Accredited Business Advisor (ABA) Part 2

Preparatory Course
LEARNING OBJECTIVES

After reviewing this chapter, you should be able to:

• Distinguish the “aggregate” theory of partnership taxation from the “entity” approach used for other business forms

• Determine the tax consequences of formation of a partnership to the partner and the partnership

• Identify when a partner may recognize gain for receipt of an interest in exchange for the performance of services

• Identify the reporting requirements for a partnership, including filing obligations and tax election issues

• Identify the key elements used to determine a partner’s basis in the partnership interest

• Identify the partnership capital account reporting available to the partnership, including both required methods and other methods that may also be useful for other purposes

• Distinguish the tax consequences of a guaranteed payment and a distribution for both the partnership and the partner

• Identify the options available to a partnership when adopting accounting methods and periods

• Distinguish recourse liabilities from nonrecourse liabilities

• Determine partners’ shares of recourse and nonrecourse liabilities

• Determine partners’ shares of income and loss of the partnership, both by agreement and special considerations applicable to built-in gains and losses

• Determine the tax consequences of distributions of money and property from the partnership to the partners
the transferee’s deduction, determined using the allocation method described in this paragraph, is prorated for the number of months remaining in the transferee’s tax year.

If real property is transferred, the transferee’s deduction for the year of the transfer is determined using the disposition rules of Regulations Section 1.168-2(a)(3). That is, the transferee is entitled to cost recovery deductions prorated through the end of the month preceding the month of transfer. This produces a result similar to that described earlier for personal property.

If the partnership’s first year is a short tax year, any otherwise allowable cost recovery deductions must be prorated by the ratio that the number of months in the short year bears to 12.

**Holding Period of Partnership Interest**

A partner’s basis in a partnership interest acquired by contribution of money or property is a substituted basis. That is, the partner substitutes the basis that he or she had in the property transferred for the basis of the partnership interest. Tax advisors often fail to distinguish a carryover basis from a substituted basis, but the distinction is important with respect to determination of holding period.

Section 1223(1) provides that when the basis of property acquired by the taxpayer is the same, in whole or in part, as the basis of property transferred in exchange for that property, then the holding period of the new property shall include the holding period of the property exchanged if the property exchanged is a capital or a Section 1231 asset.

If an interest is acquired in exchange for property that is not either a capital or a Section 1231 asset, the holding period begins on the date of acquisition of the interest.

If an interest is acquired in exchange for a transfer of capital assets (or Section 1231 assets) and other property, the partner presumably has a split holding period for the acquired interest. In Revenue Ruling 84-53, the IRS ruled that a partner has just one interest in the partnership, even if both limited and general partnership interests are held by that partner. Thus, a sale of all or a portion of a partner’s interest before the more than one year holding period of Section 1222 is satisfied may result in both long-term and short-term capital gain.

Transfers of assets to the partnership on an ongoing basis may create multiple holding periods for the partner’s interest.

**Holding Period of Contributed Assets to the Partnership**

Section 1223(2) states that if property is acquired in an exchange, and the basis of the property so acquired is the same, in whole or in part, as the basis of such property to the transferor, then the holding period shall include the holding period of the transferor. This is a carryover basis, not a substituted basis, provision and allows the holding period to include the transferor’s holding period regardless of the nature of the property transferred.

Because Section 723 states that the partnership’s basis in contributed assets is equal to the basis of such assets to the contributing partner, increased by any gain recognized under Section 721(b), the partnership has a carryover basis and is entitled to include the holding period of the contributing partner when determining its holding period. This is true regardless of the character of the assets contributed.
an HSA are tax-free when used to pay qualified medical expenses. When an HSA distribution is used for any other purpose, it is taxable as ordinary income and subject to a 20% tax penalty unless the distribution is received:

- While the account holder is disabled,
- Following the account holder’s death, or
- By the account holder after reaching the eligibility age for Medicare.

**TRANSFERS, ROLLOVERS, AND EXCHANGES MAINTAIN TAX UMBRELLA**

Investors change employers from time to time. To help ensure the protection against unwanted taxation remains in place, they may roll over qualified plan and IRA funds as shown in the following chart:

<table>
<thead>
<tr>
<th>From These Plans</th>
<th>To These Plans</th>
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</thead>
<tbody>
<tr>
<td>Qualified plan (before-tax contributions only)</td>
<td>• Another qualified plan</td>
</tr>
<tr>
<td></td>
<td>• A Section 403(b) tax-sheltered annuity</td>
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<tr>
<td></td>
<td>• A Section 457 governmental plan (that agrees to a separate arrangement for eligible retirement plan funds)</td>
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<td></td>
<td>• A traditional IRA</td>
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<tr>
<td></td>
<td>• A Roth IRA</td>
</tr>
<tr>
<td>Qualified plan (after-tax contributions)</td>
<td>• A defined contribution plan (provided the plan has separate arrangements for after-tax contributions and transfer is direct trustee-to-trustee)</td>
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<tr>
<td></td>
<td>• A traditional IRA</td>
</tr>
<tr>
<td></td>
<td>• A Roth IRA</td>
</tr>
<tr>
<td>Eligible Section 457 governmental plan</td>
<td>• Another qualified plan</td>
</tr>
<tr>
<td></td>
<td>• A Section 403(b) tax-sheltered annuity</td>
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<tr>
<td></td>
<td>• Another Section 457 governmental plan</td>
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<td></td>
<td>• A traditional IRA</td>
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<td></td>
<td>• A Roth IRA</td>
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<tr>
<td>Section 403(b) tax-sheltered annuity</td>
<td>• A qualified plan</td>
</tr>
<tr>
<td></td>
<td>Another Section 403(b) tax-sheltered annuity</td>
</tr>
<tr>
<td></td>
<td>• A Section 457 governmental plan (that agrees to separately arrange for eligible retirement plan funds)</td>
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<td>• A traditional IRA</td>
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<td></td>
<td>• A Roth IRA</td>
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<tr>
<td>Section 403(b) tax-sheltered annuity (after-tax contributions)</td>
<td>• A defined contribution plan (provided the plan separately arranges for after-tax contributions and transfer is direct trustee-to-trustee)</td>
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<td>• A traditional IRA</td>
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<td></td>
<td>• A Roth IRA</td>
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<tr>
<td>Section 403(b) tax-sheltered annuity (designated Roth arrangements)</td>
<td>• Another 403(b) plan that accepts Roth rollovers</td>
</tr>
<tr>
<td></td>
<td>• A Roth IRA</td>
</tr>
<tr>
<td>Traditional IRA (deductible contributions only)</td>
<td>• A qualified plan</td>
</tr>
<tr>
<td></td>
<td>• A Section 403(b) tax-sheltered annuity</td>
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<td></td>
<td>• A Section 457 governmental plan (that agrees to separately arrange for eligible retirement plan funds)</td>
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<tr>
<td></td>
<td>• Another traditional IRA</td>
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</tbody>
</table>
competent practitioner would under similar circumstances due to a lack of knowledge or a lack of independence standpoint, the licensee may have breached his duty of exercising reasonable care.

**EXAMPLES**

Examples of a tax practitioner’s common-law duty include:

- Duty to perform an engagement with the same care, skill, and competency as any other reasonably competent accountant would under similar circumstances
- Duty to maintain independence and objectivity during the engagement
- Duty to properly supervise personnel during the course of the engagement
- Duty to be diligent in reviewing the client’s information and determining proper accounting or tax treatment
- Duty of due diligence/further inquiry

The court found in *Brockhouse v. U.S.* that preparer penalties under Code Sec. 6694(a) were warranted when a CPA failed to pursue additional factual inquiry when facts presented by the taxpayer suggested additional information was necessary in order to properly calculate the client’s tax liability. The court stated that “this due diligence requirement means that a preparer must act as a reasonable, prudent person with respect to the information supplied to the preparer.”

The third criterion of negligence, proximate cause, includes two elements: (1) cause in fact and (2) foreseeability. In *In re: Sun Point Securities Inc.*, the issue of proximate cause was discussed at length, stating “[n]egligent acts are only a cause in fact of harm if they are a substantial factor in bringing about the harm, without which no harm would have occurred.” Foreseeability requires that a person of ordinary intelligence should have anticipated the danger created by a negligent act or omission.

**EXAMPLE**

Jean, a tax professional, does not report certain income items on her client’s tax return due to the fact that her client, Cliff, had deliberately hidden this information from her. The IRS audits Cliff and assesses an additional tax liability of $100,000 plus penalties and interest due to this omission. Cliff sues Jean as a result. He will not prevail because she properly reported the income items of which she was aware and so did not breach her duty to Cliff.

**Potential Duty Owed Through Privity**

The concept of privity means that a client may have standing to sue a tax practitioner because of the direct contractual relationship between the client and its service provider. If a state’s common law requires the plaintiff to have privity with the defendant, then that may prevent a non-client from suing a tax practitioner. It should be noted that not all states’ common law require privity, which makes it easier for non-clients to sue an accounting firm. Non-privity states permit non-clients to sue if the plaintiff’s reliance on the practitioner’s work is foreseeable. These jurisdictions have rules that failure to disclose facts in non-privity states can be treated as the equivalent of a misrepresentation of fact.

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11 749 F.2d 1248 (7th Cir 1984).
Chapter 28: Taxation of Partnerships

REVIEW QUESTIONS

1. Al and Bob form an equal partnership. Al contributes $10,000 in cash. Bob contributes Section 1231 property with a basis of $5,000 and a fair market value of $10,000. Bob has held the contributed property for 2 years. What is Bob's basis in his partnership interest, and when does his holding period begin?
   a. $10,000 basis; holding period begins at date of transfer
   b. $5,000 basis; holding period begins at the date of transfer
   c. $10,000 basis; holding period begins 2 years before the transfer
   d. $5,000 basis; holding period begins 2 years before the transfer

2. Maureen acquired a 40 percent interest in a partnership by contributing property that had an adjusted basis to her of $30,000 and a fair market value of $50,000. The property was subject to a $40,000 mortgage, which was assumed by the partnership. Following the contribution, Maureen's share of the liability is reduced to 40 percent. What is the adjusted basis of Maureen's partnership interest taking into consideration all of these facts?
   a. $30,000
   b. $24,000
   c. $16,000
   d. $6,000

3. Which of the following may be considered a “guaranteed payment” to a partner?
   a. Payment of a fixed $50,000 each year
   b. Payment of the first $25,000 in profits
   c. Payment of a preference return of 8% of unreturned capital, with a cumulative feature for unpaid amounts
   d. Payment of $35,000 to a partner for rent of a building

4. If the partnership income is not distributed to a partner as earned, the amount of undistributed income:
   a. Increases the partner's basis
   b. Decreases the partner's basis
   c. Does not affect the partner's basis
   d. Is not currently taxable
ANSWERS TO REVIEW QUESTIONS

1. a. Incorrect. It is true that you do not have to provide any reason for requesting a filing extension.

b. Correct. A filing extension only extends the time to file the return; it does not provide an extension of time to pay taxes, which are due by April 15.

c. Incorrect. An extension request must be filed by April 15.

d. Incorrect. The extension period for an individual income tax return is 6 months.

2. a. Correct. There is no cost to taxpayers who use the Fillable Forms option from the IRS website to file electronically.

b. Incorrect. While there is no cost to printing out IRS forms, there is a postage fee for mailing the form through the U.S. Postal Service or an IRS-approved private delivery service.

c. Incorrect. Whether the software is on a computer or in the cloud, there's a charge for the software.

d. Incorrect. This entails professional fees for return preparation and filing.

3. a. Incorrect. The return is not valid without a signature.

b. Incorrect. A taxpayer must include the date that the return is signed.

c. Correct. Whether to include a phone number and/or email address is optional and does not affect the processing of the return.

d. Incorrect. While instructions to the return indicate that this entry is required, it does not appear that the nature of the entry affects the processing of the return.

4. a. Incorrect. The third-party designee does not have the authority to receive a refund check on behalf of a taxpayer.

b. Incorrect. The third-party designee cannot bind the taxpayer to additional liability.

c. Incorrect. The third-party designee is not authorized to represent the taxpayer before the IRS merely through this designation.

d. Correct. The third-party designee has the right to give the IRS missing information.