PacificCPE

COURSE
33052C

Partnerships: Interests, Income, and Startup Costs

Dig into two critical areas of partnership taxation: compensatory partnership interests and the calculation of partnership income. This course walks through the tax treatment of interests received for services, then shifts to how partnership income is computed and allocated. You'll also explore the often-confusing rules around pre-opening expenses, organizational costs, and startup expenditures. Practical observations covering S corporations and LLCs help you apply the concepts across multiple entity types you're likely to encounter in practice.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

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Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recognize the characteristics of the two types of partnership interests.
- Identify the elections available at the partnership level and those available at the partner level.
-

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Chapter 1: RECEIPT OF A PARTNERSHIP INTEREST FOR SERVICES

Chapter Objective

After completing this chapter, you should be able to:

- Recognize the characteristics of the two types of partnership interests.

301 INTRODUCTION

The nonrecognition provisions that apply to the receipt of a partnership interest in exchange for a property contribution do not apply to one who receives a partnership interest in exchange for services. For this purpose, a partnership interest is divided into two interests—a capital interest and a profits interest. A capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. A profits interest is a partnership interest other than a capital interest, but it is generally understood to be a share in the results of future operations and any future appreciation in the partnership's assets[12].

The rules governing both the service partner's and the partnership's results are relatively well defined to the extent that the service partner gets an interest in the partnership's capital. The law governing the receipt of a future profits interest is less clear cut[3].

When an interest in partnership capital is received in exchange for services, the service partner must recognize income equal to the fair market value of the partnership interest received, either at the time the transfer is made for past services, or at the time the services have been performed (where the transfer depends on the completion of future services by the service partner). The time when the income is realized depends on all relevant facts and circumstances, including the existence and nature of any substantial restrictions or conditions on the service partner's right to withdraw or otherwise dispose of the interest. Note that fair market value is usually not the same as the amount credited to the partner's tax basis capital account in the partnership's books[4]. Also note that valuation discounts for lack of control and marketability should be considered.

Observation

Practitioners have often observed that the IRS position may overstate the value of the partnership interest. This is because for a partner there are restrictions on control over his or her share of the assets and the partner's partnership interest is less marketable than simply having separate ownership of property having a value equal to his or her share of the cash value of the assets.

302 CAPITAL INTEREST RECEIVED

.01 Results to Service Partner

An interest in capital transferred for services performed for the partnership is valued and treated as a guaranteed payment for services under Code Sec. 707(c) if it vests in the service partner immediately[5]. For this purpose, an interest is vested if it either is transferable or it is not subject to a substantial risk of forfeiture. If the partnership interest received by the service partner does not vest immediately, but rather is contingent (for example, upon the occurrence of future events such as the full leasing of a vacant office building, the partnership reaching a specified level of profitability, etc.) and is not transferable until that date, then the service partner recognizes no income with regard to receipt of the partnership interest until it is vested. At that time the service partner will recognize compensation income equal to the value of the partnership interest received, as measured at the vesting date.

The service partner may elect, under Code Sec. 83(b), to ignore the contingency associated with receipt of the partnership interest and include the partnership interest in income when initially received and measured at its initial value. Partners making this election cannot take into account the risk of forfeiture or lack of transferability in valuing the interest. Moreover, if the interest is subsequently forfeited, no deduction for the loss will be allowed to such partners even though they have basis in the now forfeited interest (in an amount equal to the amount previously included in income)[6].

Example 3-1

On January 1 of Year 1, Kali is granted an equal one-fourth interest in the ABCD partnership for her agreement to find tenants for the partnership's newly constructed office building. This interest is subject to the condition that it is forfeited back to the partnership in the event that the building is not at least 50% leased as of January 1 of Year 2 and 75% leased as of August 17 of Year 2. Such a partnership interest would be considered subject to a substantial risk of forfeiture. Unless the service partner elects, within 30 days of receiving the interest, to value and report the interest as income in the year received rather than when it is vested, the interest is not taxable until the risk of forfeiture lapses[7].

There are two benefits of electing to be taxed in the year of receipt:

1. The recipient avoids recognizing subsequent appreciation in the partnership interest as compensation income when the interest becomes vested, and
2. Any amounts received as partnership distributions are not recharacterized as compensation (because the service partner is recognized as a partner)[8].

The Code Sec. 83(b) election is especially beneficial when the initial value of the partnership interest received by the service partner is relatively low or when the difference between that value and the amount paid, if any, for that interest (in addition to services provided) is relatively small. In either case, little income will be recognized at the time the Code Sec. 83(b) election is made, and if the partnership interest subsequently appreciates, the appreciation will not be taxed to the partner's compensation.

Example 3-2

Eddie Horton received a 5% interest in MidCity Associates, a partnership formed to construct and manage an office tower. The interest is contingent upon Eddie's ability to find tenants for the newly constructed office tower. Construction of the building was recently completed at a total cost of $1,200,000. The partnership's debts total $1,000,000. Thus, if Eddie makes the election under Code Sec. 83(b) to recognize income from the transaction now, he will reportat most$10,000 as compensation. This amount may be further reduced by lack of marketability or lack of control discounts. Anygainssubseque ntly recognized upon dispositionof the interest would then betaxed as capital gain.

A Code Sec. 83(b) election must, as stated, be made no later than 30 days after the date on which the property is transferred and may be made prior to the transfer. The written election must be separately filed with the Internal Revenue Service Center office where the service provider regularly files income tax returns[9]. The service provider must also attach a copy of the election to his or her income tax return for the year of the transfer and must furnish a copy to the person for whom services are performed[10][11].

Until the interest vests, the regulations provide for a curious result when the Code Sec. 83(b) election is not made: the service partner is not considered a partner for tax purposes[12]. It is unclear how to give effect to this regulatory pronouncement and no specific official guidance has been offered. However, in *Crescent Holdings, LLC, et al. v. Commissioner,[13] the service partner did not elect immediate taxation of a contingent interest under Code Sec. 83(b), and resigned before the interest vested. The court ruled that the interest in question was a capital interest, and that the income from the interests should not be allocated to the service partner before the interest vested. Since the interest never* vested, the income should be allocated to the other partners, according to the court. The service partner in Crescent Holdings was sent a K-1 reflecting his “share” of partnership income, and received payments from the partnership in the amount of the income taxes he paid on the partnership income allocations. However, because he repaid these payments the court never ruled on how they should be treated. Presumably, to the extent cash and property are paid to the service partner before vesting, he or she would be treated as an employee or independent contractor. The payment would not be subject to the special rules applying to partnership payments to partners under Code Sec. 707(a) and Code Sec. 707(c). Payments would be deducted by the partnership and would be personal services income to the partner. hey would not be considered distributions of distributive shares of income.

Except for the Proposed Regulations explained in Notice 2005-43, the IRS has offered no further guidance as to how to give effect to the regulations.

Most practitioners who wish to choose a settled means of dealing with these situations elect Code Sec. 83(b) and include the value of the interest in income in the year received. The regulations clearly provide that the service partner is then treated as a partner for tax purposes[14].

.02 Results to Partnership

When the interest is vested, the partnership is treated as if it transferred a partitioned tenancy-in-common interest in its property to the service partner as compensation for

his or her past or future services. It is entitled to a deduction for the value of the capital interest paid to the service partner unless a cash payment to an independent party for such services would be nondeductible. This deduction is allocable to the continuing partners other than the service partner in proportion to their respective indirect interests in the partnership property transferred. The total deduction allowed to the partnership is equal to the value of the property deemed transferred to the service partner. Therefore, each continuing partner's deduction will equal the reduction in his or her interest in the liquidated value of the partnership[15]. The service partner's income will equal his or her increased interest in the liquidated value of the partnership[16].

Since the partnership is treated as if it transferred an undivided tenancy-in-common interest in its own property to the partner in exchange for services, it must realize gain or loss on the portion of its property used to pay for the services. This gain or loss is allocated to the same partners who are allocated the deduction because they are the partners who used their share of appreciated or depreciated property to pay for services. 13. 141 TC 477 (2013). The situation can be viewed as if the partnership paid an undivided interest in the partnership's property to the service partner who, therefore, takes it with a basis equal to its fair market value. He or she, in turn, is treated as having contributed such property back to the partnership in exchange for a partnership interest. The partnership therefore takes as its transferred basis for this portion of the property its fair market value. The net effect to the basis of the partnership's property is that it is changed by the gain or loss realized by the partnership. The portion of the partnership's property treated as paid to the service partner is stepped up or down in basis for the amount of gain or loss recognized by the partnership. This portion of the partnership's property will have a basis equal to its value. The benefit or burden of this step up or down in basis should be, and probably is, required to be allocated to the service partner in accordance with Code Sec. 704(c) considerations.

Example 3-3

The ABC partnership was formed by cash contributions and has been holding undeveloped investment realty for long-term appreciation. Its balance sheet is as follows:

ABC Partnership

Assets	***Tax Basis***	***FMV***
Real Estate	$90,000	$120,000
Liabilities	$ 0	$ 0
Capital		
A	$30,000	$40,000
B	30,000	40,000
C	30,000	40,000
	$90,000	$120,000

Kali, a real estate developer, is admitted as an equal unrestricted one-fourth partner for his promise to produce a feasibility study related to subdividing and marketing the partnership's property. Assuming no discounts for lack of control and marketability, Kali has personal service income of $30,000 and a basis in her partnership interest of $30,000[17]. Assuming Code Sec. 263A does not require capitalizing such a payment, the partnership has a $30,000 deduction[18]. This deduction should be allocated to A, B, and C only because it arose before Kali became a partner[19]. The partnership has capital gain of $7,500[20]. This gain is also allocated only to A, B, and C for the same reason that the $30,000 deduction is allocated to them alone. It is the continuing partners who have used their share of the value of the assets to pay A. They should be allowed the deduction and be required to report gain from using the share of their appreciated assets to pay Kali. The resulting partnership balance sheet is as follows:

ABCK Partnership		
Assets	***Tax Basis***	***FMV***
Real Estate	$97,500*	$120,000
Liabilities	$ 0	$ 0
Capital		
*A***	$22,500	$30,000
B	22,500	30,000
C	22,500	30,000
Kali***	30,000	30,000
	$97,500	$120,000

If the partnership later sells the real estate for its fair market value of $120,000, the gain of $22,500 ($120,000 − $97,500) will be allocated equally ($7,500 each) between A, B, and C. Kali's "share" of the basis of the property is $30,000, and his share of the sales price is $30,000, so he would recognize no gain or loss. If the sales price of the real estate was $130,000, A, B, and C would each recognize $10,000 of gain [($130,000/4) − ((97,500 − $30,000)/3)], and Kali would recognize $2,500 of gain. If the sales price was $110,000, A, B, and C would each recognize $5,000 of gain [($110,000/4((97,500 − $30,000)/3)], and Kali would recognize $2,500 of loss [($110,000/4) − $30,000].

* The real estate's basis is three-fourths of the ABC partnership's basis of $90,000, or $67,500 plus Kali's $30,000 cost basis in the real estate.

** A, B, and C's capital accounts, values, and basis in their interests are reduced by one-fourth. This is the portion of their interest in the partnership transferred to Kali. This is their original capital account of $30,000 less their $10,000 share of the deduction plus their $2,500 share of income.

*** Kali's capital account of $30,000 represents her share of the basis of the real estate. Kali is treated as having received one-fourth share worth $30,000 as payment for services and then contributing it to the partnership. This results in a capital account and basis of $30,000.

303 PROFIT INTEREST RECEIVED

Unless one chooses to rely on the Proposed Regulations, the rules governing a profit interest allowed to a partner in exchange for services are less clear cut than the rules