Staff Tax Training – Partnerships & LLCs (Form 1065)
Case Solutions

DISCLAIMER – All problems, exercises, activities, etc., have at least one suggested solution, even if there may be more than one way to solve the problem. There are no official answers, nor is there only one right way to solve the problem or to arrive at the solution.

Case 1 – Forms of Operating a Business

1. Under regulation §301.7701-2 &3, a two or more owner domestic eligible entity by default is classified for Federal income tax purposes as a partnership unless the entity elects (on a Form 8832) to be classified as a corporation.

2. Under Rev. Proc 2002-69, a qualified business entity in a community property state can be treated as one owner (i.e., disregarded entity) or two owners (i.e., a partnership). A business entity is a qualified entity if:
   a. The business entity is wholly owned by a husband and wife as community property under the laws of a state, a foreign country, or a possession of the United States;
   b. No person other than one or both spouses would be considered an owner for federal tax purposes; AND
   c. The business entity is not treated as a corporation.

3. Under regulation §301.7701-2 &3, a one owner domestic eligible entity by default is classified for Federal income tax purposes as a partnership unless the entity elects (on a Form 8832) to be classified as a corporation.

4. Since Alvin/Betty's LLC is owned solely by Alvin/Betty it is disregarded for Federal income tax purposes. Thus, Alvin/Betty are deemed to own 100% of their respective limited partnerships (directly as limited partners and indirectly through their LLCs as general partners). Under regulation §301.7701-2 &3, a one owner domestic eligible entity by default is classified for Federal income tax purposes as a partnership unless the entity elects (on a Form 8832) to be classified as a corporation.

5. Yes. In a non-community state the entity would be taxed as a partnership. See answer 1. However, a qualified business entity in a community property state can be treated as one owner (i.e., disregarded entity) or two owners (i.e., a partnership). See answer 2.

6. Since Alvin and Betty are deemed to be the sole shareholders, AB, Inc can operate as an S Corporation. This is assuming all of the other S corporation requirements are met and the Form 2553 is filed making the S corporation election.

Case 2 – Partnership Taxable Year End

ABC LLC's required taxable year is March 31 because it results in the least aggregate deferral of income.

Test 3/31 Year End	Partner's Year End	Profits Interest	Months of Deferral	Profits Interest X Deferral
Member A	3/31	40%	0	0
Member B	6/30	40%	3	1.2
Member Cindy	12/31	20%	9	1.8
			Total Deferral =	**3.0**
Test 6/30 Year End	Partner's Year End	Profits Interest	Months of Deferral	Profits Interest X Deferral
Member A	3/31	40%	9	3.6
Member B	6/30	40%	0	0
Member Cindy	12/31	20%	6	1.2
			Total Deferral =	4.8
Test 12/31 Year End	Partner's Year End	Profits Interest	Months of Deferral	Profits Interest X Deferral
Member A	3/31	40%	3	1.2
Member B	6/30	40%	6	2.4
Member Cindy	12/31	20%	0	0
			Total Deferral =	3.6

Case 3 – Partnership Formation & Initial Basis

1. None of the members will recognize a gain or loss on the contribution of property to the LLC.

2. The LLC will not recognize any gain or loss.

3. Oliver will have an initial tax basis of $75,000 (i.e., $150,000 carryover basis - $100,000 recourse debt + 25% of the $100,000 debt assumed by the LLC). Sue will have an initial tax basis of $350,000 (i.e., $300,000 cash contributed + 50% of the $100,000 debt assumed by the LLC). Uma will have an initial tax basis of $325,000 (i.e., $300,000 carryover basis + 25% of the $100,000 debt assumed by the LLC).

4. The LLC will take a carryover basis in the property contributed. Thus, they will have an inside tax basis of $150,000 in the property Oliver contributed and $300,000 in the property Uma contributed. With the $300,000 of cash that Sue contributed the total inside tax basis would be $750,000. Note – the $750,000 is equal to the sum of each member's initial outside basis (i.e., $75,000 + $350,000 + $325,000). The tax and §704(b) Book balance sheet would be recorded as follows:

	Tax	**§704(b) Book**
Property Oliver contributed	$150,000	$250,000
Cash Sue contributed	$300,000	$300,000
Property Uma contributed	$300,000	$150,000
	$750,000	$700,000
Recourse liability assumed by LLC	$100,000	$100,000
Oliver, capital	$50,000	$50,000
Sue, capital	$300,000	$300,000
Uma, capital	$300,000	$150,000
	$750,000	$700,000

Case 4 – §704(c) – Traditional & Curative Allocations

1. Brutus will be allocated $2,500 of book and tax depreciation. Sparky will be allocated $2,500 of book depreciation and $500 of tax depreciation.

	Brutus		Sparky		Depreciable Property Contributed by Sparky		
	Book	Tax	Book	Tax	Book	Tax	BIG
Capital	$100,000	$100,000	$100,000	$60,000	$100,000	$60,000	$40,000
Depreciation	**($2,500)**	**($2,500)**	**($2,500)**	**($500)**	($5,000)	($3,000)	($2,000)
Ending	$97,500	$97,500	$97,500	$59,500	$95,000	$47,000	$38,000

2. Brutus will be allocated $2,500 of book and $2,000 of tax depreciation. Sparky will be allocated $2,500 of book depreciation and $0 of tax depreciation.

	Brutus		Sparky		Depreciable Property Contributed by Sparky		
	Book	Tax	Book	Tax	Book	Tax	BIG
Capital	$100,000	$100,000	$100,000	$40,000	$100,000	$40,000	$60,000
Depreciation	**($2,500)**	**($2,000)**	**($2,500)**	**($0)**	($5,000)	($2,000)	($3,000)
Ending	$97,500	$98,000	$97,500	$40,000	$95,000	$38,000	$57,000

3. Brutus will be allocated $2,500 of book and $2,000 of tax depreciation. Sparky will be allocated $2,500 of book depreciation and $0 of tax depreciation. In addition, Brutus will be receive an additional $500 deduction (i.e., curative allocation) to offset the distortion caused by the ceiling rule in number 2 above. The offsetting entry is to allocate Sparky $500 of income.

	Brutus		Sparky		Depreciable Property Contributed by Sparky		
	Book	Tax	Book	Tax	Book	Tax	BIG
Capital	$100,000	$100,000	$100,000	$40,000	$100,000	$40,000	$60,000
Depreciation	**($2,500)**	**($2,000)**	**($2,500)**	**($0)**	($5,000)	($2,000)	($3,000)
Ending	$97,500	$98,000	$97,500	$40,000	$95,000	$38,000	$57,000
Curative Allocation		**(500)**		**500**			
	$97,500	$97,500	$97,500	$40,500			

Case 5 – Allocations of §704(c) Pre-Contribution Gains

1. Martha's built-in gain on date of contribution if $12,000 (i.e., $20,000 FMV in excess of the $8,000 adjusted basis of property contributed.

2. Martha would recognize a $16,000 tax and $4,000 book gain. Stewart would recognize a $4,000 tax and $4,000 book gain. The book and tax capital accounts would be calculated as follows.

	Martha		Stewart		Depreciable Property Contributed by Martha		
	Book	Tax	Book	Tax	Book	Tax	BIG
Capital	$20,000	$8,000	$20,000	$20,000	$20,000	$8,000	$12,000
Gain on sale	**$4,000**	**$16,000**	**$4,000**	**$4,000**	$28,000	$28,000	= SP
	$24,000	$24,000	$24,000	$24,000	$8,000	$20,000	= Gain

3. **Traditional Method -** The book depreciation for the year would be $2,000 (i.e., $20,000 x 10%) and the tax depreciation would be $800 (i.e., $8,000 x 10%). Martha would be allocated $1,000 of book depreciation and $0 of tax depreciation. Stewart would be allocated $1,000 of book depreciation and $800 of tax depreciation. The book and tax capital accounts would be calculated as follows.

	Martha		Stewart		Depreciable Property Contributed by Martha		
	Book	Tax	Book	Tax	Book	Tax	BIG
Capital	$20,000	$8,000	$20,000	$20,000	$20,000	$8,000	$12,000
Depreciation	**($1,000)**	**$0**	**($1,000)**	**($800)**	($2,000)	($800)	($1,200)
Ending	$19,000	$8,000	$19,000	$19,200	$18,000	$7,200	$10,800

4. **Traditional Method -** Martha would recognize a $500 tax and $11,300 book gain. Stewart would recognize a $500 tax and $500 book gain. The book and tax capital accounts would be calculated as follows.

	Martha		Stewart		Depreciable Property Contributed by Martha		
	Book	Tax	Book	Tax	Book	Tax	BIG
Beginning	$19,000	$8,000	$19,000	$19,200	$18,000	$7,200	$10,800
Gain on sale	**$500**	**$11,300**	**$500**	**$500**	$19,000	$19,000	= SP
Ending	$19,500	$19,300	$19,500	$19,700	$1,000	$11,800	= Gain

NOTE – Because of the ceiling rule Martha and Stewart's ending book and tax capital accounts are off by $200.

5. **Curative Allocation Method -** To offset the $200 distortion caused by the ceiling rule, the LLC would be able to allocate an additional $200 deduction to Stewart with an offsetting allocation of $200 income to Martha.

	Martha		Stewart		Depreciable Property Contributed by Martha		
	Book	Tax	Book	Tax	Book	Tax	BIG
Capital	$20,000	$8,000	$20,000	$20,000	$20,000	$8,000	$12,000
Depreciation	**($1,000)**	**$0**	**($1,000)**	**($800)**	($2,000)	($800)	($1,200)
	$19,000	$8,000	$19,000	$19,200	$18,000	$7,200	$10,800
Curative Allocation	**$0**	**$200**	**$0**	**($200)**			
	$19,000	$8,200	$19,000	$19,000			

Martha would recognize a $500 tax and $11,300 book gain. Stewart would recognize a $500 tax and $500 book gain. The book and tax capital accounts would be calculated as follows.

	Martha		Stewart		Depreciable Property Contributed by Martha		
	Book	Tax	Book	Tax	Book	Tax	BIG
Beginning	$19,000	$8,200	$19,000	$19,000	$18,000	$7,200	$10,800
Gain on sale	**$500**	**$11,300**	**$500**	**$500**	$19,000	$19,000	= SP
Ending	$19,500	$19,500	$19,500	$19,500	$1,000	$11,800	= Gain

NOTE – Because of the $200 curative allocation above, Martha and Stewart's book and tax capital accounts are equal after the sale of the depreciable property.

6. **Remedial Allocation Method –** Under the remedial allocation method, AB has book depreciation for each of its first 10 years of $1,760 (i.e., $800 tax depreciation plus $960 remainder depreciation) calculated as follows:

Book Value	$20,000
Adjusted Tax Basis	(8,000) x 10% = $800 tax depreciation for 10 years
Remainder	$12,000 x 8% = $960 for 12.5 years

Martha would be allocated $880 of book depreciation and $0 of tax depreciation. Stewart would be allocated $880 of book depreciation and $800 of tax depreciation. To offset the $80 distortion caused by the ceiling rule the LLC will make-up a remedial allocation deduction of $80 to Stewart and an offsetting allocation of $80 income to Martha. The book and tax capital accounts would be calculated as follows.

	Martha		Stewart		Depreciable Property Contributed by Martha		
	Book	Tax	Book	Tax	Book	Tax	BIG
Capital	$20,000	$8,000	$20,000	$20,000	$20,000	$8,000	$12,000
Depreciation	($880)	$0	($880)	($800)	($1,760)	($800)	($960)
Remedial Allocation	$0	$80	$0	($80)	$18,240	$7,200	$11,040
	$19,120	$8,080	$19,120	$19,120			

NOTE – To offset the $80 distortion caused by the ceiling rule the LLC will make-up a remedial allocation deduction of $80 to Stewart and an offsetting allocation of $80 income to Martha.

Martha would recognize a $380 tax and $11,420 book gain. Stewart would recognize a $380 tax and $380 book gain. The book and tax capital accounts would be calculated as follows.

	Martha		Stewart		Depreciable Property Contributed by Martha		
	Book	Tax	Book	Tax	Book	Tax	BIG
Beginning	$19,120	$8,080	$19,120	$19,120	$18,240	$7,200	$11,040
Gain on sale	$380	$11,420	$380	$380	$19,000	$19,000	= SP
Ending	$19,500	$19,500	$19,500	$19,500	$760	$11,800	= Gain

NOTE – Because of the $200 remedial allocation above, Martha and Stewart's book and tax capital accounts are equal after the sale of the depreciable property.

Case 6 – Partnership Operational Issues

Net Earnings from Self-Employment Defined (§1402(a))

IRC §1402(1) states: The term "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss from any trade or business carried on by a partnership of which he is a member. However, self-employment income excludes the partnership's distributive share of any item of income or loss of a limited partner, other than guaranteed payments to that partner for services rendered.

Prop. Reg. §1.1402(a)-2 Definition of a Limited Partner

To help clarify who is a limited partner not subject to self-employment tax, the IRS issued proposed regulations on January 13, 1997. These regulations **are intended to apply to all entities classified as partnerships** for Federal tax purposes (regardless of state law characterization). Under the regulations, an individual's net earnings from self-employment do not include the individual's distributive share of income or loss as a limited partner. However, guaranteed payments described in §707(c) made to the individual for services actually rendered to or on behalf of the partnership engaged in a trade or business are included in the individual's net earnings from self-employment. An individual is treated as a limited partner unless the individual:

1. Has personal liability for the debts of or claims against the partnership by reason of being a partner;
2. Has authority (under the law of the jurisdiction in which the partnership is formed) to contract on behalf of the partnership; OR
3. Participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year.

Holders of More Than One Class of Interest (Prop. Reg. §1.1402(a)-2)

An individual holding more than one class of interest in the partnership who is not treated as a limited partner under the general rule above is treated as a limited partner with respect to a specific class of partnership interest held by such individual if, immediately after the individual acquires that class of interest:

1. Limited partners within the general rule own a substantial, continuing interest in that specific class of partnership interest; AND
2. The individual's rights and obligations with respect to that specific class of interest are identical to the rights and obligations of that specific class of partnership interest held by the limited partners.

NOTE – A substantial interest in a class of interest is determined based on all of the relevant facts and circumstances. In all cases, however, ownership of 20% or more of a specific class of interest is considered substantial.

Holders of Only One Class of Interest (Prop. Reg. §1.1402(a)-2)

An individual who is not treated as a limited partner under the general rule solely because that individual participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year is treated as a limited partner with respect to the individual's partnership interest if, immediately after the individual acquires that interest:

1. Limited partners within under the general rule of this section own a substantial, continuing interest in that specific class of partnership interest; AND
2. The individual's rights and obligations with respect to the specific class of interest are identical to the rights and obligations of the specific class of partnership interest held by the limited partners.

Service Partners in Service Partnerships (Prop. Reg. §1.1402(a)-2)

An individual who is a service partner in a service partnership may NOT be a limited partner. Thus their distribute share of partnership income will always be subject to self-employment tax. A **service partner** is a partner who provides services to or on behalf of the service partnership's trade or business. A partner is not considered to be a service partner if that partner only provides a de minimis amount of services to or on behalf of the partnership. A **service partnership** is a partnership substantially all the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting.

Part 1(a) – General partnership

Under §1402(a) a general partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by a partnership of which he is a member. Thus, the $60,000 guaranteed payment and $400,000 of ordinary business income are subject to self-employment tax.

Part 1(b) – Limited partnership

Since Lex and Rex participate in the management of the partnership, they would most likely be classified as general partners subject to self-employment tax on both the $60,000 guaranteed payment and $400,000 of ordinary business income under §1402(a). However, if they meet the definition of a limited partner as holders of more than one class of interest under proposed regulation §1.1402(a)-2, they might be able to allocate a portion of there trade or business income through not subject to self-employment tax.

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Part 1(c) – Limited liability company (LLC)

Since members of a LLC are not general or limited partners they must look at proposed regulation §1.1402(a)-2 for the self-employment tax rules. Under these proposed regulations, an individual is treated as a limited partner (not subject to self-employment tax) unless the individual:

1. Has personal liability for the debts of or claims against the partnership by reason of being a partner;
2. Has authority (under the law of the jurisdiction in which the partnership is formed) to contract on behalf of the partnership; OR
3. Participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year.

Since Lex & Rex fail both number 2 & 3 above both the $60,000 guaranteed payment and $400,000 of ordinary business income are subject to self-employment tax. However, if they meet the definition of a limited partner as holders of more than one class of interest under proposed regulation §1.1402(a)-2, they might be able to allocate a portion of there trade or business income through not subject to self-employment tax.

Part 2

If Lexy Rexy was a service business then regardless of the form of operating the business, under IRC §1402(a) and proposed regulation §1.1402(a)-2, both the $60,000 guaranteed payment and $400,000 of ordinary business income would be subject to self-employment tax.

Part 3

Under IRC §106, health insurance premiums paid by a partnership on behalf of a partner are not excludable from the partner's income. Thus, the premiums should be reclassified as guaranteed payments to the partners. The guaranteed payments are deductible by the partnership and income to partner subject to self-employment tax.

NOTE – The partner may be able to deduct 100% of the insurance premiums on page 1 of their Form 1040 if they meet all of the requirements under IRC §162(l)(1).

Part 4

Because family attributions rules do not apply in a partnership, Lexy Rexy could have a accident and health plan (under §106) and exclude the health insurance premiums from their employees (including family member employees) wages.

Case 7 – Partner Basis Calculation

1. Frank's outside tax basis would be zero with a $6,000 loss carry-forward in excess of basis calculated as follows:

	Outside Basis	Carry-forward in excess of basis
Initial basis	$2,000	
Ordinary trade or business income	10,000	
	12,000	
Deemed distribution (i.e., decrease in share of partnership liabilities)	(3,000)	
	9,000	
Rental real estate loss (10,000/15,000 x (9,000))	(6,000)	(4,000)
Short-term capital loss (2,000/15,000 x (9,000))	(1,200)	(800)
Non-deductible expenses (3,000/15,000 x (9,000))	(1,800)	(1,200)
Ending basis	$ 0	($6,000)

2. Frank's $6,000 rental loss allowable up to basis is a passive loss. In general, passive losses can only be deducted up to passive income. However, if the taxpayer or spouse actively participated in a passive rental real estate activity, the taxpayer can deduct up to $25,000 of loss from the rental real estate activity from their non-passive income. This special allowance is an exception to the general rule disallowing losses in excess of income from passive activities. The maximum amount of the special allowance is reduced if the taxpayer's modified adjusted gross income is more than $100,000 ($50,000 if married filing separately). The $25,000 allowable limit on losses is phased-out by 50 cents for each $1 that modified adjusted gross income exceeds $100,000. Since Frank's MAGI is $142,000 the maximum rental real estate loss allowable under this special provision is $4,000. She would have to carry-forward $2,000 as a passive-loss of the Form 8582.

Case 8 – Allocation Partnership Liabilities

Part 1 - Non-Recourse Debt Allocation

Non-recourse debt is allocated based on a 3-tiered allocation. Tier 1 is the §704(b) partnership minimum gain of $15,000 ($35,000 - $20,000) allocated 50% to Jack ($7,500) and 50% to Daniel ($7,500). There is no Tier 2 §704(c) pre-contribution gain. Therefore, the Tier 3 amount of $20,000 ($35,000 - $15,000) is allocated 50% to Jack ($10,000) and 50% to Daniel ($10,000). Total non-recourse debt allocated to Jack is $17,500 and allocated to Daniel is $17,500.

	Jack	Daniel
Tier 1 - Partners' share if §704(b) partnership minimum gain	$7,500	$7,500
Tier 2 – Partner's share of §704(c) minimum gain	N/A	N/A
Tier 3 – Profit % in the LLC	10,000	10,000
Total liabilities reported to each member on their Schedule K-1	$17,500	$17,500

Part 1 - Recourse Debt Allocation

The recourse debt is allocated to the partners based on economic risk of loss. A partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner. In a constructive liquidation, the $5,000 recourse liability becomes due and payable. All of the partnership's assets (excluding assets secured by the non-recourse debt), including the depreciable property, are deemed to be worthless. Thus, the cash ($15,000), accounts receivable ($25,000) and Asset #2 ($10,000) are deemed sold for a value of zero. This results in a hypothetical loss of $50,000. Upon a constructive liquidation the capital accounts would be calculated as follows:

	Jack (GP)	Daniel (GP)
Initial contribution	$15,000	$15,000
Partners' share if §704(b) partnership minimum gain (Tier 1 above)	$7,500	$7,500
Loss on hypothetical sale	($25,000)	($25,000)
Ending capital upon constructive liquidation	($2,500)	($2,500)

As a result, both Jack and Daniel would be obligated by operation of law to make a net contribution to the partnership of $2,500. Thus, the recourse debt would be allocated equally (i.e., $2,500/$2,500) to both Jack and Daniel on their Schedule K-1.

Part 2 - Non-Recourse Debt Allocation

Non-recourse debt is allocated based on a 3-tiered allocation. Tier 1 is the §704(b) partnership minimum gain of $15,000 ($35,000 - $20,000) allocated 90% to Jack ($13,500) and 10% to Daniel ($1,500). There is no Tier 2 §704(c) pre-contribution gain. Therefore, the Tier 3 amount of $20,000 ($35,000 - $15,000) is allocated 90% to Jack ($18,000) and 10% to Daniel ($2,000). Total non-recourse debt allocated to Jack is $31,500 and allocated to Daniel is $3,500.

	Jack	Daniel
Tier 1 - Partners' share if §704(b) partnership minimum gain	$13,500	$1,500
Tier 2 – Partner's share of §704(c) minimum gain	N/A	N/A
Tier 3 – Profit % in the LLC	18,000	2,000
Total liabilities reported to each member on their Schedule K-1	$31,500	$3,500

Part 2 - Recourse Debt Allocation

Upon a constructive liquidation the capital accounts would be calculated as follows:

	Jack (GP)	Daniel (GP)
Initial contribution	$15,000	$15,000
Partners' share if §704(b) partnership minimum gain (Tier 1 above)	$13,500	$1,500
Loss on hypothetical sale	($45,000)	($5,000)
Ending capital upon constructive liquidation	($16,500)	$11,500

As a result, Jack would be obligated by operation of law to make a net contribution to the partnership of $16,500. Thus, all $5,000 of the recourse debt would be allocated to Jack on his Schedule K-1.

Part 3 - Non-Recourse Debt Allocation

Non-recourse debt is allocated based on a 3-tiered allocation. Tier 1 is the §704(b) partnership minimum gain of $15,000 ($35,000 - $20,000) allocated 90% to Jack ($13,500) and 10% to Daniel ($1,500). There is no Tier 2 §704(c) pre-contribution gain. Therefore, the Tier 3 amount of $20,000 ($35,000 - $15,000) is allocated 90% to Jack ($18,000) and 10% to Daniel ($2,000). Total non-recourse debt allocated to Jack is $31,500 and allocated to Daniel is $3,500.

	Jack	Daniel
Tier 1 - Partners' share if §704(b) partnership minimum gain	$13,500	$1,500
Tier 2 – Partner's share of §704(c) minimum gain	N/A	N/A
Tier 3 – Profit % in the LLC	18,000	2,000
Total liabilities reported to each member on their Schedule K-1	$31,500	$3,500

Part 3 - Recourse Debt Allocation

Upon a constructive liquidation the capital accounts would be calculated as follows:

	Jack (LP)	Daniel (GP)
Initial contribution	$15,000	$15,000
Partners' share if §704(b) partnership minimum gain (Tier 1 above)	$13,500	$1,500
Loss on hypothetical sale	($28,500)	($21,500)
Ending capital upon constructive liquidation	$ 0	($5,000)

As a result, Daniel, as general partner, would be obligated by operation of law to make a net contribution to the partnership of $5,000. Thus, all $5,000 of the recourse debt would be allocate to Daniel on his Schedule K-1.

Case 9 – Partnership Distributions

1. Timmy will have a $5,000 capital gain on his distribution in excess of basis calculated as follows:

	Basis	Tax Treatment
Beginning balance	$15,000	
Trade or business income	5,000	Schedule E income & SE tax
Basis before distribution	20,000	
Cash distribution	(20,000)	$5,000 capital gain > basis
Ending basis	$0	
Rental loss		($6,000) carried forward
Non-deductible expenses		($4,000) carried forward

2. The property distribution is not taxable and Timmy's basis is calculated as follows:

	Basis	Tax Treatment
Beginning balance	$15,000	
Trade or business income	5,000	Schedule E income & SE tax
Basis before distribution	20,000	
Property distribution	(15,000)	
	5,000	
Rental loss	(3,000)	Form 8582 passive loss and ($2,000) carried forward
Non-deductible expenses	(2,000)	Non-deductible and ($3,000) carried forward
Ending basis	$0	

3. Timmy will take a $15,000 basis in the property distributed to him.

Case 10 – Sale of Partnership Interest

Gain on Sale of Partnership

Jerry will have a $450,000 gain on the sale of his partnership interest calculated as follows:

Selling price	$800,000
Outside basis	(350,000)
Gain	$ 450,000

Jerry's $450,000 gain is taxed as follows:

	Gain	Rate	Tax
Accounts receivable	$200,000	35%	$70,000
Collectibles	100,000	28%	28,000
Unrecaptured §1250 gain	40,000	25%	10,000
Residual LTCG	110,000	15%	16,500
	$450,000		$124,500

Ordinary Income (Hot Assets)

Under §741, to the extent a partner is deemed to have sold his/her share of the partnership's unrealized receivables or inventory items (i.e., Hot Assets), ordinary income or loss is recognized. Jerry will have a $450,000 gain that must be broken up into ordinary income and capital gains. Jerry will have to recognize $200,000 of ordinary income to the extent of his share of the accounts receivable - $200,000 (i.e., ½ x $400,000).

NOTE – The remaining $250,000 gain is a long-term capital gain the must be allocated to the three categories of LTCGs.

28% LTCG Rate - Collectibles

Per §1.1(h)-1: when an interest in a partnership held for more than one year is sold or exchanged in a transaction in which all realized gain is recognized, the transferor shall recognize as collectibles gain the amount of net gain (but not net loss) that would be allocated to that partner if the partnership transferred all of its collectibles for cash equal to the fair market value of the assets in a fully taxable transaction immediately before the transfer of the interest in the partnership. When Jerry sold his 50% interest in the partnership, the investments had a FMV of $250,000 and cost basis $50,000 (i.e. unrealized gain of $200,000). Jerry is deemed to have sold 50% of the investments to Buckeye (i.e. a deemed gain of $100,000).

25% LTCG Rate – Unrecaptured §1250 Gains

When an interest in a partnership held for more than one year is sold or exchanged in a transaction in which all realized gain is recognized, the partner shall recognize as unrecaptured §1250 capital gain an amount that would be allocated to that partner (to the extent attributable to the portion of the partnership interest transferred that was held for more than one year) if the partnership transferred all of its §1250 property in a fully taxable transaction for cash equal to the fair market value of the assets immediately before the transfer of the interest in the partnership. When Jerry sold his 50% interest in the partnership, the building had a FMV of $500,000 and cost basis $200,000 (i.e. unrealized gain of $300,000). Jerry is deemed to have sold 50% of the building and to the extent of his share of the depreciation not taxed as ordinary income under §1250, he must recognize $40,000 of unrecaptured §1250 capital gain (i.e. ½ x $80,000 of depreciation).

NOTE – Any residual long-term capital gain on the sale of a partnership interest will not be taxed higher than 15%.

Case 11 – Sale of Partnership Interest & §754 Election

Part 1

Moe will recognize a total gain of $280,000 calculated as follows:

Selling Price	$400,000
Less: Outside basis	(120,000)
Gain on sale	$280,000

Moe will have to treat $100,000 of the gain as ordinary income because of hot assets (i.e., 33.33% x $150,000 of the accounts receivable). The remaining $180,000 will be treated as a capital gain. The $180,000 capital gain needs to be broken down into the different long-term capital gain rates as follows:

28% – collectibles	$ 0
25% - unrecaptured §1250 gain ($90,000 x 33.33%)	30,000
15% - remaining capital gain	$150,000
Total long-term capital gain	$180,000

Part 2

The $280,000 positive §743(b) adjustment is calculated as follows:

Shemp's outside basis:		
Cost of LLC interest	$400,000	
Shemp's share of liabilities ($0 x 33.33%)	0	
		$400,000
Less: Shemp's share of the inside basis:		
Cash from hypothetical sale ((\$1,200,000 - \$0 liabilities) x 33.33%)	$400,000	
Less: Shemp's share of tax gain ((\$1,200,000 - \$360,000) x 33.33%)	(280,000)	
Plus: Shemp's share of liabilities ($0 x 33.33%)	0	
		$120,000
§743(b) adjustment		$280,000

The §743(b) adjustment must be allocated between the capital gain/§1231 asset group and all other assets as follows:

Step 1: Ordinary income property ($300,000 x 33.33%)	$100,000
Step 2: Capital gain/§1231 asset group	$180,000
Total §743(b) adjustment	$280,000

Next the adjustment needs to be allocated to the assets within each class as follows:

Ordinary income assets:	
All allocated to the accounts receivable	$100,000
Capital gain/§1231 asset group:	
Land ($90,000/$540,000 x $180,000)	$ 30,000
Building ($450,000/$540,000 x $180,000)	$150,000

Part 3

The journal entry to record Shemp as a member is:

	Debit (Credit)
Accounts receivable - Shemp's §743(b) adjustment	$100,000
Land - Shemp's §743(b) adjustment	30,000
Building - Shemp's §743(b) adjustment	150,000
Capital account - Shemp	(180,000)

Part 4

The ending tax balance for Three Stooges, LLC after Shemp becomes a member is:

Cash	$150,000
Accounts receivable ($0 + $100,000)	100,000
Land ($60,000 + $30,000)	90,000
Building ($150,000 + $150,000)	300,000
	$640,000
Larry, capital	$120,000
Curly, capital	$120,000
Shemp, capital	$400,000
	$640,000

Part 5

Shemp will get allocated depreciation on his §743(b) adjustment to the building. The $150,000 will be treated as if it was newly acquired property. Therefore, Shemp will depreciate the $150,000 over 39 years.

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Case 12 – Redemption of Partnership Interest & §754 Election

Part 1

Since Gina does not receive her proportionate share of "hot assets" from the distribution, §751(b) is triggered. §751(b) treats the disproportionate distribution as a sale or exchange between the FROG partnership and Gina. Thus, part or all of the transaction may be taxable. The calculation of the gain taxable to Gina is calculated as follows:

1. Gina is deemed to have received a current distribution of her share of the accounts receivable (i.e. FMV = $45,000 and adjusted basis = $0). Gina's outside basis after the current distribution is $75,000 (i.e. $75,000 - $0 deemed receivables).

2. Gina is deemed to sell the receivable back to the partnership. As a result she will recognize an ordinary gain of $45,000 (i.e. $45,000 - $0). The FROG partnership will take a $45,000 basis in those receivables it was deemed to have purchased from Gina.

3. Gina is deemed to receive the remaining $105,000 cash in a liquidating distribution. As a result, Gina must recognize an additional capital gain of $30,000 calculated as follows:

Cash proceeds to Gina	$150,000
Less: deemed cash from sale of receivables	(45,000)
Remaining liquidating cash distribution	105,000
Less: Gina's basis	(75,000)
Capital gain	$ 30,000

NOTE – the total gain recognized by Gina of $75,000 (i.e. $45,000 ordinary gain and $30,000 capital gain) accounts for the difference between Gina's basis ($75,000) and FMV ($150,000) of assets in the partnership. Also, the partnership does not recognize any gain or loss from this transaction.

The tax and §704(b) balance sheet after the distribution would be recorded as follows:

	Tax	§704(b) Book
Cash	$30,000	$30,000
Accounts receivable	$45,000	$180,000
Land	$150,000	$240,000
	$225,000	$450,000
Frank, capital	$75,000	$150,000
Ross, capital	$75,000	$150,000
Oliver, capital	$75,000	$150,000
	$225,000	$450,000

Part 2

Since Gina receives more than her proportionate share (i.e. $45,000) of "hot assets" §751(b) is triggered. The taxable amount of the transaction is calculated as follows:

1. Gina is deemed to have received her 25% proportionate share of partnership assets in a current distribution. Therefore, Gina is deemed to have received:

	Carryover Basis	FMV
Cash	$45,000	$45,000
Accounts receivable	$ 0	$45,000
Land	$30,000	$60,000
	$75,000	$150,000

2. Since Gina is already deemed to have received $45,000 worth of receivables, the remaining $105,000 of receivables are deemed to have been purchased by Gina selling her share of cash and land back to the partnership. Thus, Gina will have a capital gain of $30,000 calculated as follows:

FMV of accounts receivable received	$105,000
Less: adjusted basis of assets sold:	
Cash	(45,000)
Land	(30,000)
Capital gain on deemed sale	$30,000

NOTE – Gina will now have a cost basis in the receivables of $105,000 and a FMV of $150,000. Thus, $45,000 of ordinary gain to Gina will be deferred until she receives payment for the receivables.

3. The partnership will recognize a $105,000 ordinary gain from the deemed sale of accounts receivable as follows:

Cash received	$45,000
FMV land received	60,000
Total proceeds received	105,000
Less: adjusted basis in accounts receivable	(0)
Ordinary gain to partnership	$105,000

The tax and §704(b) balance sheet after the distribution would be recorded as follows:

	Tax	**§704(b) Book**
Cash	$180,000	$180,000
Accounts receivable	$ 0	$30,000
Land	$150,000	$240,000
	$330,000	$450,000
Frank, capital	$110,000	$150,000
Ross, capital	$110,000	$150,000
Oliver, capital	$110,000	$150,000
	$330,000	$450,000

Case 13 – Partner & LLC Member Basis & At Risk Limitations

Required #1

Assuming Grady Enterprises was a general partnership, Kathleen's basis would be calculated as follows:

Capital contributed	$1,000
50% of loan to partnership	4,500
50% of personal guarantee	10,000
Outside basis before reductions to basis	15,500
Trade or business loss	(6,000)
§1231 loss	(3,000)
Short-term capital loss	(1,000)
Non-deductible expenses	(2,000)
Ending outside basis	$3,500

NOTE – Since the entity is a LLC, the members (other than Kathleen who personally guaranteed the debt) would not be liable for the loan. Thus, Kathleen would be personally liable for the entire loan she guaranteed and would not have a right to reimbursement from the other members. As a result, she would be at-risk for her entire basis.

Required #2

Under Prop. Reg. §1.465-6(d): If a taxpayer guarantees repayment of an amount borrowed by another person (primary obligor) for use in an activity, the guarantee shall not increase the taxpayer's amount at risk. If the taxpayer repays to the creditor the amount borrowed by the primary obligor, the taxpayer's amount at risk shall be increased at such time as the taxpayer has no remaining legal rights against the primary obligor. Thus, in general a limited liability company member would not be at-risk for personal guarantees.

NOTE – This regulation was issued in 1979 before the development of LLCs under various state laws, and at a time when entities treated as partnerships for federal tax purposes were usually state law general partnerships and limited partnerships.

It appears the IRS is now interpreting §1.465.6(d) differently for LLC members. **CCA 201308028 states:** "Accordingly, we conclude that an LLC member is at risk with respect to LLC debt guaranteed by the member (where the LLC is treated as either a partnership or a disregarded entity for federal tax purposes), but only to the extent that the member has no right of contribution or reimbursement from other guarantors and is not otherwise protected against loss within the meaning of § 465(b)(4) with respect to the guaranteed amounts. Therefore, we conclude that Prop. § 1.465-6(d) is generally not applicable to situations involving bona fide guarantees of LLC debt by one or more members of the LLC that is enforceable by creditors of the LLC under local law, where the LLC is treated as either a partnership or a disregarded entity for federal tax purposes."