# Mastering Tax Complexities in the Sale of Partnership and LLC Interests

**TUESDAY, JANUARY 13, 2015, 1:00-2:50 pm Eastern**

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Mastering Tax Complexities in the Sale of Partnership and LLC Interests

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Mastering Tax Complexities in the Sale of Partnership and LLC Interests

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Overview

• Sale of Partnership Interest
  • General Rule
  • “Hot Asset” Rule
• Purchaser Issues
• Liquidating Distributions (Redemptions)
• Net Investment Income Tax – Application to Transfers of Partnership Interests
Sale of Partnership Interest

- Sale of Entire Interest
- Sale of Partial Interest
- Split Holding Period Issues
Sale of Partnership Interest

• A partner can dispose of his or her interest in many ways:
  • sale to third party
  • sale back to partnership
  • sale to other partner

• Economically, these transactions are identical, but the tax rules sometimes treat them differently.

• We first look at sales to third parties and/or other partners
Sale of Partnership Interest

• General Rule – IRC §741

• A sale of partnership interest is a sale of a capital asset.

• Holding period requirements for long/short term capital gain/loss are measured by the seller’s ownership period, not by the partnership’s holding period of the underlying assets.

• However, a significant exception to this general rule is the “hot asset” or IRC §751 rules.
Gain/Loss Calculation

Gain/Loss from the sale of a partnership interest:

\[
\text{amount received} - \text{adjusted tax basis} = \text{gain (loss)}
\]
Gain/Loss Calculation

- amount received in the sale of a partnership interest includes the following:
  - cash received
  - FMV of property received
  - liabilities of the seller that are assumed or relieved
    - formal liabilities
    - deemed liabilities for tax purposes (i.e., partner’s share of partnership liabilities)
Gain/Loss Calculation

- adjusted tax basis includes
  - the seller’s share of partnership liabilities
  - income/loss through the date of sale (as allocated)
  - in simple cases, will often line up with capital account balance plus share of partnership liabilities
Gain/Loss Calculation

Allocation of Partnership Liabilities

- amount received and tax basis calculations both require consideration of partnership liabilities.
  - partnership recourse liabilities
  - partnership nonrecourse liabilities
- Also consider whether non-partnership liabilities are being assumed or relieved.
Gain/Loss Calculation

Example

• Adam is a member of Eden, LLC and sells his interest to Eve for $100 in cash.

• Adam’s tax basis is $40, which includes $15 in partnership liabilities.
  • Amount received = $115
    • $100 cash
    • $15 partnership liabilities relieved
  • Adjusted tax basis = $40
  • Gain = $115 - $40 = $75
Sale of A Partial Interest

• We have thus far assumed a sale of a partner’s entire partnership interest.

• In some cases, however, a partner may sell only part of his or her interest.
Sale of A Partial Interest

• Very little guidance.

• IRS position is that a taxpayer has a single tax basis, even if he/she owns different types of interests (i.e., owns a limited and general partnership interest; owns Class A and Class B units in an LLC).

• The tax regulations require that this tax basis must be “equitably apportioned” between what is sold and what is retained.

• This differs from the sale of corporate stock which utilizes a tracing approach!
Sale of A Partial Interest

Example

- In 2010, Adam buys 10 units in Eden, LLC for $200.
- In 2012, Adam buys another 10 units for $1,000.
- In 2014, Adam sells 10 units (retaining the other 10) for $2,000.
- Assume that Adam has an overall tax basis of $1,200 (no liabilities, no income allocation in excess of distributions, etc.)
Sale of A Partial Interest

Example

- If Adam allocates his basis ratably among the units, then the 10 units that are sold (representing 50% of the total units) will have a tax basis of $600 (i.e., $600 = 50\% \times $1,200 total tax basis).

  - amount received = $2,000
  - tax basis = $600
  - gain = $1,400
Sale of A Partial Interest

• The ratable/FMV allocation approach is supported by the regulations and by commentators.

• An alternative is a tracing approach.

• Assume that Adam’s tax basis in each block of LLC units is equal to his original purchase price.

• If Adam sold the second block, he might argue that he recognizes only $1,000 of gain (i.e., $2,000 amount received less $1,000 tax basis).
Sale of A Partial Interest

• What if a seller owns different *types* of LLC or partnership interests?

• limited vs. general partnership interests.

• senior vs. junior interests

• Class A vs. Class B

• The majority view is to allocate total basis in proportion to the FMV of the interests.
Sale of A Partial Interest

• **Example:** Eve owns both LP and GP units in a partnership. She has total basis of $100, and is selling her LP interest for $60. Assume the FMV of the GP interest is $90.

• Total FMV = $150, so LP interest represents 40% of the total.

• Accordingly, $40 of basis (40% x $100) is allocated to the LP interest

• Gain = $20 ($60 amount received less $40 basis)
Split Holding Period

• Because there is a significant capital gains rate differential, it can be important to determine whether the long-term capital gains holding period has been satisfied.

• If the seller acquired her partnership interest at different times, split holding periods may come into play.

• The holding period of a partnership interest is determined by reference to the holder, not the holding period of the underlying partnership assets.
Split Holding Period

**Example:** On 1/1/2014, Smith contributed cash and real property to ABC, LLC. The cash is $1,000. The real property is worth $2,000, has a basis of $100, is a capital asset and was acquired by Smith on 1/1/2000.

- The ratio of the cash to the real property is 33% to 67%.
- Smith has split holding periods.
  - 33% of her LLC interest has a holding period that started on 1/1/2014 (the cash contribution).
  - 67% of her LLC interest has a holding period that started on 1/1/2000 (the real property contribution).
Split Holding Period

• On 7/1/2014, Smith sells her LLC interest for $2,000. At the time, her basis is $1,100, resulting in gain of $900. (Assume no re-characterization of the gain under §751.)

• Because Smith has a split holding period for her LLC interest, the gain is allocated ratably:
  • 33% of her gain ($300) is treated as a short-term capital gain because the holding period began on 1/1/2014.
  • 67% of her gain ($600) is treated as long-term capital gain because the holding period began on 1/1/2000.
“Hot Asset” Rule

• Under the general rule, a sale of a partnership interest gives rise to capital gain or loss.

• However, there is a significant exception to this rule that looks to the underlying assets of the partnership.

• This exception can dwarf the general rule depending on the business of the partnership.
“Hot Asset” Rule

• Decision path:
  1. Determine whether hot asset rule applies.
  2. Determine total gain/loss.
  3. Determine gain/loss on deemed sale of hot assets.

• End result – any gain/loss on deemed sale of hot assets is re-characterized as ordinary
“Hot Asset” Rule

• Does Hot Asset Rule apply?
  • §751 applies if a partnership has §751 assets.
• What are §751 assets?
  • “unrealized receivables” and inventory
§751 Assets

• “unrealized receivables”
  • generally – receivables for goods delivered (or to be delivered) or for services rendered (or to be rendered)
  • BUT ONLY to the extent not previously included in income under the partnership’s method of accounting
  • also: recapture property to the extent of ordinary income recapture amount
§751 Assets

• inventory

  • property held for sale to customers in the ordinary course of business (including real estate held by a dealer whether or not included in inventory)

  • any other property that, on the sale or exchange by the partnership, would be considered property other than a capital asset or §1231 property; and

  • any other property that, if held by the transferor partner, would be described above
Total Gain/Loss

• Compute gain/loss as if §751 did not apply
  • Accordingly, the general rule applies, with caveats for partial interests, etc.
§751 Deemed Sale

- Determine gain/loss on all §751 assets – need FMV and tax basis of all §751 assets.

- Regulations set out specific rules:
  - receivables generally valued at present value of net cash expected, reduced by estimated cost of delivery or performance – not face value
  - inventory items valued at market using §471 principles
  - Where book/tax basis differences exist, tax basis computations can be complicated.
Re-Characterization

total gain/loss

- §751 deemed sale gain/loss

= capital gain/loss
Example

• Jones sells his 25% interest in ABC, LLC for $1,000
• Total outside basis = $750
• Two assets:
  • real estate held for investment – capital asset
    • FMV = $500
    • tax basis = $750
  • inventory items – §751 asset
    • FMV = $500
    • tax basis = $0
Example

- Does §751 apply?
  - Yes because ABC, LLC has §751 assets.
- Total gain/loss?
  - amount received = $1,000
  - tax basis = $750
  - gain = $250
Example

- Gain/loss on §751 deemed sale?
  - Amount received = FMV = $500
  - Tax basis = $0
  - Gain = $500
Example

- Recharacterization
  - Total gain/loss = $250
  - §751 gain/loss = $500
  - Capital gain/loss = - $250

- In this case, the inherent loss in the capital asset and the large gain in the hot assets are preserved under §751.
New §751 Regulations

- Changes to the §751 regulations were proposed on 10/31/2014.

- These changes do not significantly affect dispositions of partnership interests -- instead, they impact distributions in which a partner’s interest in §751 assets shifts.

- While this webinar focuses on dispositions of partnership interests, be aware that distributions that change a partner’s interest in a partnership’s §751 assets can be treated as a sale or exchange of such assets between the partner and the partnership.
Purchaser Issues

- Basis of purchased interest
- Capital account
- Basis step up/down
Purchaser Issues

- Buyer’s basis in newly purchased interest is equal to the amount paid plus the share of any liabilities assumed.
- If the seller was subject to 704(c), the buyer will generally succeed to this treatment.
- Buyer will also succeed to the seller’s capital account.
- Adjustments to the basis of partnership assets as a result of a purchase can sometimes affect the allocation of liabilities.
Liquidating Distributions

- General Rules
- §736 Issues
Liquidating Distributions

• In general, a liquidating distribution can be analogized to a stock redemption.

• The partner receives a distribution from the partnership in exchange for or liquidation of his or her interest in the partnership.

• Can be a single or series of distributions.
Liquidating Distributions

• The tax treatment of a liquidating distribution varies depending on what type of property is distributed.
  • cash – gain/loss recognized
  • “marketable securities” – treated same as cash
  • all other property – generally no gain/loss – instead take the property with a carryover basis.
Liquidating Distributions

• Cash includes “deemed” cash distributions from relief of liabilities.

• “Marketable securities” are financial instruments and foreign currencies that are actively traded – these are treated as cash substitutes and the same tax consequences attend them.

  • “financial instruments” defined as stocks and other equity interests, debt, options, forward or futures contracts, notional principal contracts, and derivatives
Liquidating Distributions

• If cash or marketable securities are received, and the total exceeds the partner’s outside tax basis, then the difference is recognized as gain.

• Loss can be recognized but only if the to the extent the distribution consists solely of cash or §751 assets.

• Receipt of other property generally will not result in gain or loss. Instead, the partner’s outside tax basis will be spread over the received property.
Retirement Payments

• An exception to the general rules on liquidating distributions applies in highly specific circumstances.

• §736 governs payments to retiring partners. Payments are separated into two classes:
  • payments for the partner’s interest in partnership property (“§736(b) payments”), and
  • all other payments (“§736(a) payments”).
Retirement Payments

• In general, §736(b) payments are taxed as distributions. So, the general rules on liquidating distributions apply to such payments.

• §736(a) payments are treated as distributive share payments or guarantee payments depending on whether they are a function of partnership income.

• KEY – a §736(a) payment is effectively excluded from partnership income and taxed only to the retiring partner.
Retirement Payments

Example

- Red, a member of Flag, LLC, receives a payment of $100 to induce Red to retire. At the time, the FMV of Red’s interest in Flag, LLC is $25.

- Under these facts, only $25 is treated as a payment for Red’s interest in Flag property. That amount is a §736(b) payment and is taxed under the liquidating distribution rules (i.e., gain to the extent the cash exceed his tax basis in his LLC interest).
Retirement Payments

Example

• The balance of the payment – $75 – is treated as a §736(a) payment.

• Because it is a fixed payment, it is treated as a guaranteed payment and is excluded from the income of the company and taxed only to Red.
Retirement Payments

Service Partnerships

• A special rule applies to a payment by a service partnership to a general partner.

• A service partnership is one in which capital is not a material income-producing factor.

• In general, §736(a) payments also include payments for:
  • partner’s share of unrealized receivables
  • partner’s share of unstated goodwill
Retirement Payments

Service Partnerships

- This expands §736(a) treatment to include some payments that are for the partner's interest in certain types of partnership property.
- Effectively, a partnership can convert part of a liquidating distribution into an income exclusion.
Tax on Net Investment Income
Tax on Net Investment Income

- Variously referred to as the "unearned income Medicare contribution tax" or the "net investment income tax" ("NIIT") or the "Obamacare tax".

- Applies to individuals, estates and trusts.

- Effective 1/1/2013 -- enacted as part of the 2010 Health Care Act.
Tax on Net Investment Income

• The tax is equal to 3.8% of the tax base.

• Tax base is the lesser of:
  • The net investment income of the taxpayer or
  • The excess of the modified AGI of the taxpayer over the threshold amount.
Tax on Net Investment Income

- Modified AGI for these purposes is identical to AGI for most taxpayers.

- For taxpayers who utilize the foreign earned income exclusion under Code Section 911, there are additional adjustments that are made.
Tax on Net Investment Income

- The “threshold amount” is:
  - $250,000 for joint returns and surviving spouses
  - $125,000 for separate return filers
  - $200,000 in all other cases
Tax on Net Investment Income

- The NIIT and the additional 0.9% medicare tax may apply to the same taxpayer in the same tax year, but not to the same items of income:
  - NIIT only applies only to net investment income
  - The 0.9% additional medicare tax applies only to wage and self-employment income
- Estimated tax rules apply.
Why is this relevant to this webinar?

• “net investment income” (NII) generally refers to passive types of income, and also includes the net taxable gain attributable to the disposition of property held in a covered NIIT trade or business.

• IMPORTANT – to prevent avoidance, the NIIT rules also apply to sales of interests in a NIIT trade or business.
NIIT – Deemed Asset Sale

• NIIT attempts to treat the sale of a partnership interest the same as the sale of a partnership’s assets.
• Proposed regulations: Prop. Reg. §1.1411-7
• Proposed and final regulations contain numerous caveats, details.
NIIT – Deemed Asset Sale

Methodology:

• Treat partnership as selling all its assets immediately prior to the sale of the partnership interest.

• Determine the gain or loss from the deemed sale that would be allocated to the selling partner.

• Net gain from deemed sale of assets of NIIT trade or business are included in the definition of net investment income and subject to 3.8% tax (even if would otherwise be CG under regular income tax rules).

Prop. Reg. §1.1411-7
Net Investment Income – Trade/Business

• NIIT will apply to a trade or business that is:
  • a passive activity with respect to the taxpayer, within the meaning of Code Section 469
  • a trade or business of trading in financial instruments or commodities, as defined in Code Section 475(e)(2).

• Regulations provide guidance on the application of NIIT to these businesses, including definitions for the terms “financial instruments” and “commodities.”

• Under the regulations, NIIT does not apply to any other trade or business.
Net Investment Income - Timing

• Because income tax principles apply to NIIT, gain that is deferred for income tax purposes is also deferred for NIIT purposes.

• Conversely, disallowance provisions applicable in determining adjusted gross income (AGI) (e.g., the limitations on investment income or the passive activity loss limitations) also apply to the computation of NII.
TRANSFERS OF PARTNERSHIP INTERESTS: SPECIAL SITUATIONS

Lynn Fowler
Special Situations

- Partnership “mergers”
- Disguised sales of Partnership Interests
- Debt for equity exchanges
Partnership Mergers: What is a "Merger"?

- No statutory or regulatory definition of partnership merger

- However it is clear that:
  - Partnership merger does not rely on state merger statutes.
  - Partnership "merger" includes many transactions that are not undertaken under state merger statutes.
  - Partnership merger excludes many transactions

- Any time partnership transaction(s), with or without state law merger, result in fewer partnerships at the end than at the beginning, ask:
  - Has there been a partnership "merger" for tax purposes?
Example: State Law Merger Without Tax Merger

• Changing jurisdiction of entity or changing type of state law entity.
  – For example, changing a Georgia LP to a Delaware LLC might be accomplished by merging the existing LP into a new LLC under Georgia and Delaware law.
  – State law mergers of this kind are becoming less common now that many states authorize direct conversions without mergers.

• In transactions like this, the IRS says that there is no partnership merger and no partnership termination.

• State law form of transaction is irrelevant to tax characterization. See Rev. Rul. 95-37, 1995-1 CB 130.
"Non-Merger" Example:

State Law Merger

A  50%  B

AB, LP (GA LP)

Whiteacre

Merge

A  50%  B

AB, LLC (DE LLC)
"Non-Merger" Example:

State Law Merger

RESULT

A

50%

50%

B

AB, LLC
(DE LLC)

Whiteacre
Federal Income Tax Analysis

• AB, LLC (DE LLC) is a continuation for tax purposes of AB, LP (GA LP).
• There is no termination of AB.
  – Tax year does not close.
  – EIN does not change.
  – There is no partnership distribution or contribution.
  – No property is deemed transferred.
• However, the transaction may have tax consequences.
  – Most importantly, the amount of liabilities allocated to a member may go down, which is treated as a distribution to the member.
Merger vs. Conversion

- Tax treatment of the *merger* of AB (GA LP) into AB (DE LCC) is more analogous to the state law treatment of a *conversion* of AB (GA LP) into AB (DE LLC).
- Tax law would not distinguish between a state law merger into a shell and a state law conversion.
Equivalent Transactions

- Tax law considers all of the following transactions to be identical
  - State law merger of AB (GA LP) into AB (DE LLC).
  - State law conversion of AB (GA LP) to AB (DE LLC).
  - Contribution of all interests in AB (GA LP) to AB (DE LLC).
  - Contribution of all assets of AB (GA LP) to AB (DE LLC).
  - Distribution to A and B of all assets of AB (GA LP) and immediate recontribution to AB (DE LLC).
Partnership Mergers: Which Partnership Survives?

- Code § 708(b)(2)(A) is the sole Code provision on partnership mergers.
  - Merely defines the survivor of a partnership merger.
  - Does not address consequences of partnership mergers, or even about what a partnership merger means.
  - The Code provision existed long before state laws provided for partnership mergers.
In the case of the merger or consolidation of two or more partnerships, the resulting partnership shall, for purposes of [Code § 708], be considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting partnership. “Code § 708(b)(2)(B). See Treas. Reg. § 1.708-1(c).
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• What if the members of two (or more) partnerships own more than 50% of the resulting partnership?
  – The continuing partnership is the one that is credited with the largest net value of assets. Treas. Reg. 1.708-1(c)(1).

• What if the members of no partnerships own more than 50% of resulting partnership?
  – All of the merged partnerships terminate. Treas. Reg. 1.708-1(c)(1).
Partnership Mergers = Distributions + Contributions

• A merger that is governed by the tax rules on partnership mergers is characterized as a combination of:
  – Contribution of assets of terminated partnership.
  – Issuance of interests of continuing partnership
  – Distribution to partners of terminated partnership.

• Distributions and contributions are often tax-free in the partnership environment. See IRC § 721; § 731

• Because the basic partnership rules on distributions and contributions are much more favorable than those for corporations, no need for the elaborate definitions of tax-free mergers found in the corporate tax context.
Partnership Mergers: Distribution Aspect

• Important exceptions:
  – Distribution of cash/marketable securities in excess of basis (including "deemed distribution" on liability shift). Code §§ 731(a)(1), 752(b).
  – Change in shares of ordinary income ("hot") assets. Code § 751(b).
  – "Mixing bowl." Code §§ 704(c)(1)(B) and 737.
Partnership Mergers: Assets Over (Default Form)

• In most instances, partnership mergers will be deemed to take the "assets-over" form.
  – The actual form of transaction under state law is irrelevant (except for "assets up," as noted below).
  – It does not matter whether there is a merger under state law.

• Under the “assets over” form, the partnership that is considered terminated is deemed to do the following:
  • Contribute all of its assets and liabilities to the resulting partnership in exchange for an interest in the surviving partnership.
  • Immediately afterwards distribute interests in the resulting partnership to its partners in liquidation.
Partnership Mergers:

• However, if a partnership merger *actually takes* the form of an "assets up" transaction, that form will be respected.

• Under this form:
  – The partnership that is terminated distributes all of its assets to its partners in liquidation.
  – Immediately afterwards the partners contribute those distributed assets to the resulting partnership.

• "Assets up" merger may be beneficial, for example, where outside basis (partners’ basis in their partnership interests) exceeds inside basis (partnership’s basis in its assets).
Merger Example:
State Law Merger

A: 50%
B: 50%

AB, LP (GA LP)

Whiteacre
FMV = $300

C: 50%
D: 50%

CD, LLC (DE LLC)

Blackacre
FMV = $200

Merge
Merger Example: State Law Merger

RESULT

ABCD, LLC (DE LLC)

Whiteacre
Blackacre

A

30%

B

30%

C

20%

D

20%
Tax Law Characterization of Transaction

AB, LP (GA LP)  
Blackacre  
FMV = $300

CD, LLC (DE LLC)  
Blackacre  
FMV = $200

AB Interests

AB Interests

A  
B

C  
D

50%  
50%

50%  
50%

50%  
50%

50%  
50%
Seven Equivalent Transactions

- Merger: AB into CD.
- Merger: CD into AB.
- Asset transfer: CD to AB.
- Asset transfer: AB to CD.
- Contribution of interests in CD to AB.
- Contribution of interests in AB to CD.
- Distribution of assets to A and B with immediate recontribution to CD.
The Only Alternative

• Each of the foregoing transactions is treated as an "assets over" merger, with AB surviving.

• The only alternative the IRS would recognize as different is an actual "assets up" transaction, with AB surviving, that is:
  – Distribution of assets to C and D.
  – Immediate recontribution to AB.
A Limited Exception

- If certain requirements are met, the regulations permit the partners of the merging partnership in an "assets over" transaction to be treated as selling their *interests* to the surviving partnership. Treas. Reg. § 1.708-1(c)(4).
- This special rule helps avoid taxable gain to the continuing partners of the merging partnership, who are not selling.
A and B want to admit C as a 1/3 partner.

C will pay $100 for his 1/3 interest

A and B will each receive $50 for giving up a 1/3 interest
Disguised Sales of Partnership Interests

Alternative 1:
Sale of Interests

A and B each sell 1/3 of their interest to C for $50 each.

Amount realized = $50

Adjusted basis of transferred interest = $25

Gain = $25
Disguised Sales of Partnership Interests

Alternative 2: Contribution by C

C contributes $100 to AB, LLC

AB, LLC distributes $50 to each of A and B

No gain to A or B because distribution does not exceed basis
Disguised Sales

- **I.R.C. § 707(a)(2)(B)**
  - **General rule:** Transfer to a partnership is treated as a sale, rather than as a tax-free contribution, if:
    - A partner transfers money or other consideration to a partnership;
    - The partnership transfers money or other partnership to another partner;
    - The two transfers are properly characterized as a sale or exchange of property.
Disguised Sales of Partnership Interests

• The law is extremely underdeveloped.
• Proposed regulations on disguised sales of partnership interests were published in 2004. REG-149519-03, 69 Fed Reg. 68838 (Nov. 26, 2004).
• The proposals were universally panned, and the IRS took the unusual step of formally withdrawing them.
• Taxpayers were advised instead to look to statutory language, case law and legislative history. Ann 2009-4, 2009-8 IRB 597.
  – Statute (enacted 1984) gives almost no guidance.
  – Case law accords great flexibility to the parties.
  – Legislative history indicates that Congress disapproved of some of the case law, but Congress left it almost entirely up to regulations to fill in the details – regulations that have never been issued and probably never will be.
What Is the Correct Analysis?

• The available authority suggests that the form is generally respected.

• In the absence of regulations, taxpayers generally do not worry about disguised sales of partnership interests except in the most blatant situations.

• Potentially relevant factors:
  – Would C have contributed the $100 but for the $100 distribution to A and B?
  – Would the partnership have distributed the $100 to B but for the $100 contribution by C?
  – Were the contribution and distribution directly related?
  – Was there much time between the contribution and distribution?
  – Can the distribution to B be traced to the contribution by C?
Transfer of Debt for Equity

- When a creditor discharges debt, the debtor has cancellation of indebtedness (COD) income.
- What if the creditor of a partnership gives up the debt owed by the partnership and takes equity in the partnership in exchange?
- Before 2004, some taxpayers took the position that the creditor’s contribution of debt to the partnership was tax-free, and that the partnership had no COD income, regardless of the value of the partnership interest.
- Congress then amended Code 108(e)(8) to remove all doubt.
- The partnership is now treated as satisfying the debt with an amount of money equal to the fair market value of the partnership interest.
New Section 108 Regulations

• Final regulations on the contribution of debt by the creditor in exchange for a partnership interest were issued November 17, 2011 (TD 9557). Reg § 1.108-8.
  – The partnership has COD income if the fair market value of the partnership interest is less than the debt.
  – The COD income usually is allocated to the partners that had included the debt in basis before the transaction.

• Lender does not recognize gain or loss. I.R.C. 721
  – Loss on the partnership interest, if and when recognized, is likely to be capital loss, rather than an ordinary business bad debt deduction.
  – The lender does not get any step-up in its share of partnership assets (inside basis) corresponding to the high basis in the partnership interest (outside basis).
Liquidation Value Safe Harbor

- The parties may be allowed to use the liquidation value of the interest as the fair market value but are not required to. Reg § 1.108-8(b)(2)(i). The liquidation value safe harbor can be used only if:
  - The creditor, the partnership, and the partners all report consistently with the safe harbor.
  - All debt for equity exchanges that are part of the same overall transaction are treated consistently with the safe harbor.
  - The terms of the exchange are comparable to terms that unrelated third parties with adverse interests would agree to.
  - The partnership does not redeem the interest issued, and no person related to the partnership or the partners acquires the interest as part of a plan that had avoidance of COD income as a principal purpose.
Debt for Equity Example (Treas. Reg. § 1.108-8(c))

Facts:
1. AB owes C $1,000.
2. C exchanges the $1,000 debt for equity of AB.
3. If AB liquidated after the exchange, C would receive $700; assume liquidation value safe harbor applies.

Analysis:
1. AB has $300 of COD income, allocated to A and B.
2. C does not have a deductible loss, but has $1,000 basis even though the liquidation value of the equity is only $700.
3. If and when C’s loss is eventually recognized, the loss is generally capital loss.
Debt for Equity Example – Debt Discharge in Advance

Facts:
1. AB owes C $1,000.
2. C writes off $300 of the debt.
3. C exchanges the $700 debt for equity of AB.
4. If AB liquidated after the exchange, C would receive $700; assume liquidation value safe harbor applies.

Analysis (assuming the form is respected):
1. AB has $300 of COD income, allocated to A and B.
2. C has a deductible loss, which may be an ordinary loss (depending on the application of Code § 166).
TAX ISSUES IN TRANSFERRING LLC AND PARTNERSHIP INTERESTS

Presented by: Janice H. Eiseman, Esq.

Cummings & Lockwood LLC • 6 Landmark Square • Stamford, CT 06901
203.351.4231 Phone • 203.708.3823 Fax
BASIS ADJUSTMENTS
I.  Overview

A. **Subchapter K**: In parts of Subchapter K, the subchapter governing the taxation of partnerships and partners, a partnership is treated as a separate entity, which is distinct from its partners. In other parts of Subchapter K, a partnership is treated as an aggregate of individuals, each of whom owns an undivided interest in partnership assets.

B. **Outside Basis**: “Outside basis” refers to a partner’s tax basis in the partnership interest itself. The partnership is treated as an entity separate from its partners and the partnership interest as an intangible asset that is separate and distinct from partnership assets. This is similar to a shareholder’s tax basis in a share of stock.
C. **Inside Basis:** “Inside basis” refers to the partner’s share of the basis in the assets held by the partnership. Because the partnership is not a separate entity, its income is allocated and taxed to its partners, treating them like owners of undivided interests in each and every partnership asset, i.e., as an aggregate of co-owners.

D. **Section 754 Election:**

1. Purpose of making a Section 754 election is to equalize the “outside basis” and the “inside basis” to the extent allowed. Prior to the American Jobs Creation Act of 2004 (the “JOBS Act”), the Section 754 election was optional. The partnership could make the election in two situations:
Overview (Cont.)

a. Sale or exchange of partnership interest, including transfer on death and non-taxable exchange; and,

b. Distribution of partnership property, and/or cash, when the distributee partner recognizes gain or loss, or when the partnership property distributed to the distributee partner has a substituted basis.

2. In the case of a transfer of a partnership interest, the Section 754 election causes the rules set forth in Code Section 743 to apply. These rules affect only the transferee’s inside basis in the partnership assets. In the case of a distribution of partnership property, the Section 754 election causes the rules on the adjustment to the basis of partnership assets set forth in Code Section 734 to apply.
Overview (Cont.)

3. If the partnership does not make a Section 754 election, then there is no adjustment to a transferee’s inside basis in partnership assets, and there is no adjustment to the tax basis of property held by the partnership upon a distribution, unless the mandatory rules on “substantial built-in loss” apply.

4. Once the amount of the adjustment to the transferee under Section 743 is determined or the amount of the Section 734 adjustment to the partnership is determined, the adjustment is allocated to partnership assets under Section 755.
Overview (Cont.)

5. The JOBS Act amended Section 743 to require a mandatory adjustment on the sale or exchange of a partnership interest if the partnership has a “substantial built-in loss.” A “substantial built-in loss” occurs if the total of the partnership’s tax bases in its assets exceeds the total fair market value of its assets by more than $250,000. The JOBS Act amended Section 734 to require a mandatory adjustment on distribution of property if there would be a “substantial basis reduction” under Section 734. A “substantial basis reduction” means a reduction in retained partnership property exceeding $250,000. Special rules apply to “electing investment partnerships as set forth in Code Section 743(e) and to securitization partnerships as set forth in both Code Section 743(f) and Code Section 734(e). The JOBS Act reflected the concern of Congress that the partnership rules allowed the inappropriate transfer of losses among partners as well as the associated duplication of a single, economic loss. See Example on next page.
### Example of Built-In Loss Rules

<table>
<thead>
<tr>
<th>Partnership</th>
<th>Tax Basis</th>
<th>FMV</th>
<th>BIL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property</td>
<td>200</td>
<td>100</td>
<td>(100)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Partners</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>100</td>
<td>50</td>
<td>(50)</td>
</tr>
<tr>
<td>B</td>
<td>100</td>
<td>50</td>
<td>(50)</td>
</tr>
</tbody>
</table>

A sells 50% partnership interest to X for $50
A recognizes $50 loss

<table>
<thead>
<tr>
<th>Partners</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>X</td>
<td>50</td>
<td>50</td>
<td>-0-</td>
</tr>
<tr>
<td>B</td>
<td>100</td>
<td>50</td>
<td>(50)</td>
</tr>
</tbody>
</table>

Partnership sells property for $100; it recognizes $100 loss, $50 of which is allocated to X if no mandatory adjustment is required. Therefore, have a duplication of loss. Under mandatory rules, if applicable, property’s tax basis is decreased by $50 for Partner X only.
II. Ability to Make a Code Section 754 Election Due to a Transfer or a Distribution

A. **Code Section 743(b):** Election may be made when there is a sale or exchange of a partnership interest or upon the death of a partner. If a triggering event has not occurred, no Code Section 754 election can be made, and, therefore, there will be no change to the tax basis of partnership assets with regard to the transferee unless the mandatory rule for basis adjustment applies.

1. **Sales or exchanges:** This includes a carryover basis exchange such as under Code Section 351. Transfers by gift do not trigger a Code Section 754 election because transfers by gift are not sales or exchanges under Code Section 743(b).
2. Distribution of partnership interest: Note that Code Section 761(e)(2) provides that for purposes of Code Section 743 any distribution of an interest in a partnership (not otherwise treated as an exchange) shall be treated as an exchange. Thus, if there is a “constructive termination” under Code Section 708(b)(1)(B), i.e., sale or exchange of 50% or more of the total interest in partnership capital and profits within a period of 12 consecutive months, then the deemed distribution of an interest in the new partnership by a terminating partnership is treated as an exchange of the interest in the new partnership for interest in the terminating partnership for purposes of Section 743. This allows the new partnership to make a Code Section 754 election because the exchange requirement of Code Section 743(b) is satisfied.
Ability to Make a Code Section 754 Election Due to a Transfer or a Distribution (Cont.)

B. Code Section 734(b):

1. Election can be made in the following two situations:
   a. Partner receives a distribution of money (or money and/or assets), and the partner recognizes gain or loss
   b. Partner receives a distribution of property and the basis of property in the hands of the distributee partner is determined by reference to the partner’s basis for his interest in the partnership, which differs from the partnership’s basis in the distributed property.

2. Section 734(b) adjustments affect the partnership property, which is different than the Section 743(b) election, which affects only the transferee. Because the adjustment applies to partnership assets, it affects all partners remaining in the partnership.
Ability to Make a Code Section 754 Election Due to a Transfer or a Distribution (Cont.)

3. If gain or loss is recognized by the distributee partner, then that amount of gain or loss is allocated among the basis of partnership property under the Section 755 rules.

4. If the adjustment is attributable to a difference in tax basis between the partnership and the distributee partner, then to the extent basis is lost, i.e., the transferee has a lower basis, the difference increases partnership assets. To the extent basis is gained, i.e., the transferee has a higher basis, the difference decreases partnership assets. See Example on next page.
Example 2 of Treas. Reg. Sec. 1.734-1(b).

ASSETS

<table>
<thead>
<tr>
<th></th>
<th>Adjusted Basis</th>
<th>Fair Market Value</th>
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</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 4,000</td>
<td>$ 4,000</td>
</tr>
<tr>
<td>Property X</td>
<td>$11,000</td>
<td>$11,000</td>
</tr>
<tr>
<td>Property Y</td>
<td>$15,000</td>
<td>$18,000</td>
</tr>
<tr>
<td>Total</td>
<td>$30,000</td>
<td>$33,000</td>
</tr>
</tbody>
</table>

Capital:

<table>
<thead>
<tr>
<th></th>
<th>Adjusted Basis</th>
<th>Fair Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>D</td>
<td>$10,000</td>
<td>$11,000</td>
</tr>
<tr>
<td>E</td>
<td>$10,000</td>
<td>$11,000</td>
</tr>
<tr>
<td>F</td>
<td>$10,000</td>
<td>$11,000</td>
</tr>
</tbody>
</table>

Assume D’s interest is liquidated by distribution of Property X.

D’s basis in Property X will be $10,000 because that is the basis in D’s partnership interest. Under Section 754, the extra $1,000 is added to the basis of Property Y, so that its basis to the partnership becomes $16,000. Thus, when Property Y is sold, E and F will each recognize $1,000 gain.
C. How to make election:

  Election under Code Section 754: Election is made by attaching statement setting forth (i) name and address of partnership making the election; (ii) signed by any one of the partners, (iii) contain a declaration that the partnership elects under section 754 to apply the provisions of section 734(b) and section 743(b). Treas. Reg. § 1.754-1(b). (See Example below)

Boxwood, LLC
[Address]
EIN  65-999999999

Boxwood, LLC hereby elects under Internal Revenue Code § 754 and pursuant to Regs. § 1.754-1(b), to apply the provisions of §§ 734(b) and 743(b), with respect to distributions of property by Boxwood, LLC to members, and sales of interests in Boxwood, LLC, beginning with the calendar year 20xx. The tax return for 20xx is filed with, and attached to, this election statement.

/s/___________________________________
[Managing Member]
D. When to make election:

1. **Time**: Election is supposed to be filed with a timely filed partnership tax return for the partnership taxable year during which the distribution or transfer occurs, i.e., on or before the due date (including extensions) of the partnership tax return. Treas. Reg. § 1.754-1(b).

   - **Automatic Extension**: Treasury Regulation § 301.9100-2(vi) provides for an automatic 12-month extension from the due date of the partnership return or from the extended due date of the partnership return if there is an extension provided that the partnership takes “corrective action” during this 12-month extension period. “Corrective action” means filing an amended return for the year in which the election should have been made and attaching to the amended return the required election statement. The statement “FILED PURSUANT TO § 301.9100-2” must be written at the top of the amended return.
Ability to Make a Code Section 754 Election Due to a Transfer or a Distribution (Cont.)

• **Discretionary Extension**: If the terms of the automatic extension have not been met, a discretionary extension of time to file the Section 754 election may still be requested from the IRS and will generally be granted if the requirements of Treasury Regulation § 301.9100-3 are met. These discretionary extensions are granted frequently in private letter rulings.

E. **Revocation of Election**: Once a Section 754 Election is made, it is revocable only with the consent of the District Director for the district in which the partnership’s returns are filed. Treas. Reg. § 754-1(c).

1. **De facto revocation**: The Section 754 election terminates when there has been a “constructive termination” of the partnership under Code Section 708(b)(1)(B), i.e., sale or exchange of 50% or more of the total interest in partnership capital and profits within a period of 12 consecutive months. With regard to the incoming partner, the Section 754 election made by the terminating partnership remains in effect. Treas. Reg. § 1.708-1(b)(5).
Ability to Make a Code Section 754 Election Due to a Transfer or a Distribution (Cont.)

F. What partnership and transferee must do if Code Section 754 election is in effect:

1. **Partnership:** Partnership must attach a statement to its return for the year of the transfer setting forth the name and taxpayer identification number of the transferee plus computation of the adjustment and the partnership properties to which adjustment has been allocated. Treas. Reg. § 1.743-1(k)(1)(i). Partnership must attach a statement to its return for the year of the distribution setting forth the computation of the adjustment and the partnership properties to which the adjustment has been allocated. Treas. Reg. § 1.734-1(d).

2. **Transferee:** Transferee must notify partnership in writing within 30 days of the sale or exchange stating the name and address of transferee, identification number, relationship (if any) between transferor and transferee, and the amount of the purchase price, the amount of any liabilities assumed or taken subject to, and any other information necessary for the partnership to compute the transferee’s basis. Treas. Reg. § 1.743-1(k)(2)(i).
Ability to Make a Code Section 754 Election Due to a Transfer or a Distribution (Cont.)

3. **Estate**: In the case of the death of a partner, the transferee has one year to notify the partnership. Treas. Reg. § 1.743-1(k)(2)(ii).

4. **No notification**: If the partnership is not notified of the transfer, then it is not required to make any adjustments under Code Section 743(b). Treas. Reg. § 1.743-1(k)(4). Upon notification, the partnership must display the following statement on the first page of the partnership return for that year and on the first page of Schedule K-1 issued to the transferee: RETURN FILED PURSUANT TO § 1.743-1(k)(5). The partnership is entitled to report the transferee’s share of partnership items without adjustment until the partnership receives the required information from the transferee. At that time, the partnership must take into account the adjustments on any amended return otherwise filed by the partnership or in the next annual partnership return. The partnership must also provide the transferee with the necessary information for the transferee to amend its prior returns to properly reflect the adjustment under Code Section 743(b). Treas. Reg. § 1.743-1(k)(5).
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III. What Happens Under Code Section 743(b) When a Code Section 754 Election is Made?

A. The Actual Amount of the Section 743(b) Adjustment: Code Section 743(b) states that the adjustment to the basis of partnership property to the transferee equals the difference between the (i) transferee’s tax basis in his partnership interest (i.e., the purchase price of the interest or its fair market value at date of death plus his share of partnership liabilities), and (ii) the transferee’s “proportionate share of the adjusted basis of partnership property.” Treasury Regulation § 1.743-1 flushes out how to determine the transferee’s “proportionate share of the adjusted basis of partnership property.”
What Happens Under Code Section 743(b) When a Code Section 754 Election is Made? (Cont.)

1. Treasury Regulation § 1.743-1(d) provides that the transferee’s “share of the adjusted basis to the partnership property” is equal to the sum of the transferee’s interest as a partner in the partnership’s previously taxed capital” plus his share of liabilities.

2. What is the transferee’s interest in the partnership’s “previously taxed capital?” In general terms, the transferee’s interest in the partnership’s “previously taxed capital” is the “tax capital account” of the transferor. However, Treasury Regulation § 1.743-1(d) does not define it that way; rather, it uses a formula to determine “previously taxed capital.”
What Happens Under Code Section 743(b) When a Code Section 754 Election is Made? (Cont.)

3. The formula used to determine “previously taxed capital” starts at the end and works backward by looking at how much cash the transferee would receive if the partnership sold all of its assets in a hypothetical sale at a price equal to the fair market value of the assets. Then from this amount, the gain that would be allocated to the transferee upon the sale is subtracted and the loss that would be allocated to the transferee upon the sale is added. The amount of gain or loss allocated to the transferee upon the hypothetical sale includes amounts allocated under Code Section 704(c) and, specifically, includes adjustments that would be made under the remedial method.

4. Note that non-contingent liabilities do not affect the amount of the adjustment because they are included in both the transferee’s tax basis for his partnership interest and the transferee’s interest in the previously taxed capital.
What Happens Under Code Section 743(b) When a Code Section 754 Election is Made? (Cont.)

B. Section 743(b) adjustment is allocated among the assets under Section 755, which is discussed, in detail, in Part IV.

C. See Exhibits A and B on next two pages showing calculations of Section 743(b) adjustments.
## EXHIBIT A

Example 1 of Treas. Reg. Sec. 1.743-1(d)(3)

[Tax Capital Account and Book Capital Account are the same; purchase of A’s interest at FMV.]

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>Adjusted Basis</th>
<th>Fair Market Value</th>
<th>Section 743(b) Adjustment to transferee of A</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$5,000</td>
<td>$5,000</td>
<td>$0.00</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>$10,000</td>
<td>$10,000</td>
<td>$0.00</td>
</tr>
<tr>
<td>Inventory</td>
<td>$20,000</td>
<td>$21,000</td>
<td>$3,333.33</td>
</tr>
<tr>
<td>Depreciable assets</td>
<td>$20,000</td>
<td>$40,000</td>
<td>$6,666.67</td>
</tr>
<tr>
<td>Total</td>
<td>$55,000</td>
<td>$76,000</td>
<td>$7,000.00</td>
</tr>
<tr>
<td>Liabilities</td>
<td>$10,000</td>
<td>$10,000</td>
<td></td>
</tr>
<tr>
<td>Capital:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>$15,000</td>
<td>$22,000</td>
<td></td>
</tr>
<tr>
<td>B</td>
<td>$15,000</td>
<td>$22,000</td>
<td></td>
</tr>
<tr>
<td>C</td>
<td>$15,000</td>
<td>$22,000</td>
<td></td>
</tr>
</tbody>
</table>

Assume sale of depreciable assets without Section 754 election:

Income allocated to transferee of A $6,666.67
Tax Basis $22,000.00
Total $28,666.67

Assume sale of depreciable assets with Section 754 election:

(Gain of $6,666.67 allocated to transferee is decreased by positive Section 743(b) basis adjustment of $6,666.67)

Income allocated to transferee of A $0.00
$22,000.00

[Note: All recapture of pre-transfer depreciation is eliminated with respect to transferee if a Code Section 754 election has been made. Treas. Reg. Section 1.1245-1(e)(3)(ii) & 1.1250-1(f)]
Example 2 of Treasury Regulation Section 1.743-1(d)(3).

[Tax Capital Account is different from and Book Capital Account]

<table>
<thead>
<tr>
<th></th>
<th>Adjusted Basis</th>
<th>Fair market value on contribution date</th>
<th>Sale of partnership interest for fair market value by A</th>
<th>Section 743(b) adjustment to transferee of A</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$ 400</td>
<td>$1,000</td>
<td>$1,300</td>
<td>$700</td>
</tr>
<tr>
<td>Cash</td>
<td>$2,000</td>
<td>$2,000</td>
<td>$2,000</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>$2,400</td>
<td>$3,000</td>
<td>$3,300</td>
<td>$700</td>
</tr>
<tr>
<td>A</td>
<td>$ 400</td>
<td>$1,000</td>
<td>$1,100</td>
<td></td>
</tr>
<tr>
<td>B</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,100</td>
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</tr>
<tr>
<td>C</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,100</td>
<td></td>
</tr>
</tbody>
</table>

**Transferee’s share of previously taxed capital:**

- Cash received on sale of assets for fair market value: $1,100
- Less: Gain allocated to transferee: $700 (Pre-contribution gain & post-contribution gain)
- Share of previously taxed capital: $400

**Section 743(b) adjustment:**

- Outside basis of price paid for partnership interest (FMV): $1,100
- Less: Share of previous taxed capital: $400
- Amount of Section 743(b) adjustment to the basis of the land: $700

Sale of land for $1,300: Gain of $700 allocated to transferee is decreased by positive section 743(b) basis adjustment of $700
IV. Code Section 755 Basis Adjustments

A. Three Sets of Rules:


2. Transfer of partnership interest involving “substituted basis exchanges” (e.g., Code Section 351 and 721 exchanges). Treas. Reg. § 1.755-1(b)(5). Also, Treasury Regulation § 1.755-1(b)(5) applies to basis adjustments that result from exchanges in which the transferee’s basis in the partnership interest is determined by reference to other property held at any time by the transferee e.g. a constructive termination under Code Section 708(b)(1)(B) in which the terminated partnership is deemed to contribute its assets to a new partnership in exchange for an interest in the new partnership and the terminated partnership is deemed to distribute interests in the new partnership in liquidation of the partner’s interest in the terminated partnership. Code Section 761(e) provides the “exchange”--the distribution of partnership interests
in the new partnership is an “exchange” for purposes of Code Section 743(b). Because the distributee-partner of the terminated partnership receives its interest in the new partnership in a liquidating distribution, the distributee takes a substituted basis in the new partnership under Code Section 732(b). A Code Section 754 election by the new partnership will bring into play Treasury Regulation § 1.755-1(b)(5).

3. Transfer of a partnership interest when the assets of the partnership constitute a trade or business, as described in Treasury Regulation § 1.1060-1(b)(2). Treas. Reg. § 1.755-1(a)(2)-(a)(6).

B. Transfer of Partnership Interest When Assets of Partnership do not Constitute a “Trade or Business.”

1. First, determine the adjusted basis and the fair market value of the partnership assets immediately after the transfer and determine how
much income, gain or loss (including remedial allocations under Treasury Regulation § 1.704-3(d)) would be allocated to the transferee-partner if the partnership were to sell all of its assets for cash in a hypothetical sale for an amount equal to their fair market values. If, in fact, the purchase price for the partnership interest equals the fair market value of the assets, then the adjustment to the basis of partnership property with respect to the transferee-partner is done. Treas. Reg. § 1.755-1(b)(1)(ii); Example 1, Treas. Reg. 1.755-1(b)(2)(ii).

2. The portion of the transferee-partner’s basis adjustment allocated to ordinary income property is equal to the total income gain or loss (including remedial allocations) that would be allocated to the transferee with respect to the hypothetical sale of ordinary income property. Treas. Reg. § 1.755-1(b)(2).
3. The portion of the transferee-partner’s basis adjustment allocated to capital gain property is equal to the Section 743(b) adjustment reduced by the amount allocated to ordinary income property. If the purchase price of the partnership interest is less than the purchase price based upon fair market value, and there has to be a decrease in capital gain property, the decrease cannot be greater than the “partnership’s basis” in the property or the transferee’s share of any remedial loss under Treasury Regulation § 1.704-3(d). Any excess is applied to reduce the basis of ordinary income property. Treas. Reg. § 1.755-1(b)(2).

• Note that this approach allocates any overpayment or underpayment for the partnership interest to the basis of capital gain property.

4. Adjustments can be made to individual assets even though the total amount of basis adjustment is zero. Treas. Reg. § 1.755-1(b)(1)(i).

• Note that in a substituted basis transaction no adjustment can be made if the total amount of the Section 743(b) adjustment is zero.
5. Allocations have to be made within the class of ordinary income property and within the class of capital gain property.

a) Within the class of ordinary income property, the basis of each property is generally adjusted by an amount equal to the income, gain, or loss (including remedial allocations) that would be allocated to the transferee upon a sale of the property in the hypothetical transaction.

b) Within the class of capital gain property, the basis of such property is generally adjusted by (1) the amount of income, gain or loss that would be allocated to the transferee in the hypothetical transaction, minus (2) a portion (based on the market value of a particular property) compared to the aggregate market value of all capital gain property. Treas. Reg. § 1.755-1(b)(3).

c) Note that there must be an adjustment whenever the actual Code Section 743(b) adjustment is either more or less than what it would be if the transferee had paid fair market value for each partnership asset.

Example 2 - Treasure Regulation §1.755-1(b)(3)(iv):
T buys A’s partnership interest for $110,000. (2-person partnership)

<table>
<thead>
<tr>
<th></th>
<th>Adjusted Basis</th>
<th>Market Value at time of contribution</th>
<th>Fair Market Value at time of sale</th>
<th>Adjustment based on FMV sale</th>
<th>Basis Adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital gain property</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Asset 1*</td>
<td>$25,000</td>
<td>$50,000</td>
<td>$75,000</td>
<td>$37,500</td>
<td>$33,604</td>
</tr>
<tr>
<td>Asset 2</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$117,500</td>
<td>$8,750</td>
<td>$2,646</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$192,500</td>
<td>$46,250</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$200,000</td>
<td></td>
<td>$240,000</td>
<td>$45,000</td>
<td>$35,000</td>
</tr>
</tbody>
</table>

Ordinary Income property

|                  |                |                                      |                                  |                              |                  |
| Asset 3          | $40,000        | $40,000                              | $45,000                          | $2,500                       | $2,500           |
| Asset 4          | $10,000        | $10,000                              | $2,500                           | -$3,750                      |                  |
|                  | $175,000       | $200,000                             | $47,500                          | -$1,250                      |                  |
| Total            | $185,000       |                                      | $247,500                         | $46,250                      |                  |

*Asset 1 (tax basis $25,000) was contributed by A, who transfers his partnership interest.

Section 743(b) adjustment:

T’s partnership basis $110,000
Less: T’s share of adjusted basis in partnership property -$75,000  **
Adjustment $35,000
Ordinary income adjustment -$1,250
Capital gain adjustment $36,250

Capital Gain Adjustment  

<table>
<thead>
<tr>
<th></th>
<th>FMV</th>
<th>Adjustment based on $110,000 purchase price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset 1</td>
<td>$37,500</td>
<td>($37,500 -($10,000*($75,000/$192,500)))</td>
</tr>
<tr>
<td>Asset 2</td>
<td>$8,750</td>
<td>($8,750 -($10,000*($117,500/$192,500)))</td>
</tr>
<tr>
<td>Total capital gain adjustment</td>
<td>$46,250</td>
<td>$36,250</td>
</tr>
</tbody>
</table>

**$120,000 (FMV) - [(($25,000 + $12,500) + $8,750 + $2,500 - $3,750) or $120,000 - $45,000 = $75,000
EXHIBIT E-1

SECTION 743(b) Computation for Real Estate Partnership and Section 755 Allocation

Decedent’s Percentage Interest: 7.62605%

Date of Death: December 5, 2009

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>Adjusted Basis of Partnership Assets At Date Of Death</th>
<th>Fair Market Value Balance Sheet</th>
<th>Adjustment to Estate Based Upon Hypothetical Sale At Fair Market Value</th>
<th>Decrease Based Upon Value At Date Of Death Of Partnership Interests</th>
<th>See Exhibit E-2: Adjustment to Gain or Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash &amp; Equivalents</td>
<td>1,793,186</td>
<td>1,793,186</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Prepaid Expenses</td>
<td>174,647</td>
<td>174,647</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Mortgage Escrow</td>
<td>107,564</td>
<td>107,564</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Repair Reserve</td>
<td>2,504</td>
<td>2,504</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Due from Others</td>
<td>14,900</td>
<td>14,900</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Security Deposits</td>
<td>132,031</td>
<td>132,031</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Current &amp; Other Assets</td>
<td>2,224,832</td>
<td>2,224,832</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Buildings and Other Depreciable Assets</td>
<td>17,725,575</td>
<td>20,960,000</td>
<td>1,390,566</td>
<td>247,446</td>
<td>1,143,120</td>
</tr>
<tr>
<td>Less: Accumulated Dep. and Amort.</td>
<td>15,000,000</td>
<td>15,000,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Buildings and Other Depreciable Asst.</td>
<td>2,725,575</td>
<td>20,960,000</td>
<td>1,390,566</td>
<td>247,446</td>
<td>1,143,120</td>
</tr>
<tr>
<td>Land</td>
<td>341,864</td>
<td>5,240,000</td>
<td>373,535</td>
<td>61,861</td>
<td>311,674</td>
</tr>
<tr>
<td>Intangible Assets</td>
<td>323,497</td>
<td>0</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less: Accumulated Amortization</td>
<td>0</td>
<td>0</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Net Intangible Assets</td>
<td>323,497</td>
<td>0</td>
<td>(24,670)</td>
<td></td>
<td>(24,670)</td>
</tr>
<tr>
<td>Total Assets</td>
<td>5,615,768</td>
<td>28,424,832</td>
<td>1,739,431</td>
<td>309,307</td>
<td>1,430,124</td>
</tr>
</tbody>
</table>

LIABILITIES

| Due to Others                                    | 9,056                                                | 9,056                           | 691                                                                |                                                                     |                                           |
| Security Deposits                                | 131,203                                              | 131,203                         | 10,006                                                             |                                                                     |                                           |
| All Nonrecourse Loans                            | 18,000,000                                           | 18,000,000                      | 1,372,689                                                          |                                                                     |                                           |
| Total Liabilities                                | 18,140,259                                           | 18,140,259                      | 1,383,385                                                          |                                                                     |                                           |
| Members Equity (Deficit)                         | (12,524,491)                                         | 10,284,573                      | 356,046                                                            |                                                                     |                                           |
| Total Liabilities & Members Equity               | 5,615,768                                            | 28,424,832                      | 1,739,341                                                          |                                                                     |                                           |
**EXHIBIT E-2**

**Code Section 743(b) Adjustment**

Tax Basis of Partnership Interest for Decedent:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Code Section 1014 tax basis</td>
<td>$475,000.00</td>
</tr>
<tr>
<td>Share of liabilities</td>
<td>$1,383,385.00</td>
</tr>
<tr>
<td>Total</td>
<td>$1,858,385.00</td>
</tr>
</tbody>
</table>

Less:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Previously taxed capital</td>
<td>($955,124.00)</td>
</tr>
<tr>
<td>Share of liabilities</td>
<td>$1,383,385.00</td>
</tr>
<tr>
<td>Share of tax basis of Partnership property</td>
<td>$428,261.00</td>
</tr>
</tbody>
</table>

**Section 743(b) Adjustment** $1,430,124.00

Decedent's interest in Partnership previously taxed capital:

Cash decedent would receive upon liquidation of partnership at fair market value $784,306.68

Less: Gain allocated to decedent from sale $1,739,430.68

($955,124.00)

[Note: The estate's share of partnership liabilities is included both in its partnership basis and the computation of its share of the common basis of partnership property; thus, partnership liabilities can be ignored.]

Building = $1,390,566 - \[\frac{309,307 \times 20,960,000}{26,200,000}\]

Land = $373,535 - \[\frac{309,307 \times 5,240,000}{26,200,000}\]

*Adjustment= (Hypothetical adjustment of asset - ((Total Hypothetical Adjustment - Total Actual Adjustment) * FMV Asset/Total FMV)
EXHIBIT F-1

Example of complicated adjustment for an interest held by a Grantor Trust upon death of Grantor; value of membership interest determined for estate tax purposes.

Calculation of Section 743(b) Adjustment to Trust

I. Step-up in basis of Company assets based on fair market value at date of death

<table>
<thead>
<tr>
<th>Proportionate Share of Tax Basis in Company's Assets</th>
<th>Gain recognized upon liquidation</th>
<th>Code § 743(b) Basis Adjustment &amp; Code § 755 Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real Estate</td>
<td>$173,500</td>
<td>$17,826,500</td>
</tr>
<tr>
<td>Accrued Dividend</td>
<td>0</td>
<td>$578</td>
</tr>
<tr>
<td>Sysco</td>
<td>0</td>
<td>$37,129</td>
</tr>
<tr>
<td>Johnson &amp; Johnson</td>
<td>0</td>
<td>$15,242</td>
</tr>
<tr>
<td>Schering Plough</td>
<td>0</td>
<td>$10,379</td>
</tr>
<tr>
<td>United Health Care</td>
<td>0</td>
<td>$6,226</td>
</tr>
<tr>
<td>Cisco</td>
<td>0</td>
<td>$18,306</td>
</tr>
<tr>
<td>Dover</td>
<td>0</td>
<td>$13,729</td>
</tr>
<tr>
<td>Emerson</td>
<td>0</td>
<td>$11,295</td>
</tr>
<tr>
<td>Bershire Hathaway A</td>
<td>0</td>
<td>$46,525</td>
</tr>
<tr>
<td>Berkshire Hathaway B</td>
<td>0</td>
<td>$30,462</td>
</tr>
<tr>
<td></td>
<td>$173,500</td>
<td>$18,016,371</td>
</tr>
<tr>
<td></td>
<td>$18,015,793</td>
<td></td>
</tr>
</tbody>
</table>

(Stock contributed by children of grantor of Trust)

II. Trust's previously taxed capital:

- Liquidation proceeds based on fair market value: $19,100,813 *
- Less: Gain recognized on liquidation: $18,016,371
- Previously Taxed Capital: $1,084,442

III. Code Section 743(b) Adjustment based on Fair Market Value:

- Fair Market Value less IRD: $19,100,235 ($19,100,813 - $578)
- Less: Previously Taxed Capital: $1,084,442
- Section 743(b) Adjustment: $18,015,793

IV. Code Section 743(b) Adjustment based on Estate Tax Audit:

- Value of Membership Interest: $17,815,000
- Less: Income in respect of a Decedent: $578
- Tax basis of Membership Interest: $17,814,422
- Less: Trust's previously taxed capital: $1,084,442
- Section 743(b) Adjustment: $16,729,980

* $19,100,813 (liquidating proceeds) = $20,609,423 (Fair Market Value of Company at date of death) * 92.68% (Trust Percentage Interest)
Calculation of Section 743(b) basis adjustments to capital gain assets based on Fair Market Value must 
must be reduced pro rata by $1,285,813 under Treasury Regulation Section 1.755-1(b)(3)(ii).

<table>
<thead>
<tr>
<th>Code Section 743(b) Adjustment based on FMV</th>
<th>Decrease*</th>
<th>Tentative Allocation</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Fair Market Value</th>
<th>$18,015,793</th>
<th>$18,015,793</th>
<th>$16,729,980</th>
</tr>
</thead>
<tbody>
<tr>
<td>$19,450,545</td>
<td>$18,015,793</td>
<td>$1,285,813</td>
<td>$16,729,980</td>
</tr>
</tbody>
</table>

*Decrease to each asset is calculated as follows:

$1,285,813 x  (Fair Market Value of each asset/$19,450,545 (Total Fair Market Value))

Note: Assets with respect to which transferee has no interest in income, gain, losses or deductions are not taken into account in applying adjustment to basis under Code Section 755. Treas. Reg. Section 1.755-1(b)(3)(iii).
Calculation of Section 755 Basis Adjustments Based On Code Section 743(b) Adjustment of $16,729,980

<table>
<thead>
<tr>
<th>(A) Proportionate Share of Tax Basis in Sasco's Assets</th>
<th>(B) § 755 Allocation</th>
<th>(C) Negative Decrease*</th>
<th>(D) § 755 Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real Estate</td>
<td>$173,500.00</td>
<td>$16,636,577.87</td>
<td>($6,249.83)</td>
</tr>
<tr>
<td>Sysco</td>
<td>0</td>
<td>$24,663.64</td>
<td>($9.17)</td>
</tr>
<tr>
<td>Johnson &amp; Johnson</td>
<td>0</td>
<td>($3,025.55)</td>
<td>$3,025.55</td>
</tr>
<tr>
<td>Schering Plough</td>
<td>0</td>
<td>$6,055.62</td>
<td>($2.25)</td>
</tr>
<tr>
<td>United Health Care</td>
<td>0</td>
<td>$2,259.59</td>
<td>($0.84)</td>
</tr>
<tr>
<td>Cisco</td>
<td>0</td>
<td>($3,261.34)</td>
<td>$3,261.34</td>
</tr>
<tr>
<td>Dover</td>
<td>0</td>
<td>$7,246.37</td>
<td>($2.69)</td>
</tr>
<tr>
<td>Emerson</td>
<td>0</td>
<td>$7,675.65</td>
<td>($2.85)</td>
</tr>
<tr>
<td>Berkshire Hathaway A</td>
<td>0</td>
<td>$31,465.87</td>
<td>($11.70)</td>
</tr>
<tr>
<td>Berkshire Hathaway B</td>
<td>0</td>
<td>$20,322.28</td>
<td>($7.56)</td>
</tr>
</tbody>
</table>

$16,729,980.00  $0.00  $16,729,980.00

Column C: Treas. Reg. §1.755-1(b)(3)(iii)(B)

(Column B Positive Adjustment) x $6,286.89 (Total Value of Negative Adjustments)

(Total Column B Positive Adjustments of $16,736,266.89)
C. Substituted Basis Exchanges

1. The rules for “substituted basis exchanges” are set forth in Treasury Regulation § 1.755-1(b)(5). If the basis adjustment is positive, an adjustment can be made only if the hypothetical sale of the partnership’s assets results in a net gain to the transferee.

   a) The increase is allocated between classes of assets, ordinary and capital, in proportion to the net income or gain of each class allocable to the transferee.

   b) Within each class, increases are first allocated to properties with unrealized appreciation in proportion to the transferee’s share of such unrealized appreciation until the transferee’s share of the appreciation is eliminated; any remaining amount is allocated among assets in the class according to the transferee’s share of the amount realized from the hypothetical sale of each asset in the class.
2. Likewise, if the basis adjustment is negative, an adjustment can only be made if the hypothetical sale results in the allocation of a net loss to the transferee.

   a) The decrease is allocated between asset classes in proportion to the net loss allocable to the transferee from the hypothetical sale of all assets in each class.

   b) Within each class, the decrease is allocated to properties with unrealized depreciation in proportion to the transferee’s shares of such unrealized depreciation until they are eliminated; remaining decreases are allocated in proportion to the transferee’s shares of the adjusted bases of all assets in the class until these shares of adjusted bases are reduced to zero, with any remaining downward adjustment suspended until the partnership acquires additional property in that class.
D. Sale of Business

1. If the assets of the partnership constitute a trade or business (as described in Treasury Regulation § 1.1060-1(b)(2)), the partnership must use the residual method to assign values to the partnership’s Section 197 intangibles. Treas. Reg. § 1.755-1(a)(2).

2. Residual method involves the following steps:
   
a) First, the partnership must determine the value of its assets other than Section 197.

b) Second, the partnership must determine “partnership gross value” under Treasury Regulation § 1.755-1(a)(4).

c) Third, the partnership gross value is then compared to the aggregate value of all partnership property other than Section 197 intangibles. If there is no residual value, then the value of all Section 197 intangibles is deemed to be zero. If there is a residual value, then the amount must be allocated to Section 197 intangibles in order to assign a value to them under the rules of Treasury Regulation § 1.755-1(a)(5).
d) “Partnership gross value” generally is equal to the amount that, if assigned to all partnership property, would result in a liquidating distribution to the partner equal to the transferee’s basis in the transferred partnership interest immediately following the relevant transfer (reduced by the amount, if any, of such basis that is attributable to partnership liabilities). Treas. Reg. § 1.755-1(a)(4)(i)(A).

e) Treasury Regulation § 1.755-1(a)(5)(i) requires that the residual value be allocated first among Section 197 intangibles other than goodwill and going concern value, but the value assigned to a Section 197 intangible (other than goodwill and going concern value) is limited to its actual fair market value on the date of the relevant transfer. Any remaining residual value is then allocated to goodwill and going concern value.