

## PARTNERSHIP TAXATION

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Page 1 of 4

### TAKE-HOME FINAL EXAMINATION

This examination consists of four questions.

Everyone must answer the first question. This counts for 40% of the grade on the examination.

Everyone further must answer any two of the last three questions. Thus everyone must answer three questions in total. These latter two questions each count for 30% of the grade on the examination.

No question necessarily presents a difficulty either proportionate or disproportionate to its weighting. Identifying one's worst question represents its own part of one's strategy.

For each question, please consider the readings and class discussion. of course, feel welcome to look beyond them insofar as additional analysis might apply. The instructor will not presume to disregard this.

There apply no limitations of space. Please feel welcome to be thorough.

Apply the law in force as of the present date.

The examination is due in my office (or with Sharon Jacks) at 6:00 p.m. (within reason), Friday, December 6, 1991.

GOOD LUCK

I. The AB Partnership comprises Ms. A and Mr. B, unrelated individuals, as equivalent partners in all respects. AB follows the cash method and the calendar year.

Capital represents a material income-producing factor in AB's activities. Further, the partnership agreement provides for the substantial economic effect of all allocations of all partnership items.

During 1991, AB will have \$40,000 of ordinary income, net of allowable deductions. AB also will have \$20,000 of long-term capital gain. Under the partnership agreement, Mr. B receives 10% of partnership profits, net before tax, for his ongoing services in managing the partnership business. These services are tantamount to what AB otherwise would procure from an independent contractor.

On July 1, 1991, Mr. B gave half of his 50% partnership interest, but including the right to all of his, Mr. B's, 50% distributive share of partnership income, to his son, Mr. S. However, Mr. B retained all of his 50% distributive share of partnership depreciation or cost recovery.

Please discuss the treatment of Messrs. B and S under Sub chapter K, for 1991, under these facts. (Please also note that this represents a restatement of problem No. 3, in Lind et al. at 211.)

II. One of my long-time, faithful clients is a high-income, high-wealth investor, W.R.N. (wishing to remain nameless). He is an individual, and follows the cash method of accounting and the calendar taxable year. The XYZ Limited Partnership was duly organized in Ohio in 1983, and also followed the cash method of accounting and the calendar taxable year. W.R.N. held a one-third interest in partnership capital, a one percent interest in partnership profits, and a two-thirds interest in partnership losses, as a limited partner in XYZ, from its inception back in 1983.

The XYZ Limited Partnership held only two assets throughout its duration, two separately described parcels of improved real estate along the riverfront in downtown Toledo. As the partnership antedated the 1984 Act, these lands and buildings were acquired and retained subject to large amounts of nonrecourse financing.

Not so fortunately, XYZ came into being just about in time to claim its own dubious part in downtown Toledo's demise. By early 1986, W.R.N. had seen that the development of Toledo's waterfront would fail. Moreover, W.R.N. saw in later 1986 that the 1984 Act would greatly reduce his marginal tax rate, hence the utility of his distributive share of partnership loss.

Thus, at the annual partners' meeting, held on December 15, 1986, W.R.N. took the floor, and announced that he would refuse "to let the tax tail wag the money dog," hence "to send good money after bad", and hence that he "would make no further capital contributions to the partnership, notwithstanding any duly authorized capital call by the general partner and notwithstanding any other provisions to the contrary in the partnership agreement. An outraged and rancorous debate ensued, but W.R.N. held firm to his statement. XYZ had exactly zero net income for 1986.

XYZ continued with exactly zero net income for the first half of 1987. Then, just as W.R.N. had seen, the partnership failed. On July 1, 1987, XYZ defaulted on the mortgage payments due on

each property. The lender immediately foreclosed on both. In each instance the outstanding balance of the nonrecourse mortgage exceeded the property's fair market value, so XYZ simply repudiated the debts and abandoned the properties. This not incidentally accomplished XYZ's liquidation and termination as well.

In drafting W.R.N.'s 1987 return I claimed the amount of his basis in his partnership interest as a long-term capital loss. Mature reflection has reduced me from the conviction to the hope that that was correct.

What do you make of it? Was W.R.N.'s long-term capital loss treatment for 1987 correct? Or, might he yet anticipate a notice from the Commissioner?

With respect to all of this, what additional facts might be well to know? Identify any such very arguable and reasonable assumptions of fact, and continue to analyze the case.

In any event, please discuss.

III. Assume a partnership, the ELKM General Partnership, having four equivalent partners. ELKM duly follows the cash method of accounting and the calendar taxable year. Each partner has a basis in his partnership interest of \$100x.

Thus far in 1991, all four partners have received two operating distributions, in kind. Both distributions proceeded entirely pro rata, by all pertinent measures, with respect to all partners. (It would have been hard but we invoked deus ex machina.)

In the first distribution, each partner received a parcel of farmland. These lands had been held for 15 years, and were held free and clear, unencumbered by debt. The partnership had claimed deductions for conservation (see IRC S 175) and clearing (see IRC S 182) with respect to the lands, though at the time of the distribution the lands lay fallow. The partnership's basis in each parcel of farmland was \$5x, and each parcel had a fair market value of \$50x.

In the second distribution, each partner received a group of accounts receivable, all from debtors with the same good credit and other pertinent characteristics. Each group of receivables had a fair market value of \$30x.

Each partner, immediately upon taking his distribution of the receivables, redistributed the receivables in gifts among his several college-age children. Each one's children then collected the receivables, promptly and without incident. Each partner will suffer the top marginal tax rate; thus, each hopes to avoid at least a little taxation within his family.

We anticipate nothing of consequence for this taxable year. One may assume that the partnership will break even, reporting exactly zero net income.

How well will this work? More particularly, what tax effects appear for the partners, and the

children, as the case would be? Please discuss.

IV. Mr. X has contributed a certain parcel of unimproved real estate to the ABC General Partnership, in exchange for a one-tenth interest in partnership capital and all partnership items. He had purchased the land for \$50,000, and held it subject to a nonrecourse mortgage of \$100,000 (this upon a recent refinancing, and not as acquisition indebtedness) . The land enjoyed at the time of its contribution to the partnership a fair market value of \$200,000.

Mr. X had not used the land for any specific activity, but kept it for speculation. The ABC partnership (and each individual partner for that matter) intends this to continue for several years.

As a condition of Mr. X's contribution of the land to ABC, the partnership assumed the mortgage indebtedness and the mortgagee accepted the substitution of the partnership for Mr. X individually on the debt. This was enforceable and otherwise proper under local law.

Mr. X refused peremptorily and pre-emptively to agree to any further provisions of or conditions to his admission to the partnership.

What treatment, both to Mr. X and to the ABC General Partnership? As before, would it be well to know any additional facts? If so, why?

Please discuss.