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Partnership Taxation: Final Examination (January 13, 1971)

William & Mary Law School

Mr. Donaldson FINAL EXAMINATION January 13, 1971

Partnership Taxation

I. A, B, & C plan to commence a business venture as equal participants on April 1, 1971. Each are on the calendar year and each are very wealthy, making annually more than $70,000 each. Because of the need for capital, they intend to permit A's corporation, "X Enterprises", to join the venture as a co-equal. They expect the business, to be named "ABCX Ventures", to lose heavily in the initial years but to become exceedingly profitable in about five years. A, B, & C are interested in good pension plans. They also intend to reinvest most of the earnings derived from the business in the business to permit expansion. It is anticipated that a substantial portion of the gains derived can be realized as capital gains. Advise the participants of the merits and demerits of the alternate forms of business organization they may chose to employ.

II. X & Y formed a two man partnership. X contributed property having a basis of $20,000, a fair market value of $40,000 and which was subject to an encumbrance of $10,000. X also contributed $20,000 in cash. Y contributed $50,000 in cash. Each of their distributive shares of the firms taxable income was $14,000, and from which, at the end of the first year of operation, each was paid $9,000. The firm also paid health insurance premiums for each partner of $200.00 each and made a charitable contribution totalling $400.00. During the year it borrowed $10,000, but repaid nothing, and the encumbrance on the property contributed by X was not reduced. What is the basis for X's interest in the partnership? At the time of the formation of the partnership, was it possible for the partner's to make an agreement providing an equitable tax adjustment to account for the difference between the basis and fair market value of X's contributed property, and if so, what could the agreement have provided?

III. A, B, & C two years ago formed a partnership. A owned a 65% interest in capital and earnings, B a 20% interest and C a 15% interest. C contributed no capital, but was given his interest because C was to manage the business. A & B are husband and wife. The business was capitalized by a $100,000 transfer of cash made by A & B. C was given, on the books, a capital interest of $15,000. Last week A sold depreciable property having a basis to him of $20,000 to the business for $50,000, its fair market value. Yesterday A sold to the business 100 shares of stock having a basis to him of $800.00 for $200.00, its fair market value. A owns an antique car valued at $10,000 and having a basis of $5,000. C owns a persian rug valued at $10,000 and having a basis of $6,000. A plans to make a capital contribution of the car to the partnership and C plans to make a capital contribution of the rug to the partnership. After a lapse of several months, it is intended that the partnership distribute the rug to A and the car to C.

A. What are the tax effects of the above transactions to the partners involved and to the partnership?

B. If C withdraws from the partnership by having his interest bought out by the partners, what will be the tax effect to him of a settlement of $20,000, consisting of $15,000 for his initial interest, $4,000 for retained earnings from earlier years and $1,000 for current earnings?

IV. A is considering withdrawing from Partnership ABC, in which he has an equal 1/3 interest. The partnership is profitable, and although A's basis for his interest is $20,000, it is valued at $40,000. The partnership, under the terms of the agreement, is obligated to buy out a withdrawing partner at the value of his interest. The partnership agreement can be amended prior to A's withdrawal. Discuss the optimal withdrawal payment arrangement best for (1) A and best for (2) B & C.

V. The books of Partnership ABCD disclose the following:

ASSETS	ADJ. BASIS	VALUE	LIABILITIES & CAPITAL	ADJ. BASIS	VALUE
CASH	18,000	18,000	LIAB.		0
Prop. X	10,000	14,000	CAP. A	12,500	15,000
Prop. Y	12,000	10,000	B	12,500	15,000
Prop. Z	8,000	11,000	C	12,500	15,000
Prop. T	2,000	7,000	D	12,500	15,000

C and D have had a falling out. C is considering withdrawing from the partnership in return for the transfer to him by the partnership of property Y and $5,000. D is considering transfering his interest to E for $15,000 in cash if C decides not to withdraw. Discuss the proposed arrangements from the standpoint C, D, E and the partnership including a consideration of the desirability of a section 754 election from the standpoint of each. Will either C's plan or D's plan result in a termination of the partnership for tax purposes?

VI. Partner X, in the XYZ Partnership, has an adjusted basis for his interest of $14,000. In a liquidation distribution X receives $8,000 in cash, real property having a basis to the corporation of $3,000 and a value of $2,000, and inventory items having a basis to the partnership of $1,500 and a value of $2,000. What is the consequence of the distribution to X in terms of gain and loss and effect on basis. Two years later X, a merchant, sells the inventory items in the ordinary course of business for $3,000. What is the tax effect of the sale? He sells the real property for $4,000? What is the tax effect?

VII. X is a sole proprietor who operates a real estate agency from a rented office, deriving all of his income from commissions. Property used by him in the business has a basis to him of $1,000 and a fair market value of $1,500. The business normally nets $30,000 a year. X is 55 years old and thinking of retirement and his 16 year old son's future. He is considering giving his invalid wife a 1/3 interest in the business and his son a 1/3 interest. His son intends to go to college and for the next six years can work only in the summer. X would remain the manager and draw a salary of $9,000 a year. The son would make $1,000 per summer. The remaining profits would be divided three ways. Should X form a partnership between himself, wife and son? Would the use of a corporation be more or less feasible?

VIII. Answer briefly.

1. What are the Kintner regulations, why are they of current interest, and what land mark case decided in the 1930's is frequently cited in regard to their alleged invalidity?

2. On the whole, do the partnership provisions reflect the entity theory, the aggregate theory, the corporate theory, the Cohen theory or some other theory of taxation. Give an example for each of two theories reflected in the provisions.

IX. Partner D's partnership interest has a basis to him of $14,000. On withdrawal from the partnership D is paid $4,000 in cash and is given real property with a basis to the partnership of $9,000 and a fair market value of $15,000. What are the tax consequences of the distribution?

X. Partnership XYZ's assets consists of cash of $15,000, unrealized receivables having a value of $18,000 (no basis) and depreciable property having a basis of $15,000 and a fair market value of $27,000. The partnership is on the cash basis of accounting and derives all of its income from commissions. Z has a basis for his interest of $10,000 and plans to sell it to A for $20,000, consisting of $16,000 in cash and property having a basis to A of $3,000 and a value of $4,000. No elections are in effect or will be in effect. Discuss the tax consequences of the sale from the standpoint of Z and A.