



NORTHERN
TRUST

CONQUERING SUBCHAPTER K(RYPTONITE):

Fundamentals Of Partnership Taxation For Estate Planners

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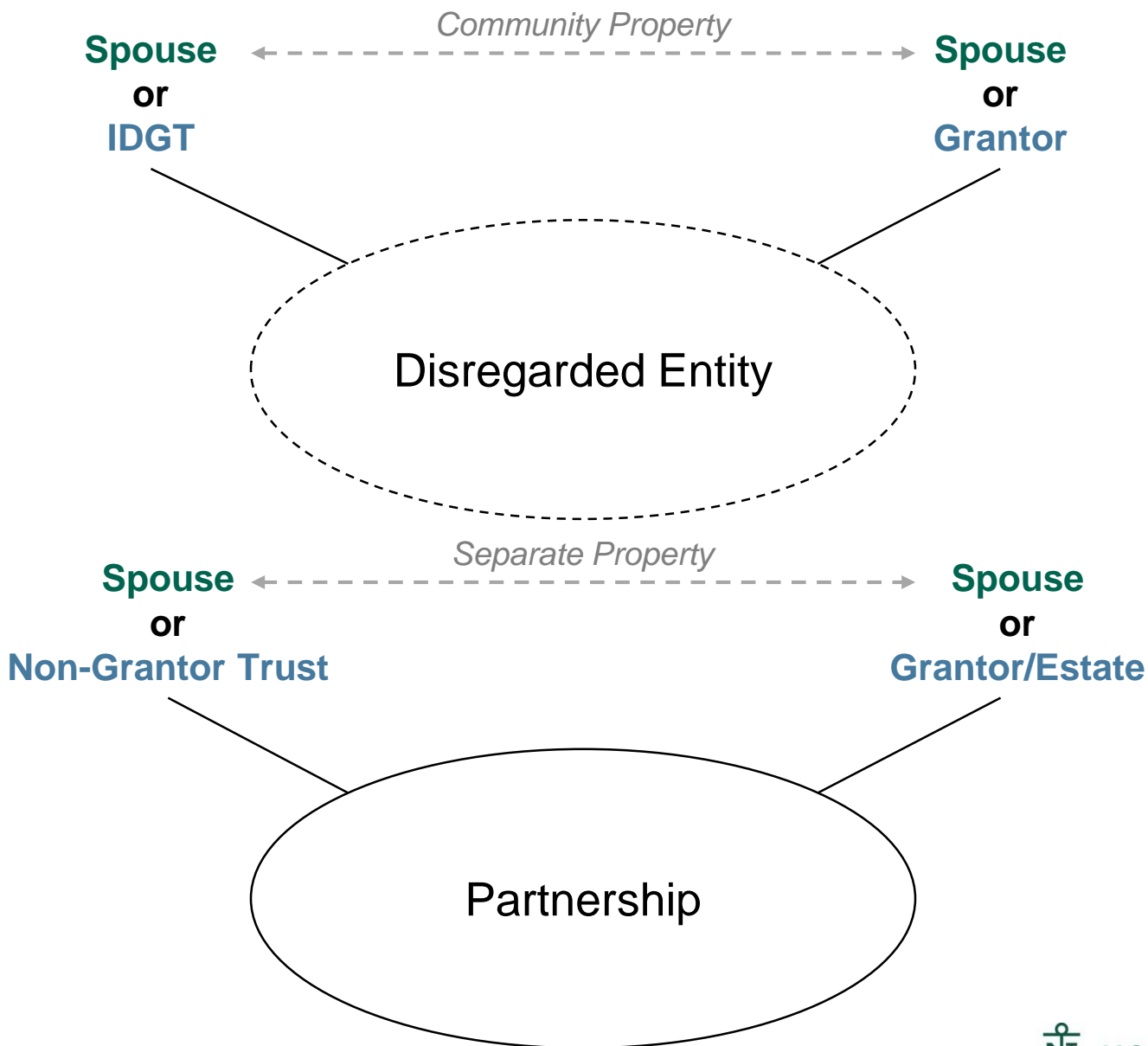
“Partnership” Formation: Choice of Entity/Check-The-Box

Entity Type	Number of Owners/ Taxpayers	Default	Check-the-Box
Limited Liability Company (LLC)	1	Disregarded Entity	C Corporation S Corporation
	2 or more	Partnership	C Corporation S Corporation
Limited Partnership (LP) Limited Liability Partnership (LLLP)	Always 2 or more	Partnership	C Corporation S Corporation
General Partnership (GP)	Always 2 or more	Partnership	C Corporation S Corporation

Don't assume default classification.
Limited Liability Companies and
partnerships are often taxed as
S Corporations and C Corporations

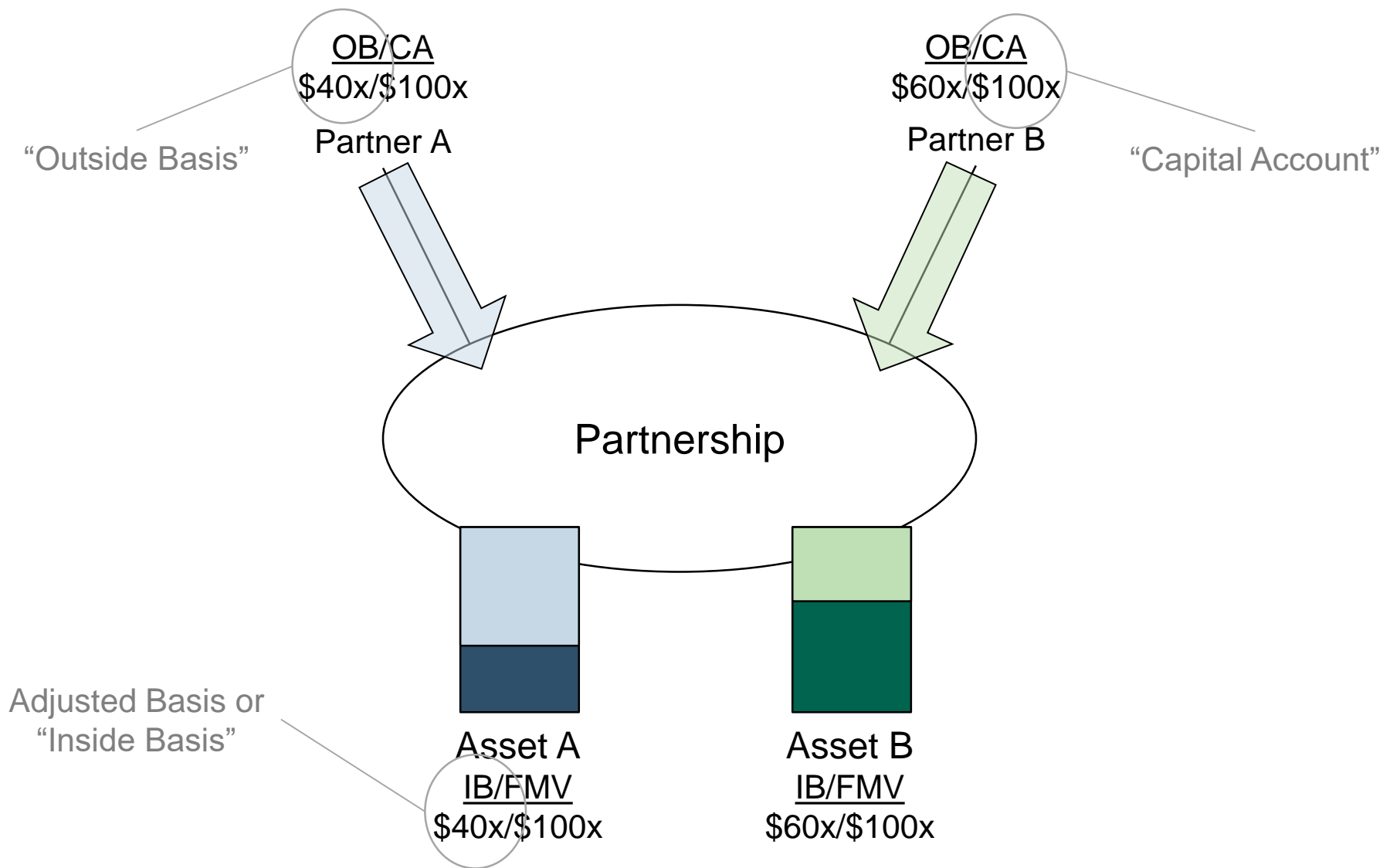


Disregarded Entity LLC Can Have More Than 1 Member



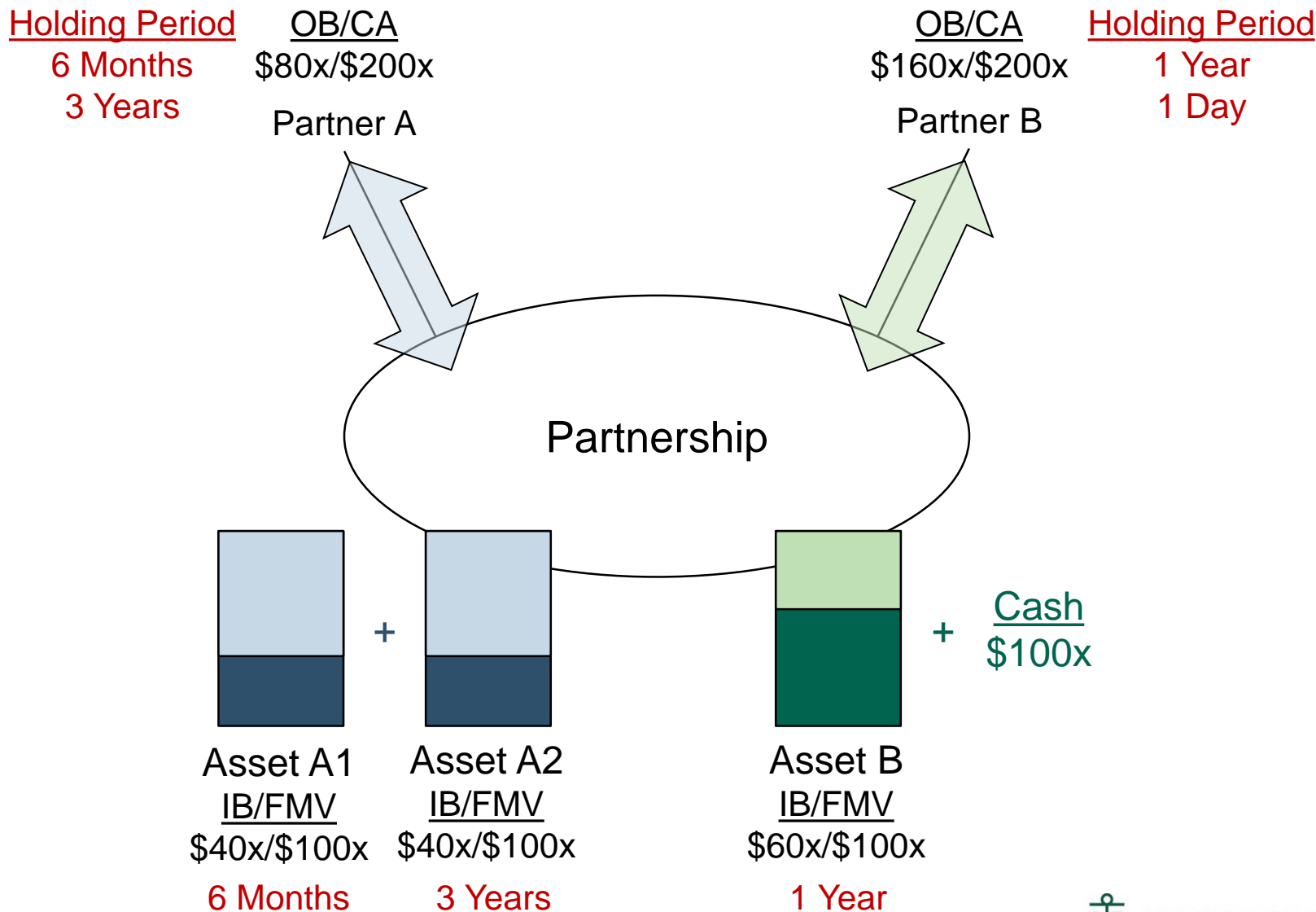


Contributions to Partnership Are Generally Non-Taxable



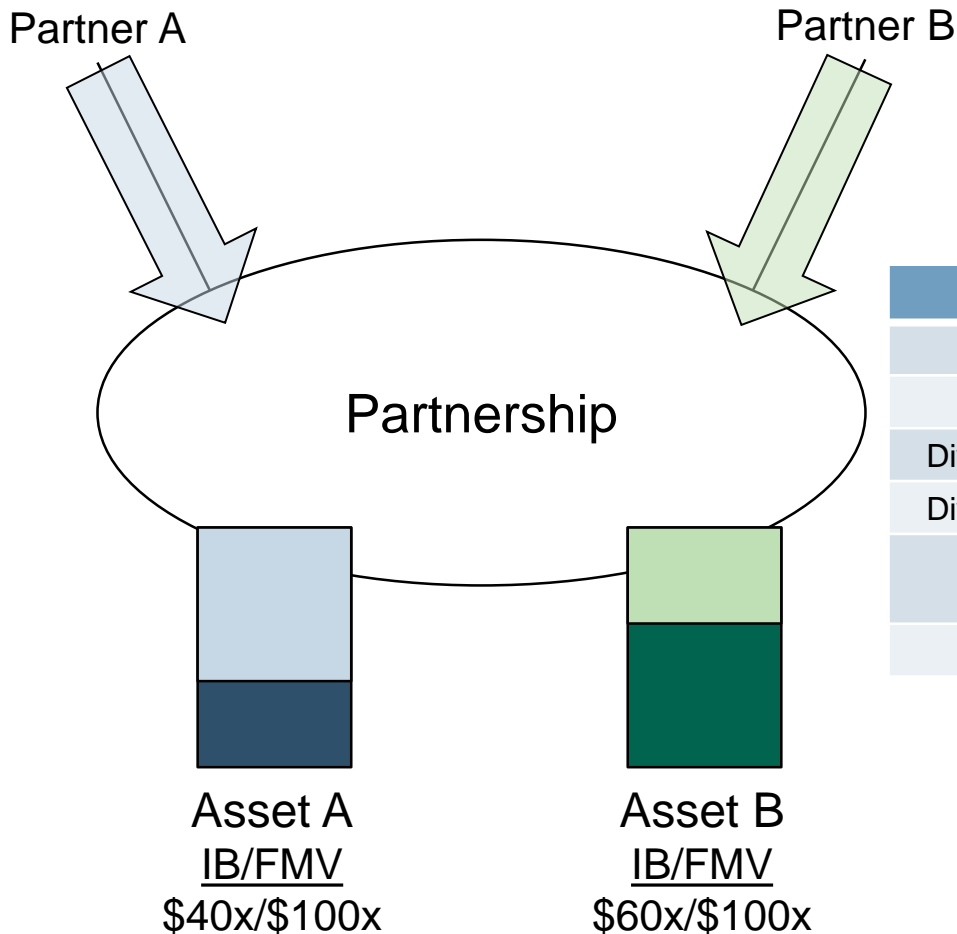


Tax Attributes Are Preserved Including Holding Period





Exception: Contributions to “Investment Company”



Diversification
+
>80% of value:

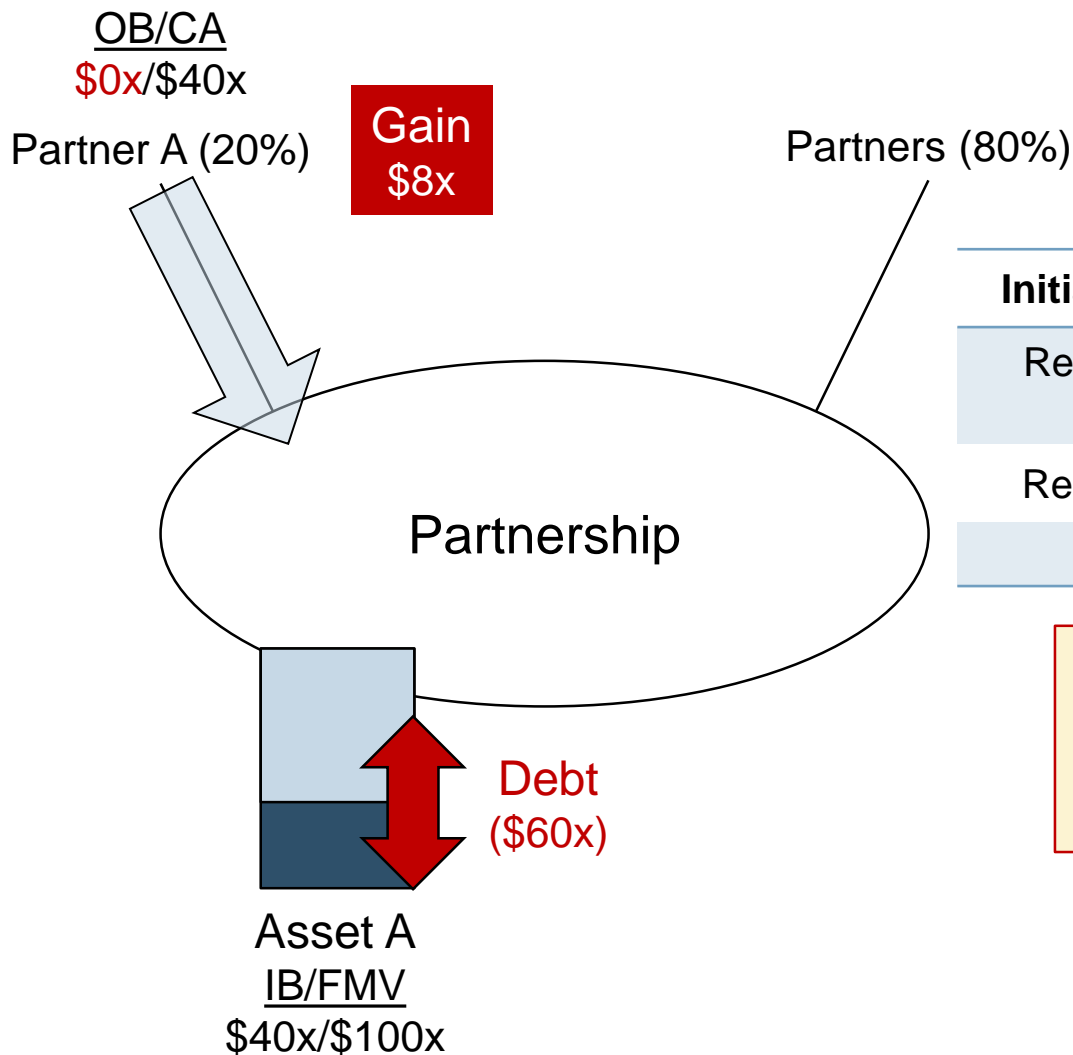
- Stock
- Securities
- Mutual Funds
- REITs

Asset A	Asset B	Result
Stock X	Stock Y	Gain
Stock X	Stock X	No Gain
Diversified Portfolio	Diversified Portfolio	No Gain
Diversified Portfolio	Stock Y	Gain (B)
Stock X	Stock Y + Real Property (20%)	No Gain
Stock X (<5%)	Diversified Portfolio	No Gain

If Partners A and B are spouses and Assets A and B are separate property, A and B should swap ½ of assets before contribution to partnership.
(IRC §§ 1041 and 2523)



Exception: Contributions of Mortgaged Property



Initial Outside Basis of A	\$40x
Reduced by Debt Relief (80% of -\$60x)	(\$48x)
Resulting Outside Basis	\$0x
Gain	\$8x

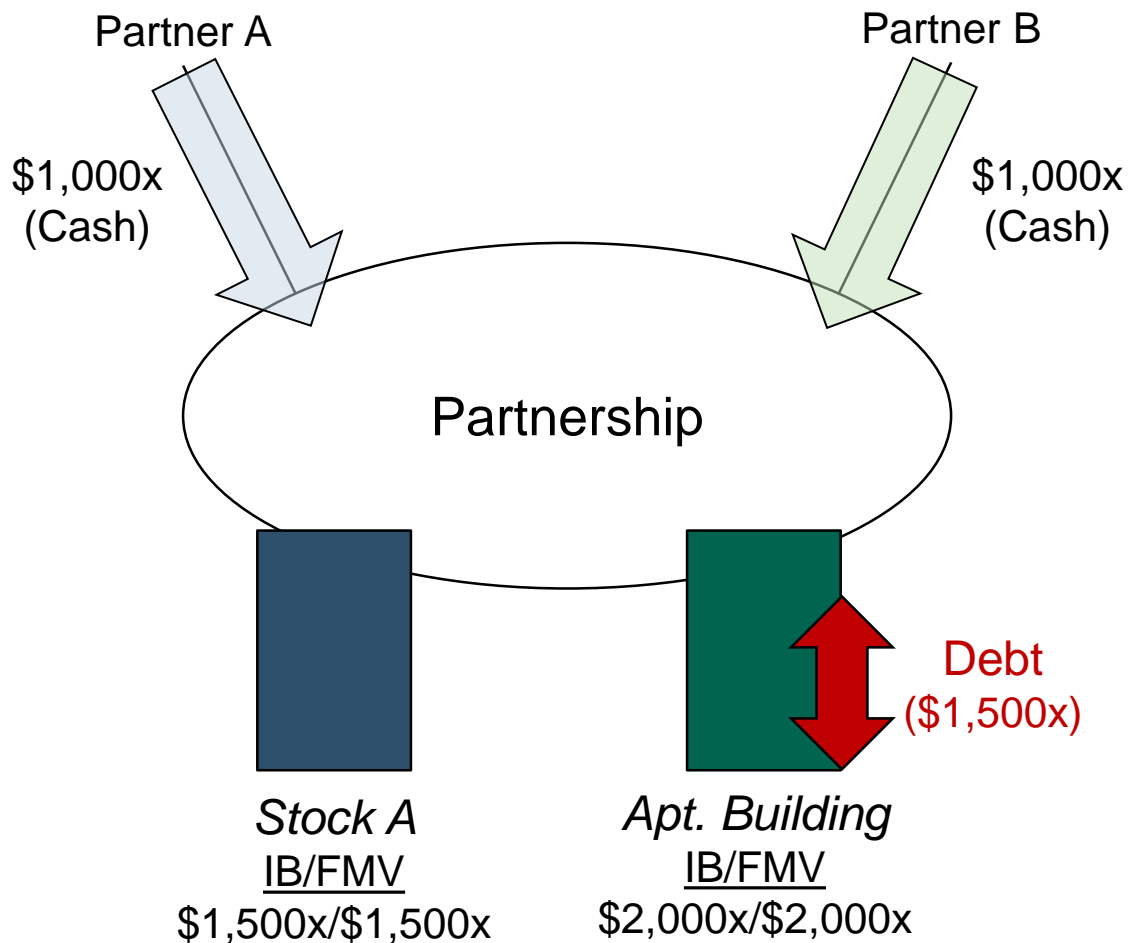
Relatively rare, but beware of:
 Low basis property,
 Highly mortgaged property, and
 Small % interest in the partnership

Gain can also be avoided if
 Partner A agrees to remain
 responsible for the debt
 (recourse as to Partner A)



Understanding Capital Accounts: Balance Sheet Concept

Example: A and B form a partnership, each contributing \$1,000x. A and B will be equal partners. The partnership purchases (i) an apartment building for \$2,000x, paying \$500x in cash and borrowing \$1,500x and mortgaging the building, and (ii) Stock A for \$1,500x.





Understanding Capital Accounts: Balance Sheet Concept

Example: A and B form a partnership, each contributing \$1,000x. A and B will be equal partners. The partnership purchases an apartment building for \$2,000x, paying \$500x in cash and borrowing \$1,500x and mortgaging the building.

AB Partnership Balance Sheet			
Assets		Liabilities	
Cash	\$1,500x	Mortgage	\$1,500x
Building	<u>\$2,000x</u>		_____
Total Assets	\$3,500x	Total Liabilities	\$1,500x
		Capital Accounts	
		Partner A	\$1,000x
		Partner B	<u>\$1,000x</u>
		Total Equity	\$2,000x

Partnership liabilities are not included in capital accounts

Think about capital accounts as the net equity each partner would receive if the partnership liquidated, paying off all debts in full.



Maintaining Capital Accounts

Default “Safe Harbor” Rules on Maintenance of Capital Accounts

Increased by:

- Money contributed
- Fair market value of contributed property (net of assumed liabilities)
- Allocations of partnership income and gain (including tax exempt income)

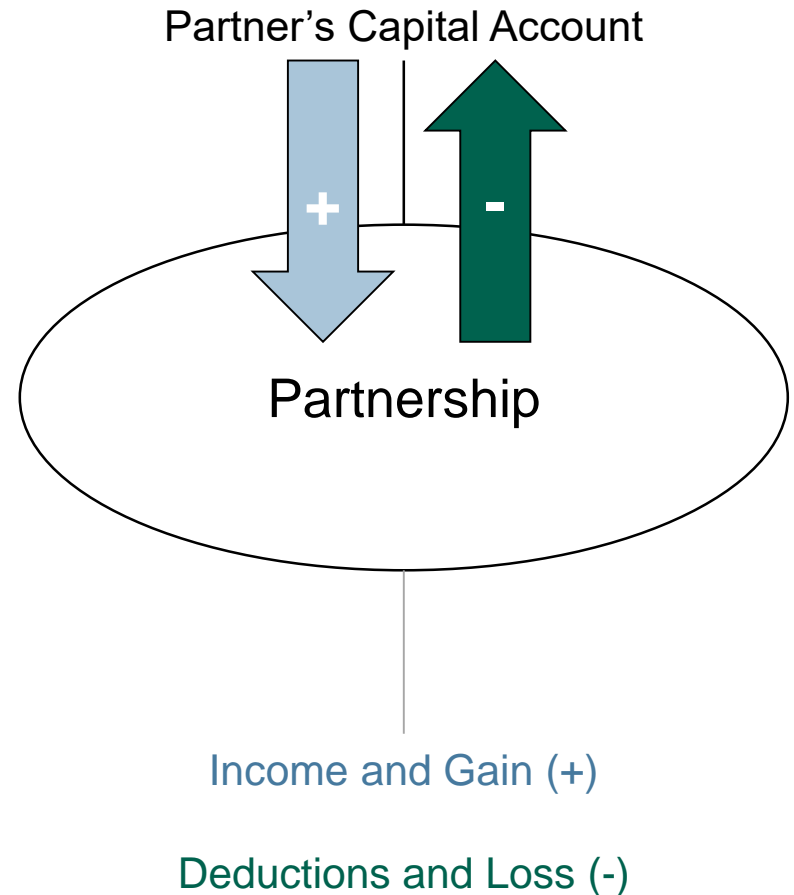
Decreased by:

- Money distributed
- Fair market value of distributed property (net of assumed liabilities)
- Allocations of partnership deductions and losses

“Substantial Economic Effect”

Almost all family partnership agreements:

- 1) Maintain capital accounts according to default rules
- 2) On liquidation of the partnership, distributions made according to capital account balances.





Outside Basis

Partner's Outside Basis

Increased by:

- Money contributed
- **Basis** of contributed property
- Allocations of partnership income and gain
- Share of partnership **liabilities**

Decreased by (but not below zero):

- Money distributed
- **Basis** of distributed property
- Allocations of partnership deductions and losses

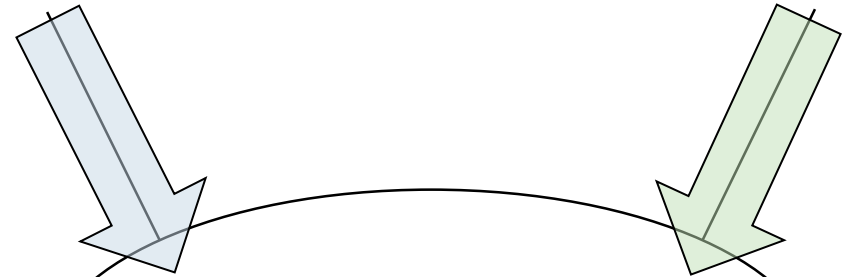
There is no such thing as
"negative basis."

OB/CA
\$40x/\$100x

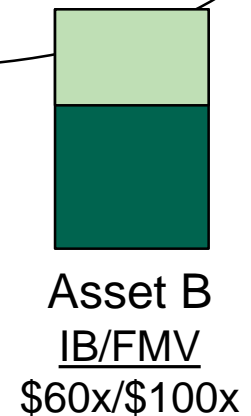
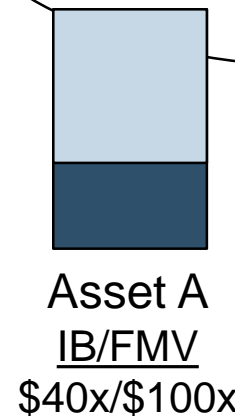
Partner A

OB/CA
\$60x/\$100x

Partner B



Partnership





How Is It Reflected on Partnership Books?

Example: A contributes Asset A (adjusted basis of \$40x and fair market value of \$100x) to a partnership; B contributes Asset B (adjusted basis of \$60x and fair market value of \$100x) A and B will be equal partners.

Partnership Balance Sheet					
Assets			Liabilities		
	Basis	Book			
Asset A	\$40x	\$100x	None		\$0x
Asset B	<u>\$60x</u>	<u>\$100x</u>			_____
Total Assets	\$100x	\$200x	Total Liabilities		\$0x
			Capital Accounts		
				Tax/Basis	Book
			Partner A	\$40x	\$100x
			Partner B	<u>\$60x</u>	<u>\$100x</u>
			Total Equity	\$100x	\$200x

“Book Tax Disparity”



Outside Basis & Capital Account: Similarities & Differences

Partner's Outside Basis

Increased by:

- Money contributed
- **Basis** of contributed property
- Allocations of partnership income and gain
- Share of partnership **liabilities**

Decreased by (but not below zero):

- Money distributed
- **Basis** of distributed property
- Allocations of partnership deductions and losses

Capital Accounts

Increased by:

- Money contributed
- **Fair market value** of contributed property (net of assumed liabilities)
- Allocations of partnership income and gain

Decreased by:

- Money distributed
- **Fair market value** of distributed property (net of assumed liabilities)
- Allocations of partnership deductions and losses

Why is outside basis important?

- Determines amount of money that can be distributed without gain
- Partnership losses are allowable only to the extent of outside basis
- Determines amount of gain or loss recognized on a taxable sale of partnership interest
- Helps maintain historic tax basis of property (contributions & distributions are tax free)

Outside Basis can not go below zero.
Capital Account can be negative.



Why Do Partnership Liabilities Increase Outside Basis?

Compare: A and B each have \$500x. A and B each borrow an additional \$500x. A and B contribute \$1,000x each to a partnership. The partnership buys Asset A worth \$2,000x. Partnership elects “bonus depreciation” on Asset A under Section 168(k), generating an immediate \$2,000x expense deduction.

	<u>Partner A</u> <u>OB/CA</u>	<u>Partner B</u> <u>OB/CA</u>
Beginning of Year	\$1,000x/\$1,000x	\$1,000x/\$1,000x
End of Year	<u>OB/CA</u> \$0x/\$1,000x	<u>OB/CA</u> \$0x/\$1,000x

Compare: A and B each have \$500x, and they each contribute 500x to a partnership. The partnership borrows \$1,000x and buys Asset A worth \$2,000x. Partnership elects “bonus depreciation” on Asset A under Section 168(k), generating an immediate \$2,000x expense deduction.

	<u>Partner A</u> <u>OB/CA</u>		<u>Partner B</u> <u>OB/CA</u>
Beginning of Year	\$1,000x/\$500x	If A and B only had \$500x in outside basis, they would not be able to use the entire deduction. They would be limited to basis.	\$1,000x/\$500x
End of Year	<u>OB/CA</u> \$0x/\$500x		<u>OB/CA</u> \$0x/\$500x



Inside Basis/Outside Basis/Capital Accounts

Example: A and B form a partnership, each contributing \$1,000x. A and B will be equal partners. The partnership purchases (i) an apartment building for \$2,000x, paying \$500x in cash and borrowing \$1,500x and mortgaging the building, and (ii) Stock A for \$1,500x.

Partnership Balance Sheet					
Assets			Liabilities		
	Basis	Book			
Stock	\$1,500x	\$1,500x	Mortgage		\$1,500x
Building	<u>\$2,000x</u>	<u>\$2,000x</u>			_____
Total Assets	\$3,500x	\$3,500x	Total Liabilities		\$1,500x
			Capital Accounts		
				Tax/Basis	Book
			Partner A	\$1,750x	\$1,000x
			Partner B	<u>\$1,750x</u>	<u>\$1,000x</u>
			Total Equity	\$3,500x	\$2,000x



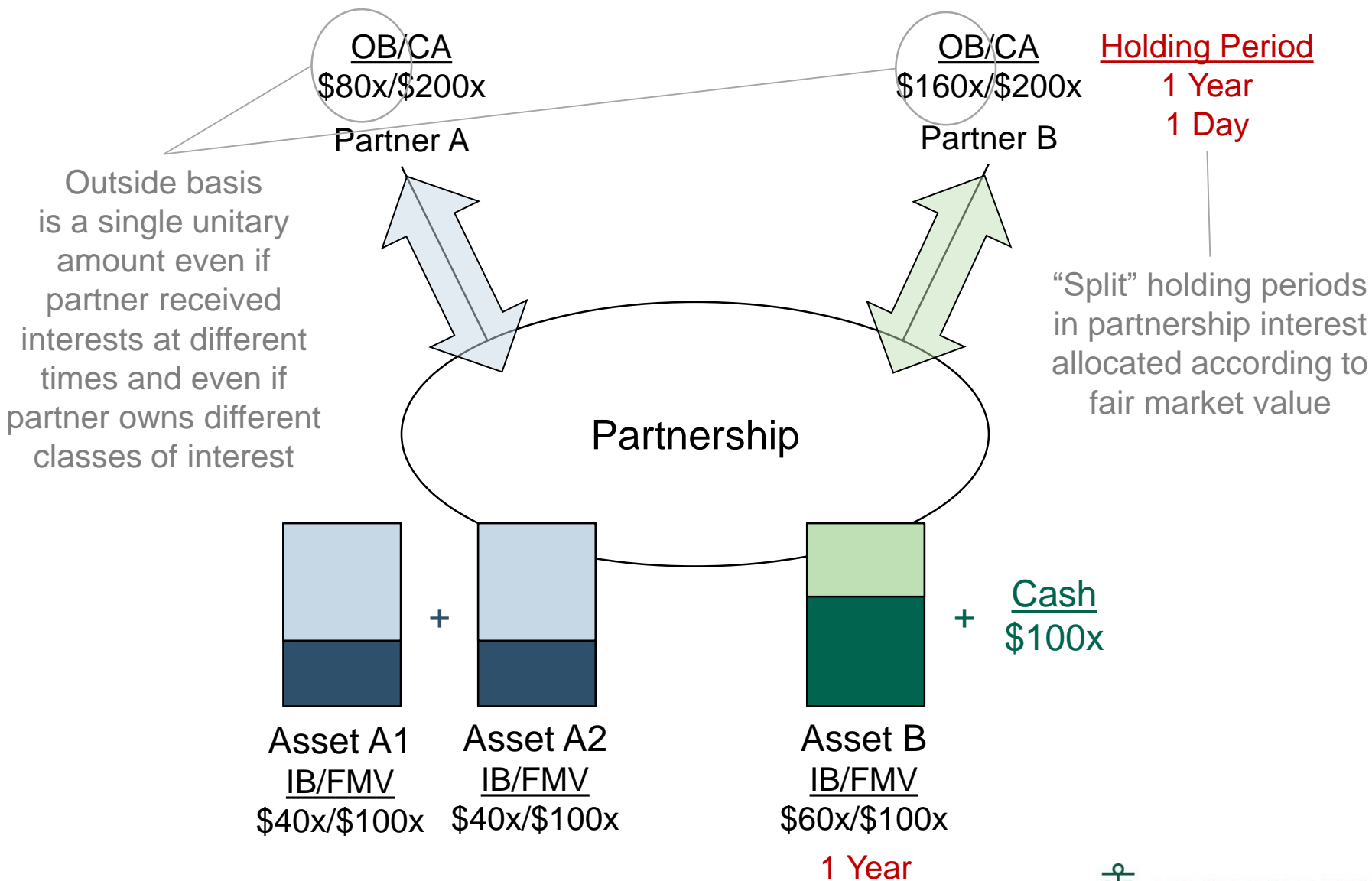
Inside Basis/Outside Basis/Capital Accounts

Example: In year one: (i) the apartment building generates (\$100x) in depreciation deductions and \$200 in rental income; and (ii) the stock earns \$100 in dividends. Total net income is \$200x.

Partnership Balance Sheet					
Assets			Liabilities		
	Basis	Book			
Cash	\$300x	\$300x	Mortgage		\$1,500x
Stock	\$1,500x	\$1,500x			_____
Building	<u>\$1,900x</u>	<u>\$1,900x</u>	<i>Total Liabilities</i>		<i>\$1,500x</i>
<i>Total Assets</i>	<i>\$3,700x</i>	<i>\$3,700x</i>	Capital Accounts		
				Tax/Basis	Book
			Partner A	\$1,850x	\$1,100x
			Partner B	<u>\$1,850x</u>	<u>\$1,100x</u>
			<i>Total Equity</i>	<i>\$3,700x</i>	<i>\$2,200x</i>

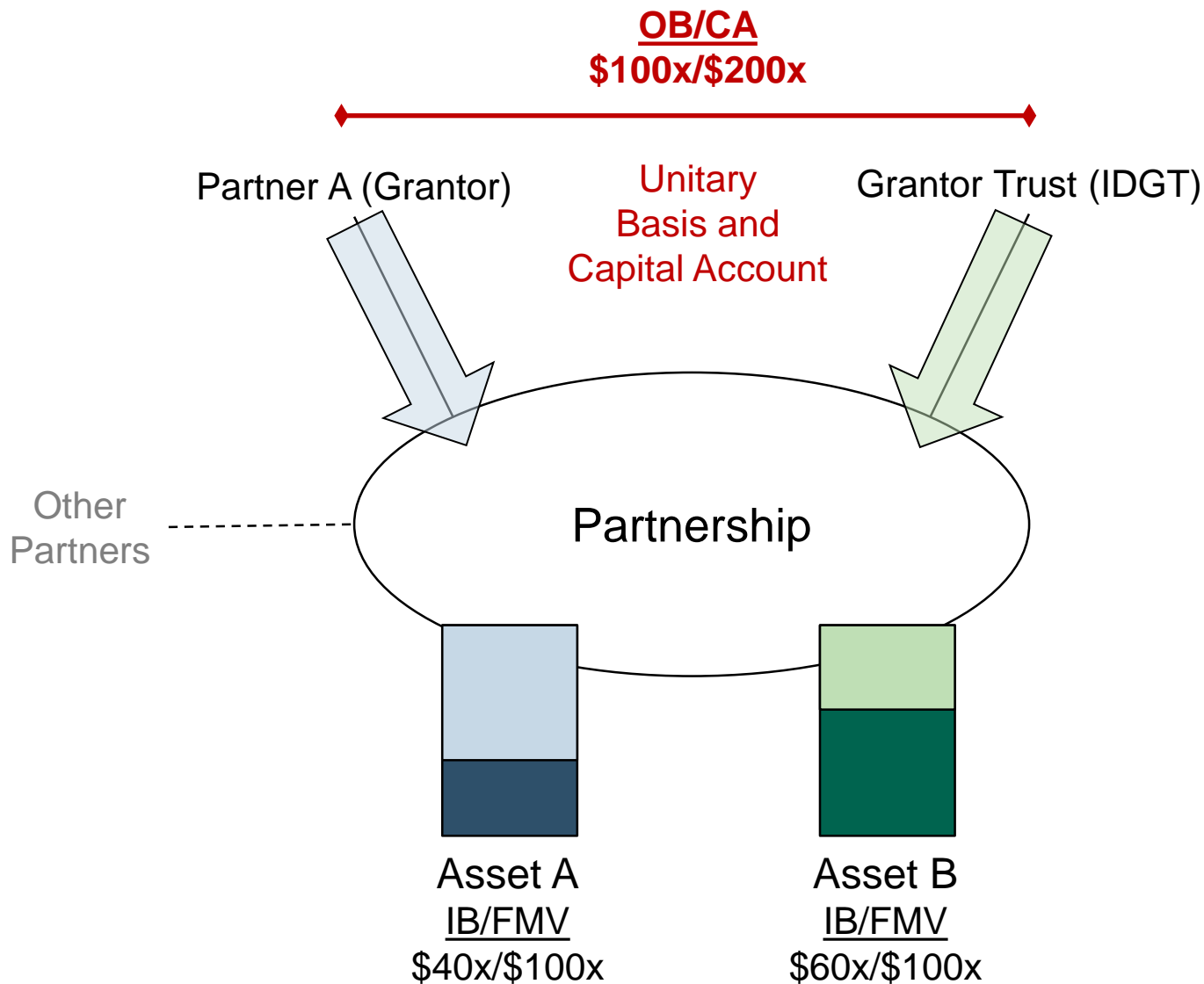


Unitary Basis Rule





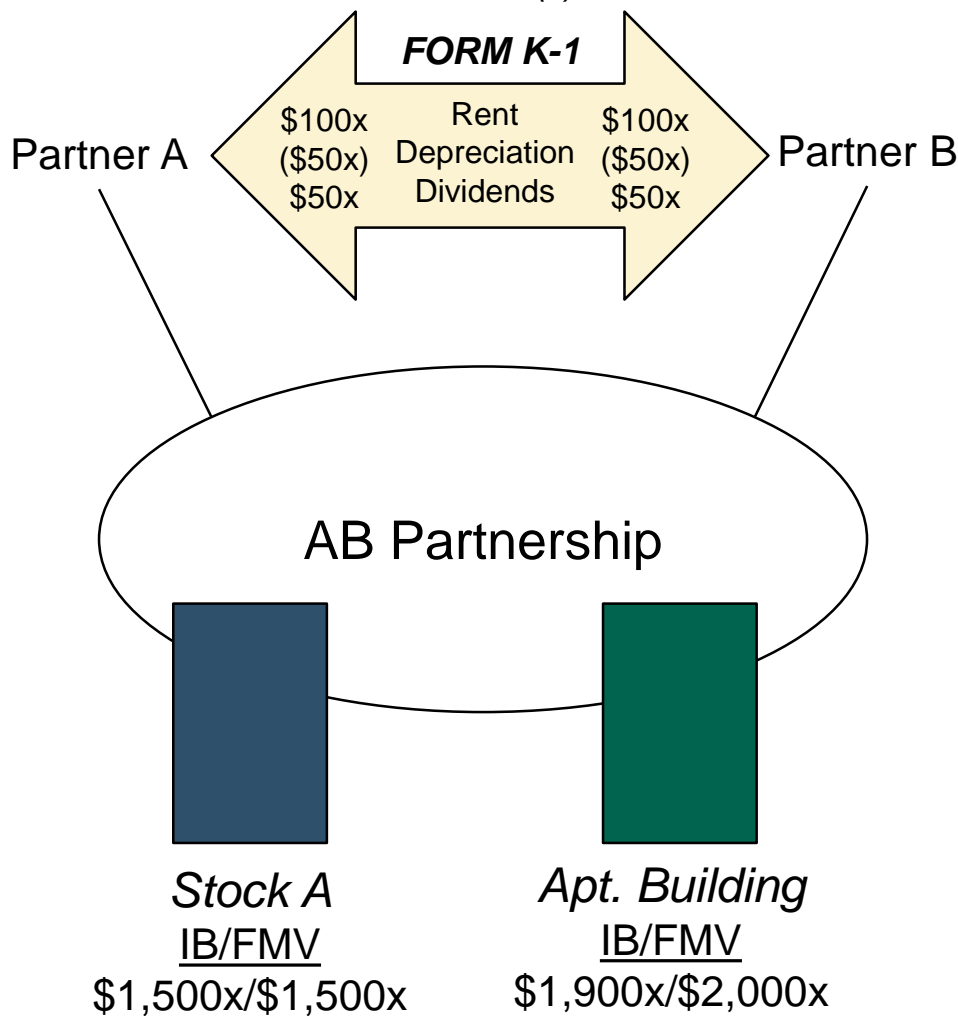
Unitary Basis Rule Applies to Grantors and Grantor Trusts





Pass-Through Taxation: Allocation of Tax Items

Example: A and B form a partnership, each contributing \$1,000x. A and B will be equal partners. Partnership purchases (i) an apartment building for \$2,000x, paying \$500x in cash and borrowing \$1,500x and mortgaging the building, and (ii) Stock A for \$1,500x. In year one: (i) the apartment building generates (\$100x) in depreciation deductions and \$200 in rental income; and (ii) the stock earns \$100 in dividends.



Allocation of tax items in most FLPs

- Usually “pro rata” according to capital account balances.
- § 2701 (Chapter 14) does not apply to transfers of the “same class.”

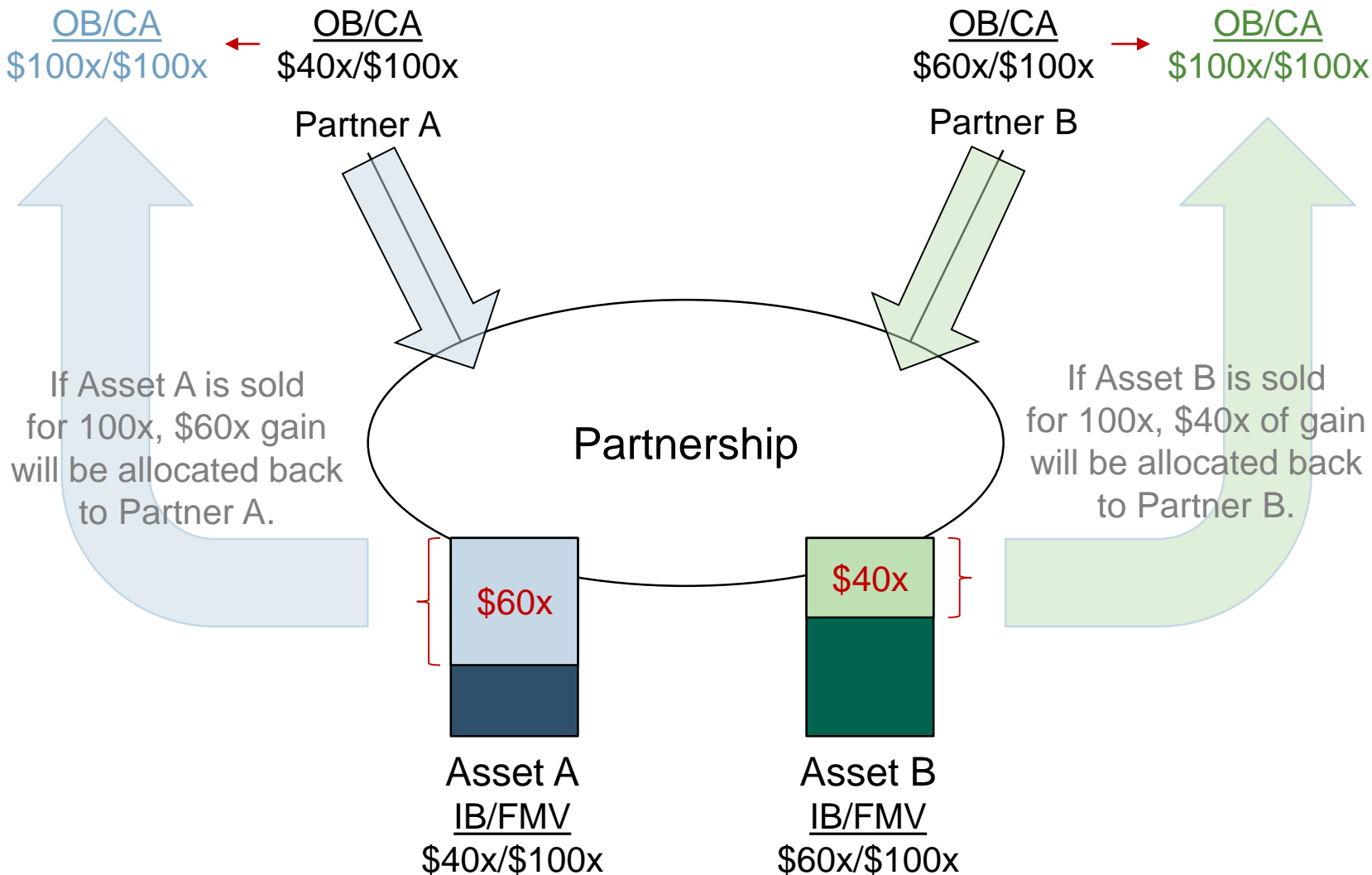
Allocation Does Not Mean Cash Flow

- Strongly consider a tax distribution clause in the partnership agreement.
- Allocations of income will increase outside basis, and distributions will decrease outside basis.
- Tax distribution will NOT trigger gain.



What Is Section 704(c)?

Built-in gain or loss on *contributed* property is allocated back to the contributing partner.





Section 704(c) on the Partnership Books

Example: A contributes Asset A (adjusted basis of \$40x and fair market value of \$100x) to a partnership; B contributes Asset B (adjusted basis of \$60x and fair market value of \$100x) A and B will be equal partners.

AB Partnership Balance Sheet

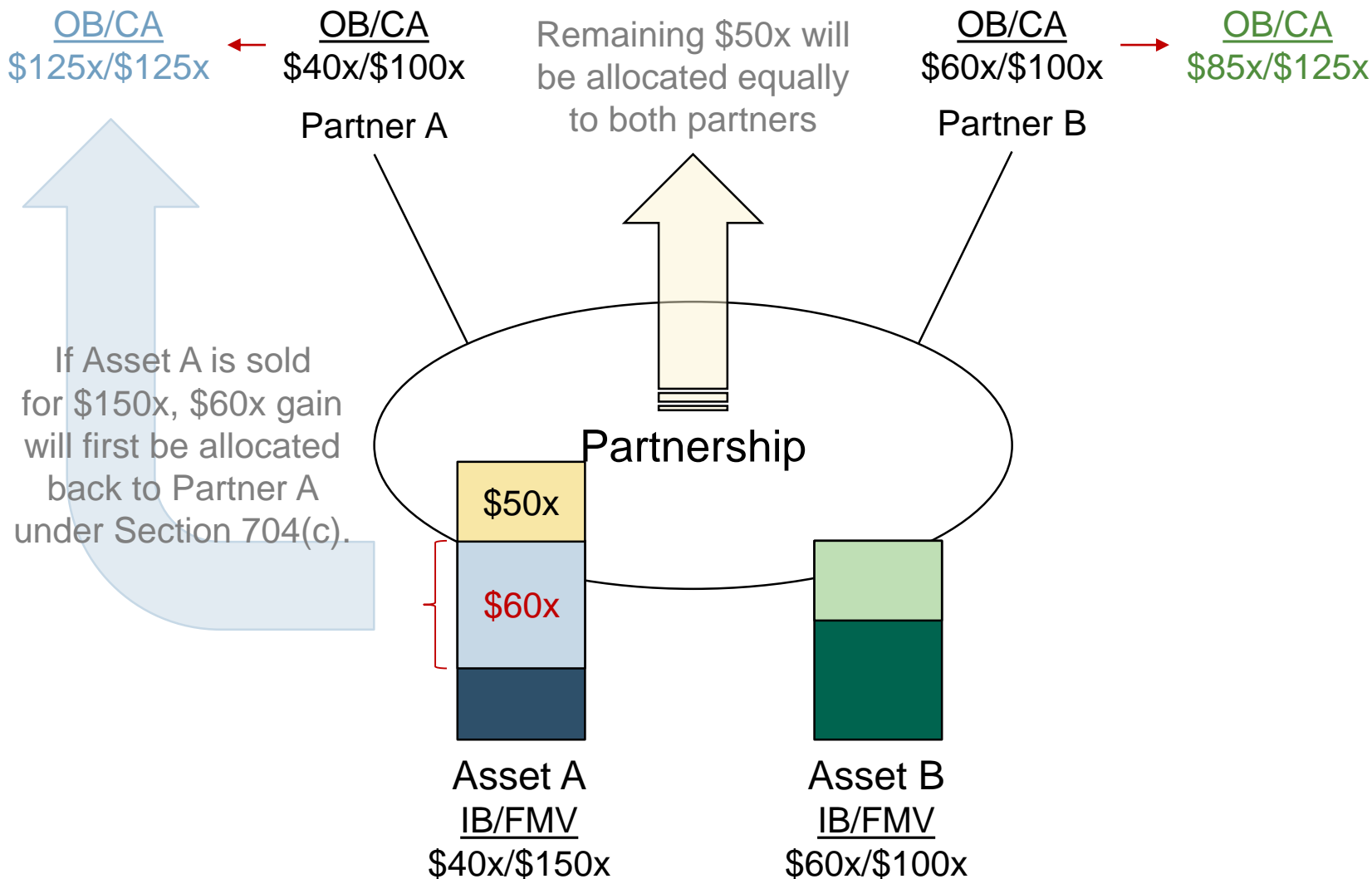
Assets			Liabilities		
	Basis	Book			
Asset A	\$40x	\$100x	None		\$0x
Asset B	<u>\$60x</u>	<u>\$100x</u>			
Total Assets	\$100x	\$200x	Total Liabilities		\$0x
			Capital Accounts		
				Tax	Book
			Partner A	\$40x	\$100x
			Partner B	<u>\$60x</u>	<u>\$100x</u>
			Total Equity	\$100x	\$200x

“Book Tax Disparity”
Partner A = \$60x
Partner B = \$40x

- Section 704(c) gain allocated to a partner will NOT increase/decrease capital account because capital accounts were credited at fair market value when contributed.
- Section 704(c) gain will increase/decrease outside basis.



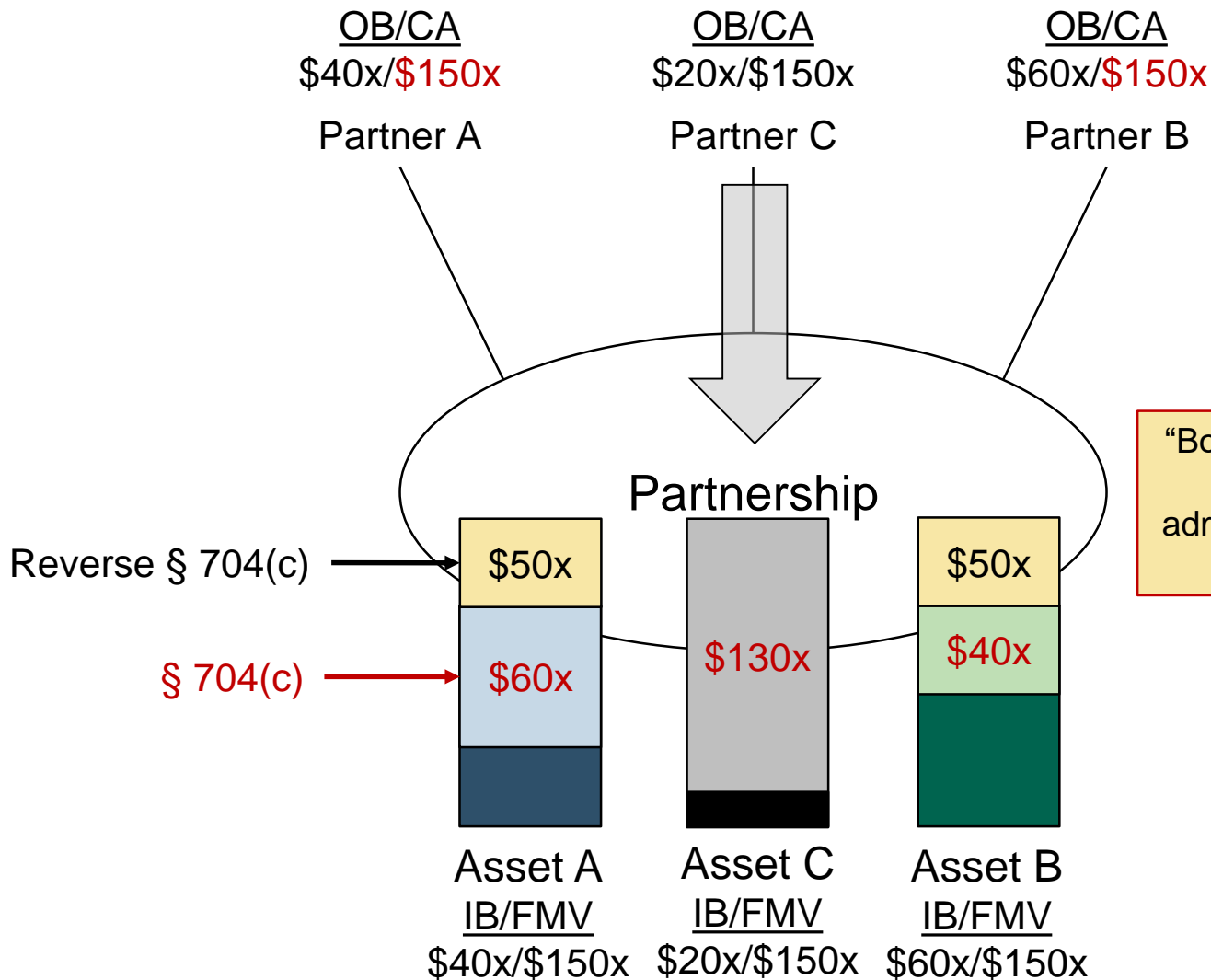
What Is Section 704(c)?





What in the Name of All That Is Holy Is “Reverse” 704(c)?

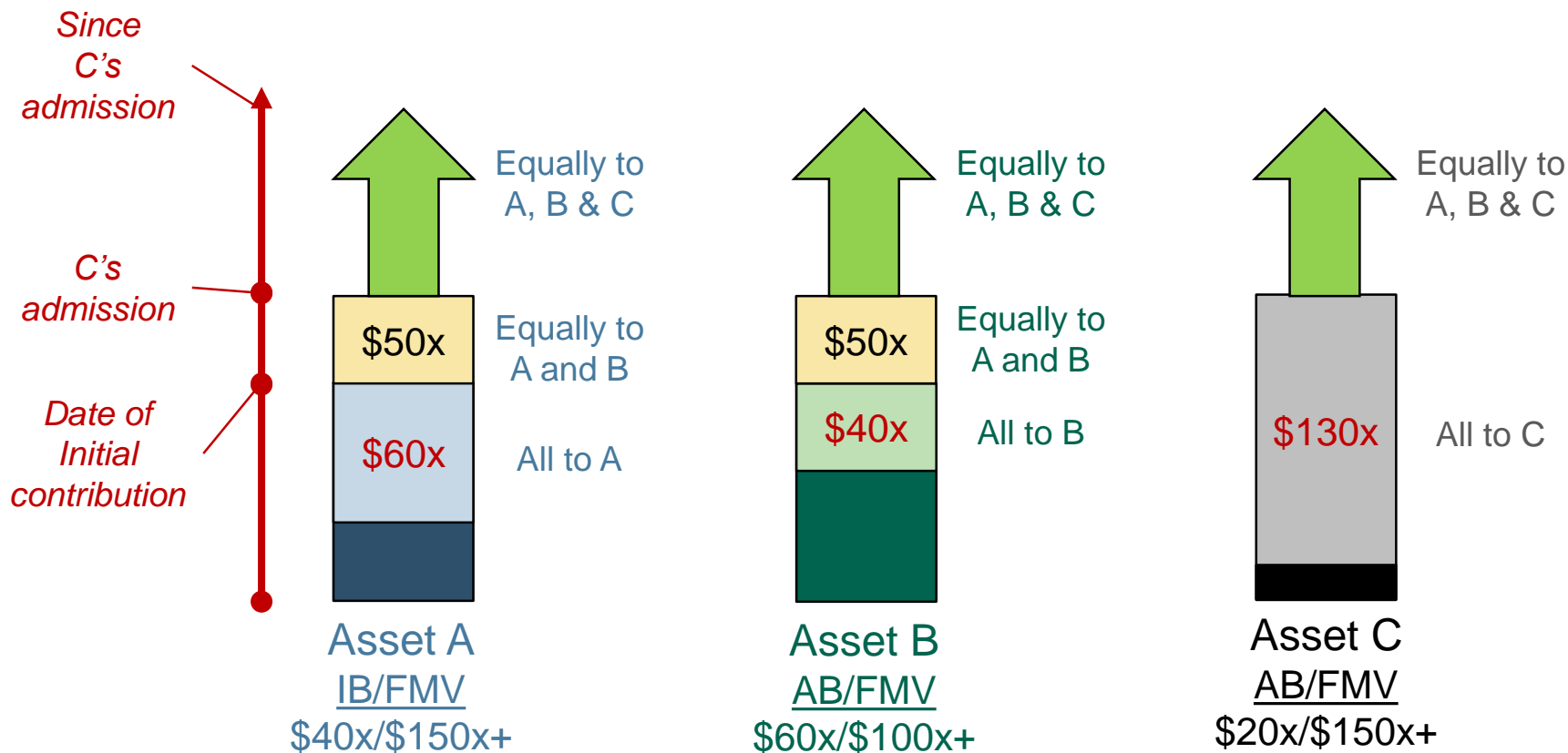
Example: Asset A and B both appreciate to \$150x in value. At that time Partner C is admitted as an equal 1/3 partner and Partner C contributes Asset C with an adjusted basis of \$20x and a fair market value of \$150x.





What in the Name of All That Is Holy Is “Reverse” 704(c)?

“Book up” of capital accounts to ensure that only pre-admission gain is allocated to the original partners.

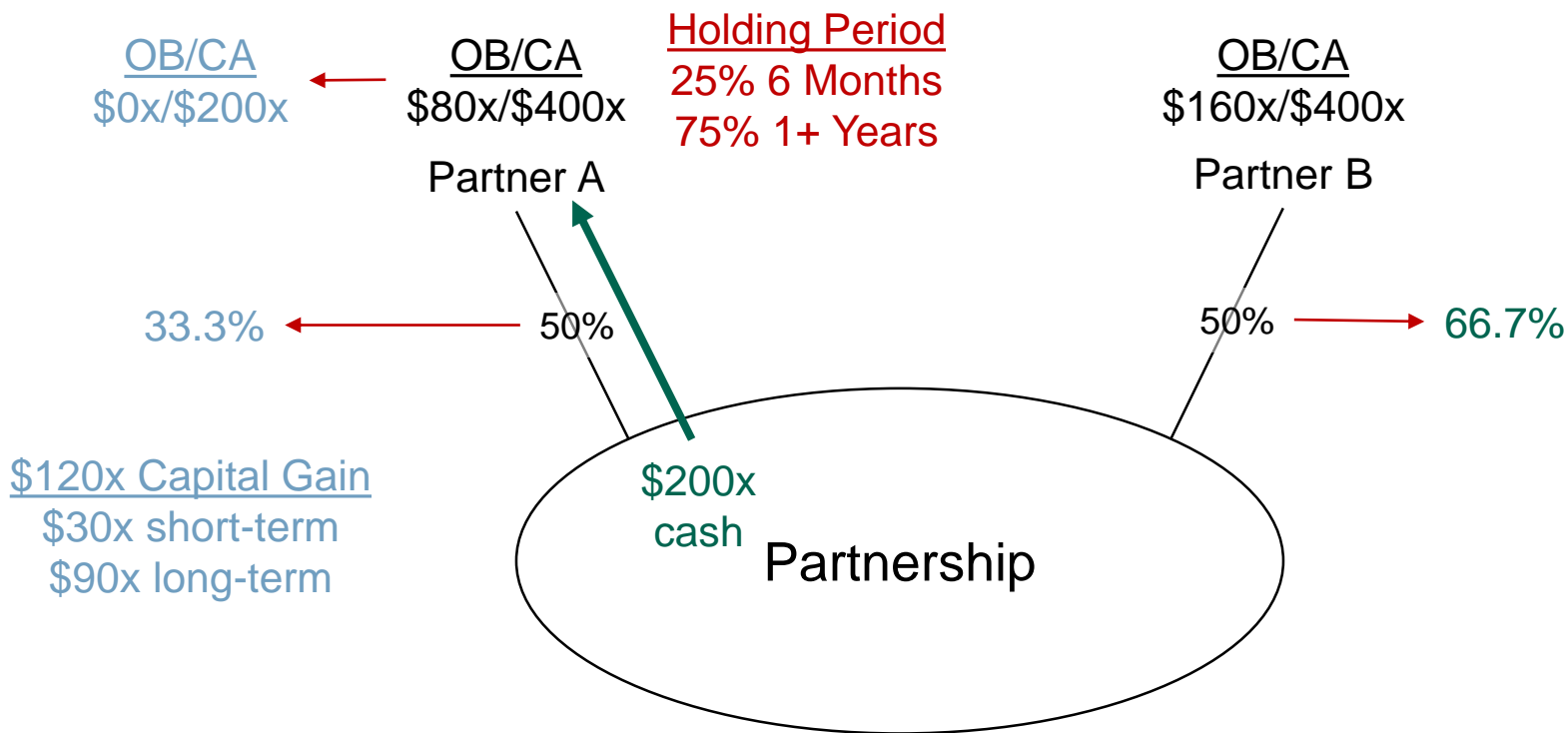




Cash Distributions: Tax Free Up to Outside Basis

Assumed to be non-liquidating or “current” distributions unless the distribution terminates the partner’s interest in the partnership (“liquidating distributions”).

Current cash distributions can only result in gain. Liquidating cash distributions can result in gain **and loss**.

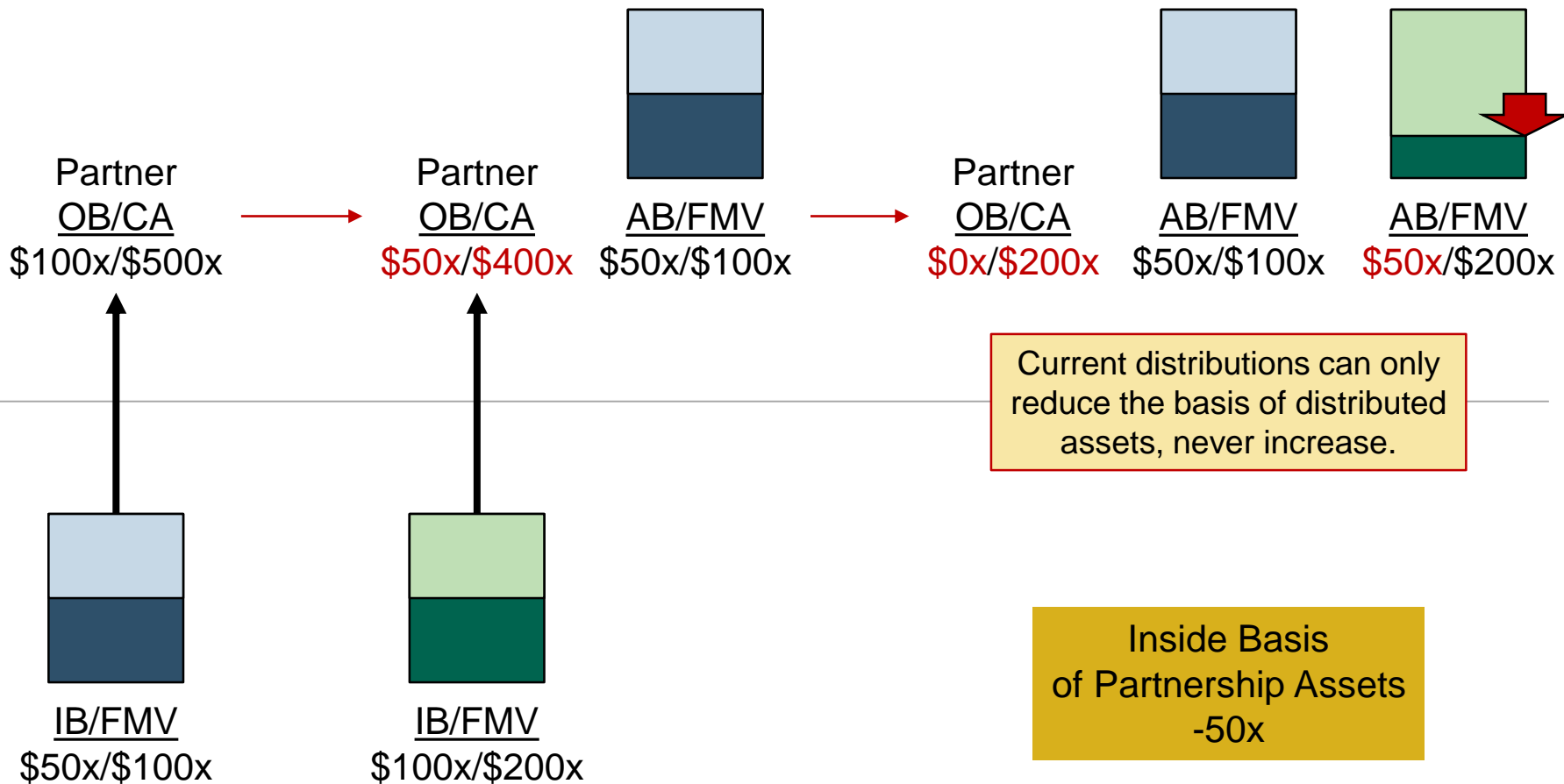


With “pro rata” family partnerships, to maintain a single class share, distributions of cash must be pro rata, or if there is a disproportionate distribution, then percentage interests (e.g., capital account balances) must be adjusted



Current Distributions of Property Are Generally Non-Taxable

Outside Partnership



Inside Partnership



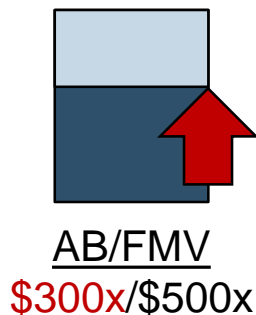
Liquidating Distributions of Property Are Different

Outside Partnership

Partner
OB/CA
\$300x/\$500x



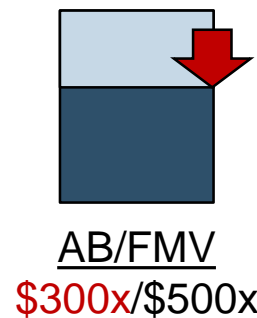
Ex-Partner
OB/CA
\$0x/\$0x



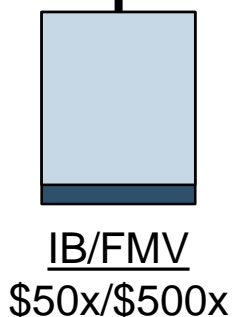
Partner
OB/CA
\$300x/\$500x



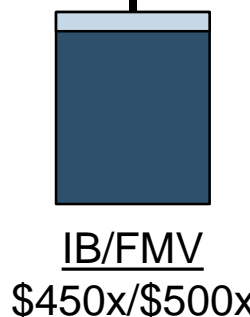
Ex-Partner
OB/CA
\$0x/\$0x



Liquidating distributions can increase and decrease the basis of distributed assets.



Inside Basis
of Partnership Assets
+250x



Inside Basis
of Partnership Assets
-150x

Inside Partnership



Liquidating Distributions Can Create Gain or Loss

Outside Partnership

Partner <u>OB/CA</u> \$400x/\$500x	→	Ex-Partner <u>OB/CA</u> \$0x/\$0x	<u>Cash</u> \$500x	Gain \$100x
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Partner <u>OB/CA</u> \$600x/\$500x	→	Ex-Partner <u>OB/CA</u> \$100x/\$0x	<u>Cash</u> \$500x	Loss -\$100x
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Cash
\$500x

Partner <u>OB/CA</u> \$600/500x	→	Ex-Partner <u>OB/CA</u> \$0x/\$0x	<u>AB/FMV</u> \$600x/\$500x
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IB/FMV
\$300x/\$500x

No loss on the distribution, but loss is transferred to the asset which can be sold to realize a loss.



Inside Partnership



Current vs. Liquidating Distributions

Current Distributions

- Only gain (not loss) can be recognized by distributee.
- Basis of in-kind property distributed to a partner is the *lesser* of:
 - ◆ Inside basis of the property; and
 - ◆ Outside basis of distributee partner.
- When outside basis is less than inside basis, basis of property is reduced or lost to the partnership.

Liquidating Distributions

- Gain *and* loss can be recognized by distributee.
- Basis of in-kind property distributed to a partner will be the outside basis of the distributee partner.
- Distributions can result in an increase *and* decrease in basis of the property. The inside basis adjustment can:
 - ◆ Increase the basis of partnership property (for a reduction of basis in the distributed property)
 - ◆ Decrease the basis of partnership property (for an increase of basis in the distributed property)



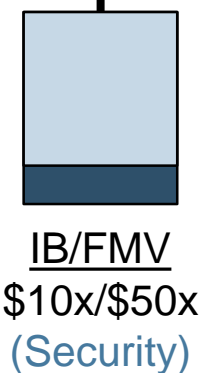
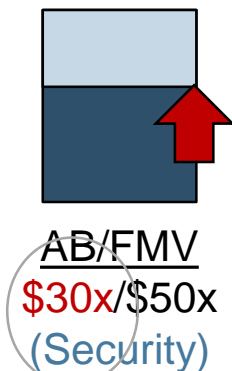
Exception: Distributions of Marketable Securities

Outside Partnership

Gain
\$20x

Partner
OB/CA
\$30x/\$200x

Partner
OB/CA
\$20x/\$150x



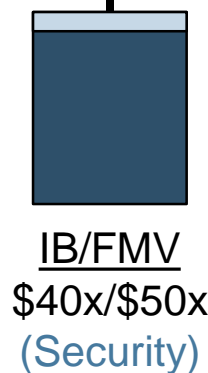
Treated as money but only for purposes of gain (not loss).
Gain reflected in the distributed security (+\$20x of basis).

Inside Partnership

Gain
\$20x

Partner
OB/CA
\$30x/\$200x

Partner
OB/CA
\$0x/\$150x



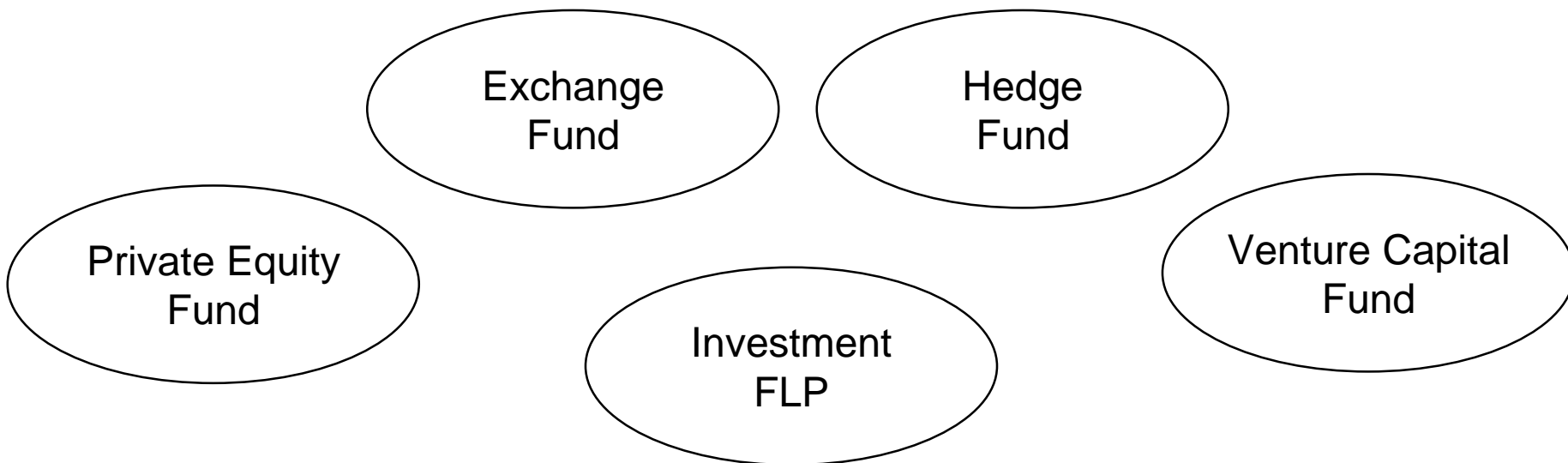
Basis in Security
(i) reduced by -\$10x to \$30x,
+
(ii) increased by gain of \$20x.



Exception to the Exception: Investment Partnerships

“Investment Partnership”
§ 731(c)(3)(C) of the Code:

- Never engaged in a trade business.
- “Substantially all” (e.g., 90%) assets are (have been):
 - Money
 - Stock in a corporation (including pre-IPO shares)
 - Notes, bonds, debentures, or other debt
 - Derivative financial instruments (e.g., options, futures, short positions)
- All distributions to “eligible partners.”





Exception: Disguised Sale Rules

Elements of a "Disguised Sale" (Facts and Circumstances):

1. Contribution of money or property by partner to partnership
2. Related transfer of money or property by the partnership to the partner
3. When viewed together, properly characterized as a sale or exchange

2-Year Rebuttable Presumption

Outside Partnership

(1)

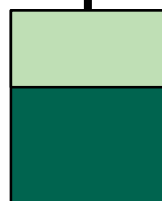
Partner
OB/CA
\$40x/\$100x



IB/FMV
\$40x/\$100x

(2)

Partner
OB/CA
\$40x/\$200x



IB/FMV
\$40x/\$60x
Cash
\$40x

Inside Partnership

No Disguised Sale

Partner
OB/CA
\$0x/\$100x



AB/FMV
\$0x/\$60x

Disguised Sale

Gain
\$60x

Partner
OB/CA
\$60x+/\$100x+



AB/FMV
\$60x/\$60x

Gain to Partner.
Deemed sale of
contributed property.

Gain
\$20x

Partnership level gain on distributed asset which may or may not be allocated to Partner

Distributions of current profits will not trigger a disguised sale.



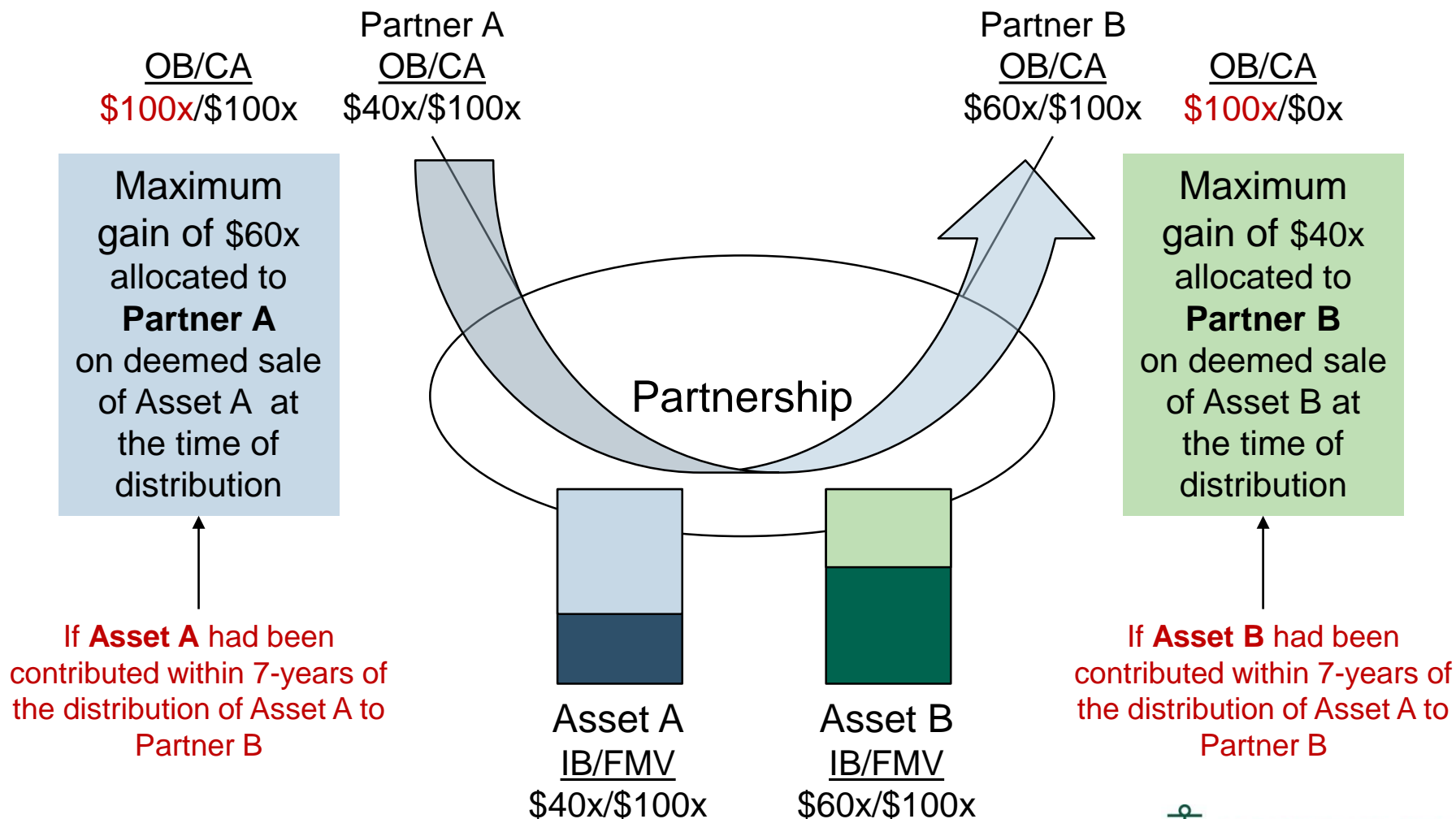
Exception: Mixing Bowl Rules

2 Forms of "Mixing Bowl" Transactions:

1. Contributed property distributed to another partner, **OR**
2. Other property distributed to contributing partner

7-Year Rule

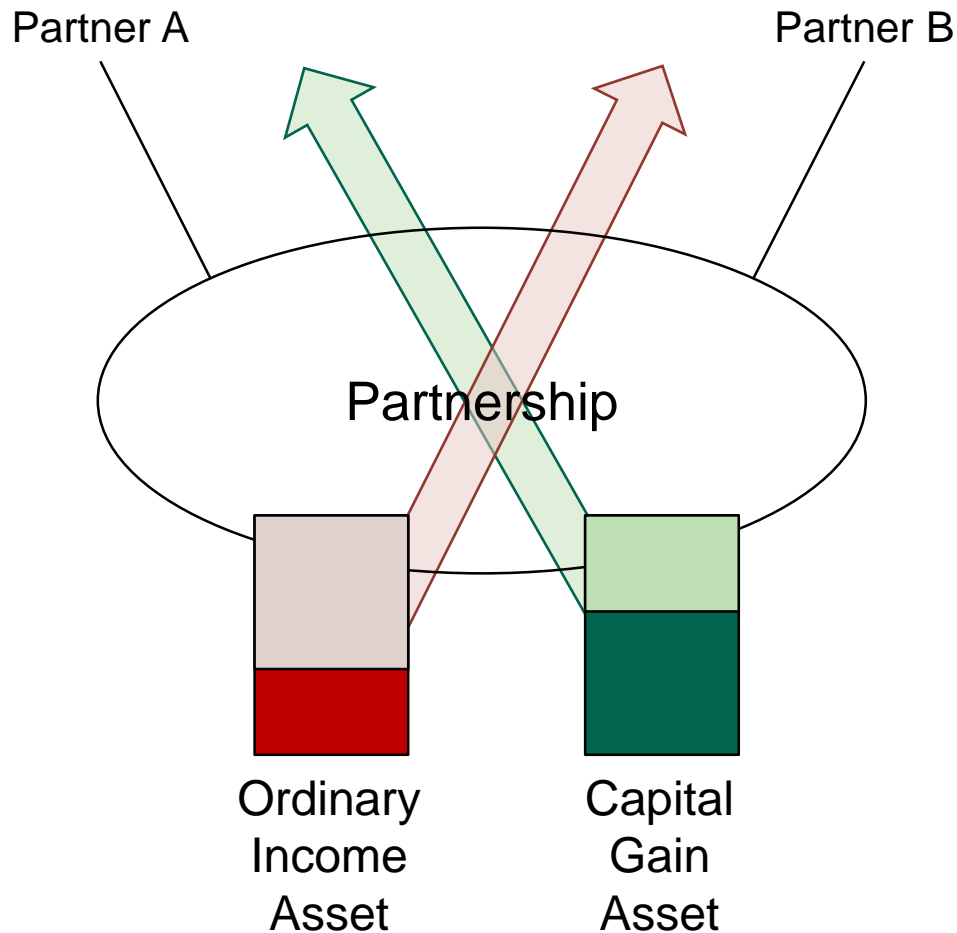
Distribution back to contributing partner is not a "mixing bowl" transaction.





Exception: “Hot” Assets

Section 751 enacted to prevent partners from converting **ordinary income** to capital gain.



Section 751 “Hot Assets” include:

- Inventory Items
- “Unrealized Receivables” (broadly defined)

A **proportionate** distribution of “hot assets” and capital gain assets will NOT trigger gain.

A **disproportionate** distribution of one type of property from a partnership that only holds that type of property will NOT trigger gain.



Taxable Sale of Partnership Interests: "Look-Through"

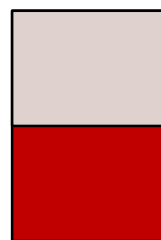
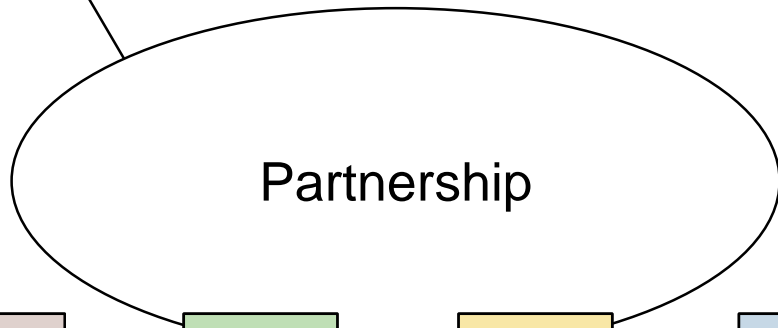
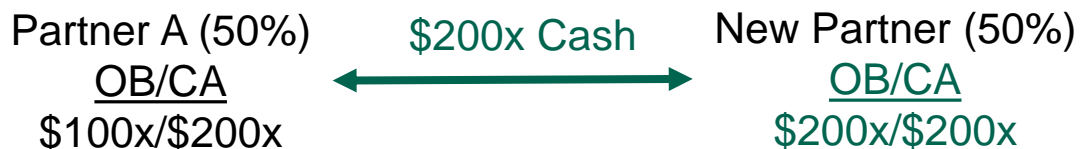
Holding Period: 100% 1+ Years

Total Gain = \$100x

A's Share of:	Amount	Tax Rate
§751(a) Income	\$25x	35%
Collectible Gain	\$10x	28%
§1250 Gain	\$40x	25%
Residual Gain	\$25x	20%

Distribution of cash and property is preferable because there is no "look-through" to 25% and 28% property.

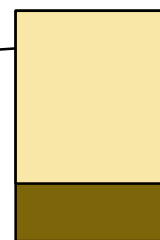
Inside Basis of Partnership Assets -100x



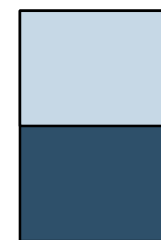
§751 Asset
IB/FMV
\$50x/\$100x



Collectible
IB/FMV
\$80x/\$100x



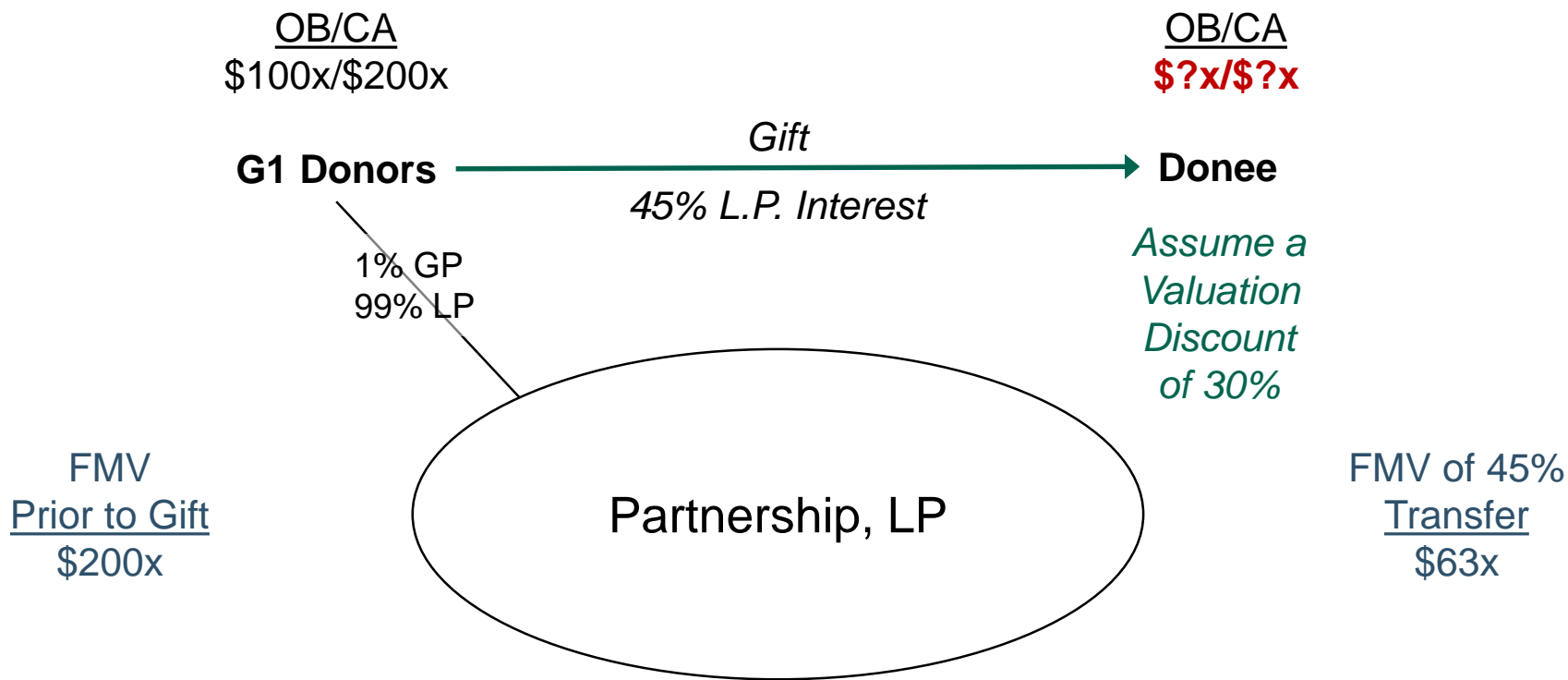
§1250 Asset
IB/FMV
\$20x/\$100x



Capital Gain
IB/FMV
\$50x/\$100x



Gratuitous Transfers of Partnership Interests





Calculating Capital Account & Basis of Transferred Interest

CAPITAL ACCOUNT OF TRANSFERRED INTEREST

Upon a transfer of all or a part of a partnership interest, the transferor's capital account "that is attributable to the transferred interest carries over to the transferee partner."

Treas. Reg. § 1.704-1(b)(2)(iv)(I). See Treas. Reg. § 1.704-1(b)(5), Ex. 13.

$$\begin{array}{rcccl} \text{Transferor's} & & \text{Percentage} & & \text{Transferee's} \\ \text{Capital Account} & & \text{Transferred} & & \text{Capital Account} \\ \hline \$200x & \times & 45\% & = & \$90x \end{array}$$

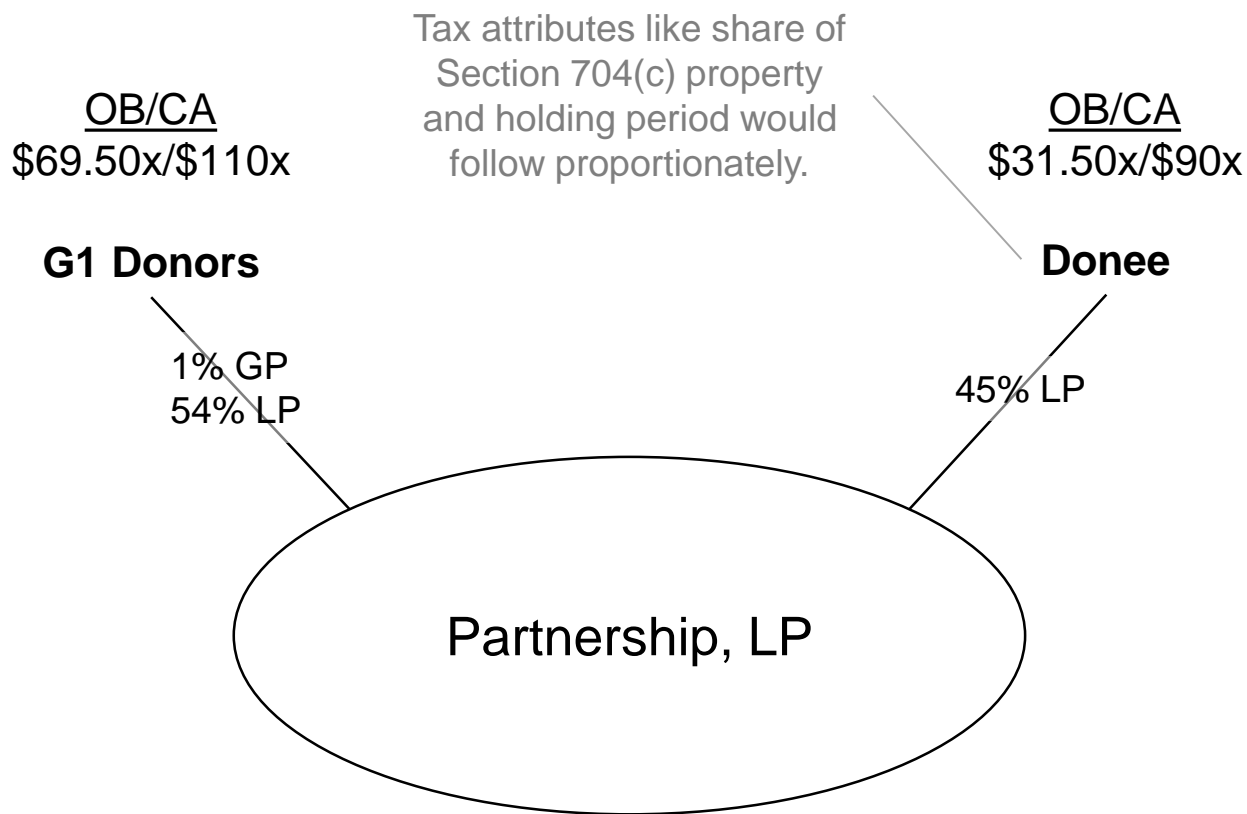
ADJUSTED BASIS OF TRANSFERRED INTEREST

"[T]he basis of the transferred portion of the interest generally equals an amount which bears the same relation to the partner's basis in the partner's entire interest as the fair market value of the transferred portion of the interest bears to the fair market value of the entire interest." Rev. Rul. 84-53, 1984-1 C.B. 159.

$$\begin{array}{rcccl} \text{Transferor's} & & \text{Fair Market Value (Discounted)} & & \text{Transferee's} \\ \text{Adjusted Basis} & & \text{Transferred Portion} & & \text{Adjusted Basis} \\ \hline \$100x & \times & \frac{\$63x}{\text{Fair Market Value}} & = & \$31.50x \\ & & \text{Transferor's Entire Portion} & & \\ & & \$200x & & \end{array}$$



Less Basis is Transferred



If the fair market value of donor's entire interest prior to the gift included the same valuation discount as the gifted interests, then 45% of the total outside basis would be transferred to the donee.



Partnership Debts and Liabilities: Nonrecourse

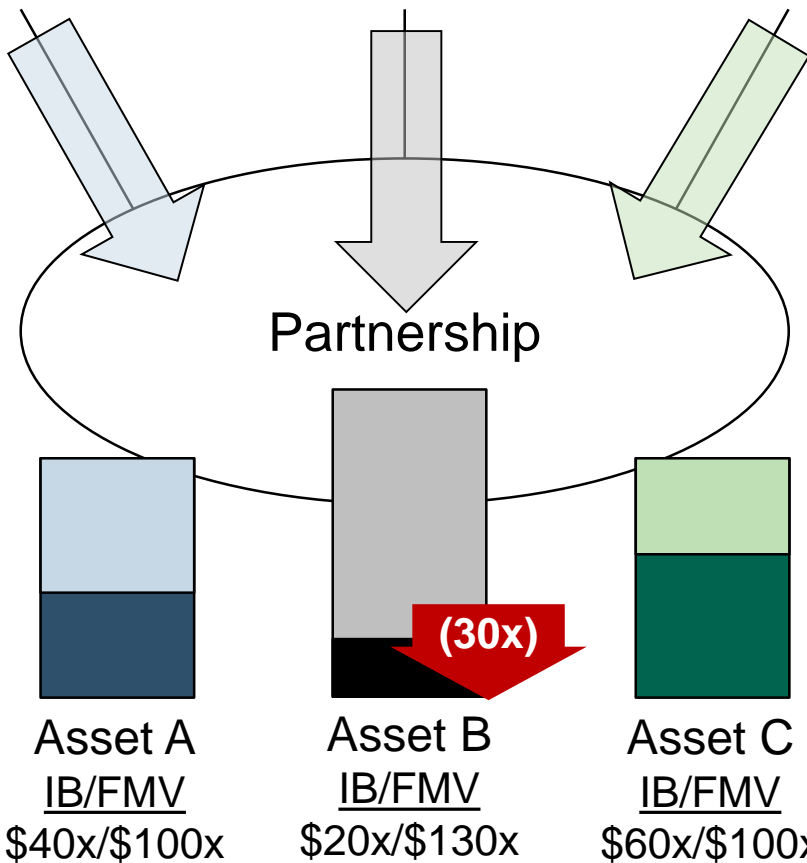
Example: A, B, and C create a partnership by contributing assets. Partnership takes Asset B subject to -30x debt. Debt is nonrecourse. No guarantees or other agreements. A, B, and C are equal partners.

OB/CA
\$50x/\$100x
Partner A

OB/CA
\$0x/\$100x
Partner B

OB/CA
\$70x/\$100x
Partner C

Nonrecourse liabilities in the FLP context are shared pro rata



OUTSIDE BASIS ADJUSTMENTS			
Partner	A	B	C
Initial OB	\$40x	\$20x	\$60x
§752(b)	\$0x	(\$30x)	\$0x
§752(a)	\$10x	\$10x	\$10x
Ending OB	\$50x	\$0x	\$70x

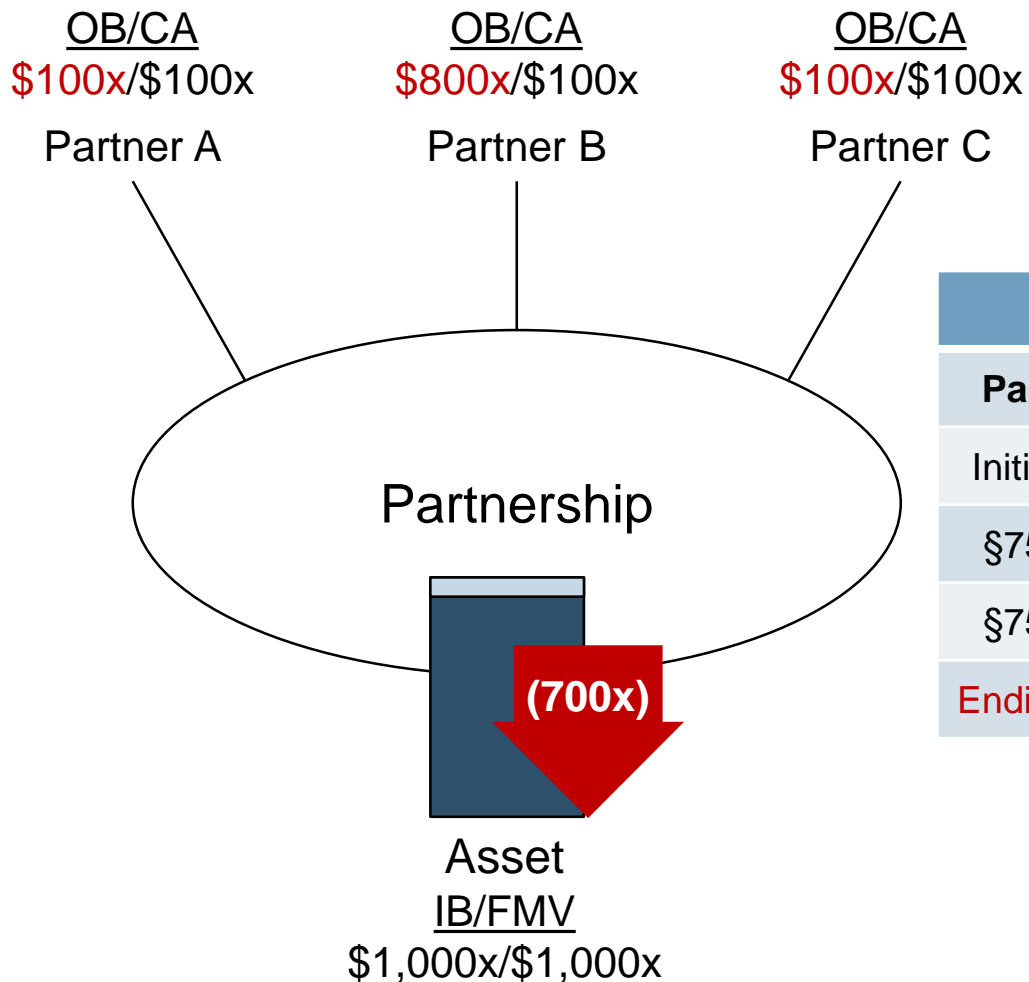
§ 752(a): **Increase** in partner's share of liabilities is considered a **contribution** of money by partner.

§ 752(b): **Decrease** in partner's share of liabilities is considered a **distribution** of money to partner.



Nonrecourse Debt Liability Guaranty

Example: A, B, and C create a partnership and each contributes \$100x cash. Partnership borrows \$700x from a lender to purchase an asset for \$1,000x. Lender will not make the loan unless B provides a guaranty for the loan. B guarantees the loan and does not right to seek reimbursement from A and C for repayment of the loan.



OUTSIDE BASIS ADJUSTMENTS			
Partner	A	B	C
Initial OB	\$100x	\$100x	\$100x
§752(b)	\$0x	\$0x	\$0x
§752(a)	\$0x	\$700x	\$0x
Ending OB	\$100x	\$800x	\$100x



Reduction of Partnership Liabilities: Liquidating Distributions

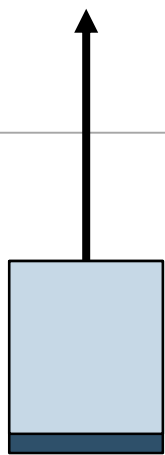
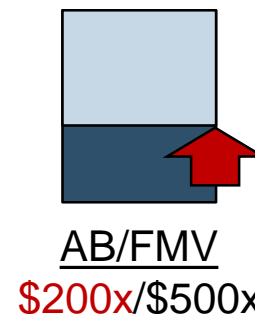
Outside Partnership

Reduction of partner's 20% share of liabilities. Deemed distribution of \$100x.

Partner (20%)
OB/CA
\$300x/\$500x

Partner (20%)
OB/CA
\$200x/\$500x

Ex-Partner
OB/CA
\$0x/\$0x



Total Nonrecourse
Partnership Liabilities
500x

Another Example: Reduction in partnership liabilities can occur when there is a distribution of partnership property to a partner subject to a debt. Remaining partners have a reduction in their share of partnership liabilities (deemed distribution of money).

Inside Partnership



Reduction of Partnership Liabilities: Sale of Interest

Gain
\$150x

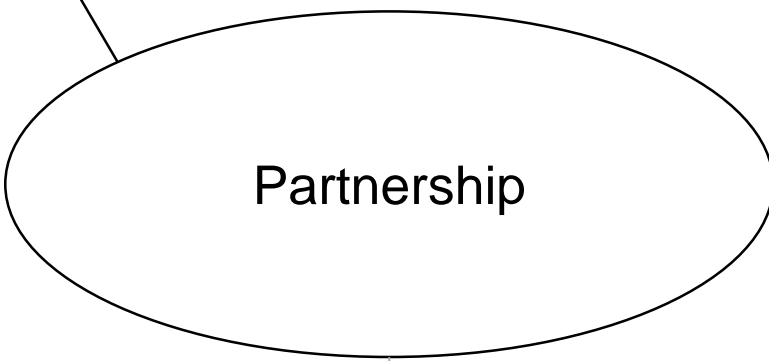
Partner A (50%)
OB/CA
\$50x/\$200x

Partner A (50%)
OB/CA
\$100x/\$200x

\$200x Cash

New Partner (50%)
OB/CA
\$250x/\$200x

Reduction of Partner A's 50% share of liabilities. Deemed distribution of \$50x.



Increase of New Partner's 50% share of liabilities. Deemed contribution of \$50x.

Total Nonrecourse Partnership Liabilities
100x

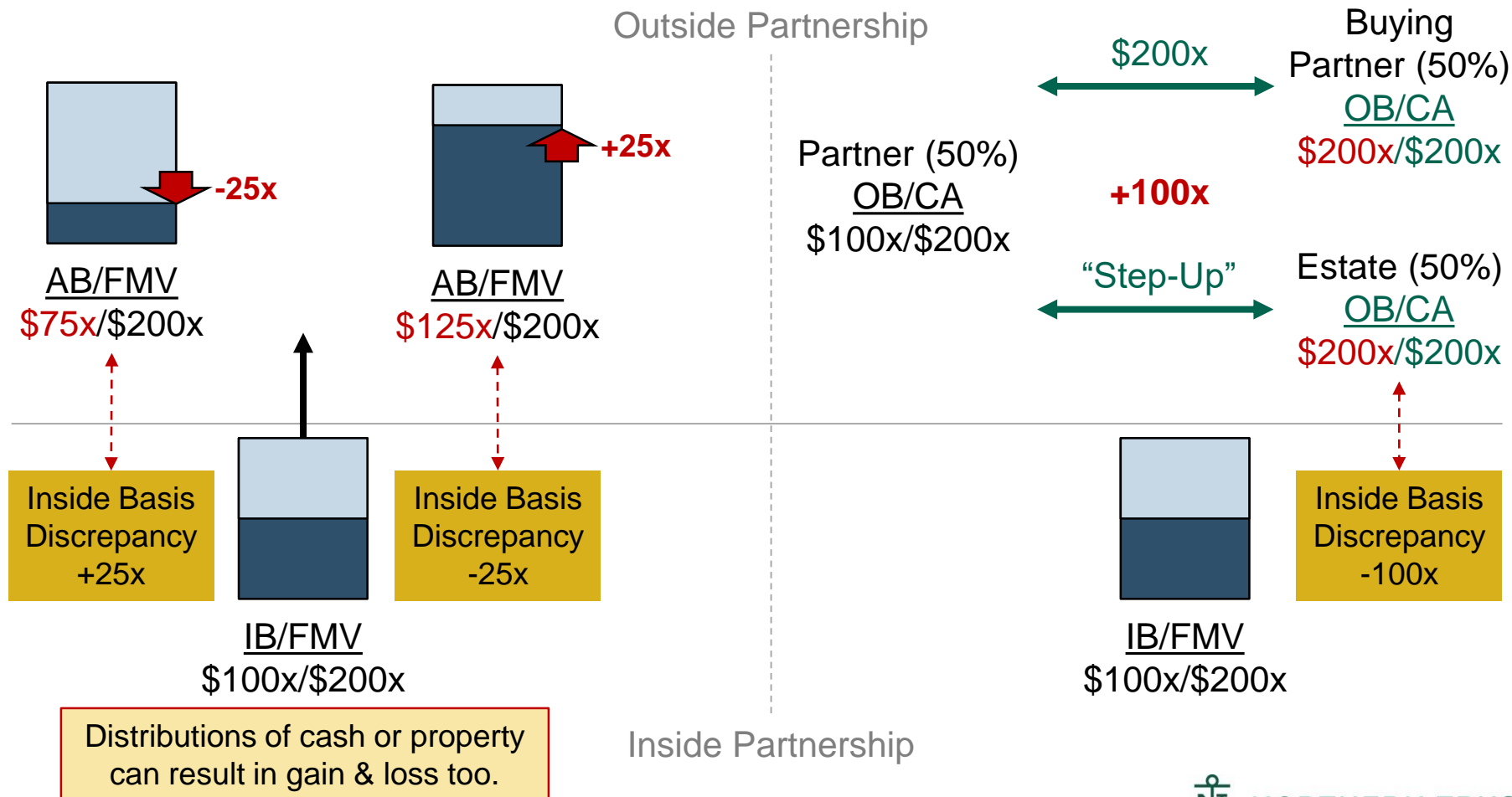


Section 754 and Inside Basis Adjustments

Section 754 election allows the partnership to adjust the inside basis of assets to cure discrepancies with the outside bases of the partners with certain transactions, including:

- **Distributions** of property to partners (§ 734); and
- **Sale** of a partnership interest (§ 743); and
- **Death** of a partner (§ 743).

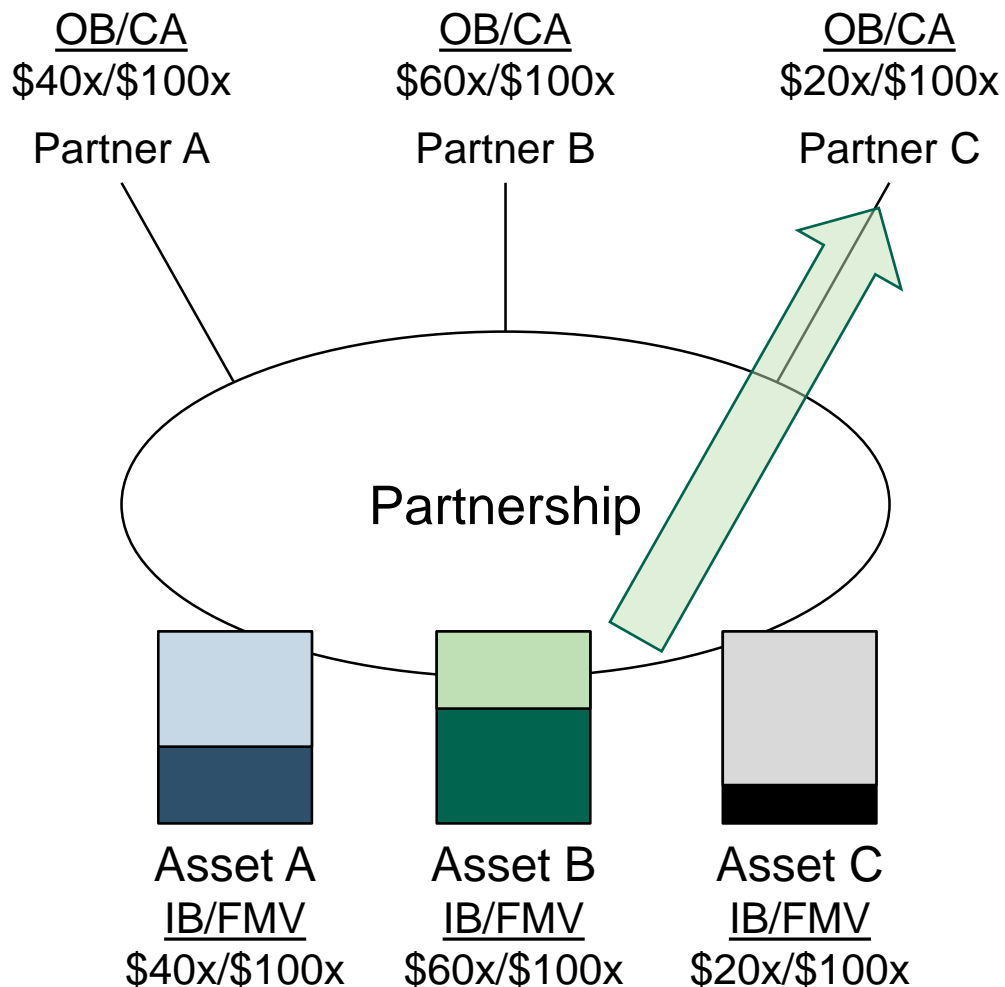
Election Is Irrevocable Without IRS Consent





Section 754 and Inside Basis Adjustments (§ 734)

Example: Partner C's interest will be liquidated by distributing Asset B. All assets have been in the partnership for 7-years or more, and there is no Section 704(c) property. Partnership has made a Section 754 election.





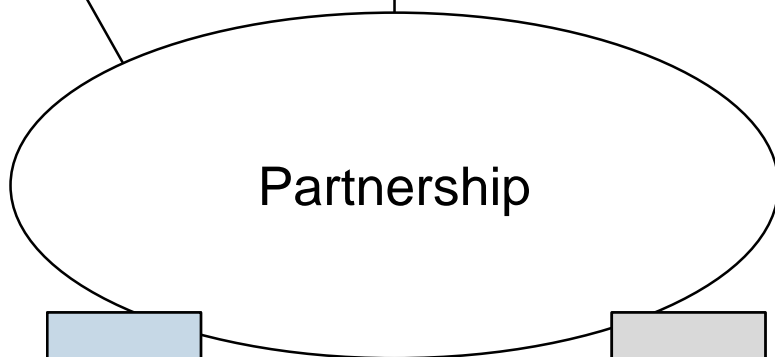
Section 754 and Inside Basis Adjustments (§ 734)

OB/CA
\$40x/\$100x

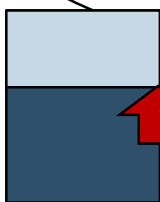
Partner A

OB/CA
\$60x/\$100x

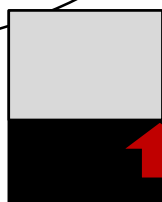
Partner B



Partnership

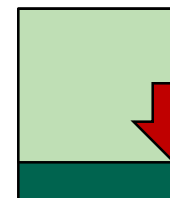


Asset A
IB/FMV
\$57x/\$100x



Asset C
IB/FMV
\$43x/\$100x

Ex-Partner C



-40x

Asset B
AB/FMV
\$20x/\$100x

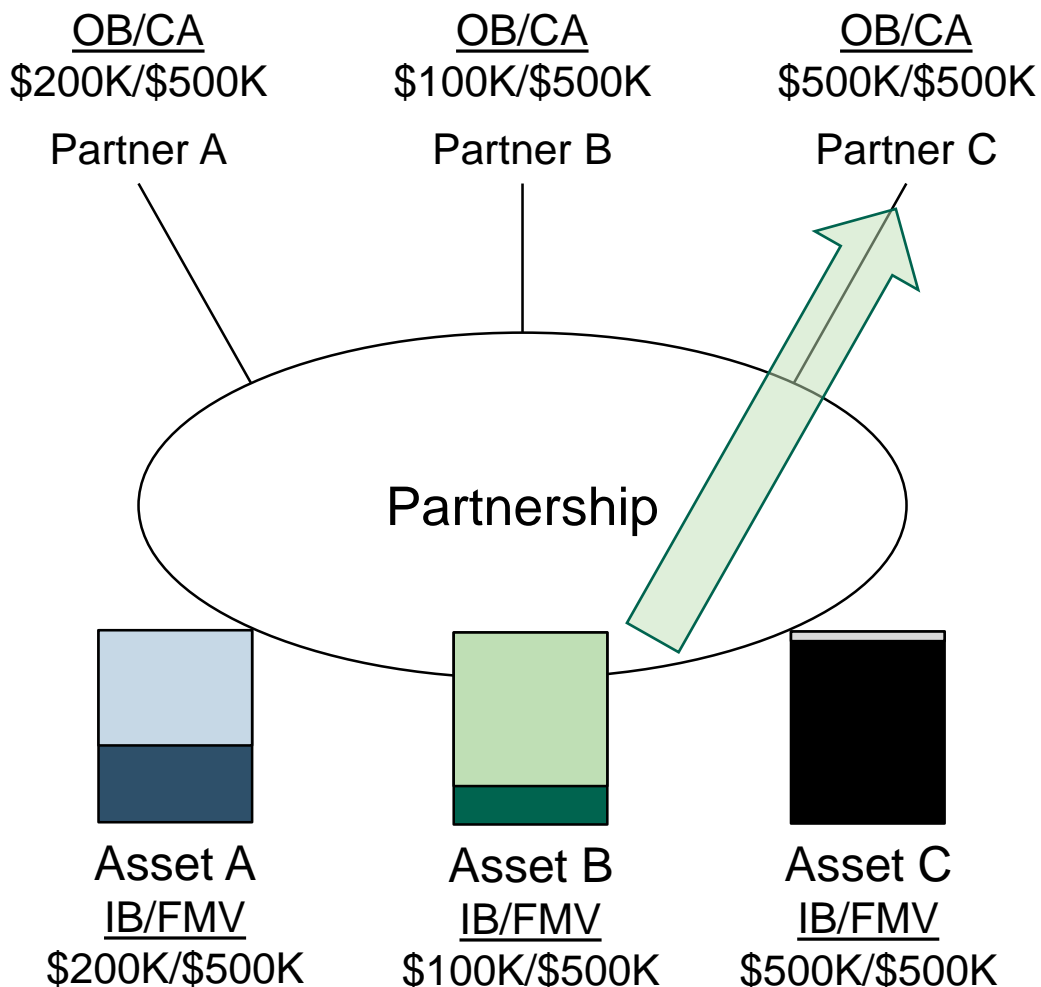
Asset A	Asset B	Asset C	Basis of A	Basis of C
Capital	Capital	Capital	57x	43x
Capital	Capital	Ordinary	80x	20x
Capital	Ordinary	Capital	Suspended	

If Partner C recognized a gain or loss upon liquidation, the inside basis adjustment could only be applied to capital assets in the partnership.



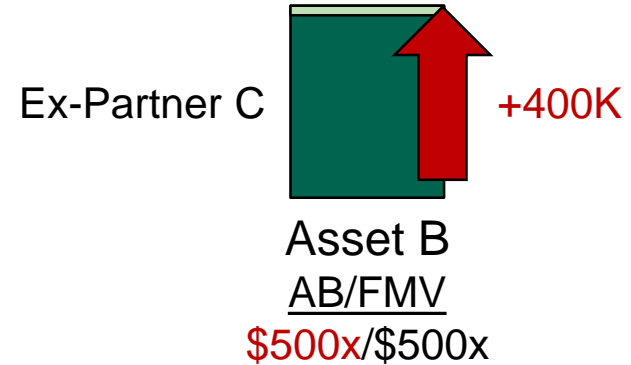
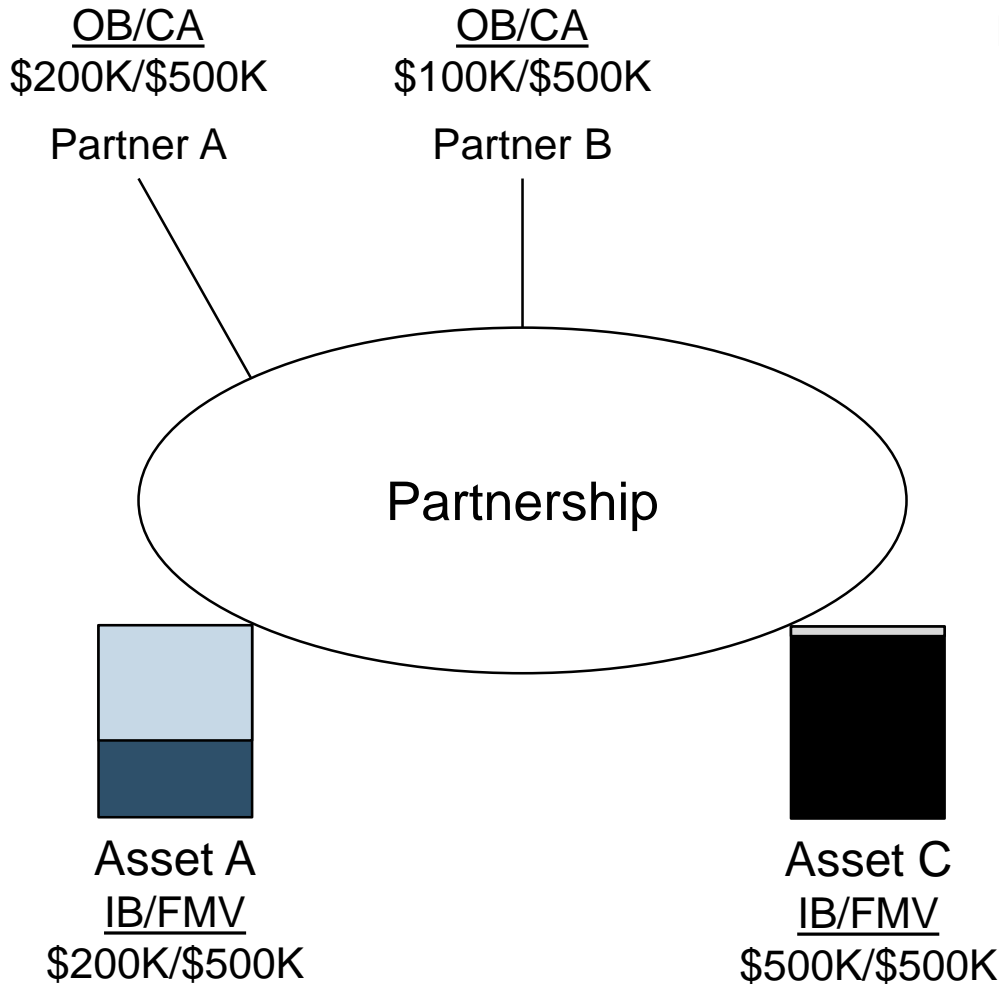
Mandatory Adjustments: Substantial Basis Reductions

Example: Partner C's interest will be liquidated by distributing Asset B. All assets have been in the partnership for 7-years or more, and there is no Section 704(c) property. There is NO Section 754 election in effect.





Mandatory Adjustment: Substantial Basis Reduction



Mandatory inside basis adjustment required when there is a "substantial basis reduction," which occurs if:

- Basis of distributed asset is **increased** by more than **\$250,000**; or
- Partner recognizes a **loss** of more than **\$250,000**.





Inside Basis Adjustments: Current vs. Liquidating Distributions

Current Distributions

- Only gain (not loss) can be recognized by distributee.
- Basis of in-kind property distributed to a partner is the *lesser* of:
 - ◆ Inside basis of the property; and
 - ◆ Outside basis of distributee partner.
- When outside basis is less than inside basis, basis of property is reduced or lost to the partnership.
- Only *increases* in partnership property under § 734(b) can occur.

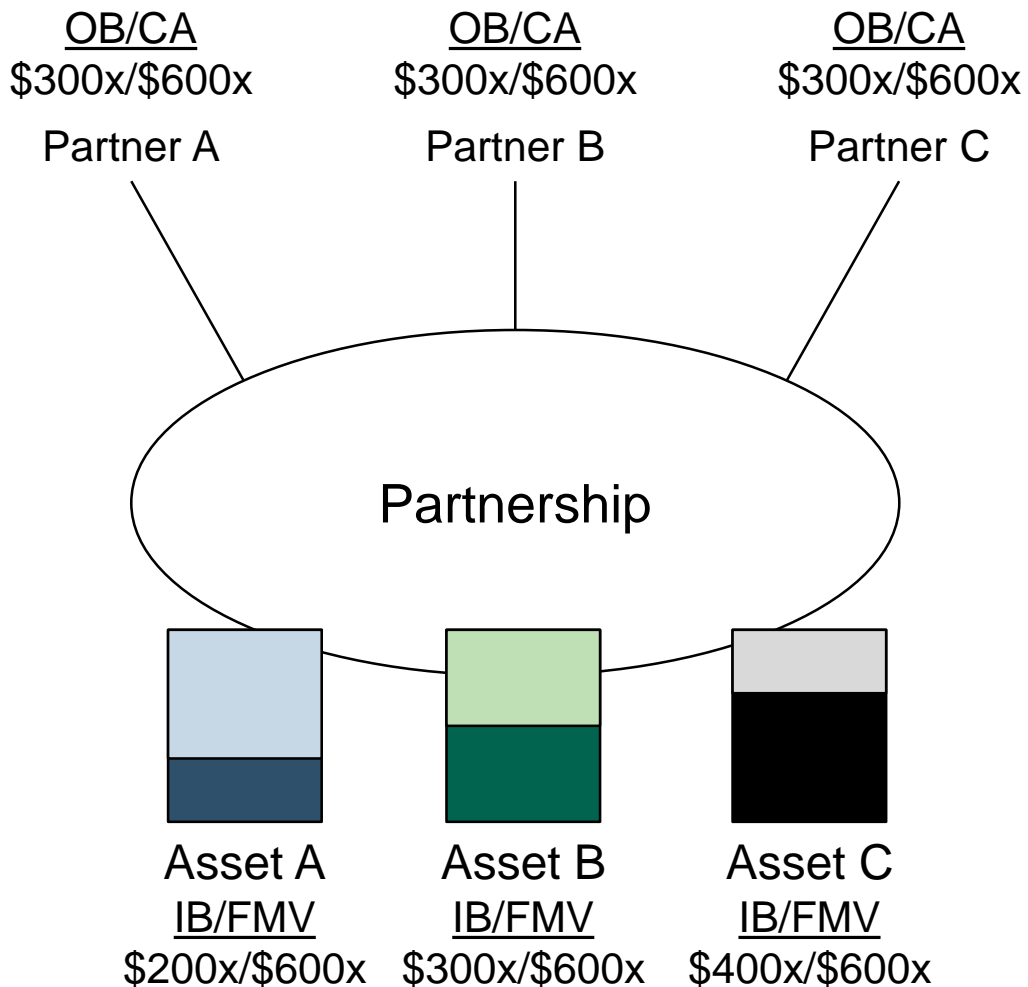
Liquidating Distributions

- Gain *and* loss can be recognized by distributee.
- Basis of in-kind property distributed to a partner will be the outside basis of the distributee partner.
- Distributions can result in an increase *and* decrease in basis of the property. The inside basis adjustment can:
 - ◆ Increase the basis of partnership property (for a reduction of basis in the distributed property)
 - ◆ Decrease the basis of partnership property (for an increase of basis in the distributed property)
- Under § 734(b), the inside basis adjustment can:
 - ◆ Increase the basis of partnership property (for gain); or
 - ◆ Decrease the basis of partnership property (for loss).
- Mandatory inside basis adjustment (reduction of basis to partnership property):
 - ◆ Partner recognizes a loss of more than \$250,000; or
 - ◆ Basis of liquidated property is increased by more than \$250,000.



Section 754 and Inside Basis Adjustments (Section 743)

Example: Partner C is going to sell entire one-third partnership interest to Partner D for cash. All assets have been in the partnership for 7-years or more, and there is no Section 704(c) property.



EACH PARTNER'S SHARE OF INSIDE BASIS

BASIS	Partner A	Partner B	Partner C	Totals
Basis A	\$67x	\$67x	\$67x	\$200x
Basis B	\$100x	\$100x	\$100x	\$300x
Basis C	133x	133x	\$133x	\$400x
Totals	\$200x	\$300	\$400x	\$900x

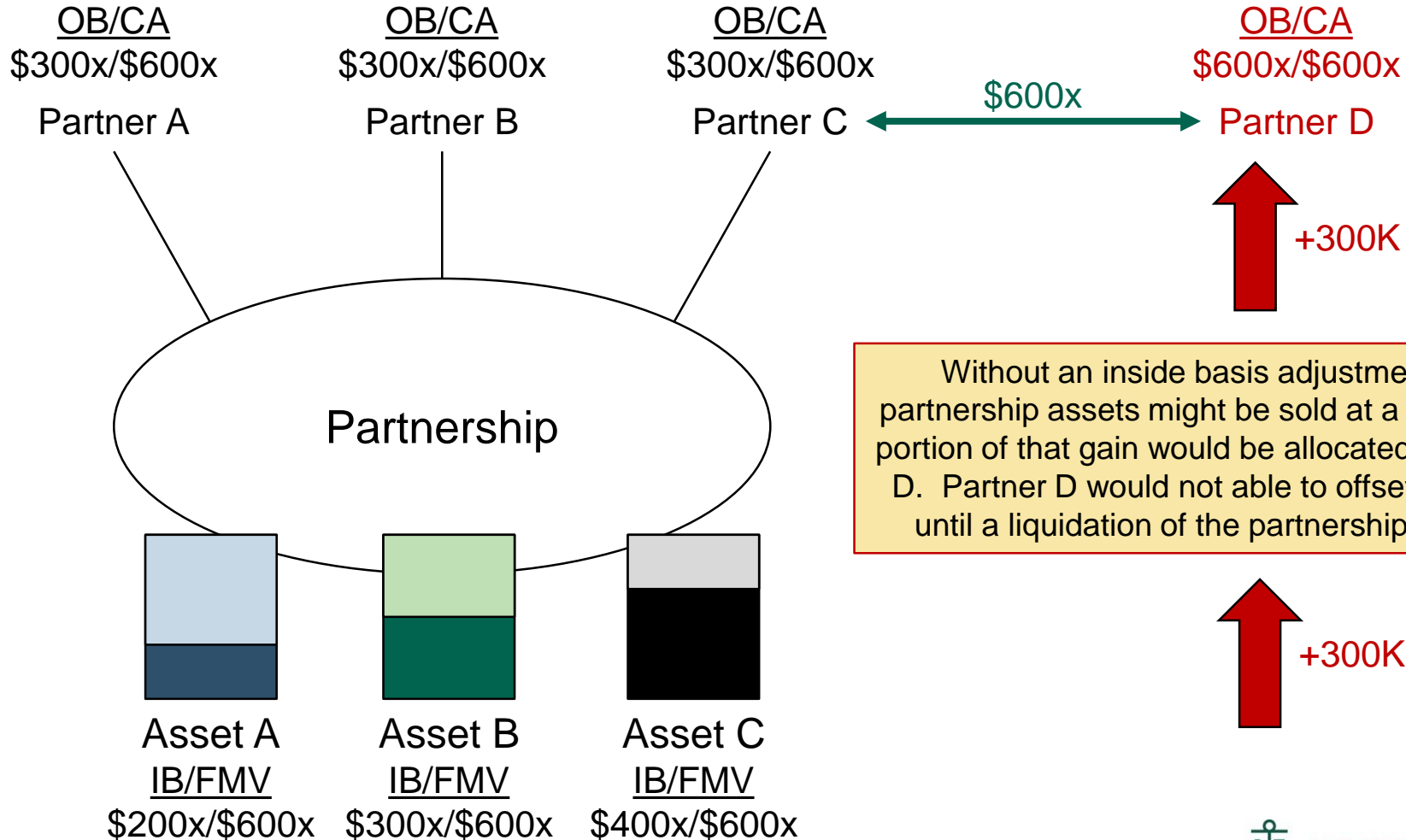
EACH PARTNER'S SHARE OF UNREALIZED GAIN

GAIN	Partner A	Partner B	Partner C	Totals
Gain A	\$133x	\$133x	\$133x	\$400x
Gain B	\$100x	\$100x	\$100x	\$300x
Gain C	\$67	\$67x	\$67x	\$200x
Totals	\$300x	\$300	\$300x	\$900x



Section 754 and Inside Basis Adjustments (Section 743)

- Inside basis adjustments under Section 734 are actual basis adjustment to partnership property for the benefit of all of the partners.
- Inside basis adjustments under Section 743 (transfers upon sale or death) are “notional” and are specific only to the transferee (purchaser or estate/heirs of the decedent).

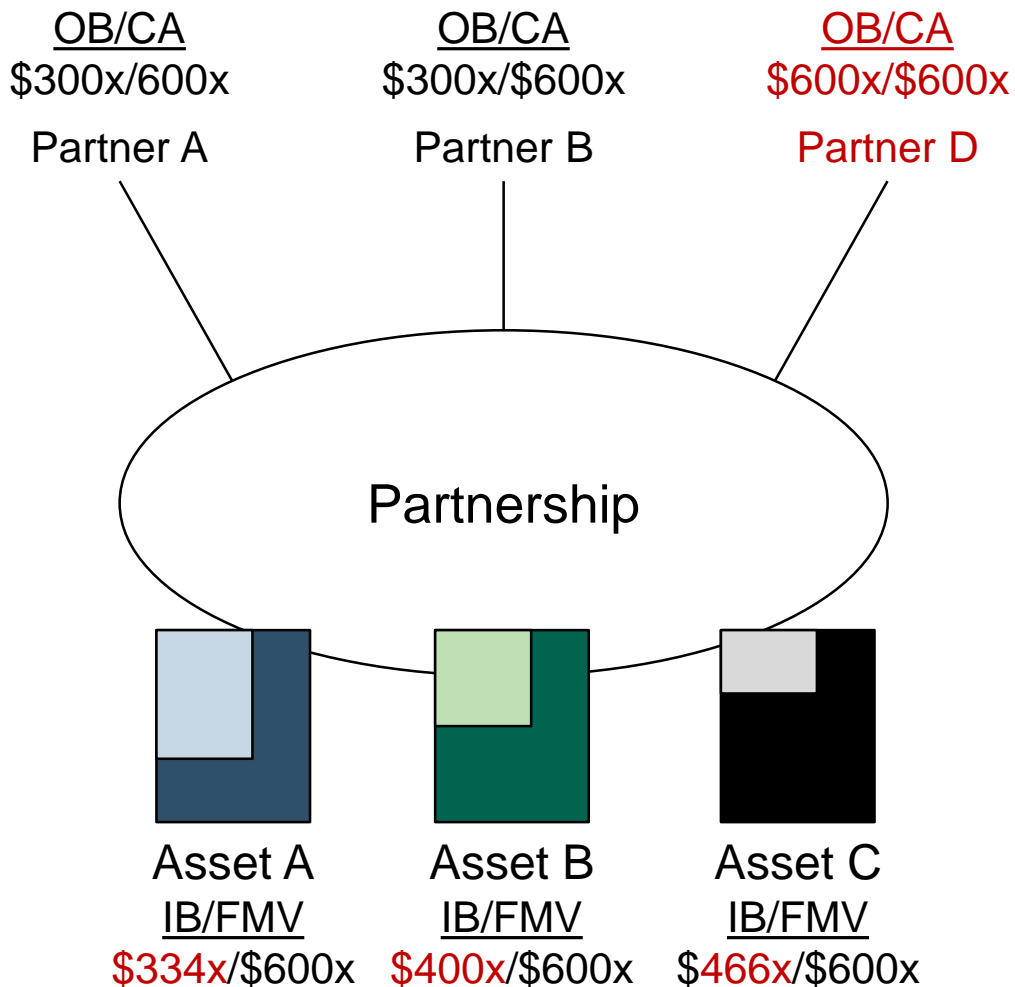


Without an inside basis adjustment, the partnership assets might be sold at a gain and a portion of that gain would be allocated to Partner D. Partner D would not be able to offset that gain until a liquidation of the partnership interest.



Section 754 and Inside Basis Adjustments (Section 743)

- Inside basis adjustments under Section 743 (transfers upon sale or death) are “notional” and are specific only to the transferee (purchaser or estate/heirs of the decedent).



EACH PARTNER'S SHARE OF INSIDE BASIS

BASIS	Partner A	Partner B	Partner D	Totals
Basis A	\$67x	\$67x	\$200x	\$334x
Basis B	\$100x	\$100x	\$200x	\$400x
Basis C	133x	133x	\$200x	\$466x
Totals	\$200x	\$300	\$600x	\$1.200x

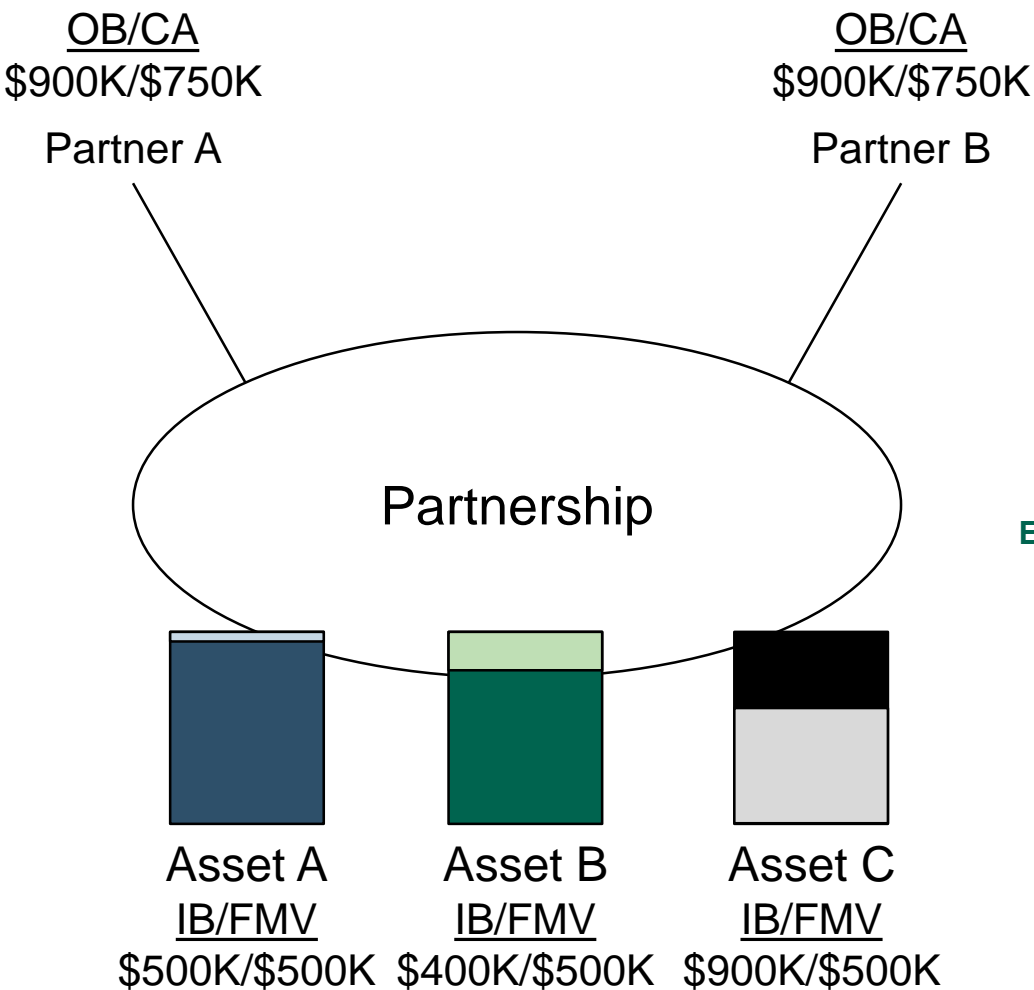
EACH PARTNER'S SHARE OF UNREALIZED GAIN

GAIN	Partner A	Partner B	Partner D	Totals
Gain A	\$133x	\$133x	\$0x	\$266x
Gain B	\$100x	\$100x	\$0x	\$200x
Gain C	\$67	\$67x	\$0x	\$134x
Totals	\$300x	\$300	\$0x	\$600x



Mandatory Basis Adjustments: Substantial Loss Property

Example: Partner B passes away. Partnership has not made a Section 754 election.



EACH PARTNER'S SHARE OF INSIDE BASIS

BASIS	Partner A	Partner B	Totals
Basis A	\$250K	\$250K	\$500K
Basis B	\$200K	\$200K	\$400K
Basis C	\$450K	\$450K	\$900K
Totals	\$900K	\$900K	\$1,800K

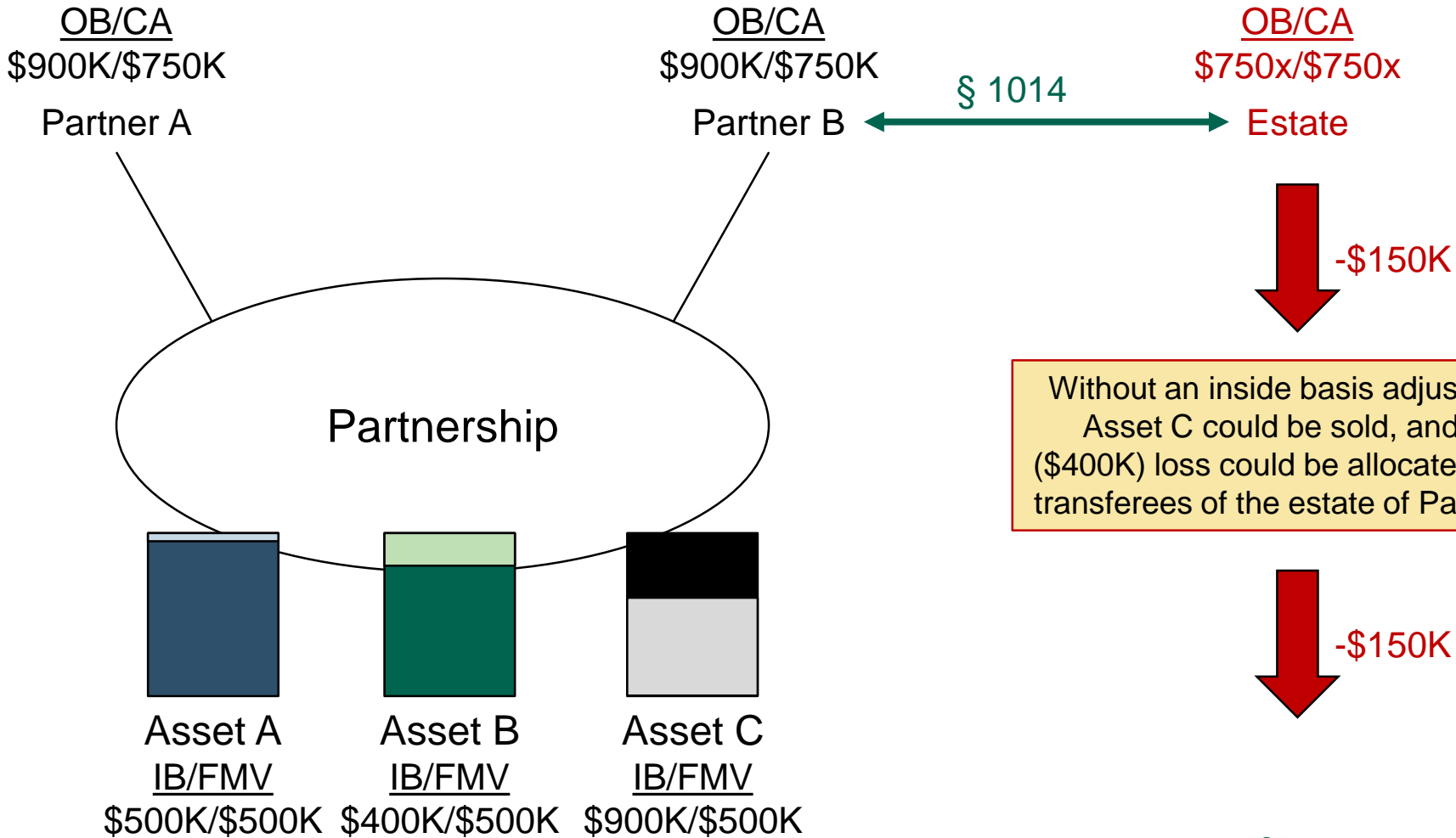
EACH PARTNER'S SHARE OF UNREALIZED GAIN/LOSS

GAIN OR LOSS	Partner A	Partner B	Totals
Gain A	\$0	\$0	\$0
Gain B	\$50K	\$50K	\$100K
Gain C	(\$200K)	(\$200K)	(\$400K)
Totals	(\$150K)	(\$150K)	(\$300K)



Mandatory Basis Adjustments: Substantial Loss Property

- A partnership has a “substantial built-in loss” if the partnership’s inside basis in the partnership property exceeds by more than \$250,000 the fair market value of such property.
- Inside basis adjustments under Section 743 even in the absence of a Section 754 election.

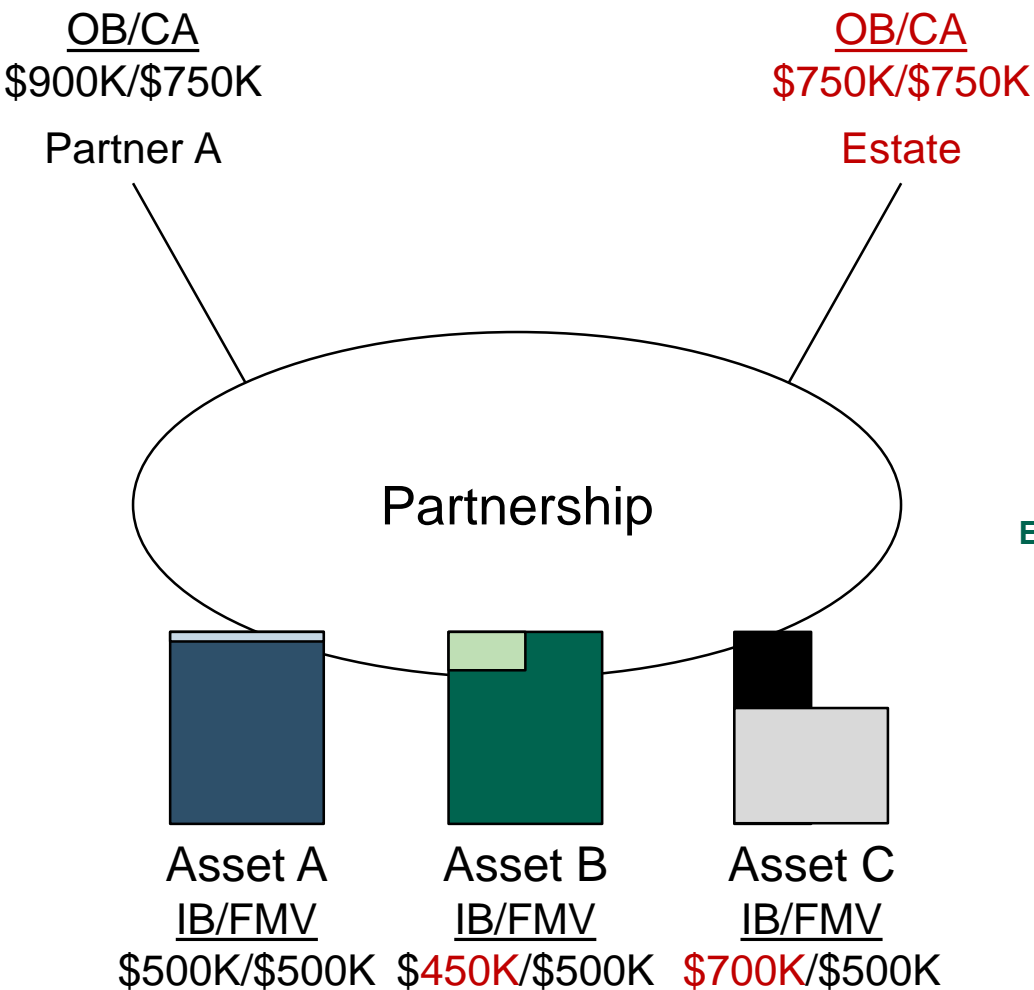


Without an inside basis adjustment, Asset C could be sold, and the (\$400K) loss could be allocated to the transferees of the estate of Partner B.



Mandatory Basis Adjustments: Substantial Loss Property

Inside basis adjustments under Section 743 (transfers upon sale or death) are “notional” and are specific only to the transferee (purchaser or estate/heirs of the decedent).



EACH PARTNER'S SHARE OF INSIDE BASIS

BASIS	Partner A	Partner B	Totals
Basis A	\$250K	\$250K	\$500K
Basis B	\$200K	\$250K	\$450K
Basis C	\$450K	\$250K	\$700K
Totals	\$900K	\$750K	\$1,650K

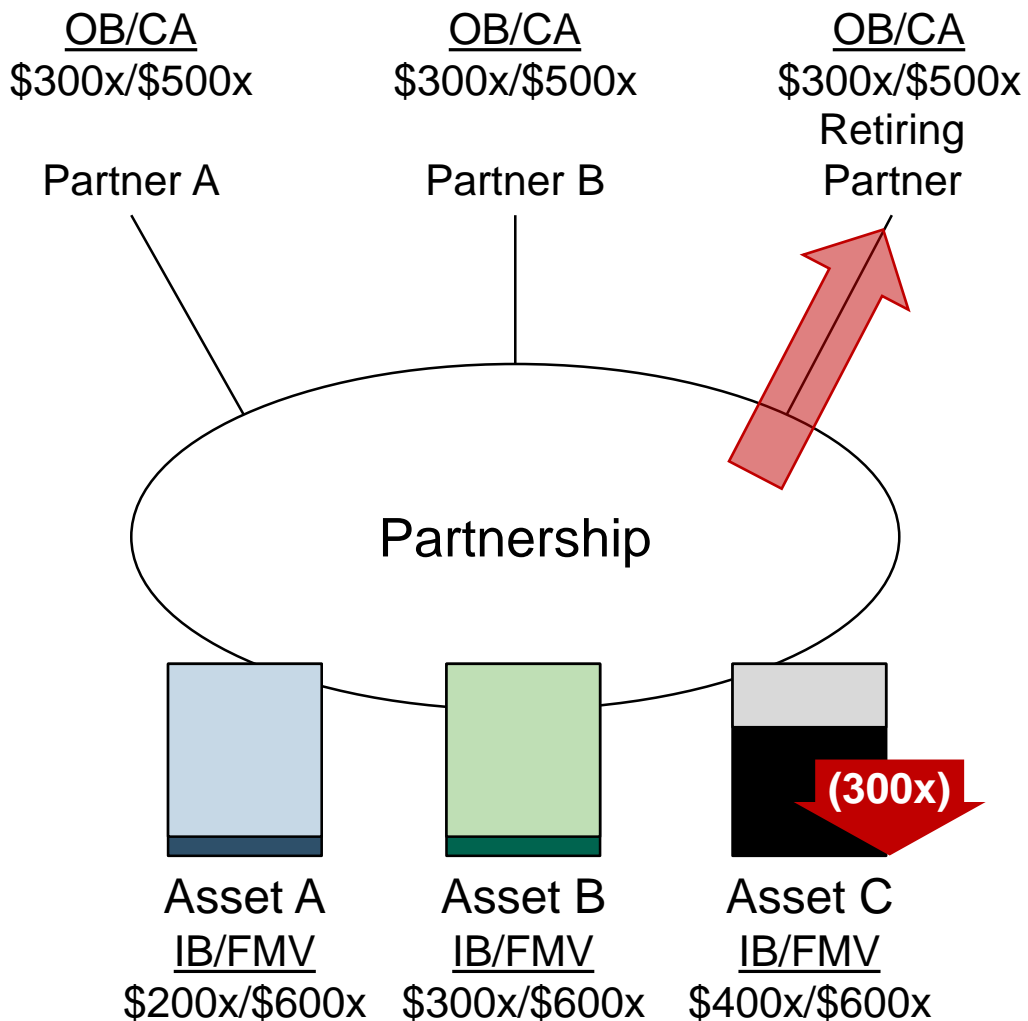
EACH PARTNER'S SHARE OF UNREALIZED GAIN/LOSS

GAIN OR LOSS	Partner A	Partner B	Totals
Gain A	\$0	\$0	\$0
Gain B	\$50K	\$0	\$50K
Gain C	(\$200K)	\$0	(\$200K)
Totals	(\$150K)	\$0	(\$150K)



Retirement/Death of Partners: Liquidation of Interests

Section 736(b): Normal distribution rules apply to payments of cash or property in liquidation of a partner.



Timing	Payments	Taxation
Year 1	\$100x	No gain or loss
Year 2	\$100x	No gain or loss
Year 3	\$100x	No gain or loss
Year 4	\$100x	\$100 capital gain
Year 5	\$100x	\$200 capital gain (\$100 reduction in liability under Section 752(b))
Totals	\$500x	\$300x capital gain

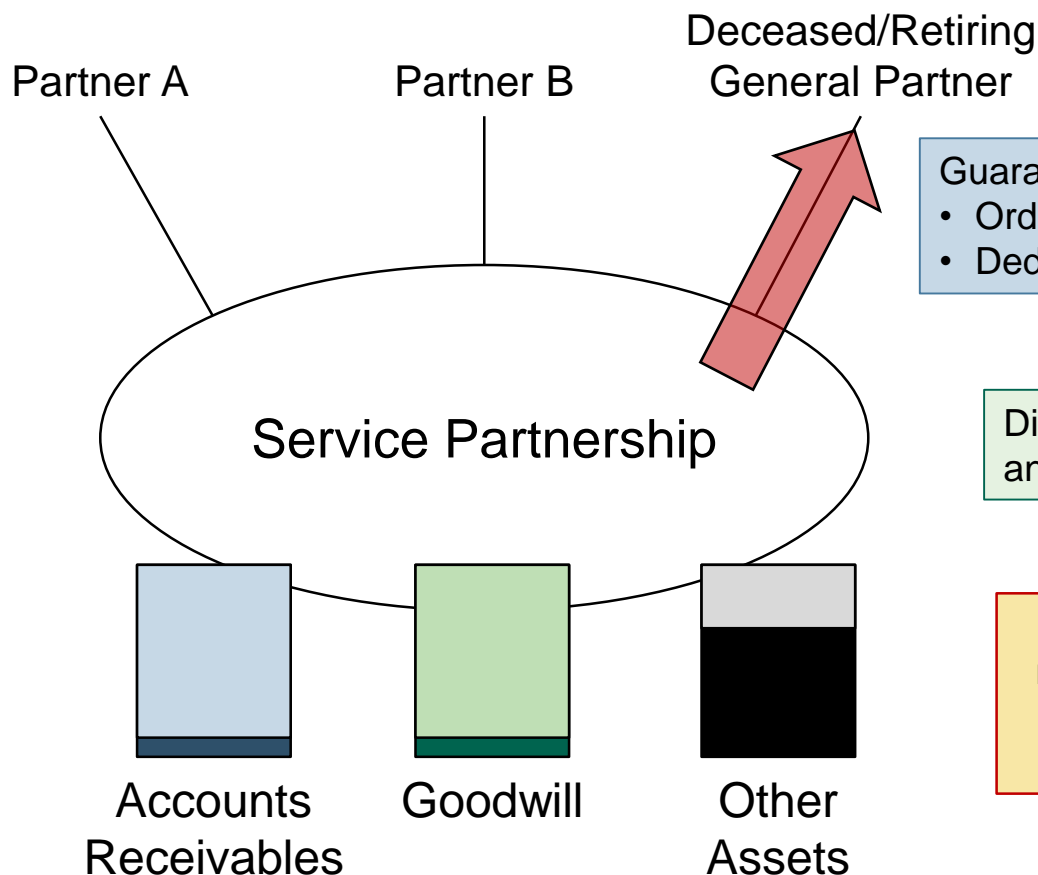
Deferred liquidation payments do not need to comply with the requirements of installment sales under Section 453 and do not need to provide for a minimum interest rate.



Retirement/Death of Service Partners: Liquidations of Interests

Section 736(a): Payments shall be treated either as **distributive share** or a **guaranteed payment** if

1. Amounts are paid to a retiring/deceased **general partner**
2. In a **service partnership** (capital is not a material income-producing factor) for
 - **Unrealized receivables** as defined under Section 751(c); or
 - **Goodwill** of the partnership.



Guaranteed payments (paid regardless of profits):

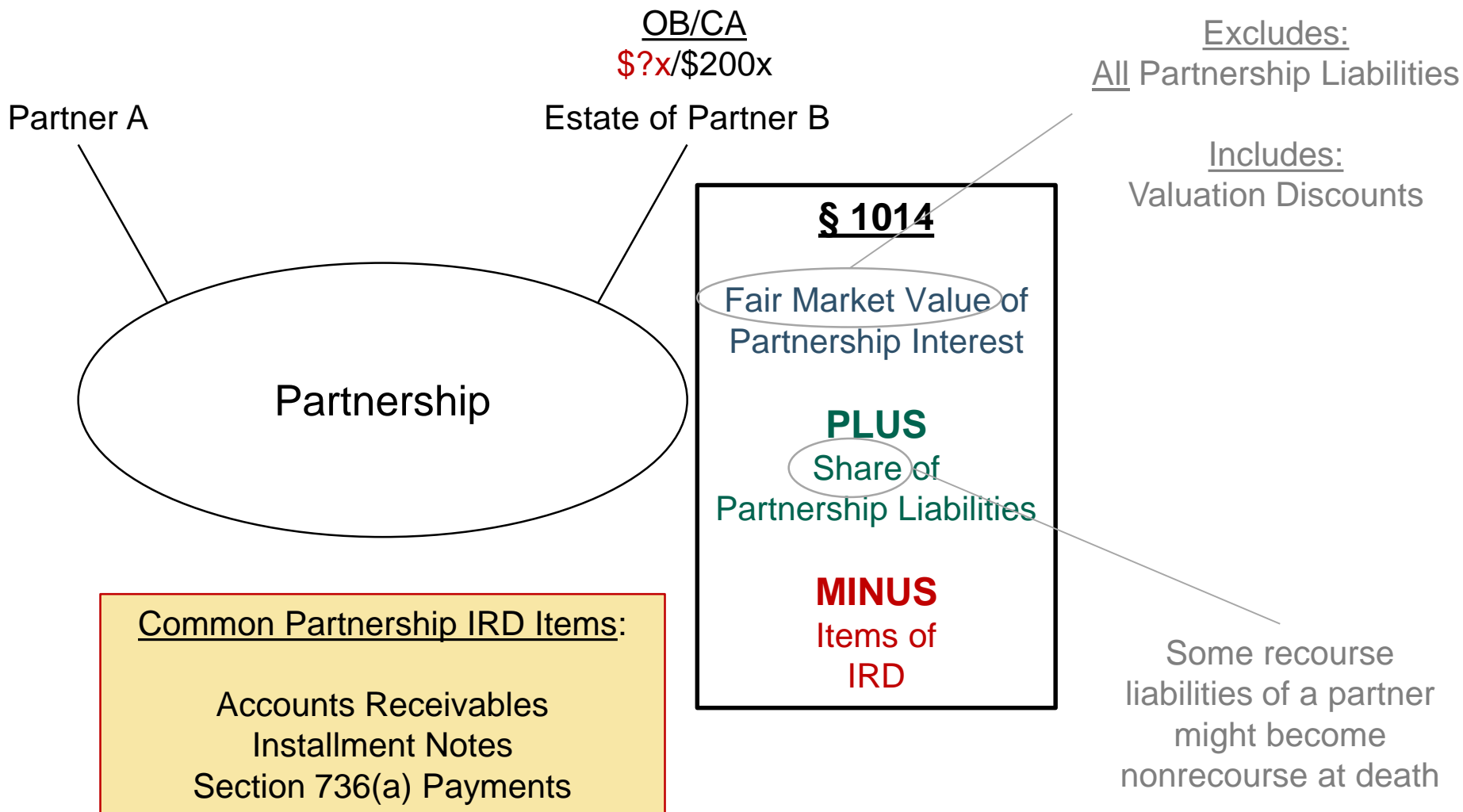
- Ordinary income to partner.
- Deductible by the partnership under Section 162(a).

Distributable share depends on future profits, and tax items depend on allocation of income.

Members of limited liability companies are not personally liable, so payments made in complete liquidation of their interests will **never** be payments under Section 736(a).



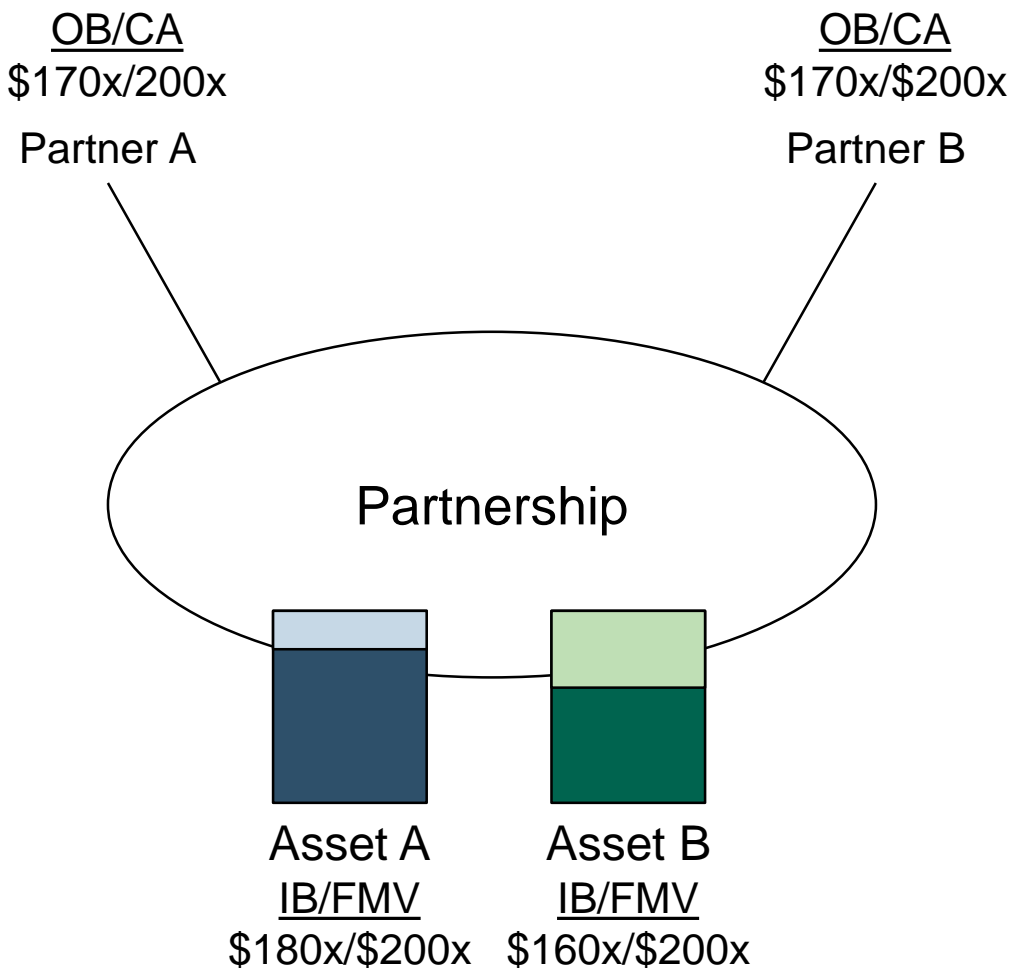
Death of a Partner and the “Step-Up” in Basis





Valuation Discounts Can Mean a Step-Down in Basis

Example: Prior to the death of Partner B, the partnership is situated, as follows:



EACH PARTNER'S SHARE OF INSIDE BASIS

BASIS	Partner A	Partner B	Totals
Basis A	\$90x	\$90x	\$180x
Basis B	\$80x	\$80x	\$160x
Totals	\$170x	\$170x	\$340x

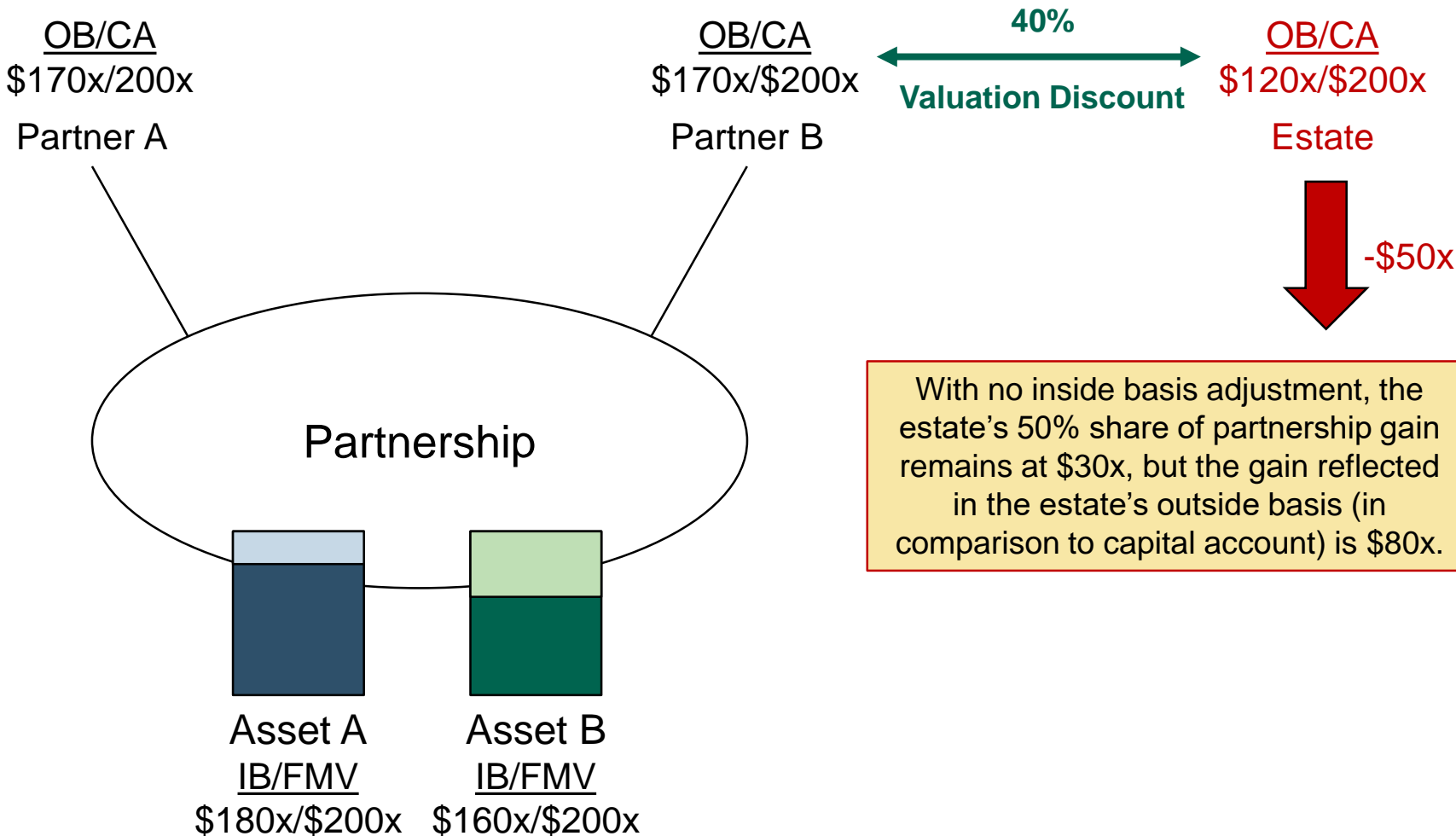
EACH PARTNER'S SHARE OF UNREALIZED GAIN

GAIN	Partner A	Partner B	Totals
Gain A	\$10x	\$10x	\$20x
Gain B	\$20x	\$20x	\$40x
Totals	\$30x	\$30x	\$60x



Valuation Discounts Can Mean a Step-Down in Basis

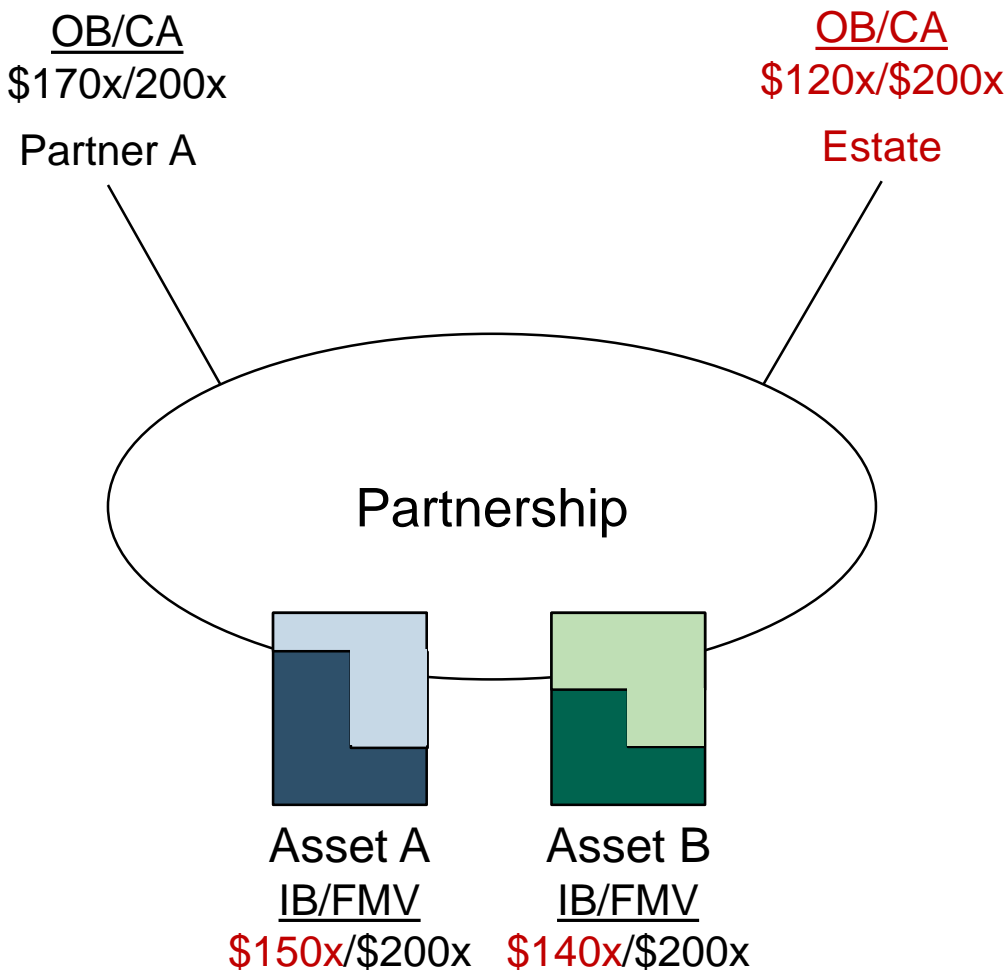
Example: Partner B passes away. Partnership does NOT have a Section 754 election in place.





Valuation Discounts Can Mean a Step-Down in Basis

Example: Partner B passes away. Partnership has a Section 754 election in place.



EACH PARTNER'S SHARE OF INSIDE BASIS

BASIS	Partner A	Estate	Totals
Basis A	\$90x	\$60x	\$150x
Basis B	\$80x	\$60x	\$140x
Totals	\$170x	\$120x	\$290x

EACH PARTNER'S SHARE OF UNREALIZED GAIN

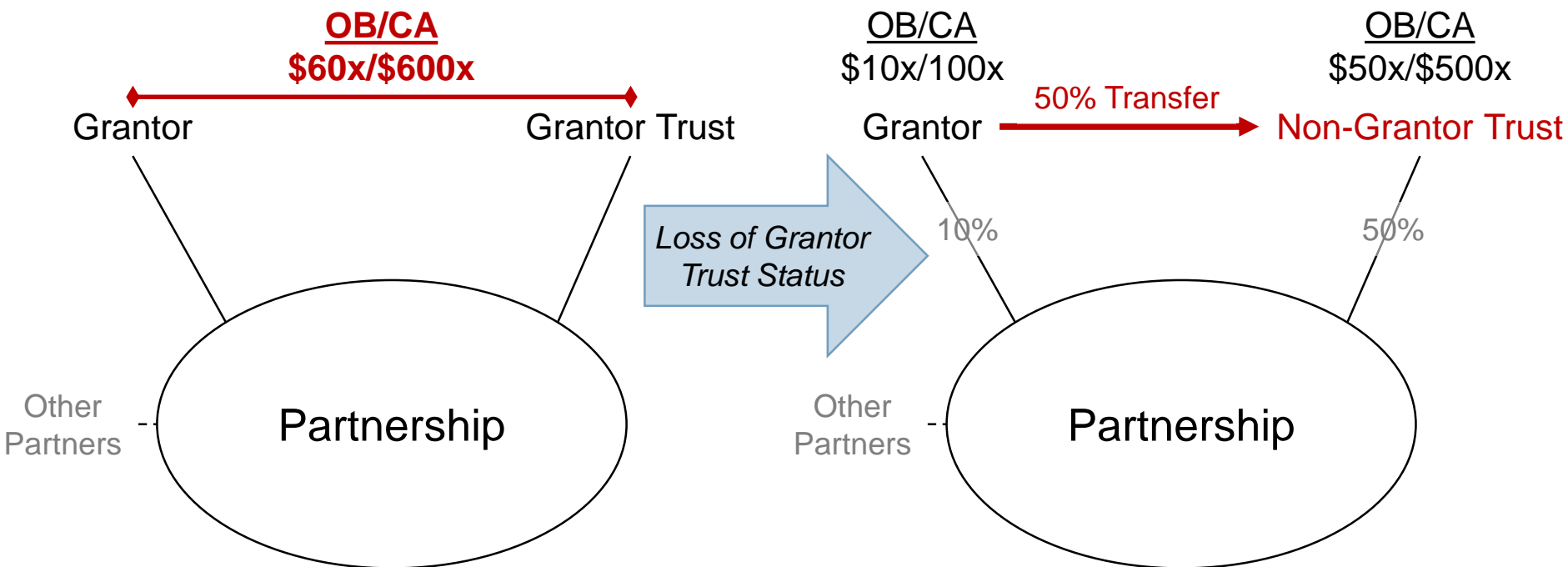
GAIN	Partner A	Estate	Totals
Gain A	\$10x	\$40x	\$50x
Gain B	\$20x	\$40x	\$60x
Totals	\$30x	\$80x	\$110x



Termination of Partnership

Partnership is terminated only if “no part of any business, financial, operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.” § 708(b)(1)(A).

Courts have held the mere collection of promissory notes is sufficient to keep a partnership from terminating.



“Technical terminations” of partnerships (sale or exchange of 50% or more of the total interest in partnership) no longer exist for taxable years beginning after December 31, 2018.



The Tax COVF EFE and Jibberish Act?



§ 199A: Qualified Business Income of “Pass-Thru” Entities

“Pass-Thru” Entities

20% DEDUCTION
“Qualified Business Income”—“Qualified Items”
“Qualified Trade or Business”—Not “Specified Service Trade or Business”

LIMITED BY THE SUM OF:
Lesser of:
(i) Combined Qualified Business Income (QBI), or
(ii) 20% taxable income over net capital gain
+
Lesser of:
(i) Qualified cooperative dividends, or
(ii) Taxable income reduced by net capital gain

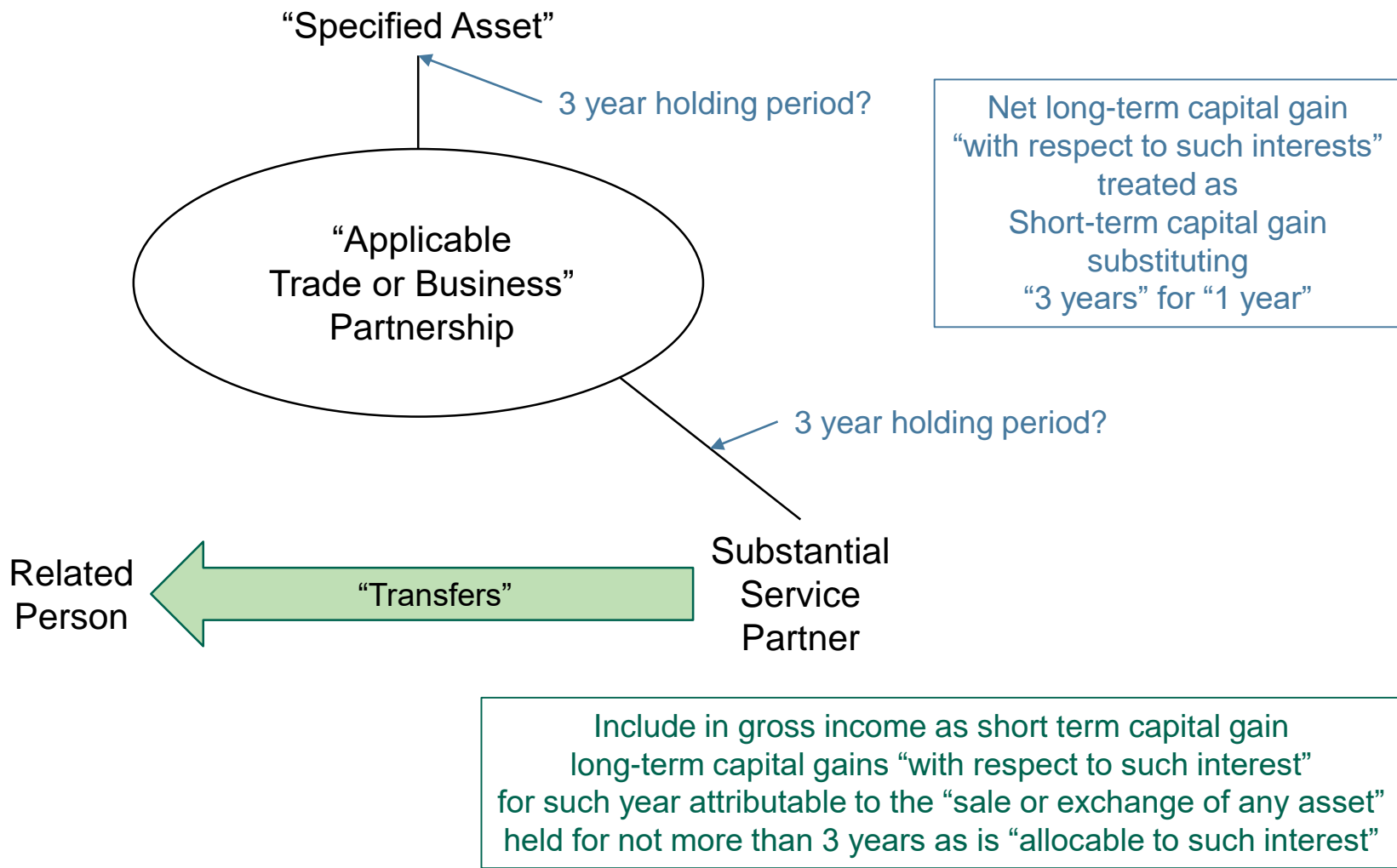
QBI—SUM OF:
(i) Deductible amount for each trade or business (DAFETB)
+
(ii) 20% qualified REIT and PTP income

DAFETB—LESSER OF:
(i) 20% QBI w/r/t each trade or business
or
(ii) *Greater of*
(a) 50% W-2 wages, or
(b) 25% W-2 wages plus 2.5% unadjusted basis immediately after acquisition of “qualified property”

*Does not apply to taxpayers below:
\$157,500/\$315,000 (\$207,500/\$415,000)*



§ 1061: “Carried Interest” Provision





Other Notable TCJA Changes to Partners and Partnerships

Topic	Change	Code Section
Technical Terminations	Effective for partnership tax years beginning after 2017, technical	708(b)(1)(B) repealed
Substantial Built-In Loss	Effective for transfers of partnership interests after December 31, 2017, the definition of substantial built-in loss expanded if transferee partner would be allocated a net loss in excess of \$250,000 upon a hypothetical disposition by partnership of all of the partnership assets in a fully taxable transaction for cash equal to the fair market value of the assets	743
Basis Limitation on Partnership Losses	Effective for partnership tax years beginning after 2017, the basis limitation on the deductibility of partner losses applies to a partner's distributive share of charitable contributions and foreign taxes. Does not apply to the excess of fair market value over adjusted basis on charitable contributions of appreciated property.	704
Sale of Partnership Interest (Grecian Magnesite)	Effective for sales and exchanges after November 27, 2017, gain or loss from the sale of an interest in a partnership engaged in a U.S. trade or business as effectively connected with a U.S. trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange	864
Limitation on Losses	Effective for tax years beginning after Dec. 31, 2017, disallows an excess business loss of a taxpayer other than a C corporation. However, an excess business loss is treated as part of the taxpayer's net operating loss carryover to the following year. An excess business loss for the tax year is the excess of aggregate deductions of the taxpayer attributable to trades or businesses of the taxpayer, over the sum of aggregate gross income or gain of the taxpayer plus a threshold amount (\$500,000 for married taxpayers filing jointly; \$250,000 for all other taxpayers (indexed for inflation)). Limitation applies at the partner level. Expires after December 31, 2025.	461



Disclosures

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