

partnership interest is \$5,250 (\$5,000 + \$5,000 - \$250 plus \$2,500 + \$500 - \$7,500).

PROBLEM 2

A and B form general partnership AB. A contributes real property with a fair market value of \$100,000 subject to a recourse mortgage of \$60,000, in exchange for an 80% interest in the partnership. The basis of the contributed property is \$20,000. B contributes \$10,000 in exchange for a 20% partnership interest.

- a. What are A's and B's bases for their partnership interests immediately following the formation of the partnership?
- b. Does A recognize any gain upon the contribution of the property?

This problem illustrates one of the differences between the formation of a partnership and the formation of a corporation. If the same contribution had been made by A to a corporation, under the provisions of I.R.C. § 357(c), A would recognize gain on the transfer because the liabilities assumed by the corporation, or to which the contributed property was subject, exceeded the contributor's basis. Because a partner is able to treat their share of the liabilities of a partnership as a capital contribution, a different result is obtained.

(i) A's Basis for his Partnership Interest

- (a) The starting point for A's basis is the basis of the property contributed by him. I.R.C. § 722. In A's case, this is \$20,000.
- (b) A is relieved of the \$60,000 mortgage resulting in a deemed distribution under I.R.C. § 752(b) of \$60,000, but under I.R.C. § 752(a), A is deemed to have made a capital contribution of his share of the \$60,000 of liabilities. Only the net decrease in A's share of liabilities is treated as a distribution by the Partnership to A. Treas. Reg. § 1.752-1(f).
- (c) The liability is a recourse liability because in a general partnership all partners are liable for the liabilities of the partnership unless the liability is nonrecourse by its terms (or the partnership is an LLP). *See* definition of recourse liability in Treas. Reg. § 1.752-1(a)(1). It is then necessary to determine who has the economic risk of loss for the liability. Under Treas. Reg. § 1.752-2(b)(1), a partner has the economic risk of loss with respect to a liability if, were the partnership constructively liquidated, the partner or related person would be obligated to make a payment and the partner would not be entitled to reimbursement from another person. In the constructive liquidation, the assets are deemed sold for no consideration.

If the AB Partnership was to liquidate, and its assets sold for no consideration, there would be a book loss of \$110,000 (i.e., the fair market value of the property contributed by A plus the cash contributed by B). This would be allocated \$88,000 to A and \$22,000 to B, resulting in A having a negative capital account of \$48,000 (\$40,000 - \$88,000), and B having a negative capital account of \$12,000 (\$10,000 - \$22,000). A would be required to contribute \$48,000 to the Partnership and B would be required to contribute \$12,000 to the Partnership and neither of them would have a right against any other party for reimbursement of those amounts. Thus, the \$60,000 liability is allocated \$48,000 to A and \$12,000 to B. Note that in this simple partnership, that is simply their respective percentage interests of the liability. Thus, there is a deemed distribution by the Partnership to A of \$12,000 (\$60,000 - \$48,000). This deemed distribution reduces A's basis for his partnership interest from \$20,000 to \$8,000, in contrast to the gain A would have to recognize in the corporate context under I.R.C. § 357(c).

- (d) Although the liability assumed by the Partnership exceeds A's basis for the property contributed by him, A does not recognize any gain. The net amount of the liability

relieved is a deemed distribution to A, reducing his basis for his partnership interest. Since the distribution does not exceed A's basis, A does not recognize any gain. I.R.C. § 731(a).

- (ii) B's Basis for her Partnership Interest.
 - (a) B's capital account initially is the amount of cash contributed by her, \$10,000. I.R.C. § 722.
 - (b) B's basis for her partnership interest is increased by her share of the \$60,000 liability, or \$12,000, resulting in her having a basis for her partnership interest of \$22,000.

PROBLEM 3

Same as Problem 2, except A and B form an LLC rather than a general partnership and there is no deficit restoration obligation.

This problem is designed to illustrate the effect of only one partner being liable for a partnership liability. If the constructive liquidation occurred, and all the partnership's assets were sold for zero consideration, A would still be liable to the creditor for the full amount of the \$60,000 mortgage indebtedness, whereas B, as a member of an LLC, would not have any obligation to make any payment. Thus, all of the \$60,000 liability is allocated to A, and none is allocated to B. Therefore, there is no net distribution to A, and A's basis for his partnership interest remains at \$20,000, and B's basis for her partnership interest remains at the \$10,000 of cash contributed by her. Saying the same thing in a different way, since A continues to have unprotected liability on the debt and B has no exposure on the debt, the entire debt is allocated to A.

PROBLEM 4

Same as Problem 2, except B guarantees the mortgage, B has no right of contribution against A or AB if she is called upon to make payment on the guaranty, and if A is required to make payment on the mortgage, A is entitled to reimbursement from B.

Since the liability is a recourse liability, typically the constructive liquidation rule applies to determine how the liability would be allocated. As indicated in Problem 2, in a constructive liquidation there would be a loss of \$110,000. Because A's loss is effectively limited to the amount contributed by him (assuming that B has sufficient assets to pay the mortgage), the loss can only be allocated to A to the extent of his capital account, or \$40,000. The balance of the loss would be allocated to B, resulting in her having a negative capital account of \$60,000 (\$10,000 - \$70,000). Thus, all of the liability is allocated to B.

Since all of the liability is allocated to B, there is a deemed distribution to A of \$60,000, which exceeds A's basis for his partnership interest by \$40,000. This excess is treated as a gain to A from the disposition of a partnership interest. I.R.C. § 731(a)(1)(A).

If B was a guarantor of the mortgage, but had a right of contribution against either A or AB, then the result would be the same as Problem 2 because B would only bear 20% of the liability.

If A paid the liability and had no right of reimbursement from B, then the results would also be the same as in the case of Problem 2.

PROBLEM 5

Same as Problem 2, except B indemnifies A with respect to 20% of the mortgage.

B's indemnification of A with respect to 20% of the mortgage does not change the economic risk of loss of the parties. As a general partnership, A would be entitled to contribution from B if A were called upon to pay the entire liability in any event.

PROBLEM 6

Same as Problem 2, except the mortgage was a nonrecourse mortgage.

Where nonrecourse debt is involved, the indebtedness is allocated among the partners based upon the three-tier formula set forth in Treas. Reg. § 1.752-3(a). Under the first tier, there is allocated to the partners their respective shares of partnership minimum gain. Since the book value of the property exceeds the liability, there is no minimum gain and, therefore, no allocation under the first tier.

Under the second tier, there is allocated to the partners the amount of gain that would be allocated to them under I.R.C. § 704(c) if the partnership disposed of the property for an amount equal to the nonrecourse liability. Since A's basis for the contributed property was \$20,000, under I.R.C. § 704(c) there would be allocated \$40,000 of gain to A if the property were sold for the \$60,000 nonrecourse debt. Thus, \$40,000 of the \$60,000 mortgage debt is allocated to A in the second tier.

Under the third tier there is allocated to the partners the balance of the nonrecourse liability in accordance with their share of partnership profits. This would result in 80% of the remaining \$20,000 (or \$16,000) being allocated to A and 40% (or \$4,000) being allocated to B.

Accordingly, \$56,000 of the mortgage would be allocated to A and \$4,000 of the mortgage would be allocated to B.

A's share of the debt before contributing the property to the partnership was \$60,000. A's share of the debt after contributing the property to the partnership is \$56,000. Thus, there has been a net decrease in A's share of the liabilities of \$4,000. I.R.C. § 752(b) treats this as a distribution of \$4,000 to A. Thus, A's basis for his partnership interest is $\$20,000 - \$4,000 = \$16,000$.

B's share of liabilities increases by \$4,000, and I.R.C. § 752(a) treats this as a contribution to the partnership. Thus, B's basis for the partnership interest is $\$10,000 + \$4,000 = \$14,000$.