23-1a. A reports as ordinary income the $10,000 guaranteed payment. Both A and B have taxable income of $50,000 because they split profits and losses of the partnership equally. If the income is long-term capital gain, A and B each include of capital gain. A also gets $10,000 in ordinary income, the partnership gets a $10,000 deduction for the payment to A, and this deduction is split $5,000 to A and $5,000 to B.

23-1b. The partnership has $10,000 of deduction, and A and B split it equally, as per the partnership agreement. A still must include the guaranteed payment as ordinary income on her individual tax return.

If the payment is not made until the middle of next year, A's inclusion and the partnership's deduction must occur in the same taxable year. If the payment is described in §707(a)(1), the deduction and inclusion occur next year (A's taxable year) under §267(a)(2). If it is a payment under §707(c), the deduction and inclusion occur this year (when the obligation accrues to the partnership. Treas. Reg. §1.707-1(c)).

23-1c. A gets $10,000 in ordinary income, but A also gets a $10,000 deduction; the two allocations net. Therefore, A reports only the $50,000 distributive share of partnership income.

23-2. The partnership has a gain of $80 on the distribution, which is allocated $40 to E and $40 to F. If the payment to E for E's services was an ordinary and necessary business expense (and therefore deductible to the partnership), the partnership would deduct $100, with $50 of the deduction allocated to E and $50 to F. Regardless of the deductibility to the partnership, E must include $100 in income. If the payment to E was deductible, the partner's final capital account balances will stand at $50 each, and so they will split the available $100. If the payment was not deductible, the partnership has some capitalized asset (going-concern perhaps) worth $100, and final capital account balances of $100 each. Each partner should receive $100 in value, with both $100 of cash and $100 of capitalized asset to distribute. If there is no going concern value, the capitalized asset should be booked down to $0 prior to the distribution, *see* Treas. Reg. §1.704-1(b)(2)(iv)(e)(1), leaving final capital account balances at $50 each and $100 in cash to be distributed.

23-3a. Because the contribution and distribution occur within 2 years, they are presumed to be related. That they in fact occurred only one day apart further justifies treating the distribution and contribution as parts of a single, related transaction. Accordingly, under §707(a)(2)(B), we tax the two transactions as a sale under §707(a)(1). Because the amount of the distribution is less than the fair market value of the contributed property, we treat the transaction as a part sale, part contribution. *See* Reg. §1.707-3(f) (ex. 1). The amount of the distribution is one-half of the fair market value of the contributed property, so we allocate one-half of Z's pre-contribution basis in the contributed property to the sale component and the remaining one-half to the contribution. Thus, Z must recognize income of $30,000 on the disguised sale (amount realized of $50,000 less allocable basis of $20,000), Z's outside basis begins at $20,000 (the portion of Z's basis in the property allocable to the contributed portion of the property), and Z's capital account begins at $50,000 (the fair market value of the contributed portion of the property). The partnership's initial basis in the property equals $70,000, of which $50,000 is the cost portion from the disguised sale and $20,000 is the carry-over portion from the contribution.

23-3b. Assuming that the contribution and distribution are still treated as related under §707(a)(2)(B) and so are treated as a disguised sale taxable under §707(a)(1), because the deemed sale price is paid more than 6 months after the transfer and does not bear interest, the sale price must be redetermined to account for implicit (unstated) interest. Assuming the appropriate interest rate is 10% per annum, compounded semi-annually, the redetermined sale price equals about $45,000. Accordingly, Z is treated as selling only about 45% of the property and of contributing the remaining 55%. On the sale component, the amount realized equals $45,000 and Z's allocable basis equals $18,000 (45% of $40,000), so that Z's gain equals $27,000. Z's capital account begins at $55,000, and Z's outside basis begins at $22,000. The partnership's basis in the property equals $67,000, of which the cost portion is $45,000 and the contribution portion equals $22,000. *See* Reg. §1.707-3(f) (ex. 2). Thus, the qualitative effect of the delay in distribution is to reduce the deemed amount realized, and that in turn decreases the sale component of the transaction and increases the contribution component.

Note: the implicit interest paid by the partnership generates an interest deduction under §163. If that deduction is not allocated entirely to the contributing partner (that is, to Z), the disguised sale will skew the economics of the partnership. Put another way, the noncontributing partners should not be affected by the disguised sale transaction, and so they should not be allocated any portion of the disguised sale interest deduction. This is discussed at pages 691-693 of the text.

23-4. **[Revised]** If the debt is a "qualified liability," then there is no disguised sale and Q's capital account begins at $800,000 and Q's outside basis begins at $500,000 (assuming the liability is allocable half to P and half to Q). P's capital account begins at $800,000 and P's outside basis begins at $1,200,000 (making the same debt assumption as above). The partnership's adjusted basis in the contributed property equals $900,000 and its book value equals $1,600,000. P has a forward §704(c) layer of $700,000.

If the debt is not a "qualified liability," then Q is treated as selling one-quarter of the property to the partnership (because the about realized equals the amount of the debt shifted to P, or $400,000, and that equals one-quarter of the value of the property). Note that the amount of the debt treated as shifting to P is equal to the amount that shifts under the §752 debt allocation rules if the debt is a recourse debt to the partner. But because the debt is a nonrecourse debt, the amount treated as shifting for purposes of §707(a)(2)(B) is the amount allocable to P only under the third-tier for allocation of nonrecourse deductions, and in using the third tier rule the ability to allocate excess §704(c) gain is excluded.

If there is a deemed sale of one-quarter of the property, then Q recognizes a gain of $175,000, that being the excess of Q's amount realized of $400,000 over the portion of Q's adjusted basis allocable to the portion of the property sold (that is, one-quarter of $900,000, or $225,000). The remainder of the property is treated as contributed to the partnership (that is, three-quarter's of the property with three-quarter's of the adjusted basis and subject to the $400,000 of unshifted debt). Accordingly, Q's capital account begins at $800,000 and Q's outside basis at $675,000 (carryover basis of $675,000 less debt contributed to the partnership of $400,000 on the contribution plus partnership debt share of $400,000). As before, P's capital account equals $800,000 and P's outside basis equals $1,200,000. Note that the disguised sale does not affect the relative capital accounts. This must be true: the disguised sale affects Q's taxes but does not affect the economics of the underlying venture. Note also that the property has an inside basis to the partnership of $1,075,000 and a book-value of $1,600,000; there is a forward §704(c) layer to Q of $525,000.

The partnership's debt now must be allocated between P and Q in accordance with the debt allocation rules of §752. Because this is nonrecourse debt, we use the three tiers of Reg. §1.752-3(a). Here, the tier 1 amount is $0 because the debt is less than the book value of the property. The tier 2 amount also is zero unless the partnership uses remedial allocations with respect to the property. If the partnership uses remedials, then the tier 2 allocation to Q equals $125,000. The optional tier 3A amount is $525,000 if remedials are not used and $400,000 if remedials are used. The tier 3B amount equals $800,000 if neither remedials nor tier 3A is used. The tier 3B will be less if other choices are made.

23-5a. Because the value of the contributed property exceeds 120% of its adjusted basis, no more than 20% of its value (that is, 20% of $5,000,000, or $1,000,000) can be reimbursed without implicating the disguised sale rules.

23-5b. To avoid this limitation, the construction should have been funded with debt and then the property, subject to the debt, could be contributed to the partnership without triggering a disguised sale because the debt is a "qualified liability" under Reg. §1.707-5(a)(6)(i)(C) (liability allocable under the rules of Reg. §1.163-8T to capital expenditures with respect to the property).

23-6. Under §704(c)(1)(B), we must determine what would have been the tax consequences if the partnership had sold the property for its fair market value instead of distributing it to Q. Such a sale would produce a gain of $5,200, of which $3,200 would be allocable to P under §704(c)(1)(A). This $3,200 is taxable to P under §704(c)(1)(B) as in part (a) above, and it produces the same double basis increase. See §704(c)(1)(B)(iii).

Accordingly, after application of §704(c)(1)(B), the property has a book value of $8,000 as well as a tax basis of $8,000. Whenever property is distributed, it must be booked to current fair market value prior to the distribution. Reg. §1.704-1(b)(2)(iv)(e)(1). This book up is independent of the application of §704(c)(1)(B). Thus, the property is booked to $10,000, and this new $2,000 of book value is allocated among the partners as they would share such gain. Here, that means each partner's capital account is increased by $1,000, because P and Q have agreed to be equal partners. When the property is distributed (now having a tax basis of $8,000 and a book value of $10,000), there is no gain or loss to Q. See §731. Q takes the property with an adjusted basis of $8,000, §732(a)(1), she reduces her outside basis to $1,000, §733(2), and she reduces her capital account to $0, Treas. Reg. §1.704-1(b)(2)(iv)(e)(1). These adjustments go into the partnership's books as follows:

P CA	P OB	Q CA	Q OB	
10,000	6,000	10,000	10,000	Starting Values
(1,000)	(200)	(1,000)	(1,000)	Depreciation
0	3,200	0	0	§704(c)(1)(B)
1,000	0	1,000	0	Revaluation
0	0	(10,000)	(8,000)	Distribution
10,000	9,000	0	1,000	Totals

The reverse §704(c) problem was caused by distributing appreciated property (appreciated in the sense that fair market value exceeds book value) other than in proportion to the way in which such appreciation was allocated among the partners. Here, the unrealized book appreciation was $2,000, allocated equally between P and Q, but Q received the entire property, so Q's capital account was reduced by the entire fair market value of the property.

If the property is worth $12,000, then the only changes are (1) there is an additional $2,000 when the property is booked to fair market value and (2) the amount booked out of Q's capital account is $12,000 rather than $10,000. If the property is worth $4,000, then a hypothetical sale of the distributed property would yield a book loss of $4,000 and a tax loss of $800. Because there is no tax loss in excess of book loss, there is no tax loss that would be allocable under §704(c)(1)(A). (Note that this answer would change if the partnership elected to use remedial allocations.) The property must be booked down to fair market value and then booked out of the distributee partner's capital account.

23-7a. Section §704(c)(1)(B) continues to apply to P as before, but now §737 applies to Q as well. Under §737, Q recognizes the lesser of (1) precontribution gain in the property Q contributed or (2) the fair market value of the property distributed less Q's predistribution outside basis. Here, the precontribution gain in the property contributed by Q is $8,000, the fair market value of the distributed property is $10,000, and Q's outside basis equals is $1,000 (initial value of $2,000 less depreciation of $1,000). Accordingly, Q has income of $8,000 under 737. There is no effect on Q's capital account.

As a consequence of this income to Q, there are two basis adjustments. First, we add the $8,000 income to Q's outside basis, increasing it to $9,000. Second, we increase the basis of the property that was contributed by Q by the same amount, so that its basis increases from $2,000 to $10,000.

Next, we apply §§731-33 to the distribution to Q. There is no gain under §731. Under §732(a)(1), Q takes a basis of $8,000 in the distributed property. And under §733(2), Q's outside basis is then reduced by $8,000 down to $1,000 under §733. The distributed property must be booked up to fair market value, increasing each partner's capital account by $1,000. The Q's capital account is reduced by the fair market value of the property (that is, by $10,000), down to $0.

(Note: rework this problem, assuming that the partnership borrows $20,000 prior to the distribution and then repays the loan subsequent to the distribution. Does the existence of the loan affect the taxation to P under §704(c)(1)(B)? Does the existence of the loan affect the taxation to Q under §737? Under any other provision?)

23-7b. If the property contributed by Q had had an adjusted basis of $9,000 rather than $2,000, the gain recognized under §737 to Q would be limited to $1,000 under §737(a)(1). Sections 704(c)(1)(B) and 731-733 continue to apply.

23-7c. If the partnership borrows $20,000 of which half is allocated to Q, then Q avoids the gain recognition under §737 because Q's outside basis is sufficient to eliminate that gain. Note that if the distributed property has a low inside basis immediately prior to the distribution, increasing the distributee partner's outside basis with partnership debt can avoid gain under §737 without using much of that debt. In particular, if the distributed property has an inside basis of $0, the distributee partner's outside basis will not be reduced as a result of the distribution and so the debt can be repaid after the distribution without triggering gain. Put another way: section 737 requires outside basis but does not itself consume outside basis.

23-8. To understand what is going on, assume X Corp. leaves the partnership after two years, receiving a cash distribution equal to its final capital account balance. Further, assume that the partnership has income of $1 million each year for its first two years and no other income or deduction. Assume also that X has an adjusted basis in the contributed business of $3 million.

Each year the partnership's income will be allocated exclusively to X, so that X will report a $1 million distributive share each year. This will increase X's capital account to $12 million and outside basis to $5 million. When X then leaves the partnership, X will receive $12 million in cash, causing X to recognize an additional $7 million of income. Thus, X winds up with $12 million of cash and has recognized $9 million of income. Y now owns the business and has reported no income or loss. Y's basis in the business is $10 million and the partnership is eliminated.

Suppose that the business had been valued at $11 million, and that there had been no gross income allocation. In each of the first two years, the partners would include a distributive share of $500,000 apiece. After 2 years, X's capital account would be $12 million and X's outside basis would be $4 million. Thus, when X exits the partnership for cash, X will receive $12 million and report a gain of $8 million on the distribution. Once again X has cash of $12 million in pocket and reports total income of $9,000,000 over the two years.

But now Y has reported income of $1,000,000 over the two years. This additional income will appear in the form of extra basis in the business, but that is disadvantageous as compared with no income and a lower asset basis. In essence, the undervaluation of the business coupled with a gross income allocation permits Y to purchase X's business with pre-tax dollars. And that is precisely the abuse to which §707(a)(2)(A) speaks.

Does §707(a)(2)(A) capture this transaction? The regulations promulgated under §707 purport to cover both §707(a)(2)(A) as well as §707(a)(2)(B), but in reality they have little relevance to §707(a)(2)(A) transactions such as the one in this problem.

The legislative history of §707(a)(2)(A) indicates that the most important factor in determinations under §707(a)(2)(A) is whether the gross income allocation is subject to appreciable risk. Here, we need more facts to know the likelihood that there will be sufficient gross income to satisfy X's allocation. The second most important factor is the duration of the distributee's status as a partner. Here, if it is understood that X will soon leave the partnership, then the transaction is more likely to be viewed as a sale *ab initio*. Finally, if there is evidence that the partners deliberately understated the value of X's business, presumably that would be fatal to the plan.

23-9. There is a realized a loss of $4,000 under §707(b)(1), but none is recognized by the selling partner. When the partnership sells the property for $18,000, there is a book gain of $2,000. How do we handle it? It is clear under the statute that the partnership has no taxable income on the sale. Under the partnership agreement, the book gain is to be allocated $1,600 to M and $400 to the remaining partners. If this tax-exempt income is allocated $1,600 to M and $400 to the other partners, there will be no book/tax disparities. Note, though, that this takes $2,000 basis from M (on the loss sale to the partnership) and gives $400 of it to the other partners.

If the partnership sells the property for $30,000, there is book gain of $14,000 although there is taxable gain of only $10,000, with the difference being tax-exempt gain. The partnership provides that the book gain of $14,000 should go $11,200 to M and $2,800 to the other partners. Of that $11,200, how much should be taxable and how much tax-exempt? My sense is that all $4,000 of the tax-exempt income should be allocable to M because it was M's disallowed loss that produced the tax-exemption, leaving only $7,200 of taxable income for M and the $2,800 remainder of the taxable income for the other partners. But some commentators have suggested that such an allocation lacks substantiality, suggesting instead that the tax-exempt income should be divided proportionately between M and the other partners.

23-10a. All of H's loss may be recognized because H is less than a 50 percent partner. If H had been a 60 percent partner, he could not take any of the loss.

23-10b. If H had been a 40% partner, the partnership simply would recognize as income the excess of its amount realized on the sale less its adjusted basis in the property sold. Thus, there would be a gain of $5,000, a loss of $1,000, or a gain of $1,000, depending on the sale price.

If H had been a 60% partner, there would be a gain of $3,000, a loss of $1,000, or no gain or loss, depending on the sale price.

23-10c. At issue is whether W should be treated as related to the partnership to any extent. Formerly, §707(b) applied only to sales between the partnership and a partner, but the "partner" language was changed in 1986 to "person," suggesting that W should be treated as a person who indirectly owns H's interest in the partnership. If so, the entire loss is allowed if H owns 40% of the partnership but none of the loss is allowed if H owns 60%. If §707(b) does not apply to the transaction, then §267(a)(1) could apply to the extent we treat the sale in whole or in part as a sale between W and H.

Under Treas. Reg. §1.267(b)-1(b)(1), we treat the partnership as an aggregate of individuals and then apply the related party rules of §267 to each such individual. Thus, if H is a 40% partner, W's loss is disallowed to the extent of 40% (i.e., $800) while if H is a 60% partner, W's loss is disallowed to the extent of 60% (i.e., $1,200). Whereas §707(b) takes an all or nothing approach, §267(a)(1) adopts a sliding scale. *Note that this regulation predates the change to §707(b) discussed above and seems inconsistent with §707(b) as now written.*

Note that §267(e)(1) applies only to the application of the timing rule in §267(a)(2) and not to the loss deduction rule in §267(a)(1).