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2013: New rules for testing partnership allocations

January 03, 2013 - Front Section

The calendar has just turned from 2012 to 2013, and the fate of a solution for the fiscal cliff remains uncertain. However, with the commencement of 2013, other changes in tax law are definite and business owners should review them with their advisors.

One certain change for 2013 affects partnership allocations. Through a recent treasury decision, issued December 21st, 2012, the IRS removed the de minimis rule for testing the substantiality of partnership allocations. The new final regulations for this rule are effective for all partnership tax years beginning on or after December 28th, 2012, and also will reach back to allocations included in partnership agreements prior to that date.

A partnership agreement's allocation of items of partnership income, gains, losses, deductions and credits will be respected for tax purposes if the allocation has "substantial economic effect." Generally, for an allocation to have substantial economic effect, it must be consistent with the underlying economic arrangement of the partners. Thus, if an allocation carries an economic benefit or burden, the partner to whom the allocation is made must bear that economic benefit or burden. The allocation will be substantial if the allocation substantially affects the dollar amounts received by each of the partners from the partnership.

Under the de minimis partner rule, when determining the substantiality of a partnership allocation, the tax attributes of de minimis partners did not need to be taken into account. A de minimis partner was any partner who directly or indirectly owned less than 10% of the capital and profits of a partnership, and who was allocated less than 10% of each partnership item of income, gain, loss, deduction and credit.

The IRS removed this de minimis rule from the regulations regarding partnership allocation, stating that it was too broad, was easily abused, and was not consistent with sound tax policy. The final regulations are effective for all partnership tax years beginning on or after December 28th, 2012, regardless of when the allocation became part of the partnership agreement. Thus, all partnership allocations must be tested, or retested, for substantial economic effect without the benefit of the de minimis partner rule. For existing partnership agreements, the retest must be done as of the first day of the first partnership tax year beginning on or after December 28th, 2012.

For questions about how the new partnership allocation rules may apply to your business, or to discuss other tax law changes that may apply to your business in 2013, consult with your tax and business planning advisors.

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