Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I Process Unit

Unit Name	Partner’s Outside Basis	
Primary UIL Code	705.00-00	Determination of Basis of Partnership Interest

Library Level	**Title**
Knowledge Base	Partnerships
Shelf	General Concepts
Book	Partner Basis in Partnership Interest
Chapter	Calculating a Partner’s Outside Basis

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Process Overview

Partner’s Outside Basis

Note: This replaces the practice unit with the same title dated 5/19/21. The practice unit was revised to reference updated training material on slide 32.

Background

A partnership is a relationship between two or more persons who join together to carry on a trade, business, or investment activity. Each partner has a basis in his partnership interest. The partner’s basis in his partnership interest is separate from the partnership’s basis in its assets. Partnership tax law often refers to “outside” and “inside” basis. Outside basis refers to a partner’s interest in a partnership. Inside basis refers to a partnership’s basis in its assets. Publication 541 contains information on outside basis. This practice unit focuses on key concepts you must understand in order to properly calculate outside basis.

The rules regarding the computation of outside basis apply to all types of partners including general partners, limited partners, and limited liability company (LLC) members. The rules apply to entities which are treated as partnerships for federal income tax purposes including general partnerships, limited partnerships, publicly traded partnerships, limited liability partnerships and limited liability companies (which have at least two owners and which do not elect to be treated as a corporation).

A partner may hold both a general and a limited partnership interest in the same partnership. In this case, the partner is considered to have only one unitary basis equal to the combined interests. Rev. Rul. 84-52. Note that the owner of a disregarded entity has no outside basis in the entity for federal income tax purposes.

Computing a partner’s outside basis is necessary when determining:

- The maximum amount of any deduction or loss that passes through to the partner,
- The gain or loss from the disposition of a partnership interest,
- The tax consequences of cash distributions, and
- The tax consequences of property distributions.

Process Overview (cont'd)

Partner's Outside Basis

<u>Nature of Partnerships</u>

Subchapter K of the Internal Revenue Code addresses rules regarding the taxation of partnerships and partners. Certain aspects of Subchapter K are governed by the "aggregate theory" which views the partnership as a collection of its partners. Other aspects are governed by the "entity theory" which treats the partnership as a "taxpayer," even though it pays no tax. For example, partnerships function as entities when a tax year and a method of accounting are chosen. It is the partnership that selects the tax year and method of accounting, not each partner. Most elections are made by the partnership. The concept that each partner must track a basis in his partnership interest reflects the entity view of partnerships.

A partnership is called a "flow-through entity" or a "pass-through entity." Partnerships pay no tax. Rather, each partner includes his share of the partnership's income, gain, loss, deduction, or credits on his personal tax return. Therefore, for purposes of reporting tax items and calculating tax liabilities, the partnership is treated as an aggregate of its partners.

As previously stated, outside basis is a partner's basis in his partnership interest. Inside basis is the partnership's basis in its assets. Typically, at the start of the partnership, the sum of each partner's outside basis equals the partnership's inside adjusted tax basis in its assets. The reason for this equality is the accounting equation Assets equal Liabilities plus Owners' Equity. In the partnership context, this is phrased as Assets equal Liabilities plus Partners' Capital Accounts. The partnership's assets were either contributed by the partners, purchased with contributed cash or earned income, or purchased with money the partnership borrowed.

There are three common reasons why the equality between inside and outside basis may change:

1. Acquisition of a partnership interest other than by contribution.
2. Gain or loss recognized by a partner on a distribution.
3. Decrease in the basis of an asset of the partnership on a current distribution or an increase in the basis of a partnership asset on a liquidating distribution (excluding 732(d) application).

If a partnership made a section 754 election, a partner's outside basis can be estimated by added his tax basis capital account, his share of liabilities, and his section 743(b) basis adjustments which can be found on the Schedule K-1 (Form 1065).

Process Overview (cont'd)

Partner's Outside Basis
Outside Basis and Inside Basis A partner's outside basis in his partnership interest can be estimated by adding his tax basis capital account, his share of liabilities, and his section 743(b) basis adjustments (if the partnership made a section 754 election). An increase in a partner's share of partnership liabilities is treated as a contribution of money by the partner to the partnership and thus increases his outside basis. A decrease in a partner's share of partnership liabilities is treated as a distribution of money to the partner and thus decreases his outside basis. IRC 752(a) and (b). Each partnership liability is part of at least one partner's outside basis. Rules concerning the definition of partnership liabilities are covered in the Determining Liability Allocations Concept Unit. Rules for allocating partnership liabilities among the partners are covered in the Determining Liability Allocations Concept Unit. While a partner's capital account may be negative (due to allocated losses and distributions), a partner's outside basis may never be a negative number. A partner whose capital account is negative may still have a positive basis in his partnership interest because his share of partnership liabilities is greater than his negative capital account.

Process Overview (cont'd)

Partner's Outside Basis

<u>Capital Account Overview</u>

Capital accounts increase or decrease every year. If the partnership is profitable, the partner's distributive share of profits increases his capital account. If the partnership generates a loss, then the partner's distributive share of the loss decreases his capital account. Additionally, a partner's contributions of cash or property increase his capital account. Conversely, a partnership's distribution of cash or property to the partner decreases his capital account.

A partner may have a negative capital account. However, a partner may never have a negative outside basis. A partner whose capital account is negative may still have a positive basis if his share of partnership liabilities exceeds his negative capital account. The four types of capital accounts are:

1. Section 704(b) Book.
2. Generally Accepted Accounting Principles (GAAP).
3. Tax Basis.
4. Other.

See Slides 10 - 12 for an explanation of the four types of capital accounts.

! **CAUTION:** The capital account reporting requirements on Schedule K-1 changed beginning in 2020. Beginning in 2020, taxpayers are required, with few exceptions, to report capital accounts on the tax basis. Please see the instructions to the Form 1065 for 2020 and later years for further guidance.

Process Overview (cont’d)

Partner’s Outside Basis

Impact of Partnership Operations on Partnership Outside Basis

A partner’s basis in his partnership interest increases or decreases each year depending on a variety of factors. The following items increase outside basis:

- An increase in the partner’s share of either recourse or nonrecourse liabilities. IRC 752(a).
- A partner’s contributions of property or money including an increased share of, or assumption of, partnership liabilities. IRC 722.
- The partner’s share of taxable partnership income, including capital gains. IRC 705(a)(1)(A).
- The partner’s share of tax-exempt income. IRC 705(a)(1)(B).
- The partner’s share of percentage depletion deductions exceeding the adjusted basis in depletable property. IRC 705(a)(1)(C).

The follow items decrease outside basis:

- A decrease in the partner’s share of partnership liabilities. IRC 752(b).
- Distributions of money (including a decreased share of partnership liabilities or an assumption of the partner's individual liabilities by the partnership) and property distributed to the partner by the partnership. IRC 733 and IRC 732.
- The partner’s share of partnership losses, including capital losses. IRC 705(a)(2)(A).
- The partner’s share of expenses that are neither deductible nor capitalized for income tax purposes. IRC 705(a)(2)(B).
- The partner’s share of depletion from oil and gas properties. IRC 705(a)(3).

Process Overview (cont’d)

Partner’s Outside Basis

Partner’s Initial Outside Basis

A partner may acquire an interest in a partnership in a variety of ways. For example, the partner may purchase his interest from an existing partner. Like any other asset, a partnership interest may be acquired through a gift or an inheritance. Additionally, a partner may contribute property and/or cash in exchange for a partnership interest. Lastly, a partner may contribute services in exchange for a partnership interest. The partner’s initial outside basis depends on how the interest was acquired.

The basis of a partnership interest acquired by contribution is the amount of cash plus the adjusted basis of any contributed property. IRC 722. Generally, a partner does not recognize gain or loss upon contributions of property to a partnership in exchange for a partnership interest. IRC 721. Instead, the contributing partner’s basis in the property becomes the partnership’s basis. IRC 723.

A partner’s holding period in a partnership interest received for a property contribution depends on the type of property contributed. If the property contributed for the interest was a capital asset or an IRC 1231 asset, the holding period of the partnership interest will include the holding period of the contributed assets. If a partner contributes any other property or money, his holding period will begin on the day after the interest is acquired. If a combination of property is contributed, the holding period of the partnership interest will be split.

When a partner buys a partnership interest from an existing partner, the purchasing partner’s initial outside basis is the consideration paid to the seller (cash plus the value of any property) plus his share of partnership liabilities assumed. IRC 742 and IRC 1012. When a partnership interest is acquired by gift, the partner’s outside basis will generally be the outside basis of the donor. IRC 742 and IRC 1015. The basis of an inherited partnership interest equals the fair market value of the partnership interest at the decedent’s date of death or the alternate valuation date, if applicable. IRC 1014.

Process Overview (cont'd)

Partner's Outside Basis

Partner's Initial Outside Basis (cont'd)

As previously stated, a partner may acquire a partnership interest in exchange for contributing cash or property. Additionally, a partner may contribute services in exchange for a partnership interest. The impact on the partner's outside basis depends on whether the partner recognizes compensation income for the services performed. This, in turn, depends on the type of interest received (a capital interest or a profits interest). Under Treas. Reg. 1.721-1(b)(1), the receipt of a vested partnership capital interest in exchange for services is taxable as compensation. An interest is vested if it is either transferable or not subject to a substantial risk of forfeiture. The partner's outside basis is increased by the amount of the compensation income recognized.

Unless an exception is met, a partner who contributes services to a partnership in exchange for a profits interest does not recognize compensation income. Therefore, the transaction has no impact on the partner's outside basis. Revenue Procedure 93-27, 1993-2 C.B. 343 and Rev. Proc. 2001-43 address the receipt of a partnership profits interest when services are provided to or on behalf of the partnership.

Under Rev. Proc. 93-27, the grant of a profits interest to a service partner is generally not a taxable event. However, under the following three exceptions, a partner who contributes services in exchange for a profits interest must recognize income:

1. The partner disposes of the interest within two years of its receipt;
2. The partnership units are publicly traded; or
3. The profits interest relates to a "substantially certain and predictable stream of income from partnership assets."

Process Overview (cont'd)

Partner's Outside Basis

Capital Accounts

A partner's equity equals the amount of money or property the partner would receive if the partnership liquidated. A partner's outside basis includes a partner's share of liabilities whereas a partner's capital account does not (Assets minus Liabilities equals Capital). When performing a risk analysis, adding the capital account as reported on the Schedule K-1, allocable share of liabilities, and any IRC 743(b) adjustments allows for an estimation of the partner's outside basis. As noted throughout this unit, the accuracy of this estimation depends on whether the capital accounts on the Schedule K-1 are reported on a tax basis.

Prior to 2020, a partnership could choose the method for reporting a partner's capital account. It could select (1) section 704(b) book; (2) GAAP; (3) tax basis; or (4) other.

Prior to 2020, the partnership had to check the appropriate box that described the method of accounting used to figure the partner's capital account for reporting purposes on each Schedule K-1 in Section L. If the method of accounting used to figure the partnership's capital account was based on the partnership's income and deductions for federal income tax purposes, the "Tax basis" box had to be checked. On the other hand, the "GAAP" box had to be checked if the figure was determined based on generally accepted accounting principles (GAAP). If the partnership arrived at the figure based on the capital accounting rules under Treas. Reg. 1.704-1(b)(2)(iv), the "Section 704(b) book" box had to be checked. If none of the three methods named above (tax basis, GAAP, or Section 704(b) book) were used, the "Other" box had to be checked, and the partnership had to attach a statement describing the method and showing how the partner's capital account was determined.

! **CAUTION:** The capital account reporting requirements on Schedule K-1 changed beginning in 2020. Beginning in 2020, taxpayers are required, with few exceptions, to report capital accounts on the Schedule K-1 on the tax basis for their ending capital account amounts and thereafter both beginning and ending balances must be reported on the tax basis. Please see the instructions to the Form 1065 for 2020 and later years for further guidance.

Process Overview (cont'd)

Partner's Outside Basis

Tax Basis Capital Account

As its name implies, the tax basis capital account is based on tax accounting. The tax basis capital account is increased by the adjusted tax basis of the contributed assets (net of liabilities) and decreased by the adjusted basis of assets distributed (net of liabilities). Second, the tax basis capital account is increased or decreased annually by increases and decreases as reflected on the partners' Schedules K-1 Part III and attached statements. Tax gain or loss on the sale or other disposition of partnership property is computed using the asset's tax basis. A partner's tax basis capital account plus his share of partnership liabilities plus his section 743(b) adjustment (assuming that the partnership made a section 754 election) generally equals his outside basis in his partnership interest. Note: The accuracy of this computation may be materially reduced if the partnership did not make a section 754 election.

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Process Overview (cont'd)

Partner's Outside Basis

IRC 704(b) Book Capital Accounts

The IRC 704(b) book capital accounting system is a creation of the partnership regulations. It is important to distinguish these "IRC 704(b) book capital accounts" from tax or GAAP capital accounts. The purpose of IRC 704(b) book capital is to reflect each partner's economic share of the partnership's assets equal to their equity in the partnership.

The rules for computing and maintaining book capital accounts are found in Treas. Reg. 1.704-1(b)(2)(iv)(b), a regulation section supporting IRC 704(b). For that reason, such capital accounts are known as "704(b) book" capital accounts. This term can be confusing because the accounting profession often equates the term "book" with financial accounting principles. Maintenance of IRC 704(b) book capital accounts are often included into partnership agreements to satisfy the safe harbor for economic effect as well as to assist in determining whether a partner's allocation has economic effect. Treas. Reg. 1.704-1(b).

IRC 704(b) book capital accounts use fair market value for property contributions and property distributions. For example, if two individuals desire to form a 50/50 partnership, they agree as to the amount of money and the value of property each must contribute so their interests are equal. Professional appraisals may be obtained to value the property or services contributed.

A partner's book capital is increased/decreased by his allocable share of partnership book income/loss for the year, including tax-exempt income. The tax character of the income or loss is not relevant, capital gain and ordinary income are treated the same. IRC 704(b) book income/loss is the same as taxable income/loss with three adjustments. First, depreciation deductions are computed by using tax depreciation concepts (that is, life method) applied to the book basis of assets. Second, gain/loss on an asset sale is computed by using the adjusted book basis of the disposed asset. Third, any inherent gain/loss in the distribution of property to a partner must be allocated to all partners in accordance with their allocation arrangement immediately prior to the distribution. A partnership agreement may, upon the occurrence of certain events, increase or decrease the book capital accounts of the partners to reflect a revaluation of partnership property (including intangible assets such as goodwill) on the partnership's books. Treas. Reg. 1.704-1(b)(2)(iv)(f).

Process Overview (cont'd)

Partner's Outside Basis
Loss Limitations In general, a partner's distributive share of partnership loss, including capital loss, is allowed only to the extent of the partner's outside basis. IRC 704(d). In determining the extent to which loss or deduction may be claimed, the partner's outside basis is first increased by his share of income, contributions, and liabilities, and decreased by both cash and property distributions and any decrease in his share of partnership liabilities. IRC 705. If the current year aggregate loss exceeds the adjusted outside basis, the loss limitation must be allocated to each type of loss or deduction, including any amounts carried over from prior years due to previous basis limitations. Treas. Reg. 1.704-1(d)(2). The Tax Cuts and Jobs Act (TCJA) amended IRC 704(d). IRC 704(d)(3)(A) provides that charitable contributions and foreign tax payments are taken into account under the basis limitation rules. Under prior law, a partner could take into account their entire distributive shares of charitable contributions or foreign tax payments even if they were in excess of outside basis. Under TCJA, for partnership tax years beginning after December 31, 2017, a partner may not take into account his distributive share of foreign tax payments if the amount of the payments exceed his outside basis. The new rule for charitable contributions is more complicated. New IRC 704(d)(3)(B) addresses situations in which a partnership donates built-in gain property, in other words, property whose fair market value exceeds its tax basis. Partners must reduce outside basis by their share of the appreciated property's tax basis. The donated property's built-in gain does not reduce outside basis and is not subject to IRC 704(d). See Examples 4 and 5 on Slide 29.

Step 1: Pre-Audit Analysis/Estimate Outside Basis

Partner's Outside Basis
Step 1
Inspect the return with a focus on the Schedules K-1 for potential issues. If outside basis is relevant to the issue, use tax return information to estimate the pertinent partner's outside basis.

Considerations	Resources
Generally, outside basis is not itself an issue. However, outside basis is inexorably intertwined with several issues which tend to be significant events. For example, if a partner sells or disposes of his partnership interest, he must know his outside basis in order to correctly determine the tax consequences. See Slide 15 for brief discussion on identifying transfers of partnership interests. The partners' Schedules K-1 indicate whether the partners were allocated a loss and whether the partners received a distribution of cash or property. As noted previously, losses in excess of outside basis are suspended. A partner may receive a distribution of cash or property in a liquidating or in a current distribution. A partner exits the partnership upon a liquidating distribution. On the other hand, a partner who receives a current distribution remains in the partnership. The type of distribution, the tax basis of the property, the amount of cash distributed, and the amount of the partner's outside basis determine the tax consequences.	▪ IRC 731

Partner's Outside Basis
Step 1

Considerations	Resources
Look for evidence of transfers of partnership interests. Some indicators are: ▪ Form 8308 is attached to the partnership return. ▪ A Schedule K-1 is marked "Final." ▪ A partner's Schedule K-1 reflects 0% at year end. ▪ A statement is attached to the partnership return indicating there was a sale, exchange, or liquidation of a partner's interest during the tax year. ▪ The partner does not receive a Schedule K-1 in the subsequent year.	

Step 1: Pre-Audit Analysis/Estimate Outside Basis (cont'd)

Partner's Outside Basis
Step 1

Considerations	Resources
A quick method for estimating a partner's outside basis from the Schedule K-1 (prior to consideration of current year activity) is to add the partner's beginning tax basis capital account, his share of liabilities (both recourse and nonrecourse), and any IRC 743(b) adjustments. The first two amounts are shown on each partner's Schedule K-1 as follows: ▪ Schedule K-1, Item L "Beginning capital account" ▪ Schedule K-1, Item K "Partner's share of liabilities" Note: This estimation becomes much less accurate if the partnership did not use the tax basis method for reporting capital accounts and if the partnership did not make a Section 754 election. Beginning in 2019, taxpayers are required to report on Schedule K-1, line 20, Code AH, the remaining Sec. 743(b) adjustments. Further, taxpayers are required to report on Schedule K-1, line 11, Code F, and line 13, Code V, any income, gain, loss, or deduction items related to an IRC 743(b) adjustment. Please see the instructions to the Form 1065 for years after 2019. Note: This represents the partner's share of the partnership's inside tax basis of its assets less the partner's share of liabilities. It is not the partner's actual outside basis which must be computed by the partner; thus, it can only be used as an estimate.	

Step 1: Pre-Audit Analysis/Estimate Outside Basis (cont'd)

Partner's Outside Basis
Step 1

Considerations	Resources
As noted, for years prior to 2020, this estimate of a partner's outside basis will be more accurate if capital accounts are reported using the tax basis method, as opposed to the IRC 704(b) book or GAAP methods. The type of capital account reported is identified on Schedule K-1, Part I, Item L for years prior to 2019. The type of capital reflected on Schedule K-1 may be different from year-to-year. These factors should be considered when assessing the accuracy of an estimate of a partner's basis. Compare the prior year ending capital account on the Schedule K-1 to the beginning capital account balance. If there is a difference, request an explanation and documentation from the partnership.	

Step 1: Pre-Audit Analysis/Estimate Outside Basis (cont'd)

Partner's Outside Basis
Step 1

Considerations	Resources
For 2019 and later years, line 20, Code AH of the Schedule K-1 will have the IRC 743(b) adjustment (if the partnership made an IRC 754 election). This figure should be added to the tax basis capital account plus allocated liabilities calculation discussed earlier. ! **CAUTION:** The capital account reporting requirements on Schedule K-1 have changed. Beginning In 2020, taxpayers are required, with few exceptions, to report capital accounts on the tax basis for their ending capital account amounts and thereafter both beginning and ending balances must be reported on the tax basis. Please see the instructions to the Form 1065 for 2020 and later years for further guidance.	

Step 2: Verify or Reconstruct Outside Basis

Partner's Outside Basis
Step 2
Use taxpayer records and internal sources to verify or reconstruct outside basis.

Considerations	Resources
Step One described how to estimate outside basis. Verify the estimate by obtaining additional information from both the partnership's representative and from internal sources.	
Often, basis is tracked at the partnership level. However, tracking outside basis is the responsibility of each partner. Treas. Reg. 1.705-1(a). The requirement to keep books and records is contained in Treas. Reg. 1.6001-1(a). A partner is required to maintain adequate books and records to substantiate basis. If a partner does not maintain adequate recordkeeping, then the burden of proof is on the partner to prove sufficient basis to deduct losses. See Nwabasili v. CIR, T.C. Memo. 2016-220.	▪ Treas. Reg. 1.705-1(a) ▪ Treas. Reg. 1.6001-1(a) ▪ Nwabasili v. C.I.R., T.C. Memo 2016-220
To verify or reconstruct a partner's outside basis, you must obtain the partner's Schedules K-1 starting with the year in which the partner was admitted to the partnership. The partnership's representative may be able to furnish the Schedules K-1. Additionally, use internal systems such as EUP, IDRS, LIN and yK-1.	
Once the Schedules K-1 are obtained, the partner's basis can be computed by using the Partner's Basis Computation Spreadsheet available in the Partnerships Knowledge Base within the IRS Virtual Library. When using the basis spreadsheet, it is important to include all partner contributions, distributions, liabilities and items of income/loss that impacts basis.	▪ Audit Tool, Partner's Basis Computation Spreadsheet

Step 2: Verify or Reconstruct Outside Basis (cont'd)

Partner's Outside Basis
Step 2

Considerations	Resources
You may obtain necessary information from years barred by the statute of limitations in order to correctly compute a partner's outside basis in your year under examination.	

Step 3: Use Alternative Rule to Compute Outside Basis

Partner's Outside Basis
Step 3
In certain circumstances, it is possible to calculate outside basis using an alternative rule under IRC 705(b).

Considerations	Resources
<u>IRC 705(b) Alternative Basis Calculation Rule</u> IRC 705(b) provides an alternative rule for computing outside basis. This alternative rule can only be used in two circumstances: 1. The circumstances are such that the partner cannot practicably apply the general rules for the computation of outside basis. 2. In the Service's opinion, it is reasonable to conclude that the result produced will not vary substantially from the result produced under the general basis rules. A partner wishing to use the alternative rule must show that the circumstances are such that he is entitled to do so. See Treas. Reg. 1.705-1(b) and examples. When the alternative rule under IRC 705(b) is used to compute a partner's outside basis, adjustments to this calculation are necessary in certain situations. For example, contributions of property by a partner to a partnership, transfers of partnership interests, and distributions of property to partners are all situations that may require adjustments.	

Partner's Outside Basis

Description

Example 1 - Determine if a Potential Basis Issue Exists

You are assigned to audit ABC Partnership's 2015 Form 1065 Tax Return. As part of your risk analysis, you review the tax return, which includes the partners' Schedule K-1s. A review of the Schedule K-1 shows the following relevant information for partner Sally Smith. Sally does not have an IRC 743(b) adjustment. Assume that the partnership uses the tax basis capital account method for purposes of the calculation:

$ (140,000)	Part II Item L – Beginning Capital Account
(120,000)	Line 1 - Ordinary Business Loss
10,000	Line 2 - Net Rental Real Estate Income
(5,000)	Line 9a - Net Long-Term Capital Loss
(115,000)	Sally Smith's 2015 Schedule K-1 Part II, Item L Current Year increase/(decrease)
(255,000)	Part II Item L – Ending Capital Account (includes current year activity & Beginning Capital Account of ($140,000))
75,000	Part II Item K - Nonrecourse Liabilities
100,000	Part II Item K - Recourse Liabilities
(80,000)	Sally Smith's Estimated 2015 Losses in Excess of Basis ($115,000 net current year loss less $175,000 share of liabilities plus ($140,000) Beginning year Capital Account)

An estimate of Sally Smith's outside basis (($140,000) plus $175,000 plus $10,000 equals $45,000) shows she may be able to deduct $45,000 of the $125,000 ($120,000 plus $5,000) in partnership losses. The remaining $80,000 loss must be suspended under IRC 704(d) until she has adequate outside basis. Remember to check the Schedule K-1, line 19 for distributions of cash and/or property. Sally's disallowed loss would have increased by the amount of the adjusted basis of any property distributed or any cash distributed.

Examples of the Process (cont’d)

Partner’s Outside Basis
Description
Example 1 - Determine if a Potential Basis Issue Exists (cont’d) Please note that this is an estimate of basis because the partnership is not required to track a partner’s outside basis. The tax basis capital account reflects the partner’s share of the partnership’s inside tax basis of its assets less the partner’s share of liabilities. For years prior to 2020, the accuracy of this computation was dependent upon the type of capital account that is reflected on Schedule K-1. If the capital account was an “IRC 704(b) book capital” or “GAAP capital,” those amounts may have differed significantly from the tax allocations to the partner since the start of her investment. For example, the book income statement may have reflected book deductions that were not allowed for tax purposes (Schedule M-3) in prior years and the current year. In that case, the capital account for book purposes will be lower than that for tax, and thus the estimated basis computed above will be lower than the actual tax basis. Beginning in 2020, partnerships are required to report capital accounts on a tax basis. In addition, for 2019 and later years, partnerships are required to report a partner’s net remaining unrecovered IRC 743(b) adjustment to line 20, Code AH. Please see the instructions to the Form 1065 for later years. ! **CAUTION:** You should not assume the partner deducted the losses in excess of basis. A review of the partner’s tax return would need to be performed to determine if she deducted all of the losses. In this example, the ordinary business losses and net rental real estate income would be reported on Sally Smith’s Form 1040, Schedule E. The net long-term capital loss would be reported on Form 1040, Schedule D. If Sally Smith correctly limited her 2015 deductible losses from ABC Partnership, then no audit adjustment to suspend the excess losses under IRC 704(d) would be necessary. If you determine Sally Smith deducted all of the 2015 losses from ABC Partnership on her 2015 Form 1040 return, then you should verify her basis in ABC Partnership to determine whether she deducted losses in excess of basis.

Examples of the Process (cont'd)

Partner's Outside Basis
Description
<u>Example 2 - Reconstructing a Partner's Outside Basis</u> You are assigned to examine XYZ Partnership's 2016 Form 1065. The Schedule K-1 of a partner named Joe Johnson shows he received a $465,000 cash distribution. You estimate that his outside basis is less than $465,000. His 2016 Form 1040 Schedule D reflects no capital gain from a cash distribution in excess of his basis in XYZ Partnership. You expand the audit to include Joe Johnson's 2016 Form 1040. An Information Document Request (IDR) is issued that requests a computation of his outside basis in XYZ Partnership as of December 31, 2016. Joe Johnson responds by providing his 2014 to 2016 Schedules K-1. He states that he has not tracked his outside basis in his partnership interest. You learn from reviewing the 2014 Schedule K-1 that Joe became a partner in XYZ Partnership on January 1, 2014. Joe Johnson's 2014 to 2016 Schedules K-1 show the following information:

Examples of the Process (cont’d)

Partner’s Outside Basis

Description

Example 2 – Reconstructing a Partner’s Outside Basis (cont’d)

Tax Year 2014	
$150,000	Part II Item L – Capital Contributed During the Year
125,000	Line 1 – Ordinary Business Income
1,000	Line 5 – Interest Income
(20,000)	Line 19 Code A – Cash Distributions
256,000	Part II Item L – Ending Capital Account (This also equals Joe’s Estimated Basis as of 12/31/2014.)
Tax Year 2015	
$100,000	Part II Item K – Recourse Liabilities at Year-End
$256,000	Part II Item L - Beginning Capital Account
(200,000)	Line 1 – Ordinary Business (Loss)
30,000	Line 2 – Net Rental Real Estate Income
1,000	Line 5 – Interest Income
(5,000)	Line 9a – Net Long-Term Capital (Loss)
82,000	Part II Item L – Ending Capital Account (Joe’s Estimated Basis as of 12/31/2015 is $82,000 plus $100,000 equals $182,000.)

Examples of the Process (cont'd)

Partner's Outside Basis

Description

Example 2 - Reconstructing a Partner's Basis (cont'd)

	Tax Year 2016
$ 100,000	Part II Item K – Recourse Liabilities at Year-End
$ 82,000	Part II Item L – Beginning Capital Account
50,000	Line 1 – Ordinary Business Income
10,000	Line 2 – Net Rental Real Estate Income
1,000	Line 5 – Interest Income
2,000	Line 9a – Net Long-Term Capital Gain
(465,000)	Line 19 Code A – Cash Distributions
(320,000)	Part II Item L – Ending Capital Account
-	Joe's Estimated Basis as of 12/31/2016
($220,000 Capital Gain from Distributions in Excess of Basis)	

You use the Basis Computation Spreadsheet in order to reconstruct Joe Johnson's basis which shows Joe Johnson's basis was $245,000 on line 11 before considering his $465,000 cash distribution. Therefore, his basis is $0 as of 12/31/2016, and he must report a $220,000 capital gain on his 2016 Form 1040 Schedule D.

! **CAUTION**: Line 19 of the Joe Johnson's Basis Spreadsheet shows a basis of ($220,000). As explained earlier in this practice unit, a partner's basis cannot fall below zero. Therefore, Joe Johnson is required to report a $220,000 capital gain for distributions in excess of basis.

Examples of the Process (cont’d)

Partner’s Outside Basis

Description

Example 3 - Alternative Rule for Reconstructing a Partner’s Outside Basis

You are assigned the 2016 ABC Partnership return and one of its major partners, Mr. Apple, for examination. The exam plan includes Mr. Apple’s distributive share of partnership loss and any potential basis limitation. An IDR was issued to Mr. Apple for documentation pertaining to his outside basis in his ABC Partnership interest. Mr. Apple is unable to provide any documentation because his records were destroyed in a house fire the previous year. He states that he and two other partners contributed cash and property in 2005 when the partnership was formed. Since 2005, no partners left, and no new partners were admitted.

You determine the circumstances warrant the use of the alternative rule under IRC 705(b). You inspect the partnership’s tax basis balance sheet which shows:

$ 100,000	Cash
250,000	Inventory
475,000	PP&E
75,000	Other Assets
900,000	Total Assets
$ 50,000	Other Liabilities
250,000	Mortgages
300,000	Total Liabilities

Examples of the Process (cont'd)

Partner's Outside Basis
Description

Example 3 - Alternative Rule for Reconstructing a Partner's Outside Basis (cont'd)

Since the partnership has liabilities, Mr. Apple's share of the basis of partnership property is computed net of liabilities. Treas. Reg. 1.705-1(b) Example 3. Since Mr. Apple has a one-third ownership in the partnership, his basis in the partnership is $300,000. This is computed as follows:

$900,000	Total Assets
(300,000)	Total Liabilities
600,000	Net Value of ABC Partnership
X 33 1/3%	
$200,000	Mr. Apple's Share of Net Assets
100,000	Mr. Apple's Share of Liabilities
300,000	Mr. Apple's Basis Under Treas. Reg. 1.705-1(b)

! **CAUTION**: If the liabilities were not allocated in proportion to Mr. Apple's ownership in ABC Partnership, Mr. Apple's basis would have been different than shown in the example above.

Examples of the Process (cont'd)

Partner's Outside Basis
Description
<u>Example 4 - Basis Reduction for Donated Appreciated Property</u> In 1990, Partner X and Partner Y formed the XY Law Partnership and opened an office. To celebrate the office's opening, a friend gifted a painting to X and Y which they contributed to the partnership and hung in the office's lobby. The donor had a zero basis in the painting. The partnership's inside basis was also zero. In 2020, in anticipation of retiring, X and Y decide to donate the painting to a museum which is an IRC 501(c)(3) charity. An appraisal determine that its fair market value is $1M. No outside basis reduction is necessary for either X or Y as the painting has a zero tax basis. However, X and Y each may claim a charitable contribution deduction of $500,000 regardless of their amounts of outside basis in the XY Partnership. The property's appreciation is not subject to a basis limitation. <u>Example 5 - Basis Reduction for Donated Appreciated Property</u> The facts are the same as in Example 4, but the XY Partnership purchased the painting for its lobby in 1990 for $100,000. Additionally, X has an outside basis of $50,000 and Y has an outside basis of $30,000. In this fact pattern, the painting's built-in gain is $900,000 ($1M minus $100,000). X and Y must reduce their outside basis by their shares of the painting's tax basis ($50,000 each). While each partner's outside basis is reduced to zero, X's charitable donation amount is $500,000 ($50,000 basis plus $450,000 share of appreciation). However, Y's charitable donation amount is limited to $480,000 (his outside basis of $30,000 plus his share of appreciation of $450,000). Note that Y's $20,000 unused charitable donation amount would carry over to a year in which he has sufficient outside basis. Note that in both examples other limitations may apply at the level of the individuals.

Index of Referenced Resources

Partner's Outside Basis
IRC 501(c)(3)
IRC 704
IRC 705
IRC 721
IRC 722
IRC 723
IRC 731
IRC 732
IRC 733
IRC 742
IRC 752
IRC 1012
IRC 1014
IRC 1015
IRC 1231
Treas. Reg. 1.704-1

Index of Referenced Resources (cont'd)

Partner's Outside Basis
Treas. Reg. 1.705-1
Treas. Reg. 1.721-1(b)(1)
Treas. Reg. 1.6001-1(a)
Rev. Proc. 93-27
Rev. Proc. 2001-43
Rev. Rul. 84-52
Form 1065, Schedule K, Partners' Distributive Share Items
Form 1065, Schedule K-1, Partner's Share of Income, Deductions, Credits, etc.
Form 1065, Schedule L, Balance Sheets per Books
Form 8308, Report of a Sale or Exchange of Certain Partnership Interests
Pub. 541, Partnerships
Nwabasili v. C.I.R., T.C. Memo 2016-220

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Training and Additional Resources

Partner’s Outside Basis	
Type of Resource	**Descriptions**
Training	▪ Formation of a Partnership, ITM 79104r ▪ Partnership Loss Limitations, ITM 79121r ▪ Partnership Operations, ITM 79106r
Reference Materials	▪ Practitioners Publishing Company (PPC), 1065 Deskbook, Transfers and Distributions, Key Issues 24
Other Training Materials	▪ Audit Tool, Partner’s Basis Computation Spreadsheet ▪ Issue Snapshot, Determining Basis in a Partnership Interest (Outside Basis)

Glossary of Terms and Acronyms

Term/Acronym	Definition
EUP	Employee User Portal
GAAP	Generally Accepted Accounting Principles
IDR	Information Document Request
IDRS	Integrated Data Retrieval System
IRC	Internal Revenue Code
LIN	LMSB Image Network
LLC	Limited Liability Company
Rev. Proc.	Revenue Procedure
Rev. Rul.	Revenue Ruling
TCJA	Tax Cuts and Jobs Act
TEFRA	Tax Equity and Fiscal Responsibility Act
Treas. Reg.	Treasury Regulation

Index of Related Practice Units

Associated UILs	Related Practice Unit
752-0	Recourse vs. Nonrecourse
752-0	Determining Liability Allocations