Course Materials

Required Materials

- Internal Revenue Code and Treasury Regulations
- Materials on Blackboard
- Cunningham, Noel, and Cunningham, Laura, The Logic of Subchapter K: A Conceptual Guide to the Taxation of Partnerships (“Logic”)

Schedule of Classes

1. September 5
2. September 12
3. September 19
4. September 26
5. October 3
6. October 10
7. October 17
8. October 24
9. October 31
10. November 7
11. November 14
12. November 21
13. November 28
14. December 5

Introductory Note

This is a challenging (but fun) course. **You must come to class prepared.** Please be sure you bring all necessary materials to class. Each class builds on the prior class, so it is very important that you not fall behind. The problems are part of the assignment. You must work through (or at least make a good faith attempt to work through) the problems before class; however, do not expect to be able to get the correct answer to every question in the problems – we will spend a good deal of class time developing the answers.

I do not anticipate using your participation (or lack thereof) in the determination of your grade; however, I reserve the right to use the quality of class participation in the grading (i) in extreme (good or bad) cases or (ii) in satisfying curve requirements. In no event will class participation affect your grade by more than half a letter grade.

I will be available to speak to you individually after every class for as long as you want to stay (or as long as we are allowed to stay in the room). I can also be reached at my office (phone: 212-479-6473; e-mail: pgall@kronishlieb.com) and will be happy to schedule other times as necessary.

For the most part, the final exam will contain role-playing questions (i.e., “You are an IRS agent,” “You are hired to give advice to a person who wants to invest in a partnership,”
“You are an associate in a law firm asked to write a memo”). You will be free to use anything except help from another person.

Cautionary Note: In a two-credit course, it is impossible to cover every issue of partnership taxation. Consequently, I will spend time emphasizing those areas that are of critical importance in understanding the fundamentals of partnership taxation. With a solid understanding of those fundamentals, you should be fully prepared to take Partnership Taxation II or to tackle other areas not covered in class in your future careers.

Assignment for First Class: Code Sections 701, 761(a), and 7701(a)(2)-(3); Treas. Reg. § 1.701-2(a) and (e); Treas. Reg. § 301.7701-1, -2, -3, -4(a)-(b); Rev. Rul. 75-374 (Item 1); Rev. Rul. 2004-77 (Item 2); Commissioner v. Culbertson (Item 3). Skim TIFD III-E Inc. v. United States (Item 4)

Logic, Chapter 1
Unit I – Partnership Formation

Assignment

Code: Sections 168(i)(7), 441(a)-(e), (g), 442, 444, 448, 453B, 706(a)-(b), 709, 721, 722, 723, 724, 752, 1223(1)-(2), 1245(b)(3). Skim Sections 351(e) and 7519.


Materials: Oden v. Commissioner (Item 5)

Logic: Chapters 2 and 3 (through p. 25)

Problems

1. Jerry and Elaine form a 50-50 partnership. Jerry contributes a building with a $30 tax basis and a $60 fair market value and inventory (in Jerry’s hands but not in the partnership’s hands) with a $25 tax basis and a $40 fair market value. Elaine contributes land with a $40 tax basis and an $80 fair market value and $20 of cash. Elaine has owned the land since 1998. Jerry purchased the building four months prior to the formation of the partnership. The partnership spends $5 of its cash on legal and filing fees for organizing the partnership.

a. Is gain recognized upon the formation of the partnership?

b. What is the partnership’s tax basis in the building? In the inventory? In the land?

c. What are Jerry’s and Elaine’s bases in their partnership interests?

d. Would the partnership recognize long-term or short-term gain on an immediate sale of the building? What about an immediate sale of the land? What about an immediate sale of the inventory?

e. Would Elaine recognize long-term or short-term gain on an immediate sale of her partnership interest?

f. What is Elaine’s outside basis if she contributes $5 of cash and her $15 note, which is due in 5 years, instead of the $20 of cash?

g. Fill in the following balance sheet for the partnership as of the time immediately following its formation (i.e., before the payment of the $5 expenditure):
h. What are the tax consequences of the partnership’s $5 expenditure?

2. On January 1, 2006, Acme Corp. (a C corporation with a January 31 fiscal year), Moe, Larry, and Curly (calendar-year taxpayers) form a limited liability company (taxed as a partnership) to operate a service business in which Moe, Larry, and Curly actively manage.

a. Based solely on the above facts, what is the LLC’s taxable year if Acme Corp. is a 97% partner and Moe, Larry, and Curly each have a 1% interest? What if they are all equal partners? What if they are all equal partners and Curly has a June 30 fiscal year?

b. What options, if any, does the LLC have to select a different taxable year?

c. Assume the members are equal partners, the LLC’s taxable year is the calendar year, and the LLC generates the following gross receipts:

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross Receipts</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>$4,000,000</td>
</tr>
<tr>
<td>2007</td>
<td>$4,000,000</td>
</tr>
<tr>
<td>2008</td>
<td>$5,500,000</td>
</tr>
<tr>
<td>2009</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>2010</td>
<td>$5,200,000</td>
</tr>
</tbody>
</table>

Can the LLC use the cash method of accounting in 2006? In 2010? In 2011?

3. A, B, C, and D form an equal partnership. A contributes equipment with a tax basis of $60 and a fair market value of $100; the $40 of gain is subject to recapture under section 1245. B contributes a building with a tax basis of $20 and a fair market value of $160 subject to a nonrecourse mortgage of $60. C contributes an installment obligation to

received from the sale of land; the installment obligation has a tax basis of $10 and a fair market value of $100. D contributes accounts receivable with a tax basis of zero and a fair market value of $60, a contract to provide consulting services to a third party with a tax basis of zero and a fair market value of $40 (i.e., the present value of the expected profit from performing the services is $40).

a. Does any partner recognize gain?

b. Fill in the following balance sheet for the partnership as of the time immediately following its formation:

<table>
<thead>
<tr>
<th></th>
<th>Tax</th>
<th>Book/FMV</th>
<th></th>
<th>Tax</th>
<th>Book/FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>B</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>C</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>D</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liabilities</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Unit II – Partnership Operations

A. Computation of Partnership Taxable Income and Effect on Outside Basis

Assignment

Code: Sections 701-703, 704(a)-(b), 705, 6031, 6698

Regulations: Treas. Reg. §§ 1.702-1, 1.703-1, 1.705-1, 1.752-1

Materials: Form 1065 (Item 6); Schedule K-1 (Item 7); Helmer v. Commissioner (Item 8); Rev. Rul. 96-10 (Item 9); Rev. Rul. 96-11 (Item 10)

Logic: Chapter 3 (pp.25-29)

Problem

X, Y, and Z were equal partners in the XYZ partnership, which had the following items occur during the taxable year:

1. How will the XYZ partnership and the partners report the income for the taxable year?

2. What is the impact of these items on the partners’ outside bases?

<table>
<thead>
<tr>
<th>Item</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Gross income from business operations</td>
<td>$390</td>
</tr>
<tr>
<td>2</td>
<td>Expenses deductible under § 162(a)</td>
<td>90</td>
</tr>
<tr>
<td>3</td>
<td>Depreciation</td>
<td>30</td>
</tr>
<tr>
<td>4</td>
<td>Charitable gifts (see §170(a), (b)(1)(A))</td>
<td>12</td>
</tr>
<tr>
<td>5</td>
<td>Gain on sale of equipment used in the business, $21 of which is ordinary under §1245(a) and $12 of which is §1231 gain</td>
<td>33</td>
</tr>
<tr>
<td>6</td>
<td>Long-term capital gain from securities</td>
<td>42</td>
</tr>
<tr>
<td>7</td>
<td>Short-term capital gain from securities</td>
<td>30</td>
</tr>
<tr>
<td>8</td>
<td>Long-term capital loss from securities</td>
<td>9</td>
</tr>
<tr>
<td>9</td>
<td>Short-term capital loss from securities</td>
<td>120</td>
</tr>
<tr>
<td>10</td>
<td>Dividends</td>
<td>27</td>
</tr>
<tr>
<td>11</td>
<td>Interest on tax-exempt bonds</td>
<td>18</td>
</tr>
<tr>
<td>12</td>
<td>Option premium received on grant of option to purchase property owned by the partnership</td>
<td>3</td>
</tr>
<tr>
<td>13</td>
<td>Distribution to partners</td>
<td>45</td>
</tr>
</tbody>
</table>
B. Allocation of Partnership Taxable Income

1. Capital Account Maintenance Rules

Assignment

Code: Section 704(a)-(b)

Regulations: Treas. Reg. §§ 1.704-1(b)(1), (2)(i)-(ii)(b), (2)(iv)(a)-(q) (skip (j)-(k), (m)); 1.704-1(b)(4)(i)

Materials: None. Spend your time on the capital account maintenance rules!

Logic: Chapter 4

Problem

Don and Paul form a partnership and agree to report equal distributive shares of the partnership’s income, gains, losses, and deductions. Assuming that capital accounts are maintained under the rules of Treas. Reg. § 1.704-1(b)(2)(iv), determine how the following events adjust their capital accounts:

1. Don contributes $500 of cash and a building with a tax basis of $100 and a fair market value of $200 that is encumbered by a $150 mortgage.

2. Paul contributes a $500 personal promissory note and a truck with a tax basis of $300 and a fair market value of $50. Does the answer change if the promissory note was owed by a third party?

3. In its first year, the partnership has the following items: $400 of operating income, $100 of tax-exempt bond interest, a $40 capital loss (not deductible by Don under IRC § 1211, fully deductible by Paul), a $60 loss (suspended under IRC § 465), and $20 of nondeductible, noncapitalizable expenses under IRC § 705(a)(2)(B) (e.g., “Key Man” term life insurance policies on the lives of the partners; the partnership is the owner and beneficiary).

4. The partnership distributes $100 to each of Don and Paul.

5. The partnership borrows $1,000. Six months later, the partnership pays off the liability.

6. The partnership borrows $1,000. Six months later, Don assumes the liability. He is subjected to personal liability with respect to the liability. The bank is fully aware of the assumption and can proceed directly against Don. As between the partnership and Don, Don is ultimately liable for the liability. One year later, the partnership pays off the liability.
(7) The partnership purchases (as an investment) a small collection of antique jewelry for $500. After it appreciates to $1,000 the partnership distributes it to Don.

(8) The partnership distributes to Paul its own promissory note with a face amount of $200. The note bears adequate interest and is payable in two years.
2. **Section 704(c)**

**Assignment**

**Code:** Sections 704(c)(1)(A) & (C), (c)(3), 168(i)(7), 197(a), 197(f)(2)

**Regulations:** Treas. Reg. § 1.704-3 (skip (e)(3)-(f)); Treas. Reg. § 1.704-1(b)(1)(vi), -1(b)(2)(iv)(g), -1(b)(4)(i), -1(b)(5) Examples 14 and 18

**Materials:** None. You will have plenty to do!

**Logic:** Chapter 7

**Problems**

1. Robin and Allison form a partnership to operate an ice cream business. Robin contributes her ice cream maker that has a tax basis of $200 and a value of $600. The ice cream maker is depreciable on a straight-line basis over six years. Allison contributes investment assets that she has held for many years with a tax basis of $100 and a value of $600; the partnership will liquidate the investment assets as its cash needs dictate. Robin and Allison agree to share all profits and losses equally. Assume that each year the partnership has $2,000 of revenues and $400 of expenses (other than depreciation).

   a. What are the tax consequences to Robin, Allison, and the partnership, if, six months after its formation, the partnership sells the investment assets for $600? For $800? For $300? Does it matter which method (i.e., the traditional method, traditional method with curative allocations, or remedial allocation method) the partnership selects for making § 704(c) allocations?

   b. Assume that, at the time of the partnership’s formation, the ice cream maker has two years left of its six-year depreciable life and is depreciated on a straight-line basis.

      (i) How is the depreciation allocated over the next two years if the partnership uses the traditional method? What are the tax consequences if the partnership sells the ice cream maker in the third year for $500?

      (ii) How is the depreciation allocated over the next two years if the partnership uses the traditional method with curative allocations?

      (iii) How is the depreciation allocated over the next two years if the partnership uses the remedial allocation method?

2. Scam Co., a very profitable corporation, and Poor Co., a company that has net operating losses to that will last for many years to come, form a partnership as equal partners. Scam Co. contributes an airplane with a $500,000 tax basis and a value of $5 million, and Poor Co. contributes stock of a subsidiary that has a tax basis and value of $5 million.
The partners agree to share profits and losses equally. The airplane has one year left in its depreciable life. The partnership elects to use the traditional method. In its second year, the partnership sells the airplane for $5 million. What are the consequences to the partners for the partnership’s first two years?

3. On January 1, 2003, Harry and Lloyd form an equal partnership by contributing $100 each to the partnership. The partnership uses the $200 to start a worm store. Five years later, the partnership admits Mary as an equal one-third partner in exchange for her cash contribution of $500. Prior to Mary’s contribution, the partnership has inventory with a tax basis and fair market value of $100, accounts receivable with a tax basis and fair market value of $80, and accounts payable of $30. Implicit in the cost of Mary’s admission to the partnership is goodwill worth $850 (do you see why?).

Assume the partnership agreement calls for a revaluation of assets under Treas. Reg. § 1.704-1(b)(2)(iv)(f) upon Mary’s contribution.

a. Prepare a partnership balance sheet for before and after Mary’s contribution.

b. What are the tax consequences to the partners if the assets of the business are sold immediately after Mary’s contribution for $1500 (plus the assumption of the accounts payable)?

c. If you were representing Mary and no sale were contemplated, which § 704(c) method(s) would you want the partnership to select? Why?

4. On January 1, 2006, Adam contributed stock (purchased five years ago) with a tax basis of $300 and a value of $100 to a partnership that had assets with an aggregate basis of $200 and a value of $900. Adam received a 10% interest in the partnership. What are the consequences if the partnership sells the stock for $100 six months after the contribution? Does it matter which § 704(c) method was selected?

a. What if the stock were sold for $50?

b. What if the stock were sold for $150?
3. **Substantial Economic Effect**

**Assignment**

**Code:** Sections 704, 761(c)

**Regulations:** Treas. Reg. §§ 1.704-1(b)(1), (2)(i)-(iii), (3), (5) Examples 1, 3, 6, 7, 8(ii), 15(i)-(ii), 16(ii), 19(i)-(ii); Treas. Reg. §§ 1.704-1(d), 1.761-1(c). **Skip** Prop. Treas. Reg. § 1.704-1(b)(2)(iii).

**Materials:** Orrisch (Item 11); Rev. Rul. 97-38 (Item 12); Rev. Rul. 99-43 (Item 13)

**Logic:** Chapter 5

**Problems**

1. Ben and Jerry form a general partnership by contributing $100 each. The partnership agreement provides that capital accounts will be maintained in accordance with Treas. Reg. § 1.704-1(b)(2)(iv).

   a. The partnership agreement provides that income, loss, and current distributions are to be shared equally and that liquidating distributions are to be made in accordance with positive capital account balances. In Year 1, the partnership earns $100. How is the income allocated under the agreement? Does the allocation have economic effect?

   b. The partnership agreement provides that income, loss, and current and liquidating distributions are to be shared equally. In Year 1, the partnership earns $100. How is the income allocated under the agreement? Does the allocation have economic effect?

   c. In Year 1, the partnership earns $100. On March 1 of Year 2, the partnership agreement is amended to provide for an allocation of $70 of Year 1 income to Ben and $30 of Year 1 income to Jerry. The partnership agreement provides that liquidating distributions are to be made in accordance with positive capital account balances. Does the “special” allocation have economic effect?

   d. The partnership agreement provides that income, loss, and current distributions are to be shared equally and that liquidating distributions are made in accordance with positive capital account balances. In Year 1, the partnership loses $100. How is the loss allocated under the agreement? Does the allocation have economic effect? Would your answer change if the partnership agreement provided for the loss to be allocated entirely to Ben?

   e. The partnership agreement provides that liquidating distributions are made in accordance with positive capital account balances. In Year 1, the partnership
loses $150. The partnership agreement provides for the loss to be allocated entirely to Ben. Does the allocation have economic effect?

f. Assume the same facts as in e., above, except the partnership is a limited liability company (an “LLC”).

(i) Does the allocation have economic effect?

(ii) How would your answer change if Ben agreed to a limited deficit restoration obligation of $50 and the partnership agreement contained a “qualified income offset” or “QIO” provision? If the partnership had a $200 loss, would an allocation of the entire loss to Ben have economic effect?

(iii) Will Ben be able to deduct the loss that is properly allocated to him?

2. Thelma and Louise form a partnership by contributing $50 each. The partnership borrows $900 and purchases a building for $1000. The debt is “interest-only,” i.e., no principal payments are required to be made, until maturity, which is in 30 years. The building is fully leased for 30 years to AAA quality lessees. Each year, the partnership will receive $250 of rent and will have operating expenses of $190, interest expense of $60, and depreciation of $50. The partnership agreement requires (i) capital accounts to be maintained in accordance with Treas. Reg. § 1.704-1(b)(2)(iv) and (ii) liquidating distributions to be made in accordance with positive capital account balances. The partnership agreement provides for a special allocation of all the depreciation to Louise; the remaining items are to be shared equally.

a. The partnership is a general partnership. The lender has full recourse against the partnership and the partners. Does the special allocation have economic effect in the first year? In the second year?

b. The partnership is a limited partnership. Thelma is the general partner, and Louise is the limited partner. The lender has full recourse against the partnership and the general partner.

(i) Does the special allocation have economic effect in the first year? In the second year?

(ii) Louise has a deficit restoration obligation (a “DRO”). Does the special allocation have economic effect in the first year? In the second year?

(iii) Louise does not have a DRO, but the partnership agreement contains a “QIO” provision. Does the special allocation have economic effect in the first year? In the second year?

(iv) Louise has a limited DRO: she agrees to contribute up to an additional $50 on the liquidation of the partnership, and the partnership agreement
contains a “QIO” provision. Does the special allocation have economic effect in the first year? In the second year? In the third year?

(v) Assume the same facts as in iv., above, except that at the end of the second year, the partnership borrows an additional $60 and distributes the proceeds equally to the partners. Does the special allocation have economic effect in the second year? Suppose the partnership delays the borrowing until year 3. What effect will that have on the second year’s allocation?

(vi) Louise does not have a full DRO, but she agrees to contribute up to an additional $50 on the liquidation of the partnership, and the partnership agreement contains a “QIO” provision. In addition, the partnership agreement contains a “charge-back” provision, which specially allocates gain to Louise to the extent she had been specially allocated depreciation. Does the charge-back provision have any effect on the special allocation of depreciation? Would your answer change if the partnership anticipated selling the building at the beginning of the third year for at least $1000?

3. Rich and Loss Co. are partners in a partnership. The partnership’s assets include shares of utility stock that produce predictable dividends of $60 per year and AAA-rated tax-exempt bonds that generate $60 of interest per year. Loss Co. has net operating loss carryforwards and does not expect to pay taxes for quite some time. Rich is in a 40% tax bracket. The partnership earns $300 of ordinary operating income, $60 of dividend income, and $60 of tax-exempt interest income. The partnership agreement provides that operating income would be allocated equally between the partners but that all of the tax-exempt interest income would be allocated to Rich and all of the dividend income would be allocated to Loss Co. Assume the allocations have economic effect.

a. Will the allocations be respected?

b. Would the allocations be respected if, instead of utility stock, the partnership owned stock that it had purchased at original issue of a high-tech start-up company with no earnings history.

4. John and Paul are equal partners in a newly formed partnership. John has a net operating loss carryover that is expected to expire at the end of the partnership’s second year. The partnership agreement is amended at the beginning of the second year to provide for the following allocations: (i) all $400 of the second year’s income to John and (ii) all future income to Paul until the effect of the income allocated to John in the second year is offset. The income of the partnership consists primarily of fixed royalties from record sales, which are expected to be $100 per year after the second year. Assume the allocations have economic effect and that John and Paul are in a 40% tax bracket.

a. Will the allocations be respected?
b. Would the allocations be respected if the income of the partnership is expected to be only $50 per year after the second year?

5. Go back to problem 2.b.vi., above. Would the special allocation be respected if Thelma was expected to be in a low (assume 0%) tax bracket for two years and Louise was in a high (assume 40%) tax bracket? Assume the partnership anticipated selling the building in year 3 for at least $1000.
4. **Allocations of Nonrecourse Deductions**

**Assignment**

- **Code:** Section 704(b)
- **Regulations:** Treas. Reg. §§ 1.704-1(b)(4)(iv), 1.704-2, 1.752-1(a)
- **Materials:** None.
- **Logic:** Chapter 6

**Problem**

On January 1, 2006, Bernie and Derek form a limited partnership to acquire and operate an office building. Bernie, the general partner, contributes $10 for a 10% interest, and Derek, the limited partner, contributes $90 for a 90% interest. Derek has no deficit restoration obligation, but Bernie, as the general partner, does have a deficit restoration obligation. A bank gives the partnership a nonrecourse mortgage of $900 in connection with the partnership’s acquisition of the office building for $1000. The mortgage is interest only for five years. The building is depreciable over a ten-year period on a straight-line basis. The partnership agreement satisfies the alternative test for economic effect in Treas. Reg. § 1.704-1(b)(2)(ii)(d) and contains a minimum gain chargeback provision.

The partnership agreement provides that, subject to the minimum gain chargeback provision, all income and loss other than “nonrecourse deductions” (as defined in Treas. Reg. § 1.704-2(b)(1)) are to be allocated 90% to Derek and 10% to Bernie until the partnership recognizes income and gain that exceed losses sustained in prior years. Thereafter, all income, gain, loss, and deduction (other than nonrecourse deductions) are to be allocated 50% to Bernie and 50% to Derek. Nonrecourse deductions are to be allocated 80% to Derek and 20% to Bernie. Cash distributions are to be made 90% to Derek and 10% to Bernie until they receive their contributions back. Thereafter, cash distributions are to be 50% to each.

For the first three years, the partnership has rental income of $70, operating expenses of $10, interest expense of $60, and a depreciation deduction of $100. Therefore, the partnership has no cash flow and a $100 loss.

1. How will the partnership’s $100 loss in the first year be allocated under the partnership agreement? Will that allocation be respected for tax purposes?

2. How will the partnership’s $100 loss in the second year be allocated under the partnership agreement? Will the allocation be respected for tax purposes?

   a. If the partnership agreement provided for nonrecourse deductions to be allocated 50% to Derek and 50% to Bernie, how would the partnership’s
loss in the second year be allocated and would the allocation be respected for tax purposes?

b. If the partnership agreement provided for nonrecourse deductions to be allocated 99% to Derek and 1% to Bernie, how would the partnership’s loss in the second year be allocated and would the allocation be respected for tax purposes?

3. If the partnership sells the building on January 1, 2008, for $1800, how would the gain be allocated? After the partnership pays off the mortgage, how would the cash be distributed? What would the result be if the lender foreclosed on the building on January 1, 2008?

4. On January 1, 2008, Bernie and Derek contribute $20 and $180, respectively, and the partnership uses the cash to pay down the mortgage to $700. What is the tax consequence of the pay-down of the mortgage?

5. On January 1, 2008, the partnership increases the size of the mortgage by $100 and distributes the $100 proceeds. How is the cash distributed under the partnership agreement? What is the tax consequence of the additional borrowing?

6. If Bernie had guaranteed the mortgage from the outset, how would the first and second year losses be allocated? What would the consequences be if there were a foreclosure at the beginning of the third year?
Unit III — Outside Basis and Partnership Liabilities

Assignment

Code: Sections 704(d), 705, 722, 752


Materials: Rev. Rul. 88-77 (Item 14); Rev. Rul. 95-26 (Item 15); Klamath Strategic Investment Fund LLC v. United States (Item 16)

Optional: Cunningham, chapter 8

Problems

1. X and Y are equal partners in a partnership that has a $2,000 capital loss and a $4,000 ordinary loss for the current taxable year. Before taking the loss into account, X’s outside basis is $1,000 and Y’s outside basis is $3,000. Assume all allocations have substantial economic effect. To what extent are the losses deductible by the partners?

2. Alice and Bob form an equal general partnership and contribute $50 each. The partnership borrows $200 on a fully recourse basis. The partnership then purchases a parcel of real estate for $300. The partnership agreement complies with the three requirements in Treas. Reg. § 1.704-1(b)(2)(ii)(b).

   a. What is each partner’s outside basis immediately after the partnership acquires the real estate? What would each partner’s outside basis be if Alice had contributed $100 and Bob contributed no initial capital?

   b. Assume the partnership agreement contained the following allocation provision: “Losses are allocated 90% to Alice and 10% to Bob. Profits are allocated first to restore prior loss allocations, then 70% to Alice and 30% to Bob.” What is each partner’s outside basis immediately after the partnership acquires the real estate?

   c. If Alice was the lender, what would each partner’s outside basis be immediately after the partnership acquires the real estate? Would your answer change if the partnership were a limited liability company and the LLC agreement satisfied the alternate test for economic effect in Treas. Reg. § 1.704-1(b)(2)(ii)(d)? What if Alice’s husband were the lender?

   d. What are the consequences if Alice assumes the $200 liability?
3. George and Martha form a limited liability company. Each member contributes $5,000. The LLC borrows $90,000 on a nonrecourse basis from the Red, White & Blue Bank and the members agree to share profits and losses equally. The LLC uses its $100,000 to buy a building.

a. What is the outside basis of each member?

b. Assume the LLC has losses of $10,000 per year and that none of the principal of the nonrecourse debt is paid off. After four years, when the basis and book value of the building is $60,000, what is each member’s share of the Red, White & Blue debt?

c. Assume that Martha guarantees the nonrecourse debt. What is each member’s outside basis?

d. Assume that, instead of cash, Martha contributes property with a tax basis of zero and a value of $25,000 subject to a $20,000 nonrecourse liability. George contributes $5,000 cash and the LLC borrows $90,000 on a nonrecourse basis. The LLC uses its $95,000 cash to buy the building. The $90,000 loan is secured by the building. What is each partner’s outside basis?
Assignment

Code: Sections 706(c)-(d), 708(b)(1)(B), 741, 742, 743, 751(a), 752(d), 754, 755, 168(i)(7), 1(h), 197(a)

Regulations: Treas. Reg. §§ 1.704-1(b)(2)(iv)(l), 1.704-3(a)(7), 1.706-1(c), 1.708-1(b), 1.741-1, 1.742-1, 1.743-1, 1.751-1(a), (c)-(d), (g) (example 1), 1.755-1(a)-(b), 1.1(h)-1, 1.1223-3, 1.197-2(g)(3)

Materials: Rev. Rul. 99-5 (Item 17); Rev. Rul. 99-6 (Item 18); Rev. Rul. 89-108 (Item 19)

Optional: Cunningham, chapter 10

Problems

1. Sam, Carla, and Norm are one-third partners in a calendar-year, cash-method partnership. Cliff would like to become a partner. On July 1, Norm sells his entire one-third interest to Cliff. If the partnership earned $300,000 during the first six months of the year, and during the last six months, it broke even, what is each partner’s distributive share of the partnership’s income for the year of the sale?

2. Monica and Rachel are partners in a general partnership that operates a business. Monica is a 40% partner, and Rachel is a 60% partner. They formed the partnership in 1998. The partnership agreement complies with the three requirements in Treas. Reg. § 1.704-1(b)(2)(ii)(b).

   a. Chandler purchases Monica’s interest for $160.

      (i) What are the consequences to Monica, Chandler, and the partnership if Monica has a zero basis in her partnership interest and the partnership’s only asset is zero-basis goodwill? Assume there is no section 754 election in effect.

      (ii) Assume the same facts as above, except that immediately prior to the sale of Monica’s interest, the partnership borrows $100 on a recourse basis and purchases $100 worth of equipment. What are the consequences to Monica, Chandler, and the partnership?

   b. Chandler wants to purchase the entire business for $400. Assume the partnership has the following assets (and no liabilities):
### Tax/Book Basis vs. FMV

<table>
<thead>
<tr>
<th>Asset</th>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real Estate</td>
<td>$26</td>
<td>$80</td>
</tr>
<tr>
<td>Inventory</td>
<td>$30</td>
<td>$40</td>
</tr>
<tr>
<td>Acct. Rec.</td>
<td>$0</td>
<td>$30</td>
</tr>
<tr>
<td>Equipment</td>
<td>$10</td>
<td>$30</td>
</tr>
<tr>
<td>ABC Stock</td>
<td>$20</td>
<td>$44</td>
</tr>
<tr>
<td>XYZ Stock</td>
<td>$24</td>
<td>$36</td>
</tr>
<tr>
<td>Goodwill</td>
<td>$0</td>
<td>$140</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>$110</strong></td>
<td><strong>$400</strong></td>
</tr>
</tbody>
</table>

Monica’s outside basis is $44, and Rachel’s outside basis is $66.

(i) What are the consequences (i.e., amount and character of gain) to Monica and Rachel if the partnership sells all of its assets to Chandler for $400?

(ii) Assume the entity is an LLC. What are the consequences to Monica and Rachel if they sell their partnership interests to Chandler for $160 and $240, respectively? What difference would it make, if any, if Chandler paid them with a note (with adequate interest) due in three years?

(iii) What are the consequences to Rachel and the partnership if Chandler buys only Rachel’s interest for $240? Assume no section 754 election is in effect.

c. Chandler purchases Monica’s interest for $160. Monica had a $56 outside basis. The partnership has the following assets (and no liabilities):
<table>
<thead>
<tr>
<th></th>
<th>Tax/Book</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Basis</td>
<td>FMV</td>
</tr>
<tr>
<td>Inventory</td>
<td>$40</td>
<td>$100</td>
</tr>
<tr>
<td>Acct. Rec.</td>
<td>$0</td>
<td>$40</td>
</tr>
<tr>
<td>DEF Stock</td>
<td>$100</td>
<td>$10</td>
</tr>
<tr>
<td>(purchased 5 years ago)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td>$0</td>
<td>$250</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$140</td>
<td>$400</td>
</tr>
</tbody>
</table>

(i) What is Chandler’s basis in his partnership interest? Does Chandler obtain amortization deductions for the goodwill?

(ii) What are the tax consequences to Chandler if the partnership sells all of its assets for their fair market values immediately after Chandler purchases Monica’s interest? What if the partnership just sold the DEF stock? Would your answer change if Monica had contributed the DEF stock with a tax basis of $100 and a value of $10?

(iii) What are the tax consequences to Chandler if he immediately sells his partnership interest for $160?

(iv) What would the consequences be if the partnership made an election under section 754? Does Chandler obtain amortization deductions for the goodwill? Would the answers to parts (ii) and (iii) change?
Unit V – Partner-Partnership Transactions

Assignment

Code: Sections 83, 267(a)(2), (e), 707, 721


Materials: Pratt v. Commissioner (Item 20); United States v. Stafford (Item 21); Sol Diamond v. Commissioner (Item 22); Campbell v. Commissioner (Item 23); Rev. Rul. 96-10 (Item 9); Rev. Proc. 93-27 (Item 24); Rev. Proc. 2001-43 (Item 25); Notice 2005-43 (Item 26)

Optional: Cunningham, chapter 9 (pp. 119-123, 127-134)

Problems

1. Partnership ABC, an accrual-method taxpayer, leases space from Partner A, a cash-method taxpayer, for $10,000 per year. ABC and Partner A are calendar-year taxpayers.
   a. ABC pays its rent for 2005 in June of 2004. What are the tax consequences to ABC and to Partner A?
   b. ABC does not pay its rent for 2004 until June of 2005. What are the tax consequences to ABC and to Partner A?

2. X and Y are partners in a partnership. X has a 60% interest in the partnership, and Y has a 40% interest in the partnership.
   a. X sells property to the partnership for $600 (its then fair market value). X’s basis in the property is $1,000. Is X’s $400 loss deductible?
   b. How much gain is recognized by the partnership if it sells the property purchased from X to an unrelated third party for $1,600 (its then fair market value)? What is the effect on the partners’ outside bases?

3. Jack and Diane are equal partners in an accrual-method, calendar-year partnership. Pursuant to the partnership agreement, Diane performs managerial services for the partnership in her capacity as a partner.
   a. Diane is entitled to a flat salary of $50,000 per year. The partnership pays Diane $50,000 for her services for 2004 in January of 2005. What are the tax consequences to the partners and the partnership if the partnership has $100,000 of capital gain income? $25,000 of ordinary income (and must use $25,000 of its cash reserves)?
b. Diane’s salary is equal to 20% of the partnership’s income. The partnership has $100,000 of taxable income ($60,000 of capital gain and $40,000 of ordinary income). What are the consequences to the partners and the partnership?

c. What are the tax consequences to the partners and the partnership if, instead of managerial services, Diane receives a flat salary of $50,000 for her performance of services related to capital improvements to the partnership’s assets? (Assume the services are provided in Diane’s capacity as a partner.)

d. What are the consequences if Diane is to receive one-third of the partnership’s income but not less than $10,000 and partnership income for the year consisted of:

   (i) ordinary income of $15,000 and long-term capital gains of $15,000
   (ii) ordinary income of $15,000
   (iii) ordinary income of $6,000
   (iv) ordinary income of $12,000 and long-term capital gains of $6,000.

4. Mike, Seth, and Bill form a partnership. Seth and Bill, the more practical of the two partners, invest $60,000 each; Mike, an energetic and creative person with no capital to invest, agrees to supply his ideas and services.

   a. What are the tax consequences to the partners and the partnership on formation if they agree to share capital and profits equally?

   b. What would the tax consequences be if Mike agrees to forfeit his one-third interest in the partnership’s capital and profits if he leaves the partnership’s service within five years?

   c. What are the tax consequences to the partners and the partnership on formation if they agree to share profits equally, but give no capital credit to Mike? Does it matter whether Mike’s interest is forfeitable?
A. Current Operating Distributions

Assignment

Code: Sections 731, 732(a), (c), (e), 733, 734(a), 735, 752

Regulations: Treas. Reg. §§ 1.731-1, -2(a)-(f), 1.732-1, 1.752-1(c), (f), 1.704-1(b)(2)(iv)(e)

Materials: Rev. Rul. 79-205 (Item 27)

Optional: Cunningham, chapter 11 (pp. 154-163)

Problem

A, B, C, and D are equal partners in a general partnership that has the following assets: $600,000 of cash, $800,000 worth of inventory with a $60,000 basis, $400,000 worth of non-depreciable beach property held for investment with a $40,000 basis, an investment in an S&P index fund worth $400,000 with a $400,000 basis, and goodwill worth $1,000,000 with a zero basis. Each partner has an outside basis of $275,000. Assume that tax basis and book basis are equal and that the partnership agreement complies with the three requirements in Treas. Reg. §1.704-1(b)(ii)(2)(b). What are the consequences of the following alternative distributions?

1. Each partner receives a $100,000 cash distribution.

2. The partnership borrows $600,000 on a recourse basis and distributes $300,000 of cash to each partner.

3. A and B each receive a $200,000 cash distribution; C and D each receive an equal undivided interest in the S&P index fund. What would the consequences be to D if he had an outside basis of $150,000?

4. A and B each receive a $200,000 cash distribution; C and D each receive an equal undivided interest in the beach property.

5. Each partner receives $100,000 of inventory; A and B each receive $300,000 in cash, and C and D each receive a $100,000 interest in the S&P index fund and an equal undivided interest in the beach property. What would the consequences be to D if he had an outside basis of $110,000?
6. Assume the partnership expects to earn $1,200,000 for the taxable year. A and B receive a distribution of $300,000 in January of the taxable year as an advance, and C and D receive a distribution of $300,000 on December 31 of the taxable year.
B. Liquidating Distributions

Assignment

Code: Sections 731-733, 735-736, 752, 761(d)

Regulations: Treas. Reg. §§ 1.731-1, 1.732-1, -2, 1.743-1(g)

Materials: Rev. Rul. 74-40 (Item 28)

Optional: Cunningham, chapter 11 (pp. 163-167)

Problem

Allison’s entire interest in a cash-method partnership (in which capital is a material income-producing factor) is terminated in exchange for the following distributions: (i) $100 of cash, (ii) inventory (in the hands of the partnership, but not Allison’s hands) with a tax basis of $50 and a value of $150, (iii) accounts receivable with a tax basis of zero and a value of $50, (iv) land that has been held for over 10 years with a tax basis of $25 and a value of $150, and (v) other capital assets that have been held for over 10 years with a tax basis of $50 and a value of $150. (Assume section 751(b) is inapplicable.)

1. What are the tax consequences to Allison if her outside basis is $600?

   a. Assume Allison purchased her partnership interest 1 year ago from a prior partner and the partnership had a section 754 election in effect and that, as a result, Allison was entitled to the following positive basis adjustments under section 743(b): $100 to inventory, $50 to accounts receivable, $125 to land, and $100 to the other capital assets. What are the tax consequences of the distribution?

   b. Assume the same facts as in question 1.a., above, except that there was not a section 754 election in effect when Allison purchased her interest. What options does Allison have to improve the tax consequences of the distribution?

2. What are the tax consequences to Allison if she receives only the cash, inventory and accounts receivable and her outside basis is $600?

3. What are the tax consequences to Allison if her outside basis is $225? What are the tax consequences if she sells the inventory two years after the distribution for $150? What are the tax consequences if she sells the capital assets nine months after the distribution for $150?

4. What are the tax consequences to Allison if her outside basis is $180? What are the tax consequences if her outside basis is $130?
C. **Section 751(b) Distributions**

**Assignment**

- **Code:** Section 751
- **Regulations:** Treas. Reg. §§ 1.732-1(e), 1.751-1(b)-(e), (g) (Examples 2-6)
- **Materials:** Rev. Rul. 84-102 (Item 29); Steps for section 751(b) (Item 30); Notice 2006-14 (Item 31)
- **Optional:** Cunningham, chapter 13

**Problem**

1. ABC is an equal partnership in which each partner has an outside basis and capital account balance of $1000. On January 1 of this year, the partnership’s balance sheet is as follows:

<table>
<thead>
<tr>
<th></th>
<th>Book</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$1800</td>
<td>$6000</td>
</tr>
<tr>
<td>Capital Asset</td>
<td>1200</td>
<td>3000</td>
</tr>
<tr>
<td></td>
<td>$3000</td>
<td>$9000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Capital</th>
<th>Accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Book</td>
<td>FMV</td>
</tr>
<tr>
<td>A</td>
<td>$1000</td>
<td>$3000</td>
</tr>
<tr>
<td>B</td>
<td>1000</td>
<td>3000</td>
</tr>
<tr>
<td>C</td>
<td>1000</td>
<td>3000</td>
</tr>
<tr>
<td></td>
<td>$3000</td>
<td>$9000</td>
</tr>
</tbody>
</table>

On this date, ABC distributes the Capital Asset to A in complete liquidation of her interest in the partnership.

a. In the absence of § 751(b), what would be the tax consequences of this distribution to the various parties? Why might Congress find these results objectionable?

b. Taking into account § 751 (b), what are the tax consequences to the partnership and each of the partners?

2. The HI law partnership has accounts receivable (basis $0; face amount and value $300); a building in which it conducts its practice (basis and value $700) which it holds subject to a mortgage of $600. The partnership admits J as a new law partner. J contributes $200 to the capital of the partnership, and it is agreed that H, I and J will share all profits and losses equally. Does J’s admission to the firm have any tax consequence to H and I?
D. Inside Basis Adjustments

Assignment

Code: Sections 731, 734, 754, 755

Regulations: Treas. Reg. §§ 1.734-1, -2, 1.755-1(a), (c)

Materials: None.

Optional: Cunningham, chapter 11 (pp. 167-168), chapter 12

Problem

Xavier, Yuri, and Zoe formed a land investment partnership 10 years ago with cash contributions. Today, that partnership has $100 of cash, a parcel of land with a $100 basis and value (“Land 1”), and a parcel of land with a $40 basis and $100 value (“Land 2”). Each partner has an outside basis of $80. Land 1 and Land 2 are capital assets.

1. What are the consequences to the partnership and its partners if the partnership distributes $100 of cash to Xavier in complete liquidation of his interest in the partnership assuming (a) the partnership does not have a section 754 election in effect and (b) the partnership does have a section 754 election in effect?

2. What are the consequences to the partnership and its partners if the partnership distributes Land 1 to Xavier in complete liquidation of his interest in the partnership assuming (a) the partnership does not have a section 754 election in effect and (b) the partnership does have a section 754 election in effect?

3. What are the consequences to the partnership and its partners if the partnership distributes Land 2 to Xavier in complete liquidation of his interest in the partnership assuming (a) the partnership does not have a section 754 election in effect and (b) the partnership does have a section 754 election in effect?
E. **Section 736 – Retirement of a Partner**

Assignment

- **Code:** Sections 706(c), 736, 761(d)
- **Regulations:** Treas. Reg. § 1.736-1
- **Materials:** Foxman v. Commissioner (Item 32)
- **Optional:** Cunningham, chapter 14

**Problem**

X, Y, and Z are equal partners in a cash-method general partnership. Z would like to retire. The partnership’s books show cash of 60, accounts receivable, which are worth 90, equipment with a tax basis and value of 45, and land with a tax basis of 60, which is worth 120. Assume that 150 of depreciation has been taken on the equipment. The partnership also has a recourse liability of 60. Each partner has an outside basis of 55. Assume the parties agree that Z’s interest is worth 110. (Why might the parties agree that Z’s interest is worth 110 and not 85?)

1. What are the tax consequences to the partners and the partnership if X and Y each give Z 55 for his interest in the partnership?

2. Assuming capital is a material income-producing factor, what are the tax consequences to the partnership and the partners if the partnership borrows another 60 and distributes 110 to Z in complete liquidation of his interest in the partnership?

3. Assuming capital is not a material income-producing factor, what are the tax consequences to the partnership and the partners if the partnership borrows another 60 and distributes 110 to Z in complete liquidation of his interest in the partnership (a) if the agreement provides for a 25 payment with respect to goodwill and (b) if the agreement does not provide for a payment with respect to goodwill?

**Note:** This problem will be a good review of a lot of the material that we’ve been covering in the past several weeks.
Unit VII – Anti-Abuse Provisions

Assignment

Code: Sections 707(a)(2), 704(c)(1)(B), 732(f), 737


Materials: None. Read the above carefully, and continue studying past material!

Optional: Cunningham, chapters 15 and 16

Problems

There are no problems for this unit. We will analyze a number of problems in class.

Be prepared.