P contributes cash of $800,000 to the XY general partnership and Q contributes nondepreciable property having adjusted basis of $900,000, fair market value of $1,600,000, and encumbered by a nonrecourse debt of $800,000. The partners agree to divide profit and loss 55% to P and 45% to Q. What are the initial capital accounts and outside bases?

The contribution by Q must be divided into the sale component and the contribution component. The value of the sale component equals the amount of debt that shift away from Q, and because we use only the third tier (tier "3B") allocation for computing the disguised sale debt shift, that equals $440,000. Accordingly, the sale component equals 27.5% of the property ($440,000/$1,600,000) and the contribution component equals 72.5% of the property.

On the contribution component, Q is treated as contributing property worth $1,160,000 with adjusted basis of $652,500 (72.5% of $900,000) and encumbered by a debt of $360,000 (45% of $800,000). This gives Q an initial capital account of $800,000 (why is this not a surprise?) and an initial outside basis of $652,500.

On the sale component, Q recognizes a gain of $192,500 (amount realized of $440,000 less 27.5% of $900,000). The partnership takes a cost basis of $440,000 in the purchased property. At this point, the books of the venture read:

P		Q	
CA	OB	CA	OB
$ 800,000	$ 800,000	$ 800,000	$ 652,500

Asset	Book Value	Inside Basis	Debt
Cash	$ 800,000	$ 800,000	
Contributed Property	1,160,000	652,500	($ 360,000)
Purchased Property	440,000	440,000	(440,000)

These books tacitly have $360,000 of the debt allocated to Q and none to P. We now have to see how the total debt of $800,000 is allocated among P and Q, and put the changes into the outside bases.

Because the book value of the asset contributed by Q has book value in excess of the debt ($1,600,000 as compared with $800,000), there is no allocation under tier 1. And if the property were sold for the amount of the debt and nothing else and assuming the partnership does not use remedial allocations for this property, there would be no taxable gain allocable under 704(c) (or under 704(c) principles) (because the amount realized would equal $800,000 while the inside basis equals $1,092,000). Accordingly, all of the debt is allocated under tier 3 (assuming the partnership does not elect to use tier 3A), so the debt is allocated $440,000 to P (55% of $800,000) and $360,000 (45% of $800,000) to Q. Accordingly, there is no change to Q's outside basis but P's outside basis increases by $440,000 to $1,240,000.

If the property eventually is sold for its current fair market value of $1,600,000, there will be a taxable gain of $507,500, all allocable to Q. That will increase Q's outside basis to $1,160,000. If the debt is then repaid, P's outside basis will decline from $1,240,000 to $800,000 and Q's outside basis will decline from $1,160,000 to $800,000, Note also that Q recognized a taxable gain of $192,500 on the disguised sale as well as $507,500 when the property is sold, for total gain recognition of $700,000 as expected (why?).

Now reconsider this problem but assume the partnership elects to use the optional tier 3A in allocating its nonrecourse debt. This does not change the computation of the disguised sale component or of the contribution component. In fact, the only change arises in the final step when we compute the sharing of the partnership's debt of $800,000. Recall that prior to this computation, the t-accounts included $0 debt in P's outside basis and $360,000 in Q's outside basis. As before, the tier 1 allocation remains $0 for each partner as does the tier 2 allocation. But now that we are using tier 3A, we ask how much 704(c) (or reverse 704(c)) gain will be allocated to each partner if the asset were sold for its book value (rather than for the debt alone). Of course, to avoid double-counting, we reduce this number by the amount determined under tier 2 (here, nothing was allocated under tier 2).

If the property were sold for its book value. There would be no book gain (of course), but there would be tax gain of $1,600,000 - $1,092,500, or $507,500. Because this is tax gain without book gain, it is 704(c) gain in its entirety. Further, because the tier 2 allocation was zero, this entire amount is tier 3A. Thus, debt equal to $507,500 is allocated to Q under tier 3A, leaving only $292,500 for tier 3B. This is allocated 55% (or $160,875) to P and 45% (or $131,625) to Q. Thus, P's total debt share is $160,875 while Q's total debt share equals $639,125 ($507,500 + $131,625). Accordingly, we increase P's outside basis by $160,875 (increasing it to $960,875) and we increase Q's outside basis by $279,125 (the increase in share from $360,000 to $639,125), making it $931,625.