

PROFESSOR BATROFF  
FINAL EXAM  
PARTNERSHIP TAXATION  
Spring 1995

EXAM NO. \_\_\_\_\_

**INSTRUCTIONS**

- (1) You may use the following for this exam: The Code & Regs., any handouts by your professor, any handwritten or typed notes prepared by the student, a nonprogrammable calculator and the answer books in addition to the exam.
- (2) Place your exam number on all answer books and the exam and turn in both when you have finished.
- (3) Unless the facts clearly indicate otherwise, you are to assume that all parties are cash basis calendar year taxpayers, all partners are equal, individual, general and actively participating service business partners, any liabilities are recourse in nature, all allocations have substantial economic effect for general partners, there are no disproportionate Sec. 751 distributions, there is no Sec. 754 basis adjustment election in effect, and capital accounts are required to always be maintained, utilized for liquidating distributions and upon liquidation any general partner must immediately restore any deficit. Also, A.B.= adjusted basis and F.M.V = fair market value.
- (4) There are 12 exam questions, 4 in each of three classes (#1, #2, & #3). The student should select and solve **only 3 of the 4 in each class**. If more than 3 are solved and the student does not identify the three that are to be graded, only the first three will be graded. As identified on the course learning objectives previously distributed, the class #1 problems require computations and supporting explanations and carry the greatest point value (40 each out of total possible exam points of 210). #2 problems (20 points each) less computation and explanation and #3 problems require only verbal explanations. The student should budget the 3 hours allowed for the exam so that the 9 questions required to be answered are and that time is spent on the problem point value of each question.
- (5) On problems involving calculations, be sure to show your calculations. Credit for incorrect amounts depends on the nature of the mistake (e.g., little if any deduction will be made for simple math errors). In all instances, it must be possible for your professor to be able to identify which answer relates to which question, so clearly mark your answer sheets.
- (6) Good luck and have a good summer!

**QUESTION I. (#1)**

The ABCD Partnership was formed on 12/10 of the current year when A, B and C each contributed \$50,000 in cash and D contributed land, with a mortgage that the partnership will assume, that he had held as an investment and which the partnership plans to build their office upon. D bought the land 4 years ago for \$5,000 and a year later executed a recourse mortgage that has a current balance of \$8,000. The F.M.V. of the land at the time of formation was \$58,000.

A. Determine the amount and character of the gain or loss recognized, if any, for:

1. The partnership
2. Partner A.
3. Partner D.

B. Determine the outside basis (e.g., for purposes of Sec. 704(d)) of the interest in the partnership for:

1. Partner A.
2. Partner D.

C. Determine the results in parts A and B above if the mortgage is nonrecourse.

D. Determine the results in parts B and C for partner A if the partnership agreement provides that A is to receive 30% of the profits and 20% of the losses.

**QUESTION II. (#1)**

D (divorced) of the ABCD Law Partnership died on 2/1 of the current year when his interest was worth \$20,000. The partnership has had and will continue to have a very steady net income of \$8,000 per month throughout the year. The partnership agreement clearly provides for liquidation of a deceased party's interest as of the date of death and it was completed by the end of the year with a \$20,000 cash payment. The balance sheet of the firm at that time of D's death was as follows:

| ASSETS              | A-B.             | F.M-V.           | PARTNERS'<br>CAPITAL | A-B.             | FMV              |
|---------------------|------------------|------------------|----------------------|------------------|------------------|
| Cash                | \$ 6,000         | \$ 6,000         | A                    | \$ 4,000         | \$ 20,000        |
| Accounts Receivable | -0-              | 20,000           | B                    | 4,000            | 20,000           |
| Corporate stock     | 10,000           | 40,000           | C                    | 4,000            | 20,000           |
| Goodwill            | -0-              | 14,000           | D                    | 4,000            | 20,000           |
|                     | <u>\$ 16,000</u> | <u>\$ 80,000</u> |                      | <u>\$ 16,000</u> | <u>\$ 80,000</u> |

- A. Determine the amount and character of the gain or loss recognized, if any, for the year for:
1. The partnership.
  2. D.
  3. D's estate.
- B. Explain, without computations, how the answers in Part A would be different if:
1. The partnership is not law but instead one in which capital is a material income producing factor, or
  2. D's son, who just passed the bar, inherited the interest and assumed D's position in the firm.

**QUESTION III. (#1)**

The AB Partnership was formed with A contributing \$100,000 in cash and B contributing property (\$60,000 basis, F.M.V. of \$100,000).

- A. If the property was land (a capital asset for the contributing partner and the partnership) and it was sold 4 years later for \$130,000, determine the tax consequences including the tax gain or loss allocable to each of the partners under all alternatives available.
- B. Same as part A except the land is sold for \$85,000.
- C. Determine the impact in part B, if any, if during the same year the partnership had a \$20,000 gain on the sale of corporate stock it bought 2-1/2 years ago.
- D. Determine the annual tax depreciation deduction allocable to each partner if the property is depreciable instead of land and there are five years remaining and straight-line method is used.

**QUESTION IV. (#1)**

A sells his entire 1/4 partnership interest in the ABCD Partnership to E for \$53,000 when the partnership balance sheet was as follows:

| ASSETS      | A.B.      | F.M.V.    | CAPITAL | A.B.      | F.M.V.    |
|-------------|-----------|-----------|---------|-----------|-----------|
| Cash        | \$ 40,000 | \$ 40,000 | A       | \$ 50,000 | \$53,000  |
| Securities  | 56,000    | 40,000    | B       | 50,000    | 53,000    |
| Sec. 1245   |           |           | C       | 50,000    | 53,000    |
| Machine     | -0-       | 4,000     | D       | 50,000    | 53,000    |
| Receivables | -0-       | 9,000     |         | \$200,000 | \$212,000 |
| Inventory   | 104,000   | 119,000   |         |           |           |
|             | \$200,000 | \$212,000 |         |           |           |

- A. Determine the amount and character of the gain or loss recognized, if any, by A.
- B. Determine the results in part A if the receivables have been realized (i.e., the basis is \$9,000) and the basis in the securities was \$47,000 (i.e., \$9,000 less).
- C. Determine the results in part A if the receivables have been realized and instead of the Sec. 1245 Machine there was Goodwill with a \$-0- basis and F.M.V. of \$4,000.

#### QUESTION V. (#2)

The ABC Café was formed as a partnership on 1/10 of the current year with A and B contributing \$30,000 each in cash which was used for working capital requirements and for a down payment on a building for the business. A \$90,000 recourse mortgage (interest but no principal to be paid for the first 18 months) was obtained from an unrelated commercial mortgage company. Partner C contributed equipment to be used in the business that had a basis to her of \$3,000 and a F.M.V. of \$30,000. The firm has no other debts, made no distributions, and the first year of operations resulted in a loss properly allocable to C of \$35,000.

- A. Determine C's deductible loss if her only other income was a \$50,000 profit on a real estate rental limited partnership she has owned for 3 years.
- B. Determine the result in part A if C is a limited partner.
- C. Determine the result in part B if the mortgage is nonrecourse.
- D. Determine the result in part B if C's only source of income was wages of \$50,000.

#### QUESTION VI. (#2)

The AB investment partnership agreement provides for equal sharing of gains or losses from the sale of securities, ordinary taxable income is to be allocated all to A (whose marginal tax rate is 15%) and tax exempt income is to be allocated 20% to A and 80% to B (whose marginal tax rate is 36%). During the year the partnership no capital gain or losses, \$20,000 of taxable income from dividends on stock and \$20,000 from tax exempt interest on state bonds.

- A. Determine the consequences for partner A for each of the above income sources.
- B. Determine how your answer in part A would differ, if at all, if the agreement provides 20 % of the ordinary taxable income in partner A is to get all of the tax exempt income and 20% addition to equal division of capital gains and losses.

### QUESTION VII. (#2)

The ABC partnership has been in existence for 6 years. On 12/3 of the current year, partner A (whose outside basis at that time was \$80,000) contributed a truck (basis of \$1,000 and a F.M.V. of \$10,000) to be used by the firm. For the year the firm had a net income of \$12,000 and the only cash distribution was \$10,000 to A on 12/30.

- A. Determine the tax consequences of the above as it relates to partner A.
- B. Determine the result in part A if the distribution was \$6000 instead of \$10,000.
- C. Determine the result in part A if no cash distributions are made to partner A for 3 years but the partnership agreement was amended to provide for the first \$10,000 of income for the current year is to be allocated to A.

### QUESTION VIII. (#2)

The AB partnership had the following items for the current year:

- (1) 1/1 partner's outside basis: A \$70,000; B \$90,000.
- (2) Receipts from services performed: \$60,000
- (3) Short-term capital loss: \$1,000
- (4) Gain from sale of equipment:
  - (a) Sec. 1245: \$3,000
  - (b) Sec. 1231: \$1,400
- (5) Interest on Ohio highway bonds: \$1,000.
- (6) Rent and utilities paid: \$ 20,000
- (7) Depreciation
  - (a) Regular: \$1,200
  - (b) Sec. 179 Expense election: \$2,000
- (8) Cash charitable contributions: \$200
- (9) Interest earned on bank accounts: \$700
- (10) Cash distribution to each partner: \$6,600.

A. Determine the amounts and manner in which the above items will be reported to each of partner by the partnership.

B. Determine B's outside basis in her partnership interest at the end of the current year.

### QUESTION IX (#3)

On Jan. 1 of the current year, the ABCD partnership was formed. On 2/7, A sold 80% of his 25% interest (a 20% interest) to E. On 4/2, B gave her entire 25% interest to F. On 6/3, F sold 60% of his 25% interest (a 15% interest) to G. On 7/7, C sold his entire 25% interest to H. On 9/9, D sold her entire 25% interest to I.

A. Determine the effect on the partnership's tax years as a result of the above.

### QUESTION X (#3)

ABC Limited was formed by A, B and C to operate a consulting business as a limited liability company (LLC) under Delaware law. The statute provides that no member is liable for the debts of a LLC. The LLC agreement states that no member can transfer an interest to another person who is not a member unless all remaining members consent and that the LLC will continue regardless of any event that terminates the continued membership of any member. The agreement also provides that the LLC will be managed by those members who have a 20% or more interest in the business. The firm had a net income of \$45,000 and \$30,000 of this amount was distributed to the members on the last day of the year.

A. Discuss the tax treatment of \$45,000 and \$30,000 amounts.

### QUESTION XI. (#3)

The ABC partnership, in addition to cash, has substantial amounts of appreciated securities and unrealized receivables. During the year, the only distribution made was a distribution of some of the appreciated securities to partner A (not in liquidation of her interest).

A. Discuss the tax consequences for each partner as a result of the above.

### QUESTION XII. (#3)

The ABC paid for the following item in connection with forming the partnership: (1) Legal fees to draft the partnership agreement, (2) Legal fees to prepare the registration with the state Securities and Exchange Commission since there was a public offering, and (3) a retainer paid to a CPA firm to prepare the firm's first year tax return.

A. Discuss the tax treatment by the partnership of these items.