ST. MARY'S UNIVERSITY SCHOOL OF LAW

PARTNERSHIP TAX -- LW8678

SPRING SEMESTER 1994

FINAL EXAMINATION

1. You may use your own copy of *Federal Income Taxation of Partnerships*, by Howard E. Abrams, your own copy of the Internal Revenue Code and Regulations, any handouts I distributed during the semester, and your own class notes and study notes. You may not use library materials, treatises, hornbooks, commercial outlines, or outlines prepared by classmates or former students. Above all, **do your own work.**

2. As you are aware, some of your classmates might not have taken this exam yet. Accordingly, you should return your copy of the exam with your paper, and you should refrain from discussing the exam with anyone.

3. You may type your answers or write them in bluebooks. Please put your exam number on your paper, and please do not identify yourself in any other way.

4. Your paper will be due at the receptionist's desk in the Law Faculty Building three hours after you pick up your copy of the exam. Please indicate in the space provided below the date and time you pick up and turn in the exam.

PLEDGE

By placing my exam number below, I affirm that I have neither given nor received unauthorized assistance on this examination and that I have not exceeded the three hour time limit.

____
Exam Number

Picked Up _______ ________
Date Time

Turned In ______ ________
Date Time

QUESTION I

Suggested Time: One Hour and Forty Five Minutes

X and Y are both publicly traded corporations, neither of which owns any interest in the other. X owns a building with a fair market value of 1000 and an adjusted basis of 600. The building is encumbered by a nonrecourse mortgage in the amount of 800. Y owns a vacant lot adjacent to X's building. Y's lot has a fair market value of 200 and an adjusted basis of 400.

X and Y decide to form a partnership. X contributes the building and Y contributes the vacant lot. X and Y agree to share profits and losses equally. You should assume that the partnership agreement satisfies the requirements of Regs. 1.704-1(b)(2) and 1.704-2(f).

A. Please discuss the tax consequences to X and Y resulting from the formation of the partnership, and prepare the partnership's opening balance sheet.

B. Assume that the partnership is entitled to a depreciation deduction of 60 with respect to the building during the partnership's first taxable year (reflecting straight-line depreciation over a useful life of ten years). Assume further that the partnership has equal amounts of income and deductions other than depreciation, so that the partnership has a net loss of 60 for its first taxable year. Please discuss the tax consequences to X and Y.

C. On the first day of its second taxable year, the partnership sells the building and the vacant lot to an unrelated buyer. The buyer pays 400 cash for the building and takes it subject to the nonrecourse mortgage, which still has a principal balance of 800. The buyer pays 300 cash for the vacant lot. X and Y agree to liquidate the partnership. Please discuss the tax consequences to X and Y, and please describe how they should divide the cash.

QUESTION II

Suggested Time: One Hour and Fifteen Minutes

The ABC partnership is a calendar year, cash method taxpayer, as are its three equal partners, A, B, and C. A, B, and C are unrelated individuals. A summary of the partners' interests and the partnership's assets, as of January 1, 1994, appears at the bottom of this page. On that date, partner A withdraws from the partnership, receiving Capital Asset #2 and 600 cash in full liquidation of her interest.

Please discuss the tax consequences to the partnership and the three partners.

Partners' Interests

Partner	OSB/Capital Acct.
A	1000
B	1000
C	1000
TOTAL	3000

Partnership Assets

Asset	AB/Book Value	FMV
Capital Asset #1	600	300
Capital Asset #2	600	900
Capital Asset #3	300	600
Inventory	600	900
Accounts Receivable	0	300
Cash	900	900
Goodwill	0	600
TOTAL	3000	4500

QUESTION I

A. Contribution

Generally, the contribution of property to a partnership is a nonrecognition event for the partners and the partnership. The partnership will take a carryover basis in the contributed assets, and the basis of the partners' interests will be a substituted basis equal to the basis of the assets they contributed. Where liabilities are involved, we must determine each partner's share. If a partner's liabilities decrease as a result of contributing encumbered property, the partner will be treated as receiving a cash distribution equal to the decrease. Conversely, if a partner's liabilities increase, the partner is treated as contributing cash equal to the amount of the increase.

In our example, the partnership will take a carryover basis of 600 in the building and a carryover basis of 400 in the vacant lot. X's outside basis will be 600, subject to adjustment for liabilities. Y's outside basis will be 400, subject to adjustment for liabilities.

Nonrecourse liabilities must be allocated in three tiers. First, liability must be allocated in proportion to any minimum gain -- gain resulting from "nonrecourse deductions" (deductions that take the basis of property below the amount of debt encumbering it). Since the partnership has just acquired the property, there have not been any nonrecourse deductions and there is not any first-tier minimum gain. (The option of allowing for anticipated future minimum gain is discussed at the end of part B, below.) The second tier allocation is in proportion to "section 704(c) minimum gain" -- the gain that would be allocated to the contributing partner under section 704(c) if the partnership abandoned the property to the lender. Here, if the partnership abandoned the property, there would be a gain of 200 (AR 800 minus AB 600). Since there is 400 of gain lurking in the property at the time of the contribution, the entire 200 of gain on abandonment would be allocated to X. Therefore, 200 of liability will be allocated to X at the second tier. The third tier allocation is in proportion to the partners' respective profits interests. There is 600 of debt to be allocated at the third tier, and each partner owns 50% of the partnership profits. Thus, 300 of debt will be allocated to each partner at the third tier. Altogether, the 800 liability is allocated 300 to Y and 500 to X.

X starts out with a liability of 800 and ends up with a liability of 500. Therefore, X is treated as having received a 300 cash distribution. This is a nontaxable recovery of capital, which reduces X's outside basis from 600 to 300. Y starts with zero liabilities and ends up with 300, so Y is treated as contributing 300 cash. This increases Y's outside basis from 400 to 700.

Balance Sheet of XY Partnership

Capital

Partner	Cap. Acct.	OSB
X	200	300
Y	200	700
Total	400	1000

Assets

Asset	Book Value	ISB
Bldg.	1000	600
Lot	200	400
	1200	1000

Liabilities

Mortg. on Bldg. 800

Assets - Liab. = 400

B. First Year Depreciation

Section 704(c) and the regulations thereunder require that depreciation deductions be allocated to take into account the disparity between the basis and fair market value of contributed property. If, as here, depreciable property has an adjusted basis less than its fair market value at the time of contribution, the noncontributing partner(s) must receive an allocation of tax depreciation equal to their share(s) of book depreciation. Here, the book deprecation is 100 per year (1000 book value allocated over ten years). Y's share of book depreciation is 50. Therefore, 50 of tax depreciation must be allocated to Y. The remaining 10 of tax depreciation will be allocated to X.

The depreciation deductions will decrease each partner's outside basis, but the allocation of liabilities also changes. Now, 60 of the liability will be allocated under the first tier -- 50 to Y and 10 to X (in proportion to the depreciation deductions, which are nonrecourse deductions because they increase the amount by which liability exceeds basis). The allocation of depreciation decreases X's potential 704(c) gain from 400 to 360, but the tier two allocation of liabilities is unchanged because the *minimum* 704(c) gain is still 200. [In other words, if the partnership abandoned the property, there would be a gain of 260 -- AR 800 minus AB 540. The first 60 of this gain would be allocated the same way as the depreciation deductions (50 to Y and 10 to X), and the remaining 200 would be allocated to X under 704(c).] The allocation of 60 of liabilities under the first tier and 200 under the second tier leaves 540 to be allocated 50/50 under the third tier. Thus, when the dust settles, X's share of liabilities is 480 (10 + 200 + 270) and Y's share is 320 (50 + 0 + 270). X's share of liabilities has decreased by 20, so X is treated as having received a cash distribution of 20. Y's share of liabilities has increased by 20, so Y is treated as having contributed 20 of cash.

Taking into account the adjustments for depreciation and liabilities, the partners' respective outside bases change as follows:

Partner	Starting Basis	Minus Deprec.	Adjust. for Liab.	Ending Basis
X	300	10	-20	270
Y	700	50	+20	670

The balance sheet now stands as follows:

Capital

Partner	Cap. Acct.	OSB
X	150	270
Y	150	670
Total	300	940

Assets

Asset	Book	ISB
Bldg.	900	540
Lot	200	400
	1100	940

Liability 800

Assets - Liab. = 300

If we X and Y want to avoid going through this exercise every year, they can allocate liabilities from the beginning based on the anticipated nonrecourse deductions. Here, since the building starts with a basis of 600, and a liability of 800, we know that all of the depreciation deductions (a total of 600 over ten years) will be nonrecourse deductions. Accordingly, we can allocate 600 of the liability the way that the depreciation will be allocated -- 500 to Y and 100 to X. The remaining 200 will be allocated to X under the second tier. Thus, from the outset we allocate 500 of liability to Y and 300 to X. If we elect to do this, X will start out with an outside basis of 100 (600 substituted basis minus 500 deemed distribution from liability shift) and Y will start out with an outside basis of 900 (400 substituted basis plus 500 liability shift).

C. Sale of assets

On the sale of the building, the partnership will have a tax gain of 660 (AR 1200 minus AB 540). Since depreciation was straight line, this gain will most likely be a 1231 gain (unless the building is tainted under section 724). The tax gain must be allocated between X and Y in three tiers -- first, in proportion to any nonrecourse deductions, second, according to any section 704(c) gain, and finally in proportion to their profits interests. Thus, X's share of the gain is 490 (10 + 360 + 120) and Y's share is 170 (50 + 0 + 120).

On the sale of the vacant lot, the partnership will have a tax loss of 100, which might be capital or 1231, depending on the partnership's use and the potential applicability of section 724 (which would depend on the character of the lot in Y's hands). Since the lot had a lurking loss of 200 at the time of contribution, all 100 of the recognized loss will be allocated to Y, the contributing partner.

Thus, when the dust settles, X will have a tax gain of 490; Y will have a tax gain of 170 and a tax loss of 100.

The partnership will have a book gain of 300 on the building (book value of 900, sold for 1200), and a book gain of 100 on the vacant lot (book value 200, sold for 300). The book gains will be allocated equally between X and Y.

Finally, X and Y will be treated as receiving cash distributions to the extent of their respective shares of the liability encumbering the building. Assuming we have not elected to allocate the entire amount of anticipated nonrecourse gain, the liability and the resulting deemed distribution will be allocated 480 to X and 320 to Y.

The balance sheet now stands as follows:

Capital

Partner	Cap. Acct.	OSB
X	350	280
Y	350	420

Assets

Asset	Book	ISB
Cash	700	700

Each partner should receive cash equal to its capital account. Since the cash available is equal to the capital accounts, this takes care of the entire distribution. On the liquidation, X will have a tax gain of 70 (capital gain per section 741), and Y will have a section 741 capital loss of 70.

If we want to reassure ourselves of the result, we can look at where each partner started and ended up. X started with property having an adjusted basis of 600 and ended up with cash of 350 and relief from an 800 liability. In the interim, X claimed 10 of depreciation and recognized a gain of 490 when the building was sold. This leaves X 70 ahead, which accounts for the 70 of gain on the liquidation. Y started out with property having an adjusted basis of 400 and ended up with 350 cash. In the interim, Y claimed 50 of depreciation and reported a gain of 170 and a loss of 100. Thus, Y is 70 behind (i.e., Y has reported 70 too much income), which is why Y will have a loss of 70 on the liquidation.

QUESTION II

Payments in liquidation of a partner's interest are governed by section 736. First we must determine whether there are any 736(a) payments. There is no "premium," so the entire payment appears to fall under 736(b) except to the extent provided in 736(b)(2). After 1993, section 736(b)(2) applies only to partnerships in which capital is not a material income-producing factor. Section 736(b)(3). Since the partnership owns several capital assets and some inventory, we will assume that capital is a material income-producing factor. Therefore, section 736(b)(2) does not apply. Accordingly, there are no 736(a) payments and we will proceed to 736(b). {If capital were not a material income-producing factor, the portion of the payment attributable to unrealized receivables (100) would be treated as a guaranteed payment, meaning ordinary income to A and a deduction for the partnership The 200 attributable to goodwill would receive similar treatment unless the partnership agreement specifically allocated a portion of the payment to goodwill.}

Under 736(b), payments received by a partner in liquidation of her interest are treated as a distribution. This invokes the regime of sections 731, 732, 751, etc. The first step is to determine whether there is a section 751(b) problem. (Since this is a final exam, one would be surprised not to find a 751(b) problem.) The 751 assets consist of the Inventory and the Receivables. A's share before the liquidation of her interest was 400 (one-third of the total value of the 751 assets). A receives only non-751's, so her share after the liquidation of her interest is zero. Thus, A has received 400 too few 751's, and we must have a constructive distribution. The constructive distribution consists of 100 worth of Accounts Receivable having a basis of zero and 300 worth of inventory having a basis of 200. This distribution decreases A's outside basis from 1000 to 800, and A takes a carryover basis in each of the assets. Then, A is deemed to exchange the Accounts Receivable and Inventory for 160 of cash and 240 worth of Capital Asset #2. This is a taxable exchange to A and to the partnership. A has a gain of 100 on the receivables and a gain of 100 on the inventory (all ordinary income per section 735). The partnership has a gain of 80 on the distributed portion of Capital Asset #2 (240 - 160 -- 27% of the value minus 27% of the basis). This gain is allocated to partners B and C, and their outside bases will be increased accordingly. A takes a tax cost basis of 240 in the 27% of Capital Asset #2 she is deemed to receive in the 751(b) exchange, and the partnership takes a tax cost basis in the portion of the receivables and inventory acquired from A.

A receives the remaining 440 of cash and the remaining 660 worth of Capital Asset #2 in a straight 731 distribution. The 440 of cash is a non-taxable recovery of capital, which reduces A's outside basis to 360. This amount (360) will be A's basis in the remaining portion of Capital Asset #2 pursuant to section 732(b). The partnership's basis in the remaining portion of Capital Asset #2 was 440, so 80 of basis has "disappeared" If a 754 election is in effect, section 734(b) will permit an increase in the inside basis of the remaining capital assets by 80. Since Capital Asset #1 has a basis greater than its fair market value, the increase will be allocated between Capital Asset #3 and the goodwill in proportion to their relative appreciation (here, 1/3 to Capital Asset #3, which has 300 of appreciation, and 2/3 to goodwill, which has 600 of appreciation).

Summary of Consequences to A

A has 200 of ordinary income and takes Capital Asset #2 with a basis of 600 (240 + 360). A had a total realized gain of 500 (1500 - 1000). Section 751 required recognition of the 200 attributable to ordinary income assets. The remaining 300 of gain now lurks in Capital Asset #2, since it has a fair market value of 900 and a basis of 600.

Summary of Consequences to B, C, and the Partnership

B and C each have 40 of capital gain and their respective outside bases increase from 1000 to 1040. The partnership's basis in the Inventory is increased from 600 to 700, and the basis of the Accounts Receivable is increased from 0 to 100. If a 754 election is in effect, the basis of Capital Asset #3 will be increased from 300 to 327, and the basis of the goodwill will be increased from 0 to 53.