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Basis Adjustments for Partnerships and LLCs: Tax Law Challenges

Navigating Complex Basis Rules and Avoiding Pitfalls in Section 754 Elections

TUESDAY, AUGUST 21, 2012

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

Today's faculty features:

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Basis Adjustments for Partnerships and LLCs: Tax Law Challenges Seminar

Aug. 21, 2012

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Today's Program

Sect. 743 Basis Adjustments
[Janice Eiseman]

Slides 7 - 45

Sect. 734 Basis Adjustments
[Lynn Fowler]

Slides 46 - 94

Janice Eiseman, Cummings & Lockwood

SECT. 743 BASIS ADJUSTMENTS

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.
- D. Challenge to partnership taxation:** It is difficult to deal with the disparity between inside and outside basis.

Overview (Cont.)

- E. Sect. 754 election:** Purpose of making a Code Sect. 754 election is to equalize the “outside basis” and the “inside basis” to the extent allowed. A Sect. 754 election activates both Sect. 743(b), which applies to certain transfers of partnership interests, and Sect. 734(b), which applies to certain distributions of property by the partnership to a partner.
1. If a Sect. 754 election is *not* made, there is no change to the inside basis of partnership assets; that is, there is no adjustment to a transferee’s “inside basis,” and no adjustment to the tax basis of partnership assets because of a distribution of property by the partnership to a partner unless mandatory adjustments are required.
 - For example, Sect. 743(a), which treats the partnership as an entity, provides that the basis of partnership property is *not* adjusted as a result of a sale, or exchange, or the death of a partner unless an election has been made under Sect. 754 or unless the partnership has a “substantial built-in loss.”

Overview (Cont.)

- If a Sect. 754 election is made, then Sect. 743(b) is operative. A Sect. 743(b) adjustment implements an aggregate approach by adjusting the tax consequences allocable to a transferee partner so as to provide the transferee with an approximation of a cost basis in an undivided interest in the partnership property. The legislative history of the 1954 Code states that the purpose of Sect. 743(b) is to ensure that a transferee's distributive share of income, gain, loss, deduction or credit is the same "as though the partnership had dissolved and been reformed, with the transferee of the interest a member of the partnership." H.R. Rep. No. 1337, 83rd Cong., 2d Sess. 70 (1954). In other words, the function of a Sect. 743(b) adjustment is to offset gain or loss that accrued prior to the transferee becoming a partner.
2. Assuming that there is a basis adjustment, the amount of the adjustment is determined under Sect. 743(b) in the case of a transfer and Sect. 734(b) in the case of a distribution.

Overview (Cont.)

- F. Sect. 755:** How the adjustment determined under Sect. 743(b) or Sect. 734(b) is allocated to partnership assets is determined under Sect. 755.

- G. Mandatory adjustment under Sect. 743:** If there is a transfer of a partnership interest, and immediately after such transfer the adjusted tax basis of all of the partnership assets exceeds the fair market value of the partnership assets by more than \$250,000 (“substantial built-in loss”), then the partnership must make a Sect. 743(b) adjustment as if an election under Sect. 754 were in effect. IRC §743(d). Exceptions are made for electing investment partnerships (e.g., buyout funds, venture capital funds and fund of funds) and securitization partnerships. IRC §§743(e) & (f)

Overview (Cont.)

- H. Mandatory adjustment under Sect. 734:** If there is a distribution of partnership property in liquidation of a partner's interest; and the difference between the sum of (i) the basis of the distributed property to the partner, which equals the value of his partnership interest in the partnership under Sect. 732(b), and the tax basis of the distributed property to the partnership, and (ii) the loss recognized by the liquidating partner exceeds \$250,000, then the tax basis of partnership property must be decreased as if a Sect. 754 election were in effect. IRC §734(d) There is an exception for securitization partnerships. IRC §734(e)

Overview (Cont.)

- I. **Summary:** Under sections 734(a) and 743(a), the partnership is treated as an *entity*. I.e., no adjustments are made to basis of partnership property unless mandatory adjustments are required. If a Sect. 754 election is made, then adjustments can be made to the basis of partnership property (the “inside basis”) under sections 734(b) and 743(b). How the amount of the adjustment is allocated among partnership assets is determined under Sect. 755.

Ability To Make A Sect. 754 Election Due To A Transfer

- A. Sect. 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 Sect. 754 election can be made, and therefore there will be no change to the tax basis of partnership assets with regard to the transferee unless the mandatory rule for basis adjustment applies.
1. Sales or exchanges: This includes a carryover basis exchange such as under Sect. 351. Transfers by gift do *not* trigger a Sect. 754 election, because transfers by gift are not sales or exchanges under Sect. 743(b).

Ability To Make A Sect. 754 Election Due To A Transfer (Cont.)

2. Distribution of partnership interest: Note that Sect. 761(e)(2) provides that, for purposes of Sect. 743, any distribution of an interest in a partnership (not otherwise treated as an exchange) shall be treated as an exchange. Thus, if there is a “constructive termination” under Sect. 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 Sect. 743. This allows the new partnership to make a Sect. 754 election, because the *exchange* requirement of Sect. 743(b) is satisfied.

Ability To Make A Sect. 754 Election Due To A Transfer (Cont.)

B. How to make an election

1. Election under Sect. 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) containing a declaration that the partnership elects under Sect. 754 to apply the provisions of Sect. 734(b) and Sect. 743(b). Treas. Reg. §1.754-1(b) (*see example below*)

Boxwood, LLC

[Address]

EIN 65-999999999

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

/s/ _____

[Managing Member]

Ability To Make A Sect. 754 Election Due To A Transfer (Cont.)

C. When to make election

1. Time: Election is supposed to be filed with a timely filed partnership tax return for the partnership taxable year during which the distribution or transfer occurs, i.e., on or before the due date (including extensions) of the partnership tax return. Treas. Reg. §1.754-1(b)
 - **Automatic extension**: Treasury Regulation §301.9100-2(vi) provides for an automatic 12-month extension from the due date of the partnership return or from the extended due date of the partnership return if there is an extension, provided that the partnership takes “corrective action” during this 12-month extension period. “Corrective action” means filing an amended return for the year in which the election should have been made and attaching to the amended return the required election statement. The statement “FILED PURSUANT TO §301.9100-2” must be written at the top of the amended return.

Ability To Make A Sect. 754 Election Due To A Transfer (Cont.)

- **Discretionary extension:** If the terms of the automatic extension have not been met, a discretionary extension of time to file the Sect. 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.

D. Revocation of election: Once a Sect. 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 Sect. 754 election terminates when there has been a “constructive termination” of the partnership under Sect. 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 Sect. 754 election made by the terminating partnership remains in effect. Treas. Reg. §1.708-1(b)(5)

Ability To Make A Sect. 754 Election Due To A Transfer (Cont.)

E. What partnership and transferee must do if Sect. 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)
2. Transferee: Transferee must notify partnership in writing within 30 days of the sale or exchange stating the name and address of transferee, identification number, relationship (if any) between transferor and transferee, and the amount of the purchase price, the amount of any liabilities assumed or taken subject to, and any other information necessary for the partnership to compute the transferee's basis. Treas. Reg. §1.743-1(k)(2)(i)

Ability To Make A Sect. 754 Election Due To A Transfer (Cont.)

3. Estate: In the case of the death of a partner, the transferee has one year to notify the partnership. Treas. Reg. §1.743-1(k)(2)(ii)
4. No notification: If the partnership is not notified of the transfer, then it is not required to make any adjustments under Sect. 743(b). Treas. Reg. §1.743-1(k)(4). Upon notification, the partnership must display the following statement on the first page of the partnership return for that year and on the first page of Schedule K-1 issued to the transferee: RETURN FILED PURSUANT TO §1.743-1(k)(5). The partnership is entitled to report the transferee's share of partnership items without adjustment until the partnership receives the required information from the transferee. At that time, the partnership must take into account the adjustments on any amended return otherwise filed by the partnership or in the next annual partnership return. The partnership must also provide the transferee with the necessary information for the transferee to amend its prior returns to properly reflect the adjustment under Sect. 743(b). Treas. Reg. §1.743-1(k)(5)

What Happens Under Sect. 743(b) When A Sect. 754 Election Is Made?

- A. The actual amount of the Sect. 743(b) adjustment:** Sect. 743(b) states that the adjustment to the basis of partnership property to the transferee equals the difference between the (i) transferee's tax basis in his partnership interest (i.e., the purchase price of the interest or its fair market value at date of death plus his share of partnership liabilities), and (ii) the transferee's "proportionate share of the adjusted basis of partnership property." Treasury Regulation §1.743-1 flushes out how to determine the transferee's "proportionate share of the adjusted basis of partnership property." To understand the Treasury regulations, it is important to always remember what the Sect. 743(b) adjustment is designed to do - namely, to prevent the transferee from recognizing gain or loss already accounted for in the purchase price of the partnership interest.

What Happens Under Sect. 743(b) When A Sect. 754 Election Is Made? (Cont.)

1. Treasury Regulation §1.743-1(d) provides that the transferee's "share of the adjusted basis to the partnership of 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 partnership liabilities. The transferee's share of "previously taxed capital" is defined to be the amount of cash the transferee would receive if the partnership were liquidated by selling its assets at fair market value, (i) increasing the amount of cash by the tax loss (including any remedial allocations under Treasury Regulation §1.704-3(d)) that would be allocated to the transferee to the extent attributable to the transferred interest, or (ii) decreasing the amount of cash by tax gain (including any remedial allocations under Treasury Regulation §1.704-3(d)) that would be allocated to the transferee to the extent attributable to the transferred interest. (Note that non-contingent liabilities do not affect the amount of the adjustment because they are included in the transferee's tax basis and the computation of the transferee's share of the adjusted basis of partnership property.)

What Happens Under Sect. 743(b) When A Sect. 754 Election Is Made? (Cont.)

Translation of formula

A. Transferee's tax basis:

Purchase price + shares of liabilities

B. Transferee's share of the adjusted basis of partnership property and share of liabilities

“Adjusted basis of partnership property” =

Transferee's share of liquidation proceeds at fair market value - gain allocated to transferee + loss allocated to transferee

or

“Transferor's tax capital account”

What Happens Under Sect. 743(b) When A Sect. 754 Election Is Made? (Cont.)

C. 743(b) basis adjustment:

Purchase price - tax capital account of transferor

Basis adjustment must be allocated to partnership assets.

When purchase price equals fair market value of assets, then Sect. 743(b) adjustment is equal to the sum of the gain and loss in each asset. See Exhibit A

ASSETS

EXHIBIT A

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

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

	Adjusted Basis	Fair Market Value	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 without Section 754 election:

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

Assume sale of depreciable assets with Section 754 election:

Income 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)
	\$22,000.00	
	\$28,666.67	

[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)]

What Happens Under Sect. 743(b) When A Sect. 754 Election Is Made? (Cont.)

2. In essence, the “tax capital account” that the transferee inherits from his transferor determines the transferee’s share of the partnership basis in its assets. By using transferor’s tax capital account to measure the Sect. 743(b) basis adjustment, the Treasury regulations generally ensure that a transferee receives a basis adjustment that takes into account both pre-contribution gain or loss and post contribution changes in value. See Exhibit B
3. As Exhibit B shows, if the partnership sells the land for \$1,300, then the gain from the sale equals \$900. Transferee will have \$700 of the gain allocated to him, and the other two partners will each have \$100 allocated to them. Because the transferee’s Sect. 743(b) basis adjustment in the land is \$700, the transferee will recognize no gain.

EXHIBIT B

Example 2 of Treasury Regulation Section 1.743-1(d)(3).

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

	<u>Adjusted Basis</u>	<u>Fair market value on contribution date</u>	<u>Sale of partnership interest for fair market value by A</u>	<u>Section 743(b) adjustment to transferee of A</u>
Land	\$ 400	\$1,000	\$1,300	\$700
Cash	<u>\$2,000</u>	<u>\$2,000</u>	<u>\$2,000</u>	<u>0</u>
Total	\$2,400	\$3,000	\$3,300	\$700
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	<u>\$ 700</u>	(Pre-contribution gain & post-contribution gain)
Share of previously taxed capital	\$ 400	

Section 743(b) adjustment:

Outside basis of price paid for partnership interest (FMV)	\$1,100
Less: Share of previous taxed capital	<u>\$ 400</u>
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

What Happens Under Sect. 743(b) When A Sect. 754 Election Is Made? (Cont.)

B. Note the following with regard to a Sect. 743(b) adjustment:

1. The adjustment applies only to the transferee partner. There is no adjustment to common basis of partnership property. The adjustment essentially operates outside the partnership. Treas. Reg. §1.743-1(j)(1)
2. The adjustment has no effect on the computation of the partnership's income or loss. Treas. Reg. §1.743-1(j)(1)
3. The adjustment has no effect on the transferee's capital account. The transferee steps into the capital account of the transferor. Treas. Reg. §1.743-1(j)(2)

What Happens Under Sect. 743(b) When A Sect. 754 Election Is Made? (Cont.)

4. The adjustments to the transferee's distributive share of income or loss must be shown on the Form K-1 issued to the transferee. Treas. Reg. §1.743-1(j)(2)
5. Where there has been more than one transfer of a partnership interest, a transferee's basis adjustment is determined without regard to any prior transferee's basis adjustment. Treas. Reg. §1.743-1(f)
6. In the case of a gift and partnership interest, the donor is treated as transferring, and the donee is receiving, that portion of a basis adjustment attributable to the gifted partnership interest. Treas. Reg. §1.743-1(f)

Sect. 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., Sect. 351 and 721 exchanges) - Treas. Reg. § 1.755-1(b)(5). Also, Treasury Reg. §1.755-1(b)(5) applies to basis adjustments that result from exchanges in which the transferee’s basis in the partnership interest is determined by reference to other property held at any time by the transferee e.g. a constructive termination under Sect. 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.

Sect. 755 Basis Adjustments (Cont.)

Sect. 761(e) provides the “exchange,” meaning the distribution of partnership interests in the new partnership is an “exchange” for purposes of Sect. 743(b). Because the distributee-partner of the terminated partnership receives its interest in the new partnership in a liquidating distribution, the distributee takes a substituted basis in the new partnership under Sect. 732(b). A Sect. 754 election by the new partnership will bring into play Treasury Regulation §1.755-1(b)(5).

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

B. Transfer of partnership interest when assets of partnership do not constitute a “trade or business”

Sect. 755 Basis Adjustments (Cont.)

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

Sect. 755 Basis Adjustments (Cont.)

3. The portion of the transferee-partner's basis adjustment allocated to capital gain property is equal to the Sect. 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, then the decrease cannot be greater than the "partnership's basis" in the property or the transferee's share of any remedial loss under Treasury Regulation §1.704-3(d). Any excess is applied to reduce the basis of ordinary income property. Treas. Reg. §1.755-1(b)(2)
 - Note that this approach allocates any overpayment or underpayment for the partnership interest to the basis of capital gain property.
4. Adjustments can be made to individual assets even though the total amount of basis adjustment is zero. Treas. Reg. §1.755-1(b)(1)(i)
 - Note that in a substituted basis transaction, no adjustment can be made if the total amount of the Sect. 743(b) adjustment is zero.

Sect. 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)
 - c) Note that there must be an adjustment whenever the actual Sect. 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 subsequent Exhibits C, D and E for examples of Sect. 755 allocations

EXHIBIT C

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

	Adjusted Basis	Market Value at time of contribution	Fair Market Value at time of sale	Adjustment based on FMV sale	Basis Adjustment
Capital gain property					
Asset 1*	\$25,000	\$50,000	\$75,000	\$37,500	\$33,604
Asset 2	\$100,000	\$100,000	<u>\$117,500</u>	<u>\$8,750</u>	<u>\$2,646</u>
			\$192,500	\$46,250	\$36,250
Ordinary Income property					
Asset 3	\$40,000	\$40,000	\$45,000	\$2,500	\$2,500
Asset 4	<u>\$10,000</u>	<u>\$10,000</u>	<u>\$2,500</u>	<u>-\$3,750</u>	<u>-\$3,750</u>
	\$175,000	\$200,000	\$47,500	-\$1,250	-\$1,250
Total			\$240,000	\$45,000	\$35,000

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

Section 743(b) adjustment:

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

<u>Capital Gain Adjustment</u>	<u>FMV</u>	<u>Adjustment based on \$110,000 purchase price</u>
Asset 1	\$37,500	\$33,604 (\$37,500 - (\$10,000 * (\$75,000 / \$192,500)))
Asset 2	<u>\$8,750</u>	<u>\$2,646</u> (\$8,750 - (\$10,000 * (\$117,500 / \$192,500)))
Total capital gain adjustment	\$46,250	\$36,250

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

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

PARTNERSHIP BASIS: INSIDE AND OUTSIDE BASIS

EXHIBIT D-1

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

Decedent's Percentage Interest: 7.62605%

Date of Death: December 5, 2009

	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	See Exhibit D-2: Adjustment to Gain or Loss
ASSETS					
Cash & Equivalents	1,793,186	1,793,186	0	0	0
Prepaid Expenses	174,647	174,647	0	0	0
Mortgage Escrow	107,564	107,564	0	0	0
Repair Reserve	2,504	2,504	0	0	0
Due from Others	14,900	14,900	0	0	0
Security Deposits	132,031	132,031	0	0	0
Current & Other Assets	<u>2,224,832</u>	<u>2,224,832</u>	0	0	0
Buildings and Other Depreciable Assets	17,725,575	20,960,000			
Less: Accumulated Dep. and Amort.	<u>15,000,000</u>	<u>0</u>			
Net Buildings and Other Depreciable Asst.	2,725,575	20,960,000	1,390,566	243,814	1,146,752
Land	<u>341,864</u>	<u>5,240,000</u>	<u>373,535</u>	65,493	308,042
Intangible Assets	323,497	0			
Less: Accumulated Amortization	<u>0</u>	<u>0</u>			
Total Net Intangible Assets	<u>323,497</u>	<u>0</u>	<u>(24,670)</u>	0	<u>(24,670)</u>
Total Assets	<u><u>5,615,768</u></u>	<u><u>28,424,832</u></u>	<u><u>1,739,431</u></u>	309,307	1,430,124
LIABILITIES					
Due to Others	9,056	9,056	691		
Security Deposits	131,203	131,203	10,006		
All Nonrecourse Loans	<u>18,000,000</u>	<u>18,000,000</u>	<u>1,372,689</u>		
Total Liabilities	<u>18,140,259</u>	<u>18,140,259</u>	<u>1,383,385</u>		
Members Equity (Deficit)	<u>(12,524,491)</u>	<u>10,284,573</u>	<u>356,046</u>		
Total Liabilities & Members Equity	<u><u>5,615,768</u></u>	<u><u>28,424,832</u></u>	<u><u>1,739,341</u></u>		

EXHIBIT D-2

Code Section 743(b) Adjustment

Tax Basis of Partnership Interest for Decedent:

Code Section 1014 tax basis	\$475,000.00
Share of liabilities	<u>\$1,383,385.00</u>
Total	\$1,858,385.00

Less:

Previously taxed capital	(\$955,124.00)
Share of liabilities	<u>\$1,383,385.00</u>
Share of tax basis of Partnership property	\$428,261.00
Section 743(b) Adjustment	\$1,430,124.00

Decedent's interest in Partnership
previously taxed capital:

Cash decedent would receive upon liquidation of partnership at fair market	\$784,306.68
Less: Gain allocated to decedent from sale	<u>\$1,739,430.68</u>
	(\$955,124.00)

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

Building =	\$1,390,566 (((\$1,764,10-\$1,454,794)x <u>(1,390,566.00)</u>) (1,764,101.00)
Land =	\$373,535-(((\$1,764,101-\$1,454,794)x <u>(373,535.00)</u>) (1,764,101.00)

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

Calculation of Section 743(b) Adjustment to Trust

EXHIBIT E-1

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

Proportionate Share of Tax Basis in Company's Assets	Gain recognized upon liquidation	Code § 743(b) Basis Adjustment & Code § 755 Allocation	
Real Estate	\$173,500	\$17,826,500	\$17,826,500
Accrued Dividend	0	\$578	0
Sysco	0	\$37,129	\$37,129
Johnson & Johnson	0	\$15,242	\$15,242
Schering Plough	0	\$10,379	\$10,379
United Health Care	0	\$6,226	\$6,226
Cisco	0	\$18,306	\$18,306
Dover	0	\$13,729	\$13,729
Emerson	0	\$11,295	\$11,295
Bershire Hathaway A	0	\$46,525	\$46,525
Berkshire Hathaway B	0	\$30,462	\$30,462
	\$173,500	\$18,016,371	\$18,015,793
(Stock contributed by children of grantor of Trust)			
II. Trust's previously taxed capital:			
Liquidation proceeds based on fair market value:		\$19,100,813 *	
Less: Gain recognized on liquidation		\$18,016,371	
Previously Taxed Capital		\$1,084,442	
III. Code Section 743(b) Adjustment based on Fair Market Value:			
Fair Market Value less IRD		\$19,100,235	(\$19,100,813 -\$578)
Less: Previously Taxed Capital		\$1,084,442	
Section 743(b) Adjustment		\$18,015,793	(Treas. Reg. Section 1.755-1(b)(4).)
IV. Code Section 743(b) Adjustment based on Estate Tax Audit:			
Value of Membership Interest		\$17,815,000	
Less: Income in respect of a Decedent		\$578	
Tax basis of Membership Interest		\$17,814,422	
Less: Trust's previously taxed capital		\$1,084,442	
Section 743(b) Adjustment		\$16,729,980	

* \$19,100,813 (liquidating proceeds) = \$20,609,423 (Fair Market Value of Company at date of death)*92.68% (Trust Percentage Interest)

EXHIBIT E -2

Calculation of Section 743(b) basis adjustments to capital gain assets based on Fair Market Value must be reduced pro rata by \$1,285,813 under Treasury Regulation Section 1.755-1(b)(3)(ii).

§ 743(b) adjustment based on FMV				
Less: § 743(b) adjustment based on Estate Tax Valuation				
Amount to be allocated among assets				
	<u>Fair Market Value</u>	<u>Code Section 743(b) Adjustment based on FMV</u>	<u>Decrease*</u>	<u>Tentative Section 755 Allocation</u>
Real Estate	\$18,000,000	\$17,826,500	\$1,189,922	\$16,636,577.87
Sysco	\$188,564	\$37,129	\$12,465	\$24,663.64
Johnson & Johnson	\$276,334	\$15,242	\$18,268	-\$3,025.55
Schering Plough	\$65,400	\$10,379	\$4,323	\$6,055.62
United Health Care	\$60,000	\$6,226	\$3,966	\$2,259.59
Cisco	\$326,250	\$18,306	\$21,567	-\$3,261.34
Dover	\$98,063	\$13,729	\$6,483	\$7,246.37
Emerson	\$54,750	\$11,295	\$3,619	\$7,675.65
Berkshire Hathaway A	\$227,800	\$46,525	\$15,059	\$31,465.87
Berkshire Hathaway B	\$153,384	\$30,462	\$10,140	\$20,322.28
	<u>\$19,450,545</u>	<u>\$18,015,793</u>	<u>\$1,285,813</u>	<u>\$16,729,980.00</u>

*Decrease to each asset is calculated as follows:

$$\$1,285,813 \times (\text{Fair Market Value of each asset} / \$19,450,545 (\text{Total Fair Market Value}))$$

Note: Assets with respect to which transferee has no interest in income, gain, losses or deductions are not taken into account in applying adjustment to basis under Code Section 755. Treas. Reg. Section 1.755-1(b)(3)(iii).

EXHIBIT E-3**Calculation of Section 755 Basis Adjustments Based On Code Section 743(b) Adjustment of \$16,729,980**

	(A) <u>Proportionate Share of Tax Basis in Sasco's Assets</u>	(B) <u>Tentative \$ 755 Allocation</u>	(C) <u>Adjustment for Negative Decrease*</u>	(D) <u>\$ 755 Allocation (B)-(C)</u>
Real Estate	\$173,500.00	\$16,636,577.87	(\$6,249.83)	\$16,630,328.04
Sysco	0	\$24,663.64	(\$9.17)	\$24,654.47
Johnson & Johnson	0	(\$3,025.55)	\$3,025.55	\$0.00
Schering Plough	0	\$6,055.62	(\$2.25)	\$6,053.37
United Health Care	0	\$2,259.59	(\$0.84)	\$2,258.75
Cisco	0	(\$3,261.34)	\$3,261.34	\$0.00
Dover	0	\$7,246.37	(\$2.69)	\$7,243.68
Emerson	0	\$7,675.65	(\$2.85)	\$7,672.80
Berkshire Hathaway A	0	\$31,465.87	(\$11.70)	\$31,454.17
Berkshire Hathaway B	0	\$20,322.28	(\$7.56)	\$20,314.72
		<u>\$16,729,980.00</u>	<u>\$0.00</u>	<u>\$16,729,980.00</u>

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

(Column B Positive Adjustment)
(Total Column B Positive Adjustments
of \$16,909,766.89)

x \$6,289.89 (Total Value of Negative Adjustments)

Sect. 755 Basis Adjustments (Cont.)

C. Substituted

1. The rules for “substituted basis exchanges” are set forth in Treasury Reg. §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.

Sect. 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.

Sect. 755 Basis Adjustments (Cont.)

D. Sale of business

1. If the assets of the partnership constitute a trade or business (as described in Treasury Reg. §1.1060-1(b)(2)), then the partnership must use the residual method to assign values to the partnership's Sect. 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 Sect. 197.
 - b) Second, the partnership must determine "partnership gross value" under Treasury Reg. §1.755-1(a)(4).
 - c) Third, the partnership gross value is then compared to the aggregate value of all partnership property other than Sect. 197 intangibles. If there is no residual value, then the value of all Sect. 197 intangibles is deemed to be zero. If there is a residual value, then the amount must be allocated to Sect. 197 intangibles in order to assign a value to them under the rules of Treasury Reg. §1.755-1(a)(5).

Sect. 755 Basis Adjustments (Cont.)

- d) “Partnership gross value” generally is equal to the amount that, if assigned to all partnership property, would result in a liquidating distribution to the partner equal to the transferee’s basis in the transferred partnership interest immediately following the relevant transfer (reduced by the amount, if any, of such basis that is attributable to partnership liabilities). Treas. Reg. §1.755-1(a)(4)(i)(A)
- e) Treasury Reg. §1.755-1(a)(5)(i) requires that the residual value be allocated first among Sect. 197 intangibles other than goodwill and going concern value, but the value assigned to a Sect. 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.

Lynn Fowler, Kilpatrick Townsend & Stockton

SECT. 734 BASIS ADJUSTMENTS

Part 1: Basic Rules

Taxation Of Partnership Distributions

- Current distributions
 - Distribution to a partner that does not terminate its interest in the partnership
- Liquidating distributions
 - Distribution to a partner that terminates its interest in the partnership

Current Distributions

- Recognition of gain or loss
 - Gain recognized by partner only to extent cash distributed to member exceeds partner's basis in its partnership interest. IRC §731(a)(1)
 - Reduction in share of liabilities treated as distribution of cash IRC §752(b)
 - Distribution of certain marketable securities treated as distribution of cash IRC §731(c)
 - Loss not recognized IRC §731(a)(2)

Current Distributions (Cont.)

- Basis of property distributed
 - Basis equal to partnership's basis in assets (partner takes inside basis) IRC §732(a)(1)
 - Limitation: Basis of distributed property cannot exceed partner's basis in partnership (limited by outside basis). I.R.C. §732(a)(2)

Liquidating Distributions

- Recognition of gain or loss
 - Gain recognized by partner only to extent cash distributed to member exceeds partner's basis in its partnership interest IRC §731(a)(1)
 - Reduction in share of liabilities treated as distribution of cash IRC §752(b)
 - Distribution of certain marketable securities treated as distribution of cash IRC §731(c)
 - Loss recognized if only money (or hot assets) distributed IRC §731(a)(2)

Liquidating Distributions (Cont.)

- Basis of property distributed
 - Basis equal to partner's basis in partnership (partner takes outside basis) IRC §732(b)

Impact Of Distributions On Partnership

- Generally, distribution of partnerships assets does not affect basis of remaining partnership assets IRC §734(a)
 - Exception if partnership has in effect a “Section 754 election”
 - Exception if “substantial basis reduction” resulting from distribution
- Can produce disparities between inside basis and outside basis

Example

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	2100	2100	Liabilities	0	0
Blackacre	900	1200	A Capital	1100	1500
Whiteacre	<u>300</u>	<u>1200</u>	B Capital	1100	1500
			C Capital	<u>1100</u>	<u>1500</u>
Total	3300	4500	Total	3300	4500

Partnership has no Sect. 754 election in place.

Example (Cont.)

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	600	600	Liabilities	0	0
Blackacre	900	1200	A Capital	0	0
Whiteacre	<u>300</u>	<u>1200</u>	B Capital	1100	1500
			C Capital	<u>1100</u>	<u>1500</u>
Total	1800	3000	Total	2200	3000

Partnership distributes \$1,500 cash to A in a liquidating distribution.

A recognizes \$400 gain – IRC 731(a)(1)

Partnership has no Sect. 754 election in place.

Example (Cont.)

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	2100	2100	Liabilities	0	0
Blackacre	900	1200	A Capital	1100	1500
Whiteacre	<u>300</u>	<u>1200</u>	B Capital	1100	1500
			C Capital	<u>1100</u>	<u>1500</u>
Total	3300	4500	Total	3300	4500

Partnership has no Sect. 754 election in place.

Example (Cont.)

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	1800	1800	Liabilities	0	0
			A Capital	0	0
Whiteacre	<u>300</u>	<u>1200</u>	B Capital	1100	1500
			C Capital	<u>1100</u>	<u>1500</u>
Total	2100	3000	Total	2200	3000

Partnership distributes \$300 cash and Blackacre to A in a liquidating distribution.

A recognizes no gain – IRC 731(a)(1)

A's basis in Blackacre = \$800 (\$1,000 - \$300)

Partnership has no Sect. 754 election in place.

Effect Of 754 Election – Sect. 734(b)

- Increases in basis of partnership assets - IRC §734(b)(1)
 - Amount of gain recognized by distributee partner on distribution
 - Amount of decrease in basis of property in hands of distributee partner compared to basis of property in hands of partnership

Example

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	2100	2100	Liabilities	0	0
Blackacre	<u>1200</u>	<u>2400</u>	A Capital	1100	1500
			B Capital	1100	1500
			C Capital	<u>1100</u>	<u>1500</u>
Total	3300	4500	Total	3300	4500

Partnership has Sect. 754 election in place.

Example (Cont.)

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	600	600	Liabilities	0	0
Blackacre	<u>1600</u>	<u>2400</u>	A Capital	0	0
			B Capital	1100	1500
			C Capital	<u>1100</u>	<u>1500</u>
Total	2200	3000	Total	2200	3000

Partnership distributes \$1,500 cash to A in a liquidating distribution.

A recognizes \$400 gain – IRC 731(a)(1)

Partnership steps up basis of Blackacre and Whiteacre by amount of gain recognized by A.

Example (Cont.)

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	2100	2100	Liabilities	0	0
Blackacre	900	1200	A Capital	1100	1500
Whiteacre	<u>300</u>	<u>1200</u>	B Capital	1100	1500
			C Capital	<u>1100</u>	<u>1500</u>
Total	3300	4500	Total	3300	4500

Partnership has Sect. 754 election in place.

Example (Cont.)

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	1800	1800	Liabilities	0	0
			A Capital	0	0
Whiteacre	<u>400</u>	<u>1200</u>	B Capital	1100	1500
			C Capital	<u>1100</u>	<u>1500</u>
Total	2200	3000	Total	2200	3000

Partnership distributes \$300 cash and Blackacre to A in a liquidating distribution.

A recognizes no gain – IRC §731(a)(1)

A's basis in Blackacre = \$800 (\$1,100 - \$300) (\$100 step-down)

Partnership increases basis in Whiteacre by amount of step-down in Blackacre basis resulting from distribution.

Effect of 754 Election – Sect. 734(b)

- Decreases in basis of partnership assets - IRC §734(b)(1)
 - Amount of loss recognized by distributee partner on distribution
 - Amount of increase in basis of property in hands of distributee partner compared to basis of property in hands of partnership

Example

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	2100	2100	Liabilities	0	0
Blackacre	900	300	A Capital	1100	900
Whiteacre	<u>300</u>	<u>300</u>	B Capital	1100	900
			C Capital	<u>1100</u>	<u>900</u>
Total	3300	2700	Total	3300	2700

Partnership has Sect. 754 election in place.

Example (Cont.)

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	1200	1200	Liabilities	0	0
Blackacre	700	300	A Capital	0	0
Whiteacre	<u>300</u>	<u>300</u>	B Capital	1100	900
			C Capital	<u>1100</u>	<u>900</u>
Total	2200	1800	Total	2200	1800

Partnership distributes \$900 cash to A in a liquidating distribution.

A recognizes \$200 loss – IRC 731(a)(2)

Partnership steps down basis of Blackacre by amount of loss recognized by A.

Example (Cont.)

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	2100	2100	Liabilities	0	0
Blackacre	900	300	A Capital	1100	900
Whiteacre	<u>300</u>	<u>300</u>	B Capital	1100	900
			C Capital	<u>1100</u>	<u>900</u>
Total	3300	2700	Total	3300	2700

Partnership has Sect. 754 election in place.

Example (Cont.)

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	1500	1500	Liabilities	0	0
			A Capital	0	0
Blackacre	<u>700</u>	<u>300</u>	B Capital	1100	900
			C Capital	<u>1100</u>	<u>900</u>
Total	2200	1800	Total	2200	1800

Partnership distributes \$600 cash and Whiteacre to A in a liquidating distribution.

A recognizes no gain – IRC 731(a)(1)

A's basis in Whiteacre = \$500 (\$1,100 - \$600) (\$200 step-up)

Partnership decreases basis in Blackacre by amount of step-up in Whiteacre basis resulting from distribution.

Allocation Of §734(b) Adjustments

Rules for allocating basis adjustments among multiple assets (Treas. Reg. §§1.755-1(a); 1.755-1(c))

- Determine the value of each of the partnership's assets
- Determine the character of any assets distributed
 - Basis adjustments arising from distributions of capital gain property are generally allocated to capital assets and §1231(b) property.
 - Basis adjustments arising from distributions of ordinary income property are generally allocated to ordinary income property.
- The basis adjustment allocated to each class is allocated among the items within each class.

§755 Allocation of §734(b) Adjustments (Cont.)

Allocation of basis adjustments within a class (Treas. Reg. §1.755-1(c)):

- Basis adjustment resulting from the recognition of gain or loss from the distribution must be allocated to the partnership's capital gain property.
- Basis increases due to “lost basis” are allocated first to properties with unrealized appreciation up to and in proportion with their respective unrealized appreciation. Any excess is allocated among all properties in the class in proportion to FMV.
- Basis decreases due to “acquired basis” are allocated first to properties with unrealized depreciation up to and in proportion with their respective amounts of unrealized depreciation. Any excess is allocated among all the properties within the class in proportion to their adjusted bases (after taking into account the first allocation).

§755 Allocation Of §734(b) Adjustments (Cont.)

Special rules:

- If a decrease in basis is required, and the basis adjustment exceeds the remaining basis in the assets in a class, the assets are reduced to zero but not below zero.
- When an increase or decrease in the basis of undistributed property cannot be made because the partnership owns no property of the character required to be adjusted, the adjustment is made when the partnership acquires property of a like character to which an adjustment can be made.

Example

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	2100	2100	Liabilities	0	0
Blackacre	900	1200	A Capital	1100	1500
Whiteacre	<u>300</u>	<u>1200</u>	B Capital	1100	1500
			C Capital	<u>1100</u>	<u>1500</u>
Total	3300	4500	Total	3300	4500

Partnership has Sect. 754 election in place.

Example (Cont.)

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	2100	2100	Liabilities	0	0
Blackacre	900	1200	A Capital	1100	1500
Whiteacre	<u>300</u>	<u>1200</u>	B Capital	1100	1500
			C Capital	<u>1100</u>	<u>1500</u>
Total	3300	4500	Total	3300	4500

Partnership distributes \$1,500 in cash to A in complete liquidation of A's interest.
 A recognizes gain = \$400
 Basis step-up = \$400

Example (Cont.)

Allocation of basis adjustment

Step 1

Gain/loss on ordinary income assets
(A/R, inventory, 1245 recapture) =

$$\text{FMV} = 0$$

$$\text{A/B} = \underline{0}$$

$$\text{Gain} = 0$$

Gain/loss on capital gain and 1231 assets
(land, stock, goodwill) =

$$\text{FMV} = 2400$$

$$\text{A/B} = \underline{1200}$$

$$\text{Gain} = 1200$$

Example (Cont.)

Step 2: Determine asset class to which increase applies

Amount of 734(b) adjustment = \$400 IRC §734(b)(1)(B)

Because gain recognized by A, allocate basis increase to capital gain assets

Example (Cont.)

Step 3: Allocate among assets in appropriate class

Amount of 734(b) adjustment = \$400

IRC §734(b)(1)(B)

	FMV	A/B	Gain	Proportion of Total
Blackacre	1200	900	300	25%
Whiteacre	1200	300	<u>900</u>	75%
Total			1200	

Example

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	600	600	Liabilities	0	0
Blackacre	1000	1200	A Capital	0	0
Whiteacre	<u>600</u>	<u>1200</u>	B Capital	1100	1500
			C Capital	<u>1100</u>	<u>1500</u>
Total	2200	3000	Total	2200	3000

Basis step-up = \$400

Partnership increases Blackacre basis by \$100 (25%) and Whiteacre basis by \$300 (75%).

Part 2: Inadvertent Basis Adjustments

Substantial Basis Reductions

- Partnership must adjust the basis of partnership assets even without a 754 election, in the case of “substantial basis reductions.” IRC §734(b)(1)
- Substantial basis reduction occurs when:
 - The sum of —
 - Loss recognized by a partner with respect to a liquidating distribution, plus
 - Any increase in basis in the hands of the distributee partner over the basis in the hands of the partnership,
 - Exceeds \$250,000. IRC §734(d)(1)

Substantial Basis Reductions (Cont.)

- Reason for the provision
 - Prior to the enactment of §755(c), partners could manufacture a loss in partnership assets by virtue of a distribution without a Sect. 754 election.

Example

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	2100	2100	Liabilities	0	0
Blackacre	900	300	A Capital	1100	900
Whiteacre	<u>300</u>	<u>300</u>	B Capital	1100	900
			C Capital	<u>1100</u>	<u>900</u>
Total	3300	300	Total	3300	2700

Partnership has no Sect. 754 election in place.

Example (Cont.)

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	1500	1500	Liabilities	0	0
Blackacre	<u>900</u>	<u>300</u>	A Capital	0	0
			B Capital	1100	900
			C Capital	<u>1100</u>	<u>900</u>
Total	2400	1800	Total	2200	1800

Partnership distributes \$600 and Whiteacre to A, in complete liquidation of A's interest. A recognizes no loss; A's basis in Whiteacre is stepped up to \$500 (\$1,100-\$600).

Part 3: Special Problems For Corporate Partners

Adjustments To Basis Of Corporate Partners

- Reason for concerns
 - A corporation does not recognize gain on the sale of its own stock (including through a partnership).
 - If a corporation liquidates a controlled subsidiary, it does not recognize gain.
 - Congress was concerned that corporations could use partnerships to increase basis in depreciable assets or loss assets at the “cost” of decreasing the basis of stock that would be held by a corporate partner.

Example

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	10	10	Liabilities	0	0
X Corp Stock	495	495	A Capital	10	10
Whiteacre	<u>10</u>	<u>495</u>	B Capital	495	495
			C Capital	<u>10</u>	<u>495</u>
Total	515	1000	Total	515	2700

Partnership has Sect. 754 election in place.

Example (Cont.)

	ASSETS			LIABILITIES/ CAPITAL	
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	10	10	Liabilities	0	0
X Corp. Stock	495	495	A Capital	10	10
Whiteacre	<u>10</u>	<u>495</u>	B Capital	495	495
			C Capital	<u>10</u>	<u>495</u>
Total	515	1000	Total	515	2700

Partnership distributes X Corp. Stock to C in complete liquidation of C's interest. C does not recognize gain; basis of X Corp stock stepped down from \$495 to \$10. Under 734(b)(1), partnership increases basis of Whiteacre by \$485/ If C is a corporation, C can liquidate X Corp. without recognizing gain or loss.

Adjustments To Basis Of Corporate Partners (Cont.)

- If IRC §732(f) applies to stock of a corporation whose stock is distributed by a partnership, the corporation must step down the basis of its assets.
- I.R.C. §732(f) applies if:
 - A partnership distributes stock of another corporation (“distributed corporation”) to a corporate partner.
 - The corporate partner has (or later acquires) control of the distributed corporation.
 - And, the corporate partner’s adjusted basis in the stock of the distributed corporation received is less than the corporate partner’s adjusted basis in such stock immediately after the distribution.

Adjustments To Basis Of Corporate Partners (Cont.)

- Limitation on adjustment (IRC §732(f)(3))
 - The amount of the basis reduction cannot exceed the adjusted bases of the distributed corporation in its property.
 - Reduction cannot exceed the amount by which the distributed corporation's basis in its property and money exceeds the corporate partner's basis in the stock of the distributed corporation.
- Gain recognition where reduction limited (IRC §732(f)(4))
 - The corporate partner recognizes long-term capital gain if the amount of the reduction exceeds the distributed corporation's aggregate adjusted bases in its property.
 - The corporate partner increases its basis in the distributed corporation by the amount of such gain.

Example

	ASSETS			LIABILITIES/ CAPITAL	
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	10	10	Liabilities	0	0
X Corp Stock	495	495	A Capital	10	10
Whiteacre	<u>10</u>	<u>495</u>	B Capital	495	495
			C Capital	<u>10</u>	<u>495</u>
Total	515	1000	Total	515	2700

Partnership distributes X Corp. Stock to C in complete liquidation of C's interest. C does not recognize gain; basis of X Corp stock is stepped down from \$495 to \$10. Under 734(b)(1), partnership increases basis of Whiteacre by \$485. If C is a corporation, C can liquidate X Corp. without recognizing gain or loss. 732(f) would require basis step-down in X Corp, assets or gain recognition to C.

Example (Cont.)

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	10	10	Liabilities	0	0
X Corp Stock	495	495	A Capital	10	10
Whiteacre	<u>10</u>	<u>495</u>	B Capital	495	495
			C Capital	<u>10</u>	<u>495</u>
Total	515	1000	Total	515	2700

Partnership has Sect. 754 election in place.

Example (Cont.)

	ASSETS			LIABILITIES/ CAPITAL	
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	10	10	Liabilities	0	0
X Corp Stock	495	495	A Capital	10	10
Whiteacre	<u>10</u>	<u>495</u>	B Capital	495	495
			C Capital	<u>10</u>	<u>495</u>
Total	515	1000	Total	515	2700

Partnership distributes Whiteacre to B in complete liquidation of B's interest.

B does not recognize gain; basis of Whiteacre stepped up from \$10 to \$495.

Under 734(b)(1), partnership decrease basis of X Corp. stock by \$485.

If C is a corporation, C can liquidate X Corp. without recognizing gain or loss.

Adjustments To Basis Of Corporate Partners (Cont.)

- No allocation is made to reduce the basis of a corporate partner's stock held by the partnership. IRC §755(c)
 - Corporate partner is defined broadly to include any related person under §267(b) or §707(b)(1).
 - Any decrease in basis that, absent this provision, would have been allocated to the stock is allocated to other partnership assets.
 - If the decrease in basis exceeds the basis of the other partnership assets, the partnership recognizes gain in the amount of the excess.

Example

	ASSETS			LIABILITIES/ CAPITAL	
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	10	10	Liabilities	0	0
X Corp Stock	495	495	A Capital	10	10
Whiteacre	<u>10</u>	<u>495</u>	B Capital	495	495
			C Capital	<u>10</u>	<u>495</u>
Total	515	1000	Total	515	2700

Partnership distributes Whiteacre to B in complete liquidation of B's interest.

B does not recognize gain; basis of Whiteacre is stepped up from \$10 to \$495.

Under 734(b)(1), partnership decrease basis of X Corp. stock by \$485.

If C is a corporation, C can liquidate X Corp. without recognizing gain or loss.

755(c) would limit basis decrease in S Corp. stock, and partnership recognizes \$485 in gain.

Part 4: Special Issues

Special Issues

- When or when not to make a §754 election
- Basis adjustments and technical terminations
- Basis adjustments and contingent liabilities
- Coordination with the “hot asset” rules under §751
- Use of the “residual method” to assign values to partnership assets
- Partnership basis adjustments attributable to deferred payments made to partners in liquidation of their partnership interest
- Treatment of partnership basis adjustments for §167 and §168 depreciation/amortization expense, and §1245 and §1250 depreciation recapture purposes