PacificCPE

COURSE

33102C

Partnerships and LLCs: Allocation Limits and Debt Allocation Rules

Two essential areas of partnership taxation come together in this course: additional limitations on partnership allocations and the rules governing a partner's share of partnership debt. Practitioners working with partnerships and LLCs will explore how these rules interact with S corporation and LLC structures, and how debt allocation affects a partner's basis. A solid grasp of these concepts is essential for accurate compliance and effective tax planning for partnership clients.

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

Start Course ↓

Final Exam Copy ↓

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

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

Copyright Notice

© 2026 Pacific CPE, LP. All rights reserved.

The materials in this course — including the text, illustrations, exhibits, examples, exam questions, and review questions — are the copyrighted property of Pacific CPE, LP. No portion of this course may be reproduced, stored in a retrieval system, distributed, or transmitted in any form or by any means (electronic, mechanical, photocopying, recording, or otherwise) without the prior written permission of Pacific CPE, LP, except for the personal, non-commercial use of the registered learner.

Pacific CPE, LP grants the registered learner a single-seat, non-transferable license to access this course for the purpose of completing the associated continuing professional education credit. Account credentials may not be shared. Group access requires a separate enterprise license.

This course is provided "as is" for educational purposes. While Pacific CPE, LP makes a reasonable effort to ensure the content is current and accurate, the materials should not be relied upon as a substitute for professional advice. Pacific CPE, LP disclaims all liability for any error, omission, or loss arising from the use of, or reliance on, the course content.

Questions about reproduction, licensing, or use of these materials should be directed to support@pacificcpe.com.

Publication Date: September 2025

TABLE OF CONTENTS

CHAPTER 01

Other Limitations On Partnership Allocations 5

1.01 301 Allocation Of Partnership Income And Loss On Transfer Or Change 5

1.02 .03 Retroactive Allocations Among Newly Admitted And Continuing Partners 12

1.03 .02 Principles Underlying Code Sec. 704(E) 13

1.04 .05 Donee'S Status As The Owner Of The Partnership Interest 16

1.05 .09 Estate Tax Planning With Family Partnerships 20

1.06 Expenditure 25

Test Your Knowledge 34

CHAPTER 02

Partner'S Share Of Partnership Debt 39

2.01 401 Introduction 39

2.02 403 What Constitutes A "Liability" For Purposes Of Code Sec. 752? 45

2.03 405 Partner'S Share Of Partnership Recourse Debt 50

2.04 .01 Nonrecourse Liabilities Allocated By Reference To Partners' Profits Interests 60

2.05 407 Reg. § 1.752-7 Liabilities 69

2.06 .05 Exceptions 74

Test Your Knowledge 79

Final Exam Copy 86

Glossary 83

Index.....

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 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

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 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

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 interest will most likely be realized in the distant future. The present value of the tax benefit obtained from the basis adjustment is much

less than the seller's. The buyer and seller should consider an increased price that would compensate the seller for any increased tax liability coupled with adopting an income allocation method that minimizes the buyer's share.

Observation

The method of allocating partnership taxable income between the buyer and seller need not be consistent with any method used to fix the price paid for the partnership interest.

.02 Special Rules Limiting Loss Allocations on Transfer or Change in a Partner's Interest

Code Sec. 706(c)(2) and (d) make it clear that the statutory prohibition against "retroactive" allocations applies to partners who acquire interests by transfer from other partners as well as those who acquire or increase their interests by making additional contributions to the partnership. Tiered partnership structures are created when a parent partnership owns an interest in a subsidiary partnership. Code Sec. 706(d) ensures that when a new partner purchases an interest in the parent partnership, the "interim closing" method of allocation cannot be used to allow the buyer to claim that, since the parent partnership only realized its share of the subsidiary's income, gain, losses, and deductions on the last day of the subsidiary's taxable year, the incoming partner was entitled to a full distributive share of any losses incurred by the subsidiary.

Code Sec. 706(d)(1) provides as a general rule that each partner's distributive share of the above items is to be determined by using any method prescribed by regulations that takes into account the varying interests of the partners in the partnership during the taxable year. This general rule is, however, subject to two exceptions specified in Code Sec. 706(d)(2) and (3). Certain "allocable cash-basis items" must be prorated over the period to which they are attributable[8]. In addition, partnerships which are partners in another partnership must consider the income of that partnership as earned pro rata over the taxable year[9]. The first exception applies only to partnerships using the cash method of accounting. The "allocable cash-basis items" that must be prorated are:

1. Interest;
2. Taxes;
3. Payment for services or for the use of property; and

4. "Any other item of a kind specified in regulations prescribed by the Secretary as being an item with respect to which the application of Code Sec. 706(d)(2) is appropriate to avoid significant misstatements of the income of the partners."

The Committee Reports accompanying passage of the statute treat retroactive allocations to the partners as significant misstatements of income. Any item within this category is to be assigned to each day in the period to which it is attributable[10]. The amounts so assigned are then apportioned among the partners in proportion to their interests in the partnership at the close of each day[11]. The determination of the period to which an expense is attributable for this purpose is to be made in accordance with "economic accrual principles." Thus, in effect, cash method partnerships are placed on the accrual method of accounting, but only for purposes of allocating income and deductions to incoming partners with respect to "allocable cash-basis items" which have been paid by the partnership. Although the partnership's deduction is allowed only when the item is paid, the accrual method must be used in determining which partners are entitled to that deduction.

Example 3-3

The DNR Partnership is a cash-basis, calendar-year partnership in which David, Neil, and Rebecca are equal partners. David sells his 1/3 interest to Steven on 5/1/ Y2. Revenue to the partnership is $6,000 per month, and expenses are $2,400 per month, not counting (1) rent expense for the year of $12,000, paid on 2/1/Y2, and (2) real estate taxes of $15,000 for the year, paid on 4/1/Y2. In addition, the partnership reported a long-term capital gain of $24,000 from the sale of property on 1/15/Y2. Under the interim closing method, David (the selling partner) would be allocated the following income and expenses in Y2:

Revenue = $6,000 × 1/3 × 4 months = $8,000

Expenses = $2,400 × 1/3 × 4 months = $3,200

Rent expense = $12,000 × (4 mo./12 mo.) × 1/3 = $1,333

Real estate taxes = $15,000 × (4 mo./12 mo.) × 1/3 = $1,667

Long-term capital gain = $24,000 × 1/3 = $8,000

Code Sec. 706(d)(2) denies the partnership the ability to allocate to Steven (the purchasing partner) any of the specified deductions that were generated prior to the admission to the partnership. These expenses will have to be allocated to the