QUESTION 1

Upon the formation of Grubco, neither Grubco nor any of the partners recognizes gain or loss. IRC § 721. Dee and Ed receive an initial basis in their partnership interests of $500,000 each. Fiona's basis in her partnership interest is a carryover basis from Blackacre, $100,000. IRC § 722. Grubco takes Blackacre with a carryover basis from Fiona, $100,000. IRC § 723.

When Grubco has $300,000 of net ordinary income, this passes through equally, $100,000, to the three partners. IRC § 704(b). Each partner's basis in his or her partnership interest increases by the pass-through income, or $100,000 each. Dee's and Ed's basis in their partnership interests increase to $600,000 each, and Fiona's basis in her partnership interest increases to $200,000. IRC § 705(a)(1)(A).

Each partner's basis in his or her partnership interest is also increased by $10,000, the partner's distributive share of Grubco's tax-exempt income. IRC § 705((a)(1)(B). The tax-exempt income does not result in gross income or taxable income to any partner.

When Grubco distributes cash to Fiona, the question arises whether the transaction is part of a sale of Blackacre by Fiona to Grubco. IRC § 707(a). Because the cash distribution comes within two years of Fiona's transfer of Blackacre to Grubco, it is rebuttably presumed to be part of a sale. Treas. Reg. § 1.707-3. If part of a sale, the distribution could result in a capital gain to Fiona on the deemed sale of Blackacre. Assuming that the presumption is rebutted, the $250,000 distribution to Fiona will be analyzed in the same manner as the distributions to Dee and Ed, discussed next.

Cash distributions from a partnership do not result in income to the distributee partner except to extent that any money distributed exceeds the partner's adjusted basis in the partner's partnership interest immediately before the distribution. Here, the partners all have sufficient basis to offset the cash distributed. Their basis in their partnership interests is reduced by $100,000 each. IRC § 733.

When the partnership collects the fee from the agricultural company, it is partnership income, passing through to the partners equally ($10,000 each). *Schneer*. Each partner's basis is increased by the $10,000 of income passing through to that partner. As compensation for services rendered, the pass-through income is ordinary income.

The partners may be entitled to deductions under Section 199A for qualified business income.

QUESTION 2

When GP borrows the $30,000, some partner or partners are treated as contributing their shares of the liability to the partnership, increasing their basis in their respective partnership interests. IRC § 752(a). The allocation of the debt among the partners is governed by the regulations under Section 752. The regulations provide different treatment for recourse and nonrecourse liabilities.

Recourse Loan

Because GP is a general partnership, a recourse loan would subject the partners to the economic risk of loss for the debt. Determining which partners bear the economic risk, and for how much, requires application of a "doomsday" analysis. The regulations require one to consider how much each partner would be forced to contribute to the partnership, and not be entitled to reimbursement from another partner, if:

- The debt becomes due and payable;
- The partnership's assets (including cash) are worthless;
- The partnership sells all of its assets for zero consideration, with the resulting loss passing through to the partners under Sections 702 and 704 of the Code; and
- The partnership liquidates.

Here, the deemed sale of all GP's assets, $6,000 cash and the Device with a basis of $34,000, for a price of zero would result in a $40,000 loss. The loss would pass through 50 percent to May ($20,000); 30 percent ($12,000) to Nancy; and 20 percent ($8,000) to Obi. This would result in negative capital accounts, which each partner would be required to pay to GP without being entitled to reimbursement from another partner. The negative capital accounts would be: May $16,000; Nancy $9,000; and Obi $5,000. Therefore, the recourse debt would be allocated among the three partners in those amounts.

May's basis in May's partnership interest would increase from $4,000 to $20,000; Nancy's basis in Nancy's partnership interest would increase from $3,000 to $12,000; and Obi's basis in Obi's partnership interest would increase from $3,000 to $8,000.

Nonrecourse Loan

Nonrecourse debt is allocated among the partners based on their shares of partnership income. Here, that would be 50 percent ($15,000) to May; 30 percent ($9,000) to Nancy; and 20 percent ($6,000) to Obi.

May's basis in May's partnership interest would increase from $4,000 to $19,000; Nancy's basis in Nancy's partnership interest would increase from $3,000 to $12,000; and Obi's basis in Obi's partnership interest would increase from $3,000 to $9,000.

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GP's initial basis in the Device is $34,000.

GP's operating loss passes through to the partners according to the allocation in the partnership agreement. IRC § 704(a). Passive loss limitations may apply. IRC § 469. In the nonrecourse debt scenario, at-risk limitations likely apply. IRC § 465.

QUESTION 3

When Xavier is admitted to the partnership, receiving a capital interest, he has gross income under Section 83(a). The amount of the gross income is the fair market value of Xavier's partnership interest, $10,000. Xavier receives an initial basis in his partnership interest of $10,000.

Lipco is entitled to a deduction in the same amount under Section 83(h). This passes through to the partners. Most likely, the pass-through would be to Vic and Wendy equally ($5,000 each), in accordance with the decreases in their capital accounts, and reducing their basis in their partnership interests to $45,000 each. The partners should clarify in the partnership agreement to whom the Section 83(h) deduction passes through. The dollar amounts in the remainder of this discussion assume that the deduction passes through $5,000 each to Vic and Wendy.

Not counting the deduction under Section 83(h), Lipco's net operating loss for 2025 is $90,000. Under the partnership agreement, this would pass through $18,000 (20 percent) to each of Vic and Xavier, and $54,000 (60 percent) to Wendy. However, Wendy's capital account is only $45,000, and because she has not agreed to restore a negative capital account, only $45,000 of loss passes through to her under Section 704(b). Wendy's outside basis is reduced from $45,000 to zero.

The rest of Lipco's loss ($9,000) is allocated among the partners based on their interests in Lipco (taking into account all facts and circumstances). It is likely that the $9,000 will be allocated equally between Vic and Xavier, who share losses in equal measure and must restore any negative capita accounts. Because their agreed-to shares of partnership loss are equal, the $9,000 loss is likely to pass through $4,500 to each. Added to their distributive shares of loss under the partnership agreement ($18,000 each), Vic and Xavier would each have a pass-through loss of $22,500 under Section 704(b).

The partners' shares of pass-through loss reduce their basis in their respective partnership interests. Vic's outside basis is reduced from $45,000 to $22,500.

Because Xavier has an initial basis in his partnership interest of only $10,000, he may deduct only that amount in 2025. IRC § 704(d). The other $12,500 of Xavier's pass-through loss for the year must be carried forward to later years. Xavier's outside basis is reduced to zero.

Because Wendy is a limited partner, Wendy's pass-through loss may be a passive loss subject to limitation under Section 469. This will not be true of Vic's and Xavier's pass-through losses if they materially participate in a Lipco business and the loss is not from a rental activity.