

PARTNERSHIP TAX TRAPS FOR REAL PROPERTY DEVELOPERS

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INTRODUCTION

The partnership form of doing business is now the preferred form for doing business, particularly after the adoption of the limited liability company (LLC) statutes. The partnership form of doing business provides the greatest tax flexibility in structuring a capital formation and profit sharing arrangement among the partners. The flexibility permitted with partnerships is generally not available to a business using the corporate form, including Subchapter S. The greater flexibility creates income tax complexity in order to insure that the taxation of partnership transactions will be consistent with and properly reflect the financial impact of the same transaction. The flexibility of partnership arrangements provides numerous planning opportunities and some unexpected consequences, especially in connection with partnership contributions or distributions.

It is important that the potential tax consequences with respect to the organization and operation of the partnership be reviewed with the partners in order to avoid any unexpected surprises. This article is intended to generally cover six areas of partnership taxation that can trap tax practitioners absent appropriate guidance.

PARTNERSHIP TAX TRAP ONE

SECTION 752 CONSTRUCTIVE DISTRIBUTIONS

Under § 752(a), each partner is treated **as contributing cash** to the partnership in an amount equal to any **increase** in her share of partnership liabilities. This will necessarily include the partner's initial share of partnership liabilities upon formation of the partnership. In combination with § 722, this has the effect of increasing the partner's outside basis by the amount of such increase.

Correspondingly, under § 752(b), a partner is treated as having received a **distribution of cash** from the partnership in an amount equal to any **decrease** in her share of partnership liabilities. In combination with § 733, this decrease has the effect of reducing the partner's outside basis (but not below zero) by the amount of the distribution. To the extent that the deemed "cash" distribution exceeds the partner's outside basis, the partner must recognize gain. IRC § 731.

This "constructive" distribution of cash can result in an unexpected gain to a partner. Examples of partnership transactions in which a constructive cash distribution may occur because of changes in either partnership or partner individual share of liabilities are as follows:

1. Contribution of encumbered property.
2. Admission of a new partner.
3. Change in debt terms (recourse for nonrecourse debt).
4. Abandonment or withdrawal by a partner from the partnership.
5. Reduction of a partner's interest in the partnership.
6. Reduction in liabilities.

An analysis of each of these examples is beyond the scope of this article. Thus, below we will focus on (1) contributions of encumbered property, (2) admission of new partners and (3) changes in debt terms (recourse mortgage refinanced with non-recourse debt).

Note that the concept of "economic risk of loss" is central to the regulations under § 752. Identifying the partner who bears the economic risk of loss associated with a partnership liability serves two essential purposes. First, it is used to characterize a liability as recourse or nonrecourse: if the economic risk of loss associated with the liability is borne by one or more of the partners, the liability is characterized as recourse. If no partner bears the economic risk of loss associated with the liability, then the liability is nonrecourse. Second, partners share partnership recourse liabilities for basis purposes in the same way that they share the economic risk of loss associated with that liability. Reg. § 1.752-2(a). Under the § 752 regulations a partner's share of partnership nonrecourse liabilities is determined under a sharing arrangement set forth in the regulations.

A. Contribution of Encumbered Property

When a partner contributes encumbered property to a partnership, the partnership replaces the partner as the obligor on the loan. Thus, the contributing partner is simultaneously relieved of her personal liability on the loan, and as a partner becomes responsible for a share of all of the partnership's liabilities, including the liability encumbering the contributed property. This results in both a decrease and an increase in the contribution partner's share of liabilities. These adjustments are deemed to occur simultaneously and only the net change is taken into account. Reg. § 1.752-1(f).

Section 752 treats changes in a partner's share of partnership liabilities as cash transactions: when there is a net increase in a partner's share of partnership liabilities, she is treated as having made a cash contribution in the amount; when there is a net decrease in her share of these liabilities, she is treated as having received a cash distribution. These rules have two important consequences: (i) a partner's outside basis reflects her share of partnership liabilities, and (ii) under some circumstances, the "deemed" cash distribution which occurs on the contribution of encumbered property may result in recognition of gain.

Example: A and B form an equal partnership, AB, in which they will share all income, gain, and loss equally. A contributes land with a fair market value of \$200 on which there is a recourse mortgage of \$180, which AB assumes (net equity of \$20). At the time of the contribution, A's basis in the land is \$20. B contributes \$20 cash. Assume that under § 752 the mortgage is allocated equally to A and B.

In this transaction, as a result of the assumption by the partnership of the \$180 mortgage, B's share of the partnership liabilities increases from \$0 to \$90. This amount is treated as a cash contribution. Therefore, B's outside basis under § 722 is equal to \$110 (\$20 cash contributed plus \$90 net increase in liabilities).

A, on the other hand, has a net decrease in partnership liabilities of \$90. Although the assumption by AB of the \$180 mortgage is treated as a decrease of \$180 in her individual liabilities, A is given tax basis credit for her share of the partnership liability of \$90. However, A's tax basis in the land contributed was only \$20 and, the deemed cash distribution of \$90 exceeded her basis by \$70, resulting in a \$70 gain and a zero (0) outside basis. §§ 731(a) and 733.

Cash "Constructively" Received by A:

Debt Transferred to Partnership	\$180
Less: Partner A's Share of Debt	(90)
Net "Constructive" Cash Distribution to A	\$ 90

Basis of Partner A in Partnership:

Basis of Property Contributed	\$ 20
<u>Less:</u> Net "Constructive Cash" Distributed to A	<u>(90)</u>
Gain Recognized by A	<u>\$ 70</u>
Remaining Basis in Partnership	\$ -0-

B. Admission of New Partner

As discussed above, the admission of new partners may afford such partner an allocable share of partnership liabilities, which triggers deemed cash distributions to the other partners to the extent of their reductions in share of partnership liabilities and possible gain recognition resulting under §731. Although generally this is capital gain, it may be converted to ordinary income under §751(b) to the extent that the distribution is deemed to be made for the distributee's interest in partnership "hot assets."

Example: Partners A and B own a 100% interest in AB partnership. Partner C is admitted to a 40% interest in capital and profits. Partner C pays \$300,000 cash directly to the partnership as his capital contribution. Recourse liabilities of the partnership are \$1,000,000 of which C assumes 40%. The \$300,000 cash contribution is subsequently used to pay down the recourse loan to \$700,000. Immediately prior to Partner C's admission, Partners A and B each have deficit capital accounts of \$400,000 from prior allocations of partnership losses.

The aggregate basis of Partner A & B before the "deemed" cash distribution is computed as follows:

Partner A & B Share of liabilities	\$1,000,000
Less: Partnership losses to date	<u>(800,000)</u>
Partner A & B Partnership Basis	<u>\$ 200,000</u>

Computation of Gain to A & B:

Partner A & B Partnership Basis	\$200,000
Constructive Deemed Distribution of Cash Deemed Contributed by C (40% x \$1,000,000)	<u>(400,000)</u>
Taxable Gain	<u>\$200,000</u>

Partners A & B have a zero basis in their partnership interests following the admission of Partner C.

When the recourse loan is paid down with the proceeds of the capital contribution by \$300,000, the original partners will realize an **additional gain** of \$180,000 (60% of \$300,000). The original partner's share of the recourse debt has been reduced, therefore, there is a constructive distribution of cash under Section 752 of 60% of the debt reduction or \$180,000. The constructive distribution exceeds

their basis in the partnership which is zero. In addition, unless Partner A & B agree to a "restoration obligation," Section 704(b) will require the next \$300,000 in losses be allocated to Partner C because he would bear the economic risk of loss with respect to those losses.

C. *Change in Nature of Partnership Debt.*

EXAMPLE: A limited liability company has a \$1,000,000 recourse mortgage that has matured and must be refinanced. The manager was the only person personally liable on the mortgage pursuant to a personal guaranty. He is able to refinance the mortgage with a nonrecourse mortgage. There are a total of ten members (one of which is also the manager). Each member has a 10% share of profit and losses. Previously, the LLC had \$190,000 of losses.

Each member originally contributed \$5,000 to the LLC. Even though the partnership agreement states that profits and losses are to be shared equally, the members, other than the manager, could not be allocated losses in excess of the capital contribution under the limitations of Section 704(b) because the manager bears the economic risk of loss with respect to the losses in excess of capital contributed. Therefore the manager was allocated \$145,000 in losses and the other nine (9) members were allocated losses of \$5,000 each.

ANSWER:

Computation of Basis Before Refinance

	<u>Manager</u>	<u>Members</u>
Capital Contribution	\$ 5,000	\$ 45,000
Share of Recourse Debt	1,000,000	-0-
Loss Allocations	<u>(145,000)</u>	<u>(45,000)</u>
Partnership Basis	<u><u>\$860,000</u></u>	<u><u>\$ -0-</u></u>

Gain Computation

	<u>Manager</u>	<u>Members</u>
Partnership Basis	\$ 860,000	\$ -0-
Increase in Liabilities (10% x \$1,000,000)	\$ 100,000	\$ 900,000
Decrease in Liabilities	<u>(\$1,000,000)</u>	<u> </u>
Gain	<u>\$ 40,000</u>	<u>\$ -0-</u>

PARTNERSHIP TAX TRAP TWO DISGUISED SALES

A. Background. Prior to 1984 taxpayers were able to use a partnership planning tool to delay or avoid taxation on sales of property to partnerships. By combining a contribution of property with a distribution of cash to the contributing partner, the economic substance of a sale could be realized without current taxation to the seller as the contributing partner, provided that the form of the transaction was respected. As can be imagined, this infuriated the Internal Revenue Service so much that it led to a number of court cases, most of which led to taxpayer victories. This was the case because generally contributions of property to and distributions of property from partnerships are not taxable to the partnership or its partners. Conversely, if the seller contributing partner received allocations of partnership taxable income under 704(b), the remaining partners would achieve the effect of a deduction for the purchase price of the property.

Long standing regulations have stated that the contribution of property followed by a distribution would be taxed as a sale if that was the economic substance of the transaction. Nevertheless, despite this economic substance language, taxpayers continued to prevail in the courts. One particular example which raised the ire of not only the IRS, but eventually Congress, was the case of J. H. Otey. *See J. H. Otey, Jr.*, 70 TC 312 affd per curiam 634 F.2d 1046 (CA-6, 1980). In that case, the taxpayer, Mr. Otey, formed a partnership with another party to construct FHA financed housing on property owned by the taxpayer. The taxpayer contributed his property to the partnership at an agreed value of \$65,000, while the other party contributed no capital but instead used his credit worthiness to obtain a construction loan for the partnership. Problems arose, however, when the amount of the construction loan was greater than needed for the construction. As a result, the taxpayer received a distribution from the partnership for the first \$65,000 of proceeds from the construction loan within six months after the formation of the partnership. The court held that the contribution of property to the partnership and the partner's distribution of cash were tax free and did not constitute a taxable sale.

B. Enactment of Code § 707(a)(2) and the Property Regulations. In the face of *Otey* and other cases like it, Congress stepped in and enacted Internal Revenue Code ("Code") § 707(a)(2) in 1984. This provision, which was effective for transfers after March 31, 1984, recharacterized transactions involving the contribution of property to a partnership and distributions of property from a partnership as one of two types of sale or exchange transactions. The first type was an exchange of property between a partner and a partnership and the second was the sale or exchange of a partnership interest from one partner to another.

In 1991 regulations were finalized in connection with property transactions (the "Property Regs"). Finally, the IRS presented final regulations regarding disguised sales of partnership interests under Reg. § 1.107-7 (the "Interest Regs"). This article will not address the Interest Regs, but instead will focus on the Property Regs. Note, however, that there are vast similarities between the Property Regs and the Interest Regs.

The focus of the Property Regs is on the facts and circumstances of a particular transfer. Specifically, the transfer of property by a partner to a partnership and the partnership's transfer of money or consideration to the partner may constitute a sale of the property in whole or in part

by the contributing partner to the partnership, but only if based on all the facts and circumstances “(i) the transfer of money or other consideration would not have been made but for the transfer of property and (ii) in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent upon the entrepreneurial risk of the partnership operation.” Reg. § 1.707-3(b)(1) (emphasis added).

Further, the regulations do not focus on the order of the transfer, but rather establish a **two-year** window in which any transfers occurring within that window are presumed to be a disguised sale. Note that if a transfer occurs within **two years**, the burden of proof that the transfer is not a disguised sale rests with the taxpayer. In other words, cash distributions during the **two year window** are presumed to be "disguised sales." However, if a transfer occurs beyond a two-year period, the burden of proof rests with the IRS. See further discussion below regarding burden of proof.

EXAMPLE: Partners A and B form an equal partnership. Partner A contributes property having a fair market value of \$100 and an adjusted basis of \$50. Partner B contributes \$50 in cash. Partners A and B have capital accounts of \$100 and \$50, respectively. The partnership agreement provides that, in order to eliminate the capital account disparity, Partner A is entitled to receive the first \$50 of cash distributions. Shortly after the formation of the partnership, A receives as a distribution the \$50 in cash contributed by Partner B.

ANSWER: If the form of the transaction is respected, Partner A recognizes no gain. Under Section 721, no gain is recognized on the transfer of the property to the partnership. Partner A’s basis in his partnership interest is \$50 (Section 722). Under Section 731, Partner A recognizes no gain upon the receipt of the \$50 cash distribution, because it does not exceed the basis of his partnership interest. However, another way of viewing the transaction is that Partner A sold a one-half interest in the property to Partner B or to the partnership for \$50, and contributed the remaining one-half interest to the partnership. In that case, Partner A would recognize gain of \$25.

EXAMPLE: A and B each contribute \$50,000 to the ABC partnership and C contributes property with a fair market value of \$150,000, but a basis of \$100,000. ABC Partnership distributes the \$100,000 in cash to C.

ANSWER: C ends up in the same economic position as if he had sold a 2/3 interest in the property for \$100,000; however, C would argue that no gain is recognized under Section 731 since the cash received from the partnership of \$100,000 does not exceed his basis in the partnership which is \$100,000 under Section 722. However, the Service would hold under the authority of the regulations under Section 707 that C has realized a taxable gain of \$33,333 (2/3 of \$50,000).

C. Facts and Circumstances Test. The determination of whether a contribution/distribution or allocation transaction should be recharacterized as a sale is based on a “facts and circumstances” test. The proposed regulations contain a nonexclusive list of ten facts and circumstances that tend to prove the existence of a sale. The ten facts and circumstances contained in Regulation § 1.707-3(b)(2)(i)-(x) are as follows:

1. Whether the time and amount of the subsequent transfer are determinable with reasonable certainty.
2. Whether the transferor has a legally enforceable right to the subsequent transfer.
3. Whether the transferor’s right is secured.
4. Whether another person is legally obligated to make contributions in order to fund the subsequent transfer to the contributing partner.
5. Whether a person has loaned or has agreed to loan money to fund the subsequent transfer, and whether such agreement is subject to conditions relating to partnership operations (the “entrepreneurial risk” test).
6. Whether the partnership has incurred or is obligated to incur debt to fund the subsequent transfer, taking into account the likelihood that the partnership will be able to incur the debt (including whether another person has agreed to guarantee or assume personal liability for that debt).
7. Whether the partnership holds money or other liquid assets beyond the reasonable needs of the business that are expected to be available to fund the subsequent transfer.

8. Whether partnership distributions, allocations or control provisions are designed to effect an exchange of the burdens and benefits of ownership of partnership property.
9. Whether the subsequent transfer is disproportionately large in relation to the partner's general and continuing interest in the partnership profits.
10. Whether the transferor partner has an obligation to return or repay the money or other consideration received in the subsequent transfer, or if he has such an obligation, whether that obligation is likely to become due only at a distant point in the future.

Note that all ten factors tend to prove the existence of a sale; none tends to disprove its existence. On their face, at least, these factors may only be used by the government to rebut a presumption that a sale did not occur. The regulations indicate, however, that the absence of these factors may be used by a taxpayer to rebut the presumption that a sale did occur. Reg. § 1.707-3(f) Ex. 3. Nevertheless, one is left with the clear impression it will be easier for the government to successfully argue that a sale has occurred even though the transfers were more than two years apart (see further discussion on the two-year rule below) than it will be for taxpayers to argue that a sale has not occurred even though both transfers occurred within two years. Also note that the first seven factors all go to the same issue: The extent to which the contributing partner's capital is subject to the entrepreneurial risk of the partnership.

D. "But For" Test. In order to fall within § 707(a)(2), the facts and circumstances must show that the transfer from the partnership to the partners would not have been made "but for" the transfer from the partners to the partnership. This test is relatively straightforward and requires the contribution and distribution to be reciprocal transfers, each in consideration of the other. In the case of a simultaneous transfer, this is the only condition that must be met. All simultaneous transfers are automatically highly suspect, and most will be recharacterized as sales.

Example: Partner E is a 50% partner of a partnership that owns Parcel 1 with a FMV of \$500,000 and Parcel 2 with a FMV of \$1,500,000. Partner E contributes Parcel 3 with an FMV of \$1,000,000 and becomes a 66-2/3% partner (he owned \$2,000,000 of the total value of \$3,000,000 in property). On the same day the partnership sells Parcel 1 for \$500,000 and distributes \$333,333 to Partner E and \$166,667 to the other partners.

In this transaction, of the \$333,333, \$250,000 would have been distributed to Partner E even if he had not contributed Parcel 3. Thus, under the "but for" test, only \$83,333 represents proceeds of a presumed disguised sale.

E. Nonsimultaneous transfers – the “two-year rule.” The regulations create two alternative presumptions that will determine the fate of most related transfers:

1. Transfers that occur **within two years** of one another are **presumed** to constitute a sale. Reg. § 1.707-3(c).
2. Transfers separated by **more than two years** are **presumed** not to constitute a sale. Reg. § 1.707-3(d).

The thrust of these presumptions is quite clear. If the taxpayer’s capital has been at the risk of the partnership venture for more than two years, the transfers normally will not be recharacterized as a sale. These presumptions may be rebutted, but only if the relevant facts and circumstances “clearly establish” the contrary.

Example: Partner A transfers property to a partnership on November 30, 2000, with a fair market value of \$650,000. He has a 50% interest in the partnership. His basis in the property is \$250,000. The Partnership borrows \$2,850,000 as a construction loan and constructs a shopping center on the Property. The Partnership closes a permanent loan of \$3,500,000 on November 29, 2002, the commitment for which was obtained at the time the property was contributed to the partnership. The loan proceeds are used to satisfy the construction loan of \$2,850,000. The balance of the loan proceeds of \$650,000 is distributed to Partner A per the allocation provisions of the partnership agreement.

In this transaction, under §707(a)(2)(B) and the regulations thereunder, the transaction is **presumed** to be a disguised sale and Partner A will recognize a **gain of \$400,000**.

Observation: The key here is that the partners had a loan commitment in place from the outset. This example is found in the regulations and is fairly common in real estate development transactions.

Example: Same facts as above, except the distribution is delayed beyond November 30, 2002. Here, the same results are likely because even after two years, the facts and circumstances clearly indicate that a sale has taken place, since the partners had a loan commitment in place from the outset..

F. The “Entrepreneurial Risk” Test. If the transfer to the partnership and the transfer to the partners are not simultaneous, there is no disguised sale if facts and circumstances reflect that the subsequent transfer depends on the entrepreneurial risk of partnership operations (i.e., how sure are the contributing partners of receiving the subsequent distribution at the time the initial contribution is made).

EXAMPLE: Same facts as in Example above except that the partnership will be able to fund the transfer of cash to Partner A only to the extent that a permanent loan can be obtained in an amount to repay the contribution and the cost of constructing the building.

ANSWER: The fact that excess permanent loan proceeds will be available only if the cost to complete the building is materially less than the amount projected by a reasonable budget and/or the center must lease up before the maturity date of the construction loan would be evidence that the transfer to Partner A is subject to the entrepreneurial risks of partnership operations and therefore not part of a “disguised sale.”

EXAMPLE: Same facts as in Example above except that the amount of the permanent loan is limited to the cost of constructing the building (and thereby limits the partnership ability to make a transfer to Partner A) unless all or a substantial portion of the building is leased.

ANSWER: Again, this would be evidence that the transfer to Partner A is not part of a sale, if a significant risk exists that the partnership may not be able to lease the building to that extent. The transfer is subject to an “entrepreneurial risk.”

G. Safe Harbor Rules (Normal Distributions). Absent a special rule, all partnership distributions to a partner who had contributed money or property within the prior two years would be presumed to be part of a sale. Most partnerships, however, make periodic distributions to their partners, including distributions of operating cash flow and guaranteed payments and preferred returns, which are intended to compensate partners for the use of capital rather than to buy out the partner’s interest in contributed capital. To prevent tainting normal distributions, the regulations provide exceptions for distributions out of operating cash flow and “reasonable” guaranteed payments and preferred returns. Reg. §§ 1.707-4(b), 1.707-4(a). In essence, these exceptions allow a partnership to make normal distributions to its partners without raising the specter of § 707(a)(2)(B). Practitioners should watch out for unusual distributions (sales, refinances, etc.) closely related to the contribution of property.

PARTNERSHIP TAX TRAP THREE
SECTION 704(c)(1)(B) SEVEN YEAR RULE

A. Background. A significant, and often-overlooked, partnership tax trap is the seven year rule of Section 704(c). This rule, set forth in Section 704(c)(1)(B) requires that if property with built-in gain or loss under Section 704(c) is distributed within a period of seven years after its initial contribution **to any partner other than the contributing partner**, the distribution is treated as if it were a sale from the partnership **to the distributee partner** at fair market value taking place on the date of the distribution. This treatment only applies to create taxable gain to the **contributing partner**, and does not affect the partnership, distributee partner, or other partners. Informal discussions with practitioners indicate that this rule is hardly ever observed.

B. Gain Recognition. The rule forces the contributing partner to recognize any gain that was inherent in the property at the time of its contribution to the partnership. The gain or loss allocated to the contributing partner is the same amount that would be allocated under the general rule of Code Section 704(c) if the partnership sold the property to the distributee partner for its fair market value on the date of distribution. Therefore, the partner who originally contributed the Section 704(c) property will recognize the lesser of (i) the built-in gain or loss inherent in the property at the time of contribution, or (ii) the gain or loss that would be allocated to the contributing partner if the partnership sold the property to the distributee partner for its fair market value on the date of distribution.

In calculating which amount of gain should be allocated to the contributing partner, the partnership will apply the usual rules of Section 704(c) as outlined above including whichever allocation method has been selected by the partnership to remedy disparities between book and tax (although this will only be an issue if there is a tax gain and a book loss).

EXAMPLE: Partner A contributes three separate tracts of land to a partnership each with a fair market value of \$50,000 and basis of \$20,000. Partners B & C each contribute \$75,000 in cash. Three years later the partnership distributes to Partner C one of the parcels which has a fair market value of \$50,000. Partner C's distributive share of losses has been \$20,000 and Partner A's share of loss has been \$40,000.

ANSWER: Partner A will be required to recognize a gain of \$30,000 in the year of the transfer by the partnership of the land to Partner C, the same gain that would have been allocated to him under Section 704(c) as if the partnership sold the property at its FMV.

As any practitioner will recognize, in the life of a business or investment partnership, seven years is an eternity. Most clients and practitioners will have great difficulty remembering what property was contributed seven years ago, and whether or not it is Section 704(c) property. Therefore, it is critical for practitioners dealing with partnerships that have Section 704(c) built-in gain or loss property to carefully document the existence of this property and set up a system to alert clients to the possibility of the imposition of the Section 704(c) seven year rule in the event of a distribution to a different partner. In addition, it is prudent for practitioners to advise their clients to have an appraisal on Section 704(c) property already in hand to counter any potential audit in the future.

C. De Minimis Rule. There is a de minimis rule allowing partnerships to disregard the seven-year Section 704(c) distribution rule if the fair market value of the contributed property does not differ from the tax basis by more than fifteen percent of the adjusted basis, and the total gross book tax disparity does not exceed \$20,000. This exception is found in Regulation Section 1.704-3(e). Another exception, found in Section 704(c)(2), allows for Section 1031 exchange treatment, instead of sale treatment, if a distribution of qualified exchange property is made to the contributing partner within a certain time period after the distribution to a non-contributing partner.

PARTNERSHIP TAX TRAP FOUR
SECTION 704(C) BUILT-IN GAIN AND LOSS

A. Background. Section 704(c) is an outgrowth of that ancient and fundamental principle of income tax administration, the "assignment of income doctrine". If a partner contributes a piece of property to a partnership with a fair market value in excess of its adjusted basis, the partner is not allowed to shift that built-in gain to other partners. If this were allowed, it would be easy for taxpayers with highly appreciated property to avoid tax on the gain in that property without necessarily losing their control over or economic interest in the property itself. Section 704(c) requires partners who contribute appreciated property to a partnership to recognize the built-in gain inherent in the property on the date of contribution when the partnership disposes of the property.

The natural consequence of the contribution of appreciated property to a partnership is that there will be a disparity between the book and tax treatment of that property. This can lead to unfair treatment of the partners.

Example: Suppose that Partner A contributes land to a partnership with an adjusted basis of \$50 and a fair market value of \$100. Suppose further that Partner B contributes \$100 in cash. Each partner will have a book capital account of \$100, but Partner A's tax capital account will be \$50 while Partner B's tax capital account will still be \$100. If the land is sold in the second year of the partnership for \$150, all will be well - under the rules of Section 704(c), Partner A will be allocated the first \$50 in gain to make sure he retains the built-in gain on the property as of the date of contribution, while the remaining \$50 of gain will be allocated equally between both Partner A and Partner B. However, if the land is sold in the second year of the partnership for only \$80, the partnership will recognize a book loss but a tax gain. In the absence of Section 704(c), this would result in Partner B being forced to recognize a \$20 gain, even though Partner B actually suffered a \$10 economic loss. Section 704(c) remedies this situation.

B. Allocation Methods. Subject to the "ceiling rule" discussed below, the partnership can use any reasonable method to make allocations so that the contributing partner receives the tax burden and benefits of any precontribution gain or loss. The partnership is permitted under the Section 704(c) regulations to make the allocations under three specific methods or any other reasonable method:

- (1) Traditional method.
- (2) Traditional method with curative allocations.
- (3) Remedial allocation method.

The partnership can use different allocation methods with respect to different items of Section 704(c) property. The method used must be consistent from year to year and must be

reasonable. The Section 704(c) allocations are tax allocations only, and do not affect the partners' capital account balances for distribution purposes.

The so-called "ceiling rule" provides an important limitation on a partnership's ability to allocate income, gain, loss and deduction among the partners. The "ceiling rule" provides that the amount of income, gain, loss and deduction that can be allocated to a partner for tax purposes cannot exceed 100% of the amount of such item that the partnership actually recognized for tax purposes. Because of the ceiling rule, in some cases, the final book capital accounts will not reconcile to the final tax basis capital account. The Treasury regulations allow partners to avoid this result by using "curative allocations" of "other items" of partnership income, gain, loss or deductions or to in essence ignore the limitation in the case of a "remedial allocation" to bridge the limitation.

The traditional method requires the partnership to allocate any gain or loss upon the disposition of contributed property in a manner that ensures the contributing partner is allocated any precontribution gain or loss. These rules also provide that any cost recovery deductions (depreciation, depletion, or amortization) with respect to contributed property must be allocated in the manner that most rapidly reduces the built-in gain or loss associated with the contributed property. This is usually accomplished by allocating book depreciation based on the economic agreement of the partners (book depreciation in this case is computed based on the FMV of the property), and then allocating tax depreciation to the noncontributing partners up to the amount of book depreciation allocated to those partners. Any remaining tax deductions are then allocated to the contributing partner or shared among the partners. The traditional method will often lead to the unfair situation to the non-contributing partner outlined in the simple example above.

EXAMPLE: (Traditional Method) Partner A contributed depreciable property with a basis of \$4,000 and FMV of \$10,000 and Partner B contributes \$10,000 in cash. The property is depreciated over ten (10) years on the straight line method.

ANSWER: The book depreciation of \$1,000 per year (10% x \$10,000) is allocated equally to each of the partners. However, the tax depreciation of \$400 (10% x \$4,000) must be allocated entirely to Partner B. As a result of the Section 704(c) allocation of all the depreciation to Partner B, Partner A's built-in gain of \$6,000 (\$10,000 less \$4,000) is reduced to \$5,600. If the property is sold for its book value of \$9,000 (\$10,000 less \$1,000 in depreciation), the gain of \$5,400 (\$9,000 less \$3,600) is allocated all to Partner A.

An alternative to the traditional method is the traditional method with curative allocations. This allocation method allows partners to overcome the distortions caused by the application of the ceiling rule, and the inequities in timing caused by the traditional method, by

making curative allocations of other partnership items of income or expense. Curative allocations are tax allocations only and do not result in any related economic allocations (i.e., there are no increases or decreases to the partners' capital accounts). A curative allocation is reasonable only to the extent it does not exceed the amount necessary to offset the effect of the ceiling rule for the current tax year, or, in the case of a curative allocation upon disposition of the property, for prior tax years. Additionally, a curative allocation is reasonable only if the items allocated have the same tax effect on the partners as the items affected by the ceiling rule.

Finally, partnerships can use the remedial allocation method. Under this method, the partnership can make tax allocations of income or gain "created by the partnership" to contributing partners, with offsetting allocations of loss or deduction "created by the partnership" to the noncontributing partner. Remedial allocations are allowed only when there is a book allocation to a noncontributing partner that is different from the tax allocation to that partner. Remedial allocations are tax allocations only and do not affect book capital accounts. Generally speaking, the remedial allocation method allows the partnership to disregard the ceiling rule when a book allocation to a noncontributing partner is different from the corresponding tax allocation. The partnership does not have to have actually realized the income, loss, or deduction used to make the remedial allocation. This method will be preferred by noncontributing partners because it stands the best chance of accelerating the reconciliation of book capital accounts in situations like the example above.

As with other types of Section 704(c) allocations, a remedial allocation is reasonable only to the extent it equals the amount necessary to offset the ceiling rule for the current tax year, and only if the income or loss allocated has the same effect on each partner's tax liability as the item limited by the ceiling rule. For example, if the item limited by the ceiling rule is a capital loss from the sale of contributed property, the offsetting remedial allocation to the contributing partner must be a capital gain from the sale of that property. In addition, if the item limited by the ceiling rule is depreciation on a rental property, the remedial allocation to the noncontributing partner must be depreciation from property used in a rental activity, and the offsetting remedial allocation to the contributing partner is ordinary income from that rental activity. Each partner then applies the passive activity loss limitation rules to the allocation as appropriate for his level of participation in the rental activity.

Section 704(c) allocations must be made not only when the partnership disposes of property, but also in each year when the partnership takes depreciation deductions with respect to Section 704(c) property. The depreciation deduction is allocated to the partners other than the one who contributed the property in the case of built-in gain property and to the contributing partner in the case of built-in loss property.

The calculation of book cost recovery deductions under the remedial allocation method is different from the calculation of such amounts under the traditional or traditional with curative allocations. The calculation method used under the remedial allocation method requires the partnership to depreciate the portion of the book basis of contributed property equal to its tax basis on the date of contribution over the remaining life and using the same method used by the contributing partner. The remainder of the partnership's book basis in the property is recovered using any recovery period and method allowed on the contribution date for newly purchased property.

A partnership does not have to apply the Section 704(c) rules to a partner's contributions in a single year if both of the following criteria are met (the "de minimis" rule found in Regulation Section 1.704-3(e)):

(1) The difference between the FMV and basis of all the contributed properties (in the aggregate) is 15% or less of the properties' basis.

(2) The total disparity between the FMV and basis for all properties contributed by the partner during the year does not exceed \$20,000.

When a partnership is formed upon the contribution of appreciated property to the partnership, the partnership agreement should set forth the partners' agreement as to which type of Section 704(c) allocation method will be utilized (traditional, traditional with curative allocations or remedial allocation).

With the enactment of the American Jobs Creation Act of 2004, practitioners must also be on the lookout for the effect of new Section 704(c)(1)(C). This new Section prevents the transfer of built-in gain and loss to purchasers of the partnership interest of the original contributing partner. Under Section 704(c)(1)(C), in determining the amount of items of income or loss to be allocated to partners other than the original contributing partner, the adjusted basis of the contributed built-in loss property in the hands of the partnership is treated as being equal to its fair market value at the time of contribution.

Therefore, if a partner contributes built-in loss property, and then later on transfers his/her partnership interest to someone else, the remaining built-in loss inherent in the property in the hands of the partnership will disappear. This is because the adjusted basis of the property inside the partnership will now be deemed lowered to the original fair market value of the property as to all partners. The purpose of this Section is to prevent the duplication of losses. For example, a partner could contribute built-in loss property to a partnership, and receive a partnership interest with a high basis. The partner could then sell that partnership interest for its fair market value, recognizing the loss originally inherent in the property he/she contributed to the partnership. Before the enactment of Section 704(c)(1)(C), when the LLC or partnership later sold the built-in loss property, the LLC would also recognize the built-in loss, and pass the built-in loss through to its partners. Section 704(c)(1)(C) prevents this result.

Finally, note that practitioners may find it difficult to comply with the Section 704(c) rules in the absence of an appraisal of the contributed property, and difficult to prove to a

reviewing revenue agent that the books and returns of the partnership were correctly prepared. Therefore, when appreciated property is contributed to a partnership, practitioners should strongly advise their clients to obtain appraisals.

PARTNERSHIP TAX TRAP FIVE SECTION 737 SEVEN YEAR RULE

A. Background. The Section 704(c) seven year rule could easily be avoided if a partner contributing appreciated property could arrange for the partnership to distribute other property to the partner to essentially cash out the contributing partner's interest in the original contributed property, without recognizing gain. Without Section 737, this would be possible under the usual distribution rules of Section 731.

Example: If Partner A contributes a parcel of land with a fair market value of \$250,000 and a basis of \$100,000 to a partnership, Partner A would have a book capital account of \$250,000 and an outside basis in her partnership interest of \$100,000. Suppose that the partnership subdivides the property and constructs single family homes on the lots. Three years after the original contribution, the partnership could distribute a few of the improved lots with an aggregate fair market value of \$250,000 to Partner A. Partner A would take a carry-over basis of \$100,000 in the improved lots, and her book capital account would be reduced to zero (ignore the possible application of the Section 751 disproportionate distribution rules for the moment). Partner A has essentially closed out her economic interest in the property originally contributed to the partnership without recognizing the Section 704(c) built-in gain. Section 737 is meant to address these types of transactions.

B. Seven Year Rule. Under Section 737, if a partner receives a distribution of property from a partnership within a seven year period of contributing appreciated property, the partner may be required to recognize gain. The gain recognized will equal the **lesser** of (i) the amount by which the fair market value of the property distributed exceeds the distributee partner's outside tax basis in his or her partnership interest, reduced by any money received, or (ii) the partner's "net precontribution gain". Net precontribution gain is defined as the total amount of Section 704(c) built-in gain that the partner has in all property that was contributed by the partner, and is still held by the partnership, during the seven years prior to the distribution.

Again, in determining the amount of net precontribution gain, the partnership will apply the Section 704(c) allocation method it has chosen for general use. There are also requirements for basis adjustments within the partnership when a Section 737 transaction occurs. The rules for these adjustments are found in Code Section 737 and Regulation Section 1.737-3.

EXAMPLE: Partner A contributes land to an equal partnership. The land has a FMV of \$50,000 and adjusted basis of \$20,000. Five (5) years later, the partnership distributes to Partner A a rental building which was acquired by the partnership four years after Partner A was admitted as a partner. It has a fair market value of \$70,000. Partner A has a basis in his partnership interest at the time of the distribution of \$30,000.

ANSWER: Partner A will be required to recognize the built-in gain of \$30,000 in the year of the transfer of the rental building, the same gain that would have been allocated to him under Section 704(c) with respect to the contributed land.

EXAMPLE: Same facts as in Example above, except Partner A has a basis in his partnership interest equal to \$60,000.

ANSWER: Partner A will recognize a gain of only \$10,000, the lesser of the pre-contribution gain of \$30,000 or the difference between the FMV of the distributed land and Partner A's pre-distribution partnership basis (\$70,000 - \$60,000).

Like the rules for recognition of pre-contribution gain or loss under Section 704(c), Section 737 applies for seven years after the contribution of appreciated property. It will apply to all distributions of property, including distributions of the original contributed property, within seven years of the contribution.

Again, seven years is an eternity in business and investment partnerships. Therefore, it is critical that practitioners maintain work papers or other systems that will alert them to the Section 704(c) and Section 737 issues when distributions of property take place. Clients must be advised of the consequences of these transactions. Section 737 represents a significant departure from the usual rule that property can be moved into and out of a partnership without the recognition of gain, and therefore clients may not be sufficiently wary when conducting these types of transactions.

PARTNERSHIP TAX TRAP SIX

CONTRIBUTION OF SERVICES FOR PARTNERSHIP INTEREST

6.01 Generally. The nonrecognition rules of Section 721 only apply to transfers of property in exchange for a partnership interest. The general nonrecognition rules do not apply to the contribution of services by a partner to a partnership because the transfer of property in connection with the performance of services is a taxable event under the general rules of Section 83. (Regulations Section 1.721-1(b)(1)). Often, partnerships will provide equity-based compensation (in the form of a partnership interest) to service providers.

When faced with equity based compensation in the context of a service partner and a partnership, there are a number of issues that need to be considered:

- A. Taxability. Is the partnership interest received in exchange for the services taxable to the service partners under the general rules of Section 83 or does it fall within the special "profits interest" only exception under the Section 721 regulations?
- B. Timing. If the partnership interest received by the service partner is taxable under the general rule of Section 83, then is it taxable immediately or is taxability delayed because the interest is subject to a substantial risk of forfeiture?
- C. Section 83(b). If the partnership interest received by the service partner is taxable under the general rule of Section 83 and is subject to a substantial risk of forfeiture, so it is not taxable immediately, should the partner consider a Section 83(b) election?
- D. Partnership Gain. If the partnership exchanges a partnership interest for services, does the partnership have a gain?
- E. Deduction. If there is a taxable exchange of services for a partnership interest, the appropriate allocation of any corresponding deduction among the partners, including the service partner, must be considered.

6.02 Special Rule. The receipt of property (any property) in exchange for services triggers ordinary income equal to the fair market value of the property received under the general rules of Section 83. However, the regulations under Section 721 carve out a special exception in the case of the receipt by a service partner of only a "profits interests" in the partnership. The receipt of only a "profits interest" vs. a capital interest does not cause the service partner to realize ordinary income upon receipt of the partnership interest (See Section 6.06).

6.03 Receipt of a Taxable Partnership Interest for Services.

- A. Receipt of a Vested Partnership Interest for Services.

1. Income. A person who exchanges services for a vested interest in property (any property, including a partnership capital interest) recognizes immediate taxable income equal to the FMV of the property received, reduced by the amount paid for the property (Section 83 or Regulations Section 1.721-1(b)(1)).
2. Allocation of Deduction. If the property in question is a partnership interest in capital, the partnership may deduct (or be required to capitalize) the amount taxed to the service provider. The timing of this deduction is determined by the method of accounting used by the partnership.
 - a. If the service partner is a partner during the year in which the service was provided, the partnership deduction arising from the transfer to the service partner will be allocated to all partners, including the service partner.
 - b. If the service partner is not yet a partner when the services were provided, only the then current partners may share in the deduction, but not the service partner.
3. Gain or Loss. If the owner of property exchanges an interest in the property for services, the owner has engaged in a taxable event which will trigger a gain or loss to the owner. If a service provider receives a partnership interest in an existing partnership with appreciated assets in exchange for services to the partnership, arguably the partnership would also recognize a gain upon the transfer of the interest, in addition to any business deduction created by the services. When the service provider receives a capital interest in the partnership, it is the equivalent of receiving a prorata interest in each of the partnership assets in exchange for the services.

EXAMPLE 6-1: Developer has arranged for the rezoning of a tract of land owned by Investor A and has negotiated the necessary easement for installation of water and sewer service to the property in anticipation of its development for which he is to receive an interest in the property. The land has a fair market value of \$100,000 and a basis of \$50,000. Investor A gives the Developer a 1/2 undivided interest in the land in exchange for his services.

ANSWER: Developer will realize immediate ordinary taxable income of \$50,000, the value of his 1/2 interest in the land under Section 83. In addition, much to the surprise of Investor A, he will be required to recognize

taxable income of \$25,000 (\$50,000 less basis of \$25,000) since he will be deemed to have exchanged a one-half interest in the property for the past services of Developer. Investor A will be required to capitalize the \$50,000 expense as part of the development of the land. Developer's tax basis in his 1/2 interest in the land will be \$50,000, and Investor A's tax basis in his 1/2 interest in the land will be \$25,000.

EXAMPLE 6-2: Same facts as in Example above, except the Developer receives a 50% capital interest in a partnership formed by a contribution of land by Investor A when Developer completed the rezoning.

ANSWER: Developer recognizes immediate taxable income of \$50,000 since he has again exchanged his services for property (i.e. the partnership interest). Investor A also must recognize a gain on the exchange of the 50% partnership interest for the services.

- B. Receipt of Nonvested Partnership Interest for Services. A person who exchanges services for an interest in nonvested property (i.e. subject to a substantial risk of forfeiture if services not completed or not successful) will also recognize taxable income; however, the amount and timing of the recipient's income recognition depends on the extent of any restrictions on the recipient's rights to full enjoyment of the property. Section 83(a) income is recognized when the property is (1) no longer subject to a substantial risk of forfeiture or (2) is transferable free of any such risk. Under the Section 83 regulations, an interest is subject to a substantial risk of forfeiture if vesting is conditioned upon the future performance of substantial services. The amount of income recognized is the FMV of the property at the time of vesting, less any amount paid for the property. Once the partnership interest vests - i.e., when there is no longer a "substantial risk of forfeiture" - current taxable income must be recognized, even if the partnership interest is subject to transfer restrictions under the partnership agreement.
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EXAMPLE 6-3: Same facts as in Example above, except that the partnership interest of Developer is subject to completion of a successful rezoning of the property which will not occur until the next year.

ANSWER: Since the interest of Developer is subject to a contingency so that the interest would be lost if the zoning is not successful, there is a “substantial risk of forfeiture.” The income recognition is postponed until the next year when there is no longer a "substantial risk of forfeiture". If, at the time the "substantial risk of forfeiture" lapses, the property is worth \$500,000, the service partner will realize \$250,000 in "ordinary" service income and Investor will realize taxable gain equal to \$225,000 (\$250,000 less \$25,000 basis).

EXAMPLE 6-4: Developer LLC has agreed to give a Property Manager a 10% membership interest in the LLC if he successfully obtains a 90% occupancy in a new developed apartment community constructed by Developer.

ANSWER: The Property Manager will realize ordinary income equal to the value of the 10% LLC interest at the time of receipt of the interest. The Developer LLC will be entitled to an ordinary deduction equal to the value of such interest that would be allocated to all the members, other than the newly admitted Property Manager. (See Section 9.05). The LLC will also realize a gain on the exchange with respect to each of its assets.

EXAMPLE 6-5: Investor A builds an office building which he contributes to an LLC. Investor A admits Member B as a member to the LLC and gives him a 25% interest in profits and capital. The office building has a FMV of \$1,000,000 and is subject to an interest only development loan of \$800,000. The membership interest of Member B will be forfeited if he is unable to lease up the building within eighteen (18) months. If it is not leased up in the eighteen (18) month period, the LLC will lose its permanent loan commitment which it needs to satisfy the development loan.

ANSWER: Member B will not recognize taxable income of \$50,000 (\$200,000 x 25%) until the substantial risk of forfeiture lapses (i.e. upon lease-up within eighteen (18) months). If Member B is able to lease up the building, he will recognize ordinary income

of \$50,000 (assuming FMV of building remains at \$1,000,000). The lease-up services of Member B are an ordinary expense of the LLC for which it would be entitled to an ordinary deduction. Unless all of the deduction is specially allocated to Investor A who "paid for it," the deduction would be allocated 75% to Investor A and 25% to Member B, since Member B was a member of the LLC when the interest vested and when the services were performed.

6.04 Special Section 83(b) Election. A service provider who exchanges his services for a capital interest in a partnership that is subject to a substantial risk of forfeiture is not taxed until the value of the interest becomes fully vested. The risk is that if the partnership interest appreciates in value between the date of the receipt of the property and the date it is no longer subject to the substantial risk of forfeiture, the service partner may be required to recognize additional ordinary income. (See Example 6-3). Section 83(b) allows the services provider to elect to have the transfer taxed upon receipt rather than when the property becomes substantially vested. The service partner who makes a Section 83(b) election may recognize less ordinary income by virtue of the Section 83(b) election and will recognize capital gain on any subsequent value appreciation.

[COMMENT: One would presumably only make the Section 83(b) election if it is expected that the partnership interest will be worth substantially more when the substantial risk of forfeiture lapses than it was when the interest was received.]

EXAMPLE 6-6: Partner A contributes vacant land to a partnership with a FMV of \$1,000,000. Partner B is admitted as a 10% partner in exchange for his agreement to supervise the construction of 300 apartment units on the land. When the project is completed in two years, it will have an estimated value of \$15,000,000, less the \$10,000,000 mortgage used to construct the apartment units.

ANSWER: The partnership interest is not taxed to Partner B until the completion of the apartments. Under these facts, Partner B will realize ordinary service income equal to \$500,000 ($\$15,000,000 - \$10,000,000 \times 10\%$) when the project is completed. If he elected under Section 83(b) to recognize income upon receipt of the partnership interest, he would only recognize service income of \$100,000 ($\$1,000,000 \times 10\%$) at that time, and would not recognize any additional taxable income when the project is completed. In either event, the income recognized will be ordinary.

6.05 Income, Deduction and Allocation Issues.

- A. Character and Timing of Income. The service partner recognizes ordinary income equal to the fair market value of the capital interest. The income is recognized either at the time of the Section 83(b) election or on the date the substantial risk of forfeiture lapses. If the service provider is considered an employee and not a partner at the time of the recognition date, the income will be subject to income and payroll tax withholding.
- B. Deduction Issues. The partnership may deduct (or be required to capitalize) the amount taxed to the service provider. The timing of this deduction will be determined under the Section 83 regulations and Regulations Section 1.721-1(b)(1). All partners will be allocated their pro rata share of the deduction. If the service provider is a partner during the period the services are rendered, all the partners, including the service partner, will receive a distributive share of the deduction under the general tax allocation rules. There are other options available, however. The partners may agree to (1) allocate the deduction to the service partner, to offset his gain on the receipt of the interest, or (2) allocate the deduction to the original partners, since they are the ones who are actually “paying” the service partner for his services by giving him a portion of their equity.
- C. Allocation Issues. If a service provider is to be admitted as a partner, even though his interest is subject to a substantial risk of forfeiture, the partnership is faced with an interesting question. During the period while the interest is subject to a substantial risk of forfeiture, will the service provider share in income, losses and distributions from the partnership? If he does share and subsequently forfeits the partnership interest, he may realize a capital gain (if he was allocated losses or received non-taxable distributions) or a capital loss (if he was allocated income). If the partners elect not to allocate income, losses or deductions to the service partner during the period while the interest is subject to a substantial risk of forfeiture, the partnership will not qualify under the safe harbor of Rev. Proc. 2001-43 discussed below.

6.06 Receipt of Profits Interests for Services.

- A. Generally: Profits Interest vs. Capital Interest. The regulations under Section 721 make it clear that the receipt of an interest in partnership capital is a taxable event if the interest is transferred to a partner as compensation for services. The regulations also state that the receipt of an interest in only the profits of the partnership does not give rise to taxable income to the service partner (whether at the time of receipt or when fully vested). Section 1-721-1(b).
- B. Rev. Proc. 93-27 - Safe Harbor. After many years of controversy over the correct interpretation of the regulations, the IRS finally issued Rev. Proc. 93-27. Rev. Proc. 93-27 confirms that the receipt of a capital interest by a service provider is

taxable compensation to the service provider. Rev. Proc. 93-27 also provides that the receipt of a "profits only" interest in a partnership for services is a nontaxable event and defines what constitutes a "profits interest," however, the safe harbor came with limitations. Under Rev. Proc. 93-27, the receipt of a profits interest in a partnership will not fall within the safe harbor, and therefore may be taxable, if:

1. the profits interest relates to a substantially certain and predictable stream of income for the partnership asset (such as a net lease);
2. the partner disposes of the profits interest within two years of receipt; or
3. the profits interest is a limited partnership interest in a publicly traded partnership.

Note: The Revenue Procedure does not state that the foregoing will cause a profits interest to be currently taxable, but only says that it may be taxable if the safe harbor requirements are not met.

- C. Profits Interest Defined. Rev. Proc. 93-27 sets forth two key definitions needed for admitting a service partner to a partnership on a tax-free basis. Rev. Proc. 93-27 defines a "capital interest" as a partnership interest that would give the service partner a share of the proceeds if the partnership assets were sold at FMV and the proceeds distributed in complete liquidation. This computation is made at the time of receipt of the partnership interest. A "profits interest" is a partnership interest other than a "capital interest."
- D. Rev. Proc 2001-43: Tax Treatment of Non-Vested Profits Interest. Until the release of Rev. Proc. 2001-43, there was concern about how to handle the tax consequences of the receipt of a profits interest for services that was subject to a substantial risk of forfeiture. Was a Section 83(b) election necessary at the time of grant? The IRS answered these questions by providing that the receipt of a partnership interest in profits that is substantially nonvested will be treated as being received on the date of its grant, and is not a taxable event to the partner at the date of grant or when the profits interest vests. No Section 83(b) election needs to be made at the date of grant. However, for the Rev. Proc. 2001-43 safe harbor to apply:
1. The service partner must be treated as the owner of the interest from the date of the grant and thereafter must take into account his distributive share of partnership income, gain, loss, deduction and credit associated with the interest under Section 706, even before the interest vests; and
 2. Neither the partnership nor any of the partners may deduct any amount (as wages, compensation or otherwise) for the fair market value of the interest granted to the service provider, whether at the time of the grant of the partnership interest or at the time the partnership interest becomes substantially vested.

EXAMPLE 6-7: A and B are equal partners in the AB accounting partnership. Originally, A and B each contributed \$20,000 to the partnership, thus each has a \$20,000 capital account. The fair market value of the partnership assets increase to \$100,000 with a basis of \$40,000 and no liabilities. The partnership admits Carl as a 1/3 partner in the partnership. Prior to his admission, Carl had been a long term employee of the firm. Carl will not be required to contribute any capital to the partnership for his interest.

ANSWER: Under Rev. Proc. 93-27, if the partnership assets were sold and the partnership immediately liquidated upon the admission of Carl, Carl would receive a liquidating distribution of \$20,000. (The first \$40,000 would be distributed to A and B in accordance with their positive capital account balances, and the remaining \$60,000 would be distributed equally to A, B and Carl.) Accordingly, the receipt of the partnership interest is a taxable event since the interest received by Carl was a "capital interest" and not merely a "profits interest."

Note: The partnership may also be entitled to a deduction of \$20,000 with respect to the exchange which must be allocated to Partners and A and B.

EXAMPLE 6-8: Same facts as in Example 6-7, except the partnership agreement provides that upon liquidation, Partners A & B are each to receive the first \$50,000 in liquidation proceeds with the balance being distributed equally to all the partners, including Carl.

ANSWER: If the partnership assets were sold and the partnership liquidated immediately after Carl's admission, Carl would not be entitled to any liquidation proceeds from the partnership. Accordingly, Carl has received only a "profits interest" in the partnership, and therefore, Carl should not be required to recognize income upon receipt of the partnership interest so long as the other requirements of Rev. Proc 93-27 are satisfied.

Note: This type of partnership agreement provision essentially is a Section 704(b) capital account "book up" to increase A and B's capital account by all asset value appreciation prior to Carl's admission.

[COMMENT:

What the IRS essentially does in Rev. Proc. 93-27 is to take the position that the service partner will pay his tax dollars with respect to the profits interest as the profits are earned.]

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