PacificCPE

Partnerships and LLCs: Part 3

Course #33103B

Taxes

2 Credit Hours

Support@PacificCPE.com | (800) 787-5313

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PARTNERSHIPS AND LLCS: PART 3

This course explains how partnerships handle special tax allocations, distributions, and adjustments. It covers when allocations are considered substantial, how distributions affect partner capital accounts, and the rules around minimum gain and revaluations. The course also discusses disproportionate distributions and their tax impact, using clear language and practical examples.

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

Limitations on the Deductibility of Partnership Losses

Study the course materials

Complete the review questions at the end of each chapter

Answer the exam questions 1 to 10

Objectives:

- Recall the characteristics of passive activity income.

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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LIMITATIONS ON THE DEDUCTIBILITY OF PARTNERSHIP LOSSES

Objective

After completing this course, you should be able to:

- Recall the characteristics of passive activity income.

¶ 501 INTRODUCTION

The deductibility of partnership losses passed through to a partner is subject to three separate limitations. First, under Code Sec. 704(d), the loss may not exceed the partner's *tax basis* in the partnership interest. Second, any losses that survive the Code Sec. 704(d) limitation are subject to the *at-risk limitation* of Code Sec. 465. Finally, losses may be disallowed under the *passive loss limitations* of Code Sec. 469 even if they do not exceed the partner's tax basis or amount at risk in the partnership interest. Note that these limitations are applied *sequentially*—the Code Sec. 704(d) limitation is applied first, followed by the Code Sec. 465 limitation, and finally the Code Sec. 469 limitation. Amounts disallowed under each section are subject to different carryforward provisions.

Example 5-1

EXAMPLE

J is a one-third partner in JDR Partnership. Her tax basis in her partnership interest is $35,000, consisting of her $15,000 investment in partnership capital and her $20,000 share of partnership nonrecourse liabilities. None of these liabilities are qualified nonrecourse liabilities (i.e., they do not increase her amount at risk, as discussed at ¶ 505). *J*'s interest in the partnership is a passive activity, and she has no passive income from any other source. For the current year, *J*'s distributive share of the partnership's loss, reported on Schedule K-1, is $45,000.

Under Code Sec. 704(d), $10,000 of *J*'s pass-through loss will be disallowed because it exceeds the tax basis of her partnership interest ($45,000 total loss – $35,000 tax basis). Of the $35,000 loss allowed under Code Sec. 704(d), an additional $20,000 will be disallowed under Code Sec. 465 because the non-qualified nonrecourse liabilities are included in her tax basis but not in her amount at risk. Finally, the remaining $15,000 of the pass-through loss will be disallowed under Code Sec. 469, since passive losses can generally only be deducted against passive income from other sources. Thus, none of the $45,000 loss allocated to *J* will be deductible this year. $10,000 will be disallowed (and carried forward) under Code Sec. 704(d), $20,000 will be disallowed (and carried forward) under the at-risk rules of Code Sec. 465, and the remaining $15,000 will be disallowed (and carried forward) under the Code Sec. 469 passive activity loss rules.

Note in the above example that although *J*'s entire pass-through loss was denied under various statutory limitations of the Internal Revenue Code, her tax basis in her partnership interest is still reduced to zero, as is her amount at risk. Because losses were allowed under Code Secs. 704(d) and 465, those losses reduce her basis and at-risk amounts, respectively, even though the losses were subsequently disallowed under different statutes.

¶ 502 DISALLOWED LOSSES ARE CARRIED FORWARD

.01 Carryforwards under Code Sec. 704(d)

Any loss passed through to a partner in excess of his basis in the partnership interest is carried forward indefinitely until such time as the partner obtains additional basis sufficient to allow the deduction. Carryforward losses unused as of the date of sale or disposition of the partnership interest are lost—they do *not* carry over to the transferee (if any) of such interest, and they do not reduce the gain (if any) or increase the loss (if any) recognized in connection with sale of the partnership interest.

Example 5-2

EXAMPLE

E is a 25% partner in Lockwood Partners. His original tax basis in his partnership interest was $35,000, but pass-through losses of $40,000 reduced that basis to zero. The $5,000 excess of his distributive share of partnership losses over his tax basis in the partnership interest is carried forward under Code Sec. 704(d), and will be deductible when (and if) he obtains additional tax basis (*e.g.*, as the result of an additional contribution to partnership capital).

This year, he sold his interest in the partnership for $10,000, recognizing a $10,000 capital gain (recall that his tax basis was zero). The gain does not increase his tax basis in the partnership interest—indeed, he no longer has an interest in the partnership. Thus, the $5,000 carryforward under Code Sec. 704(d) is lost.

Note that the loss carryforward is not deductible against *E*'s capital gain from sale of the partnership interest because it did not reduce the tax basis of that interest. Put another way, had the loss been deductible, *E*'s basis in the interest would presumably have been negative $5,000 ($35,000 tax basis less $40,000 pass-through loss). Sale of the interest for $10,000 would then have triggered a $15,000 capital gain, rather than $10,000 as above. Thus, *E*'s gain from sale of the interest is *already lower than it would have been had the loss been allowed*. Accordingly, the loss carryforward cannot be utilized to offset the gain recognized on sale of the partnership interest.

.02 Carryforwards under Code Sec. 465

Losses disallowed under the at-risk rules of Code Sec. 465 are carried forward indefinitely just as are those denied under Code Sec. 704(d). Carryforwards under the two statutes have different effects on the partner, however. As noted above, to the extent deductible under Code Sec. 704(d), a partner's allocable share of the partnership's loss reduces her tax basis in the partnership interest *whether or not it is ultimately deductible under Code Secs. 465 and 469*. Thus, a partner's tax basis in her partnership interest is reduced by losses even if they are disallowed under the at-risk rules (Code Sec. 465). As a result, the partner's gain upon a subsequent sale of that interest is increased by losses that have previously been disallowed under the at-risk rules (because these losses reduced tax basis with no corresponding tax benefit). Thus, when a partner sells her interest in the partnership, losses carried forward under Code Sec. 465, unlike those carried forward under Code Sec. 704, are deductible in full, regardless of the amount of gain or loss recognized by the partner/member on the transaction.

Example 5-3

EXAMPLE

Q is a 10% limited partner in Quantum Limited Partnership. She has a zero tax basis in her partnership interest and her amount at risk is also zero. She has an $8,000 loss carryforward under Code Sec. 704(d) and a $3,500 loss carryforward under Code Sec. 465. She sold her interest in the partnership this year for $25,000, recognizing a $25,000 capital gain.

Note that the loss carryforward under Code Sec. 704(d) is disregarded in determining the tax consequences of the sale of *Q*'s partnership interest. The carryforward cannot be deducted against her gain on the sale, and since she is no longer a partner in Quantum, she will never have additional basis in the interest. The Code Sec. 704(d) carryforward is essentially forfeited upon sale of her interest in the partnership.

In contrast, *Q*'s loss carryforward under Code Sec. 465 consists of losses previously allowed under Code Sec. 704(d) before being disallowed by Code Sec. 465. Accordingly, these losses have reduced her tax basis in the partnership interest, even though they have not actually been deducted. As a result, *Q*'s recognized gain of $25,000 exceeds the economic gain actually realized on the investment by the amount of the loss disallowed under Code Sec. 465. This imbalance is corrected by allowing *Q* to deduct her Code Sec. 465 loss carryforward *in full* on sale or disposition of her interest. She will therefore report a $25,000 capital gain and a $3,500 ordinary loss in the year of sale.[1]

1. But see Prop. Reg. §1.465-66, providing that gain recognized on the sale of the activity (if any) is treated as gain from the activity, even though the taxpayer's participation in the activity has ended. In such cases, the carryover is first allowed to the extent of the gain under the normal rules of Code Sec. 465, with the remainder of the carryforward, if any, being deductible in the year of the sale.