

# Current Developments in Partners and Partnerships

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**T**his article reviews and analyzes recent rulings and decisions involving partnerships. The discussion covers developments in partnership formation, foreign source income, debt and income allocations, partnership continuation, and basis adjustments. During the period of this update (November 1, 2007–October 31, 2008), Treasury and the IRS worked to provide guidance for taxpayers on numerous changes that had been made to subchapter K in the past few years. Treasury issued proposed and final partnership regulations about the Sec. 199 deduction, foreign source income, and the substantiality of allocations. The courts and the IRS issued various rulings that addressed partnership operations and allocations.

## **Form 1065**

The IRS has made changes to Form 1065, U.S. Return of Partnership Income, which partnerships use to file their returns. These changes are expected to be effective for tax years ending December 31, 2008. The purpose of the changes was to promote compliance by accurately reflecting the entity's ownership and to minimize the filing burden. To that end, the new forms add additional questions to existing Schedule B, Other Information. The changes focus on partnerships that have complex ownership structures. Form 1065 filers who must file a Schedule M-3, Net Income (Loss) Reconciliation for Certain Partnerships, will also have to provide more information on related-party transactions.

In addition, effective for 2008 tax returns, the extended due date for Form 1065 will be September 15 instead of October 15 (see the discussion below).

## **Recent Tax Law Changes Worker, Retiree, and Employer Recovery Act of 2008**

The Worker, Retiree, and Employer Recovery Act of 2008, P.L. 110-458, included a provision that increases the penalty for failing to timely file a partnership return or failing to file a partnership return that shows the required information from \$85 to \$89 a month, for up to 12 months. The penalty will not apply if the partnership can show reasonable cause for not filing its return or filing a return that does not contain the required information.

## **SBWOTA**

A provision from the Small Business and Work Opportunity Tax Act of 2007<sup>1</sup> (SBWOTA) that affected all taxpayers (including partnerships and their partners as well as tax practitioners) was the expansion of Sec. 6694, under which tax practitioners were required to use a

<sup>1</sup> Small Business and Work Opportunity Tax Act of 2007, P.L. 110-28.

“more likely than not” (MLTN) standard on undisclosed positions. This is in contrast to the “realistic possibility of success” standard that practitioners previously used. The MLTN provision was originally effective for returns prepared after May 25, 2007, and then amended to December 31, 2007. Under this provision, tax preparers were subjected to a higher standard of reporting than taxpayers.

Section 506 of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008<sup>2</sup> significantly revised the tax return preparer penalty rules under Sec. 6694. The effect of the new law depends in large part on the type of tax position under consideration. For tax positions that are not associated with tax shelters and reportable avoidance transactions, the penalty will not apply if there is substantial authority for the position or if the position is disclosed on the tax return and there is a reasonable basis for it. If the position is associated with a tax shelter or a reportable avoidance transaction, the penalty applies unless it is reasonable to believe that the position would more likely than not be sustained on its merits. The new rules for positions on nontax-shelter returns is retroactive to tax returns filed after May 25, 2007, while the new rules for positions related to tax shelters are effective for returns prepared for tax years ending after October 3, 2008.

## AJCA

The American Jobs Creation Act of 2004<sup>3</sup> (AJCA) changed the rules on amortization of organization and start-up costs under Secs. 195 and 709. The AJCA change allows a deduction for the first \$5,000 spent for each type of costs (as long as the total amount spent for each type of cost is \$50,000 or less), with the remainder being amortized over 180 months starting the month the partnership began business. This year Treasury issued regulations<sup>4</sup> that update the way the taxpayer elects to deduct these costs. The

regulations are effective for costs incurred after September 8, 2008.

## TEFRA Issues

In 1982, the Tax Equity and Fiscal Responsibility Act of 1982<sup>5</sup> (TEFRA) was enacted to improve the auditing and adjustment of income items attributable to partnerships. It requires determining the treatment of all partnership items at the partnership level. Two questions that continue to arise under audit are whether an item is a partnership item and what is the correct statute of limitation period. This year there were several cases that addressed both of these issues.

In *Alpha I L.P.*,<sup>6</sup> the taxpayer transferred its interests in a limited partnership (LP) to four charitable remainder trusts (CRTs). One of the assets owned by the LP was marketable securities. After the transfer of the interest, the LP sold the stock for a loss that was allocated to all the members. The IRS issued a final partnership administrative adjustment (FPAA) in which it reduced the LP's basis in the stock. The adjustment's effect was to convert the loss on the sale to a gain. In addition, the IRS determined that the transfer of the LP interests to the CRTs should be disregarded as an economic sham and that the original owners, not the CRTs, should be treated as the members of the LP.

The members contended that the court lacked jurisdiction to consider whether the transfers to the trusts were shams because the transfer was not a partnership item. The IRS argued that the identity of partners in a partnership was a partnership item or at the very least an affected item. The court found that the identity of partners was neither a partnership item nor an affected item and thus was improperly determined in the FPAA because the transfer of an interest has no effect on either the partnership's aggregate or each partner's share of partnership income or loss.

In another case,<sup>7</sup> the only change in an FPAA was the adjustment to a partner's at-risk basis. The partnership asked the court

## EXECUTIVE SUMMARY

- Treasury amended the Sec. 6694 penalties for nontax-shelter transactions.
- The IRS issued three revenue rulings and an announcement regarding interest expense in a trader partnership.
- The Tax Court determined that a deficit restoration obligation does not give rise to at-risk basis.
- Many rulings were issued on TEFRA audits, taxation of partnership income, allocation of contingent liabilities, economic substance, and other areas.
- Effective for 2008 tax returns, the extended due date for Form 1065 will be September 15 instead of October 15.

to reverse the adjustment because the partner's at-risk amount was not a partnership item. The general rule is that the determination of a partner's at-risk amount is not a partnership item but is an affected item. In this situation, the court determined that the FPAA was invalid because the adjustment was the only item in the FPAA and had nothing to do with the calculation of partnership income.

In *Petaluma FX Partners*,<sup>8</sup> a taxpayer contributed offsetting long and short foreign currency options to a partnership. He increased his basis to reflect the contribution of the long options but did not decrease the basis by the liability related to

2 Tax Extenders and Alternative Minimum Tax Relief Act of 2008, part of the Emergency Economic Stabilization Act, P.L. 110-343.

3 American Jobs Creation Act of 2004, P.L. 108-357.

4 T.D. 9411.

5 Tax Equity and Fiscal Responsibility Act of 1982, P.L. 97-248.

6 *Alpha I L.P.*, No. 06-407T (Fed. Cl. 10/9/08).

7 *Russian Recovery Fund Ltd.*, 81 Fed. Cl. 793 (2008).

8 *Petaluma FX Partners LLC*, 131 T.C. No. 9 (2008).

the short options. The partner withdrew from the partnership two months later by receiving cash and marketable securities. The taxpayer reported a loss on the sale of the marketable securities because his basis was not adjusted for contribution of the short options. The IRS later issued an FPAA that treated the partnership as a sham and reduced the basis of all assets in the partnership to zero, eliminating the loss on the stock sale. The taxpayer claimed that the court lacked jurisdiction to consider what he characterized as non-partnership items, including the partner's outside basis. The court ruled that whether the partnership was a sham was a partnership item, so the court had the jurisdiction to determine that the partner's outside basis was zero.

In another case,<sup>9</sup> partners owned various direct and indirect ownership interests in an entity that the IRS claimed had engaged in a son-of-boss transaction, by which a capital gain was restructured as a capital loss. The IRS issued an FPAA to the LP and its partners without giving the notice required by Sec. 6223(a). The taxpayers, who were partners of the LP but were not its tax matters partners, chose to elect out of the partnership-level proceeding in their capacity as indirect partners by mailing certain documents to the IRS.

In filing the petition, they asked the court to strike them from the case as indirect partners in recognition of their having elected out. The court granted them relief and rejected the IRS's claim that the petitioners' election, asserted in connection with their status as indirect partners, was ineffective, instead finding that Sec. 6223 allowed partners holding different partnership interests in the same partnership to make different elections for each interest and that their election was otherwise valid. The court held that the taxpayers' election to opt out in connection with their status as indirect partners conformed to the criteria in Temp. Regs. Sec. 301.6223(e)-2T(c) and was effective.

The issue in the *Bush* and *Shelton* cases<sup>10</sup> (and approximately 30 other cases)

revolved around the interpretation of two sentences in partnership closing agreements. The pertinent sentences allowed losses suspended under Sec. 465 to offset any income earned by the partnership. The suspended losses in question were from passive activities. The taxpayers interpreted the ruling to mean that Sec. 469 would not apply if the partnership created income, so they could offset the suspended passive activity losses against any type of income. The IRS disagreed. The court determined that the sentences in the closing agreement did not explicitly prohibit the application of Sec. 469 and that it was unreasonable to read the closing agreement as allowing the passive partners to use the suspended passive activity losses to offset any type of income.

There were also several cases that concerned the appropriate statute of limitation. In *Salman Ranch Ltd.*,<sup>11</sup> the government contended that the partnership's omission from gross income of an amount in excess of 25% of its reported gross income extended the limitation period for issuing the FPAA. The partnership argued that the extended limitation period did not apply because the alleged overstatement of basis was not an omission from income, and the transaction was adequately disclosed in returns of the partnership and partners.

The court held that the extended limitation period (six years) applied and thus the IRS had timely issued the FPAA. The partnership's gross income included gain that required calculating the excess of the amount realized over adjusted basis; thus, an omission from gross income included an overstatement of the basis figure used to derive the gain. Therefore, the partnership's full report of the amount received from the sale of the ranch did not by itself suffice to preclude an omission from gross income. Further, the returns of the partnership and the partners did not adequately disclose the nature and amount of a short-sale transaction upon which the partnership's step-up basis figure was based.

In *Prati*<sup>12</sup> and 76 similar cases, partners claimed a distributive share of tax deductions from partnerships that the IRS subsequently determined were tax shelters. The partners argued that the IRS did not make the assessments within three years after the tax return was filed. They based this argument on the fact that because the partnership-level settlement they agreed to was executed after the statute of limitation period expired, they had not waived the statute of limitation.

The court disagreed and held that the determination of partnership sham transactions and the extension of the partners' limitation periods were partnership items that should be raised at the partnership level at trial and not on appeal. Thus, the court ruled that the partners' error was that they failed to intervene in the partnership-level proceedings and therefore did not raise the issue of timely assessments with the correct court, so the partners' statute of limitation was extended.

In *Stone Canyon Partners*,<sup>13</sup> a partnership challenged an FPAA issued by the IRS. The taxpayer moved to dismiss the case for lack of jurisdiction on the grounds that the Service had failed to issue a valid FPAA. The IRS had mailed the FPAA to three different parties at three different addresses. The first party the IRS sent the FPAA to was the tax matters partner. The second was the partnership itself, but the address the IRS used was not current because the partnership had never updated its address on its return for the year. The IRS also sent an FPAA to an indirect partner.

The court ruled that by mailing FPAA's to multiple addressees at multiple addresses, the Service had made a good-faith effort to notify all affected parties about the partnership adjustments, thus satisfying the notice requirement. Because the FPAA met the notice requirement, it was valid. With respect to the FPAA mailed to the partnership, the court held that the fact that the Service mailed numerous items to another address that the partnership contended was the proper address did not change this

9 *JT USA LP*, 131 T.C. No. 7 (2008).

10 *Bush*, No. 02-1041T (Fed. Cl. 9/23/08), and *Shelton*, No. 02-1042T (Fed. Cl. 9/23/08).

11 *Salman Ranch Ltd.*, 79 Fed. Cl. 189 (2007).

12 *Prati*, 81 Fed. Cl. 422 (2008).

13 *Stone Canyon Partners*, T.C. Memo. 2007-377.

result. According to the court, the partnership did not follow the procedure in the regulations, and as a result the Service was not obligated to search its records for address information when sending the FPAA.

## Definition of a Partnership

In Secs. 761 and 7701, the term “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 that is not, within the meaning of subtitle A, a corporation, a trust, or an estate. This year in Letter Ruling 200817004,<sup>14</sup> the IRS determined whether an entity should be treated as a partnership. In this instance a state limited liability company’s (LLC) operating agreement provided that items of income, gain, loss, deduction, and credit were to be shared pro rata. Each member contributed cash to the LLC and assigned certain other property to it, in exchange for which the LLC agreed to assume unspecified liability and granted each member a certain interest in the LLC’s capital and profits.

The IRS determined that the LLC was properly treated as a partnership for federal tax purposes and that each member was properly treated as a partner thereof. Based on the definitions of “partnership” in Secs. 761 and 7701, the IRS held that the LLC was properly treated as a partnership for federal income tax purposes, with each member being treated as a partner, and that all the LLC’s expenses in connection with certain litigation were partnership expenses. Finally, the assigned items were properly treated as items of partnership income and gain.

## Types of Partnerships

### Trader Partnerships

This year the IRS and Treasury issued four different rulings regarding expenses in partnerships in the trade or business of trading securities (trader partnerships). The rulings concern fund-to-fund transfers and are limited to the facts in the specific

rulings. In Rev. Rul. 2008-12,<sup>15</sup> the IRS determined that a noncorporate limited partner’s share of partnership interest expense from a trader partnership was subject to Sec. 163(d) limitations on investment interest because a limited partner did not materially participate in the trading activity.

Rev. Rul. 2008-38<sup>16</sup> and Announcement 2008-65<sup>17</sup> allowed investment interest expense flowing through a trader partnership to be subject to Sec. 163(d) limits but to be deductible above the line on Schedule E, Supplemental Income and Loss. In addition, a reasonable allocation of net investment income is required when aggregate interest expenses exceed net investment income of a partnership and the interest expenses were attributable to both (1) property that produces portfolio income for passive activity purposes and (2) the partnership’s trade or business of trading securities for its own account (provided that the partner does not materially participate in the activity).

Finally, Rev. Rul. 2008-39<sup>18</sup> dealt with the treatment of expense deductions in tiered trader partnerships in which the upper-tier partnership was a holding company. Both the upper-tier and lower-tier partnerships paid a management fee. The IRS ruled that an upper-tier partnership’s management fee is not an ordinary and necessary expense but rather an expense for the production of income and is not deductible in computing taxable income, whereas the management fee paid by the lower-tier partnerships is a business expense that is taken into account in computing taxable income.

### Family Limited Partnerships

The IRS and taxpayers have contested transactions related to family limited partnerships (FLPs) for many years. This year in the *Gross* case,<sup>19</sup> a mother and her daughters set up an FLP. The daughters contributed cash and the mother contributed securities. A question arose about when the partnership was formed. The IRS contended that the LP was formed only when the taxpayer and

the daughters executed the partnership agreement, at which time the daughters received their partnership interests and the taxpayer transferred the securities, and that such transactions created indirect gifts of the securities. The taxpayer argued that the partnership was formed when the certificate of partnership was filed, that the taxpayer transferred the stock at a later date, and that the taxpayer subsequently gave the partnership interests to the daughters.

In another loss for the IRS, the court agreed with the taxpayer. Thus, the taxpayer was deemed to have made gifts of the partnership interests to her daughters rather than gifts of the securities. The court ruled that the taxpayer properly applied minority interest, lack of control, and lack of marketability discounts in valuing the gifts. The court also determined that regardless of when the limited partnership was formed, the taxpayer and the daughters formed at least a general partnership with agreed-upon terms by the time the certificate was filed, the taxpayer made stock transfers to the partnership before giving the daughters their partnership interests, and the time periods between the transactions precluded a finding of a single transaction.

### Joint Ventures

Sec. 761(f) allows a husband and wife who own a qualified joint venture to elect out of subchapter K. If the election is made, the joint venture is not required to file a partnership return. Instead, the income and deductions from the joint venture are reported on the husband’s and wife’s individual tax returns. Sec. 761(f) is relatively new, and the IRS is still answering many questions about this type of entity.

In CCA 200816030,<sup>20</sup> the IRS investigated whether the election of qualified joint venture status under Sec. 761(f) for a rental real estate business converted the income derived from the business into net earnings from self-employment when the income would otherwise be excluded

14 IRS Letter Ruling 200817004 (4/25/08).

15 Rev. Rul. 2008-12, 2008-10 I.R.B. 520.

16 Rev. Rul. 2008-38, 2008-31 I.R.B. 249.

17 Announcement 2008-65, 2008-31 I.R.B. 279.

18 Rev. Rul. 2008-39, 2008-31 I.R.B. 252.

19 *Gross*, T.C. Memo. 2008-221.

20 CCA 200816030 (3/18/08).

from the calculation of self-employment income. The Service concluded that if the income is otherwise excluded from self-employment income, the election under Sec. 761(f) will not convert the income into self-employment income.

## Partnership Operations and Income Allocation

Sec. 701 states that a partnership is not subject to tax. Instead, the partnership calculates its income or loss and allocates the amount to the partners. Sec. 702 specifies the items a partner must take into account separately; Sec. 703 provides that a partnership must make any election affecting the computation of the partnership's taxable income. Under Sec. 704(a), the allocation of partnership items is made based on the partnership agreement; however, there are several exceptions to this general allocation rule. Partnership returns are due on the fifteenth day of the fourth month after year end. Partnerships may apply for an extension of time to file the tax return. This year Treasury issued Regs. Sec. 1.6081-5,<sup>21</sup> which changed the extension due date for partnerships. Effective for 2008 tax returns, the extended due date will be September 15 instead of October 15. The change was made to allow individuals additional time to get Schedule K-1s and complete their individual tax returns.

## What Is Ordinary Income?

Sec. 702 requires partners to report in their income their share of the partnership's taxable income or loss. Regs. Sec. 1.702-1(a) provides that each partner is required to take into account his or her share of income or loss, whether or not distributed. In *Imprimis Investors LLC*,<sup>22</sup> an investment partnership and a venture capital partnership entered into both an LLC agreement and a consulting agreement. Disputes arose out of these agreements, resulting in litigation.

Issues in the disputes concerned whether the allocation of partnership tax items of ordinary income included short-term capital gains. Under the agreement,

the LLC was required to allocate an amount of ordinary income to the venture capital partner. In making this allocation, the LLC treated short-term capital gains (STCGs) as ordinary income. The venture capital partnership disagreed with treating the STCGs as ordinary income and reported an inconsistent treatment of the LLC's capital gains. Sec. 702 states in part that "the character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share be determined as if such item were realized directly from the source from which realized by the partnership."

The IRS argued that under Sec. 702 the term "items of ordinary income" does not include capital gains. Therefore, the court concluded that the LLC agreement provided a special allocation of ordinary income and did not provide a special allocation of capital gains. Thus, the allocation made by the LLC treating STCGs as ordinary income was inappropriate.

## Sec. 704(b) Allocations

Sec. 704(b) allows a partnership to make special allocations as long as they have substantial economic effect. This year Treasury issued final regulations under Sec. 704(b)<sup>23</sup> that provide rules for testing whether an allocation's economic effect is substantial within the meaning of Sec. 704(b) where partners are lookthrough entities or members of a consolidated group.

The regulations generally provide a lookthrough rule for testing an allocation's substantiality. In determining the after-tax economic benefit or detriment of a partnership allocation to any partner that is a lookthrough entity, the lookthrough rule takes into account the tax consequences resulting from the interaction of the allocation with the tax attributes of any owner of the lookthrough entity.

Similarly, in determining the after-tax economic benefit or detriment to any partner that is a member of a consolidated group, the regulations generally provide that the tax consequences resulting from the interaction of the allocation with the

tax attributes of the consolidated group and with the tax attributes of another member for a separate return year must be taken into account. The regulations state that a lookthrough entity means a partnership, subchapter S corporation, trust, entity disregarded for federal tax purposes, or certain controlled foreign corporations.

## Sec. 704(c) Rulings

Sec. 704(c) requires that a partnership must allocate items of income, gain, loss, and deduction attributable to contributed property to take into account any variation between the property's adjusted tax basis and its fair market value (FMV) at the time of contribution. Regs. Sec. 1.704-3(a) permits the use of any reasonable allocation method that is consistent with the purposes of Sec. 704(c).

This year Treasury issued proposed regulations under Sec. 704(c).<sup>24</sup> The proposed regulations provide that Regs. Sec. 704-3(a)(10) (the Sec. 704(c) anti-abuse rule) takes into account the tax liabilities of both the partners in a partnership and certain direct and indirect owners of such partners. The proposed regulations also provide that an allocation method cannot be used to achieve tax results inconsistent with the intent of subchapter K.

## Allocation to Foreign Partners

Final regulations<sup>25</sup> were issued that provide rules on when a partnership may consider certain deductions and losses of a foreign partner to reduce or eliminate the amount of the partnership's withholding tax obligation under Sec. 1446 on effectively connected taxable income allocable to the partner under Sec. 704. The regulations will affect partnerships engaged in a trade or business in the United States that have one or more foreign partners. The final regulations also include conforming amendments to Regs. Secs. 1.1446-3 and 1.1446-5 and to the regulations under Sec. 1464.

## Allocation of Liabilities

Sec. 752(a) provides that any increase in a partner's share of a partnership's

21 T.D. 9407.

22 *Imprimis Investors LLC*, No. 07-209T (Fed. Cl. 8/7/08).

23 T.D. 9398.

24 REG-100798-06.

25 T.D. 9394.

liabilities, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, is considered as a contribution of money by such partner to the partnership and will thus increase the partner's outside basis. Likewise, Sec. 752(b) provides that any decrease in a partner's share of the partnership's liabilities, or any decrease in a partner's individual liabilities by reason of the partnership's assumption of such individual liabilities, is considered as a distribution of money to the partner by the partnership.

In *Marriott International Resorts*,<sup>26</sup> the taxpayer claimed a tax loss on the sale of mortgage notes. The loss was a result of a series of transactions entered into by Marriott-affiliated entities with the intention of recognizing a tax loss based upon the premise that the obligation to close a short sale is not a liability for partnership tax basis purposes under Sec. 752. The IRS disallowed the claimed loss, contending that the partnership was required to include in its basis the short-sale obligations it assumed because the obligation to replace borrowed securities was a legal liability secured by the short sale, and the proceeds from the short sale quantified the amount of liability.

The partnership argued that the ultimate cost of closing the short sale could not be determined until the short seller purchased the replacement securities, and the obligation thus was not fixed in amount and so was not a liability under Sec. 752. The court held that the IRS properly adjusted the outside basis of the partners of the partnership to reflect the partnership's obligation to return the borrowed securities. The cash received in the short sale was an asset of the partnership, the basis of the partnership's assets was increased by those receipts, and symmetrical treatment called for recognition of the corresponding obligation to replace the borrowed securities. In other words, if contribution of the short-sale proceeds increased the partners' outside basis, the contribution of the obligation to return the securities that

were sold short required a decrease in the partners' outside basis. Thus, the taxpayer was not allowed to deduct the loss on the sale of the mortgage notes.

In *Jade Trading LLC*,<sup>27</sup> three taxpayers simultaneously purchased and sold a euro option by paying the difference between the purchase and the sales prices. Each taxpayer contributed the option spread to an LLC, claiming a basis in the LLC interest equal to the option's purchase price. This treatment ignored the premium for the sold call option. The artificially high basis generated a loss almost 30 times higher than the net investment.

At issue in the case was whether the spread transaction contributed to the LLC lacked economic substance such that it should be disregarded. The taxpayers argued that contingent obligations did not constitute liabilities under Sec. 752 for purposes of calculating a partner's basis. According to a literal translation of tax law, the taxpayer was correct. However, the court stated that the legitimacy of a transaction for tax purposes was not guaranteed merely because a technical interpretation of the Code would support the tax treatment. Instead, the transaction must be examined to determine if it meets the economic substance test.

The court held in this case that the transaction's fictional loss, the lack of investment character with the options, the meaningless inclusion in a partnership, and the disproportionate tax advantage compared with the amount invested all pointed to the fact that the transaction lacked economic substance. Thus, the taxpayer must take into consideration the premium for the sold call option when computing basis and will not be allowed to deduct the loss falsely created by the transaction.

### Discharge of Indebtedness Income

The AJCA amended Sec. 108(e)(8) to include discharge of indebtedness income. This year proposed regulations<sup>28</sup> were issued relating to the application of Sec. 108(e)(8) to partnerships and

their partners. These regulations provide guidance on the determination of discharge of indebtedness income of a partnership that transfers a partnership interest to a creditor in satisfaction of the partnership's indebtedness (a debt for equity exchange). The proposed regulations also provide that Sec. 721 applies to a contribution of a partnership's recourse or nonrecourse indebtedness by a creditor to the partnership in exchange for a capital or profits interest in the partnership.

### Like-Kind Exchanges

Sec. 1031 allows a taxpayer to defer the gain or loss on an exchange of like-kind property. Under Sec. 1031(a)(2)(D), the nonrecognition provisions of Sec. 1031 do not apply to the exchange of a partnership interest. However, a partnership can benefit from the like-kind exchange rules for partnership property. This year the Service ruled on several situations in which partnerships engaged in a like-kind exchange.

In Letter Ruling 200826005,<sup>29</sup> the taxpayers owned an undivided interest in several properties. Each of the properties was governed by a tenants-in-common agreement under which an affiliate of each taxpayer owned an undivided 50% interest in the properties. The taxpayers wanted to enter into a like-kind exchange and wanted to know if the ownership of the property as tenants in common would constitute a partnership interest. The IRS concluded that an undivided fractional interest in the properties would not constitute an interest in a business entity because

1. The co-ownership agreements provided that any sale or lease of the property, any creation of a blanket lien, and the hiring of a manager required the approval of the respective co-owners;
2. The co-owners' activities were limited to those customarily performed in connection with the maintenance of rental real property; and
3. The buy-sell procedure, in which the co-owners were unrelated and dealing

26 *Marriott Int'l Resorts*, No. 01-256T (Fed. Cl. 8/28/08).

27 *Jade Trading LLC*, 80 Fed. Cl. 11 (2007).

28 REG-164370-05.

29 IRS Letter Ruling 200826005 (3/17/08).

at arm's length, was consistent with establishing a right to acquire 50% of the property at FMV. Thus, the nonrecognition treatment under Sec. 1031 would apply to an exchange of like-kind property. A similar ruling can also be found in Letter Rulings 200829012 and 200829013.<sup>30</sup>

In another instance,<sup>31</sup> an LP wanted to exchange rental property the partnership owned for like-kind property owned by another partnership. As part of the agreement, the LP agreed to acquire all the interests of the other partnership. In addition, the LP planned to form a new LLC that would be the LP's new general partnership. The IRS determined that the exchange of the rental property for all the interests in the other partnership would qualify under Sec. 1031. Thus, the LP could defer any gain on the transaction. The Service also ruled that the replacement property could be held by a newly created disregarded entity without violating the Sec. 1031 rule that the replacement property must be held by the same taxpayer.

Likewise, in Letter Ruling 200812012,<sup>32</sup> a testamentary trust held an interest in an LLC. The LLC entered into a reverse like-kind exchange under Sec. 1031. The terms of the decedent's will mandated that the trust terminate on a specific date some time later. When the trust terminated, the assets in the LLC were distributed and the LLC was deemed to terminate under Sec. 708(b)(1)(B). In this instance, the Service did not rule on whether the exchange qualified under Sec. 1031, but it did rule that the distribution of assets because of the LLC's termination did not violate the rule that the replacement property had to be held by the same taxpayer, assuming the property is held for the same purpose.

In a different situation,<sup>33</sup> a partnership planned to transfer Sec. 704(c) property in a like-kind exchange. In addition, the partnership would receive cash (boot) that would require recognition of gain. Because the property exchanged was

Sec. 704(c) property, the partnership planned to first allocate a taxable gain to the partners equal to their share of book gain, then to the extent the gain exceeded the book gain to reflect the allocation of postcontribution gain in the exchanged property. The IRS found that this allocation method preserved in full any remaining built-in Sec. 704(c) gain in the replacement property and was the appropriate adjustment.

### Losses

Three items determine whether a partner can deduct his or her share of partnership losses:

- Partnership interest basis under Sec. 704(d);
- Sec. 465 amount at risk; and
- Sec. 469 passive activity income.

Last year in *Hubert Enterprises, Inc.*,<sup>34</sup> the taxpayer, a corporation, owned interests in an LLC. The LLC amended its operating agreement to include a deficit restoration obligation (DRO) that obligated the members of the LLC to satisfy any negative balances in their capital accounts upon liquidation. The taxpayer took the position that the DRO created a liability that increased the members' basis and at-risk basis. Therefore, the taxpayer deducted the loss allocated to it from the LLC. The IRS and the Tax Court disagreed, stating that if the DRO created a liability it was contingent on the LLC member's liquidation of its interest; because the taxpayer did not liquidate its interest, it could not be at risk for that amount, and so the loss was disallowed. The taxpayer appealed to the Sixth Circuit.

The appellate court determined that the Tax Court did not address whether economic circumstances beyond the LLC members' control might force liquidation of their interests, so the DRO might cause the LLC members to become liable for a portion of the LLC's debts. Thus, the appellate court vacated the Tax Court decision and remanded the case back to the Tax Court to allow the parties to develop a better record so the Tax Court could determine if the

DRO rendered the taxpayer the "payor of last resort," which would create at-risk basis for the member.

This year the Tax Court<sup>35</sup> determined that the DRO did not render the taxpayer personally liable for the debt. The court found that the person who bore the risk of loss on a default of the LLC's recourse debt was in fact the creditor, not the LLC members. Thus, the debt did not increase the taxpayer's basis and the taxpayer was not allowed to deduct the loss.

Sec. 469 allows taxpayers to group certain passive activities when determining total passive activity income or loss. Notice 2008-64<sup>36</sup> includes a proposal for reporting requirements for groupings under Sec. 469. Under the proposal, taxpayers would be required to report information about their groupings in a statement filed with the taxpayer's annual tax return. Taxpayers would be required to disclose their groupings (1) the first year activities are grouped; (2) when there is an addition to the grouping; (3) when there is a disposition of an activity of a grouping; and (4) when a regrouping is required.

### Economic Substance

A basic principle of tax law is that taxpayers are entitled to structure their business transactions in a manner that produces the least amount of tax. However, business transactions must have economic substance. For a transaction to have economic substance, it must have a reasonable possibility of a profit and there should be a tax-independent business purpose behind the transaction. The IRS has recently been very diligent in examining transactions that it considers to lack economic substance.

In *Stobie Creek Investments*,<sup>37</sup> on the advice of tax professionals, taxpayers purchased foreign currency options through single-member LLCs and transferred the options and certain stock to a newly formed partnership. They then transferred the partnership interests to single-member

30 IRS Letter Rulings 200829012 and 200829013 (3/17/08).

31 IRS Letter Ruling 200807005 (11/9/07).

32 IRS Letter Ruling 200812012 (12/19/07).

33 IRS Letter Ruling 200829023 (4/16/08).

34 *Hubert Enters., Inc.*, 230 Fed. App'x 526 (6th Cir. 2007).

35 *Hubert Enters., Inc.*, T.C. Memo. 2008-46.

36 Notice 2008-64, 2008-1 I.R.B. 268.

37 *Stobie Creek Investments, LLC*, 82 Fed. Cl. 636 (2008).

S corporations. The ultimate goal of the transaction was to step up the basis of the assets, thereby reducing the capital gain on the sale of the assets.

The IRS disregarded the partnership as a sham, disallowed the stated basis of the stock because it was attributable to a tax avoidance transaction, and increased the partnership's capital gain income from the stock sale. The court concluded that the adjustments were proper even though the partners' calculation of basis complied with the literal requirements of the Code. The court determined that the partners failed to show that any of the transactions undertaken as part of the investment strategy had economic substance beyond creating a tax advantage. Thus, the transactions constituted a tax shelter and substantial authority did not support the plaintiffs' claimed tax treatment. The partnership failed to establish that its reliance on the advice of professionals was reasonable.

The *7050 Ltd.* case<sup>38</sup> involved an investment in an alleged son-of-boss tax shelter. The partnership was at the center of a complicated series of tax-reduction transactions. The desired tax results of the transactions hinged on a distribution to the partnership's tax matters partner (TMP) being considered a "distribution in liquidation of his partnership interest" under Sec. 732(b) (which would entitle the TMP to claim a much higher basis in the distributed property).

Whether the distribution was a liquidating distribution in turn hinged on whether the partnership terminated at the time of the distribution. However, when the partnership made this distribution to the TMP, it did not distribute all of its assets, leaving behind a few thousand Canadian dollars in an interest-bearing account for two more years. Therefore, the IRS claimed, the partnership had not terminated at the time of the distribution and consequently the tax matters partner did not receive a liquidating distribution.

The court considered whether an inactive currency account was a continuation of the partnership's business activity or a part of its winding up. Based on prior case law, the court found that this minimal activity was enough to have kept the partnership in existence. The tax matters partner's interest in the partnership was therefore not liquidated for purposes of Sec. 761(d) until the later date, and he was unable to take advantage of the Sec. 732(b) basis rule.

## Distributions

Under Sec. 731(a), partners will recognize a gain to the extent they receive cash in excess of their basis in their partnership interests. Sec. 731(c)(1) provides that the term "money" includes marketable securities, which are to be taken into account at FMV as of the distribution date. "Marketable securities" refers to financial instruments that are, as of the date of distribution, actively traded and includes:

1. Any financial instrument that, under its terms or any other arrangement, is readily convertible into, or exchangeable for, money or marketable securities; and
2. Interests in any entity if substantially all the entity's assets consist (directly or indirectly) of marketable securities.

In *Countryside Limited Partnership*,<sup>39</sup> the partnership distributed nonmarketable notes that had been contributed to the partnership the prior year in redemption of the partners' limited partnership interests. The question was whether the partnership's deemed purchase and distribution of the notes could be disregarded for lack of economic substance, with the result that the liquidating distribution would be treated as equivalent to a cash distribution. The court ruled that although the transaction was designed to avoid recognition of gain to the partners, the distribution served a genuine, nontax, business purpose (i.e., to convert the partners' investments into 10-year promissory notes—two economically distinct forms of investment). The fact that

the issuer of the notes was willing to consider a modification or repurchase of the notes did not constitute evidence of an arrangement to convert the notes into cash or marketable securities, thus making them marketable securities under Sec. 731(c)(2)(B)(ii), because it would have been standard business practice for a bank or financial institution to at least consider a customer's request to modify the terms of its notes. Thus, the partner did not have to report a gain on the distribution.

Under Sec. 731(c)(3), Sec. 731(c)(1) does not apply if the securities were contributed by the same partner that is receiving the distribution. In Letter Rulings 200824005 and 200824009,<sup>40</sup> a trust formed a limited partnership, a disregarded entity. To form the partnership, the trust transferred stock and interests in an investment fund. After the death of the income beneficiary, the trust distributed a portion of its interest to its remainder beneficiary. However, in this situation the IRS ruled that the distributed property was contributed by the recipient partner, so there was no gain on the distribution.

## Sec. 754 Election

When a partnership distributes property or a partner transfers his or her interest, the partnership can elect under Sec. 754 to adjust the basis of partnership property. A Sec. 754 election allows a step-up or step-down in basis under either Sec. 734(b) or 743(b) to reflect the FMV at the time of the exchange. This election has the advantage of not taxing the new partner on gains or losses already reflected in the purchase price of his or her partnership interest. The election must be filed by the due date of the return for the year the election is effective and normally is filed with the return. If a partnership inadvertently fails to file the election, it can ask for relief under Regs. Secs. 301.9100-1 and -3.

In several rulings this year,<sup>41</sup> the IRS granted an extension of time to make a Sec. 754 election. In each case, the partnership

38 *7050 Ltd.*, T.C. Memo. 2008-112.

39 *Countryside Ltd. Partnership*, T.C. Memo. 2008-3.

40 IRS Letter Rulings 200824005 and 200824009 (3/6/08).

41 IRS Letter Rulings 200838006 (6/10/08), 200832014 (5/7/08), 200826027 (3/11/08), and 200806001 (11/5/07).

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was eligible to make the election but inadvertently omitted the election when filing its return. The Service reasoned that the partnership in each case acted reasonably and in good faith, and they granted an extension to file the election under Regs. Secs. 301.9100-1 and -3. In these rulings, each partnership had 60 days after the ruling to file the election. In another ruling,<sup>42</sup> the partnership was granted an extension to file a Sec. 754 election, but the extension period was only 30 days. In several situations,<sup>43</sup> the partnership was granted an extension to file the Sec. 754 election because its tax professional had failed to advise it of the election.

In several other instances this year,<sup>44</sup> a partner died and the partnership failed to file a timely Sec. 754 election for an optional basis adjustment. As with the other rulings, the Service concluded that it was an inadvertent failure and granted the partnership a 60-day extension to file the election.

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### EditorNotes

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42 IRS Letter Ruling 200815008 (1/9/08).

43 IRS Letter Rulings 200817026 (1/14/08) and 200827031 (3/14/08).

44 IRS Letter Rulings 200838019 (2/13/08), 200827020 (3/21/08), 200825002 (2/2/08), and 200820001 (2/1/08).