

Excerpts from legal sources on basis & deductibility

1. Determining Partner's Holding Period in Partnership Interests Acquired From Property Contributions

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Sec. 1223(2) provides that the partnership's holding period for contributed assets includes the holding period of the assets in the hands of the contributing partner. This tacking-on concept applies whether or not the contributing partner recognizes any gain on the contribution because of a net reduction in liabilities. However, if the contribution is fully taxable because of the investment company rule of Sec. 721(b), the partnership's holding period in the contributed securities begins on the contribution date. Similarly, if the contributing partner recognizes gain under the disguised-sale rules, the holding period of the property deemed purchased begins on the contribution date.

A partner's holding period for a partnership interest received in exchange for a contribution of property depends on the character of the contributed property. If the contributed property is a capital asset or property used in a trade or business (within the meaning of Sec. 1231) immediately prior to the contribution, the partner's holding period for the partnership interest includes the holding period of the contributed property (Sec. 1223(1)). If the partnership interest is received in exchange for money or other property, the partner's holding period commences on the date the interest is acquired, i.e., the contribution date. The partnership's holding period for the contributed property includes the contributor's holding period (Sec. 1223(2)).

2. Getting the Most from Individual Charitable Contributions

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Holding periods are critical when donations consist of capital gain property. A one-day difference could determine whether the deduction is equal to the property's basis or its FMV. Property must be held more than one year to be eligible for the potential FMV deduction. In this regard, "tacked on" holding periods that may result from the way the property was acquired should not be overlooked. The tacked-on holding period may result in long-term classification even though the taxpayer may not have actually held the property more than one year. Two common situations in

which a tacked-on holding period may arise are property received by gift or property acquired through a nontaxable exchange. Appreciated gift property may have a low carryover basis from the donor, so meeting the long-term holding period could be especially important.

3. The function of basis

The fundamental purpose of outside basis is to account for a partner's after-tax investment in the partnership. Outside basis determines how much a partner may withdraw or deduct from a partnership for tax purposes without recognizing additional gain or without being limited on the allowable flowthrough of partnership losses. Because of the flowthrough, single-level taxation scheme of Subchapter K where partners, not the partnership, are taxed on partnership-level transactions, a method is needed to account for each individual partner's (1) contributions and distributions; (2) allocation of profits and losses; and (3) acquisition cost for his or her partnership interest (other than by contribution). The basis calculation rules keep track of the partner's basis (i.e., his or her cost basis or after-tax investment in the partnership). The calculated basis determines the tax impact of certain transactions (e.g., if a partner receives a distribution in excess of his or her accumulated investment in the partnership).

Reducing a partner's basis in partnership interest

A partner can use only two methods to withdraw money or property from a partnership: (1) a distribution or (2) a sale or other disposition of the partner's interest. (This excludes borrowing, which is only temporary, and compensation, which is not, *per se*, a partnership transaction.) The flowthrough of partnership losses is one additional event that reduces a partner's after-tax investment. These three situations are the only means by which a partner recovers part or all of his or her outside basis in the partnership interest. The function of basis is to make sure that, over the partnership's life, the partner does not withdraw more or less than his or her investment without some tax impact.

To the extent that the partner merely withdraws his or her previously taxed investment in a partnership, there is no tax impact other than a reduction of the partner's basis in the partnership interest. If a partner withdraws more than his or her previously taxed investment, whether by distribution or as a result of the disposition of his or her interest, he or she must report a gain (Secs. 731(a)(1) and 741). If, over the life of the partnership, the sum of the partner's distributions and the amount received on disposition are less than the partner's tax investment in the partnership, he or she reports a loss (Secs. 731(a)(2) and 741). If the partnership attempts to allocate the partner more loss than the remaining outside basis in his or her partnership interest, the excess losses are suspended until he or she invests additional amounts in the partnership (or reports additional partnership income) (Sec. 704(d)).

Technically, the basis limitation that causes gain to be recognized on a distribution, or that limits the partner's ability to currently recognize loss, is the rule that a partner's basis cannot be reduced

below zero (Secs. 705(a)(2) and 733). So long as a partner has basis, distributions to the partner merely result in a reduction of his or her basis by the amount of money distributed or the basis of the property distributed. Allocated losses also reduce the partner's basis (Sec. 705(a)(2)(A)).

The function of basis

Thus, the function of basis can be summarized as follows:

- Distributions:

1. Determines whether gain or loss is recognized (Sec. 731(a)).
 2. Limits the basis of distributed property (if the basis of distributed property in the hands of the partnership exceeds the basis of the distributee in his or her partnership interest) (Sec. 732).
- *Loss limitations*: Determines the partner's allocable share of partnership losses that can currently be used by the partner to offset nonpartnership income (subject to nonpartnership limitations) (Sec. 704(d)).
 - *Disposition of partnership interest*: Determines the gain or loss on the sale or exchange of a partnership interest (Sec. 741).

4. New Limits on Partners' shares of partnership losses Frequently Asked Questions | Internal Revenue Service

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To what extent is a partner allowed to take into account its distributive share of partnership losses?

Section 704(d) of the Code provides, in general, that a partner's distributive share of partnership loss (including capital loss) is allowed only to the extent of the adjusted basis of such partner's interest in the partnership (outside basis) at the end of the partnership year in which such loss occurred. If, in a given taxable year, a partner's share of partnership losses exceeds its outside basis, then the losses are allowed to the extent of basis and any excess amount is carried over for use in the next taxable year in which the partner has outside basis available. Except for deductions relating to charitable contributions and foreign taxes, current law and prior law are the same.

Example 1:

Facts

Jen and Dave are equal partners in JD Partnership. At the end of the partnership taxable year, but prior to taking into account the partnership's income and loss items, Jen and Dave each have a \$50 basis in the JD partnership. For the taxable year the JD partnership has \$20 of non-separately stated taxable income and a \$150 long-term capital loss.

Analysis

To determine each partner's basis limitation under §704(d), Jen and Dave increase their outside bases from \$50 to \$60 under § 705(a)(1) for their \$10 distributive shares of the partnership's non-separately

stated income. Their \$75 shares of long-term capital loss are limited by §704(d) and, as a result, Jen and Dave can each take \$60 of the loss into account in the current taxable year. The remaining \$15 of long-term capital loss is carried forward. This result is the same under current and prior law.

Under prior law, was a partner's share of charitable contributions made by, or foreign taxes paid by, the partnership subject to § 704(d) basis limitation?

No, under prior law a partner's share of a partnership's charitable contributions and foreign tax payments were not subject to the § 704(d) basis limitation. This meant that partners could take into account their entire distributive shares of charitable contributions or foreign tax payments even if they were in excess of outside basis. Although a portion of certain charitable contributions and the entire amount attributable to foreign tax payments were (and still are) subject to basis reduction under § 705(a)(2), prior law did not limit a partner's deductions for payments in excess of basis.

Example 2:

Facts

Assume the same facts as in Example 1, except that, at the end of the partnership taxable year (and before partnership allocations), Jen's outside basis is \$50 and Dave's is \$30. For the taxable year, the partnership makes a contribution to a § 501(c)(3) charity of property that has a fair market value of \$300 and a basis of \$100, but has no other items of income, gain, loss, or deduction.

Analysis

Under prior law, Jen and Dave each would have been able to take into account (on their personal returns) their \$150 shares of the charitable contribution. Jen would have been required to decrease her outside basis by \$50 (her share of the partnership's basis in the property) to zero ($\$50 - \$50 = 0$). However, because Dave only has \$30 of outside basis, any basis reduction would have been limited to \$30 because outside basis cannot be decreased below zero. Therefore, under prior law, Jen would have had to decrease her outside basis by \$50 to receive the benefit the entire \$150 contribution deduction whereas Dave only would have had to decrease his outside basis by \$30 to receive the same \$150 benefit.

3. How did the TCJA change the rules for determining losses subject to the basis limitation?

The TCJA adds new § 704(d)(3)(A). That section provides that charitable contributions and foreign taxes are taken into account under the basis limitation rules, thereby putting those items on par with other losses and, as a result, limiting the benefit of such items by a partner's outside basis. However, new § 704(d)(3)(B) provides that, in the case of a charitable contribution of built-in gain property (i.e., property whose fair market value exceeds its adjusted basis), the excess amount is not limited by outside basis. These changes apply to partnership taxable years beginning after December 31, 2017. This new rule means that, for charitable contributions of appreciated property, the amount allocable to the partners will effectively be split into two parts, one equaling the property's built-in-gain amount, the other the

property's basis. The deduction for the built-in gain portion neither reduces the partner's bases nor is subject to limitation under section 704(d) (as under prior law). However, the part reflecting the property's basis is limited by section 704(d).

Example 3:

Facts

Assume the same facts as in Example 2, except that the partnership makes the contribution of appreciated property to charity in a taxable year of the partnership beginning after December 31, 2017.

Analysis

Under the new law, the portion of the contribution that is equal to **the property's basis (\$100) both reduces the partner's outside basis and is subject to section 704(d)**. The excess portion neither reduces outside basis nor is subject to section 704(d). Jen, whose outside basis is \$50, would reduce her outside basis by \$50 (her share of the basis of the contributed property) and receive a charitable contribution allocation of \$150. For Dave, whose outside basis is \$30, the basis reduction and charitable contribution with respect to the basis portion of the contribution would be limited to \$30. The \$20 excess would carry over to the following year. Dave's total charitable contribution would be \$130.

Explanation of Provision

The provision modifies the basis limitation on partner losses to provide that the limitation takes into account a partner's distributive share of partnership charitable contributions (as defined in section 170(c)) and taxes (described in section 901) paid or accrued to foreign countries and to possessions of the United States. Thus, the amount of the basis limitation on partner losses is decreased to reflect these items. In the case of a charitable contribution by the partnership, the amount of the basis limitation on partner losses is decreased by the partner's distributive share of the adjusted basis of the contributed property. **In the case of a charitable contribution by the partnership of property whose fair market value 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.**