Question 1

Formation is generally a non-recognition event under §§721-723. The fair market value of property contributed will be exchanged for a similar value partnership interest as represented by the capital account. The partners will take a carry-over basis in their partnership interest that was the same as the basis in the contributed property under §722. The partnership will take a carry-over basis from the partner in the contributed assets.

Here, only cash was contributed, therefore each partner will have an initial capital account of 100K and an outside basis of 100K.

When a partnership takes on debt, either by getting debt itself or assuming debt, under Crane, the partners get basis in that debt. The assumption is that each partner actually took the debt out itself and contributed the cash. Under §752, the allocation of the basis depends on whether the debt is recourse or non-recourse. Whether debt is recourse or not does not depend on the label on the instrument, but rather on whether any partner is personally liable for the debt. Recourse debt is allocated according to the "doomsday scenario" in 1.752-2 regulations where all partnership liability become payable in full, all assets (including cash) has a value of 0, all property is disposed of in a fully taxable transaction for no consideration, all gain/loss is passed through to the partners, the partnership is deemed liquidated, and all partner's can go against each other (all deemed to have money). Whomever has an obligation at the end gets the basis.

Recourse debt is allocated, under 1.752-3 regulations, along the profit distribution. There are three tiers to the allocation: to the extent there is minimum gain by a partner, the amount of taxable gain under §704(c), and the remainder according to the profit split (or according to the partnership agreement if it otherwise specifies). Note, the allocation of basis from debt is recalculated each partnership tax year, such that if the partner's start losing the bank's money (taking non-recourse deductions) then they may get an allocation of basis under the first tier.

Here, the partnership took on 800K in debt that is ostensibly non-recourse. Presumably the bank can only go after the equipment securing the loan and even though A is a general partner, personally liable for all partnership debts he will not be personally liable for the 800K. Therefore, the allocation of basis is under 1.752-3. Upon formation there is no minimum gain (the amount of non-recourse deductions taken by any given partner) and the equipment was not contributed by a partner so there is no built-in gain under §704(c) to consider. Therefore, all the debt basis will be allocated according to the partnership agreement profit split, 50% to A, and 25% to B and C. – See balance sheet #1 on suppl. sheet 1 for the formation balance sheet.

After the first year of operation, the partnership must allocate all income/gain/loss to the partners under §701. The partnership does not pay any tax and therefore everything must go to the partners. The gain/loss/deductions are allocated under §702 by each partner's distributive share. The distributive share will be respected so long as it has substantial economic effect. Economic effect is that a partner must be visited with the ultimate economic reality of the allocation (suffers the loss of capital account for depreciation deductions). To assure the allocations will have economic effect the partner's can adopt the BIG-3 in their partnership agreement (keep capital accounts according to the regs, honor capital account balances upon liquidation, and agree to restore negative capital accounts upon liquidation or termination). Or alternatively, if a partner does not want to agree to restore it can agree to a qualified income offset and minimum gain charge back that means a partner cannot have a negative capital account when another partner's money is still to be lost and any non-recourse deductions (that create minimum gain) will have to be taxed in proportion to how they were taken.

Here, the partnership is breaking even on operations but has a 300K deduction from the first year depreciation of the equipment (210K operating profit – 210K operating deductions – 300K equipment depreciation = 300 loss). This 300K loss must be allocated to the ABC. Upon allocation, the partner's outside basis and capital accounts will be reduced. The split is dictated in the partnership agreement 50-25-25, which would mean A would take 150K in loss on his tax return. At the end of year one, since there is no increase in capital accounts from gain, A still has a capital account of 100. However, since he has NOT agreed to restore negative capital accounts he may not take all 150K loss, since this would result in a negative capital account. That he agreed to a QIO does not help at this point because, under the partnership agreement allocation split, both B and C have positive capital accounts. Moreover, since the partner's put in 300K upfront, the first year's depreciation consists of all partner's money. The partnership will not be losing the bank's money until year 2 (at which point there is no economic effect possible so the partner's can take whatever loss they wish—accruing minimum gain on the non-recourse deductions). Therefore, the extra 50K of loss that A cannot take must go evenly to B and C. Thus, after the first year, each partner will take 100K in loss, each will have a 0 capital account, and A will have a 400 outside basis while B and C will have 200K. The partnership will have 0 cash and the equipment will not have a basis and book value of 800 (down from 1.1M). The loss will be ordinary since it is depreciation. See balance sheet #2 on suppl. sheet 1.

5/2/1

On the other hand, if A (the general partner) had elected to restore negative capital accounts he may take his full allocation of loss, the 150 and his capital account will be –50K and his outside basis will be 350K. Note, that there is plenty of basis from the debt. B and C will have capital accounts of 25K each and outside bases of 225K. This is ok because even though the partnership is losing B & C's money, if A agrees to restore, B & C will get this money back. Again, the loss is ordinary because it is for depreciation of an income earning asset. See balance sheet #3 on suppl. sheet 1.

Exam No. 1447

Question: 1

#1

Asset	IB	Book value / f.m.v.	Liability/Equity	OB	Cap Acct / f.m.v.
Cash	0	0	debt		800
Equip	1,100K	1,100			
			Equity		
			A	100+400=500	100
			B	100+200=300	100
			C	100+200=300	100
	1,100	1,100		1,100	1,100

(OB annotation: 5752)

Comments:
A B C => QIO
50/25/25

Question: 1

#2 w/o BIG-3 for A

Asset	IB	Book value / f.m.v.	Liability/Equity	OB	Cap Acct / f.m.v.
Cash	210-210=0	210-210=0	debt		800
Equip (-300 dep)	800	800			
			Equity		
			A	500-100=400	100-180=-80
			B	300-75-25	100-75-25=0
			C	300-75-25	100-75-25=0
	800	800		800	800

Comments:
300 depre pass through => 701
50/25/25
150K 75K 75K

Question: 1

#3 w/ BIG-3 for A

Asset	IB	Book value / f.m.v.	Liability/Equity	OB	Cap Acct / f.m.v.
Cash	0	0	debt		800
Eq	1100-300=800	800			
			Equity		
			A	500-150=350	100-150=-50
			B	300-75=225	100-75=25
			C	300-75=225	100-75=25
	800	800		800	800

Comments: