CHAPTER 19 - THE STRUCTURE OF PARTNERSHIP TAXATION

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19-1. Although the partnership entity does own the bond, taxation of income passes through to the partners. If the partnership has income, that income must appear on the partners' returns, regardless of any restrictions to the partnership on use of the income. Since the bond income is earmarked for charitable use, the partners, in addition to recognizing the income, will get a corresponding charitable deduction, subject to the limitations of §170(c).

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19-2. Because the partnership received the bond as a gift, there is no income to the partnership, and therefore to the partners, due to the §102 gift exclusion. To ensure that this income is permanently excluded and not merely deferred, however, X's and Y's outside bases will be increased by their pro rata share of the partnership's basis in the gift. See §705(a)(1)(B). Thus, X and Y's outside bases (and capital accounts) will increase by $500 or $400 apiece, depending on the donor's adjusted basis in the bond.

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19-3. The selling partner's initial outside basis was $10,000 under §722. She then received a distributive share of $3,000, which she reported on her individual return. Therefore, her outside basis was increased by the $3,000, under §705(a)(1)(A), to $13,000. But since $1,500 of her distributive share was actually distributed to her, her outside basis is reduced by that total to $11,500. Section 733(1). Therefore, when she sells her partnership interest for $15,000, she must recognize gain of $3,500 under §§741 and 1001(a).

19-4a. If C's outside basis initially is $35,000, the distribution will reduce C's outside basis to $21,000 under §733(2). C's basis in the distributed property is carryover -- the same as the partnership's basis in the property -- of $14,000. §732(a)(1). There is no gain or loss recognized by C under §731. Sections 732 and 733 apportion C's outside basis between the two items C now owns: the partnership interest and the property. Property basis is carryover of $14,000, and C's outside basis is reduced proportionately. There is no change in aggregate basis.

19-4b. C's outside basis is reduced from $15,000 to $1,000, for the same reasons outlined in subsection (a) above.

19-4c. C's outside basis goes to zero under §732(a)(2) because of the Code's prohibition against negative outside basis. C's basis in the property is $10,000 because it cannot go higher than C's outside basis. No gain or loss is recognized on the transaction under §731.

19-4d (1). There is no gain or loss under §731(a)(1), and outside basis is reduced to $15,000 under §733(1).

19-4d (2). Because the cash received is greater than the outside basis, C must recognize a gain of $5,000 (the difference between outside basis and cash received). Outside basis is reduced to zero. C recognizes this income because §733 prevents negative outside basis. Under §741, the recognized gain is treated as realized from the sale or exchange of a capital asset.

19-4d (3). C must recognize gain of $10,000 for the reasons outlined in subsection (d)(2) above.

19-5a. If the cash were distributed first, there would be no gain or loss on the cash under §731(a)(1) because it is not a distribution amount that exceeds outside basis. H's outside basis is reduced by the amount of cash distributed; in this case, from $10,000 to $4,000 under §733(1).

When Blackacre is distributed, H recognizes no gain or loss under §731(a)(1). Basis in Blackacre will be $4,000 under §732(a)(2) because that is all the outside basis H has left to be allocated to Blackacre. Therefore, H's outside basis in the partnership is reduced to zero under §733(2).

19-5b. If Blackacre were distributed first, there would be no gain or loss under §733(a)(1). H's basis in Blackacre will be $10,000 (basis in the property can be carried over only to the extent of H's outside basis) under §732(a)(2). H's outside basis is reduced to zero under §733(2).

When the cash of $6,000 is subsequently distributed, H must recognize gain of $6,000 under §731(a)(1) because H's outside basis is zero, and outside basis cannot go negative. After the gain is recognized, H's outside basis remains zero under §733.

19-5c. If Blackacre and the cash were distributed at the same time, there is no gain or loss under §731(a)(1) because the cash distributed is less than H's outside basis of $10,000. H's outside basis is reduced by the amount of cash distributed -- $6,000 -- under §732(a)(2). H's basis in Blackacre becomes $4,000, which is the carryover basis to the extent of H's remaining outside basis. H's outside basis is then reduced to zero under §733(1) and (2). This gives the same result as subsection (a): a tax-free transaction.

19-5d. The distribution rules encourage cash-first distributions. The only "penalty" for distributing property last is having to take a low basis in that property, which ultimately may result in more gain when the partner sells the property (depending on the sale price at the time). This defers taxation. However, if cash is distributed last, the partner immediately must recognize gain. Deferring gain, as illustrated in subsection (b), is the most favorable treatment for taxpayers.