

Sale or Exchange of a Partnership Interest

1

- **General rule:** a sale by a partner generates capital gain or loss.
- Exception for seller's share of partnership **hot asset** gains or losses (sec. 751(a))

Amount realized includes net debt relief:

For example:

\$750 Cash from Buyer

\$250 Seller share of PSP debt

“the seller realizes \$1,000 on
the transaction.”

Reg. 1.752-1(h)

3

Hot assets:

Unrealized
receivables

&

Inventory Items

4

Unrealized Receivables

Right to payment for

6

- Goods delivered or to be delivered.
- Services rendered or to be rendered.
- Recapture items

5

In *Hale v. Comm'r*, T.C. Memo 1965-274, one of the partnership's assets was a profits only interest for services conditioned on the partnership's performance of the services.

6

“It is reasonably clear from the discussion of section 751 in both the Senate and House Reports that Congress meant to exclude from capital gains treatment any receipts which would have been treated as ordinary income to the partner if no transfer of the partnership interest had occurred. Roth v. Commissioner, supra. **The receipts in question herein were precisely of this character.**”

7

Inventory Items 8

- 1) Stock in trade or inventory...
- 2) Property **other than**:
 - Capital assets
 - IRC sec. 1231 Assets
- 3) Property which would, **if held by the selling partner**, be an inventory item.

Need not be substantially appreciated

Selling Partner's Ordinary Income or Loss

Fictional sale of all
partnership hot assets
for FMV **at the
partnership level
allocated to the seller**

9

Calculation of Capital Gain or Loss with Hot Assets **9**

Realized gain or loss without
sec. 751 (at partner level).

- **Seller's share of ordinary
income or loss on fictional
hot asset sale for FMV at
PSP level.**

= **Recognized capital gain or
loss (at partner level).**

10

Example

11

- A and B are equal partners in personal service partnership PRS.
- B sells to T for an amount realized of \$16K (\$15 cash + \$1k debt shift to T)

12

Pre-Sale Balance Sheet

Assets	Tax Basis	FMV	O.B.
Cash	3,000	3,000	
Loan Rec.	10,000	10,000	
Capital. Assets	7,000	5,000	
Unrealized Rec.	<u>0</u>	<u>14,000</u>	
Total Assets	<u>20,000</u>	<u>32,000</u>	
Liabilities:	2,000	2,000	
Capital:			
A	9,000	15,000	10,000
B	<u>9,000</u>	<u>15,000</u>	10,000
Debt + Equity	<u>20,000</u>	<u>32,000</u>	

Pre-Sale Balance Sheet

Assets	Tax Basis	FMV	O.B.
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Capital. Assets	7,000	5,000	
Unrealized Rec.	<u>0</u>	<u>14,000</u>	
Total Assets	<u>20,000</u>	<u>32,000</u>	
Liabilities:	2,000	2,000	
Capital:			
A	9,000	15,000	10,000
B	<u>9,000</u>	<u>15,000</u>	10,000
Debt + Equity	<u>20,000</u>	<u>32,000</u>	

Seller B's 50% share of
ordinary income = \$7,000

Cap. Gain W/O 751

Cash from T	15,000	
Debt Shift To Buyer	<u>1,000</u>	
Amount Realized		16,000

15

Cap. Gain W/O 751

Cash from T	15,000	
Debt Shift To Buyer	<u>1,000</u>	
Amount Realized		16,000
- Outside Basis		<u>-10,000</u>
= Cap Gain		<u>6,000</u>

16

Cash from T	15,000	
Debt Shift To Buyer	<u>1,000</u>	
Amount Realized		16,000
- Outside Basis		<u>-10,000</u>
= Cap Gain w/o 751		<u>6,000</u>
- Ordinary Income		<u>-7,000</u>

17

Cap. Loss of <\$1,000>

Cash from T	15,000	
Debt Shift To Buyer	<u>1,000</u>	
Amount Realized		16,000
- Outside Basis		<u>-10,000</u>
= Cap Gain w/o 751		<u>6,000</u>
- Ordinary Income		<u>-7,000</u>
= Capital Loss		<u><1,000></u>

18

Summary of B's Tax Consequences:

Ordinary Income = \$7,000

Capital Loss = <\$1,000>

19

Prop. Reg. 1.751-1(a)(2)
Nov. 17, 2014
clarifies treatment of
sales of partnership
interests.

“The income or loss realized by a partner upon the sale or exchange of its interest **in section 751 property** is the amount of income or loss from section 751 property (taking into account allocations of tax items applying the principles of section 704(c), including any remedial allocations under § 1.704-3(d), and any section 743 basis adjustment pursuant to § 1.743-1(j)(3)) that would have been

allocated to the partner (to the extent attributable to the partnership interest sold or exchanged) **if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property** (taking into account section 7701(g)) immediately prior to the partner’s transfer of the interest in the partnership.” (Prop Reg 1.751-1(a)(2))

“Any gain or loss recognized that is attributable to section 751 property will be ordinary gain or loss. The difference between the amount of capital gain or loss that the partner would realize in the absence of section 751 and the amount of ordinary income or loss determined under this paragraph (a)(2) is the transferor’s capital gain or loss on the sale of its partnership interest....” (Prop Reg 1.751-1(a)(2))

“The rules contained in §1.751-1(a)(2) would apply to transfers of partnership interests that occur **on or after November 3, 2014.**”
(Preamble to Prop. Regs.)

Tiered Partnerships

The upper-tiered partnership is treated as owning its **proportionate share of the hot assets** of any other lower-tiered partnership in which it is a partner.

25

Collectibles

(28% max. rate)

and

Section 1250

Capital Gain

(25% max. rate)

(Section 1(h) and Reg. 1.1(h)-1)

26

These Are Not Hot Assets

(Sec. 751(a) is
inapplicable)

27

Gain Attributable to:

- Appreciated Collectibles
(28% rate)
- Section 1250 Capital Gain
(25% rate)

are subject to look-thru rules
similar to section 751(a).

(Section 1(h) and Reg. 1.1(h)-1)

28

Also applies to the sale of S corporation stock

29

“Residual” Long-term Capital Gain Or Loss

The selling partner’s share of:

“Pre-look-through LT CG or L
(section 741 gain after applying
section 751)

minus

collectibles capital gain and sec.
1250 capital gain.

30

Example 1

31

- A and B are equal partners in personal service partnership PRS.
- B sells to T for an amount realized of \$16K (\$15 cash + \$1k debt shift to T)

32

Pre-Sale Balance Sheet

Assets	Tax Basis	FMV	O.B.
Cash	3,000	3,000	
Notes Rec.	10,000	10,000	
Collectibles	1,000	3,000	
Other Cap. Assets	6,000	2,000	
Unrealized Rec.	<u>0</u>	14,000	
Total Assets	<u>20,000</u>	<u>32,000</u>	
Liabilities:	2,000	2,000	
Capital:			
A	9,000	15,000	10,000
B	<u>9,000</u>	<u>15,000</u>	10,000
Debt + Equity	<u>20,000</u>	<u>32,000</u>	

33

Cap. Gain W/O 751

Cash from T	15,000	
Debt Shift To Buyer	<u>1,000</u>	
Amount Realized		16,000
- Outside Basis		<u>-10,000</u>
= Cap Gain		<u>6,000</u>

34

“Pre-look-through” Cap. Loss of <\$1,000>

= Cap Gain w/o 751		<u>6,000</u>
- Sec. 751 O. I.		<u>-7,000</u>
= PLT Capital Loss		<u><1,000></u>

35

Residual Cap. Loss

= PLT capital gain <loss>	<\$1,000>	
- B's share of Collectible Gain	<u>-\$1,000</u>	-\$1,000
= B's Residual LTCL (20%)		<\$2,000>

36

Summary (B's realized gain is \$6,000):

Sec. 751 O.I.	=	7,000
Collect. Gain (28%)	=	1,000
Res. C.L. (20%)	=	<u><2,000></u>
Net Total	=	<u>6,000</u>

37

Sales Not Redemptions

The look-through treatment for Sec. 1250 capital gain and collectibles **does not apply to redemptions** of partnership interests
(per sec. 1.1(h)-1 regs).

38

Partner and Partnership Reporting of Sale Gain

39

Selling **Partner's** IRS Reporting Obligation
Pursuant to Reg. 1.751-1(a)(3), **a partner**
selling or exchanging any part of an interest
in a partnership that **has any section 751**
property at the time of sale or exchange must
submit with its income tax return ...the
following information—

- **The date** of the sale...;
- **The amount of any gain or loss attributable to the section 751 property**; and
- **The amount of ... capital gain or loss....**

40

Partnership Reporting Obligation

IRS Form 8308

Form **8308**

(Rev. October 2005)

Department of the Treasury
Internal Revenue Service

Report of a Sale or Exchange of Certain Partnership Interests

► Please print or type.

Name of partnership

Telephone number

()

41

Partnership Reporting Obligation

IRS Form 8308

Attach to Form 1065 and send
a copy to the transferor and
transferee

F

(F

D

Internal Revenue Service

► Please print or type.

Name of partnership

Telephone number

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42

8308 Instructions

“A partnership must file Form 8308 once the partnership has notice of the section 751(a) exchange.”

43

8308 Instructions

A partnership may rely on a written statement from the transferor that the transfer was not a section 751(a) exchange **unless the partnership has knowledge to the contrary**. If a partnership is in doubt whether partnership property constitutes unrealized receivables or inventory items or whether a transfer constitutes a section 751(a) exchange, the partnership **may file Form 8308 to avoid the risk of incurring a penalty for failure to file**.

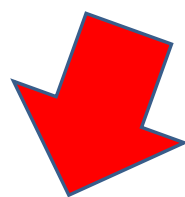
44

Section
754
Election
With Sales,
Exchanges, and
Death of a Partner

16

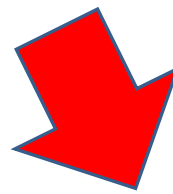
45

754 Election
Activates



Sec.
743

Sales, Exchanges,
Deaths



Sec.
734

Distributions

A written statement
attached to Form
1065 in the tax year
of transfer or
distribution – **by
extended due date**

47

Automatic 12-month
extension provided
corrective action is taken
within 12 months of the
original deadline for making
the 754 election.

(no fee)

See Reg. 301.9100-
2(a)(2)(iv).

48

Beyond that, relief requires a favorable private letter ruling granting 301.9100-3 relief.

\$10,000 IRS fee
per Rev. Proc. 2017-1
Appendix A

49

17

Revocation
Requires
IRS Approval

50

A U.S. partner may file Form 1065--on behalf of a foreign PSP--solely for the purpose of making a Sec 754 election.

Impact of 754 Election on Sale, Exchange, or Death of Partner

General Rule:

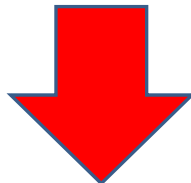
The partnership **does not adjust inside basis** following the **purchase or inheritance of a partnership interest**

The Section 754 election, **by activating sec. 743(b)**, triggers the exception, **but it only applies to the transferee partner.**

Sec. 743(b) Adjustments

55

O.B. > I.B. = 

I.B. > O.B. = 

Not a Sch. L common
balance sheet
adjustment

56

Example

100,000 O.B. Purchase*

- 70,000 Inside Basis**

= 30,000 Sec. 743(b) Adj.

* Cash + PSP debt share of buyer

** Same as seller's

57

Example

70,000 O.B. Inheritance*

- 100,000 Inside Basis**

= <30,000> Sec. 743(b) Adj.

* DOD FMV + Debt Share

** Same as decedent's

58

Section 743(b)
adjustments should
NOT be reflected **in**
the transferee
partner's book or
tax basis capital
accounts:

59

"These [Section 743(b)]
adjustments **to the transferee's**
distributive shares must be
reflected on Schedules **K and**
K-1 of the partnership's return
(Form 1065). These
adjustments to the transferee's
distributive shares **do not**
affect the transferee's capital
account."

(Reg. 1.743-1(j)(2))

60

The **important exception** is when a partner is unable to use its sec. 743 adjustment per Reg. 1.734-2(b)(1).

(Reg. 1.704(b)(2)(iv)(m)(2))⁶¹

18

Buyer/Beneficiary
Outside Basis

Buyer O.B.

- **Cost** of PSP Interest (Sec. 742)
+
- Share of **PSP debt** (Sec. 752)

(Reg. 1.742-1)

63

Beneficiary O.B.

- **FMV of PSP interest** on DOD
(§1014(a)(1))
+
- Share of **PSP debt** (§§752/742)
-
- **Value of** PSP interest
attributable to **IRD** (§1014(c))

(Reg. 1.742-1)

64

Both

Halves of Inherited Community Property

65

22

Buyer/Beneficiary Inside Basis

66

Previously Taxed Capital (PTC)
+ Debt Share
= Inside Basis

67

PTC per Sec. 743 Regs.:

Cash to buyer on hypothetical liquidation if all assets are sold for FMV.

- + loss allocated to buyer.
- gain allocated to buyer.

or shortcut:

PTC = tax basis capital account₆₈

Tax Basis Capital Acct.
+ Debt Share
= Inside Basis

69

New Basis Consistency Rule

Prop. Reg. 1.1014-10(a)(1) ¹⁹
provides that "[t]he taxpayer's
initial basis in property ...**may
not exceed the property's
final value [reported by the
estate on
Form 8971 Schedule A]."**

70

“...the taxpayer's initial basis in that property may be adjusted **due to the operation of other provisions of the Internal Revenue Code (Code) governing basis** without violating [the consistency rule]”

71

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Prop. Reg.
1.1014-10(e)
Example (1)
Modified

72

At D's death, D owned 50% of P, an LLC taxed as a partnership, which owned a rental building with a fair market value of \$10 million subject to nonrecourse debt of \$2 million.

73

Building
(on leased land) was
purchased for **\$8 mil.**
and depreciated
fully
straight-line.

74

Pre-Death Balance Sheet

Assets In Thousands	Tax Basis	FMV	O.B. 20
Building	<u>0</u>	<u>10,000</u>	
Total Assets	<u>0</u>	<u>10,000</u>	
NR Debt	2,000	2,000	
Capital:			
Ann (25%)	<500>	2,000	0
Bo (25%)	<500>	2,000	0
D (50%)	<u><1,000></u>	<u>4,000</u>	0
Debt + Capital	<u>0</u>	<u>10,000</u>	75

- D's sole beneficiary is C, D's child.
- D's interest in P is reported by the Estate on **[IRS Form 8971 Schedule A]** at \$4 million (no discount).
- **No 754 Election is made.**

The IRS accepts
the estate tax
return as filed and
the estate tax S of
L on assessment
expires.

77

C's O.B. (Reg. 1.742-1)

\$4 mil. -- FMV on DOD.

+

\$1 mil. -- Debt share

-

\$0 -- Value that is IRD

= \$5 mil.

78

Post-Death Balance Sheet

Assets (In Thousands)	Tax Basis	FMV	O.B.
Building	0	<u>10,000</u>	
Total Assets	0	<u>10,000</u>	
NR Debt	2,000	2,000	
Capital:			
Ann	<500>	2,000	0
Bo	<500>	2,000	0
C	<u><1,000></u>	<u>4,000</u>	5,000
Debt + Capital	<u>0</u>	<u>10,000</u>	79

\$4 mil. FMV of PSP
interest on Form 8971
is
consistent with
\$5 mil. beneficiary
basis due to debt
share

C sells to Bill for 20
 \$7 mil. amount realized
 (cash of \$6 mil. + debt
 assumed \$1 mil.) after
 the building has
 appreciated to
 \$14 mil.

81

Balance Sheet Before Sale

Assets (In Thousands)	Tax Basis	FMV	O.B. 20
Building	0	<u>14,000</u>	
Total Assets	0	<u>14,000</u>	
NR Debt	2,000	2,000	
Capital:			
Ann	<500>	3,000	0
Bo	<500>	3,000	0
C	<u><1,000></u>	<u>6,000</u>	5,000
Debt + Capital	<u>0</u>	<u>14,000</u>	82

In fictional sale of
PSP assets, C's
share of section
1250 capital gain
is \$4 Mil.
(50% of \$8 Mil.)

83

Pre-look Thru Cap. Gain or Loss

In Thousands

Cash from Bill	6,000	
Debt Shift To Bill	<u>1,000</u>	
Amount Realized		7,000
- O.B. (\$4K + \$1K)		<u>5,000</u>
= PLT Cap Gain \$741		<u>2,000</u>

IRS Example said \$1 million
gain; they forgot to consider
the debt assumed by Bill

84

Residual Cap. Loss

In Thousands

PLT Cap Gain §741		<u>2,000</u>
1250 Capital Gain		<u>-4,000</u>
Residual Capital Loss	=	<u><2,000></u>

85

Summary of C's Tax Consequences:

1250 Cap. Gain = \$4 mil.

Res. Capital Loss = <\$2 mil.>

86

Observation #1

21

If the partnership made a section 754 election in the year of D's death

87

Decedent's **section 743(b) adjustment, if any, disappears** at death but Beneficiary, C, is entitled to a 743(b) adjustment.

Compare gifts: Donor 743(b) adjustment, if any, is transferred to Donee.

88

C would be eligible for a
\$5,000,000 743(b)
adjustment



(\$5 million (O.B.) - \$0 (I.B.))

89

It would all be
allocated to the
building - \$5 mil.
depreciable basis
(sec. 755).

90

Impact of section 754 election on C's subsequent sale to Bill?

91

The recently proposed 751 regs. make it clear that C's \$5 mil. unused section 743(b) adjustment eliminates C's \$4 mil. look-thru sec. 1250 capital gain on the building in the sale of C's PSP interest to Bill

92

Summary of C's Tax Consequences:

1250 Cap. Gain = \$4 mil.

Res. Capital Loss = <\$2 mil.>

NO

93

C would recognize \$2 mil.
of residual capital gain:

Cash from Bill	6,000	
Debt Shift To Bill	<u>1,000</u>	
Amount Realized		7,000
- O.B. (\$4K + \$1K)		<u>5,000</u>
= Cap Gain \$741		<u>2,000</u>

94

Absent the section 754 election, C is stuck with an excess of O.B. > I.B. of \$5 million indefinitely.

95

Post Death Balance Sheet

Assets In Thousands	Tax Basis	FMV	O.B.
Building	<u>0</u>	<u>10,000</u>	
Total Assets	<u>0</u>	<u>10,000</u>	
NR Debt	2,000	2,000	
Capital:			
Ann (25%)	<500>	2,000	0
Bo (25%)	<500>	2,000	0
C (50%)	<u><1,000></u>	<u>4,000</u>	5,000
Debt + Capital	<u>0</u>	<u>10,000</u>	96

A Section 754 election also helps Bill (who purchased C's interest for \$ 7 mil.)

97

Bill would be eligible for a \$7,000,000 743(b) adjustment



(\$7 million (O.B.) - \$0 (I.B.))

all allocated to the building under 755.

98

Observation #2

21

Instead of C selling to Bill, assume C is liquidated for \$6 million cash plus \$1 mil. of debt relief.

The partnership makes a sec. 754 election

99

The PSP borrows the \$6 mil. that is used

to liquidate C

(recourse debt guaranteed by Ann & Bo)

100

Balance Sheet Before Liquidation

Assets (In Thousands)	Tax Basis	FMV	O.B.
Building	0	<u>14,000</u>	
Total Assets	0	<u>14,000</u>	
NR Debt	2,000	2,000	
Capital:			
Ann	<500>	3,000	0
Bo	<500>	3,000	0
C	<u><1,000></u>	<u>6,000</u>	5,000
Debt + Capital	<u>0</u>	<u>14,000</u>	101

The sec. 1.1(h)
 sec. 1250 look-
 thru rules for
 sales do not apply
 to liquidations.

C would have **section 731(a)(1) capital gain of \$2 mil.** (max. rate 20%):

7 mil. liquidation proceeds
- 5 mi. outside basis
= 2 mil. 731(a)(1) gain

103

Impact of
section 754
election
on
liquidation of C

104

C's unused section 743(b) adjustment of \$5,000,000 would be pushed to the common balance sheet and allocated to the building allowing Ann and Bo to benefit from the depreciation (See reg. 1.734-2(b)).

105

Plus, the partnership is entitled to an additional \$2 mil. upward section 734(b) adjustment (due to C's \$2 mil. sec. 731(a) gain) to the common balance sheet basis of the building (depreciable).

106

Debits: \$7,000,000 Building

Credits: \$1,000,000 C Cap.

\$6,000,000 Rec. Debt

Adjust both tax and book basis, but not book basis if PSP assets were (optionally) adjusted when C was liquidated.

107

Balance Sheet After Liquidation

Assets (In Thousands)	Tax Basis	FMV	Outside Basis
Building	\$7,000	<u>14,000</u>	
Total Assets	0	<u>14,000</u>	
NR Debt	2,000	2,000	
Recourse Debt	6,000	6,000	
Capital:			
Ann	<500>	3,000	3,500
Bo	<u><500></u>	<u>3,000</u>	3,500
Debt + Capital	<u>0</u>	<u>14,000</u>	

108

Observation #3

22

If the building were instead zero basis trade receivables, **IRD**, then per section 1014(c) no outside basis adjustment with respect to the **IRD**

109

Pre-Death Balance Sheet

Assets (In Thousands)	Tax Basis	FMV	O.B.
Accts. Rec.	<u>0</u>	<u>10,000</u>	
Total Assets	<u>0</u>	<u>10,000</u>	
Debt	2,000	2,000	
Capital:			
Ann (25%)	<500>	2,000	0
Bo (25%)	<500>	2,000	0
D (50%)	<u><1,000></u>	<u>4,000</u>	0
Debt + Capital	<u>0</u>	<u>10,000</u>	

110

In Thousands

Post-Death: C's O.B.

Assets	Tax Basis	FMV	O.B.
Accts. Rec.	<u>0</u>	<u>10,000</u>	
Total Assets	<u>0</u>	<u>10,000</u>	
Debt	2,000	2,000	
Capital:			
Ann (25%)	<500>	2,000	0
Bo (25%)	<500>	2,000	0
C (50%)	<u><1,000></u>	<u>4,000</u>	1,000
Debt + Capital	<u>0</u>	<u>10,000</u>	

111

C's O.B. (Reg. 1.742-1)

\$4 mil. -- FMV on DOD.

+

\$1 mil. debt share

-

\$4 mil.-- Value that is IRD

= \$1 mil (sections 752/742)

112

Arguably, C would be eligible for a \$1,000,000 743(b) adjustment with respect to the **unrealized receivable**



(\$1 million (O.B.) - \$0 (I.B.))

But is it

113

Reg. 1.755-1(b)(4)(i)

“Where a partnership interest is transferred as a result of the death of a partner, under section 1014(c) the transferee's basis in its partnership interest is not adjusted for that portion of the interest, if any, which is attributable to items representing income in respect of a decedent under section 691.

See § 1.742-1.

114

Accordingly, if a partnership interest is transferred as a result of the death of a partner, and the partnership holds assets representing income in respect of a decedent, no part of the basis adjustment under section 743(b) is allocated to these assets. See § 1.743-1(b)."

**But what about the adjustment with respect to debt share?
No debt in sole IRS example.**

115

23

Mandatory 743(b) Adjustment (Deemed 754 Election)

116

Mandatory if a
“substantial built-in loss”:

total adjusted basis of
partnership assets exceed
total FMV by $> \$250,000$

117

Example -- 10% PSP Interest
(no discount/no debt)

\$ 70,000 Inheritance (DOD FMV)*
- 100,000 Inside Basis
= <30,000> Sec. 743(b) Adj.

*DOD FMV (10%)

Asset Tax Basis	1,000,000
Asset FMV	700,000

A discount increases
the downward adjustment

118

Allocation of Sec. 743(b) Adjustment – Sec. 755

119

Example

(not in text, but similar to an example above)

120

- A and B are equal partners in personal service partnership PRS.
- B sells to T for an amount realized of \$10K (\$9 cash + \$1k debt shift to T) which reflects a discount below the net asset value of the 50% partnership interest.

121

Pre-Sale Balance Sheet

Assets	Tax Basis	FMV	O.B.
Cash	3,000	3,000	
Loan Rec.	10,000	10,000	
Capital. Assets	7,000	5,000	
Unrealized Rec.	<u>0</u>	<u>14,000</u>	
Total Assets	<u>20,000</u>	<u>32,000</u>	
Liabilities:	2,000	2,000	
Capital:			
A	9,000	15,000	10,000
B	<u>9,000</u>	<u>15,000</u>	10,000
Debt + Equity	<u>20,000</u>	<u>32,000</u>	

122

A Partnership Level Test

Assets	Tax Basis	FMV	O.B.
Cash	3,000	3,000	
Loan Rec.	10,000	10,000	
Capital. Assets	7,000	5,000	
Unrealized Rec.	<u>0</u>	<u>14,000</u>	

Seller B's 50% share of PSP
level ordinary income = \$7,000

123

Summary of Seller B's Tax Consequences:

Ordinary Income = \$7,000

Capital Loss = <\$7,000>

124

T's 743(b) Adjustment:

$$\begin{array}{r} \$10,000 \text{ O.B.} \\ \underline{\$10,000 \text{ I.B.}^*} \\ = \quad \underline{\underline{0}} \end{array}$$

$$\begin{array}{r} *9,000 \text{ (PTC)} \\ + 1,000 \text{ (debt share)} \end{array}$$


125

Post-Purchase Balance Sheet

Assets	Tax Basis	FMV	O.B.
Cash	3,000	3,000	
Loan Rec.	10,000	10,000	
Capital. Assets	7,000	5,000	
Unrealized Rec.	<u>0</u>	<u>14,000</u>	
Total Assets	<u>20,000</u>	<u>32,000</u>	
Liabilities:	2,000	2,000	
Capital:			
A	9,000	15,000	10,000
T	<u>9,000</u>	<u>15,000</u>	10,000
Debt + Equity	<u>20,000</u>	<u>32,000</u>	126

However section 755 Must Be Considered

127

The 743(b)  **adjustment allocation** is based upon a hypothetical sale of each asset at FMV
(Section 755)

128

Two Classes of
assets:

(1) Capital gain
property

(2) Ordinary income
property

129

Allocation to Ordinary
Income Property:

Gain or loss on the
fictional sale at FMV
of ordinary income
property by PSP.

= \$7,000

(§751 mirror image)

130

Allocation to Capital Gain Property:

The **total Sec. 743(b) adjustment** minus the portion allocated to ordinary income property:
= **<\$7,000>** (**\$0 - \$7,000**)

131

743(b) Adjustments

O.I. Property	+ \$7,000
Cap. Gain Prop	- \$7,000

Section 755 for buyer
mirrors sections 751(a) and
741 for seller

132

Example 1

133

- Abe and Bonnie form equal PSP AB.
- Each PTR contributes \$1 mil. cash.
- The PSP uses the cash of \$1 mil. to purchase land used in its business (section 1231(b) property), which is “capital gain” property for purposes of section 755.

134

- The PSP also purchases inventory (ordinary income property) for \$1 mil.

135

Upon Formation (In Thousands)

Assets	Tax Basis	FMV	Outside Basis
Land	\$1,000	\$1,000	
Inventory	\$1,000	\$1,000	
Total Assets	<u>\$2,000</u>	<u>\$2,000</u>	
Capital:			
Abe (50%)	\$1,000	\$1,000	\$1,000
Bonnie (50%)	<u>\$1,000</u>	<u>\$1,000</u>	\$1,000
Total Capital	<u>\$2,000</u>	<u>\$2,000</u>	

136

In the first year, the Inventory increases in value by \$500,000 and the Land declines in value by $\langle \$500,000 \rangle$.

137

After a year, Abe sells his 50% PSP interest to ALCO Inc. for \$1 mil.

138

Before Sale (In Thousands)

Assets	Tax Basis	FMV	Outside Basis
Land	\$1,000	\$500	
Inventory	\$1,000	\$1,500	
Total Assets	<u>\$2,000</u>	<u>\$2,000</u>	
Capital:			
Abe (50%)	\$1,000	\$1,000	\$1,000
Bonnie (50%)	<u>\$1,000</u>	<u>\$1,000</u>	\$1,000
Total Capital	<u>\$2,000</u>	<u>\$2,000</u>	

139

- Abe's realized gain (ignoring section 751(a)) is zero (\$1 mil. (amount realized) - \$1 mil. (O.B.)).
- But under section 751(a) Abe recognizes:
 - \$250K of ordinary inc.
 - <\$250K> of capital loss
 - (\$0 - \$250K)

140

The partnership makes a section 754 election

141

After Sale to ALCO (In Thousands)

Assets	Tax Basis	FMV	Outside Basis
Land	\$1,000	\$500	
Inventory	\$1,000	\$1,500	
Total Assets	<u>\$2,000</u>	<u>\$2,000</u>	
Capital:			
ALCO (50%)	\$1,000	\$1,000	\$1,000
Bonnie (50%)	<u>\$1,000</u>	<u>\$1,000</u>	\$1,000
Total Capital	<u>\$2,000</u>	<u>\$2,000</u>	

142

ALCO's basis adjustment under section 743(b) (without 755) is zero:

\$1 Mil. ALCO's outside basis

-\$1 Mil. ALCO's inside basis

= \$0 Section 743(b) Adjustment

143

Hypothetical Sale of Assets at FMV

Assets	Tax Basis	FMV	Gain <Loss>
Land	\$1,000	\$500	<\$500>
Inventory	\$1,000	\$1,500	\$500
Total Assets	<u>\$2,000</u>	<u>\$2,000</u>	
Capital:			
ALCO (50%)	\$1,000	\$1,000	<250> 250
Bonnie (50%)	<u>\$1,000</u>	<u>\$1,000</u>	<250> 250
Total Capital	<u>\$2,000</u>	<u>\$2,000</u>	

144

ALCO's Sec. 755 Allocations

Ordinary Inc. Property:

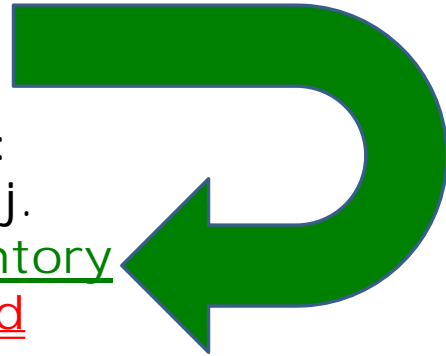
Inventory \$250K

Capital Gain Property:

0 Sec. 743(b) Adj.

- 250K Adj. for Inventory

≡ <250K> Adj. for Land



145

28

Example 3

146

Same facts as
Example 1 except
instead of a sale to
ALCO, after a year,
Abe dies and **his
estate discounts the
value of the PSP
Interest by 50%**

147

Review of Facts:

- Abe and Bonnie each contribute \$1 mil. cash.
- The PSP uses the cash of \$1 mil. to purchase land used in its business (section 1231(b) property), which is "capital gain" property for purposes of section 755.

148

Day Following Abe's DOD

Assets	Tax Basis	FMV	Outside Basis
Land	\$1,000	\$500	
Inventory	\$1,000	\$1,500	
Total Assets	<u>\$2,000</u>	<u>\$2,000</u>	
Capital:			
Abe's Estate	\$1,000	\$1,000	\$500
Bonnie	<u>\$1,000</u>	<u>\$1,000</u>	\$1,000
Total Capital	<u>\$2,000</u>	<u>\$2,000</u>	

149

Estate's basis adjustment under section 743(b) (without 755) is $\langle \$500K \rangle$:

500,000 Estate's outside basis

-1,000,000 Estate's inside basis

= $\langle 500,000 \rangle$ Section 743(b) Adjustment

150

Hypothetical Sale of Assets at FMV

Assets	Tax Basis	FMV	Gain <Loss>
Land	\$1,000	\$500	<\$500>
Inventory	\$1,000	\$1,500	\$500
Total Assets	<u>\$2,000</u>	<u>\$2,000</u>	
Capital:			
Estate (50%)	\$1,000	\$1,000	<250> 250
Bonnie (50%)	<u>\$1,000</u>	<u>\$1,000</u>	<250> 250
Total Capital	<u>\$2,000</u>	<u>\$2,000</u>	

151

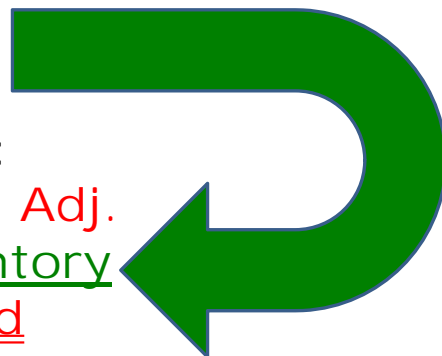
Estate's Sec. 755 Allocations

Ordinary Income Property:

Inventory \$250K

Capital Gain Property:

<500K> Sec. 743(b) Adj.
 - 250K Adj. for Inventory
 = <750K> Adj. for Land



The impact of the discount is borne 100% by the capital gain property; best for the Estate

152

What if the inventory and land did not change in value prior to Abe's death, and the Estate discounts the FMV of the PSP interest by 50%?

153

DOD Balance Sheet (In Thousands)

Assets	Tax Basis	FMV	Outside Basis
Land	\$1,000	\$1,000	
Inventory	\$1,000	\$1,000	
Total Assets	<u>\$2,000</u>	<u>\$2,000</u>	
Capital:			
Abe (50%)	\$1,000	\$1,000	\$1,000
Bonnie (50%)	<u>\$1,000</u>	<u>\$1,000</u>	\$1,000
Total Capital	<u>\$2,000</u>	<u>\$2,000</u>	

154

Day Following Abe's DOD

Assets	Tax Basis	FMV	Outside Basis
Land	\$1,000	\$1,000	
Inventory	\$1,000	\$1,000	
Total Assets	<u>\$2,000</u>	<u>\$2,000</u>	
Capital:			
Abe's Estate	\$1,000	\$1,000	\$500
Bonnie	<u>\$1,000</u>	<u>\$1,000</u>	\$1,000
Total Capital	<u>\$2,000</u>	<u>\$2,000</u>	

155

Estate's basis adjustment under section 743(b) (without 755) is $\langle \$500K \rangle$:

500,000 Estate's outside basis

-1,000,000 Estate's inside basis

= $\langle 500,000 \rangle$ Section 743(b) Adjustment

156

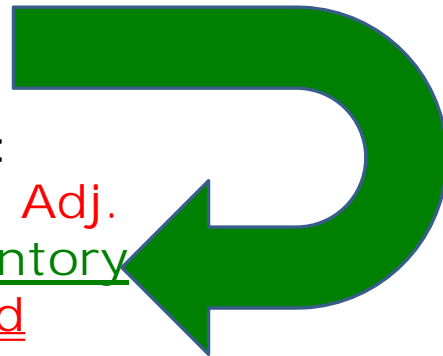
Estate's Sec. 755 Allocations

Ordinary Income Property:

Inventory \$0K

Capital Gain Property:

<500K> Sec. 743(b) Adj.
- 0K Adj. for Inventory
= <500K> Adj. for Land



The impact of the discount is borne 100% by the capital gain property.

157

In the event that a decrease in basis allocated to capital gain property would otherwise exceed the partnership's basis in capital gain property, the excess must be applied to reduce the basis of ordinary income property. Reg. 1.755-1(b)(2)(i) (second sentence).

Section
755/743
Allocations of
Section 197
Intangibles and
Goodwill

159

The existence of
goodwill and other
section 197
intangibles depends
upon the residual
method in sec. 755

160

If the value of partnership assets other than section 197 intangibles—determined at the partnership level—exceeds the **partnership gross value**, then the section 197 intangibles are worth zero for purposes of section 755.

161

Partnership gross value

“generally is equal to the amount that, if assigned to all [PSP] property, would result in a liquidating distribution to the [PTR] equal to the transferee's [outside basis] immediately following the relevant transfer” (reduced by O.B. attributed to debt).

(reg. 1.755-1(as)(4)(i)(A)).

162

Only if **partnership gross value** exceeds the value attributed to section 197 intangibles **other than goodwill**, can value be attributed to goodwill.

163

28

Example 2

Goodwill

164

- Abe and Bonnie form equal PSP AB.
- Each PTR contributes \$1 mil. cash.

165

- After a year, Abe sells his partnership interest to ALCO Inc. for \$1,500,000.
- The partnership makes a section 754 election.

166

After Sale

Assets (in thousands)	Tax Basis	FMV	Outside Basis
#1 Capital Asset	\$1,000	\$1,000	
#2 Ord. Asset	\$1,000	\$1,000	
Goodwill	<u>0</u>	<u>\$1,000</u>	
Total Assets	<u>\$2,000</u>	<u>\$3,000</u>	
Capital:			
ALCO	\$1,000	\$1,500	\$1,500
Bonnie	<u>\$1,000</u>	<u>\$1,500</u>	\$1,000
Total Capital	<u>\$2,000</u>	<u>\$3,000</u>	

167

ALCO's basis adjustment under section 743(b) (without 755) is \$500,000:

$$\begin{array}{r}
 \$1,500,000 \text{ ALCO's outside basis} \\
 \underline{-\$1,000,000 \text{ ALCO's inside basis}} \\
 \hline
 = \underline{\$500,000} \text{ Section 743(b) Adjustment}
 \end{array}$$

Can it be allocated to the
goodwill?

168

The existence of goodwill hinges on PSP gross value exceeding the value of tangible assets

169

PSP gross value is \$3 mil.:
(1.5 mil. (outside basis) ÷ 50%)

The residual section 197 intangibles value is \$1 mil.
(\$3 mil. gross value minus \$2 mil. value of PSP tangible assets)

Goodwill of \$1 mil. exists

170

Hypothetical Sale of Assets at FMV

Assets	Tax Basis	FMV	Gain
#1 Capital Asset	\$1,000	\$1,000	
#2 Ord. Asset	\$1,000	\$1,000	
Goodwill	<u>0</u>	<u>\$1,000</u>	\$1,000
Total Assets	<u>\$2,000</u>	<u>\$3,000</u>	
Capital:			
ALCO	\$1,000	\$1,500	\$500
Bonnie	<u>\$1,000</u>	<u>\$1,500</u>	\$500
Total Capital	<u>\$2,000</u>	<u>\$3,000</u>	

171

ALCO's Sec. 755 Allocations

Ordinary Income Property:

Ord. Inc. Property = \$0

Cap. Gain. Prop.:

500,000 Sec. 743(b) Adj.
 - 0 Adj. for O.I. Prop.
 = 500,000 Adj. to Goodwill



Amortized over 15 years

172

Variation on Ex. 2

Same facts but ALCO purchases Abe's PSP interest for \$1 mil. (a discount)

No Goodwill:

\$2 mil. PSP Gross Value (1 ÷ 2)

\$2 mil. Value of Tangible Assets

\$0 Residual Value

173

After Sale

Assets	Tax Basis	FMV	Outside Basis
#1 Capital Asset	\$1,000	\$1,000	
#2 Ord. Asset	\$1,000	\$1,000	
Goodwill	<u>0</u>	<u>\$1,000</u>	
Total Assets	<u>\$2,000</u>	<u>\$3,000</u>	
Capital:			
ALCO	\$1,000	\$1,500	\$1,000
Bonnie	<u>\$1,000</u>	<u>\$1,500</u>	\$1,000
Total Capital	<u>\$2,000</u>	<u>\$3,000</u>	

174

No section 743(b)
adjustment and no
section 755
allocation to
goodwill.

175

Another
Variation
on Ex. 2

176

- Abe and Bonnie form equal PSP AB.
- Each PTR contributes \$500K cash.
- One year later, Abe sells to ALCO for \$1 mil., a discount relative to net asset value of \$1.5 mil.

177

Balance Sheet Before Sale

(In Thousands)

Assets	Tax Basis	FMV	Outside Basis
#1 Land (Capital Asset)	\$0	\$1,000	
#2 Ord. Asset	\$1,000	\$1,000	
Goodwill	<u>0</u>	<u>\$1,000</u>	
Total Assets	<u>\$1,000</u>	<u>\$3,000</u>	
Capital:			
Abe	\$500	\$1,500	\$500
Bonnie	<u>\$500</u>	<u>\$1,500</u>	\$500
Total Capital	<u>\$1,000</u>	<u>\$3,000</u>	

178

The partnership makes a section 754 election

179

Post-Sale

Assets	Tax Basis	FMV	Outside Basis
#1 Land (Capital Asset)	\$0	\$1,000	
#2 Ord. Asset	\$1,000	\$1,000	
Goodwill	<u>0</u>	<u>\$1,000</u>	
Total Assets	<u>\$1,000</u>	<u>\$3,000</u>	
Capital:			
ALCO	\$500	\$1,500	\$1,000
Bonnie	<u>\$500</u>	<u>\$1,500</u>	\$500
Total Capital	<u>\$1,000</u>	<u>\$3,000</u>	

180

ALCO's basis adjustment under section 743(b) (without 755) is \$500,000:
\$1,000,000 ALCO's outside basis
- \$500,000 ALCO's inside basis
= \$500,000 Section 743(b) Adjustment

Can any of it be allocated to the goodwill?

181

Using common sense you might allocate \$250K (50%) to the land and \$250K (50%) to the goodwill (thus amortizing \$250K over 15 years).

182

Using common sense
you can calculate
the value of the
company (and its
assets) on
a common sense
basis (\$250K).

183

No Goodwill for purposes of Sec.
755:

\$2 mil. PSP Gross Value (1 ÷ 2)
\$2 mil. Value of Tangible Assets
\$0 Residual Value

184

Post-Sale Balance Sheet

Assets	Tax Basis	FMV	Outside Basis
#1 Land <small>(Capital Asset)</small>	\$0	\$1,000	
#2 Ord. Asset	\$1,000	\$1,000	
Goodwill	<u>0</u>	<u>\$1,000</u>	
Total Assets	<u>\$1,000</u>	<u>\$3,000</u>	
Capital:			
ALCO	\$500	\$1,500	\$1,000
Bonnie	<u>\$500</u>	<u>\$1,500</u>	\$500
Total Capital	<u>\$1,000</u>	<u>\$3,000</u>	

185

ALCO's Sec. 755 Allocations

Ordinary Income Property:

Ord. Inc. Property = \$0

Cap. Gain. Prop.:

500,000 Sec. 743(b) Adj.
 - 0 Adj. for O.I. Prop.
 = 500,000 Adj. to Land



186

Example 4: Sale at a Discount Triggering Sec. 751 Without section 754 Election

187

- Alice and Bill form the AB calendar year limited liability company taxed as a partnership.
- Alice, the managing member, contributes \$200,000 to AB.
- Bill, the nonmanaging member, contributes \$800,000 to AB.

188

- The partnership purchases Blackacre for \$1,000,000.
- Blackacre is held for development and sale (a hot asset).
- The partnership is in the real estate development business.

189

- The LLC agreement allocates profits and losses 20% to Alice and 80% to Bill.
- The PSP earns net income of \$500,000 in year one and uses the income to purchase a capital asset for \$500,000.
- Liquidation proceeds are distributed in accordance with capital accounts.

190

- By the end of Year 1, Blackacre (hot asset) has appreciated to \$2,000,000.
- The partnership **does not** make a section 754 Election.

191

End of Year 1 Balance Sheet (in thousands)

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Blackacre (Hot)	1,000	1,000	2,000	
Capital Asset	<u>500</u>	<u>500</u>	<u>500</u>	
Total Assets	<u>\$1,500</u>	<u>1,500</u>	<u>2,500</u>	
Capital:				
Alice (20%)	300	300	500	300
Bill (80%)	<u>1,200</u>	<u>1,200</u>	<u>2,000</u>	1,200
Total Capital	<u>1,500</u>	<u>1,500</u>	<u>2,500</u>	

192

- At the beginning of Yr. 2, Carol acquires Bill's interest for \$1,700,000.
- Although the net asset value of Bill's 80% PSP interest on the date of sale was \$2,000,000 (80% x \$2,000,000) Carol negotiated a fractional interest discount of **\$300,000**.

193

Bill's Cap. Gain W/O 751

(in thousands)

Cash from Carol	1,700	
Amount Realized		1,700
- Outside Basis		<u>-1,200</u>
= Cap Gain w/o 751		<u><u>500</u></u>

194

How much
ordinary income
must Bill
recognize per
Sec. 751(a)?

195

Bill's share of
the \$1 mil. of
sec. 751(a) hot
asset gain is
\$800,000 (80%)

196

Lesson: The discounted sales price does not discount the sec. 751(a) O.I.

197

= Cap Gain w/o 751		<u>500</u>
- Ordinary Income		<u>-800</u>

198

Cap. Loss of <\$300>

= Cap Gain w/o 751		<u>500</u>
- Ordinary Income		<u>-800</u>
= Capital Loss		<u><300></u>

199

Balance Sheet After C's Purchase (in thousands)

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Blackacre (Hot)	1,000	1,000	2,000	
Capital Asset	<u>500</u>	<u>500</u>	<u>500</u>	
Total Assets	<u>\$1,500</u>	<u>1,500</u>	<u>2,500</u>	
Capital:				
Alice (20%)	300	300	500	300
Carol (80%)	<u>1,200</u>	<u>1,200</u>	<u>2,000</u>	1,700
Total Capital	<u>1,500</u>	<u>1,500</u>	<u>2,500</u>	

200

After the sale to Carol, Blackacre is sold for \$2 mil.

201

O.I. of \$1 mil. (\$2 mil. - \$1 mil.),

Allocated:

\$800,000 to Carol

\$200,000 to Alice

202

Balance Sheet After Sale of Blackacre (in thousands)

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	2,000	2,000	2,000	
Capital Asset	<u>500</u>	<u>500</u>	<u>500</u>	
Total Assets	<u>\$2,500</u>	<u>2,500</u>	<u>2,500</u>	
Capital:				
Alice (20%)	500	500	500	500
Carol (80%)	<u>2,000</u>	<u>2,000</u>	<u>2,000</u>	\$2,500
Total Capital	<u>2,500</u>	<u>2,500</u>	<u>2,500</u>	203

The capital asset is also sold (zero gain or loss) and the partnership liquidated.

Balance Sheet Before Liquidation (in thousands)

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	2,500	2,500	2,500	
Total Assets	<u>\$2,500</u>	<u>2,500</u>	<u>2,500</u>	
Capital:				
Alice (20%)	500	500	500	500
Carol (80%)	<u>2,000</u>	<u>2,000</u>	<u>2,000</u>	\$2,500
Total Capital	<u>2,500</u>	<u>2,500</u>	<u>2,500</u>	

205

The **\$500K** of liquidation proceeds are a tax free recovery of O.B. for Alice.

206

Carol recognizes a $\langle \$500,000 \rangle$ capital loss on liquidation (\$2 Mil. (Dist.) - \$2.5 mil. (O.B.))

Section 731(a)(2)

207

<u>Alice (20%)</u>		<u>Carol (80%)</u>		
<u>BCA</u>	<u>OB</u>	<u>BCA</u>	<u>OB</u>	
500	500	2,000	2,500	Yr. 3 Beg.
<u>-500</u>	<u>-500</u>	<u>-2,000</u>	<u>-2,000</u>	Distribution
<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	
			<u><500></u>	Capital Loss

208

What pushed Carol's O.B.
\$500K higher than the
net asset value of her
interest?

The difference between
her O.B. (\$1.7 mil.) and
I.B. (\$1.2 mil.) on
purchase

209

Summary of Carol's Tax Consequences

\$800K Ord. Inc.

<\$500K> Cap. Loss

210

This despite no change in asset value between Carol's purchase and redemption.

211

Carol's
NET Gain of \$300K
(800K O.I. - \$500K cap.
loss) is due to her
purchase at a \$300K
discount from Bill
and
sec. 751(a) makes it O.I.

212

Carol's
\$500K O.I. and
<\$500K> Capital Loss
could have been
eliminated with a
section 754 election
by the PSP

213

Lesson: Failure by
the PSP to make
the section 754
election is a **tax
disaster** for Carol

214

Example 8: Same
as Ex. 7 above but
with 754 Election

215

Carol is now
entitled to a
section 743(b)
adjustment at the
time she acquired
her partnership
interest from Bill.

216

Balance Sheet Before Bill Sells to Carol For \$1,700K

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Blackacre (Hot)	1,000	1,000	2,000	
Capital Asset	<u>500</u>	<u>500</u>	<u>500</u>	
Total Assets	<u>\$1,500</u>	<u>1,500</u>	<u>2,500</u>	
Capital:				
Alice (20%)	300	300	500	300
Bill (80%)	<u>1200</u>	<u>1,200</u>	<u>2,000</u>	1,200
Total Capital	<u>1,500</u>	<u>1,500</u>	<u>2,500</u>	

217

Bill's Tax Consequences on Sale (In Thousands)

Cash from Carol	1,700	
Amount Realized		1,700
- Outside Basis		<u>-1,200</u>
= Cap Gain w/o 751		<u>500</u>
- O.I. per sec. 751		<u>-800</u>
= Capital Loss		<u><300></u>

218

Summary of Bill's Tax Consequences

\$800K Ord. Inc.

<\$300K> Cap. Loss

219

Carol's Sec. 743(b)/755 Adjustments (In Thousands)

O.I. Property	+ \$800K
Cap. Gain Prop	- \$300K

Section 755 for Carol/buyer
mirrors section 751(a)
for Bill/seller

220

- Carol would recognize \$300K of cap. gain. when the capital asset was subsequently sold.

Zero PSP level gain but Carol's <\$300K> downward 743(b) adjustment triggers Carol's gain of \$300K

- No gain or loss on liquidation.

221

Summary of Carol's Tax Consequences

\$300K Cap. Gain
(caused by \$300K
discounted purchase
price)

222

Section 743(b)
also applies to
"substituted basis
transactions"

223

For Example:

- Contribute PSP interest to a corporation (sec. 351).
- Contributed PSP interest to a partnership (sec. 721)

224

Example

(Not in Text)

225

Balance Sheet (in thousands)

Assets	Tax Basis	FMV	Outside Basis
Cash	\$3,000	\$3,000	
Building	<u>\$1,500</u>	<u>\$4,500</u>	
Total Assets	<u>\$4,500</u>	<u>\$7,500</u>	
Capital:			
Abe	\$1,500	\$2,500	\$1,500
Bonnie	\$1,500	\$2,500	\$1,500
Katherine	<u>\$1,500</u>	<u>\$2,500</u>	\$2,000
Total Capital	<u>\$4,500</u>	<u>\$7,500</u>	

226

Katherine inherited her
1/3 PSP interest 9
years ago which
explains the \$500K
excess of O.B. over I.B.

227

- The PSP refused to make a section 754 election in the year Katherine inherited her 1/3 PSP Interest
- In the current year, the PSP agrees to make a 754 election (too late for year of death).

228

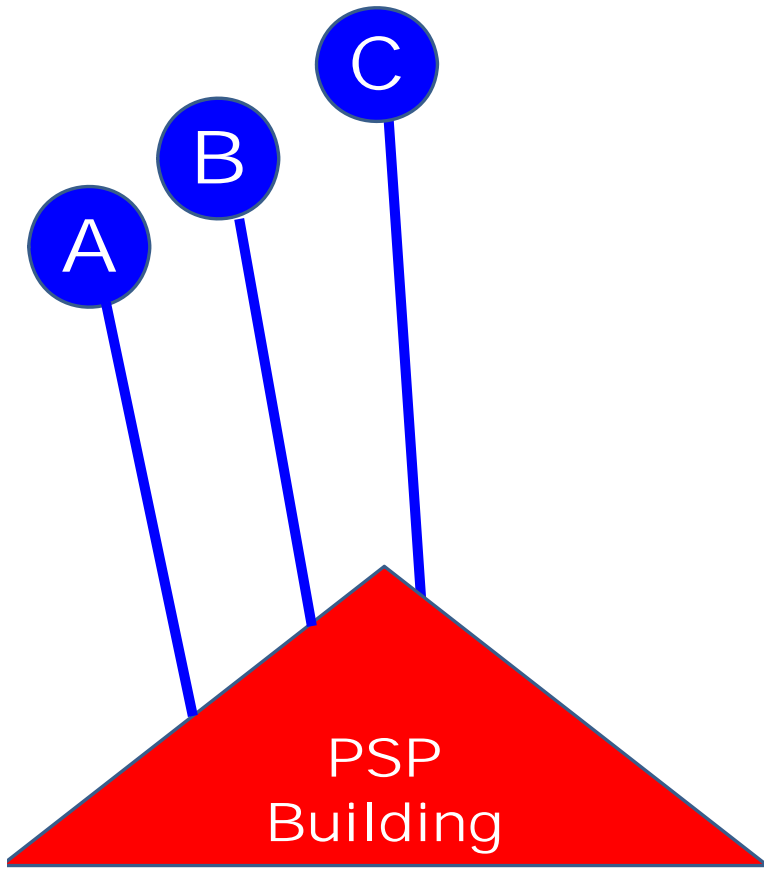
Katherine could contribute
her PSP interest to another
partnership -- UTP
(sec. 721 tax free)
and UTP will be eligible for a
sec 743(b) adjustment of
\$500,000

229

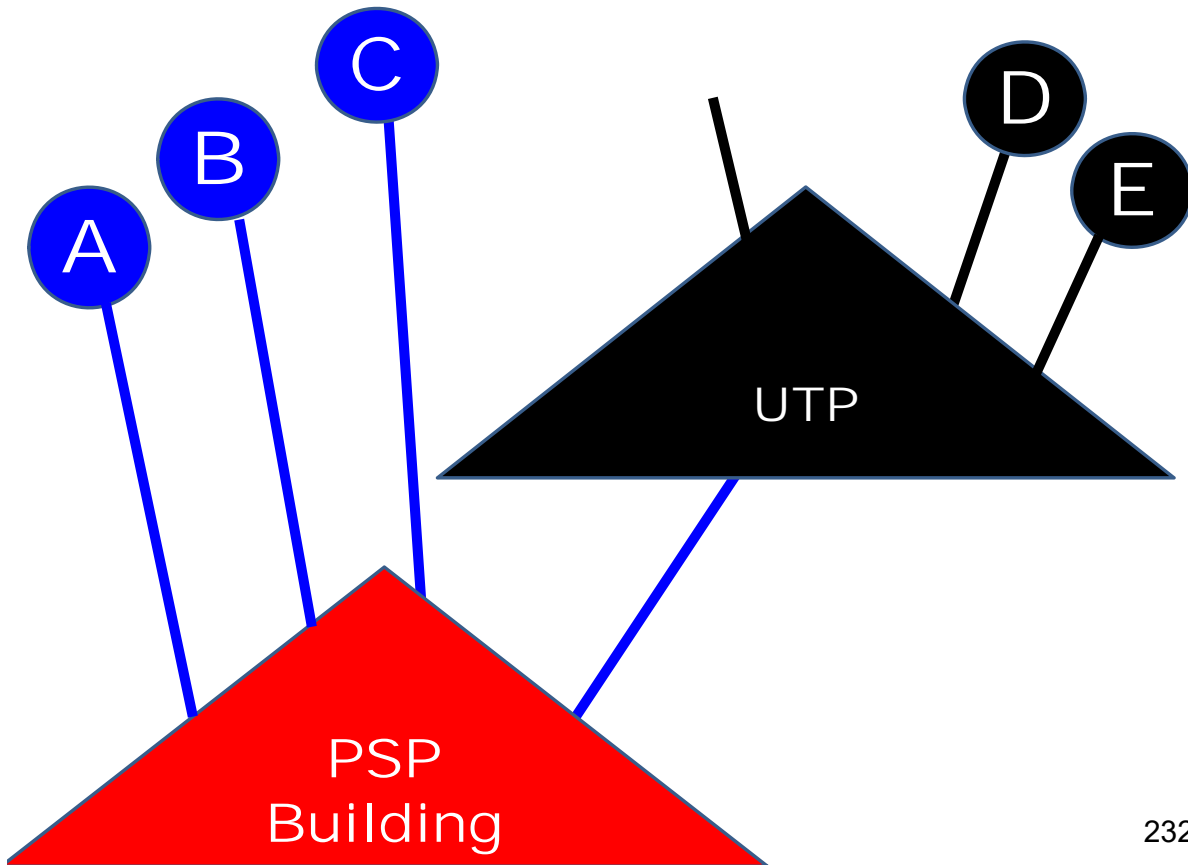
Or contribute it to a 100%
owned S corporation

(If Katherine were a 50% partner
(not on our facts), that would
cause a deemed termination of
the PSP per caselaw).

230



231



232

Impact on Book Capital Accounts

233

The typical
partnership agreement
language puts the
burden on the tax
accountant to
understand Reg.
1.704(b)(2)(iv)(m):

234

*The General Partner may, in its discretion, cause the Partnership to make a timely election under **Section 754** of the Code....If the Partnership elects under Code Section 754 to adjust the basis of Partnership property under Code Section 734(b) **and Section 743(b)**, (i) the General Partner shall make such adjustments to the definition of Gross Asset Value and Profits and Losses,*

235

*and to the special allocations required by Section __ hereof as are necessary to carry out the provisions of **Treasury Regulations Section 1.704-1(b)(2)(iv)(m)(2) and 1.704-1(b)(2)(iv)(m)(4)**; and (ii) a Partner who acquires interests in the Partnership **shall furnish to the General Partner such information as the General Partner shall reasonably request to enable it to compute the adjustments required by Code Section 755....***

236

Example (1)

Sale Without 754 Election

237

On Formation of ABC PSP, the founders contribute \$12 mil:

- A contributes \$3 mil.
- B contributes \$3 mil.
- C contributes \$6 mil.

ABC purchases Blackacre for \$2 mil.

238

- Allocation:
 - 25% to A,
 - 25% to B,
 - 50% to C.
- **Income and expenses are equal** except for gain or loss on the sale of Blackacre.
- By the beginning of Year 2, the FMV of Blackacre is \$6 million.

239

Beg. of Yr. 2 Balance Sheet

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	10,000	10,000	10,000	
Blackacre	2,000	2,000	6,000	
Total Assets	<u>12,000</u>	<u>12,000</u>	<u>16,000</u>	
Capital:				
A 25%	3,000	3,000	4,000	3,000
B 25%	3,000	3,000	4,000	3,000
C 50%	<u>6,000</u>	<u>6,000</u>	<u>8,000</u>	6,000
Total Capital	<u>12,000</u>	<u>12,000</u>	<u>16,000</u>	

240

Partner A sells A's entire 25% partnership interest to D at the beginning of Year 2 for \$4 million (no discount for simplicity).

241

The partnership does not make a section 754 election.

242

Balance Sheet Following A's Sale to D

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	10,000	10,000	10,000	
Blackacre	2,000	2,000	6,000	
Total Assets	<u>12,000</u>	<u>12,000</u>	<u>16,000</u>	
Capital:				
D 25%	3,000	3,000	4,000	4,000
B 25%	3,000	3,000	4,000	3,000
C 50%	<u>6,000</u>	<u>6,000</u>	<u>8,000</u>	6,000
Total Capital	<u>12,000</u>	<u>12,000</u>	<u>16,000</u>	

243

Neither Tax nor
Book capital
accounts
change.

Next, Blackacre
is sold for \$6 mil.
for a gain of \$4
mil.

$$(6 \text{ (A.R.)} - 2 \text{ (A.B.)})$$

245

Allocation of \$4 mil. Gain:
\$1 mil. to D (25%)
\$1 mil. to B (25%)
\$2 mil. to C (25%)

246

After Sale of Blackacre

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	16,000	16,000	16,000	
Total Assets	<u>16,000</u>	<u>16,000</u>	<u>16,000</u>	
Capital:				
D 25%	4,000	4,000	4,000	5,000
B 25%	4,000	4,000	4,000	4,000
C 50%	<u>8,000</u>	<u>8,000</u>	<u>8,000</u>	8,000
Total Capital	<u>16,000</u>	<u>16,000</u>	<u>16,000</u>	

247

The allocation of gain has substantial economic effect under section 704(b).

(Reg. 1.704-1(b)(5)
Example 13(ii))

248

If D were liquidated for
\$4 mil.,

D would recognize a
tax loss of <\$1 mil.>
(4 (Distrib.) – 5 (O.B.))

249

Example (2) Sale With 754 Election

250

Same as Example (1)
except the PSP makes
a section 754 Election

251

Beg. of Yr. 2 Balance Sheet

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	10,000	10,000	10,000	
Blackacre	2,000	2,000	6,000	
Total Assets	<u>12,000</u>	<u>12,000</u>	<u>16,000</u>	
Capital:				
A 25%	3,000	3,000	4,000	3,000
B 25%	3,000	3,000	4,000	3,000
C 50%	<u>6,000</u>	<u>6,000</u>	<u>8,000</u>	6,000
Total Capital	<u>12,000</u>	<u>12,000</u>	<u>16,000</u>	

252

Partner A sells A's entire 25% partnership interest to D at the beginning of Year 2 for \$4 million (no discount for simplicity).

253

Balance Sheet Following A's Sale to D

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	10,000	10,000	10,000	
Blackacre	2,000	2,000	6,000	
Total Assets	<u>12,000</u>	<u>12,000</u>	<u>16,000</u>	
Capital:				
D 25%	3,000	3,000	4,000	4,000
B 25%	3,000	3,000	4,000	3,000
C 50%	<u>6,000</u>	<u>6,000</u>	<u>8,000</u>	6,000
Total Capital	<u>12,000</u>	<u>12,000</u>	<u>16,000</u>	

254

Sec. 743(b) Adj.



$$\begin{aligned} & 4,000,000 \text{ O.B.}^* \\ - & \underline{3,000,000} \text{ Inside Basis}^{**} \\ = & \underline{1,000,000} \text{ Sec. 743(b) Adj.} \end{aligned}$$

* Cash + Debt Share (\$0 here)

** Same as seller's

255

When Blackacre is sold for \$6 million, the \$4 mil. gain is allocated:

\$1 mil. to D (25%)

\$1 mil. to B (25%)

\$2 mil. to C (25%)

256

On D's K-1:

\$1 mil. Sale Gain

\$1 mil. 743(b) Basis Adj.

Resulting net gain = \$0

D's O.B. is \$4 mil.

257

Neither tax nor book
basis capital accounts
were altered by the
section 743(b)
adjustment.

(See Reg. 1.704-1(b)(5)
Example 13(iii))

258

After Sale of Blackacre

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	16,000	16,000	16,000	
Total Assets	<u>16,000</u>	<u>16,000</u>	<u>16,000</u>	
Capital:				
D 25%	4,000	4,000	4,000	4,000
B 25%	4,000	4,000	4,000	4,000
C 50%	<u>8,000</u>	<u>8,000</u>	<u>8,000</u>	8,000
Total Capital	<u>16,000</u>	<u>16,000</u>	<u>16,000</u>	

259

40

Example (3) Section 743(b) Adjustment That Impacts Capital Accounts

260

Beg. of Yr. 2 Balance Sheet

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	10,000	10,000	10,000	
Blackacre	2,000	2,000	6,000	
Total Assets	<u>12,000</u>	<u>12,000</u>	<u>16,000</u>	
Capital:				
A 25%	3,000	3,000	4,000	3,000
B 25%	3,000	3,000	4,000	3,000
C 50%	<u>6,000</u>	<u>6,000</u>	<u>8,000</u>	6,000
Total Capital	<u>12,000</u>	<u>12,000</u>	<u>16,000</u>	

261

Partner A dies on
 January 2nd of Yr. 2
 and the partnership
 immediately purchases
 A's PSP interest from
 A's estate for \$4 million
 (net asset value)

262

Estate Bene. O.B.

- **FMV of PSP interest** on DOD (§1014(a)(1))
- +
- Share of **PSP debt** (§§752/742)
-
- **Value of PSP interest** attributable to **IRD** (§1014(c))

(Reg. 1.742-1)

263

After A Dies (before buy-out)

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	10,000	10,000	10,000	
Blackacre	2,000	2,000	6,000	
Total Assets	<u>12,000</u>	<u>12,000</u>	<u>16,000</u>	
Capital:				
Estate 25%	3,000	3,000	4,000	4,000
B 25%	3,000	3,000	4,000	3,000
C 50%	<u>6,000</u>	<u>6,000</u>	<u>8,000</u>	6,000
Total Capital	<u>12,000</u>	<u>12,000</u>	<u>16,000</u>	

264

Estate's Sec. 743(b) Adj.



$$\begin{aligned} & 4,000,000 \text{ O.B.}^* \\ & - \underline{3,000,000 \text{ Inside Basis}^{**}} \\ & = \underline{1,000,000 \text{ Sec. 743(b) Adj.}} \end{aligned}$$

* DOD FMV + Debt Share

** Same as seller's

265

Buy-Out Of the Estate

266

\$4 mil. Dist. To Estate
- \$4 mil. Estate O.B.
= \$0 Gain Recognized on
Liquidation (per
sections 731 and 732).

The estate did not use its
section 743(b) adjustment.

267

So, "the unused [743(b)]
special basis adjustment of
the distributee shall be applied
as an adjustment to the
partnership basis of the
property retained by the
partnership" when "the
distributee did not use [its]
special basis adjustment."

(Reg. 1.734-2(b)(1))

268

Tax and Book Basis Accounting Entries:

Debit:

\$3,000,000 Estate's Cap.

\$1,000,000 Blackacre

(unused 743(b) adj.)

Credit: \$4,000,000 Cash

269

Both tax **and book**
basis capital accounts
are increased by \$1
mil. for the Estate's
unused section 743(b)
adjustment.

(Reg. 1.704-1(b)(2)(iv)(m)(2))

270

Post-Liquidation Bal. Sheet.

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	6,000	6,000	6,000	
Blackacre	3,000	3,000	6,000	
Total Assets	<u>9,000</u>	<u>9,000</u>	<u>12,000</u>	
Capital:				
B (1/3)	3,000	3,000	4,000	3,000
C (2/3)	<u>6,000</u>	<u>6,000</u>	<u>8,000</u>	6,000
Total Capital	<u>9,000</u>	<u>9,000</u>	<u>12,000</u>	

271

If Blackacre is then sold for \$6 mil., the tax gain is \$3 mil. (instead of \$4 mil.) so B and C benefit from the 754 Election.

272

Reporting Sec. 743(b) Adjustments To the IRS

42

273

Form 1065 Schedule B, Question 12:

-
- 12a** Is the partnership making, or had it previously made (and not revoked), a section 754 election?
See instructions for details regarding a section 754 election.
- b** Did the partnership make for this tax year an optional basis adjustment under section 743(b) or 734(b)? If "Yes," attach a statement showing the computation and allocation of the basis adjustment. See instructions
- c** Is the partnership required to adjust the basis of partnership assets under section 743(b) or 734(b) because of a substantial built-in loss (as defined under section 743(d)) or substantial basis reduction (as defined under section 734(d))? If "Yes," attach a statement showing the computation and allocation of the basis adjustment. See instructions
-

274

Sec. 743 Adjustments:

- **On Sch. K and K-1**
- **Not reflected on the partnership balance sheet**

275

Sale or Exchange

- **Buyer notifies the partnership within 30 days.**
- **Notice includes purchase price and information to determine **outside basis.****
- **Partnership need not make Sec. 743 adjustments until it has notice.**

276

Beneficiary on Death of Partner

- Beneficiary notifies the partnership within **one year** of death.
- Notice includes the FMV of the partnership interest and **how determined.**
- Partnership may generally rely on the notice to determine O.B.

277

If partnership is aware of a transfer but does not have the proper information from the transferee, then the partnership must make a statement on **Form 1065 and the K-1** must state:

RETURN FILED PURSUANT TO REG. SEC. Reg. 1.743-1(k)(5).

Upon later receipt of info, may amend or report on following years Form 1065.

278

Invenergy Wind sale to Terraform

“Tax Characterization. With respect to the acquisition of the interests in the Acquired Partnership, each of the Parties hereto agrees that, for each taxable year in which the Closing Date occurs, all income, gains, losses, deductions, credits and other tax incidents resulting from the operations of the Acquired Partnership shall be allocated, as between Seller and Purchaser, using the "closing of the books" method permitted by Treasury Regulations and Code SS 706.

279

“The Seller shall deliver to the Purchaser a copy of the statement required under Treasury Regulations SS 1.751- 1(a)(3) setting forth in reasonable detail a good faith calculation of the amount of any gain or loss attributable to Code SS 751 property, and the amount of any gain or loss attributable to capital gain or loss on the sale of the partnership interests in the Acquired Partnership. Each of the Parties agree that each party hereto shall file all its federal income Tax Returns consistent with the foregoing and (ii) the Parties shall make no elections or take any actions inconsistent with the such treatment unless otherwise required by Law.”

280

TMCT, LLC

“Right to Make Section 754 Election. The Tax Matters Member may make or revoke, on behalf of the Company, all elections in accordance with Section 754 of the Code, so as to adjust the basis of Company property in the case of a distribution of property within the meaning of Section 734 of the Code, and in the case of a transfer of a Company interest within the meaning of Section 743 of the Code. Each Member shall, upon request of the Tax Matters Member, supply the information necessary to give effect to such an election.

281

Any Trust Member or Representative has the right to require the Tax Matters Member to make a Section 754 election.”

282

Florida Asset Resolution

“The Company shall make an election in accordance with Section 754 of the Code, so as to adjust the basis of Company property in the case of a distribution of property within the meaning of Section 734 of the Code and in the case of a transfer of a Company interest within the meaning of Section 743 of the Code, and the Company shall not apply for permission from the Commissioner of the Internal Revenue Service to revoke such election without the prior written consent of each Member (not to be unreasonably withheld).

283

Each of the Members shall, upon request of the Tax Matters Partner, supply the information necessary to give effect to such an election.”

284