Partnership Tax
Bogdanski
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Exam Answer Outlines

Question 1

Part A

No gain or loss is recognized to Arthur, Corp, or Limco on the formation of the partnership. IRC § 721. Arthur's basis in his partnership interest is $40,000, carried over from the cash and account receivable that he transfers to Limco. Limco's basis in the account receivable is zero, carried over from Arthur. Corp's basis in its partnership interest is $20,000, carried over from the inventory that it contributed to Limco. Limco's basis in the inventory is $20,000, carried over from Corp.

When Klint pays Limco $60,000 on the receivable, Limco recognizes $60,000 of ordinary income. All of this income passes through to Arthur (as ordinary income) under IRC § 704(c) and the regulations thereunder. Arthur's basis in his partnership interest increases by $60,000.

When Limco sells the inventory for $45,000 cash, it recognizes a $25,000 gain, all of which is ordinary income. Limco, however, suffers an economic loss of $5,000 on the transaction. Under the regulations under IRC § 704(c), there are three methods for allocating the ordinary income on the sale between the partners for tax purposes. Limco can choose any of the methods. Under the traditional method, the $25,000 of ordinary income passes through to Corp, increasing Corp's basis in its partnership interest by that amount. No more than $25,000 of income can pass through to Corp under the traditional method; this is what is known as the "ceiling rule."

Under the remedial method, Arthur is allocated a made-up tax loss – an ordinary deduction – equal to his share of Limco's economic loss. As 60 percent partner, Arthur suffers 60 percent of the $5,000 economic loss, or $3,000. Therefore, under the remedial method, Arthur receives a $3,000 ordinary deduction, and his basis in his partnership interest decreases by the same amount. Corp, in addition to its $25,000 of ordinary income under the traditional method, would recognize an additional $3,000 of ordinary income, created to offset Arthur's tax deduction. Corp's basis in its partnership interest would also increase by this amount, for a total basis increase of $28,000.

Under the traditional method with curative allocations, in the year the inventory is sold, the tax results would be as described earlier under the traditional method. Then, in a later year, tax allocations would differ from allocations of economic gain, so as to correct the distortions created by the ceiling rule. For example, $5,000 of partnership income could be taxed all to Corp even though it is being credited 60 percent to Arthur's capital account ($3,000) and 40 percent to Corp's. The partners' bases in their partnership interests would increase in accordance with the tax allocations in the later year.

Part B

In general, the partnership must use the calendar year as its taxable year because its majority interest partner, Arthur, uses that year. IRC § 706(b)(1)(B)(i). Arthur is the majority interest partner because he owns 66.67 percent of partnership capital ($100,000 out of $150,000) and 60 percent of partnership profits.

If Limco can establish to the IRS's satisfaction a valid business purpose for using a different taxable year, it may do so. IRC § 706(c)(1)(C). Regardless of any lack of a business purpose, Limco can use a taxable year ending September 30 or later if it makes an election under IRC § 444. Such an election requires that Limco keep funds on deposit with the IRS so as to eliminate any advantage to Limco from the time value of the tax deferral, as compared to using the calendar year.

Question 2

The formation of Genco does not cause any gain or loss to be recognized to Mai, Nick, Oba, or Genco. IRC § 721. Each partner gets an initial cost basis of $20,000 in the partner's interest in Genco.

When Genco borrows $40,000 from the bank, each partner is treated as contributing his or her share of that liability to the partnership, thus increasing the partner's basis in his or her partnership interest. IRC § 752(a). Because the debt is a recourse loan, it is allocated among the partners under Reg. § 1.752-2. This regulation requires that one analyze the consequences of a constructive liquidation of the partnership under a "doomsday scenario." In this hypothetical scenario, the debt is due and payable in full; the partnership's assets have zero value; the partnership sells all its assets for zero consideration, with the resulting loss passing through to the partners; and the partnership liquidates. The regulation asks how much each partner would have to pay or contribute, without right of reimbursement from another partner, in this scenario. This hypothetical out-of-pocket amount is the partner's share of the partnership debt.

In this case, if Genco sold all of its assets for zero, it would recognize a $100,000 loss. Under IRC § 704(b) and the regulations thereunder, no more than $20,000 of this loss could pass through to Oba, because Oba has not agreed to restore a negative capital account. Therefore, the other $80,000 of loss would pass through to Mai and Nick, with each being allocated a $40,000 loss. This would reduce Mai's and Nick's capital accounts to negative $20,000 each, which each of them would have to restore, pursuant to the partnership agreement, upon the constructive liquidation. Therefore, Mai and Nick each are allocated $20,000 of the bank debt. Their bases in their respective partnership interests is increased to $40,000 each.

In year 1, when Genco incurs a loss of $40,000, the loss passes through pursuant to the partnership agreement. IRC § 704(a). Thus, $10,000 of the loss passes through to Mai, $10,000 of the loss passes through to Nick, and $20,000 of the loss passes through to Oba. This reduces Mai's and Nick's capital accounts to $10,000 each, and Oba's capital account to zero. The pass-through loss also reduces each partner's basis in his or her partnership interest.

In year 2, when Genco incurs a loss of $10,000, none of it passes through to Oba, because Oba is not required to restore a negative capital account. $5,000 of the Genco loss passes through to each of Mai and Nick, reducing their capital accounts and their bases in their partnership interests accordingly.

The pass-through losses in both years are subject to the passive loss limitations of IRC § 469 and the at-risk loss limitations of IRC § 465. These are applied at the partner level.

Question 3

Xco, an unincorporated business entity with more than one owner, is treated as a partnership for federal tax purposes.

In general, an operating distribution of property other than money does not result in any gain or loss to the partnership or the distributee partner. IRC § 731. In general, the distributed asset takes the same basis in the distributee partner's hands as the asset had when held by the partnership, IRC § 732(a)(1), but never more than the partner's basis in his or her partnership interest (a.k.a. the partner's "outside basis") immediately before the distribution, IRC § 732(a)(2). The distributee partner's outside basis is reduced by the amount of cash distributed, and the basis assigned to any distributed property. IRC § 733.

These rules are overridden, however, by IRC § 751(b), which provides that if a distribution alters the partners' shares of unrealized receivables or substantially appreciated inventory items, the transactions are treated as a taxable sale or exchange of property between the distributee and the partnership.

Here, the inventory is substantially appreciated, and the distribution of the inventory entirely to Faye alters the partners' interests in that item. Therefore, the regulations recharacterize the distribution covered by IRC §§ 731−733 as follows: Xco distributes to Faye $5,000 worth of inventory (her one-third share of it) with an adjusted basis of $1,000; $4,000 cash; and a share of the capital asset, with a fair market value of $6,000 and an adjusted basis of $2,000.

Next, the regulations treat Faye and Xco as entering into a fully taxable exchange, in which Faye transfers back to Xco the constructively distributed share of the capital asset and the constructively distributed cash in exchange for the other $10,000 worth of inventory (two thirds of it). In the taxable exchange, Xco recognizes $8,000 of ordinary income on the two-thirds of the inventory; this passes through to Delfina and Emilio, increasing their outside bases. Also in the taxable exchange, Faye recognizes $4,000 of capital gain on transferring the constructively distributed share of the capital asset back to Xco for $6,000 worth of inventory.

After all of these transactions are taken into account, Faye's basis in the inventory is computed as follows: a $1,000 carryover basis from Xco on the recharacterized distribution of a third of the inventory, plus $10,000 of basis on account of the constructive taxable exchange for the other two thirds of the inventory. Faye's basis in her partnership interest is reduced under IRC § 732(a) by the cash constructively distributed ($4,000); the basis of the share of the capital asset constructively distributed ($2,000); and the basis of the one third of the inventory in the recharacterized distribution ($1,000). Thus, her outside basis is reduced from $16,000 to $9,000.

Xco's basis in the capital asset is increased with respect to the share that was constructively distributed to Faye (which had a basis of $2,000 and a value of $6,000). The $4,000 of gain inherent in that share was recognized in the deemed taxable exchange; therefore, the capital asset's basis increases from $15,000 to $19,000.

After the distribution and all of the foregoing tax consequences, the partnership balance sheet is as follows:

Assets			***Liabilities***		
	Adjusted basis	*Fair market value*		*Adjusted basis*	*Fair market value*
				Partners' capital	
Cash	$30,000	$30,000	Delfina	$ 9,000	$15,000
			Emilio	20,000	30,000
Capital asset	19,000	45,000	Faye	20,000	30,000
			Total partners' capital	*49,000*	*75,000*
Total assets	***$49,000***	***$75,000***	***Total liabilities***	***$49,000***	***$75,000***