

Chapter 10

Sole Proprietorships and Flow-Through Entities

Solutions to Develop Research Skills

Note to Instructor: No research aids or “hints” are provided in the textbook for problems in this chapter. Before the solution to each problem, however, suggested research aids are provided. This allows you to choose whether or not to provide any hints to your students for a particular problem. For problems that can be solved using free Internet sources, you must provide students with the citations in these hints and refer students to Figure 2.2 of Chapter 2 in the text for the URLs to enable them to solve these problems using free Internet sources. Some of the problems require access to *Checkpoint®* or a similar service. The research process for solving a sample problem is illustrated in Appendix A through screen captures for *Checkpoint®*.

52. Tax Issues

Locate a recent appellate court case that has reversed a Tax Court decision regarding a partnership or S corporation tax issue.

- Summarize the facts, issues, and conclusions of the case.
- Explain why the appellate court reversed the Tax Court.
- Explain the impact this decision has on tax planning for clients.

Solution: Cases will differ among students.

53. Sale of Partnership Interest (can be solved using free Internet sources)

Roberta Wynn has been a partner in the Cato Partnership for a number of years. With the permission of the other partners, she sells her partnership interest to a third party. At the time of sale, her basis in her partnership is only \$100. For the portion of the year to the date of sale, she is allocated a partnership loss of \$2,100. If she receives \$10,000 for her partnership interest, what are the tax consequences of the sale and the results of partnership operations in her final year?

Hint: IRC Sections 704(d), 705(a), and 741.

Issue: Will Roberta be allowed to deduct the full amount of her loss in the year she disposes of her partnership interest?

Conclusion: Roberta will only be permitted to recognize \$100 of the \$2,100 partnership loss which will reduce her basis to zero. Roberta’s \$10,000 long-term capital gain will result in a tax liability of \$1,500.

Discussion of Reasoning and Authorities: Section 704(d) limits a partner’s distributive share of partnership loss to the extent of the partner’s adjusted basis. The excess loss will be allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership. As such, the \$2,100 loss is limited to \$100 which will reduce Roberta’s basis to zero. The only way Roberta could recognize the additional \$2,000 loss would be to increase her basis. Under Section 705(a)(1), a partner’s basis is increased by the distributive share of taxable income. Another way to increase basis is for the partner to make an additional contribution to the partnership. Unless Roberta contributes \$2,000 to the partnership prior to the sale, the excess loss cannot be deducted. Unlike passive losses for which there is a specific provision for the deduction of suspended losses when a passive investment is completely disposed of, no such provision exists for partnership losses held in suspense due to lack of basis. Roberta will have a \$10,000 long-term capital gain from the sale of the partnership pursuant to Section 741. She will be taxed using the 15% LTCG tax rate, resulting in a \$1,500 tax liability.

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54. *Incorporating a Partnership (can be solved using free Internet sources)*

The partners of JPG Partnership want to change the form of entity from a partnership to a corporation. The corporation can be formed in several ways: The partnership can distribute the assets to the partners who then contribute the assets to the corporation. The partnership can transfer the assets directly to the corporation. The partners can transfer their partnership interests to the corporation. Write a memo outlining the tax effects of the various methods of forming the corporation.

Hint: PLR 8714042 and PLR 8107136

Solution:

To: JPG Partnership

Pursuant to Private Letter Ruling 8714042, a partnership meets the provisions of a Section 351 exchange by transferring all its assets and liabilities to the corporation, in exchange for common stock of the corporation. Under Section 351, no gain or loss is recognized by the partnership or the corporation as a result of the transfer. The partnership then distributes all of the common stock to the partners in complete termination of the partnership. This allows nonrecognition of gain or loss by the partnership on the liquidating distribution. The partners will only recognize gain if money is distributed that exceeds the basis of the partnership interests. The basis of the stock received by the partnership will be the same as the basis of the business assets surrendered in the exchange, decreased by the amount of liabilities assumed in the exchange, and by the amount of liabilities to which the transferred assets are subject. The basis to the corporation of the business assets received in the exchange will be the same as the basis of such assets in the hands of the partnership immediately prior to the exchange.

Private Letter Ruling 8107136 provides that no gain or loss will be recognized by the partnership or partner in a Type A reorganization. A Type A reorganization is when the partners transfer their partnership interests directly to the new corporation in exchange for stock and assumption of partnership liabilities. The partners will only recognize gain if money is distributed that exceeds the basis of the partnership interests. To the extent each partner is relieved of any partnership liabilities by reason of the assumption of such liabilities by the corporation, each partner will be considered to have received a distribution of money. The basis of the stock received by the partner in complete liquidation of his interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.

If the partnership distributes the assets to the partners prior to the incorporation, the partners will take a basis in the distributed assets equal to their basis in their partnership interest and will generally recognize gain only if they receive money in excess of this basis. If the assets are distributed and immediately contributed to the partnership, the Service may simply disregard the intermediate step using the step transaction doctrine and treat this transaction as a contribution of assets.