Partnership Tax
Spring 2019
Exam Issue Outlines

Question 1

RST is a partnership for tax purposes. It is an unincorporated entity with more than one owner and has not elected to be treated as an association.

None of the transfers from any of the partners results in any recognized gain or loss at the partnership level.

Ruth's exchange of cash for a partnership interest results in no realized gain or loss to Ruth. Ruth's initial basis in her partnership interest is a cost basis, $100,000.

Sadie's exchange of Blackacre for a partnership interest results in no recognized gain or loss to Sadie. Sadie's initial basis in her partnership interest is the same as her basis in the Blackacre immediately before the exchange, $40,000. RST's basis in Blackacre is the same as Sadie's basis immediately before the exchange, $40,000.

Sadie's exchange does not qualify for nonrecognition if RST would have been an investment company if it had been a corporation. IRC § 721(b). Under IRC § 351(e) however, RST would not be an investment company, because more than 20 percent of the value of its assets consists of assets other than stocks and securities.

Under IRS rulings, Taz's exchange of services for a partnership interest in profits only, results in no immediate recognized gain or loss to Taz. Taz's initial basis in his partnership interest is zero.

Taz's service arrangement with RST raises issues under IRC § 707(a). If the services that Taz renders to RST are not in his capacity as a partner, then payments to him for such services are treated, by both him and RST, as it were a transaction between strangers. This would result in Taz having ordinary income (for compensation) rather than (pass-through) capital gain, and RST being eligible for a deduction or additional basis in property.

Taz's service transaction may be covered by IRC § 707(a) because tax preparation is probably not one of the "basic duties" of this partnership. However, the allocation of income to him is risky, it is long-lived, and there is no apparent obligation on the part of RST to distribute money or property to Taz except on liquidation. Thus, the transaction is probably covered by the pass-through and distribution rules of IRC §§ 702 and 731 rather than by IRC § 707((a).

RST's sale of Blackacre results in $90,000 of gain. The character of the gain is determined at the partnership level, and the gain retains that character as it passes through to the partners. Here, assuming that RST is not a real estate dealer, the gain is capital gain.

The amount of gain passing through to each partner is governed by IRC § 704(c). This provision requires that the built-in gain of $60,000 that was present on Blackacre when it was contributed to RST pass through to the contributing partner, Sadie. The allocation of the other $30,000 of gain passing through to the partners is governed by IRC §§ 704(a) and (b), which follow the partnership agreement. Thus, one third of that $30,000 of gain passes through to each of the three partners in equal amounts ($10,000 each).

Each partner's basis in his or her partnership interest is increased by the gain passing through to the partner. This results in Ruth's basis increasing from $100,000 to $110,000; Sadie's basis increasing from $100,0000 to $110,000; and Taz's basis increasing from zero to $10,000.

Section 1061 likely applies to Taz. This Code provision may turn pass-through long-term capital gain into short-term capital gain for the managing partner of an investment partnership such as RST. The unfavorable rule applies if an asset sold by the partnership had a holding period prior to sale of less than three years. Here, RST held Blackacre for only 18 months. However, Sadie's holding period for Blackacre is "tacked" onto RST's, IRC §1223(2), and Sadie herself actually held Blackacre for many years. Thus, IRC § 1061 appears to have no impact on these facts.

Question 2

Firm is a partnership for tax purposes. It is an unincorporated entity with more than one owner and has not elected to be treated as an association.

The $340,000 cash distribution in liquidation of Jared's partnership interest is covered in part by IRC § 736(a) and in part by IRC § 736(b). The $40,000 amount he receives in excess of the fair market value of his interest is governed by IRC §736(a). As this "premium" is a fixed amount, not contingent on partnership income, it is treated as a guaranteed payment under IRC § 707(c). It is ordinary income to Jared, and deductible by Firm under IRC §162. The deduction passes through $20,000 each to Hua and Imma, reducing their bases in their partnership interests from $220,000 each to $200,000 each.

Immediately after this analysis, the balance sheet of Firm is as follows:

	Assets			**Liabilities**	
	Adjusted Basis	**Fair Market Value**		**Adjusted Basis**	**Fair Market Value**
			Debt		-0-
Cash	$ 320,000	$ 320,000		*Partners' Equity*	
Accounts receivable	-0-	75,000	Hua	$ 200,000	$ 280,000
Supplies (previously expensed)	-0-	15,000	Imma	200,000	280,000
Office building	300,000	450,000	Jared	220,000	300,000
Total Assets	$ 620,000	$ 860,000		$ 620,000	$ 860,000

The remaining $300,000 of the liquidating distribution is covered by IRC § 736(b) and the distribution rules of IRC §§ 731−735, including the "hot asset" distribution rules of IRC § 751(b). Under the latter rules, amounts paid to a distributee partner in exchange for the partner's share of unrealized receivables and substantially appreciated inventory items are treated as amounts paid to the partner for his or her share of those assets in a taxable sale.

Here, the partnership has two "hot assets": the account receivable and the previously expensed supplies. The supplies are "inventory items" in that they would generate ordinary income if they were sold. IRC §§ 751(d)(2), 1221(a)(8). They are also substantially appreciated, in that their basis is zero.

Under the regulations under IRC § 751(b), Jared's distribution under IRC § 736(b), or $300,000, constructively consists of his share of the "hot assets" – $25,000 worth of accounts receivable and $5,000 worth of supplies – plus $270,000 cash. On the distribution, the "hot assets" retain their "inside" basis of zero under IRC §§ 732(b) and 732(c). The distribution of $270,000 cash results in $50,000 of capital gain to Jared under IRC § 731(a), as his basis in his partnership interest was $220,000.

Immediately after this stage of the analysis, the balance sheet of Firm is as follows:

	Assets			**Liabilities**	
	Adjusted Basis	**Fair Market Value**		**Adjusted Basis**	**Fair Market Value**
			Debt		-0-
Cash	$ 50,000	$ 50,000		*Partners' Equity*	
Accounts receivable	-0-	50,000	Hua	$ 200,000	$ 280,000
Supplies (previously expensed)	-0-	10,000	Imma	200,000	280,000
Office building	300,000	450,000			
Total Assets	$ 350,000	$ 560,000		$ 400,000	$ 560,000

Under IRC §751(b), Jared is then treated as selling his share of the "hot assets" back to Firm for the other $30,000 of cash he actually received. This results in $30,000 of ordinary income to Jared. Firm receives a cost basis under IRC § 1012 in the one-third share of the "hot assets" it is deemed to have repurchased from Jared.

Immediately after this stage of the analysis, the balance sheet of Firm is as follows:

	Assets			**Liabilities**	
	Adjusted Basis	**Fair Market Value**		**Adjusted Basis**	**Fair Market Value**
			Debt		-0-
Cash	$ 20,000	$ 20,000		*Partners' Equity*	
Accounts receivable	25,000	75,000	Hua	$ 200,000	$ 280,000

Supplies (previously expensed)	5,000	15,000	Imma	200,000	280,000
Office building	300,000	450,000			
Total Assets	$ 350,000	$ 560,000		$ 400,000	$ 560,000

There is a mismatch between Firm's basis in its assets and the partners' bases in their partnership interests as a result of Jared's recognizing $50,000 of capital gain under IRC § 731(a). Firm can remedy this by making a section 754 election. Under such an election, the basis of Firm's assets would be increased by the $50,000 capital gain recognized by Jared. Under the regulations under IRC § 755, all of that increase would be allocated to the "non-hot" asset, the office building. Reg. § 1.755-1(c)(1)(ii).

Question 3

LP is a partnership for tax purposes. It is an unincorporated entity with more than one owner and has not elected to be treated as an association.

No gain or loss is recognized by LP, Gina, or Leah upon formation of the partnership. Gina and Leah each get a cost basis in their partnership interests equal to their cost.

When LP borrows money, under IRC § 752(a) some partner or partners are treated as contributing that amount to the partnership, thus increasing the basis of the partner's interest in the partnership. Under Reg. § 1.752-2, a partner's share of recourse liabilities corresponds to the partner's economic risk of loss with respect to the debt, judged under a hypothetical liquidation of the partnership sometimes known as the "doomsday scenario."

Under this scenario, the partnership's assets are deemed to be worthless, the partnership liability is due and payable in full, the partnership sells all of its assets for zero, the loss passes through to the partners under IRC §§ 702 and 704, and the partners and the lender exercise their rights against each other. Here, if all of the partnership assets became worthless and were sold for zero consideration, LP would have a $500,000 loss, which would pass through $80,000 to Leah and $420,000 to Gina under IRC § 704(b). (See further analysis under IRC §704(b) below.) This would result in Gina having a negative capital account of $400,000, which she would have to restore to LP under the partnership agreement. Therefore, Gina bears the full economic risk of loss for the $400,000 loan, and adds the entire $400,000 to her basis in her partnership interest.

When LP sustains an operating loss of $150,000, the loss passes through to the partners under IRC § 702. The allocation of the loss between the partners is determined under IRC § 704. IRC § 704(a) states that the allocation is to be governed by the partnership agreement, but IRC §704(b) disregards the agreement allocation to the extent that it does not have substantial economic effect. Under the regulations under IRC § 704(b), pass-through losses reduce a partner's capital account, and a partner's capital account generally cannot be reduced below zero unless the partner has agreed to restore a negative capital account upon liquidation of his or her interest. Here, only Gina has agreed to restore a negative capital account, and therefore only her capital account can be reduced below zero as a result of pass-through losses. Therefore, when

LP has its $150,000 loss, only $80,000 can pass through to Leah – Leah has a capital account of only $80,000 (her capital contribution). The other $70,000 of the LP loss passes through to Gina.

Under IRC § 705, the pass-through losses reduce the partners' bases in their partnership interests. Gina's basis is reduced from $420,000 to $350,000. Leah's basis is reduced from $80,000 to zero.

Losses that pass through to either partner may not be fully deductible if they run afoul of the passive loss rules of IRC § 469, which apply at the partner level.

When LP has a taxable profit of $50,000, it passes through to the partners under IRC §§ 702 and 704(a) – 80 percent ($40,000) to Leah and 20 percent ($10,000) to Gina. This increases their bases in their partnership interests to $360,000 for Gina and $40,000 for Leah.

When LP repays $100,000 of debt to the bank, this is treated as a distribution of money to the partner whose share of the debt is reduced. IRC § 752(b). Since the debt was allocated entirely to Gina, the distribution is treated as $100,000 cash paid her. This deemed distribution is tax-free to her under IRC § 731(a) to the extent of her basis in her partnership interest, but under IRC §733, that basis is then reduced, from $360,000 to $260,000.