P and Q form the PQ limited liability company, with P contributing cash of $240,000 and Q contributing property with a fair market value of $160,000, an adjusted basis of $100,000, and encumbered by a nonrecourse debt of $80,000. P and Q agree to divide all profits and losses 75% to P and 25% to Q except as required by section 704(c). Assume the debt encumbered the property contributed by Q is not a “qualified” liability.

For purposes of section 707(a)(2)(B), three-quarters of the liability (that is $60,000 of the liability) is treated as shifting to P. Accordingly, the transaction is treated as if three-eighths of the property (that is, $60,000 worth of the property) were sold to the partnership and five-eighths of the property (that is, $100,000 worth of the property) were contributed. On the sale component, Q recognizes a gain of $60,000 less $37,500, or $22,500. On the contribution component, Q takes a capital account of $100,000 (five-eighths of the gross value) less $20,000 (portion of the debt not allocated to Q for purposes of section 707(a)(2)(B)), or $80,000. Q's initial outside basis on the deemed contribution of five-eighths of the property equals $62,500 (100,000 total basis of property – 37,500 (basis of sold portion of property)). In tabular form:

|  |  |  |  |
| --- | --- | --- | --- |
|  | Total | Sale Portion | Contribution |
| Debt | 80,000 | 60,000 | 20.000 |
| Value | 160,000 | 60,000 | 100,000 |
| Basis | 100,000 | 37,500 | 62,500 |
| Equity | 80,000 |  | 80,000 |

At this point, the t-accounts read:

\_\_\_\_\_\_\_\_\_\_P\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_Q\_\_\_\_\_\_\_\_\_\_

Capital Basis Capital Basis

$ 240,000 $ 240,000 $ 80,000 $ 62,500

These books tacitly include only that portion of the debt treated as encumbering the contributed portion of the property (that is, $20,000 of the debt), all tacitly allocated to Q (because none has been reallocated to P). To determine how the remainder of the debt is allocated, we must apply the rules of section 752 to all of the debt and determine how the total debt is shared immediately after formation of the partnership. Assuming the partnership does not use remedial allocations for this property and elects to allocate all residual tier 3 debt in proportion to general profits interests, the total debt is allocated three-quarters to P (that is, $60,000) and one quarter to Q ($20,000). Thus, P's outside basis increases by $60,000 while Q's remains unchanged, and so the t-accounts become:

\_\_\_\_\_\_\_\_\_\_P\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_Q\_\_\_\_\_\_\_\_\_\_

Capital Basis Capital Basis

$ 240,000 $ 240,000 $ 80,000 $ 62,500

60,000 0

$ 240,000 $ 300,000 $ 80,000 $ 62,500