

- 21-1a. With the zero-value sale, there is a book loss of \$100,000, which is the partnership's basis in the property. Both E and F get \$50,000 of loss as per the partnership agreement, which states that the partners will share losses equally. This leaves both E's and F's capital accounts at a hypothetical balance of (\$30,000). This hypothetical zero-value sale and liquidation shows that both E and F will get \$30,000 of debt added to their outside bases.
- 21-1(b). If the losses are allocated 90 percent to E and 10 percent to F: The book loss of \$100,000 is split according to the hypothetical zero-value sale and liquidation, \$90,000 into E's capital account and \$10,000 into F's capital account. This leaves E with a balance of (\$70,000) and F with a balance of \$10,000. Therefore, the entire \$60,000 debt goes into E's outside basis, leaving E with a total of \$80,000. E gets all the debt under the §752 regulations, although, according to the partnership agreement, seemingly F should get 10 percent.
- 21-1c. If F is a limited partner who cannot be required to contribute more than an additional \$10,000, the loss of \$100,000 in the zero-value liquidation is allocated \$30,000 to F (because that is \$10,000 more than F's current capital account, which is F's limit on additional contributions). Therefore, the remaining \$70,000 is allocated to E, leaving E with a balance of (\$50,000) and F with a balance of (\$10,000). This shows that E will have \$50,000 added to his outside basis for a total of \$70,000, and F will have \$10,000 added to her outside basis for a total of \$30,000.
- 21-1d. This is the same as 1(a). The guarantee means the lender can go after the guarantor for the debt, and the guarantor can turn to the other partners for reimbursement. The effect of the guarantee to the partnership is zero: either the partnership pays the lender or it pays the guarantor after the guarantor pays the lender. This does not affect the partners' ultimate liability.
- 21-1e. The lender can go after E for payment of the debt, but, because the loan is nonrecourse, E cannot go after the other partners. Therefore, the entire debt goes to E because she bears the ultimate risk of loss.
- 21-2a. Following a hypothetical zero-value liquidation, the debt is allocated 50-50, so each gets \$40,000.
- 21-2b. B is a "related person" under the regulations. Regs. §1.752-4(b) states that the definition of related persons under §267 is to be used for §752 purposes, but changes, among other things, the percentage of capital interest one must have to be considered an insider. Under the §752 regulations, that percentage is 80 percent. Therefore, B gets the entire debt.
- 21-2c. Neither A nor B is a "related person", so R is treated as an unrelated entity. Although R is wholly owned by the partners, neither meets the 80 percent rule. Thus, the loan is treated as a true nonrecourse loan, and is allocated according to the nonrecourse loan rules. Because we do not know how the partners share profits, we do not know how the loan should be allocated.
- 21-3a. Prior to any debt reallocation, the opening books will be:

P		Q		
CA	OB	CA	OB	
4,000	4,000	6,000	6,000	Formation

Because the debt is nonrecourse, it is allocated according to the three tiers. Under tier 1, there is no minimum gain because the debt of \$6,000 does not exceed the \$10,000 book-value of the property. Thus, no part of the debt is allocable under tier 1.

Under tier 2, we ask how much gain would be allocable to the partners under §704(c)(1)(A) if the property were sold for the amount of the debt and no other consideration. If the property were sold for \$6,000, there would be a book loss of \$4,000 but a tax gain of \$2,000. This book loss would be allocated \$1,600 to P and \$2,400 to Q and the entire tax gain is allocable to P. This implicates the ceiling limitation under 704(c)(1)(A). If the partners agree to address ceiling limitations from this property using the traditional method or using the traditional method with curative allocations, there is \$2,000 of gain allocable to P under tier 2. If they agree to use the remedial allocation method, there will be income of \$4,400 to P under tier 2 (dispositional gain of \$2,000 plus remedial allocation of \$2,400). The remainder of the debt can be allocated according to the partners' profits interests (that is, 40% to P and 60% to Q) or the remainder of the debt can be allocated to P to account for built-in gain not reflected in tier 2 (i.e., \$2,000 if remedial allocations are not used and \$1,600 if they are used). *Assuming the partners use the remedial allocation method and do not account for additional built-in gain in tier 3, the remainder of the debt is \$1,600, and that is allocated \$640 to P and \$960 to Q. Thus, assuming the partners use the remedial allocation method and general profits interests only in tier 3, the debt is allocated \$5,040 to P and \$960 to Q. That is a debt reduction of \$960 for P and a debt increase of \$960 for Q. Accordingly, the books become:*

P		Q		
CA	OB	CA	OB	
4,000	4,000	6,000	6,000	Formation
0	(960)	0	960	Debt Reallocation
<u>4,000</u>	<u>3,040</u>	<u>6,000</u>	<u>6,960</u>	After Reallocation

But what if the partners had elected not to use the remedial allocation method? In that case, the amount of the debt allocated under tier 2 would be only \$2,000, allocable entirely to P. That would leave \$4,000 of the debt for tier 3, allocable \$1,600 (i.e., 40%) to P and \$2,400 (i.e., 60%) to Q. Thus, the debt would be allocated \$3,600 to P and \$2,400 to Q, for a net reallocation of \$2,400 from P to Q. Accordingly, the books of the partnership would become:

P		Q		
CA	OB	CA	OB	
4,000	4,000	6,000	6,000	Formation
0	(2,400)	0	2,400	Debt Reallocation
<u>4,000</u>	<u>1,600</u>	<u>6,000</u>	<u>8,400</u>	After Reallocation

- 21-3b. The property's remaining depreciable life is 5 years while it would have a 10-year useful life if newly purchased. Using the remedial allocation method, we recover the book value

of the property in two pieces: a continuing piece of \$4,000 recovered over the remaining 5 years and a new piece of \$6,000 recovered over 10 years. Using the straight-line method of recovery, that means there is book depreciation in year 1 of \$1,400 (\$800 from the continuing piece and \$600 from the new piece), while there is tax depreciation of only \$800 (all from the continuing piece). Under the terms of the partnership agreement, this book depreciation is allocated equally between the partners, \$700 each. The noncontributing partner (that is, Q) gets tax depreciation equal to book depreciation, while P as the contributing partner gets tax the remaining tax depreciation of \$100. (Note that there is no need of a remedial allocation in this year because there is sufficient tax depreciation to cover the book depreciation allocated to the non-contributing partner.) Accordingly, after one year *but prior to any debt reallocation*, the books of the partnership read:

P		Q		
CA	OB	CA	OB	
4,000	3,040	6,000	6,960	Starting Values
(700)	(100)	(700)	(700)	Depreciations
<u>3,300</u>	<u>2,940</u>	<u>5,300</u>	<u>6,260</u>	After Depreciation

At this point, the property has a book value of \$8,600, an adjusted basis to the partnership of \$3,200, and remains encumbered by a debt of \$6,000. Once again there is no tier 1 allocation because there is no partnership minimum gain. Under tier 2, we ask how much income would be allocable under §704(c)(1)(A) if the property were sold for the debt and for no other consideration. Here, a sale for \$6,000 would produce a book loss of \$2,600 and a tax gain of \$2,800. The book loss would be allocated \$1,040 to P and \$1,560 to Q, requiring a remedial allocation of \$1,560 of deduction to Q and an offsetting remedial allocation of \$1,560 of income to P. Thus, \$4,360 (\$2,800 + \$1,560) of the debt is allocable to P under tier 2. The \$1,640 remainder of the debt is allocated 40% (or \$656) to P and 60% (or \$984) to Q if they use general profits interests. Accordingly, P's total share of the debt is now \$5,016 and Q's share of the debt is now \$984. Since P's share of the debt used to be \$5,040, P's share of the debt has decreased by \$24. Equivalently, Q's share of the debt has increased from \$960 to \$984, for an increase of \$24. Accordingly, the books of the partnership become:

P		Q		
CA	OB	CA	OB	
3,300	2,940	5,300	6,260	Prior Reallocation
0	(24)	0	24	Debt Reallocation
<u>3,300</u>	<u>2,916</u>	<u>5,300</u>	<u>6,284</u>	End of Year 2

Of course, if the partners do not use the remedial allocation method, the result would be different. Under this assumption, recall that the books of the partnership after formation are:

P		Q		
CA	OB	CA	OB	
4,000	4,000	6,000	6,000	Formation
0	(2,400)	0	2,400	Debt Reallocation
<u>4,000</u>	<u>1,600</u>	<u>6,000</u>	<u>8,400</u>	After Reallocation

There is annual book depreciation of \$2,000 and tax depreciation of \$800. The book depreciation is allocated equally between the two partners. Under 704(c)(1)(A), all the tax depreciation must be allocated to Q as the non-contributing partner. (Because we have assumed that the partners are not using the remedial allocation method to address ceiling limitations issues, there are no further tax consequences of the depreciation). Accordingly, after one year but prior to any debt reallocation, the books of the partnership read:

P		Q		
CA	OB	CA	OB	
4,000	1,600	6,000	8,400	Starting Values
(1,000)	0	(1,000)	(800)	Depreciation
<u>3,000</u>	<u>1,600</u>	<u>5,000</u>	<u>7,600</u>	After Depreciation

There is still no debt allocation under tier 1 because there is no minimum gain. The adjusted basis of the property is now \$3,200, so that if the property were sold for the amount of the debt and nothing else, there would be gain of \$2,800, allocable entirely to P under §704(c)(1)(A), so that defines the tier 2 allocation. The \$3,200 remainder of the debt would go 40% to P (i.e., \$1,280) and 60% to Q (i.e., \$1,920) assuming they use general profits interests, so P's total share of the debt is now \$4,080 and Q's share of the debt is now \$1,920, and this reflects a reallocation of \$480 of the debt away from Q and back to P. Accordingly, the books of the partnership become:

P		Q		
CA	OB	CA	OB	
3,000	1,600	5,000	7,600	Prior to Debt Realloc.
0	480	0	(480)	Debt Reallocation
<u>3,000</u>	<u>2,080</u>	<u>5,000</u>	<u>7,120</u>	End of Year 2

What if the debt had been with recourse (and assuming the partnership does not use the remedial allocation method)?

It begins the same. Prior to any debt reallocation, the opening books will be:

P		Q		
CA	OB	CA	OB	
4,000	4,000	6,000	6,000	Formation

A zero-value sale will produce a book loss of \$16,000, allocable 40% (or \$6,400) to P and 60% (or \$9,600) to Q. This will give P a negative capital account of (2,400) and will give Q a negative capital account of (\$3,600), so that is the proportions in which P and Q share the debt once the partnership is formed. Because the debt was entirely P's prior to formation, the effect of formation of the partnership in allocation of the debt is to shift \$3,600 away from P and to Q. Accordingly, the books become:

P		Q		
CA	OB	CA	OB	
4,000	4,000	6,000	6,000	Formation
0	(3,600)	0	3,600	Debt Reallocation
<u>4,000</u>	<u>400</u>	<u>6,000</u>	<u>9,600</u>	End of Year 1

21-3b. After one year of depreciation but prior to any new debt reallocation, the books will be:

P		Q		
CA	OB	CA	OB	
4,000	400	6,000	9,600	Beginning of Year 2
(1,000)	0	(1,000)	(800)	Depreciation
3,000	400	5,000	8,800	Tentative Total

At this point, a zero-value sale will produce a book loss of \$14,000, allocable 40% (or \$5,600) to P and 60% (or \$8,400) to Q. This will give P a negative capital account of (\$2,600) and Q a negative capital account of (\$3,400), so the partners now share the debt in that proportion. This represents a shift of \$200 away from Q and to P as compared with the sharing at the beginning of the year. Accordingly, the books become:

P		Q		
CA	OB	CA	OB	
3,000	400	5,000	8,800	Tentative Total
0	200	0	(200)	Debt Reallocation
3,000	600	5,000	8,600	End of Year 2

21-4. Of the \$18,000 nonrecourse liability, none is allocated under tier 1, \$3,000 is allocated under tier 2 to partner Z, and the remaining \$15,000 is allocated among the partners as they share income under tier 3. (Note: the tier 2 allocation is based on the assumption that the partnership does not use remedial allocation if the property is sold for \$18,000. If remedial allocations were used, then the tier 2 allocation to Z would equal \$4,500. Note also that the tier 3 allocation is based on the assumption that all tier 3 debt is allocated based on general profit interests.) Accordingly, 75% of \$15,000, or \$11,250, of the debt is allocated away from partner Z and to partners X and Y (one-half each). This reallocation of the debt will increase X and Y's outside bases to \$8,625 each, while Z's initial outside basis will equal \$3,750. In tabular form, the allocation of the debt is:

	X	Y	Z	Total
Tier 1	0	0	0	0
Tier 2	0	0	3,000	3,000
Tier 3	5,625	5,625	3,750	15,000
Total	5,625	5,625	6,750	18,000

X		Y		Z	
CA	OB	CA	OB	CA	OB
3,000	3,000	3,000	3,000	2,000	15,000
0	5,625	0	5,625	0	(11,250)
3,000	8,625	3,000	8,625	2,000	3,750

If there is tax depreciation of \$6,000, there is book depreciation \$8,000 (because the ratio of tax depreciation to adjusted basis must equal the ratio of book depreciation to book value). Of that book depreciation, \$3,000 is allocated to X, \$3,000 is allocated to Y, and \$2,000 is allocated to Z under the partnership agreement. Partners X and Y get tax depreciation equal to book depreciation, leaving no tax depreciation for partner Z. Thus,

after the depreciation deduction and prior to any reallocation of the debt under §752, the books stand as follows:

X		Y		Z	
CA	OB	CA	OB	CA	OB
3,000	8,625	3,000	8,625	2,000	3,750
(3,000)	(3,000)	(3,000)	(3,000)	(2,000)	0
0	5,625	0	5,625	0	3,750

The book value of the property is now \$12,000 while the debt is \$18,000, so there is \$6,000 of partnership minimum gain. Accordingly, \$6,000 of the debt must be allocated under tier 1 as the partners shared the nonrecourse deductions. The adjusted basis of the machinery is now \$9,000 while its book value is \$12,000, so \$3,000 of the debt must be allocated to Z under tier 2. The remaining \$9,000 of the debt is then allocable according to the partners' profits interests under tier 3. Thus, the debt is now allocated as follows:

	X	Y	Z	Total
Tier 1	2,250	2,250	1,500	6,000
Tier 2	0	0	3,000	3,000
Tier 3	3,375	3,375	2,250	9,000
Total	5,625	5,625	6,750	18,000

The partners continue to share the debt as they did prior to the depreciation, and so there is no reallocation under §752. This example assumes that the partners have not agreed to use the remedial allocation method for making §704(c) allocations.

You might want an additional problem on the nonrecourse debt rules. If so, here is one:

X and Y each contribute \$100 to the XYZ partnership in exchange for a 50% interest in profits and losses. XYZ then purchases depreciable property for \$1,000, paying cash of \$200 and signing a nonrecourse note for \$800. Assume the property is depreciable over 4 years using the straight-line method, and ignore the mid-year convention.

On the first day of the second taxable year, Z joins the partnership by contributing cash of \$10 in exchange for a 20% share of profit and loss, with Y and Z reducing their shares down to 40% each. The partnership elects to revalue its assets and restate capital accounts immediately prior to the admission of Z; at that time, the property is worth \$840.

Compute the books of the partnership at the close of the partnership's second taxable year. Assume the partnership does not use any "tier 3A" allocation of the debt and does NOT use remedial allocations in connection with the reverse-704(c) (i.e., book-up) layer.

The answer is:

Answer Assuming An Election to Use Tier "3A"
 (Note: No Tier "3A" Possible In Year 2)

X		Y		Z		
CA	OB	CA	OB	CA	OB	
\$ 100	\$ 100	\$ 100	\$ 100	\$	\$	Formation
	400		400			Borrowing
(125)	(125)	(125)	(125)			Depreciation
45	0	45	0			Book-up
				10	10	Z's cash
0	(71)	0	(71)	0	142	Debt shift
(112)	(97)	(112)	(97)	(56)	(56)	Depreciation
<u>0</u>	<u>(3)</u>	<u>0</u>	<u>(3)</u>	<u>0</u>	<u>6</u>	Debt Shift
(\$ 92)	\$ 204	(\$ 92)	\$ 204	(\$ 46)	\$ 102	Total

Answer Assuming An Election Not to Use Tier "3A"

X		Y		Z		
CA	OB	CA	OB	CA	OB	
\$ 100	\$ 100	\$ 100	\$ 100	\$	\$	Formation
	400		400			Borrowing
(125)	(125)	(125)	(125)			Depreciation
45	0	45	0			Book-up
				10	10	Z's cash
0	(75)	0	(75)	0	150	Debt shift
(112)	(97)	(112)	(97)	(56)	(56)	Depreciation
<u>0</u>	<u>1</u>	<u>0</u>	<u>1</u>	<u>0</u>	<u>(2)</u>	Debt Shift
(\$ 92)	\$ 204	(\$ 92)	\$ 204	(\$ 46)	\$ 102	Total

Asset	Book	Basis	Debt
Property	\$560	\$500	(800)
Cash	10	10	0

	96	96	48	Total
Tier 1	96	96	48	240
Tier 2	30	30	0	60
Tier 3	<u>200</u>	<u>200</u>	<u>100</u>	<u>500</u>
Total	326	326	148	800