

# Publication 541

(Rev. December 2024)

## Partnerships

For use in preparing

**2024** Returns

Volume 1 of 2



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## Reminder

**Section 1061 reporting.** Section 1061 recharacterizes certain long-term capital gains of a partner that holds one or more applicable partnership interests as short-term capital gains. An applicable partnership interest is an interest in a partnership that is transferred to or held by a taxpayer, directly or indirectly, in connection with the performance of substantial services by the taxpayer or any other related person, in an applicable trade or business.

See Section 1061 Reporting Instructions for more information.

### **Schedules K-2 and K-3 (Form 1065).**

Schedules K-2 and K-3 replaced the reporting of certain international transactions on Schedules K and K-1. The schedules were designed to provide greater clarity for partners on how to compute their U.S. income tax liability with respect to items of international tax relevance, including claiming deductions and credits. See the Partnership Instructions for Schedules K-2 and K-3 for more information.

**Photographs of missing children.** The Internal Revenue Service is a proud partner with the National Center for Missing & Exploited Children® (NCMEC). Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank.

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## **Introduction**

This publication provides supplemental federal income tax information for partnerships and partners. It supplements the information provided in the Instructions for Form 1065, U. S. Return of Partnership Income; the Partner's Instructions for Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc.; and the instructions for Schedule K-2 and Schedule K-3 (Form 1065). Generally, a partnership doesn't pay tax on its income but "passes through" any profits or losses to its partners. Partners must include partnership items on their tax returns.

For a discussion of business expenses a partnership can deduct, see the 2022 version of Pub. 535, Business Expenses.

Members of oil and gas partnerships should read about the deduction for depletion in chapter 9 of that publication.

For tax years beginning before 2018, certain partnerships must have a tax matters partner (TMP) who is also a general partner.

The TMP has been replaced with partnership representative for partnership tax years beginning after 2017. Each partnership must designate a partnership representative unless the partnership has made a valid election out of the centralized partnership audit regime. See *Designated Partnership Representative* in the Form 1065 instructions and Regulations section 301.6223-1.

**Withholding on foreign partner or firm.** A partnership that has foreign partners or engages in certain transactions with foreign persons may have one (or more) of the following obligations.

***Fixed or determinable annual or periodical (FDAP) income.*** A partnership may have to withhold tax on distributions to a foreign partner or a foreign partner's distributive share when it earns income not effectively connected with a U.S. trade or business. A partnership may also have to withhold on payments to a foreign person of FDAP income not effectively connected with a U.S. trade or business. See section 1441 or 1442 for more information.

***Withholding under the Foreign Investment in Real Property Tax Act (FIRPTA).*** If a partnership acquires a U.S. real property interest from a foreign person or firm, the partnership may have to withhold tax on the amount it pays for the property (including cash, the fair market value (FMV) of other property, and any assumed liability). See section 1445 for more information.



***Withholding on foreign partner's effectively connected taxable income (ECTI).***

If a partnership has income effectively connected with a trade or business in the United States (including gain on the disposition of a U.S. real property interest), it must withhold on the ECTI allocable to its foreign partners. See section 1446(a) for more information.

***Withholding on foreign partner's sale of a partnership interest.***

A purchaser of a partnership interest, which may include the partnership itself, may have to withhold tax on the amount realized by a foreign partner on the sale for that partnership interest if the partnership is engaged in a trade or business in the United States. See section 1446(f) for more information.

***Withholding under the Foreign Account Tax Compliance Act (FATCA).***

A partnership may have to withhold tax on distributions to a foreign partner of a foreign

partner's distributive share when it earns withholdable payments. A partnership may also have to withhold on withholdable payments that it makes to a foreign entity. See sections 1471 through 1474 for more information. A partnership that has a duty to withhold but fails to withhold may be held liable for the tax, applicable penalties, and interest. See section 1461 for more information.

For more information on withholding on nonresident aliens and foreign entities, see Pub. 515.

**Comments and suggestions.** We welcome your comments about this publication and suggestions for future editions.

You can send us comments through [IRS.gov/FormComments](https://www.irs.gov/FormComments). Or, you can write to the Internal Revenue Service, Tax Forms and Publications, 1111 Constitution Ave. NW, IR-6526, Washington, DC 20224.

Although we can't respond individually to each comment received, we do appreciate your feedback and will consider your comments and suggestions as we revise our tax forms, instructions, and publications.

**Don't** send tax questions, tax returns, or payments to the above address.

***Getting answers to your tax questions.*** If you have a tax question not answered by this publication or the *How To Get Tax Help* section at the end of this publication, go to the IRS Interactive Tax Assistant page at [IRS.gov/ Help/ITA](https://www.irs.gov/help/ita) where you can find topics by using the search feature or viewing the categories listed.

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## Useful Items

You may want to see:

### Publication

- ☐ **334** Tax Guide for Small Business
- ☐ **505** Tax Withholding and Estimated Tax
- ☐ **515** Withholding of Tax on Nonresident Aliens and Foreign Entities
- ☐ **537** Installment Sales
- ☐ **538** Accounting Periods and Methods
- ☐ **544** Sales and Other Dispositions of Assets

- **551** Basis of Assets
- **925** Passive Activity and At-Risk Rules
- **946** How To Depreciate Property

See *How To Get Tax Help* at the end of this publication for information about getting publications and forms.

## **Forming a Partnership**

The following sections contain general information about partnerships.

### **Organizations Classified as Partnerships**

An unincorporated organization with two or more members is generally classified as a partnership for federal tax purposes if its members carry on a trade, business, financial operation, or venture and divide its profits. However, a joint undertaking merely to share expenses is not a partnership.

For example, co-ownership of property maintained and rented or leased is not a partnership unless the co-owners provide services to the tenants.

The rules you must use to determine whether an organization is classified as a partnership changed for organizations formed after 1996.

**Organizations formed after 1996.** An organization formed after 1996 is classified as a partnership for federal tax purposes if it has two or more members and it is none of the following.

- An organization formed under a federal or state law that refers to it as incorporated or as a corporation, body corporate, or body politic.
- An organization formed under a state law that refers to it as a joint-stock company or joint-stock association.
- An insurance company.

- Certain banks.
- An organization wholly owned by a state, local, or foreign government.
- An organization specifically required to be taxed as a corporation by the Internal Revenue Code (for example, certain publicly traded partnerships).
- Certain foreign organizations identified in Regulations section 301.7701-2(b)(8).
- A tax-exempt organization.
- A real estate investment trust (REIT).
- An organization classified as a trust under Regulations section 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code.
- Any other organization that elects to be classified as a corporation by filing Form 8832.

For more information, see the instructions for Form 8832.

***Limited liability company (LLC).*** An LLC is an entity formed under state law by filing articles of organization as an LLC. Unlike a partnership, none of the members of an LLC are personally liable for its debts. However, if the LLC is an employer, an LLC member may be liable for employer-related penalties. See Pub. 15, (Circular E), Employer's Tax Guide, and Pub. 3402, Taxation of Limited Liability Companies. An LLC may be classified for federal income tax purposes as either a partnership, a corporation, or an entity disregarded as an entity separate from its owner by applying the rules in Regulations section 301.7701-3. See Form 8832 and Regulations section 301.7701-3 for more details.



*A domestic LLC with at least two members that doesn't file Form 8832 is classified as a partnership for federal income tax purposes.*



**Organizations formed before 1997.** An organization formed before 1997 and classified as a partnership under the old rules will generally continue to be classified as a partnership as long as the organization has at least two members and doesn't elect to be classified as a corporation by filing Form 8832.

**Community property.** Spouses who own a qualified entity (defined below) can choose to classify the entity as a partnership for federal tax purposes by filing the appropriate partnership tax returns. They can choose to classify the entity as a sole proprietorship by filing a Schedule C (Form 1040) listing one spouse as the sole proprietor. A change in reporting position will be treated for federal tax purposes as a conversion of the entity.

A qualified entity is a business entity that meets all the following requirements.

- The business entity is wholly owned by spouses as community property under the laws of a state, a foreign country, or a possession of the United States.
- No person other than one or both spouses would be considered an owner for federal tax purposes.
- The business entity is not treated as a corporation.

For more information about community property, see Pub. 555, Community Property. Pub. 555 discusses the community property laws of Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

## **Partnership Interests Created by Gift**

**Gift of capital interest.** If a family member (or any other person) receives a gift of a capital interest in a partnership in which capital is a material income-producing factor, the donee's distributive share of partnership

income is subject to both of the following restrictions.

- It must be figured by reducing the partnership income by reasonable compensation for services the donor renders to the partnership.
- The donee's distributive share of partnership income attributable to donated capital must not be proportionately greater than the donor's distributive share attributable to the donor's capital.

**Purchase considered gift.** For purposes of determining a partner's distributive share, an interest purchased by one family member from another family member is considered a gift from the seller. The FMV of the purchased interest is considered donated capital. For this purpose, members of a family include only spouses, ancestors, and lineal descendants (or a trust for the primary benefit of those persons).

## **Partnership Interests Held in Connection With Performance of Services**

Section 1061 recharacterizes certain net long-term capital gains of a partner that holds one or more applicable partnership interests as short-term capital gains. The provision generally requires that a capital asset be held for more than 3 years for capital gain and loss allocated with respect to any applicable partnership interest (API) to be treated as long-term capital gain or loss. Proposed Regulations ([REG-107213-18](#)) were published in the Federal Register on August 14, 2020. Final regulations (Treasury Decision (T.D.) 9945) were published in the Federal Register on January 19, 2021. T.D. 9945, 2021-5 I.R.B. 627, is available at [IRS.gov/irb/2021-5 IRB#TD-9945](#). Owner taxpayers and pass-through entities may rely on the proposed regulations for tax years beginning before

January 19, 2021, (the date final regulations were published in the Federal Register) provided they follow the proposed regulations in their entirety and in a consistent manner. An owner taxpayer or pass-through entity may choose to apply the final regulations to a tax year beginning after December 31, 2017, provided that they consistently apply the final section 1061 regulations in their entirety to that year and all subsequent years. Owner taxpayers and pass-through entities must apply the final regulations to tax years beginning on or after January 19, 2021. See Section 1061 Reporting Instructions, later.

**Applicable partnership interest (API).** An API is any interest in a partnership that, directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any “applicable trade or business.” The special recharacterization rule applies to:

1. Capital gains recognized by a partner from the sale or exchange of an applicable partnership interest under sections 741(a) and 731(a); and
2. Capital gains recognized by a partnership, allocated to a partner with respect to an API.

**Applicable trade or business.** An applicable trade or business means any activity conducted on a regular, continuous, and substantial basis (regardless of whether the activity is conducted through one or more entities) which consists in whole or in part of raising and returning capital, and either:

- Investing in or disposing of “specific assets” (or identifying specified assets for investing or disposition), or
- Developing specified assets.

**Specified assets.** Specified assets are:

- Securities (as defined in section 475(c)(2), under rules for mark-to-market accounting for securities dealers);
- Commodities (as defined under rules for mark-to-market accounting for commodities dealers in section 475(e)(2));
- Real estate held for rental or investment;
- Options or derivative contracts with respect to such securities;
- Cash or cash equivalents; or
- An interest in a partnership to the extent of the partnership's proportionate interest in the foregoing.

**Security.** A security for this purpose means any of the following.

- Share of corporate stock.

- Partnership interest or beneficial ownership interest in a widely held or publicly traded partnership or trust.
- Note, bond, debenture, or other evidence of indebtedness.
- Interest rate, currency, or equity notional principal contract.
- Interest in, or derivative financial instrument in, any such security or any currency (regardless of whether section 1256 applies to the contract).
- Position that is not such a security and is a hedge with respect to such a security and is clearly identified.

## **Business Owned and Operated by Spouses**

If spouses carry on a business together and share in the profits and losses, they may be partners whether or not they have a formal partnership agreement.



If so, they should report income or loss from the business on Form 1065. They should not report the income on a Schedule C (Form 1040) in the name of one spouse as a sole proprietor. However, the spouses can elect not to treat the joint venture as a partnership by making a qualified joint venture election.

### **Qualified Joint Venture Election**

A "qualified joint venture," whose only members are spouses filing a joint return, can elect not to be treated as a partnership for federal tax purposes. A qualified joint venture conducts a trade or business where the only members of the joint venture are spouses filing jointly; both spouses elect not to be treated as a partnership; both spouses materially participate in the trade or business (see *Passive Activity Limitations* in the Instructions for Form 1065 for a definition of material participation);

and the business is co-owned by both spouses and is not held in the name of a state law entity such as a partnership or an LLC.

Under this election, a qualified joint venture conducted by spouses who file a joint return is not treated as a partnership for federal tax purposes and therefore doesn't have a Form 1065 filing requirement. All items of income, gain, deduction, loss, and credit are divided between the spouses based on their respective interests in the venture. Each spouse takes into account their respective share of these items as a sole proprietor. Each spouse would account for their respective share on the appropriate form, such as Schedule C (Form 1040). For purposes of determining net earnings from self-employment, each spouse's share of income or loss from a qualified joint venture is taken into account just as it is for federal income tax purposes (that is, based on their respective interests in the venture).

If the spouses do not make the election to treat their respective interests in the joint venture as sole proprietorships, each spouse should carry their share of the partnership income or loss from Schedule K-1 (Form 1065) to their joint or separate Form(s) 1040. Each spouse should include their respective share of self-employment income on a separate Schedule SE (Form 1040), Self-Employment Tax.

This generally doesn't increase the total tax on the return, but it does give each spouse credit for social security earnings on which retirement benefits are based. However, this may not be true if either spouse exceeds the social security tax limitation.

For more information on qualified joint ventures, go to [IRS.gov/QJV](https://www.irs.gov/QJV).

## **Partnership Agreement**

The partnership agreement includes the original agreement and any modifications. The modifications must be agreed to by all partners or adopted in any other manner provided by the partnership agreement. The agreement or modifications can be oral or written.

Partners can modify the partnership agreement for a particular tax year after the close of the year but not later than the date for filing the partnership return for that year. This filing date doesn't include any extension of time.

If the partnership agreement or any modification is silent on any matter, the provisions of local law are treated as part of the agreement.

# Terminating a Partnership

A partnership terminates when all its operations are discontinued and no part of any business, financial operation, or venture is continued by any of its partners in a partnership.

See Regulations section 1.708-1(b)(1) for more information on the termination of a partnership. For special rules that apply to a merger, consolidation, or division of a partnership, see Regulations sections 1.708-1(c) and 1.708-1(d).

**Date of termination.** The partnership's tax year ends on the date of termination. The date of termination is the date the partnership completes the winding up of its affairs.

**Short period return.** If a partnership is terminated before the end of what would otherwise be its tax year,

Form 1065 must be filed for the short period, which is the period from the beginning of the tax year through the date of termination. The return is due the 15<sup>th</sup> day of the 3<sup>rd</sup> month following the date of termination. See *Partnership Return (Form 1065)*, later, for information about filing Form 1065.

**Conversion of partnership into LLC.** The conversion of a partnership into an LLC classified as a partnership for federal tax purposes doesn't terminate the partnership. The conversion is not a sale, exchange, or liquidation of any partnership interest; the partnership's tax year doesn't close; and the LLC can continue to use the partnership's taxpayer identification number (TIN).

However, the conversion may change some of the partners' bases in their partnership interests if the partnership has recourse liabilities that become nonrecourse liabilities.

Because the partners share recourse and nonrecourse liabilities differently, their bases must be adjusted to reflect the new sharing ratios. If a decrease in a partner's share of liabilities exceeds the partner's basis, they must recognize gain on the excess. For more information, see *Effect of Partnership Liabilities* under *Basis of Partner's Interest*, later.

The same rules apply if an LLC classified as a partnership is converted into a partnership.

## **Electronic Filing**

Certain partnerships that (a) have more than 100 partners, or (b) are required by the Code or regulations to file at least 10 returns during the calendar year ending with or within the tax year of the partnership, are required to file Form 1065, Schedule K-1, and related forms and schedules electronically. For tax years beginning after July 1, 2019, a religious or apostolic organization exempt from income tax under section 501(d) must file Form 1065

electronically. Other partnerships generally have the option to file electronically. For details about electronic filing, see the Instructions for Form 1065.

## **Exclusion From Partnership Rules**

Certain partnerships that do not actively conduct a business can choose to be completely or partially excluded from being treated as partnerships for federal income tax purposes. All the partners must agree to make the choice, and the partners must be able to figure their own taxable income without figuring the partnership's income. However, the partners are not exempt from the rule that limits a partner's distributive share of partnership loss to the adjusted basis of the partner's partnership interest. Nor are they exempt from the requirement of a business purpose for adopting a tax year for the partnership that differs from its required tax year.



**Investing partnership.** An investing partnership can be excluded if the participants in the joint purchase, retention, sale, or exchange of investment property meet all the following requirements.

- They own the property as co-owners.
- They reserve the right separately to take or dispose of their shares of any property acquired or retained.
- They do not actively conduct business or irrevocably authorize some person acting in a representative capacity to purchase, sell, or exchange the investment property. Each separate participant can delegate authority to purchase, sell, or exchange their share of the investment property for the time being for their account, but not for a period of more than a year.

**Operating agreement partnership.** An operating agreement partnership group can be excluded if the participants in the joint

production, extraction, or use of property meet all the following requirements.

- They own the property as co-owners, either in fee or under lease or other form of contract granting exclusive operating rights.
- They reserve the right separately to take in kind or dispose of their shares of any property produced, extracted, or used.
- They don't jointly sell services or the property produced or extracted. Each separate participant can delegate authority to sell their share of the property produced or extracted for the time being for their account, but not for a period of time in excess of the minimum needs of the industry, and in no event for more than 1 year.

However, this exclusion doesn't apply to an unincorporated organization one of whose principal purposes is cycling, manufacturing,

or processing for persons who are not members of the organization.

**Electing the exclusion.** An eligible organization that wishes to be excluded from the partnership rules must make the election not later than the time for filing the partnership return for the first tax year for which exclusion is desired. This filing date includes any extension of time. See Regulations section 1.761-2(b) for the procedures to follow.

## **Partnership Return (Form 1065)**

Every partnership that engages in a trade or business or has gross income must file an information return on Form 1065 showing its income, deductions, and other required information. The partnership return must show the names and addresses of each partner and each partner's distributive share of taxable income. The return must be signed by a partner.

If an LLC is treated as a partnership, it must file Form 1065 and one of its members must sign the return.

A partnership is not considered to engage in a trade or business, and is not required to file a Form 1065, for any tax year in which it neither receives income nor pays or incurs any expenses treated as deductions or credits for federal income tax purposes.

See the Instructions for Form 1065 for more information about who must file Form 1065.

## **Partnership Distributions**

Partnership distributions include the following.

- A withdrawal by a partner in anticipation of the current year's earnings.
- A distribution of the current year's or prior years' earnings not needed for working capital.
- A complete or partial liquidation of a partner's interest.

- A distribution to all partners in a complete liquidation of the partnership.

A partnership distribution is not taken into account in determining the partner's distributive share of partnership income or loss. If any gain or loss from the distribution is recognized by the partner, it must be reported on their return for the tax year in which the distribution is received. Money or property withdrawn by a partner in anticipation of the current year's earnings is treated as a distribution received on the last day of the partnership's tax year.

**Effect on partner's basis.** A partner's adjusted basis in their partnership interest is decreased (but not below zero) by the money and adjusted basis of property distributed to the partner. See Adjusted Basis under Basis of Partner's Interest, later.

**Effect on partnership.** A partnership generally doesn't recognize any gain or loss because of distributions it makes to partners.

The partnership may be able to elect to adjust the basis of its undistributed property.

**Certain distributions treated as a sale or exchange.** When a partnership distributes the following items, the distribution may be treated as a sale or exchange of property rather than a distribution.

- Unrealized receivables or substantially appreciated inventory items distributed in exchange for any part of the partner's interest in other partnership property, including money.
- Other property (including money) distributed in exchange for any part of a partner's interest in unrealized receivables or substantially appreciated inventory items.

See *Payments for Unrealized Receivables and Inventory Items* under *Disposition of Partner's Interest*, later.

This treatment doesn't apply to the following distributions.

- A distribution of property to the partner who contributed the property to the partnership.
- Payments made to a retiring partner or successor in interest of a deceased partner that are the partner's distributive share of partnership income or guaranteed payments.

***Substantially appreciated inventory items.*** Inventory items of the partnership are considered to have appreciated substantially in value if, at the time of the distribution, their total FMV is more than 120% of the partnership's adjusted basis for the property. However, if a principal purpose for acquiring inventory property is to avoid ordinary income treatment by reducing the appreciation to less than 120%, that property is excluded.

## Partner's Gain or Loss

A partner generally recognizes gain on a partnership distribution only to the extent any money (and marketable securities treated as money) included in the distribution exceeds the adjusted basis of the partner's interest in the partnership. Any gain recognized is generally treated as capital gain from the sale of the partnership interest on the date of the distribution. If partnership property (other than marketable securities treated as money) is distributed to a partner, they generally don't recognize any gain until the sale or other disposition of the property.

For exceptions to these rules, see *Distribution of partner's debt* and *Net precontribution gain*, later. Also, see *Payments for Unrealized Receivables and Inventory Items* under *Disposition of Partner's Interest*, later.

**Example.** The adjusted basis of Jo's partnership interest is \$14,000.



She receives a distribution of \$8,000 cash and land that has an adjusted basis of \$2,000 and an FMV of \$3,000. Because the cash received doesn't exceed the basis of her partnership interest, Jo doesn't recognize any gain on the distribution. Any gain on the land will be recognized when she sells or otherwise disposes of it. The distribution decreases the adjusted basis of Jo's partnership interest to \$4,000 [ $\$14,000 - (\$8,000 + \$2,000)$ ].

***Qualified opportunity investment.*** If you held a qualified investment in a qualified opportunity fund (QOF) at any time during the year, you must file your return with Form 8997, Initial and Annual Statement of Qualified Opportunity Fund (QOF) Investments, attached. See the Form 8997 instructions.

### **Marketable securities treated as money.**

Generally, a marketable security distributed to a partner is treated as money in determining whether gain is recognized on

the distribution. This treatment, however, doesn't generally apply if that partner contributed the security to the partnership or an investment partnership made the distribution to an eligible partner.

The amount treated as money is the security's FMV when distributed, reduced (but not below zero) by the excess (if any) of:

1. The partner's distributive share of the gain that would be recognized had the partnership sold all its marketable securities at their FMV immediately before the transaction resulting in the distribution, over
2. The partner's distributive share of the gain that would be recognized had the partnership sold all such securities it still held after the distribution at the FMV in (1).

For more information, including the definition of marketable securities, see section 731(c).

**Loss on distribution.** A partner doesn't recognize loss on a partnership distribution unless all the following requirements are met.

- The adjusted basis of the partner's interest in the partnership exceeds the distribution.
- The partner's entire interest in the partnership is liquidated.
- The distribution is in money, unrealized receivables, or inventory items.

There are exceptions to these general rules. See the following discussions. Also, see *Liquidation at Partner's Retirement or Death* under *Disposition of Partner's Interest*, later.

### **Distribution of partner's debt.**

If a partnership acquires a partner's debt and extinguishes the debt by distributing it to the partner, the partner will recognize capital gain

or loss to the extent the FMV of the debt differs from the basis of the debt (determined under the rules discussed under Partner's Basis for Distributed Property, later).

The partner is treated as having satisfied the debt for its FMV. If the issue price (adjusted for any premium or discount) of the debt exceeds its FMV when distributed, the partner may have to include the excess amount in income as canceled debt.

Similarly, a deduction may be available to a corporate partner if the FMV of the debt at the time of distribution exceeds its adjusted issue price.

**Net precontribution gain.** A partner generally must recognize gain on the distribution of property (other than money) if the partner contributed appreciated property to the partnership during the 7-year period before the distribution.

The gain recognized is the lesser of the following amounts.

1. The excess of:
  - a. The FMV of the property received in the distribution; over
  - b. The adjusted basis of the partner's interest in the partnership immediately before the distribution, reduced (but not below zero) by any money received in the distribution.
2. The "net precontribution gain" of the partner. This is the net gain the partner would recognize if all the property contributed by the partner within 7 years of the distribution, and held by the partnership immediately before the distribution, were distributed to another partner, other than a partner who owns more than 50% of the partnership.

For information about the distribution of contributed property to another partner, see Contribution of Property under Transactions Between Partnership and Partners, later.

The character of the gain is determined by reference to the character of the net precontribution gain. This gain is in addition to any gain the partner must recognize if the money distributed is more than their basis in the partnership.

For these rules, the term “money” includes marketable securities treated as money, as discussed earlier under Marketable securities treated as money.

***Effect on basis.*** The adjusted basis of the partner's interest in the partnership is increased by any net precontribution gain recognized by the partner.

Other than for purposes of determining the gain, the increase is treated as occurring immediately before the distribution. See *Basis of Partner's Interest*, later.

The partnership must adjust its basis in any property the partner contributed within 7 years of the distribution to reflect any gain that partner recognizes under this rule.

***Exceptions.*** Any part of a distribution that is property the partner previously contributed to the partnership is not taken into account in determining the amount of the excess distribution or the partner's net precontribution gain. For this purpose, the partner's previously contributed property doesn't include a contributed interest in an entity to the extent its value is due to property contributed to the entity after the interest was contributed to the partnership.

Recognition of gain under this rule also doesn't apply to a distribution of unrealized receivables or substantially appreciated

inventory items if the distribution is treated as a sale or exchange, as discussed earlier under *Certain distributions treated as a sale or exchange*.

## **Partner's Basis for Distributed Property**

Unless there is a complete liquidation of a partner's interest, the basis of property (other than money) distributed to the partner by a partnership is its adjusted basis to the partnership immediately before the distribution. However, the basis of the property to the partner cannot be more than the adjusted basis of their interest in the partnership reduced by any money received in the same transaction.

***Example 1.*** The adjusted basis of Emily's partnership interest is \$30,000. She receives a distribution of property that has an adjusted basis of \$20,000 to the partnership and \$4,000 in cash. Her basis for the property is \$20,000.



**Example 2.** The adjusted basis of Steve's partnership interest is \$10,000. He receives a distribution of \$4,000 cash and property that has an adjusted basis to the partnership of \$8,000. His basis for the distributed property is limited to \$6,000 (\$10,000 – \$4,000, the cash he receives).

**Complete liquidation of partner's interest.** The basis of property received in complete liquidation of a partner's interest is the adjusted basis of the partner's interest in the partnership reduced by any money distributed to the partner in the same transaction.

**Partner's holding period.** A partner's holding period for property distributed to the partner includes the period the property was held by the partnership. If the property was contributed to the partnership by a partner, then the period it was held by that partner is also included.

**Basis divided among properties.** If the basis of property received is the adjusted basis of the partner's interest in the partnership (reduced by money received in the same transaction), it must be divided among the properties distributed to the partner. For property distributed after August 5, 1997, allocate the basis using the following rules.

1. Allocate the basis first to unrealized receivables and inventory items included in the distribution by assigning a basis to each item equal to the partnership's adjusted basis in the item immediately before the distribution. If the total of these assigned bases exceeds the allocable basis, decrease the assigned bases by the amount of the excess.
2. Allocate any remaining basis to properties other than unrealized receivables and inventory items by

assigning a basis to each property equal to the partnership's adjusted basis in the property immediately before the distribution. If the allocable basis exceeds the total of these assigned bases, increase the assigned bases by the amount of the excess. If the total of these assigned bases exceeds the allocable basis, decrease the assigned bases by the amount of the excess.

***Allocating a basis increase.*** Allocate any basis increase required in rule (2) above first to properties with unrealized appreciation to the extent of the unrealized appreciation. If the basis increase is less than the total unrealized appreciation, allocate it among those properties in proportion to their respective amounts of unrealized appreciation. Allocate any remaining basis increase among all the properties in proportion to their respective FMVs.

**Example.** Eun's basis in her partnership interest is \$55,000. In a distribution in liquidation of her entire interest, she receives properties A and B, neither of which is inventory or unrealized receivables. Property A has an adjusted basis to the partnership of \$5,000 and an FMV of \$40,000. Property B has an adjusted basis to the partnership of \$10,000 and an FMV of \$10,000.

To figure her basis in each property, Eun first assigns bases of \$5,000 to property A and \$10,000 to property B (their adjusted bases to the partnership). This leaves a \$40,000 basis increase (the \$55,000 allocable basis minus the \$15,000 total of the assigned bases). She first allocates \$35,000 to property A (its unrealized appreciation). The remaining \$5,000 is allocated between the properties based on their FMVs. \$4,000 ( $\$40,000/\$50,000$ ) is allocated to property A and \$1,000 ( $\$10,000/\$50,000$ ) is allocated to property B.

Eun's basis in property A is \$44,000 (\$5,000 + \$35,000 + \$4,000) and her basis in property B is \$11,000 (\$10,000 + \$1,000).

***Allocating a basis decrease.*** Use the following rules to allocate any basis decrease required in rule (1) or rule (2), earlier.

1. Allocate the basis decrease first to items with unrealized depreciation to the extent of the unrealized depreciation. If the basis decrease is less than the total unrealized depreciation, allocate it among those items in proportion to their respective amounts of unrealized depreciation.
2. Allocate any remaining basis decrease among all the items in proportion to their respective assigned basis amounts (as decreased in (1)).

***Example.*** Armando's basis in his partnership interest is \$20,000. In a distribution in liquidation of his entire interest,

he receives properties C and D, neither of which is inventory or unrealized receivables. Property C has an adjusted basis to the partnership of \$15,000 and an FMV of \$15,000. Property D has an adjusted basis to the partnership of \$15,000 and an FMV of \$5,000.

To figure his basis in each property, Armando first assigns bases of \$15,000 to property C and \$15,000 to property D (their adjusted bases to the partnership). This leaves a \$10,000 basis decrease (the \$30,000 total of the assigned bases minus the \$20,000 allocable basis). He allocates the entire \$10,000 to property D (its unrealized depreciation). Armando's basis in property C is \$15,000 and his basis in property D is \$5,000 (\$15,000 – \$10,000).

***Distributions before August 6, 1997.*** For property distributed before August 6, 1997, allocate the basis using the following rules.

1. Allocate the basis first to unrealized receivables and inventory items included in the distribution to the extent of the partnership's adjusted basis in those items. If the partnership's adjusted basis in those items exceeded the allocable basis, allocate the basis among the items in proportion to their adjusted bases to the partnership.
2. Allocate any remaining basis to other distributed properties in proportion to their adjusted bases to the partnership.

***Partner's interest more than partnership basis.*** If the basis of a partner's interest to be divided in a complete liquidation of the partner's interest is more than the partnership's adjusted basis for the unrealized receivables and inventory items distributed, and if no other property is distributed to

which the partner can apply the remaining basis, the partner has a capital loss to the extent of the remaining basis of the partnership interest.

**Special adjustment to basis.** A partner who acquired any part of their partnership interest in a sale or exchange or upon the death of another partner may be able to choose a special basis adjustment for property distributed by the partnership. To choose the special adjustment, the partner must have received the distribution within 2 years after acquiring the partnership interest. Also, the partnership must not have chosen the optional adjustment to basis when the partner acquired the partnership interest.

If a partner chooses this special basis adjustment, the partner's basis for the property distributed is the same as it would have been if the partnership had chosen the optional adjustment to basis.



However, this assigned basis is not reduced by any depletion or depreciation that would have been allowed or allowable if the partnership had previously chosen the optional adjustment.

The choice must be made with the partner's tax return for the year of the distribution if the distribution includes any property subject to depreciation, depletion, or amortization. If the choice doesn't have to be made for the distribution year, it must be made with the return for the first year in which the basis of the distributed property is pertinent in determining the partner's income tax.

A partner choosing this special basis adjustment must attach a statement to their tax return that the partner chooses under section 732(d) to adjust the basis of property received in a distribution.

The statement must show the computation of the special basis adjustment for the property distributed and list the properties to which the adjustment has been allocated.

**Example.** Chin Ho purchased a 25% interest in X partnership for \$17,000 cash. At the time of the purchase, the partnership owned inventory having a basis to the partnership of \$14,000 and an FMV of \$16,000. Thus, \$4,000 of the \$17,000 he paid was attributable to his share of inventory with a basis to the partnership of \$3,500.

Within 2 years after acquiring his interest, Chin Ho withdrew from the partnership and for his entire interest received cash of \$1,500, inventory with a basis to the partnership of \$3,500, and other property with a basis of \$6,000. The value of the inventory received was 25% of the value of all partnership inventory. (It is immaterial whether the inventory he received was on hand when he acquired his interest.)

Because the partnership from which Chin Ho withdrew didn't make the optional adjustment to basis, he chose to adjust the basis of the inventory received. His share of the partnership's basis for the inventory is increased by \$500 (25% of the \$2,000 difference between the \$16,000 FMV of the inventory and its \$14,000 basis to the partnership at the time he acquired his interest). The adjustment applies only for purposes of determining his new basis in the inventory, and not for purposes of partnership gain or loss on disposition.

The total to be allocated among the properties Chin Ho received in the distribution is \$15,500 (\$17,000 basis of his interest – \$1,500 cash received). His basis in the inventory items is \$4,000 (\$3,500 partnership basis + \$500 special adjustment). The remaining \$11,500 is allocated to his new basis for the other property he received.

***Mandatory adjustment.*** A partner doesn't always have a choice of making this special adjustment to basis. The special adjustment to basis must be made for a distribution of property (whether or not within 2 years after the partnership interest was acquired) if all the following conditions existed when the partner received the partnership interest.

- The FMV of all partnership property (other than money) was more than 110% of its adjusted basis to the partnership.
- If there had been a liquidation of the partner's interest immediately after it was acquired, an allocation of the basis of that interest under the general rules (discussed earlier under *Basis divided among properties*) would have decreased the basis of property that couldn't be depreciated, depleted, or amortized and increased the basis of property that could be.

- The optional basis adjustment, if it had been chosen by the partnership, would have changed the partner's basis for the property actually distributed.

**Required statement.** Generally, if a partner chooses a special basis adjustment and notifies the partnership, or if the partnership makes a distribution for which the special basis adjustment is mandatory, the partnership must provide a statement to the partner. The statement must provide information necessary for the partner to figure the special basis adjustment.

**Marketable securities.** A partner's basis in marketable securities received in a partnership distribution, as determined in the preceding discussions, is increased by any gain recognized by treating the securities as money. See Marketable securities treated as money under Partner's Gain or Loss, earlier.

The basis increase is allocated among the securities in proportion to their respective amounts of unrealized appreciation before the basis increase.

## **Transactions Between Partnership and Partners**

For certain transactions between a partner and their partnership, the partner is treated as not being a member of the partnership. These transactions include the following.

1. Performing services for, or transferring property to, a partnership if:
  - a. There is a related allocation and distribution to a partner; and
  - b. The entire transaction, when viewed together, is properly characterized as occurring between the partnership and a partner not acting in the capacity of a partner.

2. Transferring money or other property to a partnership if:
  - a. There is a related transfer of money or other property by the partnership to the contributing partner or another partner, and
  - b. The transfers together are properly characterized as a sale or exchange of property.

**Payments by accrual basis partnership to cash basis partner.** A partnership that uses an accrual method of accounting cannot deduct any business expense owed to a cash basis partner until the amount is paid. However, this rule doesn't apply to guaranteed payments made to a partner, which are generally deductible when accrued.

## **Guaranteed Payments**

Guaranteed payments are those made by a partnership to a partner that are determined without regard to the partnership's income.

A partnership treats guaranteed payments for services, or for the use of capital, as if they were made to a person who is not a partner. This treatment is for purposes of determining gross income and deductible business expenses only. For other tax purposes, guaranteed payments are treated as a partner's distributive share of ordinary income. Guaranteed payments are not subject to income tax withholding.

The partnership generally deducts guaranteed payments on Form 1065, line 10, as a business expense. They are also listed on Schedules K and K-1 of the partnership return. The individual partner reports guaranteed payments on Schedule E (Form 1040) as ordinary income, along with their distributive share of the partnership's other ordinary income.

Guaranteed payments made to partners for organizing the partnership or syndicating interests in the partnership are capital



expenses. Generally, organizational and syndication expenses are not deductible by the partnership. However, a partnership can elect to deduct a portion of its organizational expenses and amortize the remaining expenses (see *Business start-up and organizational costs* in the [Instructions for Form 1065](#)). Organizational expenses (if the election is not made) and syndication expenses paid to partners must be reported on the partners' Schedules K-1 as guaranteed payments.

**Minimum payment.** If a partner is to receive a minimum payment from the partnership, the guaranteed payment is the amount by which the minimum payment is more than the partner's distributive share of the partnership income before taking into account the guaranteed payment.

**Example.** Under a partnership agreement, Divya is to receive 30% of the partnership income, but not less than \$8,000.

The partnership has net income of \$20,000. Divya's share, without regard to the minimum guarantee, is \$6,000 ( $30\% \times \$20,000$ ). The guaranteed payment that can be deducted by the partnership is \$2,000 ( $\$8,000 - \$6,000$ ). Divya's income from the partnership is \$8,000, and the remaining \$12,000 of partnership income will be reported by the other partners in proportion to their shares under the partnership agreement.

If the partnership net income had been \$30,000, there would have been no guaranteed payment because her share, without regard to the guarantee, would have been greater than the guarantee.

**Self-employed health insurance premiums.** Premiums for health insurance paid by a partnership on behalf of a partner, for services as a partner, are treated as guaranteed payments.

The partnership can deduct the payments as a business expense, and the partner must include them in gross income. However, if the partnership accounts for insurance paid for a partner as a reduction in distributions to the partner, the partnership cannot deduct the premiums.

A partner who qualifies can deduct 100% of the health insurance premiums paid by the partnership on their behalf as an adjustment to income. The partner cannot deduct the premiums for any calendar month, or part of a month, in which the partner is eligible to participate in any subsidized health plan maintained by any employer of the partner, the partner's spouse, the partner's dependents, or any children under age 27 who are not dependents. For more information on the self-employed health insurance deduction, see chapter 8 of Pub. 334.

**Including payments in partner's income.**

Guaranteed payments are included in income in the partner's tax year in which the partnership's tax year ends.

**Example 1.** Under the terms of a partnership agreement, Erica is entitled to a fixed annual payment of \$10,000 without regard to the income of the partnership. Her distributive share of the partnership income is 10%. The partnership has \$50,000 of ordinary income after deducting the guaranteed payment. She must include ordinary income of \$15,000 (\$10,000 guaranteed payment + \$5,000 (\$50,000 × 10%) distributive share) on her individual income tax return for her tax year in which the partnership's tax year ends.

**Example 2.** Lamont is a calendar year taxpayer who is a partner in a partnership. The partnership uses a fiscal year that ended January 31, 2024. Lamont received guaranteed payments from the partnership from February 1, 2023, until

December 31, 2023. He must include these guaranteed payments in income for 2024 and report them on his 2024 income tax return.

***Payments resulting in loss.*** If guaranteed payments to a partner result in a partnership loss in which the partner shares, the partner must report the full amount of the guaranteed payments as ordinary income. The partner separately takes into account their distributive share of the partnership loss, to the extent of the adjusted basis of the partner's partnership interest.

## **Sale or Exchange of Property**

Special rules apply to a sale or exchange of property between a partnership and certain persons.

**Losses.** Losses will not be allowed from a sale or exchange of property (other than an interest in the partnership) directly or indirectly between a partnership and a person

whose direct or indirect interest in the capital or profits of the partnership is more than 50%.

If the sale or exchange is between two partnerships in which the same persons directly or indirectly own more than 50% of the capital or profits interests in each partnership, no deduction of a loss is allowed.

The basis of each partner's interest in the partnership is decreased (but not below zero) by the partner's share of the disallowed loss.

If the purchaser later sells the property, only the gain realized that is greater than the loss not allowed will be taxable. If any gain from the sale of the property is not recognized because of this rule, the basis of each partner's interest in the partnership is increased by the partner's share of that gain.

**Gains.** Gains are treated as ordinary income in a sale or exchange of property directly or

indirectly between a person and a partnership, or between two partnerships, if both of the following tests are met.

- More than 50% of the capital or profits interest in the partnership(s) is directly or indirectly owned by the same person(s).
- The property in the hands of the transferee immediately after the transfer is not a capital asset. Property that is not a capital asset includes accounts receivable, inventory, stock-in-trade, and depreciable or real property used in a trade or business.

**More than 50% ownership.** To determine if there is more than 50% ownership in partnership capital or profits, the following rules apply.

1. An interest directly or indirectly owned by, or for, a corporation, partnership, estate, or trust is considered to be owned

proportionately by, or for,  
its shareholders, partners,  
or beneficiaries.

2. An individual is considered to own the interest directly or indirectly owned by, or for, the individual's family. For this rule, "family" includes only brothers, sisters, half-brothers, half-sisters, spouses, ancestors, and lineal descendants.
3. If a person is considered to own an interest using rule (1), that person (the "constructive owner") is treated as if actually owning that interest when rules (1) and (2) are applied. However, if a person is considered to own an interest using rule (2), that person is not treated as actually owning that interest in reapplying rule (2) to make another person the constructive owner.



**Example.** Individuals A and B and Trust T are equal partners in Partnership ABT. A's husband, AH, is the sole beneficiary of Trust T. Trust T's partnership interest will be attributed to AH only for the purpose of further attributing the interest to A. As a result, A is a more-than-50% partner. This means that any deduction for losses on transactions between her and ABT will not be allowed, and gain from property that in the hands of the transferee is not a capital asset is treated as ordinary, rather than capital, gain.

**More information.** For more information on these special rules, see *Sales and Exchanges Between Related Persons* in chapter 2 of Pub. 544.

## **Contribution of Property**

Usually, neither the partner nor the partnership recognizes a gain or loss when property is contributed to the partnership in exchange for a partnership interest.

This applies whether a partnership is being formed or is already operating. The partnership's holding period for the property includes the partner's holding period.

The contribution of limited partnership interests in one partnership for limited partnership interests in another partnership qualifies as a tax-free contribution of property to the second partnership if the transaction is made for business purposes. The exchange is not subject to the rules explained later under *Disposition of Partner's Interest*.

**Disguised sales.** A contribution of money or other property to the partnership followed by a distribution of different property from the partnership to the partner is treated not as a contribution and distribution, but as a sale of property, if both of the following tests are met.

- The distribution wouldn't have been made but for the contribution.

- The partner's right to the distribution doesn't depend on the success of partnership operations.

All facts and circumstances are considered in determining if the contribution and distribution are more properly characterized as a sale. However, if the contribution and distribution occur within 2 years of each other, the transfers are presumed to be a sale unless the facts clearly indicate that the transfers are not a sale. If the contribution and distribution occur more than 2 years apart, the transfers are presumed not to be a sale unless the facts clearly indicate that the transfers are a sale.

***Form 8275 required.*** A partner must attach Form 8275, Disclosure Statement, (or other statement) to their return if the partner contributes property to a partnership and, within 2 years (before or after the contribution), the partnership transfers

money or other consideration to the partner. For exceptions to this requirement, see Regulations section 1.707-3(c)(2).

A partnership must attach Form 8275 (or other statement) to its return if it distributes property to a partner, and, within 2 years (before or after the distribution), the partner transfers money or other consideration to the partnership.

Form 8275 must include the following information.

- A caption identifying the statement as a disclosure under section 707.
- A description of the transferred property or money, including its value.
- A description of any relevant facts in determining if the transfers are properly viewed as a disguised sale. See Regulations section 1.707-3(b)(2)

for a description of the facts and circumstances considered in determining if the transfers are a disguised sale.

**Contribution to partnership treated as investment company.** Gain is recognized when property is contributed (in exchange for an interest in the partnership) to a partnership that would be treated as an investment company if it were incorporated.

A partnership is generally treated as an investment company if over 80% of the value of its assets is held for investment and consists of certain readily marketable items. These items include money, stocks and other equity interests in a corporation, and interests in regulated investment companies (RICs) and REITs. For more information, see section 351(e)(1) and the related regulations. Whether a partnership is treated as an investment company under this test is ordinarily determined immediately after the transfer of property.

This rule applies to limited partnerships and general partnerships, regardless of whether they are privately formed or publicly syndicated.

**Contribution to foreign partnership.** A domestic partnership that contributed property after August 5, 1997, to a foreign partnership in exchange for a partnership interest may have to file Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships, if either of the following applies.

1. Immediately after the contribution, the partnership owned, directly, indirectly, or by attribution, at least a 10% interest in the foreign partnership.
2. The FMV of the property contributed to the foreign partnership, when added to other contributions of property made to the partnership during the preceding 12-month period, is greater than \$100,000.

The partnership may also have to file Form 8865, even if no contributions are made during the tax year, if it owns a 10% or more interest in a foreign partnership at any time during the year. See the form instructions for more information.

**Basis of contributed property.** If a partner contributes property to a partnership, the partnership's basis for determining depreciation, depletion, gain, or loss for the property is the same as the partner's adjusted basis for the property when it was contributed, increased by any gain recognized by the partner at the time of contribution.

**Allocations to account for built-in gain or loss.** The FMV of property at the time it is contributed may be different from the partner's adjusted basis. The partnership must allocate among the partners any income, deduction, gain, or loss on the property in a manner that will account for the difference.

This rule also applies to contributions of accounts payable and other accrued but unpaid items of a cash basis partner.

The partnership can use different allocation methods for different items of contributed property. A single reasonable method must be consistently applied to each item, and the overall method or combination of methods must be reasonable. See Regulations section 1.704-3 for allocation methods generally considered reasonable.

If the partnership sells contributed property and recognizes gain or loss, built-in gain or loss is allocated to the contributing partner. If contributed property is subject to depreciation or other cost recovery, the allocation of deductions for these items takes into account built-in gain or loss on the property. However, the total depreciation, depletion, gain, or loss allocated to partners cannot be more than the



depreciation or depletion allowable to the partnership or the gain or loss realized by the partnership.

**Example.** Areta and Sofia formed an equal partnership. Areta contributed \$10,000 in cash to the partnership and Sofia contributed depreciable property with an FMV of \$10,000 and an adjusted basis of \$4,000. The partnership's basis for depreciation is limited to the adjusted basis of the property in Sofia's hands, \$4,000.

In effect, Areta purchased an undivided one-half interest in the depreciable property with her contribution of \$10,000. Assuming that the depreciation rate is 10% a year under the General Depreciation System (GDS), she would have been entitled to a depreciation deduction of \$500 per year, based on her interest in the partnership, if the adjusted basis of the property equaled its FMV when contributed.

To simplify this example, the depreciation deductions are determined without regard to any first-year depreciation conventions.

However, because the partnership is allowed only \$400 per year of depreciation (10% of \$4,000), no more than \$400 can be allocated between the partners. The entire \$400 must be allocated to Areta.

**Distribution of contributed property to another partner.** If a partner contributes property to a partnership and the partnership distributes the property to another partner within 7 years of the contribution, the contributing partner must recognize gain or loss on the distribution.

The recognized gain or loss is the amount the contributing partner would have recognized if the property had been sold for its FMV when it was distributed. This amount is the difference between the property's basis and its FMV at the time of contribution.

The character of the gain or loss will be the same as the character of the gain or loss that would have resulted if the partnership had sold the property to the distributee partner. Appropriate adjustments must be made to the adjusted basis of the contributing partner's partnership interest and to the adjusted basis of the property distributed to reflect the recognized gain or loss.

**Disposition of certain contributed property.** The following rules determine the character of the partnership's gain or loss on a disposition of certain types of contributed property.

1. ***Unrealized receivables.*** If the property was an unrealized receivable in the hands of the contributing partner, any gain or loss on its disposition by the partnership is ordinary income or loss. Unrealized receivables are defined later under

Payments for Unrealized Receivables and Inventory Items. When reading the definition, substitute “partner” for “partnership.”

2. ***Inventory items.*** If the property was an inventory item in the hands of the contributing partner, any gain or loss on its disposition by the partnership within 5 years after the contribution is ordinary income or loss. Inventory items are defined later under Payments for Unrealized Receivables and Inventory Items.
3. ***Capital loss property.*** If the property was a capital asset in the contributing partner's hands, any loss on its disposition by the partnership within 5 years after the contribution is a capital loss. The capital loss is limited to the amount by which the partner's adjusted basis for the property

exceeded the property's FMV immediately before the contribution.

4. ***Substituted basis property.*** If the disposition of any of the property listed in (1), (2), or (3) is a nonrecognition transaction, these rules apply when the recipient of the property disposes of any substituted basis property (other than certain corporate stock) resulting from the transaction.

## **Contribution of Services**

A partner can acquire an interest in partnership capital or profits as compensation for services performed or to be performed.

**Capital 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 FMV and the proceeds were distributed in a complete liquidation of the partnership. This determination is generally made at the time of receipt of the partnership interest.

The FMV of such an interest received by a partner as compensation for services must generally be included in the partner's gross income in the first tax year in which the partner can transfer the interest or the interest is not subject to a substantial risk of forfeiture. The capital interest transferred as compensation for services is subject to the rules for restricted property discussed under *Employee Compensation* in Pub. 525, *Taxable and Nontaxable Income*.

The FMV of an interest in partnership capital transferred to a partner as payment for services to the partnership is a guaranteed payment, discussed earlier under *Guaranteed Payments*.

**Profits interest.** A profits interest is a partnership interest other than a capital interest. If a person receives a profits interest for providing services to, or for the benefit of, a partnership in a partner capacity or in anticipation of being a partner,

the receipt of such an interest is not a taxable event for the partner or the partnership. However, this doesn't apply in the following situations.

- The profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease.
- Within 2 years of receipt, the partner disposes of the profits interest.
- The profits interest is a limited partnership interest in a publicly traded partnership.

A profits interest transferred as compensation for services is not subject to the rules for restricted property that apply to capital interests.

## **Basis of Partner's Interest**

The basis of a partnership interest is the money plus the adjusted basis of any

property the partner contributed. If the partner must recognize gain as a result of the contribution, this gain is included in the basis of their interest. Any increase in a partner's individual liabilities because of an assumption of partnership liabilities is considered a contribution of money to the partnership by the partner.

**Interest acquired by gift, etc.** If a partner acquires an interest in a partnership by gift, inheritance, or under any circumstance other than by a contribution of money or property to the partnership, the partner's basis must be determined using the basis rules described in Pub. 551.

## **Adjusted Basis**



*There is a worksheet for adjusting the basis of a partner's interest in the partnership in the Partner's Instructions for Schedule K-1 (Form 1065).*



The basis of an interest in a partnership is increased or decreased by certain items.

**Increases.** A partner's basis is increased by the following items.

- The partner's additional contributions to the partnership, including an increased share of, or assumption of, partnership liabilities.
- The partner's distributive share of taxable and nontaxable partnership income.
- The partner's distributive share of the excess of the deductions for depletion over the basis of the depletable property, unless the property is oil or gas wells whose basis has been allocated to partners.

**Decreases.** The partner's basis is decreased (but never below zero) by the following items.

- The money (including a decreased share of partnership liabilities or an assumption

of the partner's individual liabilities by the partnership) and adjusted basis of property distributed to the partner by the partnership.

- The partner's distributive share of the partnership losses (including capital losses).
- The partner's distributive share of nondeductible partnership expenses that are not capital expenditures. This includes the partner's share of any section 179 expenses, even if the partner cannot deduct the entire amount on their individual income tax return.
- The partner's deduction for depletion for any partnership oil and gas wells, up to the proportionate share of the adjusted basis of the wells allocated to the partner.
- A partner's distributive share of foreign taxes paid or accrued by the partnership for tax years beginning after 2017.

- A partner's distributive share of the adjusted basis of a partnership's property donation to charity.

**Note.** If the property's FMV exceeds its adjusted basis, a special rule provides that the basis limitation on partner losses does not apply to the extent of the partner's distributive share of the excess for tax years beginning after 2017.

***Partner's liabilities assumed by partnership.*** If contributed property is subject to a debt or if a partner's liabilities are assumed by the partnership, the basis of that partner's interest is reduced (but not below zero) by the liability assumed by the other partners. This partner must reduce their basis because the assumption of the liability is treated as a distribution of money to that partner. The other partners' assumption of the liability is treated as a contribution by them of money to the partnership. See *Effect of Partnership Liabilities*, later.

**Example 1.** Ivan acquired a 20% interest in a partnership by contributing property that had an adjusted basis to him of \$8,000 and a \$4,000 mortgage. The partnership assumed payment of the mortgage. The basis of Ivan's interest is:

Adjusted basis of contributed property . . . . .	\$8,000
Minus: Part of mortgage assumed by other partners (80% (0.80) × \$4,000) . . . . .	3,200
Basis of Ivan's partnership interest	\$4,800

**Example 2.** If, in *Example 1*, the contributed property had a \$12,000 mortgage, the basis of Ivan's partnership interest would be zero. The \$1,600 difference between the mortgage assumed by the other partners, \$9,600 (80% × \$12,000), and his basis of \$8,000 would be treated as capital gain from the sale or exchange of a partnership interest.

However, this gain wouldn't increase the basis of his partnership interest.

**Book value of partner's interest.** The adjusted basis of a partner's interest is determined without considering any amount shown in the partnership books as a capital, equity, or similar account.

**Example.** Enzo contributes to his partnership property that has an adjusted basis of \$400 and an FMV of \$1,000. His partner contributes \$1,000 cash. While each partner has increased his capital account by \$1,000, which will be reflected in the partnership's books, the adjusted basis of Enzo's interest is only \$400 and the adjusted basis of his partner's interest is \$1,000.

**When determined.** The adjusted basis of a partner's partnership interest is ordinarily determined at the end of the partnership's tax year.

However, if there has been a sale or exchange of all or part of the partner's interest or a liquidation of their entire interest in a partnership, the adjusted basis is determined on the date of sale, exchange, or liquidation.

**Alternative rule for figuring adjusted basis.** In certain cases, the adjusted basis of a partnership interest can be figured by using the partner's share of the adjusted basis of partnership property that would be distributed if the partnership terminated.

This alternative rule can be used in either of the following situations.

- The circumstances are such that the partner cannot practicably apply the general basis rules.
- It is, in the opinion of the IRS, reasonable to conclude that the result produced will not vary substantially from the result under the general basis rules.

Adjustments may be necessary in figuring the adjusted basis of a partnership interest under the alternative rule. For example, adjustments would be required to include in the partner's share of the adjusted basis of partnership property any significant discrepancies that resulted from contributed property, transfers of partnership interests, or distributions of property to the partners.

### **Effect of Partnership Liabilities**

A partner's basis in a partnership interest includes the partner's share of a partnership liability only if, and to the extent that, the liability:

1. Creates or increases the partnership's basis in any of its assets;
2. Gives rise to a current deduction to the partnership; or
3. Is a nondeductible, noncapital expense of the partnership.

The term “assets” in (1) includes capitalized items allocable to future periods, such as organization expenses.

A partner's share of accrued but unpaid expenses or accounts payable of a cash basis partnership is not included in the adjusted basis of the partner's interest in the partnership.

**Partner's basis increased.** If a partner's share of partnership liabilities increases, or a partner's individual liabilities increase because they assume partnership liabilities, this increase is treated as a contribution of money by the partner to the partnership.

**Partner's basis decreased.** If a partner's share of partnership liabilities decreases, or a partner's individual liabilities decrease because the partnership assumes their individual liabilities, this decrease is treated as a distribution of money to the partner by the partnership.