24-1. Prior to the borrowing, A's capital account will equal $100 and A's outside basis will equal $60 while B's capital account will equal $100 and B's capital account will equal $25. A zero-value sale produces a book loss of $380, which is allocable 25% (i.e., $95) to A and 75% (i.e., $285) to B. Thus, the zero-value liquidation will leave A with a capital account surplus of $5 and B with a capital account deficit of $185. The partnership's indebtedness of $180 is allocated entirely to B. Because A's pre-admission share of the debt was $20 while B's pre-admission share of the debt was $160, this allocation reduces A's share by $20 and increases B's share by the same amount. Accordingly, there is a deemed distribution of cash of $20 to A under §752(b) and a deemed contribution by B in the same amount pursuant to §752(a). Thus, the books of the partnership end up as follows:

A		B		
CA	OB	CA	OB	
100	60	100	25	Initial Values
0	(20)	0	20	Reallocation of Debt
100	40	100	45	Final Values

24-2a. X and Y each begin with a capital account of $100, Z begins with a capital account of $200,, and the aggregate book value of the assets is $550. A zero-value liquidation thus produces a book loss of $550, allocable 25% to X, 25% to Y, and 50% to Z. (Quaere: should the payables be treated as producing $50 of book *gain* on the zero-value sale and liquidation? I will assume not though the answer in this problem will not change until part (d) if you make the opposite assumption.) Thus, the zero-value liquidation will leave X and Y with capital account deficit restoration obligations of $37.50 and Z with a capital account deficit restoration obligation of $75. The partnership's debt of $100 (note that payables contributed by a cash-basis partner are not treated as partnership debt but rather are handled under §704(c)(1)) is allocated in those proportions (i.e., 25% to X, 25% to Y, and 50% to Z), and this results in a shift of $50 of the debt away from Z. Because Z's outside basis cannot absorb the full $50 deemed distribution, Z must recognize gain of $10 under §731(a)(1). Accordingly, prior to the any disposition of the partnership's assets, the books of the partnership read as follows:

X		Y		Z		
CA	OB	CA	OB	CA	OB	
100	0	100	120	200	40	Start
0	25	0	25	0	(40)	Debt
100	25	100	145	200	0	Final

Assets	Book	Basis	Liability
Receivables	150	0	0
Payables	(50)	0	0
Real Estate	100	120	0
Investment Property	300	40	(100)

Under §704(c)(1), the income on the receivables is allocated to X as is the deduction from the payables, loss from the real estate is allocated to Y, and gain on the investment property is allocated to Z. Note that no changes are made to the partners' capital accounts because these gains and losses were credited to the partners' capital accounts on formation. Thus, the books of the partnership end up as:

X		Y		Z		
CA	OB	CA	OB	CA	OB	
100	25	100	145	200	0	Start
0	150	0	0	0	0	Receivables
0	(50)	0	0	0	0	Payables
0	0	0	(20)	0	0	Real Estate
0	0	0	0	0	260	Investment Property
100	125	100	125	200	260	Final

Assets	Books	Basis
Cash	$ 500	$ 500

Liabilities	
Debt	$ 100

24-2b. The income from collecting on the receivables is ordinary under §724(a), the loss from the real estate will be capital, assuming the real estate was a capital asset in the hands of Y as well as in the hands of the partnership, and the gain from disposition of the investment property is capital.

24-2c. Tacking is permitted for both assets under §1223(2).

24-2d. With these changed facts, it now matters whether we ignore the payables or treat them as producing income on the hypothetical zero-value sale. If we ignore the payables, then (as before) the zero-value sale and liquidation yields a book loss of $550, allocated $110 to X, $110 to Y, and $330 to Z. Thus, after the allocation of the book loss, X has a capital account deficit balance of $10, Y has a capital account deficit balance of $10, and Z has a capital account deficit balance of $130. As a result, the debt presumably is allocated one-fifteenth to A, one-fifteenth to B, and thirteen-fifteenths to Z.

If we treat the payable as producing $50 of income on the hypothetical zero-value sale, then there is a book loss of only $500, allocable $100 to X, $100 to Y, and $300 to Z. As a result, X and Y each have a zero capital account balance and Z has a capital account deficit balance of $100 so that the debt is allocated entirely to Z.

Note that in no event are the payables treated as liabilities to be allocated under section 752 because the contributing partner is a cash-basis taxpayer.

24-3a. $4,000 ordinary gain (if held less than five years); $2,000 of book income.

24-3b. $1,500 ordinary gain (if held less than five years); $500 of book loss.

24-3c. $1,000 ordinary gain (if held less than five years); $3,000 book income.

24-3d. $1,000 ordinary gain (because it was inventory to the partnership); $3,000 book income.

24-3e. $3,000 total loss, of which $2,000 is capital under §724(c) and $1,000 of which is not capital; $1,000 book loss.

24-3f. $1,000 ordinary loss; $3,000 book loss.

24-4a. Prior to C's admission to the partnership, the books read:

A		B	
CA	OB	CA	OB
40,000	40,000	40,000	40,000

To ensure that C gets no share of the current value of the partnership's assets, the partnership should revalue its assets and restate capital accounts; this seems to be required by Rev. Proc. 93-27. Note that the 704(b) regulations authorize a revaluation of partnership property upon the contribution of services in exchange for a partnership interest. Reg. §1.704-1(b)(2)(iv)(f)(5)(iii).

A		B		C		
CA	OB	CA	OB	CA	OB	
40,000	40,000	40,000	40,000			Start
40,000	0	40,000	0			Book-up
0	0	0	0	0	0	C Joins
80,000	40,000	80,000	40,000	0	0	Final

This creates a reverse §704(c) problem for A and B. But note that it is possible that the partners have agreed not on a book-up but instead to give C a share of all taxable profits including a share of the unrealized appreciation in the racehorse as of the date of C's admission (see part (d) below). If that is the deal, then C is immediately taxable on C's one-fourth value of the racehorse (i.e., on $20,000). This will give C an immediate capital account and outside basis of $20,000; presumably A and B now have a capitalized cost of $20,000 that can be amortized over two years. Some would argue that the partnership (and, through it, A and B) should be taxed on the transaction as if the racehorse had been sold. The better view rejects that analysis; see the next section of the casebook.

24-4b. If C contributes $15,000 cash, A's and B's accounts are booked up as before, but C's capital account and outside basis will equal $15,000.

24-4c. Should C file an election under §83(b)? In the second case (where C contributes $15,000), perhaps C has paid close to full value for her interest. If so, then an election under §83(b) is relatively costless. Many advisors recommend such an election but Rev. Proc. 2001-43 indicates that an election under §83 is not necessary.

24-4d. Because C is receiving an immediate interest in partnership capital, C is taxable immediately on the current fair market value of C's partnership interest. On these facts, that should be $40,000. This will be the value of C's initial outside basis and capital account. The partnership should be entitled to claim a deduction for $40,000 if that the cost of training the horse is an ordinary and necessary expense of the partnership; on these facts, presumably A and B now have a capitalized cost of $40,000 that can be amortized over two years. The deduction (whether immediate or over two years) should be allocated equally between A and B as per their partnership agreement. When C joins the partnership, they should book-up the value of the partnership's assets (i.e., the horse) to current fair market value. Thus, the books will become (assuming for convenience that the transfer to C is immediately deductible):

A		B		C		
CA	OB	CA	OB	CA	OB	
40,000	40,000	40,000	40,000	40,000	40,000	Start
(20,000)	(20,000)	(20,000)	(20,000)	0	0	Comp. paid
40,000	0	40,000	0	0	0	Book-up
60,000	20,000	60,000	20,000	40,000	40,000	Totals

When the horse is sold, the first $80,000 of tax gain should be allocated only between X and Y.

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24-5(a). The bank’s outside basis should equal cost of $20,000.

24-5(b). The bank's capital account will be negative $10,000 because the transferee of a partnership interest acquires the capital account of the transferor. Treas. Reg. §1.704-1(b)(2)(iv)(*l*).