Tax Issues in Sale of Partnership and LLC Interests: Structuring the Purchase Agreement


THURSDAY, JULY 19, 2018

1pm Eastern  |  12pm Central  |  11am Mountain  |  10am Pacific

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Tax Issues in Sale of Partnership & LLC Interests: Structuring the Purchase Agreement

Chad J. Resner
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Sale of assets

- Gain from the sale of property equals the excess of the amount realized minus the adjusted basis. Section 1001(a).
- Loss from the sale of property equals the excess of the adjusted basis minus the amount realized. Section 1001(a).
- Amount realized equals the sum of any money received plus the FMV of the property (other than money) received. Section 1001(b).
  » The amount of any debt on the asset sold is included in the amount realized for purposes of determining gain or loss.
- Basis of property acquired by purchase is its cost. Section 1012.
  » Original basis equals purchase price. If some of the purchase price is from borrowed funds these amounts are still included in original basis.
Sale of assets

- Character of assets
  - Capital asset – generally means any property held by a taxpayer, whether or not connected with a trade or business except:
    - Stock in trade of the taxpayer (inventory), or
    - Property, used in a trade or business, of a character that is subject to the allowance for depreciation or real property used in a trade or business.
  - Ordinary income assets
  - Section 1231 property

- Holding period
  - Capital and section 1231 property held for more than one year qualifies for the lower tax rate applicable to long-term capital gain.
Tax Implications for Buyer and Seller

> Sale of assets
  – Holding period
    » The sale of an asset held for one year or less will produce short-term gain or loss and the sale of an asset held for more than one year will produce long-term capital gain or loss. Section 1222.
  – A single asset may have more than one holding period.

> Sale of partnership interest
  – Gain or loss from the sale of a partnership interest equals the difference between the amount realized and the adjusted basis. Section 1001.
  – Amount realized equals the sum of any money received plus the FMV of the property (other than money) received. Section 1001(b).
    » Liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships. Section 752(d).
Sale of partnership interest

- Initial basis
  - Contribution to partnership
    - Amount of money and adjusted basis of property contributed to the partnership. Section 722.
  - Purchase of partnership interest
    - Basis is determined under the general rules of section 1011 and following. Section 742.

- Adjustments to basis
  - Increased for taxable and tax-exempt income allocated to the partner. Section 705(a)(1).
  - Decreased, but not below zero, by taxable losses and nondeductible expenses allocated to the partner. Section 705(a)(2).
Sale of partnership interest

- Adjustments to basis
  - Assumption of partnership liabilities by partner or an increase in partners share of partnership liabilities increases partners basis in partnership interest. Section 752(a).
  - Assumption of partner liabilities by partnership or a decrease in partners share of partnership liabilities decreases partners basis in partnership interest. Section 752(b).

- Character of gain or loss
  - Gain or loss from the sale of a partnership interest results in capital gain except as provided in section 751. Section 741.

- Holding period
  - Holding period of partnership interest received for the contribution of a capital asset or section 1231 asset in a tax deferred exchange includes the holding period of the contributed asset. Section 1223(a).
Sale of partnership interest

- Holding period
  - Holding period for partnership interest acquired for cash or property other than a capital asset or section 1231 property starts the day after acquisition.
  - Partnership interest can have bifurcated holding period. Regulation 1.1223-3.

Buyer’s cost basis and section 754 election

- Buyer’s basis in assets purchased equals cost.
- Basis of partnership assets may not be adjusted if partnership has not made a section 754 election.
- Example – The AB partnership has the following FMV and tax basis balance sheet. A sells his partnership interest to C for $50.
## Tax Implications for Buyer and Seller

> Example

- C will have a tax basis in its partnership interest equal to $50.
- If there is no section 754 election in place the partnership’s tax basis in Asset remains $30.
- If there is a section 754 election in place there will be a $35 section 743(b) adjustment to the tax basis of Asset that is allocated to C.

<table>
<thead>
<tr>
<th></th>
<th>FMV</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset</td>
<td>100</td>
<td>30</td>
</tr>
<tr>
<td>Liabilities</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>A capital</td>
<td>50</td>
<td>15</td>
</tr>
<tr>
<td>B capital</td>
<td>50</td>
<td>15</td>
</tr>
</tbody>
</table>
> **Buyer’s cost basis and section 754 election**
  
  – Purchase and sale agreement should contain language regarding section 754 election if partnership interest is being purchased.
  
  – Purchase and sale agreement should allocate the purchase price to the assets purchased.
  
  – Purchase and sale agreement for the purchase of a partnership interest should determine the FMV of the partnership assets.

> **Income / loss allocation issues**
  
  – Partnership must determine each partner’s distributive share of partnership items when a partner’s interest in a partnership varies during the taxable year as a result of the disposition of a partial or entire interest in a partnership.
  
  – Different segments will be created based on sales of partnership interests.
> Allocation of income and loss when partnership interest is sold

– Possible allocation methods
  » Interim closing method
  » Proration method

– Absent an agreement of the partners to use the proration method the partnership must use the interim closing method. Regulation 1.706-4(a)(3)(iii).
  » Agreement of the partners must be in a dated, written statement maintained by the partnership’s books and records, including, for example, a selection that is included in the partnership agreement. Regulation 1.706-4(f).

– Extraordinary items
  » May not be prorated. Partnership must allocate extraordinary items among the partners in proportion to their interests in the partnership item at the time of day on which the extraordinary item occurred. Regulation 1.706-4(e)(1).
Examples of extraordinary items include:
- Sale of a capital asset,
- Sale of a section 1231 asset,
- COD income, and
- Other items listed in regulation 1.706-4(e)(2).

Items for purchase and sale agreement when purchasing a partnership interest:
- Determine allocation method under section 706 that will be used.
  » Determine whether there is a written agreement allowing use of the interim closing method and, if desired, whether an agreement will be executed.
  » Determine if partnership agreement allows a partner to elect method – agree to method that partner will elect.
  » Consider what is desired for future sales of partnership interests.
- Identify extraordinary items to the extent possible.
STRUCTURING THE PURCHASE AGREEMENT

July 19, 2018

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STRUCTURING THE PURCHASE AGREEMENT

Structuring the Sale: Asset vs. Entity Sale

Asset Sale - the LLC or partnership sells all or substantially all of its assets to the buyer; the seller continues to own its interests in the LLC or partnership

Entity Sale - the seller sells its interests in the LLC or the partnership to the buyer; the LLC or partnership retains ownership of the assets.
Determining Factors

- Retained assets
- Subsidiaries or other operations
- Liabilities
- Tax considerations
STRUCTURING THE PURCHASE AGREEMENT
Structuring the Sale: Asset vs. Entity Sale

Tax Implications of an Asset Sale

- Basis of assets
- Allocation of purchase price and cost recovery
- Determination of character
- Effect on seller
- Effect on buyer
STRUCTURING THE PURCHASE AGREEMENT

Structuring the Sale: Asset vs. Entity Sale

Tax Implications of an Entity Sale

- Amount realized
- Determination of gain
- Character of gain
- Basis of partnership assets
- Effect on seller
- Effect on buyer
STRUCTURING THE PURCHASE AGREEMENT

Structuring the Sale: Asset vs. Entity Sale

Which is Better?

- Who do you represent?
- What are the assets?
- What are the liabilities?
Drafting Considerations

- Purchase price allocation
- Elections
- Allocation of risk
III. Allocation Of Purchase Price In An Asset Sale

Brian Keida
Character – Asset Sale – Valuation of Assets

• **Section 1060**
  – Provides rules for determining transferee’s basis and transferor’s gain or loss when there is an applicable asset acquisition.
  – Applicable asset acquisition is any transfer –
    ▪ Of assets constituting a trade or business,
    ▪ Where the transferee’s basis is determined wholly by reference to the consideration paid for such assets.
  – Consideration must be allocated among the assets in the same manner as under Section 338(b)(5).

• **Allocation of consideration**
  – Allocated under the residual method under regulations 1.338-6 and 1.338-7.
  – Seven classes of assets used in the residual method.

• **When should IRC §1060 type considerations be applied to valuing assets?**
Character – Asset Sale – Valuation of Assets

• **Form 8594 Asset Acquisition Statement Under Section 1060**
  – Both the seller and purchaser of a group of assets that makes up a trade or business and purchaser’s basis in the assets is determined wholly by the amount paid for the assets.
  – A group of assets makes up a trade or business if goodwill or going concern value could attach to the assets.

• **Seven Asset Classes**
  – Class I – cash and general deposit accounts.
  – Class II – certificate of deposits and foreign currency
  – Class III – mark-to-market assets and A/R
  – Class IV – stock in trade and inventory
  – Class V – anything not in other classes, PP&E, buildings, land and vehicles
  – Class VI – section 197 Intangibles
  – Class VII – goodwill and going concern value
Character – Asset Sale

• Gain or loss from the sale of assets
  – Difference between the amount realized and the adjusted basis of the property sold. Section 1001(a).

• Character
  – Capital gain or loss from sale of capital assets
  – Ordinary income or loss from noncapital assets
  – Net gain taxed as capital gain and net loss treated as ordinary loss from the sale of Section 1231 assets

• Gain or loss allocated under the partnership agreement
  – If the partnership sells assets the gain or loss is recognized by the partnership.
  – Allocation of gain or loss by partnership must satisfy Section 704(b).
Sale of Partnership Interest – Character – Section 751(a)

- IRC §741 – Generally considered gain or loss from the sale of a capital asset.

- IRC §751(a) (exception) – The amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or a part of his/her interest in the partnership attributable to unrealized receivables or inventory items of the partnership shall be considered as an amount realized from the sale or exchange of property other than a capital asset.

  – For sales and exchanges of interests, “inventory” includes all inventory items, not only “substantially appreciated” inventory items as in the case of disproportionate distributions subject to Section 751(b).

  – Unrealized receivables and inventory items, as described in Section 751, are also known as “hot assets”.

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Unrealized Receivables

• Evolving definition – Has always included rights to payment for:

  – Goods delivered or to be delivered.

  – Services rendered or to be rendered.

  – Amounts not previously included in income under partnership’s method of accounting.

  – Applies only to rights arising from contracts/agreements that exist at time of sale (or distribution).

  – Basis includes costs or expenses paid or accrued but not previously taken into account under the partnership’s method of accounting.
Unrealized Receivables

• Evolving definition – Other Items Reg 1.751-1(c)(4)

  Gain from mining property – Section 617(f)(2)
  Gain from Section 1245 Property
  Gain from Section 1250 Property
  Farm Land Gain – Section 1252(a)(2)
  Natural resource recapture – Section 1254(a)

  Gain from stock in a DISC – Section 992(a)
  Gain from PFIC Stock – Section 1248
  Gain from Farm Recapture Property – §1251(c)
  Gain from Franchises, Trademarks, and Trade Names – Section 1253(a)
Inventory Items
Reg 1.751-1(d)(2)

• Property of the partnership of the kind described in section 1221(a)(1).

• Any other property which, on sale or exchange, would be considered property other than a capital asset under section 1221 and other than property described in section 1231.
  – Accounts receivable acquired in the ordinary course of business for services.

• Any other property retained by partnership which, if held by the selling partner would be considered property described above.
Character – Section 751(a)

Amount subject to IRC §751(a)
Net amount of income or loss from IRC §751 property that would have been allocated to the transferor partner (to the extent attributable to their interest sold or exchanged) if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the FMV of such property (§1.751-1(a)(2)).

• Amount subject to IRC §751(a) is ordinary income or loss and the remaining amount of “gain or loss” is capital.

Preliminary Capital Gain or Loss
Less Section 751(a) Ordinary Income or Loss
Equals Actual Capital Gain or Loss
Applicable Capital Gains Rate

- Aggregate theory applies to sale of partnership interest.
  - Look through partnership to underlying assets.

- Example: A contributes $80,000 and B contributes $120,000 to Partnership AB for a 40%/60% interest in Partnership AB. Partnership AB acquires land for $200,000 and generates $12,000 in a receivable (rent).

- In a pure aggregate view, if A sells the 40% interest, A is selling a 40% interest in the land plus a 40% interest in the receivable.

- Maximum rates for LTCG:
  - 28% rate for collectibles gain.
  - 25% rate for unrecaptured sec. 1250 gain.
  - 20% rate for balance.
Applicable Capital Gains Rate

• Partnership collectibles and IRC §1250 property:

  – Selling partner recognizes gain as if the partnership sold all of its collectibles and IRC §1250 property in a fully taxable transaction immediately before the partner sold their interest.

  – Does not apply to redemptions.

  – Look through rule for tiered partnerships.
Applicable Capital Gains Rate

<table>
<thead>
<tr>
<th>Amount realized</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less (Adjusted basis)</td>
</tr>
<tr>
<td>= Total gain or loss</td>
</tr>
<tr>
<td>Less (Ordinary income (section 751(a)))</td>
</tr>
<tr>
<td>Less (STCG or STCL)</td>
</tr>
<tr>
<td>= “Pre-Look-Through” LTCG or LTCL</td>
</tr>
<tr>
<td>Less (Collectibles gain)</td>
</tr>
<tr>
<td>Less (Unrecaptured section 1250 gain)</td>
</tr>
<tr>
<td>= Residual LTCG or LTCL</td>
</tr>
</tbody>
</table>
Example 1

• A and B are equal partners in a partnership with each having contributed cash to the partnership in formation.

• After holding his interest for more than one year, A sells his entire interest in the partnership to C for $10,000.

• The partnership has the following balance sheet:
### Example 1

<table>
<thead>
<tr>
<th>Assets</th>
<th>Tax Basis</th>
<th>FMV</th>
<th>A's Share of Gain (Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Collectibles</td>
<td>1,000</td>
<td>2,000</td>
<td>500</td>
</tr>
<tr>
<td>Unrealized receivables</td>
<td>0</td>
<td>14,000</td>
<td>7,000</td>
</tr>
<tr>
<td>Section 1250 property <em>(original cost &gt; 1,000)</em></td>
<td>0</td>
<td>1,000</td>
<td>500</td>
</tr>
<tr>
<td>Other capital assets</td>
<td>6,000</td>
<td>3,000</td>
<td>(1,500)</td>
</tr>
<tr>
<td>Total Assets</td>
<td>7,000</td>
<td>20,000</td>
<td>6,500</td>
</tr>
</tbody>
</table>

| Capital: A                   | 3,500     | 10,000| 6,500                   |
| Capital: B                   | 3,500     | 10,000| 6,500                   |
| Total Liabilities/Capital    | 7,000     | 20,000| 6,500                   |
Example 1

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount realized</td>
<td>10,000</td>
</tr>
<tr>
<td>(Adjusted basis)</td>
<td>(3,500)</td>
</tr>
<tr>
<td>Total gain or loss</td>
<td>6,500</td>
</tr>
<tr>
<td>(Ordinary income (section 751 (a)))</td>
<td>(7,000)</td>
</tr>
<tr>
<td>(STCG or STCL)</td>
<td>0</td>
</tr>
<tr>
<td>“Pre-Look-Thru” LTCG or (LTCL)</td>
<td>(500)</td>
</tr>
<tr>
<td>(Collectibles gain)</td>
<td>(500)</td>
</tr>
<tr>
<td>(Unrecaptured section 1250 gain)</td>
<td>(500)</td>
</tr>
<tr>
<td>Residual LTCG or (LTCL)</td>
<td>(1,500)</td>
</tr>
<tr>
<td></td>
<td>(6,500)</td>
</tr>
</tbody>
</table>
Example 2 – Section 704(c)

• A and B are equal partners in personal service partnership PRS. B contributed the Unrealized Receivable when it had a FMV of $10,000 and an adjusted basis of $0. B transfers its interest in PRS to T for $15,000 when PRS’s balance sheet is as follows:

• Note: The capital assets are non-depreciable
<table>
<thead>
<tr>
<th>Assets</th>
<th>Basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$3,000</td>
<td>$3,000</td>
</tr>
<tr>
<td>Loans Receivable</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Capital Assets</td>
<td>$7,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>Unrealized Receivables</td>
<td>$0</td>
<td>$14,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$20,000</td>
<td>$32,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities &amp; Capital</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Capital</td>
<td></td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>$14,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>B</td>
<td>$4,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$20,000</td>
<td>$32,000</td>
</tr>
</tbody>
</table>
Example 2 – Gain Calculation

B’s Gain without Section 751(a)

<table>
<thead>
<tr>
<th>Item</th>
<th>Value</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount Realized</td>
<td>$16,000</td>
<td>Includes $15,000 of cash plus $1,000 of Section 752 reduced share of liabilities</td>
</tr>
<tr>
<td>Adjusted Basis</td>
<td>$5,000</td>
<td>Includes $4,000 regular basis plus $1,000 share of liabilities</td>
</tr>
<tr>
<td>Gain</td>
<td>$11,000</td>
<td></td>
</tr>
</tbody>
</table>
**Example 2 - Section 751 Gain Calculation**

<table>
<thead>
<tr>
<th>Item</th>
<th>Value</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount Realized</td>
<td>$14,000</td>
<td>Value of Unrealized Receivables</td>
</tr>
<tr>
<td>Adjusted Basis</td>
<td>$0</td>
<td></td>
</tr>
<tr>
<td>Section 704(c) Income on Sale of Unrealized Receivable</td>
<td>$10,000</td>
<td>FMV at contribution less AB at contribution</td>
</tr>
<tr>
<td>Remaining Income from Sale of Unrealized Receivable</td>
<td>$4,000</td>
<td></td>
</tr>
<tr>
<td>B’s 50% share of Income from sale of Unrealized Receivable</td>
<td>$2,000</td>
<td></td>
</tr>
<tr>
<td>Total Section 751 Gain to B</td>
<td>$12,000</td>
<td>704(c) share of Section 751 Gain, plus remaining (704(b) share) of Section 751 Gain</td>
</tr>
</tbody>
</table>
## Example 2 – Capital Gain/Loss Calculation

<table>
<thead>
<tr>
<th>Item</th>
<th>Value</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gain from Sale without Section 751</td>
<td>$11,000</td>
<td>From slide 31</td>
</tr>
<tr>
<td>Section 751 Gain from Sale</td>
<td>$12,000</td>
<td>From slide 32</td>
</tr>
<tr>
<td>Capital Gain/(Loss) from Sale</td>
<td>($1,000)</td>
<td>Loss from Sale without Section 751 minus the amount of Section 751 Gain</td>
</tr>
</tbody>
</table>
Section 751(a) – Reporting Requirements

• A partnership must file Form 8308, *Report of a Sale or Exchange of Certain Partnership Interests*
  – Generally attach to Form 1065 unless the partnership receives notice of transfer subsequent to the filing of Form 1065
  – A separate Form 8308 with respect to each section 751(a) sale or exchange of an interest.
  – Within 30 days of the exchange, each transferor partner must provide the partnership with the information needed to complete the form.

• The transferor partner in a partnership holding section 751 property must attach a statement to its tax return reporting –
  – The date of the sale or exchange;
  – The amount of gain or loss attributable to section 751 property; and
  – The amount of any gain or loss attributable to capital gain or loss
Impact on Selling Partner – Recap

• **Amount of gain or loss**
  – Liabilities relieved included in amount realized
  – Adjusted tax basis includes seller’s distributive share of income or loss through the date of sale
  – Section 706 – Taxable Years of Partner and Partnership

• **Character of gain or loss:**
  – Capital, unless section 751 applies.

• **Holding period may be bifurcated:**
  – Part short-term / Part long-term.

• **Different capital gains rates may apply.**
Impact on Buying Partner

• **Basis in acquired interest equals:**
  – Cost (cash + FMV of property);
  – *Plus* share of liabilities assumed.

• **Consider basis adjustments.**

• **No longer termination of the partnership.**
  – Impact on income allocations after the acquisition.
  – Filing of tax return or changes to Tax Representative.
  – Close the books.

• **Impact on partnership’s tax year?**
**Purpose of Section 743(b) Adjustments**

- Protects purchasing partner from gain or loss inherent in the partnership interest.
- Treats partner as if he purchased an interest in each partnership asset.
- Affects transferee partner only.
- Adjust for the difference between
  - transferee’s outside basis (sections 742 and 752, reduced by share of liabilities)
  - Transferee’s share of inside basis – proceeds of hypothetical liquidation adjusted for gain/loss
- Allocated under Section 755 & Treas. Reg. 1.755-1(b)(2).
Effect of Section 743(b) Adjustments

- Sale of adjusted property:
  - Sec. 743(b) adjustment does not affect gain recognized by the partnership on sale of its assets.
  - Adjustment affects gain recognized by the transferee partner only.

- Three basic steps:
  1. Compute partnership’s gain or loss from sale of property.
  2. Allocate gain or loss to the partners under sec. 704(b) and 704(c).
  3. Adjust transferee partner’s share of gain or loss for sec. 743(b) adjustments on the property.
Effect of Section 743(b) Adjustments

• **Adjustments to depreciable property:**
  – Positive Adjustments:
    ▪ Treated as a newly placed in service asset.
    ▪ Creates additional depreciation for the transferee partner.
  
  – Negative Adjustments:
    ▪ Recovered over remaining useful life of property.
    ▪ Reduces the transferee partner’s depreciation allocation.
    ▪ May trigger ordinary income.
Reporting Requirements

• The transferee partner that acquires interest in PRS that has section 754 election in effect must notify PRS of transfer within 30 days.
  1. Include names, addresses, and tax identification number of transferee and transferor (if known)
  2. Date of transfer
  3. Relationship, if any, of transferee and transferor
  4. Other information necessary so that the partnership can calculate transferee’s basis in its acquired interest (e.g., purchase price and liabilities assumed)

• PRS must include statement with return for taxable year that it acquires knowledge of transfer.
  – Identify transferee, show basis adjustment, and the allocation of the adjustment.
Impact on Buying Partner – Recap

- **Basis in the partnership interest acquired**
  - Cost basis (assuming taxable purchase)
  - Share of partnership debt

- **Section 754 election**
  - Already in effect or should the partnership make one?
  - Mandatory adjustment?

- **Section 706 method**

- **Section 704(c)**
  - Step-in-the-shoes
  - Section 704(c)(1)(C) exception – built-in loss
STRUCTURING THE PURCHASE AGREEMENT

Structuring Payment Terms

- Cash payment
- Installment sale
- Balloon payment
- Covenants not to compete
- Consulting agreements
V. Factors to consider under new tax law in negotiating and drafting purchase agreements
Depreciation Changes – Bonus Depreciation

Bonus Depreciation

• 100% bonus depreciation for assets acquired pursuant to a written binding contract entered into from September 28, 2017 through December 31, 2022.

  • Example: On September 1, 2017 Taxpayer and vendor sign a binding purchase order for a piece of equipment. The equipment is delivered to the customer and placed in service on October 2, 2017. The equipment does not qualify for 100% bonus depreciation because the binding contract was signed prior to September 28, 2017. The property will continue to qualify for 50% bonus depreciation.

• Allows for bonus depreciation on used property.

• Phases out bonus depreciation from 2023 through 2027.

• 50% bonus depreciation on new property acquired before 9/28/2017

• Section 743(b) adjustment may be eligible for bonus depreciation. Depending on guidance issued by IRS.

• Industry Elections

  • Electing real estate trade or business must depreciate non-residential real estate, residential real estate and QIP under the ADS regime.
  
  • Electing farming businesses must use ADS for property with a recovery period of 10 years or more
Depreciation Changes – Real Estate Improvements

Real Estate Improvements

- Qualified Retail Improvement Property (QRIP), Qualified Leasehold Improvement Property (QLIP) and Qualified Restaurant Property (QRP) rules remain in effect through December 31, 2017
  - 15 year recovery period
  - Generally eligible for bonus depreciation
  - Eligible for 179 expense

- Qualified Improvement property (QIP) replaces QRIP, QLIP and QRP on January 1, 2018
  - Contrary to language in conference committee report, Section 168 as revised failed to include QIP as 15 year property.
  - As a result of this omission:
    - 39 year recovery period
    - No bonus depreciation
    - Eligible for 179 expense

- Real estate industry representatives are in active conversation with Treasury and the Joint Committee on Taxation regarding this matter and are working toward a solution.
Section 199A Deduction

New 20 percent deduction for a portion of pass through income.

**Sunsets on December 31, 2025**

- **Step 1**
  - Tentative deduction is 20% of pass through income not to exceed the greater of:
    - 50% of W-2 wages paid by the business
    - 25% of W-2 wages paid by the business plus 2.5% of the initial tax basis (not reduced by depreciation) of qualified property
  - No limitation if owner's income is less than $315,000 ($157,500 single). Phases out over next $100,000 of income ($50,000 single)

- **Step 2**
  - Deduction allowed is lesser of:
    - Tentative deduction computed in step 1
    - 20% of adjusted taxable income
  - Calculation is with respect to each trade or business. Does Section 469, including grouping, control the definition of trade or business?
  - For pass through entities with foreign activity, 20% deduction limited to amounts effectively connected with the conduct of a US trade or business
Other Significant Changes

- Like kind exchanges repealed for except for real property not held for sale.

- Technical Terminations - Section 708(b)(1)(B) is repealed effective for partnership tax years beginning on or after January 1, 2018.

- Carried Interest - imposed a three year holding period on assets to qualify for capital gains on profits allocated under a carried interest.

- Management Fees – Will no longer be deductible to individuals as an itemized deduction on Schedule A.
New Partnership Audit Rules – Key Points

• Effort to streamline the examination and judicial process to allow centralized collection of additional tax owed

• IRS is no longer required to determine each partner’s share of adjustments

• Unlike TEFRA, distinctions between partnership items, affected items, and non-partnership items are no longer made

• Centralized partnership audit regime applies to any adjustment to items of income, gain, loss, deduction, or credit of a partnership and any partner’s distributive share of these items

• Tax will be assessed and paid at the partnership level, unless election made to push the tax liability out to the partners
New Partnership Audit Rules – Key Points

• Tax Matters Partner (TMP) is replaced with Partnership Representative (PR) who doesn’t have to be a partner but can bind the partnership at audit

• All partners are bound by a final resolution in the partnership proceeding

Every partnership agreement and LLC Operating Agreement that does not reflect the BBA provisions should be amended to reflect the new regime, including appointment of a partnership representative