**QUESTION 1**

When Lee contributes Blackacre to LP, no gain or loss is recognized by Lee or LP. LP takes Blackacre with a carryover basis from Lee, $100,000. Lee’s basis in Lee’s partnership interest carries over from Blackacre, $100,000.

When Greta contributes Greenacre to LP, the question arises to whom the assumed mortgage is allocated for purposes of Section 752. Under that section, the $120,000 increase in a partner’s share of LP’s liabilities is treated as a contribution of money by the partner to the partnership. Under the regulations under Section 752, a recourse liability is allocated according to the partners’ economic risk of loss. Economic risk of loss is determined based on the partners’ obligations to make payments, and not be entitled to reimbursement from other partners, in a hypothetical “doomsday” scenario. In that scenario, the liability is due and payable in full, LP sells all of the assets for zero, the loss is allocated among the partners under Section 704, and the partnership liquidates.

Here, in such a scenario, Greta would be required to pay the full $120,000 of the mortgage and would not be entitled to reimbursement from Lee. Therefore, all of the $120,000 increase in partnership liabilities is allocated to Greta.

Greta and LP recognize no gain or loss on Greta’s contribution of Greenacre to LP. LP takes Blackacre with a carryover basis from Greta, $50,000. Greta’s basis in Greta’s partnership interest also carries over, $50,000. Under Section 752(a), Greta’s $120,0000 share of partnership liabilities is added to that basis, giving Greta a basis in her partnership interest of $170,00. Then, however, under Section 752(b), LP’s assumption of Greta’s individual liability is treated as a distribution of money by LP to Greta, thus reducing her basis in her partnership interest to $50,000. IRC §§ 731, 733.

When LP sells Blackacre for $160,000 cash, LP recognizes $60,000 gain. Under IRC § 704(c), none of the gain is allocated to Greta. Under the traditional method of applying Section 704(c), all $60,000 of the gain is allocated to Lee.

Under the remedial method of applying Section 704(c), LP may allocate a $10,000 loss to Greta for tax purposes, matching Greta’s book loss. In that case, LP would assign an additional $10,000 fictional tax gain to Lee, leaving Lee with a total of $70,000 gain from the sale.

Under the traditional approach with remedial allocations, all $60,000 of the gain is initially allocated to Lee. In the succeeding tax year, LP allocates $10,000 of tax items between Lee and Greta that differ from the changes to their capital accounts, so as to alleviate the disparity between Greta’s tax and book consequences from the sale of Blackacre.

The character of the gain or loss depends on Lee’s status as a dealer or nondealer of real estate with respect to Blackacre. IRC § 724.

Each partner’s basis in his or her partnership interest is adjusted to reflect the items passing through to that partner. IRC § 705.

## QUESTION 2

The distribution of the receivable to Cara changes the partners' shares of an unrealized receivable, thus triggering Section 751(b). Under the regulations under that section, Genco constructively transfers for Cara her one-third share of the receivable, with a basis of zero and a fair market value of $20,000. The other $40,000 of Cara's distribution is treated as being a combination of cash and a portion of the capital asset. The precise mix is based on the relative fair market values of those assets, so that 40 percent ($120,000/300,000) is cash and 60 percent ($180,000/300,000) is the portion of the capital asset. The cash, therefore, is $16,000, and the constructively distributed portion of the capital asset has a fair market value of $24,000.

The constructive mixed distribution results in Cara having a zero basis in the receivable and a basis in the distributed portion of the capital asset of $8,000. IRC § 732(a)(1). This reduces the basis of Cara's partnership interest from $60,000 to $52,000, and the constructive distribution of the cash reduces it further, to $36,000. IRC § 733. Genco's basis in the capital asset it retains is $52,000.

Next, section 751(b) treats Cara and Genco as entering into a taxable exchange of the constructively distributed money and portion of the capital asset for the other two thirds of the receivable, worth $40,000. This results in Cara recognizing a capital gain of $16,000 on the capital asset. ($24,000 minus $8,000 basis). This also results in Genco having $40,000 of ordinary income on the receivable, which passes through equally to Ahmad and Bea. Each of Ahmad and Bea gets a $20,000 increase in their respective partnership interests, from $60,000 to $80,000.

Cara gets a cost basis in the receivable of $40,000. Genco's basis in the capital asset is increased from $52,000 to $76,000, in that it is treated as buying back a portion of that asset with a value of $24,000 in a taxable transaction. The final balance sheet is:

| | ***Assets*** | | | ***Liabilities*** | |
|---|---|---|---|---|---|
| | **Adjusted basis** | **Fair market value** | | **Adjusted basis** | **Fair market value** |
| Cash | $ 120,000 | $ 120,000 | Debt | | -0- |
| | | | | *Members' capital* | |
| Capital asset | 76,000 | 180,000 | Ahmad | $ 80,000 | $ 120,000 |
| | | | Bea | 80,000 | 120,000 |
| | | | Cara | 36,000 | 60,000 |
| Total | $ 196,000 | $ 360,000 | Total | $ 196,000 | $ 360,000 |

**QUESTION 3**

Upon Tara's admission to the partnership, no gain or loss is recognized to either Tara or XYZ because Tara's interest, in profits only, is too difficult to value. An exception might apply if Tara sells her interest within two years of receiving it. Tara's basis in her interest is zero.

The bank debt is a nonrecourse liability within meaning of the regulations under section 752. It is allocated among the members based on their shares of partnership income, namely, one third each. Thus, Rob's basis in his partnership interest increases from $50,000 to $100,000, and the same is true of Sam's interest. Tara's basis in her interest increases from zero to $50,000. The members' capital accounts are unchanged.

When XYZ incurs the $120,000 loss for 2023, each member takes into account his or her distributive share of the loss for federal income tax purposes. Under Section 704(a), partners' distributive shares are determined under the partnership agreement. However, under Section 704(b), the distributive shares are determined based on the partners' interests in the partnership (taking into account all facts and circumstances) if the partnership agreement's allocation does not have substantial economic effect.

Under the regulations under Section 704(b), allocations of losses to Sam and Tara beyond their respective capital accounts do not have economic effect, because they are not required to restore any deficit in their capital accounts upon liquidation of their interests. Therefore, only $50,000 of the loss may be allocated to Sam, and none may be allocated to Tara. The remaining $70,000 of XYZ's loss should be allocated to Rob.

As the distributive shares of XYZ's loss pass through to the partners, their respective bases in their partnership interests, and their capital accounts, are reduced accordingly. Rob's basis is reduced from $100,000 to $30,000. Sam's basis is reduced from $100,000 to $50,000. Tara's basis remains at $50,000.