QUESTION 1

Upon formation of ABC, Ana and Cai get an initial cost basis in their partnership interests of $100,000 and $300,000, respectively. Neither Bob nor ABC recognize any gain or loss on the exchange of Blackacre for a partnership interest. IRC § 721. Bob's initial basis in Bob's partnership interest is a carryover basis from Blackacre, $100,000. IRC § 722. ABC's basis in Blackacre is a carryover basis from Bob, $100,000. IRC § 723.

Under the capital account rules for substantial economic effect, each partner's capital account includes the fair market value of assets contributed by the partner to a partnership. Thus, Ana's initial capital account is $100,000; Bob's initial capital account is $200,000; and Cai's initial capital account is $300,000.

Upon ABC's borrowing $400,000, some partner or partners are treated as contributing that amount to the partnership, thus increasing that partner's or partners' basis in his or her partnership interest. IRC § 752(a). To determine which partner receives the additional basis, the regulations on recourse debt under section 752 allocate the partnership liability among the partners based on their respective shares of economic loss. This determination focuses on which partner would have to make a payment, and not be entitled to reimbursement from another partner or related person, in a "doomsday scenario." Reg. § 1.752-2.

In that scenario, one assumes that the debt is immediately due and payable in full, and that the partnership's assets have value of zero. One assumes additionally that the partnership sells all of its assets (including cash) in a fully taxable transaction for no consideration, that the resulting tax items pass through to the partners, and that the partnership liquidates.

In this case, at the time the loan is made, ABC's basis in its assets (including cash) is $900,000 ($800,000 cash and $100,000 basis in Blackacre). Upon the sale of the assets for zero consideration, ABC would have a loss of $900,000. This loss would pass through to the partners equally, under section 704(a), reducing their capital accounts by $300,000 each. This would result in a capital account of negative $200,000 for Ana, negative $100,000 for Bob, and zero for Cai.

Because the partnership agreement satisfies the primary test for substantial economic effect, it requires the partners to restore a deficit in their capital accounts upon liquidation. Reg. § 1.704-1(b)(2)(ii)(b)(3), Thus, in the "doomsday" scenario, Ana would be required to contribute $200,000 to ABC, and Bob would be required to contribute $100,000. These amounts would be available to pay off $300,000 of the debt.

The bank could then proceed against any of the general partners to collect the remaining $100,000 of the debt, but because the partners have agreed to share losses equally, any partner required to pay more than a third of the $100,000 would be entitled to reimbursement for the excess amount above the partner's one-third share. Thus, of the remaining $100,000 of partnership debt, each partner is allocated one third for purposes of section 752(a), or $33,333.

In sum, under section 752(a), the bank debt would give rise to $233,333 of basis for Ana, $133,333 of basis for Bob, and $33,333 of basis for Cai. With this added to their initial bases noted earlier, Ana would have a basis in her partnership interest of $333,333; Bob would have a basis in Bob's partnership interest of $233,333; and Cai would have a basis in Cai's partnership interest of $333,333.

ABC's basis in the additional assets it purchases would be their cost, or $800,000.

QUESTION 2

XYZ recognizes no gain or loss in the distributions. IRC § 731(b).

Upon the distribution to Xi, Xi recognizes $5,000 of gain under section 731(a). The amount of money distributed exceeds Xi's basis in Xi's partnership interest by that amount. IRC § 731(a). Xi's basis in the capital asset Xi receives is zero. IRC § 732(a)(2). Xi's basis in Xi's partnership interest is also zero. IRC § 733.

Upon the distribution to Yon, Yon recognizes no gain or loss under section 731(a). The amount of money distributed does not exceed Yon's basis in Yon's partnership interest. IRC § 731(a). Yon's basis in the capital asset Yon receives is zero. IRC § 732(a)(2). Yon's basis in Yon's partnership interest is also zero. IRC § 733.

Upon the distribution to Zeke, Zeke recognizes no gain or loss under section 731(a). The amount of money distributed does not exceed Zeke's basis in Zeke's partnership interest. IRC § 731(a). Zeke's basis in the capital asset Zeke receives is a carryover basis from XYZ of $1,000. IRC § 732(a)(1). Zeke's basis in Zeke's partnership interest is $79,000: the $95,000 basis prior to the distribution, minus $15,000 cash received, minus $1,000 basis in the capital asset received in the distribution. IRC § 733.

Under section 734(a), no change is made to the "inside" basis of XYZ's assets as a result of the distribution. Therefore, following the distribution, the "inside" basis of XYZ's assets does not match the "outside" basis of the partners' partnership interests:

	Assets			**Liabilities**	
	Adjusted basis	**Fair market value**		**Adjusted basis**	**Fair market value**
Cash	$ 45,000	$ 45,000	Debt		-0-
Capital assets	9,000	45,000		*Members' capital*	
Inventory	18,000	30,000	Xi	$ -0-	$ 40,000
			Yon	-0-	40,000
			Zeke	79,000	40,000
Total	$ 72,000	$120,000	Total	$ 79,000	$120,000

XYZ may remedy this situation by making an election under section 754. This will result an increase in the "inside" bases of some of XYZ's assets, under section 734(b). The regulations under section 755 allocate the increase in basis to the capital assets. Reg. § 1.755-1(c)(1). Under section 734(b)(1), the basis of the assets is increased by the $5,000 of gain recognized by Xi, plus the basis in the distributed assets lost by application of section 732(a)(2), namely, $2,000. Thus, the basis of the capital assets is increased from $9,000 to $16,000.

QUESTION 3

On formation of LP, each partner receives a cost basis in her partnership interest: $50,000 for Gemma and $50,000 for Latifah. The partners' capital accounts are the same amounts.

When LP borrows the $100,000 from the investment banker, some partner or partners are treated as contributing that amount to the partnership, thus increasing that partner's or partners' basis in his or her partnership interest. IRC § 752(a). To determine which partner receives the additional basis, the regulations on nonrecourse debt under section 752 allocate the partnership liability among the partners based on their respective shares of partnership income. Reg. § 1.752-3. At the time the loan is made, Gemma's share of partnership income is 20 percent, and Latifah's is 80 percent. Thus, the debt is allocated $20,000 to Gemma and $80,000 to Latifah. Thus, the bases of their partnership interests increase to $70,000 for Gemma, and $130,000 for Latifah. The debt does not change the partners' capital accounts.

The $50,000 net operating loss for 2022 passes through in accordance with the partnership agreement. Although the agreement does not satisfy the third of the "Big 3" requirements for economic effect under the section 704(b) regulations, it does qualify under the alternate test for economic effect, because of the "qualified income offset," so long as the allocation of losses does not cause Latifah to have a deficit in her capital account. Passing through $40,000 of losses to Latifah in 2022 reduces her capital account to a positive $10,000.

Under section 705, as Gemma deducts $10,000 of pass-through losses foe 2022, her adjusted basis in her partnership interest is reduced from $70,000 to $60,000. Gemma's capital account is decreased from $50,000 to $40,000.

Under section 705, as Latifah deducts $40,000 of pass-through losses foe 2022, her adjusted basis in her partnership interest is reduced from $130,000 to $90,000. Latifah's capital account is decreased from $50,000 to $10,000.

The $50,000 net operating loss for 2023 does not pass through in accordance with the partnership agreement. The agreement does not satisfy the third of the "Big 3" requirements for economic effect under the section 704(b) regulations, and the "qualified income offset" does not permit Latifah to have a deficit in her capital account. Thus, only $10,000 of the loss passes through to Latifah under section 704(a). The other $40,000 of the losses passes through based on the partners' interest in the partnership. Given that Gemma still has a positive capital account of $40,000, the loss would pass through to her.

Under section 705, as Gemma deducts $40,000 of pass-through losses foe 2023, her adjusted basis in her partnership interest is reduced from $60,000 to $20,000. Gemma's capital account is decreased from $40,000 to zero.

Under section 705, as Latifah deducts $10,000 of pass-through losses foe 2023, her adjusted basis in her partnership interest is reduced from $90,000 to $80,000. Latifah's capital account is decreased from $10,000 to zero.

Pass-through losses are subject to limitation at the partner level under sections 465 (the at-risk rules) and 469 (the passive activity loss rules).