

27-1a. C's basis in the distributed property equals \$27,000 under the limitation of §732(a)(2). As a result, there is a \$6,000 upward adjustment to the basis of partnership assets under §734(b)(1)(B). Because the asset causing the basis adjustment was an ordinary income asset, this basis adjustment can only be made to the partnership's remaining ordinary income assets (that is, to the two receivables), Reg. §1.755-1(c)(1)(i), in proportion to their unrealized appreciation and then in proportion to their fair market values, Reg. §1.755-1(c)(2)(i). On the facts of problem (1), that means that one-quarter of the adjustment (or \$1,500) is made to Receivable #1 and three-quarters of the adjustment (or \$4,500) is made to Receivable #2. These adjustments benefit all of the partners in the partnership and each partner increases her capital account by her share of the adjustments, Reg. §1.704-1(b)(2)(iv)(m)(4).

27-1b. C's basis in the distributed securities equals \$27,000 under the limitation of §732(a)(2). As a result, there is an upward adjustment to the basis of partnership assets under §734(b)(1)(B) of \$3,000. Because the asset causing the basis adjustment was a capital asset, this basis adjustment can be made only to the partnership's remaining capital assets and §1231 assets (that is, to the land and building (assuming the building was held for more than one year)), Reg. §1.755-1(c)(1)(i)-(ii), in proportion to their unrealized appreciation and then fair market values, Reg. §1.755-1(c)(2)(i). On the facts of this problem, that means that the adjustment is allocated only to the Building (which thus takes an adjusted basis of \$12,000). This basis adjustment benefits all the partners and results in capital account adjustments.

27-1c. C's basis in the distributed receivable equals \$0 under §732(b)-(c), and C recognizes a loss on the distribution of \$27,000 under §731(a)(2). As a result, there is a negative adjustment to the basis of the partnership's assets under §734(b)(2)(A). This adjustment must be made to the partnership's remaining capital assets under Reg. §1.755-1(c)(1)(ii), in proportion to their unrealized loss and then in proportion to adjusted bases, Reg. §1.755-1(c)(2)(ii). On the facts of this problem, that means that \$3,000 of the basis adjustment is allocated to the land and the remaining \$24,000 basis adjustment is made to the securities. These adjustments affect all the remaining partners and result in capital account adjustments.

27-2. From problem 1(b), the Building has an adjusted basis of \$9,000 plus \$3,000, or \$12,000. When the asset is sold for its current fair market value of \$18,000, there is a taxable gain of \$6,000. Because each partner has a one-third interest in the profits of the partnership, each partner's distributive share of the gain equals \$2,000.

27-3a. Immediately after the distribution, the books of the partnership become:

A		B		
CA	OB	CA	OB	
\$ 100	\$ 100	\$ 100	\$ 100	
120	0	120	0	Blackacre revaluation
30	0	30	0	Whiteacre revaluation
( 200)	( 100)	0	0	Distribution
\$ 50	\$ 0	\$ 250	\$ 100	Totals

The inside basis adjustment equals \$40 under §734(b)(1)(B). **Period.** But in a perfect world, the distribution to A would result in a remedial allocation of \$30 gain to B (reflecting B's share of the book-up in the distributed property), increasing B's outside basis by \$30. In addition, A would be entitled to a remedial allocation of deduction of \$30 (suspended under §704(d) because A's outside basis is zero). The inside basis adjustment under §743(b)(1)(B) of \$40 would then be made for the benefit of A alone, so that when Blackacre is sold by the partnership, there would be taxable gain to A of \$120 less \$40, (that is, \$80) as well as gain to B of \$120. Also when Blackacre is sold by the partnership, the suspended loss would be unsuspended (because A now has a positive outside basis), so the books would be:

A		B		
CA	OB	CA	OB	
\$ 100	\$ 100	\$ 100	\$ 100	
120	0	120	0	Blackacre revaluation
30	0	30	0	Whiteacre revaluation
( 200)	( 100)	0	0	Distribution
0	0	0	30	Remedial allocations
0	80	0	120	Sale of Whiteacre
0	( 30)	0	0	Unsuspended loss
<u>\$ 50</u>	<u>\$ 50</u>	<u>\$ 250</u>	<u>\$ 250</u>	Totals

27-4a. The amount of the inside basis adjustment, determined under §743(b), equals the difference between the purchaser's outside basis (i.e., \$45,000) and the purchaser's share of inside basis, where "share of inside basis" is defined to equal the amount of cash the purchaser would receive if the partnership sold all of its assets and then liquidated, but decreased by distributive share of taxable income and increased by distributive share of taxable loss. Here, that amount equals \$27,000 (i.e., the purchaser's capital account) because the purchaser's capital account does not include any §704(c) or reverse-§704(c) adjustment. Accordingly, the net §743(b) adjustment equals \$45,000 less \$27,000, or \$18,000.

To determine the appropriate adjustment to the class of ordinary income assets pursuant to §755 and the regulations, we determine the amount of ordinary income that would be allocated to the purchaser if the partnership sold all of its assets for current fair market value. Here, that amount equals one third of \$72,000, or \$24,000. The capital adjustment then equals the total adjustment of \$18,000 less the ordinary adjustment of \$24,000, or (\$6,000).

The ordinary adjustment of \$24,000 must now be allocated among the various ordinary income assets in proportion to unrealized appreciation and loss. Thus, \$4,000 is allocated to the inventory, \$5,000 is allocated to receivable #1, and \$15,000 is allocated to receivable #2.

The capital adjustment of (\$6,000) is now allocated among the various capital assets in proportion to unrealized gain and loss. Thus, (\$1,000) is allocated to the land, \$3,000 is allocated to the building, and (\$8,000) is allocated to the securities.

- 27-4b. For the continuing partners, the §743(b) basis adjustment has no effect. For the purchaser, one effect of the §743(b) basis adjustment is to increase the depreciation deduction. The regulations provide that the additional \$3,000 allocated to the basis in the building is recovered as if the property were newly placed in service; that is, the additional \$3,000 will be recovered by the purchaser over 27.5 or 39 years (depending on the use to which the building is put, see §168(c)(1)).
- 27-4c. If the partnership sells all of its assets immediately after the purchaser joins the entity, the continuing partners (that is, A and B) will each recognize \$4,000 of ordinary income from the inventory, \$5,000 of ordinary income from receivable #1, \$15,000 of ordinary income from receivable #2, (\$1,000) of capital loss from sale of the land, \$3,000 of §1231 gain from the building, and (\$8,000) of capital loss from the securities. In each case, the purchaser will recognize the same income less any positive basis adjustment or the same loss less any negative basis adjustment, which means that the purchase recognizes no gain or loss from the sale. And that is the whole point of the regulations: the purchaser in effect takes a cost basis in each of the partnership's assets.
- 27-5. *This answer assumes that the partners have agreed to allocate all items equally between P and Q except as required by §704(c).* After the partnership's first year, the property contributed by Q has a book value of \$8,000 and an inside basis of \$4,800. Q's capital account equals \$9,000 and Q's outside basis equals \$5,800. When R purchases half of Q's interest for \$4,600, Q takes an outside basis of \$4,600 and half Q's capital account, or \$4,500. Reg. §1.704-1(b)(2)(iv)(l).

The amount of the adjustment under §743(b) equals the excess of the purchaser's outside basis (that is, cost of \$4,600) over that partner's share of the partnership's inside basis. Because there is no indebtedness in this partnership, a partner's share of inside basis equals the partner's share of previously-taxed capital. Reg. §1.743-1(d)(1). The purchaser's share of previously-taxed capital equals the amount of cash that would be distributed to the partner in a liquidating distribution following a sale of all the partnership's assets for fair market value less any taxable gain on that sale and plus any taxable loss on that sale. *Id.*

On a sale by the partnership of the asset contributed for \$8,400, there would be book gain of \$400 and tax gain of \$3,600. Of the book gain, \$100 is allocable to R. Of the tax gain, \$1,600 is allocable to R under §704(c) and \$100 is allocable to R under §704(b), for total taxable gain of \$1,700. Accordingly, R's share of the partnership's previously-taxed capital equals \$4,600 (final capital account balance) less \$1,700, or \$2,900. From this, the basis adjustment made in favor of R equals \$4,600 less \$2,900, or \$1,700, all allocable to the property contributed by Q.

If that property were immediately sold for its current value of \$8,400, P would increase her capital account by \$200 while Q and R would increase capital accounts by \$100 each. Of the \$3,600 taxable gain, \$200 would be allocable to (and includible by) P, \$1,700 would be allocable to (and includible by) Q, and \$1,700 would be allocable to R. Reg. §1.743-

1(j)(2). Because of the §743(b) adjustment, R would include zero taxable gain. Reg. §1.743-1(j)(3).

27-6a. If the partnership distributes receivable #1 to partner A, then the \$5,000 formerly allocated to that asset must be reallocated to the partnership's remaining ordinary income assets in proportion to unrealized appreciation (but there is none as to the purchaser because of the prior adjustments), then in proportion to relative fair market values. Here, that means that the \$5,000 is allocated half to the inventory and half to receivable #2.

27-6b. If receivable #2 is instead distributed to D (that is, to the purchasing partner), then we apply the familiar rules of §§731-733 to the distribution but we treat the partnership's inside basis in the asset as equaling the partnership's common basis in the distributed asset plus D's basis adjustment in that asset. Because this is a liquidating distribution consisting only of an ordinary income asset, loss can be recognized. Under §732(b) and (c)(1), D takes a carryover basis of \$15,000 (that is, common inside basis of \$0 plus adjustment of \$15,000) in the distributed receivable. Because D's outside basis immediately prior to the liquidating distribution was cost of \$45,000, there is a recognized capital loss on the distribution of \$30,000 under §731(a)(2).

If the distribution were nonliquidating, the application of §§731-733 would be: there is no gain or loss on the distribution, §731(a)(1), D takes a carryover basis in the distributed asset of \$15,000, §732(a)(1), and D reduces her outside basis from \$45,000 down to \$30,000, §733(2).