CHAPTER 20

PARTNERSHIPS

SOLUTIONS TO PROBLEM MATERIALS

Question/ Problem	Topic	Status: Present Edition	Q/P in Prior Edition
1	Entity and aggregate theories	New	
2	Is entity a partnership?	Unchanged	2
3	Application of § 721	Unchanged	3
4	Issue ID	Unchanged	4
5	Treatment of expenses of new partnership	Modified	5
6	Issue ID	Unchanged	6
7	Assumption of partner's liability by partnership	Unchanged	7
8	Adjustments to partner's basis	Unchanged	8
9	Loss limitations	New	
10	Guaranteed payments	Unchanged	11
11	Issue ID	Unchanged	12
12	Partnership compared to C corporation	New	
13	Partnership formation and operations issues	Unchanged	13
14	Formation of partnership; inside and outside basis	Unchanged	14
15	Formation of partnership; inside and outside basis	New	
16	Formation of partnership; inside and outside basis; character of gain on later sale	Unchanged	16
17	Basis of property received as gift; receipt of interest for services; planning for service interests	Unchanged	17
18	Disguised sale versus distribution	Modified	18
19	Treatment of contributed property	Unchanged	19
20	Precontribution gain [§ 704(c)]	Unchanged	20
21	Definition of organization costs; amortization of organization costs	Unchanged	21
22	Computation of partnership's required tax year under the least aggregate deferral method	Unchanged	22
23	Date basis of partner's interest; gain on sale of contributed land with precontribution built-in gain	Unchanged	23

Question/ Problem	Topic	Status: Present Edition	Q/P in Prior Edition
24	Date basis of partner's interest; loss on sale of contributed land	Unchanged	24
25	Computation of partner's outside basis at beginning and end of year when several transactions took place	New	
26	Allocations to partner under § 704(b) and § 704(c)	Unchanged	26
27	Partnership income; partner's basis; separately stated items; guaranteed payments	Unchanged	27
28	Partnership income; partner's basis; loss limitations; guaranteed payments	Modified	28
29	Basis and loss limitations	New	
30	Allocations under § 704(b); gain calculation	New	
31	Allocations to partner; basis in interest; loss limitations	Unchanged	30
32	Formation of partnership; gain or loss recognized by contributing partners; basis of contributed property to partnership; basis of interests to contributing partners	Unchanged	31
33	No negative basis for a partner's interest; no gain recognized by partner contributing appreciated property encumbered by nonrecourse debt; basis of contributed property to partnership; basis of interests to contributing partners	Unchanged	32
34	Sharing recourse debt for basis purposes	New	
35	Loss disallowance under § 704(d), § 465, and § 469	Unchanged	35
36	Timing of recognition of guaranteed payments	Unchanged	36
37	Partnership has operating loss after deducting guaranteed payment to partner	Unchanged	37
38	Disallowed § 267 loss from sale of property to partnership by partner; conversion of capital gain to ordinary income from sale of investment property to partnership by partner	Unchanged	38
39	Nonliquidating distribution; basis of assets distributed (limited); partner's outside basis	New	
40	Nonliquidating distributions; amount and nature of gain or loss; basis of assets distributed; partner's outside basis	Unchanged	40
41	Allocation of basis to multiple assets distributed	Unchanged	41
42	Issue ID	Unchanged	42
43	Issue ID	Unchanged	43
44	Distribution of precontribution gain property; gain or loss to contributing partner; gain or loss to distributee partner; effect on basis of distributed property; effect on basis of contributing partner's interest in partnership	Unchanged	44

Question/ Problem	Topic	Status: Present Edition	Q/P in Prior Edition
45	Sale of partnership interest; amount and nature of gain or loss; basis of new partner's interest; election to adjust basis of partnership property	New	

CHECK FIGURES

14.a.	$0; $0.
14.b.	$70,000.
14.c.	$60,000.
14.d.	$60,000 basis in property.
15.a.	($20,000) realized; $0 recognized.
15.b.	$40,000.
15.c.	$60,000.
15.d.	$60,000.
15.e.	Sell and contribute cash.
16.a.	$0 recognized.
16.b.	$155,000.
16.c.	$0.
16.d.	$20,000.
16.e.	$25,000 gain, $10,000 § 1231 gain allocated to Lewis, $15,000 § 1231 gain allocated to the other partners.
17.a.	$0.
17.b.	$40,000.
17.c.	$40,000 ordinary income.
17.d.	$100,000.
17.f.	Contribute "property" of "permits" and "development plan" – completed before contribution.
18.a.	Distribution.
18.b.	$0 gain or loss.
18.c.	$40,000.
18.d.	Disguised sale.
18.e.	$24,000.
18.f.	$64,000.
19.a.	Sarah $160,000; Joe $240,000.
19.b.	60,000 ordinary income.
19.c.	2005 $20,000 capital loss and $12,000 ordinary loss; 2010 $10,000 ordinary loss.
20.a.	$40,000 (2004) ordinary income to Sarah; $20,000 (2004) ordinary income allocated equally; ($20,000) capital loss (2005) to Joe; ($12,000) ordinary loss (2005) allocated equally; ($10,000) (2010) ordinary loss to Joe.
20.b.	Sarah $204,000; Joe $214,000.
21.	2003 $700; 2004 $1,700.
25.a.	$25,000.
25.b.	$18,600.
27.a.	$9,000; interest $3,000, tax-exempt interest $6,000.
27.b.	$19,000 basis.
27.c.	$21,000 basis.
28.a.	($31,000); interest $3,000, tax-exempt interest $6,000.
28.b.	$0 basis; $14,500 loss, $1,000 suspended.
28.c.	$15,500 loss; $1,500 interest income, $1,000 basis.
29.a.	$24,000.
29.b.	$4,000.
29.c.	$0.
29.d.	$4,000.
29.e.	Don can contribute capital or partnership can incur debt.
30.a.	Year 1—Fred $49,600; Manuel $78,400. Year 2—Fred $960; Manuel $75,840.
30.b.	Gain $43,200 allocated equally. Basis—Fred $22,560, Manuel $97,440.
30.c.	Fred's cash = $22,560; Manuel's cash = $97,440.
30.d.	Yes.
30.e.	Tax savings now or cash later; not both.
31.	Deduct $54,000 of loss unless basis increased before year-end.
32.a.	$0.
32.b.	$7,500.
32.c.	$0.
32.d.	$18,500.
32.e.	$20,000.
32.f.	$15,000.
32.g.	$16,000.
33.a.	$3,750.
33.b.	$0.
33.c.	$19,750.
33.d.	$22,500.
33.e.	$15,000.

22. October 31.
23.a. $30,000.
23.b. Three years.
23.c. $10,000 gain.
24.a. $16,000 loss; $10,000 to Lana and remaining $6,000 allocated equally among partners.
37.a. $12,500 (only $10,000 currently deductible).
37.b. $25,000.
37.c. $0.
38.a. $0.
38.b. $10,000.
38.c. $80,000 gain; may be ordinary.
39.a. $0.
39.b. $0.
39.c. Account receivable $0; land $15,000; partnership interest $0.
40.a. $10,000 gain and basis in partnership interest $0; partnership $0 gain.
40.b. Land $25,000 basis and basis in partnership $10,000; partnership $0 gain.
40.c. Same as b., except land basis $10,000 and basis in partnership interest $0.
40.d. $0 gain; $0 basis in A/R; $10,000 basis in partnership interest.
41.a. No gain or loss.
41.b. $14,000 in item 1 and $7,000 in item 2.
34. Kim $120,000; Craig $20,000.
35. $48,000 deducted. $14,000 suspended—§ 704(d); $8,000 suspended—§ 469.
36.a $70,000.
36.b. $25,000.
36.c. $70,000.
42.a. Precontribution gain property and disproportionate distribution.
42.b. Disproportionate distribution, precontribution gain, and marketable securities treated as cash.
42.c. Proportionate distribution.
43. Design distribution so proportionate, with precontribution gain property returned to contributor; watch marketable securities to minimize gain.
44.a. $9,000 gain; $49,000 basis.
44.b. $25,000 basis.
44.c. $0 gain; $15,000 basis.
44.d. $5,000 gain; equitable.
44.e. Yes. No gain to contributing partner.
45.a. $70,000 realized.
45.b. $20,000 ordinary income.
45.c. $5,000 capital gain.
45.d. $70,000 basis.
45.e. $20,000 to accounts receivable, $5,000 to capital assets.

DISCUSSION QUESTIONS

1. Under the entity concept, the partnership has an existence distinct from its partners. This concept gives the partnership its own tax personality. As an example, the partnership makes most elections and calculates gains and losses at the partnership level.

   Under the aggregate or conduit concept, a partnership is considered as a collection of taxpayers joined in an agency relationship with each other. The partnership is only a gathering vehicle for information. Income and deductions from partnership operations flow through to the individual partners for final reporting. Items for which different taxpayers might receive different treatment are shown as separately stated items.

   Many partnership taxation rules contain elements of both entity and aggregate theory concepts.

   p. 20-9 and Concept Summary 20-1

2. a. It is probably a partnership for tax purposes. Although Dan does not exercise much managerial control over the day-to-day operations of the venture, he can help determine which real estate is purchased through the exercise of his veto power. If the intent of the partnership is to operate a real estate business, a partnership exists.

   b. If Dan has no veto power and is merely guaranteed a 10% annual return, his contribution to the venture appears to be more in the nature of a loan. If it is a loan, no partnership exists for tax purposes.

   p. 20-4

3. When Justin contributes the land to the partnership, he recognizes no gain or loss. Instead, he takes a substituted basis of $85,000 in his partnership interest ($20,000 cash, plus $65,000 basis in land). The partnership takes a $65,000 carryover basis in the contributed land. The "built-in gain" on the contribution must be tracked and allocated to Justin if the property is ever sold at a gain [§ 704(c)].

   Tiffany can either contribute the assets to the partnership or sell them to a third party. If she contributes the assets, she will have a $125,000 basis in a partnership interest worth $100,000. Similarly, the partnership will have a $125,000 basis in equipment worth $100,000.

   Section 721 prevents Tiffany from recognizing the $25,000 loss on contribution to the partnership. The partnership will step into Tiffany's shoes in determining depreciation deductions. Since this is "built-in loss" property, § 704(c) applies, and the depreciation must be allocated in accordance with Reg. § 1.704-3 (not discussed in detail in this text). Basically, a large portion of the depreciation deductions would be allocated to Tiffany to reduce the difference between her basis and the fair market value of her partnership interest as quickly as possible. (If the property basis was less than its fair market value, depreciation would first be allocated to the other partner.)

   If Tiffany sells the assets to a third party and contributes the $100,000 of cash, she can claim a loss of $25,000 under § 1231. The partnership would use $10,000 of the cash contributed by Justin, plus all of Tiffany's cash, to acquire similar new assets. Tiffany would take a $100,000 basis in her partnership interest, and the partnership would have a $110,000 cost basis in depreciable equipment. The partnership would depreciate the equipment according to its depreciable life, and the depreciation would be allocated between the partners equally or in whatever manner was prescribed by the partnership agreement.

pp. 20-9 to 20-13, 20-25, and Example 9

4. If a contribution of property to a partnership is followed shortly by a distribution of cash to the contributing partner, the IRS may recharacterize the transactions as a disguised sale of the property. In this case, Gerald would be treated as contributing 75% of the property and selling the remaining 25% of the property for cash [$60,000 sales price (distribution amount) ÷ $240,000 property value]. He would recognize $30,000 of gain on the deemed disguised sale [$60,000 deemed selling price less $30,000 basis ($120,000 X 25%)].

   The parties could use any of several techniques to minimize the possibility that the IRS will recharacterize the transaction as a sale. First, a proportionate distribution made to all the partners should avoid any recharacterization. Second, if the contribution is not contingent on the later distribution of cash, the disguised sales rules are not likely to apply. Third, even if the distribution is required to ensure the contribution, the distribution can be contingent on the partnership achieving a certain level of profits. Fourth, if the distribution is made in stages over a longer (say, three-year) time period, it may be viewed as being a reasonable return of Gerald's capital: each $20,000 payment would represent a 10% return on his capital. Finally, if the distribution can be deferred until two years following the capital contribution, it will be presumed not to be part of a disguised sale transaction.

   p. 20-11 and Example 12

5. Expenditures might include the following and would be treated as indicated.

TYPE OF EXPENDITURE	TREATMENT	REFERENCE
Acquisition of property	Capitalized and depreciated	§ 167, § 168
Pre-operating expenses	Capitalized and amortized over $\geq$ 60 months	§ 195
Organization costs	Capitalized and amortized over $\geq$ 60 months	§ 709
Syndication costs	Capitalized; no amortization permitted	§ 709
Ordinary and necessary post-operating business expense	Deductible currently	§ 162

   pp. 20-16, 20-17, and Example 18

6. In 2002 and 2003, BR can use either the cash, accrual or a hybrid method of accounting. BR has at least one Subchapter C corporation as a partner, but BR's average annual gross

receipts did not exceed $5,000,000 in either 2002 or 2003. (BR's average annual gross receipts were $4,600,000 for 2002 and $4,800,000 for 2003.)

In 2004, BR must change to the accrual method of accounting. BR has at least one Subchapter C corporation as a partner during that year, and BR's average annual gross receipts exceeded $5,000,000 during that year. (Average annual gross receipts were $5,200,000 in 2004.)

p. 20-18

7. When property subject to a liability is contributed to a partnership, the basis of the contributing partner's interest must be reduced by the amount of the liabilities assumed by the other partners. Correspondingly, the noncontributing partners may increase their outside bases by that portion of the liabilities they assumed upon the transfer. pp. 20-27, 20-28, and Examples 26 and 27

8. Under § 722, a partner's initial basis is determined by reference to the amount of money and the basis of other property contributed to the partnership. This basis is increased by any gain recognized under § 721(b) and the partner's share of any partnership liabilities. Basis is decreased by any partner liabilities assumed by the partnership.

   Basis is also adjusted to reflect the effect of partnership operations: it is increased by the partner's share of taxable and nontaxable income and is decreased by the partner's share of loss and nondeductible/noncapitalizable expenses. Certain adjustments for depletion are also made.

   Finally, a partner's basis is increased by additional contributions to the partnership and by increases in the partner's share of partnership debt. Basis is decreased by distributions from the partnership and decreases in the partner's share of partnership debt.

   A partner's basis is adjusted any time it may be necessary to determine the basis for the partnership interest. For example, when a distribution was made during the taxable year, or at the end of a year in which a loss arises. A partner's basis may never be reduced below zero (i.e., no negative basis).

   pp. 20-25, 20-26, 20-31, and Figure 20-3

9. Losses may be limited by the partner's basis in the partnership [§ 704(d)], the at-risk limitations [§ 465], or the passive loss limitations [§ 469], in that order. The basis limitations prevent a partner from claiming a loss for amounts in excess of the amounts invested in the partnership. The at-risk limitations further limit the losses to the amounts the partner could actually (theoretically) lose if the partnership were to liquidate in bankruptcy. (The major exception to this premise is the inclusion of "qualified nonrecourse financing" in the amount at risk.) The passive loss rules limit deduction of losses in a passive activity. Passive losses from one activity are generally only deductible to the extent of passive income from another activity.

   pp. 20-32 to 20-36 and Example 33

10. Guaranteed payments are payments to partners determined without regard to the partnership's ordinary income. Generally, they are deductible by the partnership as ordinary and necessary business expenses and must be reported as ordinary income by

the receiving partners. Such payments may be provided for services rendered or for the use of capital. However, to be deductible a guaranteed payment cannot be a capital expenditure and must meet the tests as ordinary and necessary business expenses. pp. 20-36, 20-37, and Examples 40 to 42

11. The parties should address the following issues:

- **Debt vs. Equity/Capital:** Should Marcie loan the money to Sam, or should she become a permanent co-owner? If she loans money, at what interest rate and over what time period will she be repaid? If she contributes capital to a partnership or buys stock in a corporation, will she require a preferred return (e.g., through preferred stock or preferred cash flow distributions on her partnership interest)?

- **Entity form:** If the parties decide Marcie will become a permanent co-owner, should the entity be formed as a corporation or a partnership? If they decide to use the corporate form, will they operate as a C corporation or an S corporation? If they decide to form a partnership, will they operate as a general or limited partnership, or as an LLP or LLC? This decision cannot be made until other issues described below are decided upon. pp. 20-2 and 20-3

- **Liability protection:** Given the liability inherent in offering alcoholic beverages for sale to the public, how can the parties protect their personal assets? Both entity form and purchased insurance should be used to protect their assets. A C corporation, S corporation, or LLC could be used to shield both Sam's and Marcie's personal assets. Also, if a partnership is used, Marcie could be admitted as a limited partner to minimize her personal liability. Umbrella liability insurance coverage will further protect personal and business assets. p. 20-4

- **Flow through of losses:** If the expansion is expected to produce tax losses for a few years, what is the best entity structure to use to ensure the losses flow through to the owners? Both a partnership or a Subchapter S corporation will allow losses to flow through to the partners or shareholders. p. 20-32

- **Interest for services:** If Sam contributes 40% of the capital for 50% of the business, will he be deemed to receive an additional 10% ($250,000) of the business in exchange for services? Whether a C corporation or partnership is formed, compensation for services will be subject to current tax. How could this tax be minimized? The parties could make the initial contributions in proportion to the ultimate share of profits they will receive (e.g., Marcie would only contribute $1,000,000 on formation of the business). Any additional contributions could be made at a later date or could be loaned to the business with a specified payback rate and time frame. (Note that any additional contribution by Marcie could not be required under the partnership agreement, or the income from services would still be charged to Sam. However, a loan would avoid income to Sam even if it is made at the same time the entity is formed, because it does not result in a shift in capital from Marcie to Sam.) p. 20-12

- **Special allocations of depreciation:** Since Marcie's investment will be used for equipment, should depreciation deductions be specially allocated to her? This can only be accomplished through a partnership. p. 20-24

- **Cash flow allocations:** Marcie will likely want regular cash distributions to compensate her for the use of money, and Sam will feel he deserves cash distributions to compensate him for his time. If a partnership is used, a typical compromise might award a guaranteed payment to both parties. Marcie's guaranteed payment would equal a specified percent of her capital contribution each year. Sam's distribution would include a percent of his capital contribution plus an amount equal to the value of the services he provides to the business. Any additional cash flows would be divided equally between the partners. Alternatively, Marcie might require Sam to forgo distributions related to his capital contributions (since the tax basis of his assets is so low) until termination of the partnership. Such a preferential distribution to Marcie could not be used by an S corporation, and it could only be used by a C corporation if Marcie receives both preferred and common stock (the result would still differ slightly from that achieved with a partnership). pp. 20-36 and 20-37

- **Allocation of built-in gains:** There is $800,000 of untaxed appreciation related to the assets Sam will contribute. When and if realized, this income must be allocated to Sam under § 704(c). Also, if Sam's property is depreciable, special allocations of depreciation may be required (depreciation allocations for precontribution gain properties are not discussed in the text). These allocations are not possible if the entity is an S corporation. pp. 20-24 and 20-25

12. A partnership may be advantageous in the following situations:

- Special allocations of income, expenses, cash flows, etc. are desired by the entity owners.

- The entity is reporting taxable losses which the owners would like to utilize on their personal tax returns.

- The partnership generates net passive income which would offset passive losses of the owners.

- If the entity operated as a Subchapter C corporation, it would be required to report taxable income since other means of reducing such income (interest, rents, salaries to owners) have been maximized.

- The entity would not qualify under at least one of the Subchapter S requirements (e.g., too many shareholders, nonqualifying shareholders, more than one outstanding class of stock, etc.)

- The entity will likely exist for only a short period of time. Liquidation of a corporate entity would result in large tax liabilities as a result of taxation of appreciation in assets.

The partnership form may be disadvantageous when:

- The entity income will be significant and will be taxed at higher individual rates than if the income were accumulated by a corporation.

- The entity is in a high risk area from which the owners require protection from personal liability. (An LLC or LLP may be useful in such situations.)

Correct answers may include other advantages and disadvantages of the partnership form.

p. 20-50 and Concept Summary 20-5

13. a. False. The entity is required to file an information return, generally by the fifteenth day of the fourth month after the end of the partnership's tax year. The return includes data concerning the partners' allocable shares of the financial activities of the partnership. In addition, property, sales, and employment tax returns are likely to be required of the entity. pp. 20-20 and 20-21

b. False. The partnership chooses tax accounting periods and methods that are applied to all of the partners. pp. 20-15 and 20-18

c. False, but there are exceptions to the general nonrecognition of such contributions under § 721, including those pertaining to the receipt of boot, the contribution of property with liabilities in excess of basis, and the receipt of a partnership interest in exchange for services provided to the partnership. pp. 20-10 and 20-11

d. True. p. 20-32

e. False. The partner recognizes ordinary income, to the extent of the fair market value of the partnership interest that is received in this manner. p. 20-12

f. False. Such losses can be deducted by partners who hold a 50% or less ownership interest in the entity. p. 20-38

g. False. An alternative tax year will never be required by the IRS; instead, the partnership must request permission from the IRS and illustrate to the IRS that it has a business purpose for using an alternative tax year. pp. 20-19 and 20-20

h. True. pp. 20-27 and 20-28

i. True. Built-in losses, as well as gains, must be allocated to the contributing partner when recognized by the partnership. p. 20-24

j. False. If property which was inventory in the hands of the transferor partner is sold by the partnership within five years of the date it was contributed, any gain will be treated as ordinary income, regardless of the manner in which the property was held by the partnership. p. 20-13

PROBLEMS

14. a. Under § 721, neither the partnership nor the partners recognizes any gain on formation of the entity. pp. 20-9 and 20-10

b. Kate will take a cash basis of $70,000 in her partnership interest. Example 14

c. Drew will take a substituted basis of $60,000 in his partnership interest ($60,000 basis in the property contributed to the entity). p. 20-12 and Example 14

d. The partnership will take a carryover basis in the assets it receives ($70,000 basis in cash, and $60,000 basis in property). p. 20-12 and Example 14

15. a. Lynne has a realized loss of $20,000. However, § 721 contains the general rule that no gain or loss is recognized to a partnership or any of its partners upon the contribution of money or other property in exchange for a capital interest. Since Lynne is subject to this rule, she does not recognize the loss. pp. 20-9 and 20-10

b. $40,000. Section 722 provides that the basis of a partner's interest acquired by a contribution of property, including money, is the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution.

c. $60,000, the adjusted basis of the contributed property (§ 722).

d. $60,000. Under § 723, the basis of property to the entity is the adjusted basis of such property to the contributing partner at the time of the contribution, increased by any § 721(b) gain recognized by such partner. Since no such gain (and no loss) was recognized by Lynne on the contribution, the partnership takes a carryover basis in the property. Example 14

e. A more efficient tax result may arise if Lynne sells the property to an unrelated party for $40,000, recognizes the $20,000 loss on the property, and contributes $40,000 cash to the partnership. The partnership could then use the $40,000 to acquire similar property, in which it would take an $40,000 basis. Example 9

Concept Summary 20-1

16. a. Lewis does not recognize the $5,000 realized gain on the land contribution. Section 721 applies to both the formation and later contributions of property.

b. Lewis's basis in his partnership interest is increased by $95,000 ($75,000 cash plus $20,000 land basis), to $155,000 ($60,000 initial basis plus $95,000 increase).

c. The partnership recognizes no gain or loss on this contribution.

d. H & L takes a carryover basis of $20,000 in the land contributed by Lewis.

e. When the partnership sells the land after four years, it recognizes a $25,000 gain ($45,000 selling price – $20,000 basis). Of this, $5,000 is a precontribution gain allocable to Lewis. Twenty-five percent of the remaining gain, or $5,000, is also allocated to Lewis for a total allocation of $10,000. The land is a § 1231 asset to the partnership. Therefore, Lewis's gain is a § 1231 gain even though the property was a capital asset in his hands.

Examples 8, 10, 17, and 24

17. a. None. Under § 721, neither the partnership nor any of the partners recognize gain on contribution of property to a partnership in exchange for a partnership interest.

b. $40,000. Nate's basis in his partnership interest will equal the basis he held in the property received from his father as a gift. The basis a donee takes in property received as a gift generally equals the donor's basis in the asset. In this case, the father's basis is the amount paid, or $40,000. pp. 20-25 and 20-26

c. Ashley will recognize $40,000 of ordinary income. The fair market value of Ashley's 50% partnership interest is $100,000. Since Ashley will contribute only $60,000 of property, the difference between the amount contributed and the value of the interest will be treated as being for services rendered to the partnership. Services do not constitute "property" for purposes of § 721 nonrecognition treatment. p. 20-12

d. Ashley's basis in her partnership interest will be $100,000 [$60,000 (cash contributed) + $40,000 (the amount of ordinary income recognized for services rendered to the partnership)]. Example 13

e.

Assets	Basis	FMV
Cash	$ 60,000	$ 60,000
Land	40,000	100,000
Land improvements	40,000	40,000
Total assets	$140,000	$200,000
Nate's capital	$ 40,000	$100,000
Ashley's capital	100,000	100,000
Total capital	$140,000	$200,000

Note that the partnership will capitalize the $40,000 deemed payment for Ashley's services, since the services relate to a capitalizable expenditure. The partnership will reflect this $40,000 in "cost of lots sold" as the development lots are sold.

f. Ashley could prepare a development plan and secure zoning permits before the partnership is formed. She could then contribute these plans and permits to the partnership in addition to the $60,000 cash. Since a completed plan would be considered "property," no portion of her partnership interest would be received in exchange for services if this were done. The entire transaction would be considered under § 721. p. 20-12 and Example 13

18. a. Under general guidelines, the $40,000 would be treated as a distribution. The distribution would reduce Nate's basis in his partnership interest to $0.

b. $0. The distribution reduces Nate's basis in the partnership interest. Figure 20-3

c. The partnership would take a basis of $40,000 in the land, Nate's basis in the property at the time of the contribution.

d. The IRS might assert that the contribution and distribution transactions were in effect a disguised sale of 40% ($40,000 distribution ÷ $100,000 fair market value) of the property from Nate to the partnership.

e. $24,000. Under disguised sale treatment, Nate will recognize gain on a sale of 40% of his interest in the land. He will be deemed to have received $40,000 in exchange for 40% of the land, with a basis of $16,000 ($40,000 basis X 40%). Total gain recognized, then, is $24,000.

f. $64,000. The partnership will be deemed to have paid $40,000 for 40% of the land. The remaining 60% is deemed to be contributed to the partnership, and the partnership will take a carryover basis of $24,000 in this parcel. The partnership's total basis is $64,000 ($40,000 + $24,000).

g. The distribution is less likely to be treated as a disguised sale if (1) Nate is subject to "entrepreneurial risk" with respect to the distribution (e.g., the amount will not be paid unless the partnership achieves a specified earnings level) and/or (2) there is an extended amount of time between the date of the formation and the distribution. Regulations have adopted a two-year rebuttable presumption that a distribution made after that time period is not part of a disguised sale transaction.

p. 20-11 and Example 12

19. a. The partners' initial bases in their partnership interests are the same amounts as their bases in the contributed property (§ 722).

Sarah's basis	$160,000
Joe's basis	240,000

b. The 2004 sale results in ordinary income of $60,000 to the partnership.

2004 sale:	Selling price	$220,000
	Basis	(160,000)
	Gain	$ 60,000

The gain is ordinary income, since the land is held as inventory by the partnership. The land was a capital asset to Sarah, but no code provision allows treatment of the gain based on Sarah's use rather than the partnership's use.

c. The 2005 sale results in a $20,000 capital loss, and a $12,000 ordinary loss. The sale in year 2010 results in a $10,000 ordinary loss. As a sale of inventory (determined at the partnership level), both sales would normally result in ordinary losses. However, § 724 overrides the normal treatment and converts a portion of the loss to capital loss for the sale which occurs within 5 years of the contribution date.

2005 sale:	Selling price	$ 88,000
	1/2 basis	(120,000)
	Loss	$ 32,000

The 2005 sale was within five years of the capital contribution date, so the loss is capital in nature to the extent of the built-in loss at the contribution date, which is:

1/2 FMV at contribution	$100,000
1/2 basis	(120,000)
Capital loss	$ 20,000

The remaining $10,000 loss in 2005 is an ordinary loss.

2010 sale:	Selling price	$110,000
	1/2 basis	(120,000)
	Loss	$ 10,000

The 2010 sale was not within five years of the contribution date, so the character of the loss is determined solely by reference to the character of the asset to the partnership. Since the land is inventory to the partnership, the loss is ordinary.

pp. 20-12 to 20-14 and Examples 16 and 17

20. a. The gains determined in Problem 19 cannot be allocated equally between the partners, since both properties are subject to built-in gains or losses which must be allocated under § 704(c). This solution assumes the "traditional method" under Reg. § 1.704-3 is used.

The gain on land contributed by Sarah is partially a precontribution gain and partially allocated equally among the partners. The first $40,000 of the gain is allocated to Sarah; the remaining $20,000 is allocated $10,000 to each partner.

The $20,000 capital loss on the 2005 sale of the land Joe contributed is allocated to Joe as a precontribution loss; the remaining $12,000 ordinary loss is allocated equally. The $10,000 ordinary loss on the sale in year 2010 is allocated to Joe since it, too, is a built-in loss.

b. The partners' capital account balances are shown below:

	Sarah	Joe
Initial basis	$160,000	$240,000
2004 § 704(c) capital gain	40,000	-0-
2004 additional ordinary gain	10,000	10,000
2005 § 704(c) loss	-0-	(20,000)
2005 additional loss	(6,000)	(6,000)
2010 § 704(c) loss	0-	(10,000)
Basis, 12/31/10	$204,000	$214,000

Sarah's and Joe's bases are different since $10,000 of Joe's built-in loss was offset by appreciation in the property after the date of the contribution. This is called a "ceiling rule" effect.

Both of the other allocation methods allowed under Reg. § 1.704-3 (the "Traditional Method with Curative Allocations" and the "Remedial Allocation Method") would reallocate the loss on the year 2010 sale of land contributed by Joe. The result would essentially be a greater loss allocation to Joe and a gain or additional income to Sarah on this sale. Under these methods, after disposal of all precontribution gain properties, Joe's basis would equal Sarah's.

pp. 20-24, 20-25, and Example 24

21. Sparrow's legal fees and accounting fees are organizational costs. The "pre-opening" expenses are start-up costs. Both of these types of expenditures may be amortized over 60 months (or longer). The printing costs are syndication costs and are not deductible.

    In 2003, Sparrow can deduct 6/60 (or 10%) of the organizational and start-up expenses actually paid during the year. The 2003 deduction, then, is $700 for organizational costs (10% X $7,000 paid), and $2,000 for start-up expenses (10% X $20,000).

    In 2004, Sparrow can deduct 12/60 (or 20%) of the total amount of organizational and start-up expenses. In addition, Sparrow can "make up" the deduction for the 2003 amortization of the $1,000 of legal expenses paid in 2004. The 2004 deduction is $1,700 for organizational costs [(20% X $8,000) + (10% X $1,000)] and $4,000 for start-up expenses (20% X $20,000).

    In its initial tax return, Sparrow should include elections to amortize organizational expenses and start-up costs.

    pp. 20-16, 20-17, and Example 18

22. October 31. To determine the required tax year of a partnership under the least aggregate deferral method, perform the following steps:

    - Select one partner's tax year as a test year.
    - Calculate the number of months from the end of the test year to the next year-end for each partner (i.e., determine the number of deferral months for each partner).
    - Multiply the number of income deferral months for each partner by each partner's profit percent.
    - Add the products to determine the aggregate number of deferral months for the test year.
    - Repeat the process until each partner's tax year has been used as a test year.
    - Compare the aggregate number of deferral months for each test year.
    - The test year that has the smallest number of aggregate deferral months is the required tax year.

TEST FOR 12/31 YEAR-END (Justin's year-end)

Partner	Year Ends	Profit Interest		Months of Deferral		Product
Justin	12/31	1/2	X	0	=	0.00
Kara	10/31	1/4	X	10	=	2.50
Lindsey	6/30	1/4	X	6	=	1.50
Aggregate number of deferral months						4.00

TEST FOR 10/31 YEAR-END (Kara's year-end)

Partner	Year Ends	Profit Interest		Months of Deferral		Product

Justin	12/31	1/2	X	2	=	1.00
Kara	10/31	1/4	X	0	=	0.00
Lindsey	6/30	1/4	X	8	=	2.00
Aggregate number of deferral months						3.00

TEST FOR 6/30 YEAR-END (Lindsey's year-end)

Partner	Year Ends	Profit Interest		Months of Deferral		Product
Justin	12/31	1/2	X	6	=	3.00
Kara	10/31	1/4	X	4	=	1.00
Lindsey	6/30	1/4	X	0	=	0.00
Aggregate number of deferral months						4.00

Since 3.00 (for 10/31) is smaller than 4.0 (for 6/30 and 12/31), the required tax year for the partnership is October 31, under the least aggregate deferral method. Figure 20-2 and Example 19

23. a. Lana's basis is $30,000. Under § 722, the basis of a partner's interest equals the adjusted basis of contributed property at the time of contribution. Since Lana paid $30,000 for the property, her basis in her partnership interest is $30,000. Example 14

b. The partnership's holding period includes the period during which Lana owned the investment property; thus, Redbird's holding period began three years ago. Concept Summary 20-1

c. $10,000 gain. Under § 704(c), all unrealized gain or loss at the contribution date on property contributed for a partnership interest belongs to the contributing partner. On the land sale, the partnership incurred a gain of $10,000 ($40,000 selling price minus $30,000 adjusted basis). This gain is allocated entirely to Lana, since this was the amount of the unrealized gain on the land at the contribution date. Example 24

d.

	Basis	FMV		Basis	FMV
Cash	$40,000	$ 40,000	Interest, Lisa	$ 2,500	$ 40,000
Land	5,000	80,000	Interest, Lori	2,500	40,000
			Interest, Lana	40,000*	40,000
	$45,000	$120,000		$45,000	$120,000

* $30,000 partnership interest plus $10,000 gain

24. a. $16,000 loss. Under § 704(c), all unrealized gain or loss at the contribution date on property contributed for a partnership interest belongs to the contributing partner. Gain or loss in excess of that amount on the subsequent sale or exchange of the property is divided among the partners according to their profit and loss sharing ratios. On the land sale, the partnership has a loss of $16,000 ($50,000 adjusted basis minus $34,000 selling price), $10,000 of which is allocated to Lana under § 704(c) (Lana's basis of $50,000 in the land at the contribution date minus the land's FMV of $40,000 at that date). The remaining loss of $6,000 is allocated equally among the partners.

b.

	Basis	FMV		Basis	FMV
Cash	$34,000	$ 34,000	Interest, Lisa	$ 500	$ 38,000
Land	5,000	80,000	Interest, Lori	500	38,000
			Interest, Lana	38,000	38,000
	$39,000	$114,000		$39,000	$114,000

Immediately after the sale, the adjusted basis of each partner's interest is determined as follows:

	Total	Lori	Lisa	Lana
Before sale	$55,000	$2,500	$2,500	$50,000
Built-in loss on land	(10,000)			(10,000)
Loss on land after contribution date	(6,000)	(2,000)	(2,000)	(2,000)
After sale	$39,000	$ 500	$ 500	$38,000

The FMV amount for each partner after the sale is determined as follows:

	Total	Lori	Lisa	Lana
Before sale	$120,000 *	$40,000	$40,000	$40,000
Loss on land after contribution date	(6,000)	(2,000)	(2,000)	(2,000)
After sale	$114,000	$38,000	$38,000	$38,000

*$80,000 FMV of existing land plus $40,000 FMV of Lana's contribution.

Example 24

25. a. Assuming that Earl's capital account reflects an accurate number for basis purposes, the calculation is as follows:

Capital account balance, beginning of year	$10,000
Share of EZ's debt ($30,000 X 1/2)	15,000
Earl's basis, beginning of year	$25,000

b.

Capital account balance, beginning of year		$10,000
Add:		
Taxable income	$ 5,000	
§ 1231 gain	3,000	
Long-term capital gain	1,000	9,000
		$19,000
Less:		
Short-term capital loss	$ 300	
Charitable contribution	100	
Payment of Earl's medical expenses	6,000	
Cash distribution to Earl	14,000	(20,400)
		($ 1,400)
Plus: Share of EZ's debt ($40,000 X 1/2)		20,000
Earl's basis, end of year		$18,600

Note that payment of Earl's medical costs is treated as a distribution to Earl.

pp. 20-25 to 20-31, Examples 31 and 32, and Figure 20-3

26. $20,000 of the taxable income is allocated to Barry under § 704(c), since this income was realized before he contributed the accounts receivable to the partnership. Similarly $40,000 of gain on land sale is allocated to Geneva.

The municipal bond income can all be allocated to Aaron since the "economic effect" requirements are met, and since no offsetting allocation will be made in future years [which would violate the "substantial" requirement of the § 704(b) regulations].

The resulting allocation is as follows:

		Taxable Income	Municipal Bond Income	Capital Gain
Barry				
	§ 704(c)	$ 20,000		
	§ 704(b)	90,000	$ -0-	$20,000
Aaron				
	§ 704(b)	45,000	8,000	10,000
Geneva				
	§ 704(c)			40,000
	§ 704(b)	45,000	-0-	10,000
Total		$200,000	$8,000	$80,000

Examples 5, 6, 21, and 24

27. a. The partnership's ordinary taxable income is determined as follows:

Sales revenue	$200,000
Cost of sales	(110,000)
Guaranteed payment to Sid	(30,000)
Depreciation expense	(15,000)
Utilities	(20,000)
Rent	(16,000)
Total ordinary income	$ 9,000

Separately stated items:

Interest income	$3,000
Tax-exempt interest income	6,000

The payment to Medical Center Hospital for Sal's medical expenses is treated as a distribution to Sal in the amount of $10,000. Sal may be able to claim a deduction for medical expenses on her personal tax return.

b. Sal's basis in her partnership interest at the end of the tax year is determined as follows, using the ordering rules in Figure 20-3:

Beginning basis	$20,000
Share of partnership income	4,500 *
Share of separately stated income items:	
Interest income	1,500 *
Tax-exempt interest income	3,000 *
Distribution (payment for medical expenses)	(10,000)
Ending basis in interest	$19,000

*These items are reported on Sal's personal income tax return for the year. (The tax-exempt interest is only an information item on the personal return.)

c. Sid's basis in his partnership interest at the end of the tax year is determined as follows:

Beginning basis	$12,000
Share of partnership income	4,500 *
Share of separately stated income items:	
Interest income	1,500 *
Tax-exempt interest income	3,000 *
Ending basis in interest	$21,000

*These items are reported on Sid's personal income tax return for the year. (The tax-exempt interest is only an information item on the personal return). In addition, Sid will report ordinary income from the guaranteed payment in the amount of $30,000. Reporting the guaranteed payment as income does not increase Sid's basis in his partnership interest.

Note that the partnership deducts the guaranteed payment, and it affects both partners' capital accounts equally.

pp. 20-20 to 20-22 and Examples 20 and 41

28. a. The partnership's ordinary taxable income is determined as follows:

Sales revenue	$160,000
Cost of sales	(110,000)
Guaranteed payment to Sid	(30,000)
Depreciation expense	(15,000)
Utilities	(20,000)
Rent	(16,000)
Total ordinary loss	($ 31,000)

Each partner's share of the loss is $15,500.

Separately stated items remain as reported in Problem 28, with allocations to each partner as follows:

	Total Amount	Amount for Each Partner
Interest income	$3,000	$1,500
Tax-exempt interest income	6,000	3,000

The payment to Medical Center Hospital for Sal's medical expenses is treated as a distribution to Sal in the amount of $10,000. Sal should determine whether she can claim a deduction for medical expenses on her personal tax return. Both partners must also consider whether the distributions they received are taxable.

b. Sal's basis in her partnership interest at the end of the tax year is determined as follows, using the ordering rules in Figure 20-3:

Beginning basis	$20,000
Share of separately stated income items:	
Interest income	1,500*
Tax-exempt interest income	3,000*
Basis before loss allocation and distribution	$24,500
Less: Distribution	(10,000)
Basis before loss allocation	$14,500
Less: Ordinary loss allowed under § 704(d)	(14,500)*
Ending basis in interest	$ -0-

*As in Problem 28, Sal reports the interest income and tax-exempt income. The distribution from the partnership is not taxable since it is less than her basis after current income items. Her ordinary loss from the partnership is limited under § 704(d). Of the $15,500 total loss, only $14,500 is deductible currently. The remaining $1,000 ordinary loss is carried forward until such time as Sal has sufficient basis in her partnership interest to utilize the loss.

Example 34 and Figure 20-3

c. Sid's basis in his partnership interest at the end of the tax year is determined as follows:

Beginning basis	$12,000
Share of separately stated income items:	
Interest income	1,500 *
Tax-exempt interest income	3,000 *
Basis before loss allocation	$16,500
Ordinary loss allowed under § 704(d)	(15,500)*
Ending basis in interest	$ 1,000

*Sid reports the interest income and reflects this amount and the tax-exempt income in his basis for his partnership interest before considering the loss from the partnership. Since he has adequate basis, the allocated loss is fully deductible.

Sid additionally will report as ordinary income the $30,000 guaranteed payment. (His partnership interest basis is not increased by the guaranteed payment.) Note that the partnership deducts the guaranteed payment, and it affects both partners' capital accounts equally.

pp. 20-32 to 20-34, Figure 20-3, and Examples 34 and 41

29. a. $24,000. Don's share of last year's partnership loss is $30,000 ($120,000 X 25%). However, his loss is limited to his basis in the partnership interest, or

$24,000. The remaining $6,000 loss is carried forward until such time as Don has adequate basis in the partnership to deduct the loss.

b. $4,000. Don's share of the current year partnership income is $10,000. He can offset the $6,000 loss carryforward against this amount for net reportable income of $4,000.

c. Don's basis in the partnership at December 31 of last year is $0. His beginning basis of $24,000 is reduced by the $24,000 loss he utilized last year.

d. Don's basis in the partnership at December 31 of this year is $4,000. His beginning basis of $0 is increased by his $10,000 share of current year income, and reduced by the $6,000 of loss carryforward utilized.

e. At the end of last year, Don could have contributed $6,000 of cash to the partnership to ensure his entire loss was deductible. Also, (assuming Don shares proportionately in partnership liabilities) the partnership could have incurred additional liabilities of $24,000.

Examples 34 and 35

30. a. The partners' bases at the end of the first year are determined as follows:

	Fred	Manuel
Capital contribution	$100,000	$100,000
Loss allocation	(20,000)	(20,000)
Depreciation allocation	(30,400)	(1,600)
Basis at end of Year 1	$ 49,600	$ 78,400

The partners' bases at the end of the second year are determined as follows:

	Fred	Manuel
Basis at end of Year 1	$49,600	$78,400
Depreciation allocation	(48,640)	(2,560)
Basis at end of Year 2	$ 960	$75,840

None of the losses are suspended for either partner, since the initial capital contribution exceeds cumulative loss allocations.

b. Gain must be recognized on sale of the equipment:

Selling price		$120,000
Less: Adjusted basis		
Original basis	$160,000	
Less: Yr. 1 depreciation	(32,000)	
Less: Yr. 2 depreciation	(51,200)	(76,800)
Gain		$ 43,200

This gain is reflected in basis as follows:

	Fred	Manuel
Basis at end of Year 2	$ 960	$75,840
Plus: Gain on equipment	21,600	21,600
Basis before final distribution	$22,560	$97,440

c. Each partner will receive cash from the $120,000 sale proceeds in the amount of the capital account balance reflected above. (Fred gets $22,560 and Manuel gets $97,440, for a total of $120,000.)

d. These allocations have economic effect since (1) gains, income, loss, etc. allocations are reflected in capital account balances, (2) liquidating distributions are in accordance with ending capital account balances, and (3) deficit capital account balances must be restored.

e. Fred has directly reduced his right to cash flows on liquidation in favor of current deductions from taxable income. Absent the special allocation of depreciation, the parties would each have received $60,000 on the distribution of sale proceeds. The economic effect rules ensure that a deduction reflects a true economic consequence to the partner. The partners must decide which is more valuable: the value of a current deduction [with tax savings of up to about $.40 for each $1 of deduction (for an individual)], or the present value of $1 of cash distributed on termination of the partnership.

p. 20-24 and Example 22

31. Willis, Hoffman, Maloney, and Raabe, CPAs
5191 Natrop Boulevard
Mason, OH 45040

September 26, 2003

Ms. Jeanine West
Williams Institute of Technology
76 Bradford Lane
St. Paul, MN 55164

Re: Allocations from the Research Industries Partnership

Dear Jeanine:

You have asked us to assist you in determining treatment of the expected 2003 results of operations of the Research Industries Partnership (RIP).

Allocation. RIP is expected to report a loss from operations of $200,000. WIT's 60% share of this loss is $120,000. The partnership will also report a $100,000 capital gain from sale of land. Much of this gain arose before DASH contributed the property to the partnership. To that extent, the gain is allocated back to DASH [see § 704(c)(1)(A)]. Of the total gain, $40,000 arose after the property was contributed [$300,000 (selling price) – $260,000 (value at contribution date)]. Sixty percent of this amount, or $24,000, is allocated to WIT.

WIT's basis in the partnership interest at the beginning of the year was $120,000, including the $90,000 share of partnership liabilities. All the liabilities were repaid during the year.

Basis. The capital gain and the decrease in liabilities are taken into account before we determine whether any of the loss is deductible. WIT's basis before the loss deduction is determined as follows.

Beginning basis (1/1/2003)	$120,000
Increase for share of capital gain	24,000
Decrease in share of partnership liabilities	(90,000)
Basis before loss	$ 54,000

Limitation. Unless WIT can increase its basis in the partnership before year end, WIT will only be able to deduct $54,000 of the $120,000 loss. The Company can consider contributing an additional $66,000 cash before year end. Also, the partnership could borrow $110,000 cash on a short-term basis; WIT's 60% share of this debt would increase its basis so it is adequate for WIT to deduct its full share of RIP's loss.

If you have any questions, please do not hesitate to contact me.

Sincerely,

Joseph Sanders

Instructor Note: The at-risk amount is the same as the general basis limitation under § 704(d), and the loss is not further subject to the passive loss rules since WIT is a material participant in partnership activities.

Examples 20, 24, and 33

32. a. None. Section 721 contains the general rule that no gain or loss is recognized to a partnership or any of its partners upon the contribution of property in exchange for a capital interest in the partnership.

b.

Adjusted basis of Lee's contributed property	$15,000
Less: Liability assumed by partnership (per § 752)	(10,000)
Plus: Allocation of partnership liability to Lee ($10,000 X 25%)	2,500
Adjusted basis of Lee's interest in LBR Partnership	$ 7,500

c. None. Section 721 applies to Brad's contribution.

d.

Adjusted basis of Brad's contributed property	$16,000
Plus: Allocation of partnership liability to Brad ($10,000 X 25%)	2,500
Adjusted basis of Brad's interest in LBR Partnership	$18,500

e.

Cash contributed by Rick	$15,000
Plus: Allocation of partnership liability to Rick ($10,000 X 50%)	5,000
Adjusted basis of Rick's interest in LBR Partnership	$20,000

f. $15,000. Section 723 states that the basis of property contributed to a partnership by a partner is the adjusted basis of such property to the contributing partner at the time of the contribution, increased by any § 721(b) gain recognized by such partner. Since no gain was recognized by Lee on the contribution, the partnership takes a carryover basis in the property.

g. $16,000. Section 723 applies.

pp. 20-9, 20-10, 20-12, and Example 27

33. a.

	Adjusted basis of Lee's contributed property	$15,000
Less:	Liability assumed by partnership (per § 752)	(20,000)
Plus:	Allocation of nonrecourse debt for precontribution liability in excess of basis ($20,000 – $15,000)	5,000
Plus:	Allocation of remaining liability [($20,000 – $5,000) X 25%]	3,750
	Adjusted basis of Lee's interest in the LBR partnership	$ 3,750

b. Lee recognizes $0 gain on the contribution because the $5,000 debt allocation to Lee (the amount of minimum gain) ensures he does not have a deemed distribution (relief of debt) in excess of his basis in the contributed property.

c.

	Adjusted basis of Brad's contributed property	$16,000
Plus:	Allocation of residual nonrecourse liability ($15,000 X 25%)	3,750
	Adjusted basis of Brad's interest in LBR Partnership	$19,750

d.

	Cash contribution by Rick	$15,000
Plus:	Allocation of residual nonrecourse liability ($15,000 X 50%)	7,500
	Adjusted basis of Rick's interest in LBR Partnership	$22,500

e. $15,000. Lee's basis in the contributed property.

Example 30

34. December 10, 2003

TAX FILE MEMORANDUM

FROM: Jane Student

SUBJECT: KC Partnership debt allocation

Facts: The KC Partnership will be formed before the end of the current year to acquire a $200,000 parcel of land. The partnership will be equally owned by Kim and Craig. It will purchase the land for $200,000, with $60,000 paid in cash. The $140,000 remaining purchase price will be borrowed from First State Bank. The loan will be secured by the land, and will be personally guaranteed by both partners.

The partnership agreement provides that 75% of all income, losses, etc. will initially be allocated to Kim, and the remainder is allocated to Craig. Capital accounts will be appropriately maintained under the § 704(b) regulations. Any partner with a deficit capital account balance upon liquidation of the partnership will be required to contribute cash in the amount of the deficit at that time.

Issues: The partners would like to know how the $140,000 debt will be allocated between them for basis purposes.

Conclusion: Application of the "constructive liquidation" scenario contained in Reg. § 1.752-2 results in an allocation of $120,000 to Kim and $20,000 to Craig.

Law and Analysis: Under the constructive liquidation scenario, the partnership's assets are first deemed to be worthless and sold for a loss, which is allocated in accordance with the partnership agreement. This would result in a loss of $200,000 on the land, which is allocated 75% to Kim and 25% to Craig, as follows.

	Kim	Craig
Capital account	$ 30,000	$30,000
Loss allocation	(150,000)	(50,000)
Ending capital account	($120,000)	($20,000)

The partners each have a negative capital account balance after this allocation, and under the partnership agreement, they would be required to contribute this amount to the partnership upon its liquidation. The combined amount would be used to repay the partnership debt of $140,000.

The allocation of the debt equals the amount of any liquidating contribution which would go to repay that debt, or $120,000 and $20,000, respectively.

[**Instructor note**: In this case, the ending debt allocation does not equal either (1) the proportion of the initial capital contributions by the partners or (2) the allocation of income/loss, etc. under the partnership agreement.]

Examples 28 and 29

35. January 26, 2004

TAX FILE MEMORANDUM

FROM: Beth Mullins

SUBJECT: Partnership loss deductibility

Facts: Chris Elton has the following allocations and bases in her partnership interests for the current year.

Partnership:	Cardinal	Bluebird
Income/(loss) allocation	($70,000)	$23,000
Basis excluding liabilities	40,000	N/A
Recourse liability allocation	10,000	N/A
Nonrecourse liability allocation	6,000 *	N/A

*The partnership obtained the debt from an unrelated bank; it is secured solely by real estate.

Chris spends significant time working for each partnership during the year. Her modified AGI is $100,000 before considering partnership activities.

Issues: How much of the $70,000 loss from the Cardinal Partnership can Chris deduct in the current year?

Under what Code provision are any disallowed losses suspended?

Conclusion: Chris can deduct $48,000 of the $70,000 loss. Of the disallowed loss, $14,000 is suspended under § 704(d). An additional $8,000 loss is suspended under the passive loss rules of § 469, after application of the special $25,000 deduction for active participation in a passive real estate activity. None of the loss is suspended under the at-risk rules (§ 465).

Law and analysis: Under § 704(d), Chris may deduct a portion of the Cardinal loss equal to her basis in her partnership interest, including recourse and non-recourse liabilities. The basis is $56,000 ($40,000 + $10,000 + $6,000), and the excess $14,000 loss is suspended.

Since the nonrecourse debt was obtained from a third party lender and relates only to real estate, this debt is qualified nonrecourse financing and is also included in Chris's amount at-risk. There is no additional § 465 deduction limitation.

Both activities are treated as rental activities, which, by definition, are passive for purposes of § 469. The Cardinal loss is deductible to the extent of the $23,000 income from Bluebird. Also, since Cardinal is a rental real estate activity, and Chris is an active participant owning more than 10%, this loss is eligible for an additional $25,000 deduction. The full $25,000 is deductible since Chris's modified AGI does not exceed $100,000.

Examples 33, 38, and 39

36. a. In his June 30, 2004 tax return, Fred reports income from F & F of $70,000. This includes his $50,000 guaranteed payment, and his 50% distributive share of the partnership's $40,000 of taxable income for the tax year ended December 31, 2003.

b. In her December 31, 2004 tax return, Fran reports income from F & F of $25,000. This is her 50% share of the partnership's $50,000 of taxable income for the tax year ended December 31, 2004.

c. If Fred's guaranteed payment increases to $60,000 on January 1, 2004, Fred's income for his June 30, 2004 tax year would still be $70,000 (as in a. above). The salary increase is reflected as a guaranteed payment on the K-1 issued for Fred for the partnership year ended December 31, 2004, and Fred reports this amount in his June 30, 2005 tax return.

Examples 41 and 42

37. a. Ned's distributive share of the partnership loss is $12,500. This amount is subject to the limitation imposed by § 704(d), so only $10,000 is currently deductible.

b. $25,000 [$35,000 as ordinary income (guaranteed payment) less Ned's $10,000 share of the partnership loss—as limited under § 704(d)].

b. Ned's basis following the two transactions is $0.

Basis before current year activity	$10,000
Less: loss allocation allowed under § 704(d)	(10,000)
Ending basis	$ -0-

Note that the guaranteed payment does not directly affect Ned's basis, since it is not considered to be a distribution for basis purposes. Ned will carry the $2,500 unused loss forward until such time as he has adequate basis to permit a deduction.

Examples 34 and 41

38. a. Zero. Section 707(b)(1)(A) applies, and Anne's $50,000 realized loss is not deductible.

b. $10,000. Section 267(d) permits the partnership to offset any subsequent gain by the loss previously disallowed ($60,000 gain less $50,000 previously disallowed loss).

c. $80,000 gain. Anne's $80,000 gain would be ordinary under § 707(b)(2) if the investment property immediately after the transfer is not a capital asset of the Four Lakes Partnership.

Examples 45 and 46

39. a. A partnership recognizes no gain or loss on a distribution that does not alter the partner's proportionate ownership of hot assets.

b. No gain or loss is recognized by Peggy from the distribution. Only gain can be recognized from a nonliquidating distribution and then only if the amount of cash or certain marketable securities received exceeds Peggy's outside basis immediately before the distribution.

c. The cash is deemed distributed first and reduces Peggy's outside basis to $15,000. The account receivable is distributed next, and takes a carryover basis to Peggy of $0. The receivable does not change Peggy's outside basis. The land is distributed last, and takes a substituted basis to Peggy of $15,000. The land reduces Peggy's outside basis for the partnership interest to $0. The value she received was

$110,000, but she does not recognize gain because of the basis allocation and ordering rules.

Examples 52 and 53

40. a. Martha recognizes a $10,000 gain on the distribution. Her outside basis for her partnership interest is reduced to $0. The partnership does not recognize any gain or loss on the transaction.

b. The $30,000 cash is deemed distributed first and reduces Randy's outside basis to $35,000. The land takes a $25,000 carryover basis to Randy, and his outside basis for his partnership interest is reduced to $10,000. The partnership recognizes no gain or loss on the transaction.

c. The answer is the same as in b., above, except that the land takes a substituted basis to Randy of $10,000, and his outside basis for his partnership interest is reduced to $0.

d. The cash is deemed distributed first and results in no taxable gain to Curt. The account receivable takes a $0 carryover basis. Curt's basis is reduced to $10,000 after the cash distribution. The receivable distribution does not affect his basis. The partnership recognizes no gain or loss on the distribution.

Examples 48 to 53

41. a. Tom does not recognize a gain or loss on the distribution, since this is a nonliquidating distribution. Gains are only recognized in a nonliquidating distribution if distributed cash exceeds the partner's basis in the partnership, which did not happen in this case. Losses are not recognized in nonliquidating distributions.

b. Tom's basis in the two inventory items is limited to the basis in his partnership interest, less the amount of cash received, or $21,000. Since the partnership's basis in the two inventory items ($40,000) exceeds the amount Tom can allocate to these assets, his basis in each item is determined in three steps as follows:

1. The inventory items both are initially allocated a basis equal to the partnership's basis in the assets, or $20,000 each.

2. Since the second inventory item is depreciated in value, Tom's basis is reduced to the amount of its fair market value, or $10,000. The first inventory item is appreciated, so its basis is not further reduced in this step.

3. Tom now has inventory with bases totaling $30,000 and a capital account that can absorb $21,000 of basis. Therefore, he must reduce the bases in the inventory items an additional $9,000. This reduction is applied proportionately to the two inventory items:

$$\$9,000 \text{ X } \frac{\$20,000}{\$30,000} = \$6,000$$

$$\$9{,}000 \text{ X } \frac{\$10{,}000}{\$30{,}000} = \$3{,}000$$

The basis in the first inventory is reduced to $14,000 ($20,000 – $6,000) and the basis in the second inventory is reduced to $7,000 ($10,000 – $3,000).

Example 54

42. Instructor note: This problem is designed to demonstrate the unusual results that can arise when distributions of different properties are made to different partners. The students are not asked to calculate the results of each distribution, but they should be able to identify relevant issues, such as "a disproportionate distribution of hot assets will result in ordinary income to some of the partners."

a. Generally, a current distribution of property does not result in gain or loss. However, a distribution of precontribution gain property less than seven years after it was contributed can result in a taxable gain to the contributing partner if the distribution is to a partner *other than* the contributing partner. In this case, Walden would be taxed on $20,000 of built-in gain when the land is distributed to Xavier and Yolanda.

In addition, § 751(b) must be considered when there is a disproportionate distribution of "hot assets." In this case, both Yolanda's and Xavier's share of unrealized receivables is reduced from a value of $24,000 ($80,000 X 30%) before the distribution to $6,000 ($20,000 X 30%) following the distribution. This will result in ordinary income recognition to Yolanda and Xavier.

b. The disproportionate distribution of accounts receivable to Xavier will result in ordinary income to Yolanda and Walden, as described in a. above.

Gain will arise on a current distribution of cash which exceeds the partner's outside basis. The $60,000 distribution of cash exceeds Walden's basis by $20,000, so he will be taxed on a $20,000 gain. Per the last paragraph, there is a disproportionate distribution of accounts receivable, so a portion of Walden's gain will be ordinary income.

A distribution of marketable securities is treated as a distribution of cash, but the amount of the distribution treated as cash is the fair value of the security reduced by the partner's share of appreciation which attaches to these securities. In this case, the partnership has realized substantial appreciation, so after the reduction, the $45,000 distribution is not likely to result in an amount in excess of Yolanda's $30,000 basis.

In addition, some of the securities are deemed a payment in exchange for Yolanda's share of (distributed) unrealized receivables, so the result is ordinary income to Yolanda.

c. This distribution is proportionate with respect to "hot assets," so the receivables do not trigger ordinary income recognition by any of the partners. For Yolanda and Xavier, the cash is distributed first. Since the cash does not exceed their outside basis, no gain is recognized. The receivables are distributed second and the partners take a carryover basis of $0 in the receivables.

For Walden, the receivables are deemed distributed first, and take a carryover basis. The land is distributed next. Since he is merely receiving a return of precontribution gain property he contributed, he will not recognize any gain or loss. Note that there is no requirement for cash and capital gain property distributions to be proportionate for each specific property.

Examples 50 and 53

43. If accounts receivable are distributed disproportionately to the partners, the nondistributee partners will be required to recognize ordinary income currently, and the distributee partner will be able to defer the ordinary income until such time as the receivables are collected.

Since Walden contributed the appreciated land less than seven years ago, if any of the land is distributed to any of the other partners, Walden will be required to recognize part or all of the $20,000 precontribution gain. The postcontribution gain will be deferred until the land is sold. If the land is distributed to Walden, though, he will not be required to recognize gain until he later sells the property. The Code does not require the gain to be reported merely because a partner contributes a property and later receives it in a distribution.

The cash and marketable security distributions may result in capital gains to the partners if the distribution exceeds a partner's outside basis. The potential gain from the securities is deferred to the extent it relates to appreciation earned by the partnership.

Example 56

44. a. Under § 704(c)(1)(B), Gabriella recognizes gain on the distribution to Juanita in the amount of the original precontribution gain on the contributed property, $9,000. Her basis in her partnership interest is increased accordingly, to $49,000.

b. Juanita's basis in the property received equals the predistribution basis in the property received, $16,000, plus the gain recognized by Gabriella, $9,000, for a total basis in the property of $25,000.

c. Juanita recognizes no gain or loss on the distribution of the property. Her basis in her partnership interest is reduced by her basis in the distributed property of $25,000, to $15,000.

d. If Juanita sold the land immediately after the distribution, she would recognize a $5,000 gain: $30,000 (fair market value) – $25,000 (basis in property). The overall result is equitable: Juanita pays tax on postcontribution gain, and Gabriella pays tax on precontribution gain.

e. If the precontribution gain property were contributed to the partnership more than seven years prior to the distribution of the property to Juanita, Gabriella would not be required to recognize gain on the distribution, and Juanita's basis in the property would be $16,000.

45. a.

Cash received	$65,000
Add: Liabilities assumed by Lou	5,000
Total amount realized	$70,000

b. $20,000 (Art's one-third share of unrealized accounts receivable).

c. $5,000

		Total
Total realized		$70,000
Less: Basis of Art's interest:		
Capital	$40,000	
Debt share	5,000	(45,000)
Gain to Art		$25,000
Less: Ordinary income		(20,000)
Capital gain		$ 5,000

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NOTES