PacificCPE

COURSE
33101C

Partnerships and LLCs: Income Allocations and Contributed Property

Understanding how partnership income is allocated among partners is fundamental to avoiding costly tax mistakes. This course covers the substantial economic effect requirement under the partnership allocation rules, including how LLCs are affected in practice. It also tackles the often-complex rules for allocating income and deductions related to contributed property under Code Sec. 704(c), a critical area for partnerships and LLCs where partners contribute appreciated or depreciated assets.

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

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LEARNING ASSIGNMENTS AND OBJECTIVES

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

- Recall the items that result in an increase to partnership capital accounts.
- Recall the reasonable allocation methods allowed under Code Sec. 704(c).

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Chapter 1: ALLOCATION OF PARTNERSHIP INCOME AMONG THE PARTNERS: THE SUBSTANTIAL ECONOMIC EFFECT REQUIREMENT

Chapter Objective

After completing this chapter, you should be able to:

- Recall the items that result in an increase to partnership capital accounts.

101 INTRODUCTION

Although the partnership reports its taxable income to the IRS on Form 1065, it pays no income tax. Instead, it allocates its taxable income to its partners and they pay any appropriate tax on the income they have been allocated. Note that partners must pay income tax on their allocated shares of partnership income whether or not such income is actually distributed to them.

The code gives partnerships wide latitude in determining how income is allocated among their partners. Generally speaking, partnerships are allowed to allocate their income among the partners in any way that the partners see fit, subject to the following limitations:

- Code Sec. 704(b) requires that allocations must have "substantial economic effect";
- Code Sec. 704(c) requires that pre-contribution, or "built-in," gain or loss must be allocated to the partner(s) who contributed the property;
- Code Sec. 704(e) limits the ability of family partnerships to allocate income derived from services provided by one partner to other partner-family members;
- Code Sec. 706(d) prohibits partnerships from allocating income to partners that was earned by the partnership before such partners joined.

This chapter focuses on the first restriction above, the requirement that allocations have substantial economic effect. The requirement that built-in gains be allocated to the contributing partners is the subject of Chapter 2. The rules governing family partnership allocations and retroactive allocations are discussed in Chapter 1 of course 33102D.

.01 S Corporation Comparison

S corporations are not allowed any similar flexibility in the allocation of income and deductions to their shareholders. All items of income and deductions are allocated to the shareholders strictly on a per-share, per-day basis. In fact, none of the shares of an S corporation are allowed to differ in any respect, except where voting rights are concerned.

102 THE PARTNERSHIP AGREEMENT IS A LEGAL CONTRACT

Under Code Sec. 704(b), the partnership can allocate any item of taxable income or loss in any manner the partners decide as long as the tax allocation reflects the manner in which the partners are sharing the economic effects of the action that generated the related tax item. The tax law relies on an evaluation of the partnership agreement to determine how the partners share in the economic benefits or detriments of partnership operations. Since the partnership agreement represents the legal contract between the partners, partners generally must abide by the provisions contained therein unless such provisions are in violation of local or state law. The law therefore determines from the partnership agreement to how partners have agreed to share the profits and losses generated by partnership operations. The partnership agreement also governs how partnership assets will be divided among the partners in the event of liquidation of the partnership, or of a partner’s interest therein. The partnership agreement is considered to retroactively include all changes made by the due date of the partnership tax return (excluding extensions)[3].

Generally speaking, an allocation has economic effect if it affects the amount of money or other assets to which the partner will be entitled upon leaving the partnership. If the partnership agreement does not tie the partner’s rights at liquidation to the allocations he or she has received during the time he/she has been a member of the partnership, then those allocations will not have “economic effect[4].”

Example 1-1

Bill Burke became a 25% partner in the Bowhay partnership by contributing land with a basis of $300,000 and a fair market value of $400,000. The partnership agreement allocates 40% of all income and losses for the first four years to Bill, but if the partnership liquidates, the partnership agreement provides that the liquidation proceeds will be divided equally among the four partners. The 40% allocation of partnership profits and losses is a discretionary allocation under Code Sec. 704(b). However, the allocation will be invalid because it will not be reflected in the distributions that will occur upon liquidation, and thus has no "economic effect."

If the allocation of partnership profits and losses provided for in the partnership agreement has "substantial economic effect," amounts allocated to partners will be valid for income tax purposes[5]. If, however, the allocation of any item lacks "substantial economic effect," such item must be reallocated among the partners according to their interests in the partnership[6]. It is therefore very important that the allocations provided for in the partnership agreement have "substantial economic effect" in order for the intended allocations of income and deductions to be allowed for tax purposes.

103 GENERAL REQUIREMENTS FOR SUBSTANTIAL ECONOMIC EFFECT

The "substantial economic effect" test is intended to ensure that if a tax deduction allowed for a partnership expense involves a possible economic risk of loss to the partnership itself, then that tax deduction is allocated to the specific partner who is most likely to bear the economic burden of that loss. It is also intended to ensure that taxable income is allocated only to partners most likely to enjoy the economic benefit from the transaction generating the taxable income.

The "substantial economic effect" test has two parts:

1. Does the agreement have "economic effect?"
2. If the agreement has "economic effect," is that economic effect "substantial?"

104 THE FIRST REQUIREMENT: "ECONOMIC EFFECT"

The regulations provide that an allocation of taxable income or deductions in a partnership agreement can be determined to have "economic effect" if the allocation meets the requirements of any one of three different sets of rules:

1. The allocation has economic effect under the general rule; [7]

2. The allocation meets the alternate test for economic effect;[8] or
3. The allocation has economic effect equivalence.

These rules ensure that in order for an allocation to be allowed, it must be consistent with the underlying economic arrangement of the partners. This means that in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive the related economic benefit or bear the related economic burden.

.01 General Rule

To satisfy the economic effect requirement under the general rule three tests must be satisfied[9]. The partnership agreement (or local law) must provide that:

1. The partners' capital accounts must be "properly maintained" in accordance with the accounting rules contained in the regulations (Code Sec. 704(b) accounting);
2. Liquidating distributions must be made in accordance with those capital accounts; and
3. Partners with a deficit balance in their capital accounts must be required, either by local law or the partnership agreement, to restore such deficit balances to the partnership upon liquidation of their interests (e.g., by making a payment to the partnership sufficient to bring the balance in their accounts back to zero).

The third requirement above assures that sufficient funds will be available to the partnership to repay its creditors and to liquidate the interests of those partners with positive capital balances.

Example 1-2

Wayne is a one-third partner in the Andrews Partnership. Although Wayne contributed only one-third of the partnership's capital, he is allocated 50% of the profits and losses of the partnership under the partnership agreement. Assume that the partners' capital accounts are maintained in accordance with Code Sec. 704(b), and any liquidating distributions must be made according to the partners' capital account balances. However, the partnership agreement provides that if Wayne has a negative capital account balance upon liquidation, the other partners will contribute money or property on his behalf to bring it up to zero. Since the third test of the general rule is not met, the 50% allocation does not have economic effect, and will not be recognized for tax purposes.

Example 1-3

Rico, Ariana, and Dan form the equal RAD partnership with cash contributions of $200,000 each. The partnership used the cash to purchase equipment for $600,000. The equipment has a depreciable life of four years, and depreciation is computed using the straight-line method. Under the partnership agreement, all depreciation expense is allocated to Rico. Capital accounts are properly maintained. The partnership agreement also provides that liquidating distributions will be made in accordance with the capital accounts of each partner. Partners are required to restore deficit capital accounts upon liquidation. Income before depreciation is $90,000 each year. Assuming that the fair market value of the equipment is equal to its book value, the partners would receive the following amounts if the partnership were to liquidate at the end of year one:

	Rico	Ariana	Dan
Contribution	$200,000	$200,000	$200,000
Income	$30,000	$30,000	$30,000
Depreciation (1 yr)	-$150,000		
Capital balance, End of year 1	**$80,000**	**$230,000**	**$230,000**

If the liquidation occurred at the end of year two, each partner would receive the following amount:

	Rico	Ariana	Dan
Contribution	$200,000	$200,000	$200,000
Income (2 yrs)	$60,000	$60,000	$60,000
Depreciation (2 yrs)	-$300,000		
Capital balance, end of year 2	**-$40,000**	**$260,000**	**$260,000**
Liquidation amount	**$0**	**$260,000**	**$260,000**

Note that the only way Ariana and Dan will actually receive $260,000 each is if Rico contributes $40,000 to the partnership. Otherwise the partnership assets will only total $480,000 ($600,000 equipment price − $300,000 depreciation + $180,000