
<td>$ 1,450</td>
<td>$ 1,050</td>
</tr>
<tr>
<td>At-Risk</td>
<td>$ 1,450</td>
<td>$ 1,050</td>
<td></td>
</tr>
</tbody>
</table>

The allocations of debt for tax basis are the same as in the prior example.

Because Jewels was formed to hold real estate (and assuming the debt meets the other requirements of qualified nonrecourse debt), both partners would be at-risk for the mortgage.
XIV. Qualified Nonrecourse Debt

Example 13: LLC formed to hold real estate

Same facts only Jewels is an LLC formed to hold real estate. At the end of the year the basis and at-risk amounts are calculated as follows:

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Member—Pearl</th>
<th>Member—Opal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Capital Accounts</td>
<td>$ 100</td>
<td>$ 50</td>
<td>$ 50</td>
</tr>
<tr>
<td>Liabilities:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>400</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>Mortgage/Nonrecourse</td>
<td>2,000</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Total Tax Basis</td>
<td>$ 2,500</td>
<td>$ 1,250</td>
<td>$ 1,250</td>
</tr>
<tr>
<td>At-risk</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$ 1,050</td>
<td>$ 1,050</td>
<td></td>
</tr>
</tbody>
</table>

Because Jewels is an LLC, the accounts payable will now be considered nonrecourse debt and will be allocated for tax basis (outside basis) purposes based upon member interest. Neither member would be deemed at risk for the accounts payable. Because the LLC was formed for holding real estate (and assuming the mortgage meets the other requirements), both members would be deemed to be at-risk for their share of the mortgage.
XIII. Effect of Nonrecourse Carve Out Guarantees (AM 2016-001)

A. “Bad boy” events that IRS determined in CCA 201606027 would convert non-recourse loan to become recourse:

1. Failure to obtain lender consent before obtaining subordinate financing.
2. A voluntary bankruptcy petition by borrower.
3. Person in control voluntarily files bankruptcy.
4. Person in control solicits bankruptcy by other creditors.
XIII. Effect of Nonrecourse Carve Out Guarantees (AM 2016-001)

A. “Bad boy” events that IRS determined in CCA 201606027 would convert non-recourse loan to become recourse:

5. Borrower voluntarily joins a bankruptcy action.
6. Person in control consents to an appointment of a receiver or custodian of assets.
7. Borrower makes an assignment for the benefit of the creditors.
XIII. Effect of Nonrecourse Carve Out Guarantees (AM 2016-001)

C. Resolution – IRS issues Advice Memorandum 2016-001

D. If the “bad boy” event is the condition for the occurrence of the event it will not convert the non-recourse financing to recourse.
XVII. Reporting Passive Activity Information to Partners

Some problems with LLC members i.e. active versus passive and IRS answers with a Proposed Reg.

NOTE: The IRS has issued Prop. Reg. 1.469-5(e) after losing several cases involving LLC members and the passive activity rules of IRC Sec. 469. At issue is whether or not LLC members were properly treated as limited partners for purposes of passing the material participation tests. The courts ruled an LLC member is not the same as a limited partner and may in some cases be a general partner when applying the passive activity rules. The new proposed regulations would treat a member as a limited partner (more likely to be passive) if:

1. The entity is classified as a partnership for tax purposes, and
2. The member does not have rights to manage the entity at all times during the tax year.

These rules only apply for purposes of applying the passive activity rules.
XVII. Reporting Passive Activity Information to Partners

Each activity of the partnership MUST be reported on the K-1 in a manner that will allow the partner to separate those activities if necessary.
XVII. Reporting Passive Activity Information to Partners

D. In the event there is a controversy regarding classification Best Practice may demand that a statement be obtained from the partner who is ultimately responsible for the classification on their return.

PLANNING TIP: Grouping of activities often has a tremendous impact on meeting the material participation standard. However, grouping of activities also makes it tougher to meet the “substantial disposition” standard that allows for the deduction of suspended passive losses. Failure to separately report activities can lead to an inadvertent grouping that may harm the partner.
XVIII. Understanding Interaction Between Basis, At Risk and Passive Limits

C. Ordering of Limitations

1. Basis – Is there sufficient basis to claim the losses.

2. At-Risk – Determine if there is sufficient at-risk – In the event the at-risk rules prohibit the deduction the basis is reduced.

3. Passive Activity – If the taxpayer fails the passive activity test the basis and at-risk amounts are reduced to reflect the losses.
XIX. Sources of Further Information

A. PPC's 1065 Deskbook
B. PPC's Tax Planning for Partnerships
C. Mckee, Nelson & Whitmire
D. Federal Taxation of Partnerships & Partners
E. IRS Publication 541, Partnerships
F. IRS Publication 925, Passive Activity and At-Risk Rules

At www.irs.gov
Partnership FAQs
irs.gov/e-file-providers/partnership-faqs
Partnership – Audit Technique Guide
irs.gov/businesses/partnerships/partnership-audit-techniques-guide-atg

19 - Basis and At Risk Rules for Partnerships