QUESTION ONE

No gain or loss is recognized to GP or to either partner on the formation of GP. X's initial basis in her partnership interest is $2,000,000. Y's initial basis in his partnership interest is $1,400,000. GP's initial basis in Blackacre is $1,400,000.

The allocation of the $140,000 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, X) first, up to the amount of book depreciation charged to X's capital account. The rest of the depreciation deduction is allocated to Y.

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 $200,000 ($2,000,000 divided by 10) each year. This is allocated between the partners' capital accounts equally, that is, $100,000 each, as they have agreed to share losses equally. Therefore, the first $100,000 of depreciation deductions for tax purposes is allocated to X, and the other $40,000 is allocated to Y.

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 $1,900,000, and Y's outside basis is reduced to $1,360,000.

The depreciation deduction of $140,000 reduces GP's basis in Blackacre from $1,400,000 to $1,260,000.

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 TWO

Ace has gain on the sale of his partnership interest to Pat. Ace's amount realized on the sale includes his share of partnership liabilities. Ace's share of partnership liabilities is $500, as he alone bore the economic risk of loss with respect to the debt. Thus, Ace's amount realized on the sale is $950, and this is Pat's basis in the partnership interest.

The character of Ace's gain is governed by the "hot asset" rules of Section 751(a). Ace's share of the ordinary income of the partnership is half of the income with respect to the accounts receivable – half of $400, or $200. Thus, Ace has $200 of ordinary income on the sale. As his overall gain on the sale is only $100, he is allowed a $100 capital loss under Section 741.
The sale results in a mismatch between the partnership's basis in its assets ($1,200) and the partners' total basis in their partnership interests ($350 for Bailey and $950 for Pat, or $1,300).

The basis of the assets inside the partnership generally is not adjusted upon the sale of a partnership interest. Section 743(a). However, if the partnership makes an election under Section 754, the basis of each asset is adjusted, solely for the benefit (or to the detriment) of Pat. Section 743(b). Section 755 governs the allocation of the basis adjustment. Here, the “hot asset” has appreciated by $400, and so it would receive a $200 basis increase for the benefit of Pat; the basis of the capital asset would be reduced by half of the inherent loss of $200, or a $100 decrease to the detriment of Pat.

The partnership’s taxable year closes as to Ace upon the sale of his entire partnership interest.

QUESTION THREE

Mia has gross income on her admission to the partnership. Under Section 83(a), the amount of gross income is the fair market value of the partnership interest she receives, $600. This is ordinary income. She receives a “tax cost” basis of $600 in her partnership interest. Genco has a $600 deduction, passing through in equal parts to Kareem and Lana, under Section 83(h), unless Mia’s services provide a long-term benefit creating a capital expenditure for Genco. The deduction passing through to Kareem and Lana reduce their basis in their respective partnership interests.

The transfer of the capital interest to Mia is treated as a constructive transfer by Genco of one third of each of its assets in a taxable transaction. This results in one-third of the gain on capital asset no. 2, or $150, being recognized by the partnership. Because capital asset no. 2 had been contributed to Genco by Lana with $450 of ”built-in” gain, all of the $150 of capital gain recognized by Genco passes through to Lana under Section 704(c), and increases her basis in her partnership interest.

Lana is treated as contributing one third of each asset back to the partnership under Section 721, with the basis of each asset, stepped up by the taxable transaction, carrying over to Genco. As a result, Genco’s basis in capital asset no. 2 is increased by the $150 of gain, from $150 to $300.