EXAMPLIFY PASSWORD:

Advanced Partnership Tax **Spring 2025**
Bogdanski

WRITE YOUR EXAM NUMBER HERE: ________

FINAL EXAMINATION
(Three hours)

INSTRUCTIONS

This examination consists of three essay questions, each of which will be given equal weight in determining grades. Three hours will be permitted for this examination.

The suggested time limit for each question is one hour. Experience has shown that failure to budget one's time according to this limit can result in a drastic lowering of one's overall grade on this examination.

At the end of the three hours, you must turn in this set of questions in the original envelope in which this set came. You must submit your answers using Examplify. If you wish to submit handwritten partnership balance sheets with your answers, you must (1) enclose them in the envelope, clearly labeled with your exam number and the question to which they relate, and (2) refer to them in your answers.

No credit will be given for anything written on this set of questions. Only your electronic answer file and any enclosed balance sheets will be graded.

Pay close attention to the final portion, or "call," of each question. Failure to respond to the matters called for will result in a low score for the question. On the other hand, discussion of matters outside the scope of the call of the question will not receive credit.

Be sure to explain as thoroughly as possible your answers to the questions posed. Your reasoning, discussion, and analysis are often as important as any particular conclusion you reach.

Unless otherwise instructed, assume that:

- all partners described in the question are individuals and U.S. citizens;
- all entities described in the questions are organized and operated exclusively in the United States;
- all parties described in the questions use the calendar year as their taxable year for federal income tax purposes; and
- all parties described in the questions report their income using the cash method of accounting for such purposes.

Any references to "the Code" are to the Internal Revenue Code of 1986, as amended.

QUESTION 1
(One hour)

Dee, Ed, and Fiona form a general partnership, Grubco, to operate a catering service. The Grubco partnership agreement satisfies the primary test for economic effect (also known as the "Big Three") set out in the regulations under Section 704(b) of the Code. The partnership agreement provides that all items of income, gain, deduction, loss, and credit are to be shared equally among the three partners.

In the formation transaction, Dee and Ed each contribute $500,000 cash to Grubco in exchange for that partner's partnership interest. In exchange for Fiona's partnership interest, Fiona contributes to Grubco a parcel of undeveloped real estate, Blackacre. Immediately before the exchange, Blackacre's adjusted basis in Fiona's hands is $100,000, and Blackacre's fair market value is $1,000,000. Blackacre is owned free and clear of any mortgages, liabilities, liens, or encumbrances.

In the first year of its operations, Grubco has gross income (all ordinary income) of $800,000 and deductions (all ordinary and necessary business expenses) of $500,000. Grubco also has $30,000 of tax-exempt income from interest it receives on a state government bond.

On the first day of its second year, Grubco distributes $100,000 cash to each partner. At the time of the distribution, Grubco holds no unrealized receivables or inventory items. The distributions are not "draws."

The Grubco partnership agreement provides that any income that any partner earns as compensation for personal services in the food industry must be assigned to Grubco and become part of the income of the partnership. In the second year of Grubco's operations, Dee earns $30,000 as a consultant to an agricultural company. In keeping with the partnership agreement, Dee assigns the income to Grubco. When the income is received by Grubco, Grubco credits it equally among the partners, that is, $10,000 is added to each partner's capital account.

Grubco continues to hold Blackacre in its undeveloped state.

Assuming that Grubco does not elect to be taxed as an association, what are the federal tax consequences of the transactions just described to Grubco, Dee, Ed, and Fiona, with and without all available tax elections? Be sure to discuss the amount, timing, and character (capital or ordinary) of any income, gain, loss, or deduction realized or recognized by each party; and each party's basis in the partnership interest or assets that party holds (actually or constructively), at each stage of the transactions.

Discuss.

(End of Question 1)

QUESTION 2
(One hour)

GP is a general partnership with three partners, May, Nancy, and Obi. At the start of the year, the balance sheet of GP is as follows:

Assets			**Liabilities**		
Asset	**Adjusted basis**	**Book value**	***Debt***		
Cash (checking account)	$ 10,000	$ 10,000	*Total debt*		*-0-*
Furniture and equipment	-0-	-0-			
Trade name and goodwill	-0-	-0-	***Equity (partners' capital)***		
			Partner	**Adjusted basis**	**Book value**
			May	$ 4,000	$ 4,000
			Nancy	3,000	3,000
			Obi	3,000	3,000
			Total equity	*$ 10,000*	*$ 10,000*
Total assets	**$ 10,000**	**$ 10,000**	**Total liabilities**	**$ 10,000**	**$ 10,000**

The partnership agreement of GP satisfies the primary test for economic effect (also known as the "Big Three") set out in the regulations under Section 704(b) of the Code. The partnership agreement provides that all items of income, gain, deduction, loss, and credit are to be shared as follows: 50 percent allocated to May; 30 percent allocated to Nancy; and 20 percent allocated to Obi.

GP wishes to obtain a loan to purchase some specialized equipment (the "Device") from an unrelated seller. GP and its unrelated commercial lender, Banco, agree that Banco will lend GP most of the $34,000 purchase price for the Device. The loan, scheduled to close early in the current year, will be a 30-year loan in the amount of $30,000. GP will grant to Banco a security interest (the equivalent of a mortgage) in the Device. In addition to the borrowed funds, GP will use $4,000 from its checking account to complete the purchase.

In the preliminary loan discussions, Banco offers GP two alternative options: (1) a recourse loan, or (2) a nonrecourse loan at a higher interest rate.

GP and the partners approach you for advice regarding the differences between the two options offered by Banco for the $30,000 loan. GP is expecting to generate a substantial tax loss this year due to large depreciation deductions available for the Device.

Assuming that GP does not elect to be taxed as an association, what are the federal income tax consequences of the alternative loan terms just described – to May, Nancy, Obi, and GP – with and without all other available elections? Be sure to discuss the amount, timing, and character (capital or ordinary) of any income, gain, loss, or deduction realized or recognized by each party; and each party's basis in the partnership interest or assets that party holds (actually or constructively), at each stage of the transactions.

Explain.

(End of Question 2)

QUESTION 3
(One hour)

Vic and Wendy are equal partners in a limited partnership, Lipco. Vic is the general partner and Wendy is the limited partner. At the end of 2024, the balance sheet of Lipco is as follows:

Assets			**Liabilities**		
Asset	**Adjusted basis**	**Book value**	***Debt***		
Cash	$ 100,000	$ 100,000	*Total debt*		*-0-*
			Equity (partners' capital)		
			Partner	**Adjusted basis**	**Book value**
			Vic	$ 50,000	$ 50,000
			Wendy	50,000	50,000
			Total equity	*$ 100,000*	*$ 100,000*
Total assets	**$ 100,000**	**$ 100,000**	**Total liabilities**	**$ 100,000**	**$ 100,000**

On January 1, 2025, Vic and Wendy admit Xavier as a second general partner. Xavier has been an employee of Lipco, and receives his general partner interest in exchange for his past services in the day-to-day operation of Lipco's business. The partnership interest that Xavier receives includes both a share of future profits and a share of current partnership capital. Xavier is given an initial capital account of $10,000; Vic's capital account is reduced to $45,000, and Wendy's capital account is also reduced to $45,000. The fair market value of Xavier's partnership interest is $10,000 at the time Xavier receives it.

With Xavier becoming a partner, the three partners execute a revised partnership agreement for Lipco. The agreement provides that capital accounts will be maintained for each partner in accordance with the regulations under Section 704(b) of the Code; and that upon liquidation of any partner's interest (including upon liquidation of Lipco), the partner will receive a distribution equal to that partner's positive capital account balance, if any. The agreement also provides that upon liquidation of Vic's or Xavier's interest (including upon liquidation of Lipco), that partner will pay to the partnership cash in the amount of any deficit balance in that partner's capital account. As to Wendy, the agreement contains a "qualified income offset" (as defined in the regulations under Section 704(b) of the Code).

The revised partnership agreement provides that until certain specified financial success measures are reached, all of the income, loss, deduction, and credit of Lipco will be allocated as follows: 20 percent to Vic, 60 percent to Wendy, and 20 percent to Xavier.

In 2025, not counting the tax consequences of the admission of Xavier to the partnership, Lipco has a net operating loss (negative taxable income) of $90,000. In light of these unfavorable results, Lipco makes no distributions to any of the partners in 2025.

Assuming that Lipco does not elect to be taxed as an association, what are the federal income tax consequences of the transactions just described – to Vic, Wendy, Xavier, and Lipco – with and without all other available elections? Be sure to discuss the amount, timing, and character (capital or ordinary) of any income, gain, loss, or deduction realized or recognized by each party; and each party's basis in the partnership interest or assets that party holds (actually or constructively), at each stage of the transactions.

Discuss.

(End of examination)