QUESTION 1

No gain or loss is recognized to Gco or to either partner on the formation of GP. Dawn's initial basis in her partnership interest is $10,000,000. Ellen's initial basis in her partnership interest is $7,000,000. GP's initial basis in Blackacre is $7,000,000.

The allocation of the $700,000 loss, attributable entirely to depreciation deductions, is governed by Section 704(c) and the regulations thereunder. Under the regulations, depreciation deductions are allocated to the noncontributing partner (here, Dawn) first, up to the amount of book depreciation charged to Dawn's capital account. The rest of the depreciation deduction is allocated to Ellen.

Book depreciation is computed using the same depreciation method and recovery period as tax depreciation. Here, using 10-year straight-line depreciation, book depreciation is $1,000,000 ($10,000,000 divided by 10) each year. This is allocated between the partners' capital accounts equally, that is, $500,000 each, as they have agreed to share losses equally. Therefore, the first $500,000 of depreciation deductions for tax purposes is allocated to Dawn, and the other $200,000 is allocated to Ellen.

Each partner's basis in his or her partnership interest is reduced by the amount of the pass-through loss allocated to that partner. Therefore, X's outside basis is reduced to $9,500,000, and Y's outside basis is reduced to $9,800,000.

The depreciation deduction of $700,000 reduces Gco's basis in The Tower from $7,000,000 to $6,300,000.

The losses passing through to the partners may be limited by the passive activity loss rules of Section 469.

The character of the pass-through loss is determined at the partnership level, and the loss retains that character as it passes through to the partners. Depreciation deductions are ordinary deductions rather than capital losses, because no sale or exchange is involved.

QUESTION 2

Under the regulations under section 752 of the Code, the bank debt is a nonrecourse liability because no member bears the economic risk of loss. Thus, it is shared among the members based on their shares of Lilco's profits. Because they share the profits equally, each partner's basis includes one third of the debt, or $100,000.

When Ava sells her partnership interest to Rico, her amount realized is $700,000: the $600,000 she receives in cash, plus her one-third share of the partnership liability. IRC § 752(d). Therefore, subtracting her basis of $600,000, she recognizes a gain of $100,000. Section 741 states that the gain is a capital gain, except that section 751(a) contains an exception. Under section 751(a), Ava must report her share of the ordinary income attributable to the inventory as ordinary income. The ordinary income attributable to the inventory is $150,000, and Ava's share of it is $50,000. Therefore, $50,000 of Ava's gain on the sale of her Lilco interest is ordinary income; the other $50,000 is capital gain.

The partnership taxable year closes as to Ava when she sells her interest.

Lilco, Brian, and Chen recognize no gain or loss on the sale of Ava's Lilco interest.

Rico gets an initial basis in his Lilco interest of $700,000: his $600,000 cash purchase price, plus one third of Lilco's liability to the bank (that share being $100,000).

Under section 743(a), the sale does not affect the basis to Lilco of its assets unless an election under section 754 is made.

If an election under section 754 is made, Lilco gets to increase the basis of its assets by $100,000, but only for the benefit of Rico. This is because following Rico's purchase of Ava's Lilco interest, the partners' "outside" bases total $1,900,000, whereas under section 743(a), the "inside" basis of the assets is only $1,800,000.

If the election is made, the $100,00 increase in basis is allocated between the inventory and capital assets based on their relative appreciation. Here the appreciation on the inventory and the appreciation on the capital assets are the same, $150,000. Therefore, the basis of each category of asset is increased by $50,000, but only for the benefit of Rico.

If no section 754 election is made, when the inventory is sold for $600,000, Lilco recognizes a $150,000 gain, ordinary income, passing through one-third each to Rico, Brian, and Chen.

If a section 754 election has been made, when the inventory is sold for $600,000, Lilco recognizes a $100,000 gain, ordinary income, passing through one-half each to Brian and Chen.

In either case, each member increases the basis of the member's Lilco interest by the amount of income passing through to that member. IRC § 705.

QUESTION 3

Under the regulations under section 752 of the Code, the mortgage on Greenacre is a nonrecourse liability because no member bears the economic risk of loss. The regulations under section 752 allocate nonrecourse liabilities among partners in three tiers. The first tier is the partners' shares of partnership minimum gain, which is not present here.

The second tier allocates to a partner contributing property subject to a debt the amount of gain the partner would recognize under section 704(c) if the partnership walked away from the debt. In this case, that would be $40,000: the $60,000 mortgage balance minus the $20,000 basis that the partnership receives in Greenacre under section 723. Therefore the first $40,000 of the bank debt is allocated to Luis. Reg. § 1.752-3(a)(2).

The other $20,000 of bank debt is allocated equally among the partners equally, or $6,667 each. Reg. § 1.752-3(a)(3). Therefore, of the $60,000 debt, the section 752 regulations allocates $46,667 to Luis, and $6,667 each to Jen and Karl.

As a result, when Jen and Karl each contribute $60,000 cash in exchange for an interest in XYZ, their initial basis in their interest is $66,667 each.

The tax consequences of Luis's contribution to XYZ are as follows: Under section 722, Luis starts with a basis of $20,000, a carryover basis from Greenacre. To this is added $46,667 in basis under section 752(a), for a total of $66,667. Then under 752(b), XYZ's assumption of Luis's mortgage is treated as a cash distribution of $60,000 to Luis, reducing his basis in his partnership interest to $6,667.

XYZ recognizes no gain or loss on the receipt of money or property in exchange for partnership interests. IRC § 721(a). XYZ's basis in Greenacre is a carryover basis from Luis, $20,000.

When XYZ repays $10,000 of principal on the debt, this reduces the amount of gain that XYZ, and therefore Luis, would recognize if the partnership walked away from the debt. Thus, the $10,000 principal payment is treated as a distribution of money to Luis. Because Luis's basis in his partnership interest is only $6,667, this results in $3,333 gain to Luis on the constructive distribution of $10,000 to him. It is capital gain. IRC § 731(a) (last sentence). Luis's basis in his XYZ interest is reduced to zero.