Partnerships and LLCs: Part 2

Course #33102B

Taxes

2 Credit Hours

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PARTNERSHIPS AND LLCS: PART 2

This course explains how a partner's capital account is affected by contributions, allocations, and distributions. It also breaks down the rules in Section 704(b) and 704(c), showing how to properly track changes to each partner's capital. Learners will understand how to allocate income, losses, and property basis fairly between partners under different methods and rules. Simple examples help clarify complex tax rules around partnership equity and basis adjustments.

LEARNING ASSIGNMENTS AND OBJECTIVES

As a result of studying each assignment, you should be able to meet the objectives listed below each individual assignment.

SUBJECTS

Other Limitations on Partnership Allocations
Partner's Share of Partnership Debt

Study the course materials

Complete the review questions at the end of each chapter

Answer the exam questions 1 to 10

Objectives:

- Identify the characteristics of allocations in family partnerships.
- Identify the characteristics of recourse and nonrecourse liabilities.

NOTICE

Program publication date **9/15/25**

EXAM OUTLINE

- **TEST FORMAT:** The final exam for this course consists of 10 multiple-choice questions and is based specifically on the information covered in the course materials.

- **ACCESS FINAL EXAM:** Log in to your account and click Take Exam. A copy of the final exam is provided at the end of these course materials for your convenience, however you must submit your answers online to receive credit for the course.

- **LICENSE RENEWAL INFORMATION:** This course qualifies for **2** CPE hours.

- **PROCESSING:** You will receive the score for your final exam immediately after it is submitted. A score of 70% or better is required to pass.

- **CERTIFICATE OF COMPLETION:** Will be available in your account to view online or print. If you do not pass an exam, it can be retaken free of charge.

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CHAPTER 1: OTHER LIMITATIONS ON PARTNERSHIP ALLOCATIONS

Chapter Objective

After completing this chapter, you should be able to:

- Identify the characteristics of allocations in family partnerships.

¶ 301 ALLOCATION OF PARTNERSHIP INCOME AND LOSS ON TRANSFER OR CHANGE IN A PARTNER'S INTEREST IN THE PARTNERSHIP

.01 General

When a partner transfers his or her interest in a partnership, the partnership must allocate partnership profit or loss between the transferor partner and the transferee partner. Similarly, if a new partner is admitted to the partnership or a partner's interest is increased, reduced or liquidated, it is necessary to allocate the partnership's income by taking into account the partners' varying interests in the partnership during the year. Generally, the taxable year of the partnership as a whole does not close on the transfer of a partner's interest.[1] Nor does the taxable year of the partnership *as a whole* close upon the admission of a new partner, departure of a partner, or change in a partner's interest in the partnership.[2] However, the partnership tax year does close with respect to a partner who terminates his or her entire partnership interest by transfer, death or liquidating distribution.[3] In such cases, the partnership's tax year closes with respect to the departing partner on the date of sale, death or liquidating distribution, and the departing partner's distributive share of partnership income or loss for the short period ending on the disposition date is included in his or her tax return for the taxable year that includes the date of sale.

Ordinarily, this requirement results in the departing partner including a partial year share of the partnership's taxable income in his or her tax return for the year of sale. Where the partnership does not use the calendar year for tax purposes, this can accelerate the recognition of income by the departing partner into the tax year ending before the partnership's tax year ends. For example, assume a calendar year partner who has an interest in a partnership with a July year end. If the partner sells his partnership interest in December of Year 1, he will have to report a share of his income for the partnership tax year ending July, Year 2. Had he waited to sell his interest until January of Year 2, he could defer recognition of this income for an additional year.

Note that not only does the above rule have the potential to accelerate the recognition by the partner of income, it can also result in the partner having to report more than a year's share of partnership income in a single tax year. Consider the above example in which a calendar year partner sells his or her

1. Code Sec. 706(c)(1). This is true even though the transfer results in the partnership's technical dissolution under the nontax rules of most states.
2. Code Sec. 706(c)(1).
3. Code Sec. 706(c)(2)(A).

interest in a partnership with a July year end. Assume, however, that the partner waits until December of Year 2 to sell his partnership interest, rather than selling in December of Year 1. For calendar year 2, the partner will report his share of the partnership's income for the period ending in July, Year 2, *plus* his share of the partnership's income for the five months from August through December. Thus, in this case, the partner will be required to report as many as 17 months of partnership income on his tax return for the year of sale.

If a partner transfers less than his or her entire interest in a partnership or the interest is partially liquidated, the partnership year does *not* close with respect to the selling partner; the selling partner's distributive share of partnership income is includible in his or her taxable year, within which ends the normal partnership year-end. However, the partner is allowed to increase the tax basis of the portion of the interest sold by the appropriate share of partnership income through the date of the sale or partial liquidation.

Example 3-1

EXAMPLE

J was a 30% partner in JDR Partners until July 1, when she sold half her interest in the partnership to *Q*. Her tax basis in the partnership interest at the beginning of the year was $10,000. The partnership reported net taxable income for the year of sale of $30,000. Both *J* and the partnership use the calendar year for tax purposes. *J*'s share of the partnership's income for the entire year will be $6,750, computed as follows:

Partnership income, January 1–July 1	$15,000
J's share (30%)	4,500
Partnership income, July 1–December 31	$15,000
J's share (15%)	2,250
J's total share of partnership income ($4,500 + $2,250)	$6,750

J's tax basis in her partnership interest as of July 1 will be $14,500 (beginning basis of $10,000 plus $4,500 share of partnership income through July 1). Her basis in the portion of the interest she sold (50%) will therefore be $7,250.

As illustrated in Example 3-1, the partner must adjust the tax basis of that portion of the interest that is transferred to reflect his or her share of the partnership's profit or loss up to the date of sale.[4] Even though the income attributable to the portion of the partnership interest transferred is includible in the partner's income at the same time as the income attributable to the retained portion, any gain or loss on the transfer is determined by adding the partner's share of income to the basis of the portion of the partnership interest that is transferred.

A transferring partner's distributive share of partnership income, gain, loss, deduction, and credit is determined by taking into account his or her "varying interest" in the partnership during the year of the sale. The regulations afford the partners a measure of flexibility in making this determination by

4. Reg. § 1.705-1(a)(1).

providing two methods of allocation.[5] The first method provides for an "interim closing" of the partnership books whenever the partners' interests change, whereas the second (which requires "agreement among the partners") provides for the proration of partnership income, gain, loss, deduction, and credit over the entire taxable year of the partnership.[6] In addition, if the partnership liquidates a partner's interest, or if there is a change in a partner's share of partnership profits and losses during the year as a result of a contribution or distribution or otherwise, the partner's share of partnership profits and losses is determined by using the same two methods.[7]

Example 3-2

EXAMPLE

On December 1 of Year 1, *D* buys *A*'s one-third interest in the ABC partnership. ABC is a calendar-year partnership with total expenses of $360,000 for the year, $240,000 of which were accrued prior to December 1. The remaining $120,000 of the partnership's expenses were incurred in the month of December. The partnership has total income of $360,000, which has been earned equally over the taxable year.

Under the "interim closing" method of allocation, *D*'s distributive share of the partnership's expenses is $40,000 (incurred during December of Year 1 after *D* bought the partnership interest), and *D*'s share of partnership income is $10,000. Accordingly, *D* reports a $30,000 loss from the partnership.

Under the second method of allocation, *D*'s share of partnership income will be decidedly different. If the partnership chooses a prorated method of allocation, *D*'s share of partnership expenses will be $10,000 (1/3 partner × 1/12 of the year × $360,000), and his share of partnership income is also $10,000 (1/3 partner × 1/12 of the year × $360,000). Accordingly, *D* would report no income or loss from the partnership for Year 1.

Even though the buyer and seller's initial impression is that each will prefer the method of income allocation that will result in the least income, a closer analysis will reveal that the buyer is normally much more concerned with avoiding income than is the seller. For example, if the seller agrees to the method of income allocation that increases his or her share of the year's partnership income, the seller also increases basis in the partnership interest by an equal amount. This increased basis results in a decreased gain on sale of the partnership interest. The offsetting amounts occur in the seller's same taxable year. Typically the seller has no change in the amount of income, but will have less capital gain and more ordinary income. The net result is increased tax for the ordinary income/capital gains rate differential applied to the income shifted to him.

The buyer's increased income share also results in an increased basis for his or her partnership interest. But the buyer reports the income currently while any benefit from the increased basis in the partnership

5. Reg. §1.706-1(c).

6. Reg. §§1.706-1(c)(4) and 1.706-4(a)(3)(iii).

7. Reg. §1.706-4(a)(1). See also S. Rep. No. 938, 94th Cong., 2d Sess. 98 (1976); Richardson v. Commr., 76 TC 512, Dec. 37,801 (1981), aff'd, 83-1 USTC ¶9109, 693 F2d 1189 (5th Cir.).