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**BASIC PARTNERSHIP ALLOCATIONS**

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## TABLE OF CONTENTS

I. Introduction .....	1
II. General Matters .....	1
A. Formation .....	1
1. Contributions – IRC § 721 .....	1
2. Character of Contributed Assets.....	2
3. Basis .....	3
a. Outside Basis – IRC § 722.....	3
b. Inside Basis – IRC § 723.....	3
c. Allocations: Continual Adjustments to Outside Basis – IRC § 705 .....	3
B. Basis of Transferred Partnership Interests – IRC § 742.....	4
C. Impact of Liabilities – IRC § 752 .....	4
D. Holding Period.....	5
1. Partnership Interest – IRC § 1223(1).....	5
2. Partnership Assets – IRC § 1223(2) .....	6
E. Distributions.....	6
1. Gain and Loss – IRC § 731 .....	6
2. Basis – IRC § 732.....	6
3. Character of Distributed Assets – IRC § 735 .....	6
4. Holding Period of Distributed Assets – IRC § 735 .....	7
F. Hot Assets – IRC § 751.....	7
G. Mixing Bowl Rules .....	7
1. Disguised Sales – IRC § 707(a)(2)(B).....	7
2. IRC § 704(c)(1)(B).....	8
3. IRC § 737 .....	8
H. Anti-Abuse Rules.....	8
I. Basis Adjustments.....	8
1. Section 754 Election.....	8
III. Partnership Allocations.....	9
A. Substantial Economic Effect (“SEE”).....	10
1. Economic Effect .....	10
a. The Basic Test.....	10
b. Alternative Test.....	11
c. Economic Effect Equivalence Test .....	11
2. Substantiality .....	11
a. Pre-Tax Test.....	11
i. General Rule .....	12
ii. Shifting Tax Consequences Rule .....	12
iii. Transitory Allocations Rule .....	13
(A) General Rule .....	13
(B) Applicable Presumptions .....	14
b. After-Tax Test.....	15
B. Partner’s Interest in the Partnership (“PIP”) .....	15
C. Special Rules.....	16
1. General .....	16
2. Allocations Attributable to Nonrecourse Liabilities.....	16
a. Nonrecourse Liabilities.....	16
b. Partnership Nonrecourse Liability .....	17
i. General.....	17
ii. Partnership Minimum Gain.....	18

(C) Increases in PMG.....	18
(D) Decreases in PMG .....	18
iii. Partner’s Share of Partnership Minimum Gain.....	18
iv. Minimum Gain Chargeback.....	19
c. Partner Nonrecourse Liabilities .....	20
i. General.....	20
ii. Partner Nonrecourse Debt Minimum Gain .....	21
iii. Partner’s Share of Partner Nonrecourse Debt Minimum Gain .....	21
iv. Partner Nonrecourse Debt Minimum Gain Chargeback .....	22
IV. Family Partnership Allocations .....	22
V. Conclusion.....	23

## I. Introduction

Most non-tax lawyers openly acknowledge that they do not understand the allocation provisions contained in their form partnership agreements. But becoming a master of the realm of partnership allocations is even a great challenge to lawyers specializing in the subject. Here is how one preeminent partnership tax lawyer, Terry Cuff, describes the partnership allocation rules contained in the Code<sup>1</sup> and its related Treasury regulations:

The tax rules governing partnership allocations are complex, pointillist, and stochastic. The rules are complex in the sense that the text of Treasury Regulations is long, difficult to understand, and bewildering to read. Few partnership tax specialists are masters of the rules of substantial economic effect. The rules are pointillist in the sense that regulations, cases, and administrative authority are a set of dots; they address a number of limited situations. Many situations are not directly addressed by Treasury Regulations. You must generalize from the pointillist dots to see the full picture. The rules are stochastic in the sense that many of the rules cannot be applied with mathematical precision. Draftsmen can apply tax rules only in terms of probabilities of a particular answer being correct. There is considerable uncertainty built into the partnership tax rules. New partnership tax rules often address problems in terms of probability.<sup>2</sup>

Nevertheless, because of the extensive use of family limited partnerships<sup>3</sup> in the estate planning arena, it is important that estate planning lawyers have a general understanding of partnership allocation

provisions. If they do not, they are performing a disservice to their clients and themselves. If an estate planning lawyer improperly drafts or intentionally omits key allocation provisions from a partnership agreement,<sup>4</sup> that lawyer has granted the IRS an open invitation to change previously reported allocations of income, gain, loss and deduction among partners. Such a change is both frustrating to the client and embarrassing for the drafting lawyer. With these concerns in mind, the objective of this paper is to enable the estate planning lawyer to gain a conceptual understanding of the typical partnership tax allocation provisions that should be included in a partnership agreement.

## II. General Matters

### A. Formation

#### 1. Contributions – IRC § 721

Generally, no gain or loss will be recognized either to a partnership or to any of its partners upon a contribution of appreciated property to the partnership in exchange for a partnership interest.<sup>5</sup> This rule applies whether the contribution is made to a partnership in the process of formation or to a partnership which is already formed and operating.

The non-recognition rule of Code section 721(a) does not apply to the issuance of a vested capital interest in a partnership in connection with the performance of services rendered to the partnership. Such an issuance is taxable as compensation to the partner as a guaranteed payment for services under section 707(c).<sup>6</sup>

The non-recognition rule of Code section 721(a) does not apply in the case of a transaction between a partnership and a partner when the partner is not acting in his capacity as a partner.<sup>7</sup> In such a case, the transaction is governed by section 707. For example, rather than contributing property to a partnership, a partner may sell property to the partnership or may retain the ownership of property and allow the partnership to use it under a lease arrangement. In all

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<sup>1</sup> For purposes of this paper, any reference to the “Code” or “IRC” refers to the Internal Revenue Code of 1986, as amended.

<sup>2</sup> Terence Floyd Cuff, *Several Comments on How to Compromise Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements*, 33<sup>rd</sup> Annual Advanced Tax Law Course, p. 457, October 29-30, 2015.

<sup>3</sup> For purposes of this paper, any reference to a “partnership” means any entity (including a partnership or limited liability company) treated as a partnership for federal income tax purposes.

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<sup>4</sup> For purposes of this paper, any reference to a “partnership agreement” means any agreement (including, a partnership agreement, limited partnership agreement or operating agreement) governing the allocation of income, gain, loss and deduction between or among owners of a partnership.

<sup>5</sup> IRC § 721(a); Reg. § 1.721-1(a).

<sup>6</sup> Prop. Reg. § 1.721-1(b); Rev. Proc. 93-27, 1993-2 C.B. 343; Rev. Proc. 2001-43, 2001-2 C.B. 191.

<sup>7</sup> Reg. § 1.721-1(a).

cases, the substance of the transaction will govern, rather than its form.

Though the non-recognition rule of section 721(a) generally applies to a contribution of a partnership's indebtedness by a creditor to the debtor partnership in exchange for a capital or profits interest in the partnership (commonly referred to as a debt-for-equity exchange),<sup>8</sup> the non-recognition rule does not apply to the creditor in a debt-for-equity exchange to the extent the transfer of the partnership interest to the creditor is in exchange for the partnership's indebtedness for unpaid rent, royalties, or interest (including accrued original issue discount) that accrued on or after the beginning of the creditor's holding period for the indebtedness.<sup>9</sup> The debtor partnership, however, will not recognize gain or loss upon the transfer of a partnership interest to the creditor.

The non-recognition rule does not apply to any gain realized on the transfer of property to a partnership that is treated as an "investment company" if the contribution results in the diversification of the transferor's assets.<sup>10</sup> Subchapter K relies on the investment company rules set forth in Code section 351(e). A partnership generally will be deemed to be an investment company if, after the transfer, more than 80% of the fair market value of the partnership's assets (excluding cash and non-convertible debt obligations) are held for investment and consists of are readily marketable stocks or securities,<sup>11</sup> or

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<sup>8</sup> Reg. § 1.721-1(d)(1).

<sup>9</sup> Reg. § 1.721-1(d)(2).

<sup>10</sup> IRC § 721(b).

<sup>11</sup> Reg. § 1.351-1(c)(1)(ii). The phrase "readily marketable stocks and securities" appears in the regulations. It is important to note, however, that the Taxpayer Relief Act of 1997 made two significant changes to IRC § 351(e). First, it expanded the definition of stocks and securities to include money, stocks and other equity interests in a corporation, evidences of indebtedness, options, forward or futures contracts, notional principal contracts or derivatives, foreign currency, certain interests in precious metals, interests in real estate investment trusts, regulated investment companies, common trust funds and publicly-traded partnerships or other interests in non-corporate entities that are convertible into or exchangeable for any of the above described assets. IRC § 351(e). Second, the Taxpayer Relief Act of 1997 did not include the "readily marketable" concept for investments. Consequently, prior to the Taxpayer Relief Act of 1997, the contribution of closely-held business interests into a partnership did not raise investment company concerns.

interests in regulated investment companies or real estate investment trusts.<sup>12</sup> Diversification generally results when two or more persons contribute non-identical assets to the partnership.<sup>13</sup>

The non-recognition rule of section 721(a) may not apply if a corporate parent contributes its stock (or stock of an affiliate) to a partnership in which it is a partner.<sup>14</sup>

The non-recognition rule of section 721(a) may not apply if a member of a consolidated group contributes an asset to a partnership if that asset was subject to an intercompany transaction in which gain was deferred under the consolidated return rules.<sup>15</sup>

## 2. Character of Contributed Assets

As a general matter a partnership is treated as an entity distinct from its owners for purposes of determining the character of income, gain, loss, deduction or credit.<sup>16</sup> Consequently, when the partnership sells an asset that was contributed to it by a partner, the character of the asset (i.e., the character

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That may no longer be the case. It should be noted, however, that the Senate Report to the Taxpayer Relief Act of 1997 states that the reason for expanding the definition of stock and securities was to prevent taxpayers from receiving an interest in an entity (known as a "swap fund") that is "*essentially a pool of high-quality investment assets*" without current taxation. S. REP. NO. 105-220 (1997) (Conf. Rep.). Based on the Senate Report, it would seem that contributions of closely-held operating businesses to a partnership should not trigger an investment company concern. Nevertheless, one must contend with the plain language used in IRC § 351(e).

<sup>12</sup> IRC §§ 721(b), 351(e); Reg. § 1.351-1(c)(1)(ii).

<sup>13</sup> Reg. § 1.351-1(c)(5). If any transaction involves one or more transfers of non-identical assets which, taken in the aggregate, constitute an insignificant portion of the total value of assets transferred, such transfers shall be disregarded in determining whether diversification has occurred. *Id.* A transfer of stocks and securities will not be treated as resulting in a diversification of the transferors' interests if each transferor transfers a diversified portfolio of stocks and securities. Reg. § 1.351-1(c)(6). A portfolio of stocks and securities will be considered diversified if not more than 25% of the value of the total portfolio is invested in the stock and securities of any one issuer and not more than 50% of the value of the total portfolio is invested in the stock and securities of five or fewer issuers. This test is known as the 25% and 50% test of IRC § 368(a)(2)(F)(ii).

<sup>14</sup> Temp. Reg. § 1.337(d)-3T.

<sup>15</sup> Reg. § 1.1502-13.

<sup>16</sup> IRC § 702(b).

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