LLC and Partnership Purchases: Entity Interests vs. Asset Sales

WEDNESDAY, JUNE 5, 2019, 1:00-2:50 pm Eastern

IMPORTANT INFORMATION FOR THE LIVE PROGRAM

This program is approved for 2 CPE credit hours. To earn credit you must:

- **Participate in the program on your own computer connection (no sharing)** – if you need to register additional people, please call customer service at 1-800-926-7926 ext. 1 (or 404-881-1141 ext. 1). Strafford accepts American Express, Visa, MasterCard, Discover.
- **Listen on-line** via your computer speakers.
- **Respond to five prompts during the program plus a single verification code.**
- To earn full credit, you must remain connected for the entire program.

WHO TO CONTACT DURING THE LIVE PROGRAM

For Additional Registrations:
-Call Strafford Customer Service 1-800-926-7926 x1 (or 404-881-1141 x1)

For Assistance During the Live Program:
-On the web, use the chat box at the bottom left of the screen

If you get disconnected during the program, you can simply log in using your original instructions and PIN.

Tips for Optimal Quality

FOR LIVE PROGRAM ONLY

Sound Quality

When listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, please e-mail sound@straffordpub.com immediately so we can address the problem.

LLC and Partnership Purchases: Entity Interests vs. Asset Sales

June 5, 2019

Professor Bradley T. Borden, Professor of Law
Brooklyn Law School
brad.borden@brooklaw.edu

Joseph C. Mandarino, Partner
Smith Gambrell & Russell
jmandarino@sgrlaw.com

Notice

ANY TAX ADVICE IN THIS COMMUNICATION IS NOT INTENDED OR WRITTEN BY THE SPEAKERS' FIRMS TO BE USED, AND CANNOT BE USED, BY A CLIENT OR ANY OTHER PERSON OR ENTITY FOR THE PURPOSE OF (i) AVOIDING PENALTIES THAT MAY BE IMPOSED ON ANY TAXPAYER OR (ii) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY MATTERS ADDRESSED HEREIN.

You (and your employees, representatives, or agents) may disclose to any and all persons, without limitation, the tax treatment or tax structure, or both, of any transaction described in the associated materials we provide to you, including, but not limited to, any tax opinions, memoranda, or other tax analyses contained in those materials.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

LLC and Partnership Purchases: Entity Interests vs. Asset Sales

Impact of the New IRS Partnership Audit Rules

June 5, 2019

Joseph C. Mandarino

Smith, Gambrell & Russell, LLP
Promenade, Suite 3100
1230 Peachtree Street N.E.
Atlanta, GA 30309
www.sglaw.com

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

Disclaimer

IRS CIRCULAR 230 DISCLOSURE:

Unless explicitly stated to the contrary, this outline, the presentation to which it relates and any other documents or attachments are not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

Overview

A. Background – Liability Issues in Entity vs. Asset Purchases

B. The CPAR Rules – Overview and Examples

C. Structuring Acquisitions under the CPAR Rules

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

Background – Liability Issues in Entity vs. Asset Purchases

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

Background

- A purchaser of a business or investment will typically want to avoid any liability for actions or events prior to the purchase.
- The most common way to avoid pre-closing liabilities is to structure the transaction as an asset purchase.
- In contrast to an asset purchase, a "stock" or "entity" purchase involves purchasing an existing owner's interest in the entity that operates the business or owns the investment. Alternatively, the buyer could acquire a wholly new interest from the entity itself.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

Background

- In the case of an “entity” purchase, the buyer is not protected from the pre-closing liabilities of the entity.
- While indemnity or other arrangements can provide some protection, there is no legal way to prevent a pre-closing liability from burdening the buyer’s interest in the entity.
- For an entity taxed as partnership, however, there was an important caveat. Generally, income tax liability was allocated to the owners of the entity for the periods in which the liability arose.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

Background

- Example: ABC Partnership is owned equally by individuals A, B and C. On 1/1/2017, C sells its interest to D, an unrelated purchaser for cash.
- Later, it turns out that ABC was responsible for a $1 million contract claim that arose in 2015, and a $1 million unreported tax liability that arose in 2016. Neither liability was disclosed to D at the time of the purchase.
- D will indirectly bear a 1/3 burden of the contract claim, unless she there is an indemnity or escrow arrangement that may provide some relief.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

Background

- With respect to the income tax liability, however, the burden of that falls solely on the partners of ABC in 2016, when the liability arose.
- D will have no direct or indirect share of that liability.
- Thus, until recently, a purchaser could rely on the fact that he or she was unlikely to ever bear exposure for income tax liabilities from pre-closing periods.
- Unfortunately, that rule changed starting in 2018.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

The CPAR Rules -- Overview

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

The New Rules

A. Basics

B. Audit Rules

C. Settlement/Payment

C. Coverage/Election Out

D. Push-Out Election

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

The New Rules – Basics

- Enacted on November 2, 2015, as part of the Bipartisan Budget Act of 2015.
- Is effective for partnership tax years beginning after 2017.
  - BUT – may be able to elect to apply new rules to earlier years.
- Estimated to raise $9.3 billion in tax revenue over first 10 years.
- Repeals the TEFRA rules and creates new terms and rules, located in Code Sections 6221 through 6241.
- The IRS refers to the new rules as the “Centralized Partnership Audit Regime” (“CPAR”).

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

The Audit Rules – General

- Like TEFRA, the IRS will audit and litigate partnership items at the partnership level.
- BUT – unlike TEFRA, liability is asserted against the partnership itself at the highest applicable tax rate.
    - HUGE CHANGE IN TAX LAW!!!

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

The Audit Rules – the PREP

- Instead of a TMP, each partnership will designate a "partnership representative" ("PREP") who will have the sole authority to act on behalf of the partnership in any IRS audit.
- Unlike the TMP, the PREP need not be a partner or member of the partnership, but does have to have a "substantial presence" in the U.S.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

The Audit Rules – the PREP

- If the partnership fails to designate a PREP, the IRS can designate "any person" to act as the PREP.
  - Key – do not neglect this. Although a partnership agreement need not designate the PREP, the GP or manager can and should designate a PREP if only to block the IRS from picking one.

SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

The Audit Rules -- Consistency

- After the final resolution of an audit, all partners are bound by that determination.
- Partners do not have the right to participate in a proceeding or receive notice of the same – this is another change from TEFRA.
- The partnership agreement itself can limit the PREP’s rights, but nothing in the statute or regs will.
- Partners can file a notice of inconsistent position.

SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

The Audit Rules -- Terms

- “reviewed year” – the year under audit.
- “adjustment year” – the year in which the adjustment for the reviewed year occurs.
  - Can happen by settlement or court decision in the case of an adjustment stemming from an audit.
  - Can also be the year in which an adjustment is made because the partnership requests an administrative adjustment (i.e., tantamount to an amended return).

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

Settlement/Payment

- Any adjustment is assessed in the adjustment year, not the reviewed year.
  - Example: IRS audits Newco in 2020 for its 2018 tax year. In 2021, IRS proposes a net adjustment to the 2018 tax year and Newco concedes. The tax liability is assessed in the 2021 tax year.
- Moreover, the tax liability – the "imputed underpayment amount" – is assessed against the partnership, not the partners.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

Settlement/Payment -- IUA

- “imputed underpayment amount” (“IUA”) – the net non-favorable adjustment to the partnership tax year, multiplied by the highest applicable tax rates in section 1 or 11 of the Code.
- Thus, for the first time, income taxes are assessed at the entity level and not at the partner level.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH,GAMBRELL
& RUSSELL, LLP
Attorneys at Law

Settlement/Payment – IUA

- Note that penalties are also determined at the partnership level. However, the push out rules bring back partner-level defenses to penalties.
- Only the partnership statute of limitations controls.
  - For example, the 6-year substantial understatement statute of limitations is determined at the partnership level, not the partner level.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH,GAMBRELL & RUSSELL, LLP
Attorneys at Law

Settlement/Payment – IUA

- Statute provides that the following should be taken into account in calculating the IUA :
  - if a portion of any reallocation would go to a tax-exempt entity;
  - if ordinary income amounts are allocable to a C corporation;
  - if capital gain or qualified dividends are allocable to individuals; and
  - if there are reallocations from one partner to another that results in a decrease income/gain or a decrease in deductions/losses/credits.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

Settlement/Payment – Returns

- Unless the partnership elects out of CPAR or makes the push out election, partners of the partnership will **not** be directly liable for adjustments arising from audits.
- Instead, the partnership is liable.
- Caveat – The IRS has the power to ignore the partnership and collect against the partners directly.
- However, it appears that the IRS will only be able to exercise this right if the underlying partnership is unable to pay the IUA.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

Settlement/Payment – Returns

- So it is now clear that if the partnership agrees to an adjustment and pays it, the partners will never have to file amended returns.
- However, partners from the reviewed year can file amended returns and pay their corresponding liability and this payment can offset the payment that the partnership would otherwise owe.
- Note that while the IRS cannot require partners to file amended returns, the partnership agreement could. Conversely, the partnership agreement could mandate that partners need never file amended returns.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

Settlement/Payment

Example 1 - Partnership Adjustments that Result in an Imputed Underpayment:

- Partnership reports on its 2019 partnership return ordinary income of $300, long-term capital gain of $125, long-term capital loss of $75, and a depreciation deduction of $100.
- The IRS determines ordinary income of $500 ($200 adjustment), long-term capital gain of $200 ($75 adjustment), long-term capital loss of $25 ($50 adjustment), and a depreciation deduction of $70 ($30 adjustment).
- The adjustments are part of the “residual grouping”. The adjustment to ordinary income and the depreciation deduction are grouped together in an ordinary subgrouping within the residual grouping and netted with each other because they are both ordinary in character and neither is subject to differing restrictions or limitations.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR SMITH, GAMBRELL & RUSSELL, LLP Attorneys at Law

Settlement/Payment

Example 1 (continued):

- The decrease in the depreciation deduction is treated as an increase in income of $30. Thus, $200 (adjustment to ordinary income) plus $30 (depreciation adjustment treated as increase in income) yields $230 of additional income in the ordinary subgrouping within the residual grouping.
- For similar reasons, the adjustments to long-term capital gain and long-term capital loss are grouped together in a long-term capital subgrouping within the residual grouping and netted with each other. For purposes of netting, the decrease in capital loss is treated as an increase in income of $50.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

Settlement/Payment

<u>Example 1 (continued):</u>

- Thus, $75 (long-term capital gain adjustment) plus $50 (long-term capital loss adjustment) yields $125 of additional income in the long-term capital subgrouping within the residual grouping.
- With respect to the ordinary subgrouping, the $230 adjustment to ordinary income is a net positive adjustment for that subgrouping and is added to the $125 of additional income in the long-term capital subgrouping, for a total netted partnership adjustment of $355. The total netted partnership adjustment is multiplied by the applicable tax rate (taking into account the identity of the taxpayers and special rates for capital gain.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

Settlement/Payment

Points to consider:

- Each imputed underpayment is calculated solely with respect to a single taxable year.
- Grouping of adjustments by category: (1) “Reallocation” (2) Credits; (3) “Residual”.
- Within Residual Grouping, items are subgrouped for character and holding period.
- NO NETTING of subgroups or Groups!
- Only positive adjustments are used in determining the imputed underpayment.
- Imputed Underpayment Amount” (“IUA”) – the non-favorable adjustment to the partnership tax year, multiplied by the highest applicable tax rates in section 1 or 11 of the Code.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR SMITH, GAMBRELL & RUSSELL, LLP Attorneys at Law

Settlement/Payment

Example 2 - Modification of Imputed Underpayment:

- The IRS initiates an administrative proceeding with respect to Partnership's 2019 taxable year. Partnership has two equal partners during its 2019 taxable year: an individual, A, and a partnership-partner, B.
- For 2019, B has two equal partners: a tax-exempt entity, C, and an individual, D. The IRS mails a NOPPA to Partnership for its 2019 taxable year showing a single partnership adjustment increasing Partnership's ordinary income by $100, resulting in a $40 imputed underpayment ($100 total netted partnership adjustment multiplied by 40% hypothetical tax rate).

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

Settlement/Payment

Example 2 continued:

- Partnership requests modification under Treas. Reg. §301.6225-2(d)(3) with respect to B's partner, C, a tax-exempt entity.
- Partnership's partnership representative provides the IRS with documentation that C is a tax-exempt entity that is not subject to tax with respect to its share of the partnership adjustment.
- IRS approves the modification and the $25 increase in ordinary income allocable to C is not included in the calculation of the total netted partnership adjustment. Partnership's total netted partnership adjustment is reduced to $75 ($100 adjustment less C's share of the adjustment, $25), and the imputed underpayment is reduced to $30 (total netted partnership adjustment of $75, after modification, multiplied by 40%).

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

Settlement/Payment

Points to consider:

- Adjustment for amended return filed by a Reviewed Year partner.
- Adjustment for Tax-exempt partner.
- Adjustment for C corporation partner.
- “Other” modifications on a case by case basis as approved by the IRS.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

Coverage – General

- The new rules only apply to certain partnerships. If a partnership qualifies, it can elect out on its tax return.
- If the election is effective, the partnership will not be subject to the new rules and, because the TEFRA rules are repealed for all purposes, will not be subject to those rules either.
- Effectively, an electing out partnership can go back to the “bad old days” when the IRS had to audit individual partners.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

Coverage – Election Out

- A partnership can elect out if it has 100 or fewer partners.
- Technically, this is determined by counting K-1s, so clarify whether your partnership may be issuing K-1s when unnecessary.
- Also, each shareholder of a S corporation partner is included in the count.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

Coverage – Election Out

- Even if you meet the 100-partner rule, those partners must be one of the following;
  - an individual
  - a C corporation
  - a foreign C corporation
  - an S corporation, or
  - an estate of a deceased partner.
- If there are any other types of entities, or any partners that are themselves partnerships, then the election is not permitted.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

Coverage – Election Out

- The upper-tier partnership limitation is so significant that it may cause partnerships to limit who can become a partner and to limit transfers so that disqualifying partners cannot enter the partnership.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

Coverage – Election Out

- Note that under the proposed regulations, a disregarded entity of an otherwise eligible partner can invalidate the election out.
- Example – Newco is owned 50/50 by Adam and Eve. Adam holds his partnership interest in Holdco, a single member LLC that is treated as a disregarded entity for tax purposes.
- The mere existence of Holdco in the ownership structure – even though it is ignored for tax purposes – prevents Newco from election out of CPAR.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

Coverage – Election Out

Planning Note:

- If the IRS does not change its stance on disregarded entities (DREs), it may make sense to reorganize.
- In our example, Adam could cause Holdco to transfer the interest in Newco to Adam directly, which would satisfy the election out rules.
- Conversely, Holdco could elect to be a C corporation or an S corporation.
- Key – how important is it for your client to be able to elect out of CPAR?

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

Push-Out Election

- Another alternative is the so-called “push-out” election.
- Under this approach, the partnership makes a special election without 45 days of receiving a final partnership administrative adjustment (“FPAA”).
- The partnership then issues “statements” (i.e., amended K-1s) to the partners for the reviewed year reflecting the FPAA.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

Push-Out Election

- But, for the reviewed year partners it is not as simple as determined the additional tax liability in the reviewed year and paying the tax.
- Each partner also has to take into account any tax liabilities in the interim years as a result of the effect of the resulting change in tax attributes in the reviewed year.
- The sum of such liabilities, plus penalties, plus interest in due in the year in which the statement is issued.
- And, the interest rate is 2% points higher than whatever interest rates would otherwise apply.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

Push-Out Election

- The push-out election does save the partnership from paying entity-level taxes and places the burden for those taxes on the reviewed year partners, which seems fairer.
- But the interest rate increase has to be taken into account, and the complicated tax liability calculations that are needed.
- Even with these hurdles, it may be more equitable (from the partnership's perspective) to make this election and it may be simpler than setting up an indemnity regime to recover these amounts.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

Push-Out Election

Example 1 – Push Out of Partnership Adjustments:

- Partnership has two equal partners for 2020 tax year A (an individual) and B (a partnership). B has two equal partners, C and D.
- IRS mails an FPA on June 1, 2023, increasing ordinary income by $500 and asserting an imputed underpayment of $200. Partnership petitions the Tax Court which issues a final decision sustaining the IRS position. The Partnership does not appeal and the determination becomes effective on December 15, 2025.
- Partnership makes a timely push out election under section 6226. The due date for calculation to partners and the IRS is 60 days after the adjustment becomes final, in this case February 13, 2026.
- Due date of the Adjustment Year return (i.e., the 2025 Form 1065 for Partnership) is March 15, 2026, subject to extension.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

Push-Out Election

Example 1 – Push Out of Partnership Adjustments (continued):

- Statements to A and B each reflect adjustment of $250 of ordinary income.
- A (the individual) taxes the adjustment into account on its 2025 Form 1040.
- B (the upper tier partnership) must either make a payment based on the adjustment, or furnish a statement to its partners that held an interest in the pass through partner at any time during the year to which the adjustments relate.
- Statements from B to C and D (B's partners), must be issued before the due date for B's Form 1065 for the Adjustment Year.
- If C and D receive the statements after their return due date for the Adjustment Year, they have 30 days to report and pay the tax.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

International Aspects

The IRS issued regulations covering a variety of international partnership tax issues:

- Withholding taxes generally are not within CPAR, but the IRS can conduct a partnership-level audit of withholding obligations under existing law.
- Creditable foreign tax expenditures and the indirect foreign tax credit can be audited at the partnership level under CPAR.
- The IRS is seeking guidance on how to take into account possible modifications to the imputed underpayment rate to reflect the status of non-US partners and for tax rates determined under tax treaties.
- If the IRS conducts a withholding tax audit and collects withholding tax from the partnership, that adjustment is ignored for purposes of any imputed underpayment under the CPAR rules.
- If the IRS conducts a CPAR audit and collects an imputed underpayment from the partnership for an amount subject to withholding, the IRS will credit that amount.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

Structuring Acquisitions under the CPAR Rules

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

Overview

1. Adding Language to Address CPAR
2. Electing Out
3. Mandatory Push-Out Election
4. Bolster Minority Owner Rights
5. Diligence

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

Add CPAR Clause to Partnership Agreement

- A surprising number of partnership and LLC agreements do not contain any language address CPAR. Some still have the old TEFRA rules re TMPs, etc.
- A buyer purchasing an interest in a partnership should require that the partnership amend its agreement to add CPAR rules.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

Add CPAR Clause to Partnership Agreement

- Some of the approaches to take are as follows:
  - Put in language providing for the appointment of the PREP.
  - Provide that the partnership will always elect out of CPAR for each year possible.
  - Provide that, if the partnership cannot elect out of the new rules for any reason, then it will make the push-out election.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

Electing Out

- As noted, many partnerships will be unable to elect out because of the presence of upper tier partnerships or DREs.
- A new buyer should undertake diligence to determine the obstacles to electing out.
- For example, can DREs be eliminated? Can the partnership make a §761 election?
- If possible to elect out with some restructuring, the existing owners may be amenable.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

Mandatory Push Out

- If the IRS asserts a liability, the partnership can elect to push it out to the parties who were the partners at issue in the reviewed year. This effectively replicates the old TEFRA rules and ensures that new partnership will not directly or indirectly bear the burden of that liability.
- A buyer should consider requiring the partnership to amend its relevant documents so that in any such situation the partnership will make a push out election.
- Many banks are similarly requiring partnerships and LLC to do this as part of the lending process.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

Mandatory Push Out

- Example: Buyer purchases a 25% interest in Oldco from Seller, a retiring partner, on 1/1/2020. In 2022, the IRS determines that Oldco grossly understated income in 2019, resulting in a $1 mm liability.
- Assume Oldco consents to the assessment and pays the liability under the CPAR rules. Thus, although Buyer was not personally liable, it bears 25% of the burden, even though the benefit of the understatement was actually enjoyed by the seller, the retiring partner.
- It is possible that Buyer might have indemnity rights against Seller, but exercising them may be time-consuming and Seller may have no assets.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

Mandatory Push Out

- Example: Same facts, but as part of the purchase, Buyer required that Oldco's partnership agreement be amended to require a mandatory push out election.
- Thus, following the IRS audit, Oldco pushes out the liability and Buyer bears none of it, directly or indirectly.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

Minority Rights

- As noted, the relevant statute and regulations do not require the PREP to confer or defer to the partners.
- Language, similar to that of the TEFRA clauses in older agreements, can be crafted to make the PREP heed to the will of the partners.
- However, this often means heeding to the will of the majority owner. In the case of a buyer purchasing a minority interest, it would be advisable to set up the deference provisions so that unanimous consent is required.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SGR
SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

Diligence

- Because of the risk of liability for pre-closing income taxes, it is important that buyers increase the scope and quality of income tax diligence.
- While in previous periods a buyer could rely on the pass-through nature of a partnership to insure that it would not be directly or indirectly liable for pre-closing tax liabilities, that is no longer the case.

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

Thanks!

Joe Mandarino

Smith, Gambrell & Russell, LLP
Promenade, Suite 3100
1230 Peachtree Street N.E.
Atlanta, GA 30309
www.sgrlaw.com

© 2019 Smith, Gambrell & Russell, LLP, All Rights Reserved

SMITH, GAMBRELL & RUSSELL, LLP
Attorneys at Law

IRC Section 743(b) Basis Adjustments

Professor Bradley T. Borden
Brooklyn School of Law
brad.borden@brooklaw.edu

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.

Overview (Cont.)

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 taxable entity, its income is allocated and taxed to its partners, treating them like owners of undivided interests in the assets and business of the partnership, i.e., as an aggregate of individuals. This does not have a direct analog in the Subchapter C or Subchapter S world because corporations are treated as separate entities.

Overview (Cont.)

D. Benefit of Partnership Taxation: If a partnership makes a Code Section 754 election, Section 743(b) of the partnership tax law allows the "outside basis" and the "inside basis" to be equal. What this means is the following: If the partnership were liquidated for cash immediately after the event causing the Section 754 election for an amount equal to the outside tax basis to the partner for whom the election applies, that partner would recognize no gain or loss from the sale of the partnership assets or from the liquidating distribution.

Overview (Cont.)

E. **Section 754 Election**:

1. 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:
   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

Overview (Cont.)

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.

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 the tax basis of retained partnership property exceeding $250,000. Special rules apply to "electing partnerships as set forth in Code

Overview (Cont.)

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

Partnership	Tax Basis	FMV	BIL
Property	200	100	(100)
Partners			
A	100	50	(50)
B	100	50	(50)
A sells 50% partnership interest to X for $50 A recognizes $50 loss			
Property	200	100	(100)
Partners			
X	50	50	-0-
B	100	50	(50)
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.

Ability to Make a Code Section 754 Election Due to a Transfer or a Distribution (Cont.)

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

Ability to Make a Code Section 754 Election Due to a Transfer or a Distribution (Cont.)

"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.)

A. 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.

Ability to Make a Code Section 754 Election Due to a Transfer or a Distribution (Cont.)

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.
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.

Ability to Make a Code Section 754 Election Due to a Transfer or a Distribution (Cont.)

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.

Ability to Make a Code Section 754 Election Due to a Transfer or a Distribution (Cont.)

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

Ability to Make a Code Section 754 Election Due to a Transfer or a Distribution (Cont.)

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]

Ability to Make a Code Section 754 Election Due to a Transfer or a Distribution (Cont.)

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

Ability to Make a Code Section 754 Election Due to a Transfer or a Distribution (Cont.)

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.

- **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.

Ability to Make a Code Section 754 Election Due to a Transfer or a Distribution (Cont.)

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).

Ability to Make a Code Section 754 Election Due to a Transfer or a Distribution (Cont.)

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).
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).

Ability to Make a Code Section 754 Election Due to a Transfer or a Distribution (Cont.)

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

Ability to Make a Code Section 754 Election Due to a Transfer or a Distribution (Cont.)

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).

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

What Happens Under Code Section 743(b) When a Code Section 754 Election is Made? (Cont.)

"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."

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.

What Happens Under Code Section 743(b) When a Code Section 754 Election is Made? (Cont.)

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."
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.

What Happens Under Code Section 743(b) When a Code Section 754 Election is Made? (Cont.)

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. (See Exhibits A & B.)

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.

Example 1 of Treasury Regulation Section 1.743-1(d)(3).

EXHIBIT A

Tax Capital Account and Book Capital Account are the same.

	Adjusted Basis	Fair market value on date of sale by A	Section 743(b) adjustment to transferee of A
Cash	$ 5,000	$ 5,000	$ 0.00
Accounts Receivable	$10,000	$10,000	$ 0.00
Inventory	$20,000	$21,000	$3,333.33
Depreciable assets	$20,000	$40,000	$6,666.67
Total	$55,000	$76,000	$7,000.00
Liabilities	$10,000	$10,000	
Capital:			
A	$15,000	$22,000	
B	$15,000	$22,000	
C	$15,000	$22,000	

Assume sale of depreciable assets with Section 754 election:

Gain allocated to transferee of A $0.00

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

Assume sale of depreciable assets **without** Section 754 election:

Gain allocated to transferee of A $6,666.67

[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).

EXHIBIT B

Tax Capital Account and Book Capital Account are different.

A contributes land; B and C contribute cash.

	Adjusted Basis	Fair market value on contribution date	Fair market value on date of sale by A	Section 743(b) adjustment to transferee of A
Land	$ 400	$1,000	$1,300	$700
Cash	$2,000	$2,000	$2,000	0
Total	$2,400	$3,000	$3,300	$700
Capital:				
A	$ 400	$1,000	$1,100	
B	$1,000	$1,000	$1,100	
C	$1,000	$1,000	$1,100	

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 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:

1. Transfer of partnership interest when assets of partnership do not constitute a trade or business. Treas. Reg. § 1.755-1(b)(1)-(b)(4).
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

Code Section 755 Basis Adjustments (Cont.)

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 distribute-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 755 Basis Adjustments (Cont.)

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). In this case, residual method must be used to assign values to intangibles.

Code Section 755 Basis Adjustments (Cont.)

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

Code Section 755 Basis Adjustments (Cont.)

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).

Code Section 755 Basis Adjustments (Cont.)

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).

Code Section 755 Basis Adjustments (Cont.)

- 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). See Exhibit C.
   - Note that in a substituted basis transaction no adjustment can be made if the total amount of the Section 743(b) adjustment is zero.

Exhibit C

Example 2 of Treas. Reg. § 1.755-1(b)(2)(ii): T buys A's interest for $1,000, and outside basis equals inside basis.

	Adjusted Basis	Fair Market Value	743(b) Adjustment
Capital Gain Property			
Asset 1	$500	$750	$125
Asset 2	500	500	
Ordinary Income Property			
Asset 3	$500	$250	($125)
Asset 4	500	500	
	$2,000	$2,000	0
Capital:			
A	1,000	1,000	
B	1,000	1,000	

With Section 754 election in effect, if there is a sale of partnership property immediately after purchase, then T will **NOT** recognize an ordinary loss of $125.00 and will **NOT** recognize a capital gain of $125.00.

Code Section 755 Basis Adjustments (Cont.)

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).

Code Section 755 Basis Adjustments (Cont.)

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.

6. See Exhibits D and E for examples of Code Section 755 allocations.

Exhibit D

Example 2 of Treas. Reg. § 1.755-1(b)(3)(iv): T buys A's interest for $110,000.

	Adjusted Basis	Fair Market Value at time of contribution	Fair Market Value at time of sale	Adjustment based on FMV sale ($45,000)	Basis Adjustment based on actual sale ($35,000)
Capital gain property					
Asset 1	$25,000	$50,000	$75,000	$37,500	$33,604
Asset 2	$100,000	$100,000	$117,500	$8,750	$2,646
				$46,250	$36,250
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)	($3,750)
	$175,000	$200,000	$240,000	($1,250)	($1,250)

Capital:		
A (contributed Asset 1 + $50,000 cash)	$75,000	$100,000
B (contributed cash)	$100,000	$100,000

Section 743(b) adjustment:		
T's partnership basis	$110,000 (purchase price)	$120,000 (Fair Market Value)
Less: T's share of adjusted basis in partnership property	($75,000) **	($75,000) **
Adjustment	$35,000	$45,000
Ordinary income adjustment	($1,250)	($1,250)
Capital gain adjustment	$36,250	$46,250

Accounting for $10,000 difference		
Asset 1	$33,604	($37,500 -($10,000 *$ 75,000/$192,500)) [$75,000 + $117,500 = $192,500]
Asset 2	$2,646	($8,750 - ($10,000 *$117,500/$192,500))
Total capital gain/Adjustment	$36,250	

**($25,000 + $12,500) + $8,750 + $2,500 - $3,750 = $45,000

Asset 1 Gain Asset 2 Gain Asset 3 Gain Asset 4 Loss

$120,000 (FMV) - $45,000 = $75,000

Exhibit E

	SECTION 743(b) COMPUTATION for REAL ESTATE PARTNERSHIP and SECTION 755 ALLOCATION						
Decedent's Percentage Interest	**7.62605%**						
Date of Death: December 5, 2009							
	Adjusted Basis of Partnership Assets At Date Of Death	Fair Market Value Balance Sheet	Adjustment to Estate Based Upon Hypothetical Sale At Fair Market Value	Decrease Based Upon Value At Date Of Death Of Partnership Interests*	Adjustment to Gain or Loss	Estate's Basis Inside Partnership Prior To Adjustment	Estate's Basis Inside Partnership After Adjustment
ASSETS							
Cash & Equivalents	1,793,186	1,793,186	0	0	0	136,749	136,749
Prepaid Expenses	174,647	174,647	0	0	0	13,319	13,319
Mortgage Escrow	107,564	107,564	0	0	0	8,203	8,203
Repair Reserve	2,504	2,504	0	0	0	191	191
Due from Others	14,900	14,900	0	0	0	1,136	1,136
Security Deposits	132,031	132,031	0	0	0	10,069	10,069
Current & Other Assets	2,224,832	2,224,832	0	0	0	169,667	169,667
Buildings and Other Depreciable Assets	17,725,575	20,960,000					
Less: Accumulated Dep. and Amort.	15,000,000	0					
Net Buildings and Other Depreciable Asst.	2,725,575	20,960,000	1,390,566	247,445	1,143,121	207,853	1,350,974
Land	341,864	5,240,000	373,534	61,861	311,673	26,071	337,744
Intangible Assets	323,497	0					
Less: Accumulated Amortization	0	0					
Total Net Intangible Assets	323,497	0	(24,670)	0	(24,670)	24,670	0
Total Assets	5,615,768	28,424,832	1,739,431	309,307	1,430,124	428,261	1,858,385
LIABILITIES							
Due to Others	9,056	9,056	691			691	691
Security Deposits	131,203	131,203	10,006			10,006	10,006
All Nonrecourse Loans	18,000,000	18,000,000	1,372,689			1,372,689	1,372,689
Total Liabilities	18,140,259	18,140,259	1,383,385			1,383,385	1,383,385
Members Equity (Deficit)	(12,524,491)	10,284,573	356,046			(955,124)	475,000
Total Liabilities & Members Equity	5,615,768	28,424,832	1,739,341			428,261	1,858,385

Exhibit E - (Cont.)

Code Section 743(b) Adjustment

Tax Basis of Partnership Interest for Decedent

Code Section 1014 tax basis	475,000.00	
Share of liabilities	1,383,385.00	
Total	1,858,385.00	
Previously taxed capital	(955,124.00)	
Share of liabilities	1,383,385.00	
Total (Share of tax basis of Partnership property (inside basis))	$ 428,261.00	
Section 743(b) Adjustment	**1,430,124.00**	($1,858,385 - $428,261)

*Decedent's interest in Partnership previously taxed capital:

Cash received upon liquidation of partnership at fair market value	784,306.68	(7.62605% x $10,284,573 (Member Equity at FMV))
Less: Gain allocated to decedent from liquidation	1,739,430.68	(7.62605% x ($10,284,573 + $12,524,491))
	(955,124.00)	

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

(A) Bldg: $1,390,566 - ((1,739,431 - 1,430,124) * 20,960,000/$26,200,000)) = $1,143,121
(B) Land: $ 373,534 - ((1,739,431 - 1,430,124) * 5,240,000/$26,200,000)) = $ 311,673

Code Section 755 Basis Adjustments (Cont.)

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.

Code Section 755 Basis Adjustments (Cont.)

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.

Code Section 755 Basis Adjustments (Cont.)

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).

Code Section 755 Basis Adjustments (Cont.)

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).

Code Section 755 Basis Adjustments (Cont.)

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. See Exhibit F.

Exhibit F

Example 1 of Treasury Reg. §1.755-1(a)(6): D buys A's interest for $650,000.

Sale of A's Interst to D for $650,000 (ex. 1)						
		FMV		Gross Value		
Inventory		$1,000,000		$2,950,000	(aggregate value)	
Building		2,000,000				
Intangible 1		50,000		0		
Intangible 2		50,000		0		
		$3,100,000		$2,950,000		
Liability		1,000,000		1,000,000		
Capital:						
A		$700,000		$650,000		
B		700,000		650,000		
C		700,000		650,000		

Example 2 of Treasury Reg. §1.755-1(a)(6): D buys A's interest for $1,000,000.

		FMV		Gross Value		
Inventory		$1,000,000		$1,000,000		
Building		2,000,000		2,000,000		
Intangible 1		300,000		300,000		
Intangible 2		300,000		300,000		
Goodwill		0		400,000		
		$3,600,000		$4,000,000		
Liability		1,000,000		1,000,000		
Capital:						
A		866,667		1,000,000		
B		866,667		1,000,000		
C		866,667		1,000,000		