CHAPTER 20 – DETERMINING DISTRIBUTIVE SHARES

Problem, page 600

20-1. Both B's and W's capital account starts at $25,000, which is the fair market value of the property each contributed to the partnership. Since B and W receive equal allocations of gain and loss, they each receive $5,000 from renting Blackacre, and they each lose $3,000 from the operation of Whiteacre. Therefore, each capital account goes up by $5,000 and down by $3,000, for a net total of $27,000 in each capital account after one year.

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20-2. Yes. Suppose the partnership earns $10,000 in its first year and loses the same amount in its second year. In year 1, the gain is allocated 50/50, so that P's capital account is increased by $5,000 as is Q's capital account. In year 2, the loss of $10,000 is allocated 60/40, so P's capital account is decreased by $6,000 and Q's capital account is decreased by $4,000. Thus, over the two years, P's capital account is down $1,000 while Q's capital account is up by the same amount. Yet, had the gains and losses been incurred in a single year, there would be nothing to allocate, and so there would be no change to the capital accounts.

20-3.
Capital Accounts

(a) *Maintenance.* Capital accounts shall be maintained in accordance with applicable treasury regulations.

(b) *Distributions in Liquidation of a Partnership Interest.* Upon liquidation of any partner's interest in the partnership, the partner shall receive a distribution equal to such partner's final capital account balance.

(c) *Deficit Restoration Obligation.* Any partner with a capital account deficit at liquidation must restore the amount of that deficit to the partnership within 90 days.

Tax Allocations

(a) Definitions.

(1) <u>Book Income and Loss.</u> The partnership's book income or loss for any year shall be determined in accordance with the rules specified in Treas. Reg. §1.704-1(b)(2)(iv) regarding the maintenance of capital accounts.

(2) <u>Current Net Income</u>. If the partnership's book income for the current year exceeds its deductions, such excess shall be the Current Net Income. If there is no such excess, Current Net Income shall be zero.

(3) <u>Current Net Deduction</u>. If the partnership's book deductions for the current year exceeds its income, such excess shall be the current net deduction. If there is no such excess, Current Net Deduction shall be zero.

(4) <u>Prior Net Loss Allocations</u>. To the extent that Current Net Deduction for past partnership taxable years exceeds Current Net Income for past partnership taxable years, such excess shall be the Prior Net Loss Allocations. If there is no such excess, Prior Net Loss Allocations shall be zero.

(5) <u>Prior Net Income Allocations</u>. To the extent that Current Net Income for past partnership taxable years exceeds Current Net Deduction for past partnership taxable years, such excess shall be the Prior Net Income Allocations. If there is no such excess, Prior Net Income Allocations shall be zero.

(b) *Allocation of Net Income*. To the extent of Prior Net Loss Allocations, Current Net Income shall be 50% to X and 50% to Y. All additional Current Net Income shall be allocated 60% to X and 40% to Y.

(c) *Allocation of Net Deduction*. To the extent of Prior Net Income Allocations, Current Net Deduction shall be allocated 60% to X and 40% to Y. All additional Current Net Deduction shall be allocated 50% to X and 50% to Y.

(d) *Consistency in Individual Items.* Each item of book income, deduction, credit and loss shall be allocated in any one partnership taxable year in the same proportion between the partners as all other book items for that year.

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20-4a. Each partner's capital account starts at $10,000 to reflect the cash contribution of $10,000 made by each partner. Because neither partner has an unconditional deficit restoration obligation, the allocations to each partner must satisfy the alternate test for economic effect. The alternate test for economic effect does not impose any limitation on an allocation of deduction so long as the allocation does not drive the partner's capital account below the amount of the partner's limited deficit restoration obligation (if any). Because the first $10,000 of depreciation will not reduce either partner's capital account below zero regardless of how it is allocated, the partners are free to allocate the first $10,000 of depreciation however they desire.

20-4b. The second $10,000 of depreciation must be allocated so as to reduce each partner's capital account to zero. So, for example, if the first $10,000 was allocated entirely to M, then the second $10,000 of depreciation must be allocated entirely to N. As a second

example, if the first $10,000 of depreciation was allocated $6,000 to M and $4,000 to N, then the second $10,000 of depreciation must be allocated $4,000 to M and $6,000 to N.

To see why this is true, consider what would happen if the second $10,000 was allocated in any other proportion and then the partnership sold it asset for book value of $80,000 and then liquidated. The proceeds from the asset sale would have to be given entirely to the lender, leaving nothing to be distributed to either partner. Since neither partner has any obligation to restore a capital account deficit in favor of the other partner, this means that each partner will receive nothing and will be owed nothing. As a result, the requirement of economic effect demands that each have a capital account balance of $0; that is, the depreciation over the first two years be allocated $10,000 to M and $10,00 to N.

An equivalent way to get to the same answer is to observe that allocating more than $10,000 of depreciation to either partner in the first two years will drive that partner's capital account below $0. This is permitted under the alternate test for economic effect only if the partner has a deficit restoration obligation. But because the net book value of the partner's assets is $0 after two years, a capital account deficit for one partner will be offset by a capital account surplus for the other. But neither partner has an obligation to restore a deficit to fund the other's partner's surplus, and so neither partner can be allocated deductions driving her capital account negative.

20-4c. The partners are free to allocate the third year's depreciation however they desire. Once each partner's capital account declines to zero, a deficit capital account for one partner (or for both) represents a potential obligation to the lender. Because the partnership agreement imposes on each partner an obligation to restore a deficit capital account in favor of a third-party lender, creating one or two capital account deficits in year 3 is permitted under the alternate test for economic effect. (Note that the actual fair market value of the property is irrelevant; under Rev. Rul. 97-38, the amount of each partner's limit deficit restoration obligation when limited to satisfaction in favor of third-parties is the excess, if any, of the partnership's indebtedness over the book value of the partner's assets based on the misnamed "value equals basis" rule of Reg. §1.704-1(b)(2)(iii).)

20-5. The partnership's capital accounts:

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      G                    L              Explanation
   60,000               60,000           Contributions
 ( 6,000)              (24,000)          Year 1 Depreciation
   54,000               36,000           Year 1 Totals
 ( 6,000)              (24,000)          Year 2 Depreciation
   48,000               12,000           Year 2 Totals
 ( 6,000)              (24,000)          Year 3 Depreciation
   42,000              (12,000)          Year 3 Tentative Totals
 (12,000)               12,000           Reallocation
   30,000                    0           Year 3 Totals
 ( 6,000)              (24,000)          Year 4 Depreciation
   24,000              (24,000)          Year 4 Tentative Totals
 (14,000)               14,000           Reallocation
   10,000              (10,000)          Year 4 Totals
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20-6.   The following chart sets forth the partners' capital accounts after the first taxable year, assuming the allocations as specified by the partnership agreement are valid. Note that because the partnership's borrowing does not change the net worth of the partnership, it cannot affect the partners' capital accounts. *See* Reg. §1.704-1(b)(2)(iv)(c).

X	Y	Explanation
100	900	Contributions
0	0	Partnership Borrowing
(200)	(1800)	Depreciation
(100)	(900)	End of Year 1

Because neither partner has an unconditional DRO, these allocations must be checked against the alternate test for economic effect. In particular, neither partner can be allocated deductions that will drive the partner's capital account more negative than the amount of the partner's limited DRO. Under Rev. Rul. 97-38, the total DRO of the two partners combined is the excess of the debt (i.e., $9,000) over the book value of the property (i.e., $8,000), or $1,000. Thus, if the property were sold for the current book value of the property, each partner would have to make good on its DRO in full because the entire amount of each deficit is owed to the lender. Thus, X's share of the $1,000 deficit is $100, and so X's capital account can go negative by that amount; Y's share of the deficit is $900, so Y's capital account can go negative by that amount. Since no allocation drove either partner's capital account more negative than the partner's limited DRO for year, the allocations are valid.

The same analysis applies each year, resulting in the following:

X	Y	Explanation
(100)	(900)	End of Year 1
(600)	(5400)	Depreciation: Years 2-4
(700)	(6300)	End of Year 4

At this point, the property has a book value and adjusted basis of $2,000, and the debt remains at $9,000. If the property is transferred in complete satisfaction of the debt, there is income to the partnership of $7,000. In addition, each partner's limited DRO has been reduced to $0 (because there is no longer any outstanding debt, which means that neither partner now has any obligation, under the terms of the partnership agreement, to fund a DRO). Thus, the Qualified Income Offset ("QIO") provision of the partnership agreement is triggered, forcing the partnership to allocate income to X and to Y as quickly as possible to restore their capital accounts to $0 (because each now has a $0 DRO). Thus, the $7,000 of income must be allocated $700 to X and $6300 to Y, and all's right with the world! For the definition of a QIO, see Reg. §1.704-1(b)(2)(ii)(d)(6) (final paragraph).

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20-7.   The books of the PQ partnership would be as follows after two years of depreciation:

P		Q		Explanation
CA	OB	CA	OB	
10,000	10,000	10,000	6,000	Contributions
(1,000)	(1,000)	(1,000)	(200)	Year 1 Depreciation
(1,000)	(1,000)	(1,000)	(200)	Year 2 Depreciation
8,000	8,000	8,000	5,600	Year 2 Totals

When the property is sold for $8,000, there is a book gain of $2,000 and a tax gain of $4,400. (Thus, there is §704(b) gain of $2,000 and §704(c) gain of $2,400). That book and tax gain would be allocated as follows:

P		Q		Explanation
CA	OB	CA	OB	

8,000	8,000	8,000	5,600	Year 2 Totals
			2,400	Section 704(c) Gain
1,000	1,000	1,000	1,000	Section 704(b)
9,000	9,000	9,000	9,000	Totals

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20-8a   i. Using the traditional method:

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              J                        K                 Explanation
    CA            OB           CA            OB
  24,000        24,000       24,000         8,000        Contributions
( 3,000)      ( 2,000)     ( 3,000)             0        Year 1 Depreciation
( 3,000)      ( 2,000)     ( 3,000)             0        Year 2 Depreciation
( 3,000)      ( 2,000)     ( 3,000)             0        Year 3 Depreciation
( 3,000)      ( 2,000)     ( 3,000)             0        Year 4 Depreciation
      0             0            0              0        Years 5-10
  12,000        16,000       12,000         8,000        Totals
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20-8a   ii. Using the traditional method with curative allocations. Because there is no income or deductions other than the depreciation, there is nothing to generate curative allocations. Accordingly, on these facts the books will look the same whether the partnership uses the traditional method or the traditional method with curative allocations.

20-8a   iii. Using the remedial allocation method, we treat K as if she contributed two separate assets. The first asset has adjusted basis and fair market of $8,000 and a depreciable life of 4 years, and the second asset has an adjusted basis of $0, a fair market value $16,000, and a depreciable life of 10 years. Accordingly, there is book depreciation of $3,600 for years 1-4 and $1,600 for years 5-10 while there is tax depreciation of $2,000 for years 1-4 and no tax depreciation thereafter.

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              J                        K                 Explanation
    CA            OB           CA            OB
  24,000        24,000       24,000         8,000        Contributions
( 1,800)      ( 1,800)     ( 1,800)     (   200)        Year 1 Depreciation
( 1,800)      ( 1,800)     ( 1,800)     (   200)        Year 2 Depreciation
( 1,800)      ( 1,800)     ( 1,800)     (   200)        Year 3 Depreciation
( 1,800)      ( 1,800)     ( 1,800)     (   200)        Year 4 Depreciation
(   800)            0      (   800)            0        Year 5 Depreciation
      0       (   800)            0           800        Year 5 Remedy
  16,000        16,000       16,000         8,000        Totals After Year 5
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Years 6 through 10 are identical to year 5.

20-8b   i. Using the traditional method **(revision in bold)**:

J		K		Explanation
CA	OB	CA	OB	
24,000	24,000	24,000	8,000	Contributions
(3,000)	(2,000)	(3,000)	0	Year 1 Depreciation
1,000	1,000	1,000	1,000	Year 1 Income
(3,000)	(2,000)	(3,000)	0	Year 2 Depreciation
1,000	1,000	1,000	1,000	Year 2 Income
(3,000)	(2,000)	(3,000)	0	Year 3 Depreciation
1,000	1,000	1,000	1,000	Year 3 Income
(3,000)	(2,000)	(3,000)	0	Year 4 Depreciation
1,000	**1,000**	1,000	1,000	Year 4 Income/Cure
0	0	0	0	Years 5-10 Depr.
6,000	6,000	6,000	6,000	Years 5-10 Income
22,000	26,000	22,000	18,000	Totals

20-8b   ii. Using the traditional method with curative allocations:

J		K		Explanation
CA	OB	CA	OB	
24,000	24,000	24,000	8,000	Contributions
(3,000)	(2,000)	(3,000)	0	Year 1 Depreciation
1,000	0	1,000	2,000	Year 1 Income/Cure
(3,000)	(2,000)	(3,000)	0	Year 2 Depreciation
1,000	0	1,000	2,000	Year 2 Income/Cure
(3,000)	(2,000)	(3,000)	0	Year 3 Depreciation
1,000	0	1,000	2,000	Year 3 Income/Cure
(3,000)	(2,000)	(3,000)	0	Year 4 Depreciation
1,000	0	1,000	2,000	Year 4 Income/Cure
0	0	0	0	Years 5-10 Depr.
6,000	6,000	6,000	6,000	Years 5-10 Income
22,000	22,000	22,000	22,000	Totals

20-8b   iii. Using remedial allocations:

J		K		Explanation
CA	OB	CA	OB	
24,000	24,000	24,000	8,000	Contributions
(1,800)	(1,800)	(1,800)	(200)	Year 1 Depreciation
1,000	1,000	1,000	1,000	Year 1 Income
(1,800)	(1,800)	(1,800)	(200)	Year 2 Depreciation
1,000	1,000	1,000	1,000	Year 2 Income
(1,800)	(1,800)	(1,800)	(200)	Year 3 Depreciation
1,000	1,000	1,000	1,000	Year 3 Income
(1,800)	(1,800)	(1,800)	(200)	Year 4 Depreciation
1,000	1,000	1,000	1,000	Year 4 Income
(800)	0	(800)	0	Year 5 Depreciation
1,000	1,000	1,000	1,000	Year 5 Income
0	(800)	0	800	Year 5 Remedy
21,000	21,000	21,000	13,000	Totals After Year 5

20-8c   i. Using the traditional method:

J		K		Explanation
CA	OB	CA	OB	
24,000	24,000	24,000	8,000	Contributions
(3,000)	(2,000)	(3,000)	0	Year 1 Depreciation
(3,000)	(2,000)	(3,000)	0	Year 2 Depreciation
(3,000)	(2,000)	(3,000)	0	Year 3 Depreciation
(500)	(500)	(500)	(500)	Year 3 Loss
(3,000)	(2,000)	(3,000)	0	Year 4 Depreciation
(500)	(500)	(500)	(500)	Year 4 Loss
(3,000)	(3,000)	(3,000)	(3,000)	Years 5-10 Loss
8,000	12,000	8,000	4,000	Totals

20-8c   ii. Using the traditional method with curative allocations **(revision in bold)**:

J		K		Explanation
CA	OB	CA	OB	
24,000	24,000	24,000	8,000	Contributions
(3,000)	(2,000)	(3,000)	0	Year 1 Depreciation
(3,000)	(2,000)	(3,000)	0	Year 2 Depreciation
(3,000)	(2,000)	(3,000)	0	Year 3 Depreciation
(500)	(1,000)	(500)	0	Year 3 Loss/Cure
(3,000)	(2,000)	(3,000)	0	Year 4 Depreciation
(500)	(1,000)	(500)	0	Year 4 Loss/Cure
(3,000)	(3,000)	(3,000)	(3,000)	**Years 5-10 Loss**
8,000	11,000	8,000	5,000	Totals

20-8c   iii. Using the remedial allocation method:

J		K		Explanation
CA	OB	CA	OB	
24,000	24,000	24,000	8,000	Contributions
(1,800)	(1,800)	(1,800)	(200)	Year 1 Depreciation
(1,800)	(1,800)	(1,800)	(200)	Year 2 Depreciation
(1,800)	(1,800)	(1,800)	(200)	Year 3 Depreciation
(500)	(500)	(500)	(500)	Year 3 Loss
(1,800)	(1,800)	(1,800)	(200)	Year 4 Depreciation
(500)	(500)	(500)	(500)	Year 3 Loss
(800)	0	(800)	0	Year 5 Depreciation
(500)	(500)	(500)	(500)	Year 5 Loss
0	(800)	0	800	Year 5 Remedy
14,500	14,500	14,500	6,500	Totals After Year 5

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20-9. Before C is admitted, the partnership's books are:

A		B		
CA	**OB**	**CA**	**OB**	Explanation
40,000	40,000	40,000	40,000	Starting Values

While current book value of the partnership's property is $80,000, the fair market value of that property is $100,000. C should have to put in property with the same fair market value as that of A and B in order to make C an equal partner.

20-9a. Once C is admitted, we book up existing assets to fair market value and this $20,000 of book gain is allocated as per the partnership agreement. Here, we add $10,000 to both A's and B's capital account. This book-up is done under Reg. §1.704-1(b)(2)(iv)(f) -- we book up when an economic event occurs of which the partnership must take notice. We want the books to reflect the equal partnership. Once C is admitted, the books of the partnership are:

A		B		C		
CA	**OB**	**CA**	**OB**	**CA**	**OB**	Explanation
50,000	40,000	50,000	40,000	50,000	0	Book-Up

20-9b. If the partnership receives payment on the receivables, there is no book gain, because C already was credited with the $65,000 in the partnership books. There is a tax gain of $65,000, and the entire amount of that gain must be allocated to C under §704(c)(1).

C gets the deduction if the partnership pays the payables, because he already took the hit in the books. That deduction is allocable to C again under §704(c)(1).

If the partnership sells Purpleacre for $160,000, there will be book gain of $60,000 and tax gain of $80,000. The first $20,000 of book gain is already in A's and B's capital accounts ($10,000 apiece), so they must each be allocated $10,000 of tax gain as a reverse §704(c) allocation. The remainder is allocated as per the partnership agreement, one-third to each partner. Thus, the books now read:

A		B		C		
CA	OB	CA	OB	CA	OB	Explanation
50,000	40,000	50,000	40,000	50,000	0	Starting Values
0	0	0	0	0	65,000	Receivables
0	0	0	0	0	(15,000)	Payables
0	10,000	0	10,000	0	0	Pre-Admission Gain
<u>20,000</u>	<u>20,000</u>	<u>20,000</u>	<u>20,000</u>	<u>20,000</u>	<u>20,000</u>	Post-Admission Gain
70,000	70,000	70,000	70,000	70,000	70,000	Totals

20-10. Under §168(i)(7)(A), the partnership will continue (for tax purposes) to depreciate the property contributed by Y using Y's depreciation schedule (the "step-in-the-shoes" rule). Thus, the property's inside basis of $6,000 will be recovered over 5 years at a rate of $1,200 per year. Under the remedial allocation method, the partnership recovers an equal amount of book value using the same schedule but recovers the remainder of the property's book value as if newly placed in service. Thus, the "old" piece of the property yields book and tax depreciation of $1,200 per year for years 1 through 5 while the "new" piece of the property yields no tax depreciation but book depreciation of $600 per year for years 1 through 7. Combining these two pieces, there is tax depreciation of $1,200 for the first 5 years, book depreciation of $1,800 during the first 5 years, and $600 of book depreciation for years 6 and 7. Thus, after 1 year the books of the partnership become:

X		Y				
CA	OB	CA	OB			Explanation
10,200	10,200	10,200	6,000			Starting Values
(900)	(900)	(900)	(300)			Depreciation
9,300	9,300	9,300	5,700			Totals

Note that at this point the property has a book value of $8,400 and inside basis of $4,800.

After 1 year, assume Z joins the partnership as a one-third partner in exchange for a cash contribution of $9,615 because the value of the property contributed by Y now equals $9,030. (Thus, each partner's interest in the partnership is worth exactly $9,615 both before and after the admission of Z.) The partnership elects to revalue its assets and restate the capital accounts as a result of the admission of Z, and it elects to use the remedial allocation method to address the reverse-704(c) issue caused by the asset book-up.

The reverse-704(c) layer addresses the variation between the book value of the property immediately before Z joins (that is, $8,400) and the restated book value immediately thereafter (that is, $9,030). Thus, the amount of the reverse-704(c) layer is $630. Under the remedial allocation method, the property is now divided into three pieces: the "old" piece having adjusted basis and book value of $4,800, recovered over the next 4 years; the "new" piece having a book value of $3,600 and a $0 adjusted basis, recovered over the next 6 years, and the "really new" piece having a book value of $630 and a zero adjusted basis, recovered over 7 years (that is, over years 2-8). Combining these three pieces, we get the following: for years 2-5, there is book depreciation of $1,890 per year and tax depreciation of $1,200 per year. For years 6-7, there is book depreciation of $690 per year and no tax depreciation, and for year 8 there is book depreciation of $90 and no tax depreciation. In each year the book depreciation is shared equally among the partners because they have agreed to be equal partners.

Allocation of Tax Depreciation: Year 2

	X's Share	Y's Share	Z's Share	Total
Old Piece	(400)	(400)	(400)	(1,200)
New Piece	(200)	400	(200)	0
Really New Piece	15	15	(30)	0
Totals	(585)	15	(630)	(1,200)

X should receive tax depreciation equal to a full one-third share of the pre-restated book value of the property, or $600. Netting this against X's share of the remedial allocation of $15 from the reverse-704(c) layer, this means X should get a net tax depreciation allocation of $585. But after Z's share of $630 there is only $570 of tax depreciation remaining. As a result, there must be a remedial allocation of deduction of $15 to X and offsetting income to Y of $15. Multiplying these numbers by 4 to get the results for years 2-5 yields:

X		Y		Z		
CA	OB	CA	OB	CA	OB	Explanation
9,615	9,300	9,615	5,700	9,615	9,615	After Year 1
(2,520)	(2,340)	(2,520)	(0)	(2,520)	(2,520)	Years 2-5 Depreciation
0	(0)	0	60	0	0	Years 2-5 Remedial allocations
7,095	6,960	7,095	5,760	7,095	7,095	Totals After Year 5

In each of years 6 and 7, the book depreciation of $690 is allocated $230 to each partner. Since there is no tax depreciation, there is a remedial allocation of $230 of depreciation (per year) to Z, of which $200 is from the 740(c) layer and $30 is from the reverse-704(c) layer. X should get a full tax share of the 704(c) layer, or $200, less one-half of Z's remedial allocation from the reverse-704(c) layer, for a net allocation depreciation of $185. Because there is no tax depreciation to the partnership in this year, that means X get a remedial allocation of deduction of $185. Y therefore must receive a remedial allocation of income of $230 + $185, or $215.

Allocation of Tax Depreciation: Year 6

	X's Share	Y's Share	Z's Share	Total
New Piece	(200)	400	(200)	0
Really New Piece	15	15	(30)	0
Totals	(185)	415	(230)	0

Multiplying these number by 2 to get the results for years 6 and 7 yields:

X		Y		Z		
CA	OB	CA	OB	CA	OB	Explanation
7,095	6,960	7,095	5,760	7,095	7,095	After Year 5
(460)	0	(460)	0	(460)	0	Years 6-7 Depreciation
0	(370)	0	830	0	(460)	Years 6-7 Remedial allocations
6,635	6,590	6,635	6,590	6,635	6,635	Totals After Year 7

In year 8, the book depreciation of $90 is allocated $30 to each partner. Because there is no tax depreciation, there is a remedial allocation of $30 of depreciation to Z as well as remedial allocations of $15 of income to both X and Y. (Thus, Z gets a full tax share of book depreciation, and X and Y split paying for it.)

X		Y		Z		
CA	OB	CA	OB	CA	OB	Explanation
6,635	6,590	6,635	6,590	6,635	6,635	After Year 7
(30)	0	(30)	0	(30)	0	Year 8 Depreciation
0	15	0	15	0	(30)	Year 8 Remedial allocations
6,605	6,605	6,605	6,605	6,605	6,605	Totals After Year

Problem 20-11, page 643

20-11. The facts of the problem do not make clear how the partners mean the term "profit" when they say that the first $200,00 of "profit" will be allocated 90/10. I assume that they mean the net profit from the venture, so that there is an appropriate gain chargeback in their agreement (taking into account the operating cash flow). I also assume that the cash distribution in year 2 could not have been reasonably anticipated in year 1. When the property is sold for $2,000,000, it will have a book value to the partnership of $1,140,000, producing a book gain of $860,000. Of that amount, $360,000 should be subject to the gain chargeback, $160,000 should be allocated 90/10 to reflect L's preferred position under the agreement, and the remainder of $340,000 should be allocated equally between the partners as provided for in their agreement. When the partnership

liquidates, it should have funds representing its economic profit of $500,000 from the sale of the property as well as its $40,000 positive cash flow from operations, for a total of $540,000. Thus:

	L	G		Minimum Gain
	L	G		Minimum Gain
Formation	90,000	10,000		
year 1	0	0	Debt	
	135,000	15,000	Rents	
	(126,000)	(14,000)	Interest	
	(81,000)	(9,000)	Depreciation	
	18,000	2,000		90,000
year 2	135,000	15,000	Rents	
	(126,000)	(14,000)	Interest	
	(90,000)	(10,000)	Distribution	
	(81,000)	(9,000)	Depreciation	
	(144,000)	(16,000)		180,000
year 3	135,000	15,000	Rents	
	(126,000)	(14,000)	Interest	
	(81,000)	(9,000)	Depreciation	
	(216,000)	(24,000)		270,000
year 4	135,000	15,000	Rents	
	(126,000)	(14,000)	Interest	
	(81,000)	(9,000)	Depreciation	
	(288,000)	(32,000)		360,000
year 5	324,000	36,000	gain chargeback	
	144,000	16,000	90/10 gain	
	170,000	170,000	50/50 gain	
	350,000	190,000		0

Notes: (1) If the distribution could have been anticipated in year 1, there would be no change except that L's capital account would start at $0 instead of $90,000; (2) At the end

of each year, L's capital account deficit cannot be more negative that L's share of the partnership's minimum gain.

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20-12a. The books of the partners immediately prior to the sale would be:

L	M	Explanation
10,000	10,000	Contributions
1,500	1,500	Year 1 Income
(4,000)	0	Year 1 Depreciation
7,500	11,500	Year 1 Totals
1,500	1,500	Year 2 Income
(4,000)	0	Year 2 Depreciation
5,000	13,000	Year 2 Totals

At this point, the partnership has cash of $6,000 and machinery with book value and adjusted basis of $12,000. Sale for $28,000 therefore produces book and tax gain of $16,000. Of this amount, $8,000 is first allocated to L under the gain chargeback provision and the remaining gain of $8,000 is allocated $4,000 to each partner. Further, because disposition of the machinery is subject to depreciation recapture under §1245, L must report ordinary income of $8,000. Thus, L reports ordinary income of $8,000 and capital gain (actually §1231 gain) of $4,000, while M reports only $4,000 of capital gain (actually §1231 gain). Each partner's capital count equals $17,000.

20-12b. If the partnership agreement does not include a gain chargeback and the property is sold for $22,000, then there is book gain of $10,000, allocated equally between the partners (i.e., $5,000 to each partner). Of that gain, $8,000 is recaptured under §1245 as ordinary income and the remainder is §1231 gain. All of L's income is ordinary while G has $3,000 of ordinary income and $2,000 of §1231 gain.

20-12c. The tax credit must be allocated according to the partners' general interest in the partnership. Presumably this would be 50%/50% because of the general sharing (other than cost recovery); the gain chargeback further supports a general 50%/50% relationship.

20-13. Without the contribution, the partnership would not be permitted to revalue its assets and restate capital accounts. As a result, the disproportionate allocation of the cancellation of indebtedness income would be valid because it would not be offset by any other allocation. This would be true even if the partners also agreed to offset the cancellation of indebtedness allocation by a subsequent allocation of dispositional loss

from the partnership's property because, under the misnamed "value equals basis" rule, there is a conclusive presumption that the partnership's assets are worth book value. Thus, without the revaluation, the partnership is able to do what could not be done on the actual facts in Rev. Rul. 99-43. *See generally* Howard E. Abrams, *Adding a Cash Partner to an Operating Partnership, 4* Business Entities 38, 38-40 (March/April 2002).

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20-14. Yes and no. D cannot be allocated any of the partnership's deductions that accrued prior to D's admission. Suppose, however, that D is allocated exactly one-third of the partnership's income and deductions from the period after D joins and nothing from the period prior to D's admission. D's share of the partnership's income and deductions will equal one-third of three-quarters (nine months being three-quarters of the year), or one-quarter, exactly what the partners desire. Note that the other partners will each be allocated one-third of the income and deductions for the first three months of the year and two-ninths of the income and deductions from the last none months.

20-15. No, the partnership cannot allocate to T the entire $60,000 interest deduction. It can only give T the interest that accrued after T joined the partnership. Interest is a cash-basis item that must be prorated. §706(d)(2). Note that the same result is achieved by applying §704(c)(1)(A) principles upon the admission of T to force the partnership to book its assets (including cash-basis items of income and deduction) to fair market value.

In December, the partnership will have $8,000 in income, $6,000 in deductions and $60,000 interest payment. Therefore, the partnership could allocate to T the $6,000 in deductions and one-twelfth the interest payment. None of the December income need be allocated to C.