

CHAPTER 26 - LOSS LIMITATIONS

Problem, page 792

- 26-1a. Section 704(d) limits a partner's pass-thru deductions to outside basis, so J can claim only \$10,000 of her \$25,000 share. The remaining \$15,000 is suspended.
- 26-1b. The partnership's taxable year, with respect to J, closes on the date of sale. If the partnership uses an interim closing of the books, the partnership has a net loss of \$300,000, of which J's share is \$30,000. She cannot claim any of that share, however, because her outside basis is now \$0. See §704(d).

If the partnership elects to apportion its year-end totals ratably over the year, there is a year-long gain of \$100,000, half of which is allocable to the first half of the year. Of that \$50,000 income, J's share equals \$5,000, so she reports that amount. This allows her to also claim \$5,000 of the suspended loss. Thus, her outside basis remains at \$0.

- 26-1c. When J pays back the deficit, she cannot claim the suspended loss: she can only claim such a loss when she has positive outside basis, and since she's not a partner anymore, she has no outside basis. *Sennett v. Commissioner*, 80 T.C. 825 (1983), aff'd per curiam, 752 F.2d 428 (9th Cir. 1985). She may be able to deduct it as a business expense, however. She may have to treat it as a capital loss under the *Arrowsmith* doctrine: because the partnership interest was a capital asset that gave rise to capital gain, she may be forced to treat post-disposition payments on that partnership interest as a return of some of the purchase price. See generally *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952). Part (b) above shows, though, that if there was a suspended ordinary loss at the time of the sale, J should be entitled to an ordinary deduction on the repayment. I know of no authority on this point.

Problem, page 798

- 26-2. Consider first year one. Before borrowing, K's outside basis was \$10,000; after borrowing, it was \$35,000. Therefore, §704(d) presents no barrier to K deducting \$20,000, because the deduction is not greater than K's outside basis. However, §465 might suspend the loss.

If the debt is recourse, it goes into K's amount at risk; if not, it is not part of the amount at risk (unless it meets an exception under §465(b)(3) for "qualified nonrecourse financing"). If the debt is not at-risk, K's loss is limited to her pre-loan \$10,000 amount at risk. If it is considered at-risk, the \$35,000, post-debt limit applies.

In year two, K gets another \$20,000 in loss. Her outside basis is now \$15,000 (regardless of whether K gets to take the deduction on the return, her outside basis goes down by her distributive share). Only \$15,000 of the loss makes it through §704(d) while \$5,000 of the deduction is suspended.

Under §465, if the loan is at risk, K passes this hurdle. But if the loan does not contribute to K's at-risk amount, the \$15,000 deduction surviving §704(d) is suspended at this point.

In year three, K must include her \$40,000 distributive share of income. To the extent of prior losses suspended under §§704(d), 465, 469, and 163(d), such losses will now be allowable. Thus, K's outside basis should now be back to \$10,000.

Problem, page 801

- 26-3 In the chart that follows, row 1 represents the capital contributions, row 2 the initial debt allocations, row 3 the distribution to X, row 4 the distribution to Y, and row 5 the debt reallocation caused by the distribution to Y. Note that the negative basis adjustment to X in row 5 (indicated in bold) does not actually occur; rather, X recognizes \$100 of income.

X		Y		Z	
CA	OB	CA	OB	CA	OB
\$ 10	\$ 10	\$ 100	\$ 100	\$ 100	\$ 100
0	60	0	0	0	0
(70)	(70)	0	0	0	0
0	0	(80)	(80)	0	0
0	[10]	0	10	0	0
(\$ 60)	\$ 0	\$ 20	\$ 30	\$ 100	\$ 100

Might any loss limitation apply to these transactions? Assuming the debt is fully recourse and that each partner has an unlimited deficit restoration obligation, there should be no limitation under §704(b) or under §704(d). While §465 or §469 could apply, neither section affects the analysis presented above.

Problems, page 805

- 26-4. Consider first year one. Before borrowing, K's outside basis was \$10,000; after borrowing, it was \$35,000. Therefore, §704(d) presents no barrier to K deducting \$20,000, because the deduction is not greater than K's outside basis. However, §465 might suspend the loss.

If the debt is recourse, it goes into K's amount at risk; if not, it is not part of the amount at risk (unless it meets an exception under §465(b)(3)). If the debt is not at-risk, K's loss is limited to her pre-loan \$10,000 amount at risk. If it is considered at-risk, the \$35,000, post-debt limit applies.

Another loss limit may apply: §469 prevents passive losses from offsetting anything other than passive gain. If K doesn't materially participate in the partnership, this will be considered passive loss. If so, K won't get the loss until she has offsetting passive gain (from any source), or until she sells her partnership interest.

The next hurdle is §163(d), which states that a taxpayer cannot claim investment interest that exceeds investment income. If this is an interest deduction, K may lose it all here

(depending on her other investments). Note that §163(d) does not apply to interest deductions arising from passive investment because such interest deductions are covered by §469.

In year two, K gets another \$20,000 in loss. Her outside basis is now \$15,000 (regardless of whether K gets to take the deduction on the return, her outside basis goes down by her distributive share). Only \$15,000 of the loss makes it through §704(d) while \$5,000 of the deduction is suspended.

Under §465, if the loan is at risk, K passes this hurdle. But if the loan does not contribute to K's at-risk amount, the \$15,000 deduction surviving §704(d) is suspended at this point. Sections 469 and 163(d) apply as they did in year one.

In year three, K must include her \$40,000 distributive share of income. To the extent of prior losses suspended under §§704(d), 465, 469, and 163(d), such losses will now be allowable. Thus, K's outside basis should now be back to \$10,000. Of course, the service might try to characterize this year's income from the partnership as portfolio, thereby continuing the suspension of losses disallowed under §469.

- 26-5. No: if the obligation did not add to X's outside basis, the release should have no tax effect. I know of direct authority on this point, but no other result makes sense.
- 26-6. C's outside basis is \$10,000; her share of interest income is \$2,000. Therefore, she can claim all \$10,000 of her share of loss from the football team the first year under §704(d). However, this loss will be suspended under §469 unless C has some passive income for the year. Note that the \$2,000 distributive share of interest income is not passive.

The second year, C's outside basis is \$2,000 and goes to \$4,000 with the interest income. Therefore, she can claim only \$4,000 of the loss under §704(d) and the remaining \$6,000 is suspended. However, that \$4,000 loss that survived §704(d) will be suspended under §469 unless C has some passive income.

If C is both a limited partner and a general partner, Treas. Regs. §1.469-5T(e)(3)(ii) states that C is considered to be a general partner under §469. C still must prove "material participation," however, to avoid the passive loss limitations.