



NORTHERN
TRUST

CONQUERING SUBCHAPTER K(RYPTONITE):

Fundamentals Of Partnership Taxation For Estate Planners

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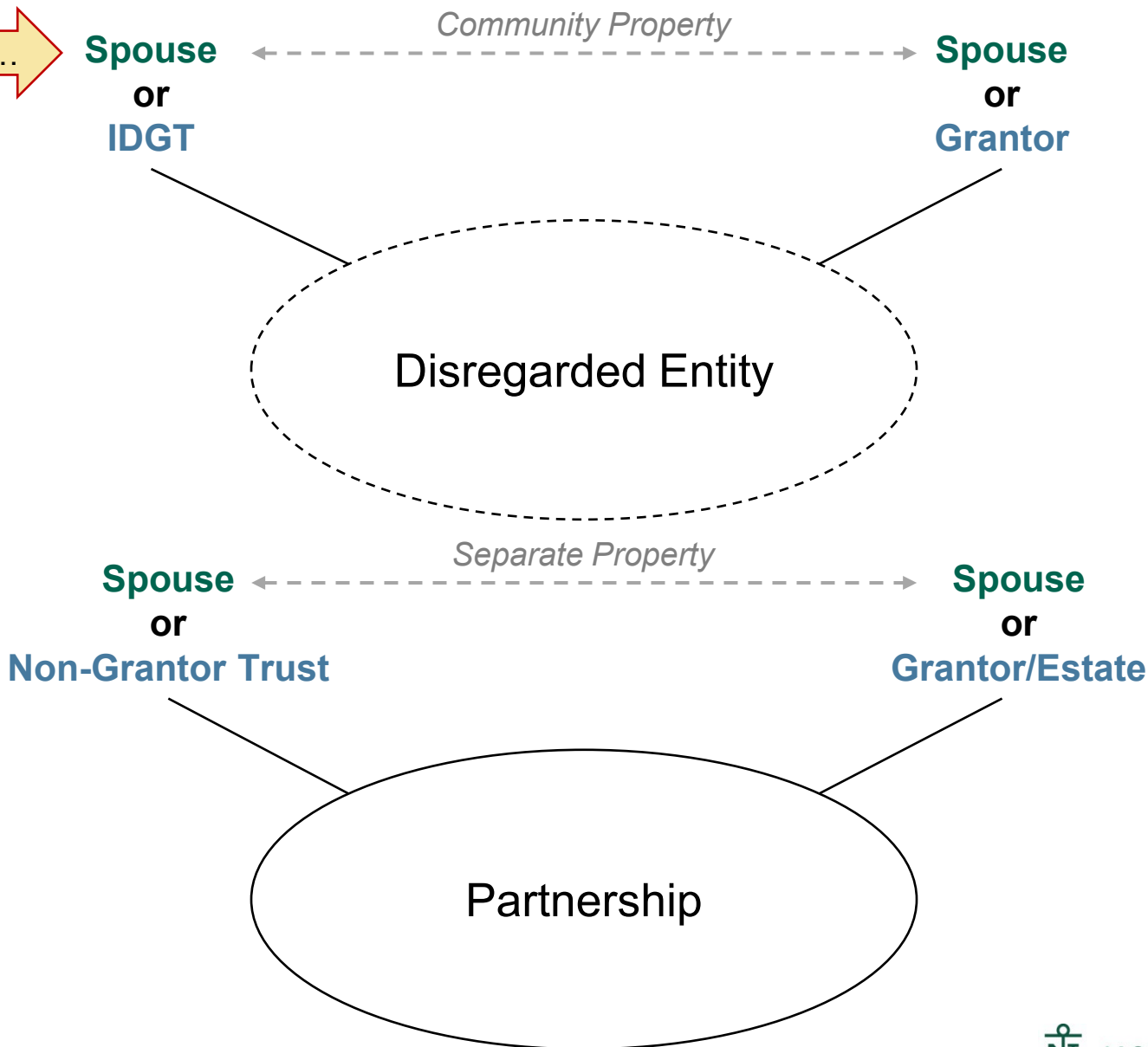
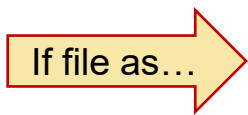
“Partnership” Formation: Choice of Entity/Check-The-Box

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

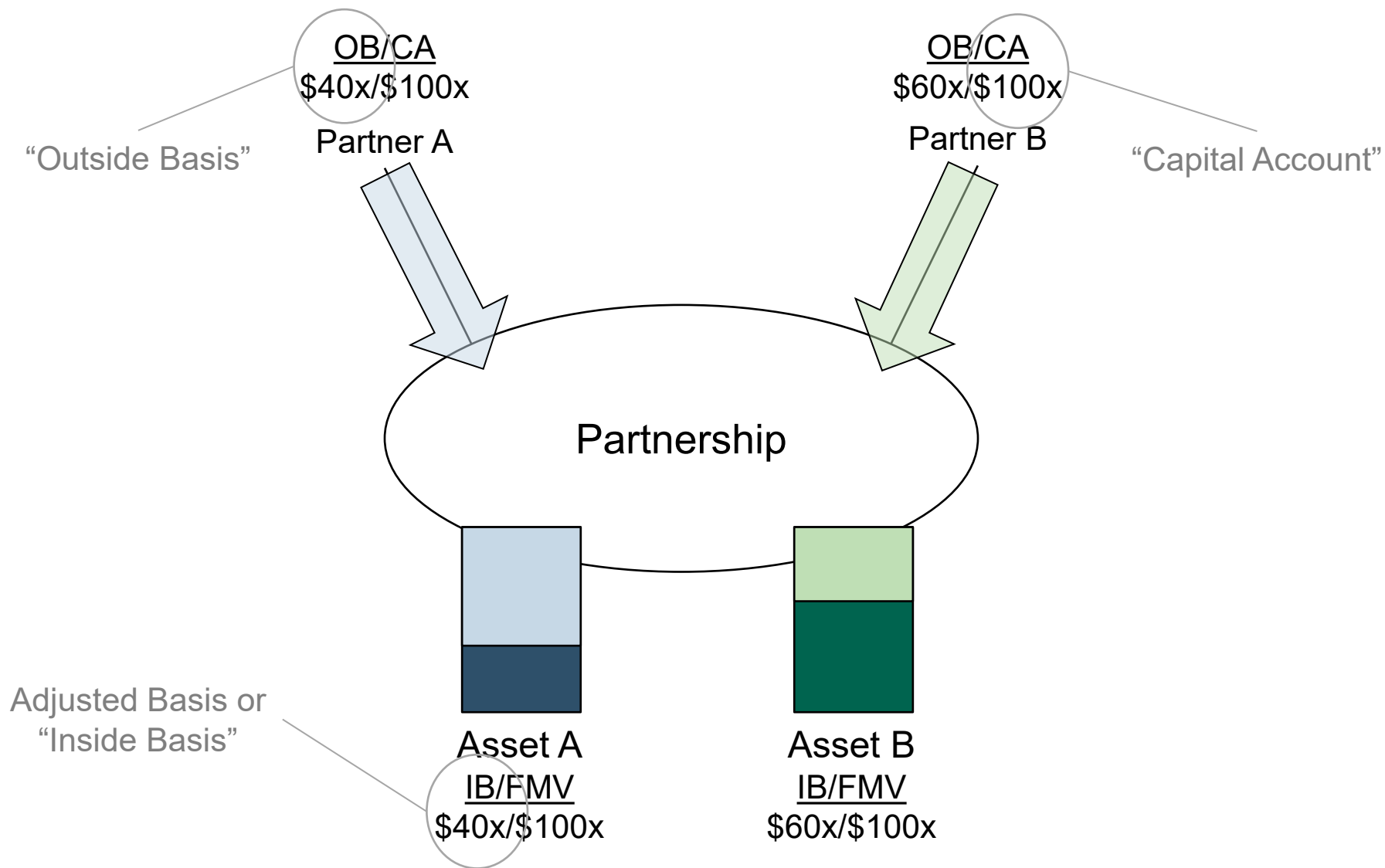


Disregarded Entity LLC Can Have More Than 1 Member



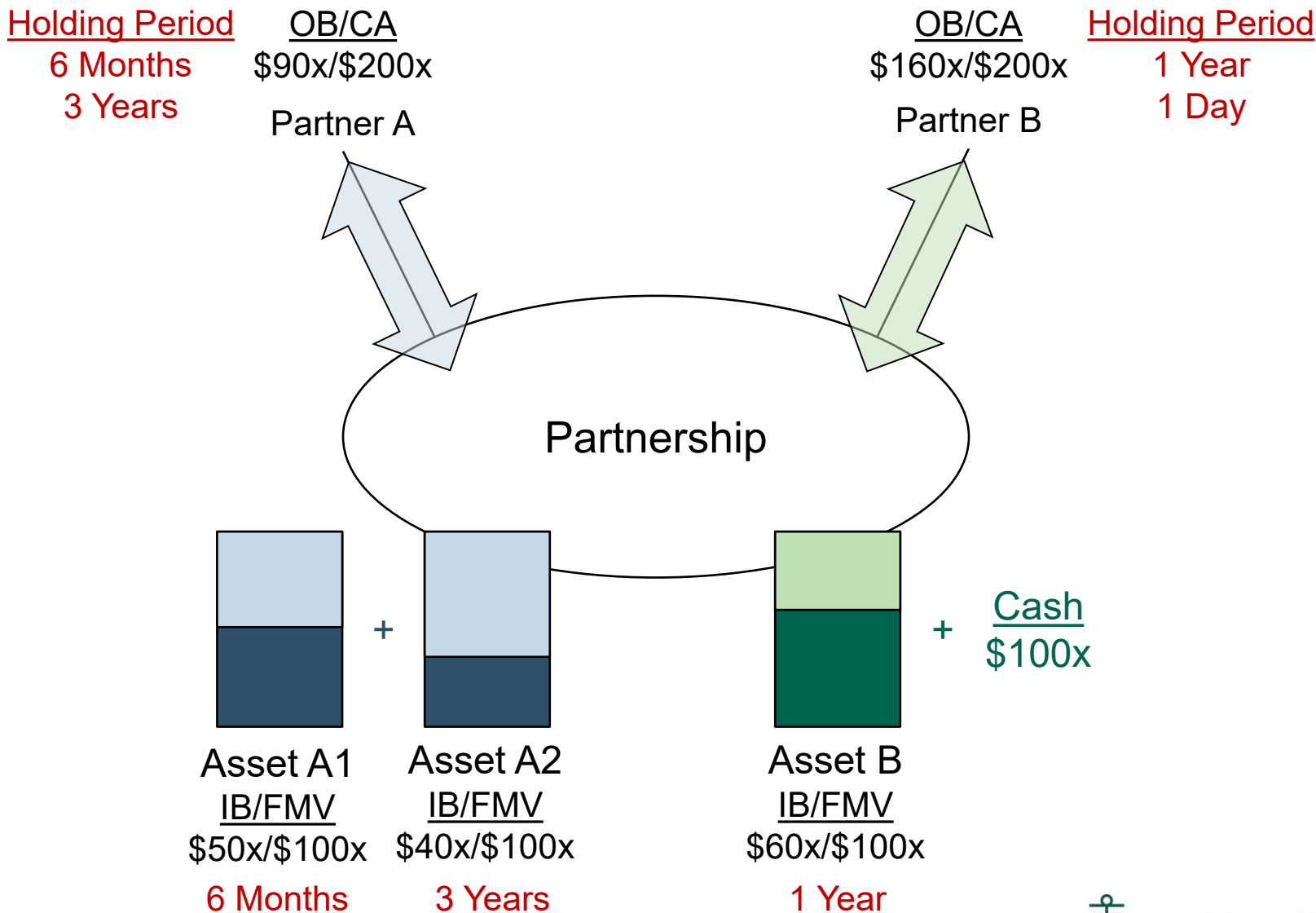


Contributions to Partnership Are Generally Non-Taxable



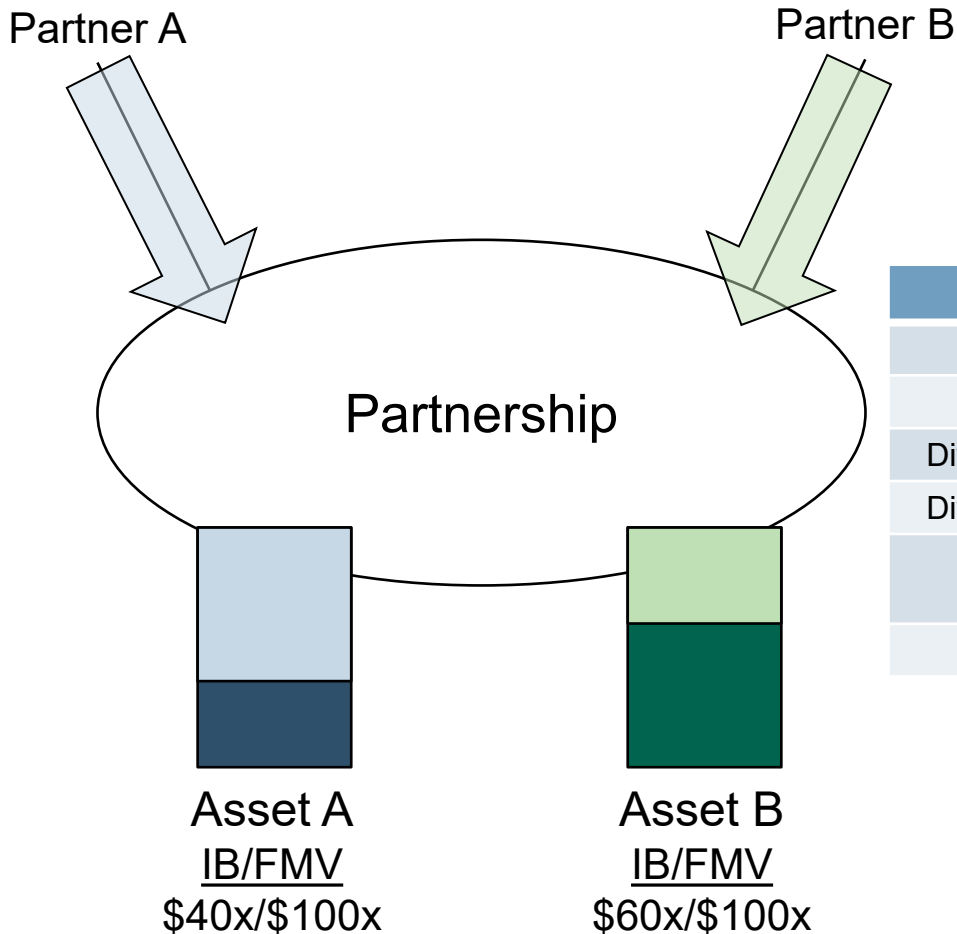


Tax Attributes Are Preserved Including Holding Period





Exception: Contributions to “Investment Company”



Diversification
+
>80% of value:

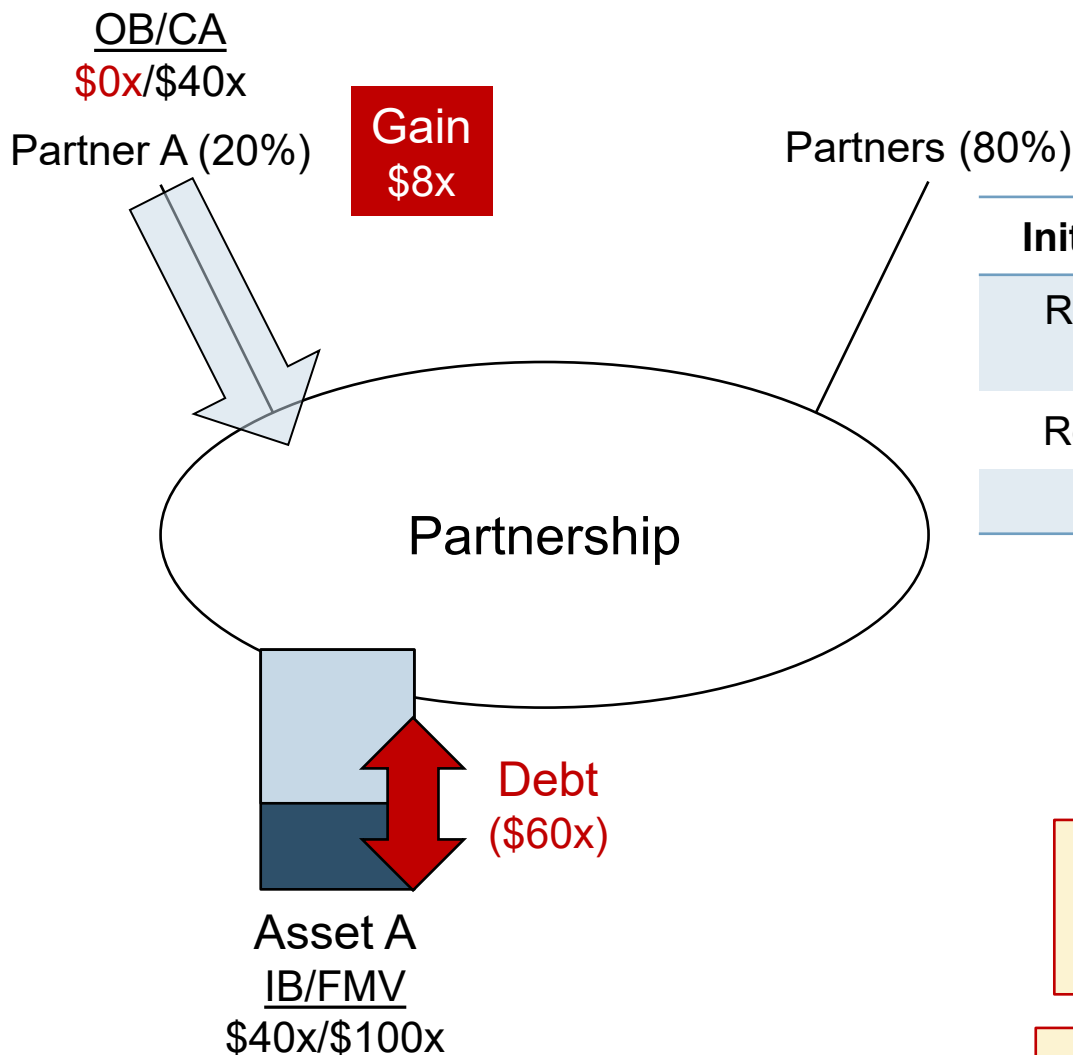
- Stock
- Securities
- Mutual Funds
- REITs

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

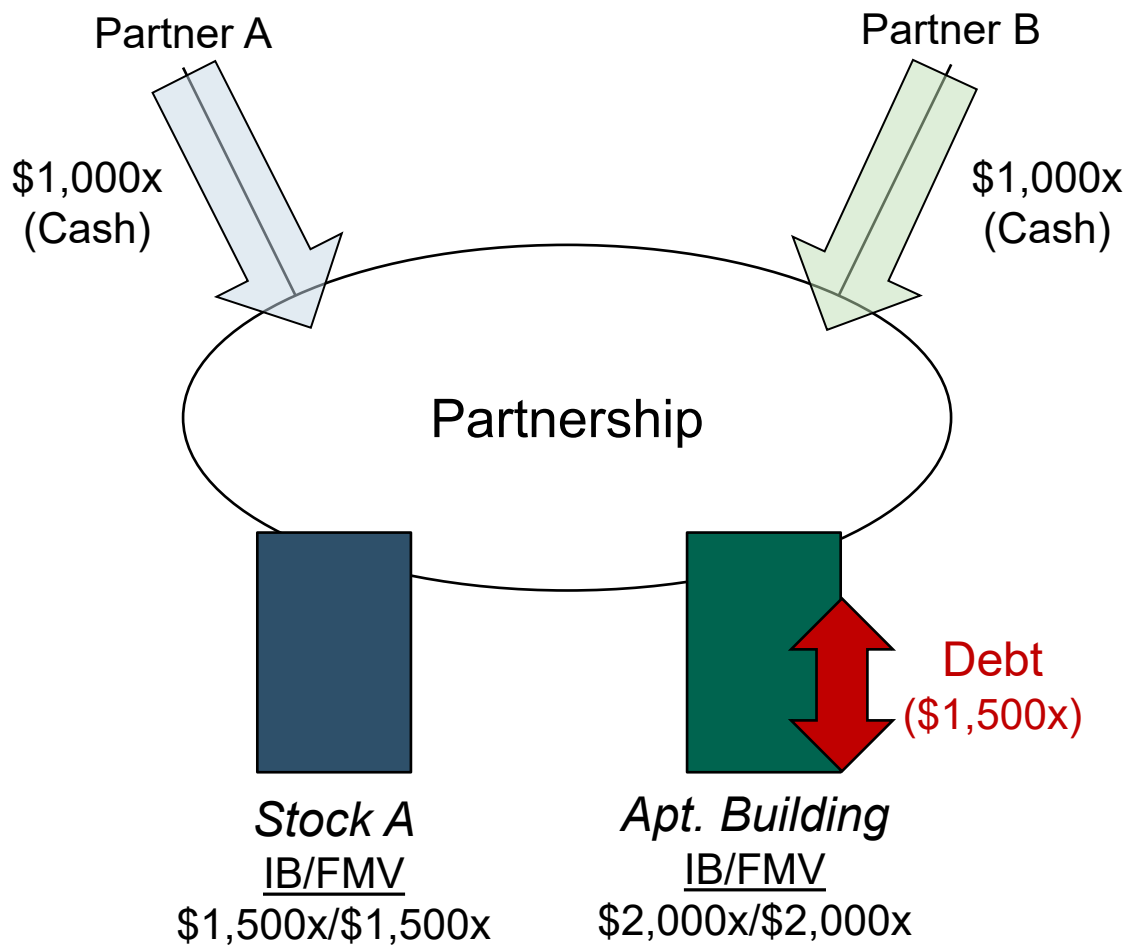
Gain can also be avoided if Partner A agrees to remain responsible for the debt (recourse as to Partner A)

Only recourse debt can cause gain.
Nonrecourse debt never causes gain.



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 (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: (i) an apartment building for \$2,000x, paying \$500x in cash and borrowing \$1,500x (mortgaging the building); and (ii) Stock A for \$1,500x.

AB Partnership Balance Sheet			
Assets		Liabilities	
Stock A	\$1,500x	Mortgage	\$1,500x
Building	<u>\$2,000x</u>		<u> </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)

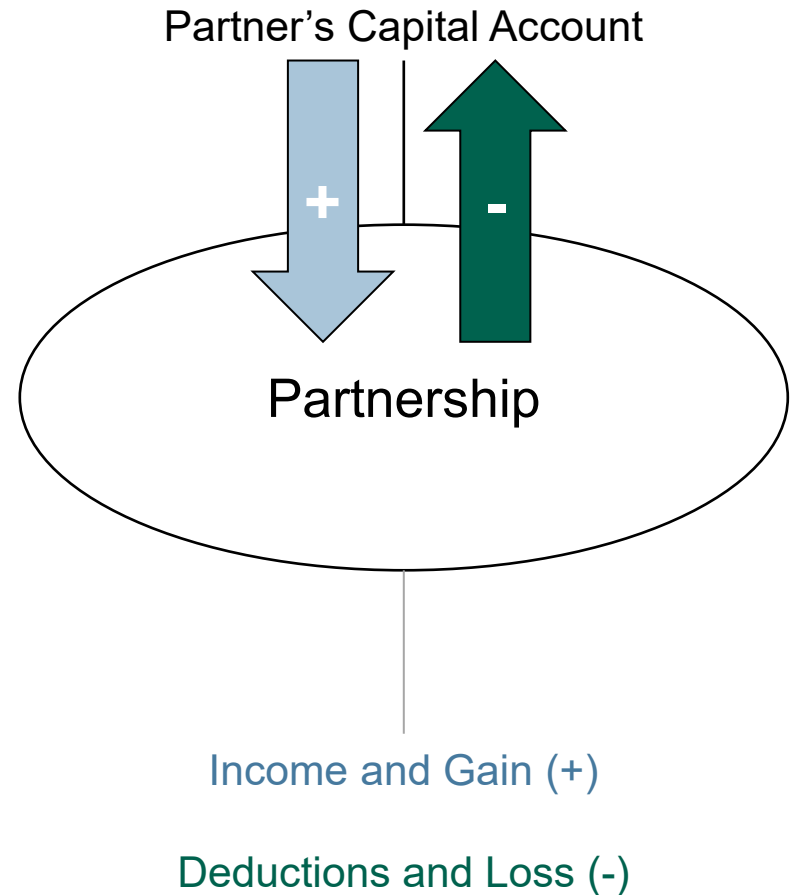
Decreased by:

- 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
- Reduction in share of partnership **liabilities**

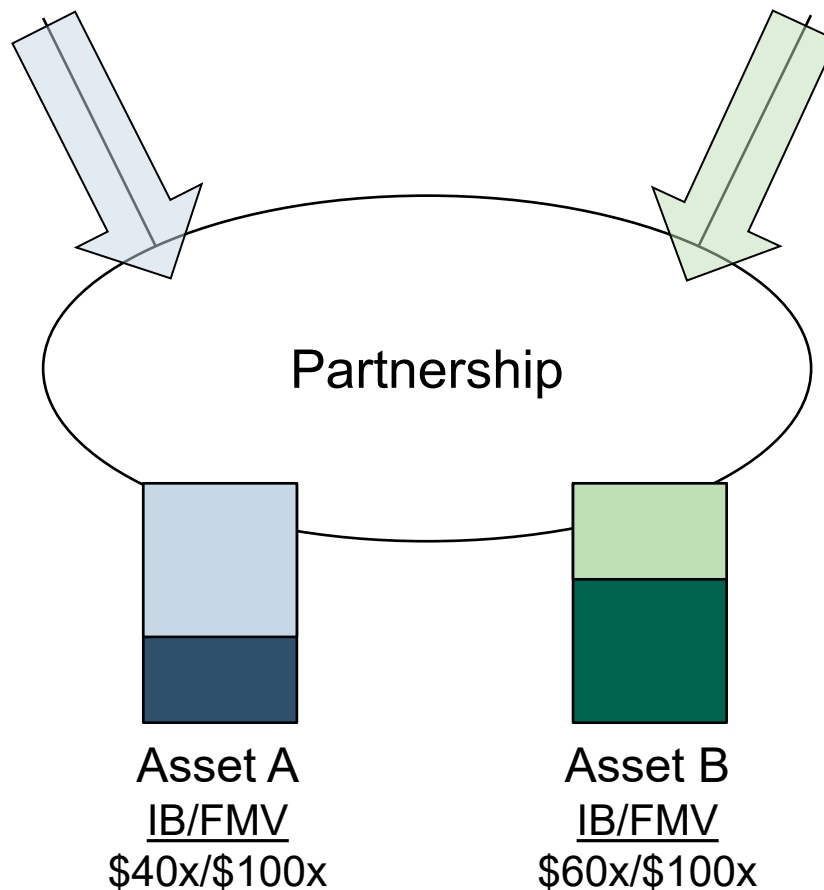
There is no such thing as
"negative basis."

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

Partner A

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

Partner B





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
- Reduction in share of partnership **liabilities**
- 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.



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 (mortgaging the building); and (ii) Stock A for \$1,500x.

Partnership Balance Sheet					
Assets			Liabilities		
	Basis	Book			
Stock A	\$1,500x	\$1,500x	Mortgage		\$1,500x
Building	<u>\$2,000x</u>	<u>\$2,000x</u>			<u> </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



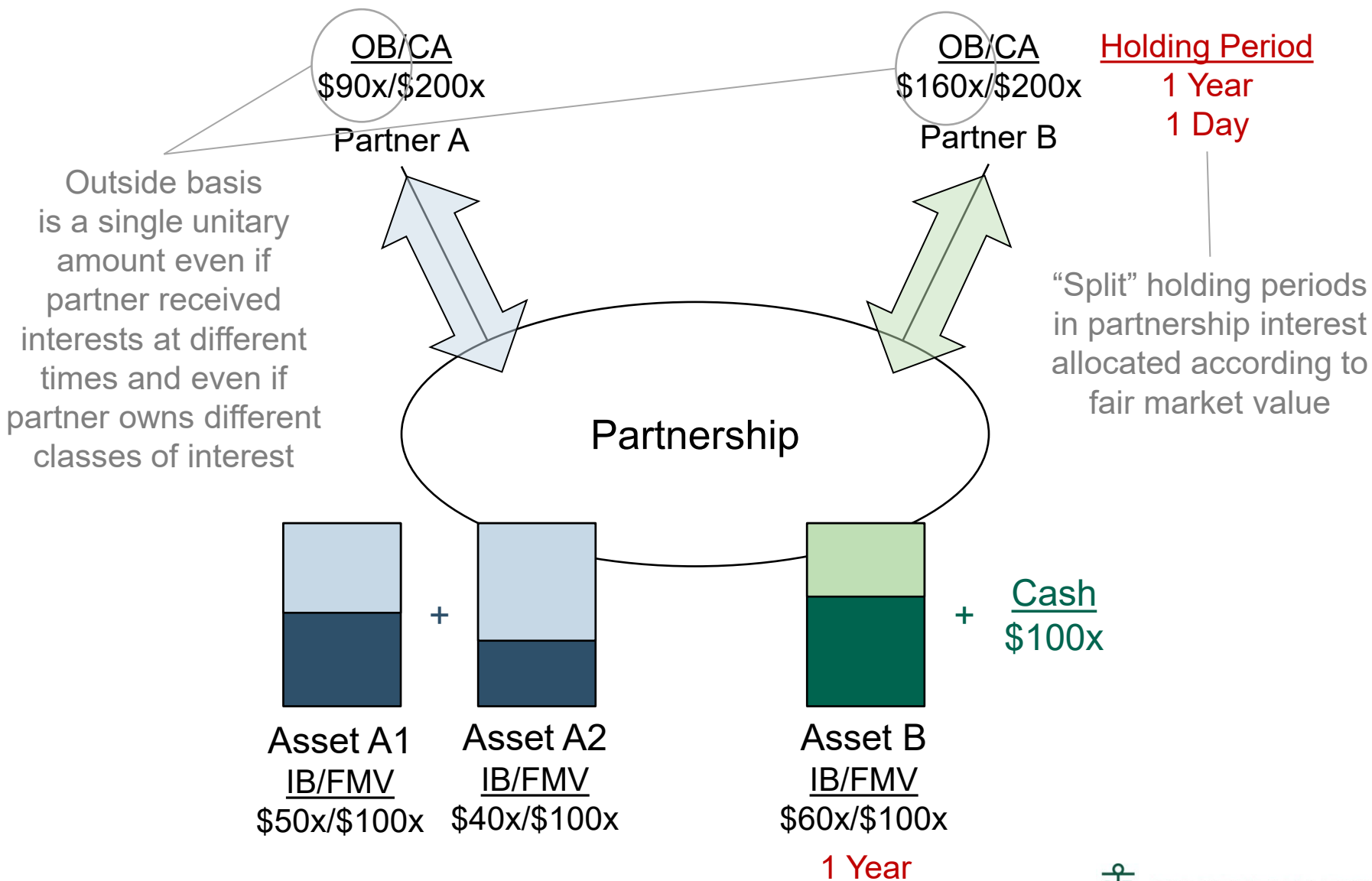
Inside Basis/Outside Basis/Capital Accounts

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 A	\$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>

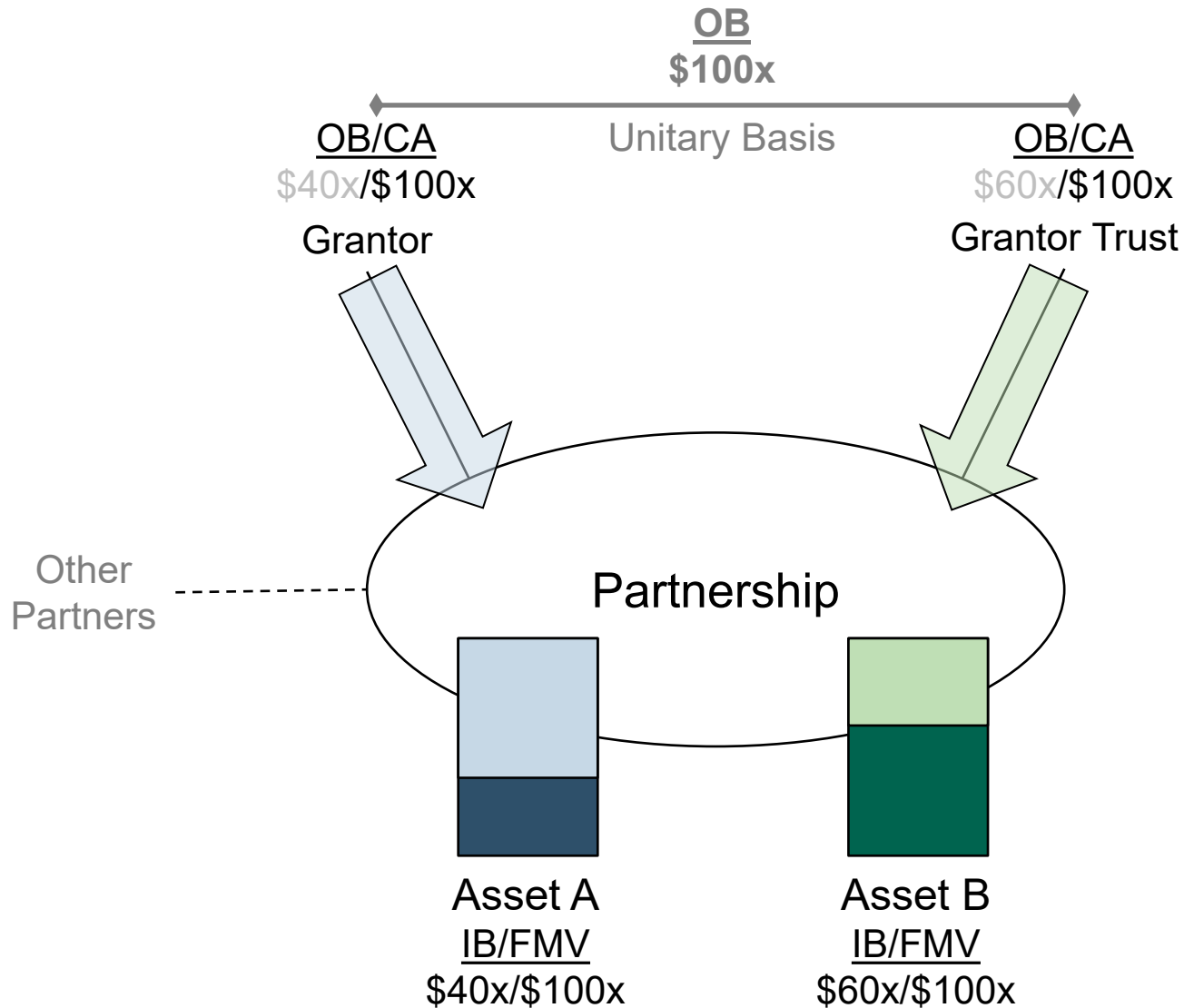


Unitary Basis Rule





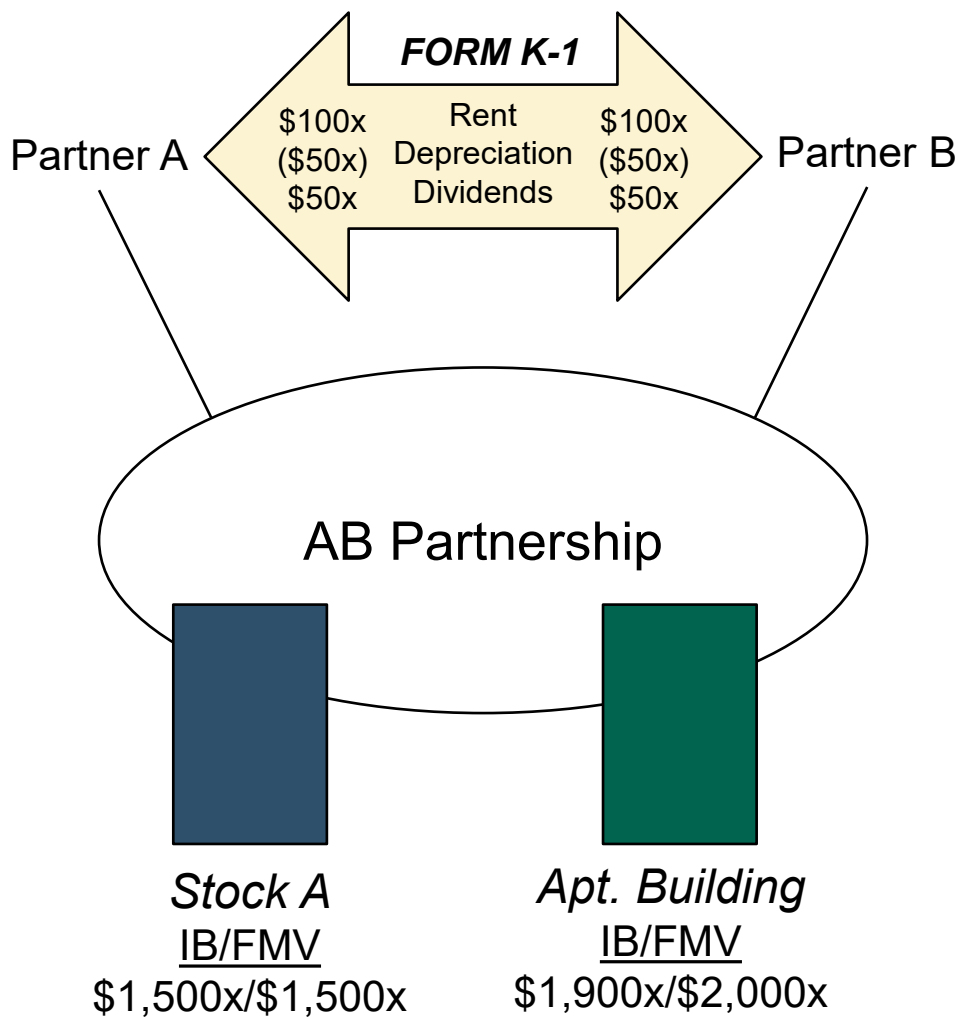
Unitary Basis Rule Applies to Grantors and Grantor Trusts





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. The partnership purchases: (i) an apartment building for \$2,000x, paying \$500x in cash and borrowing \$1,500x (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.”

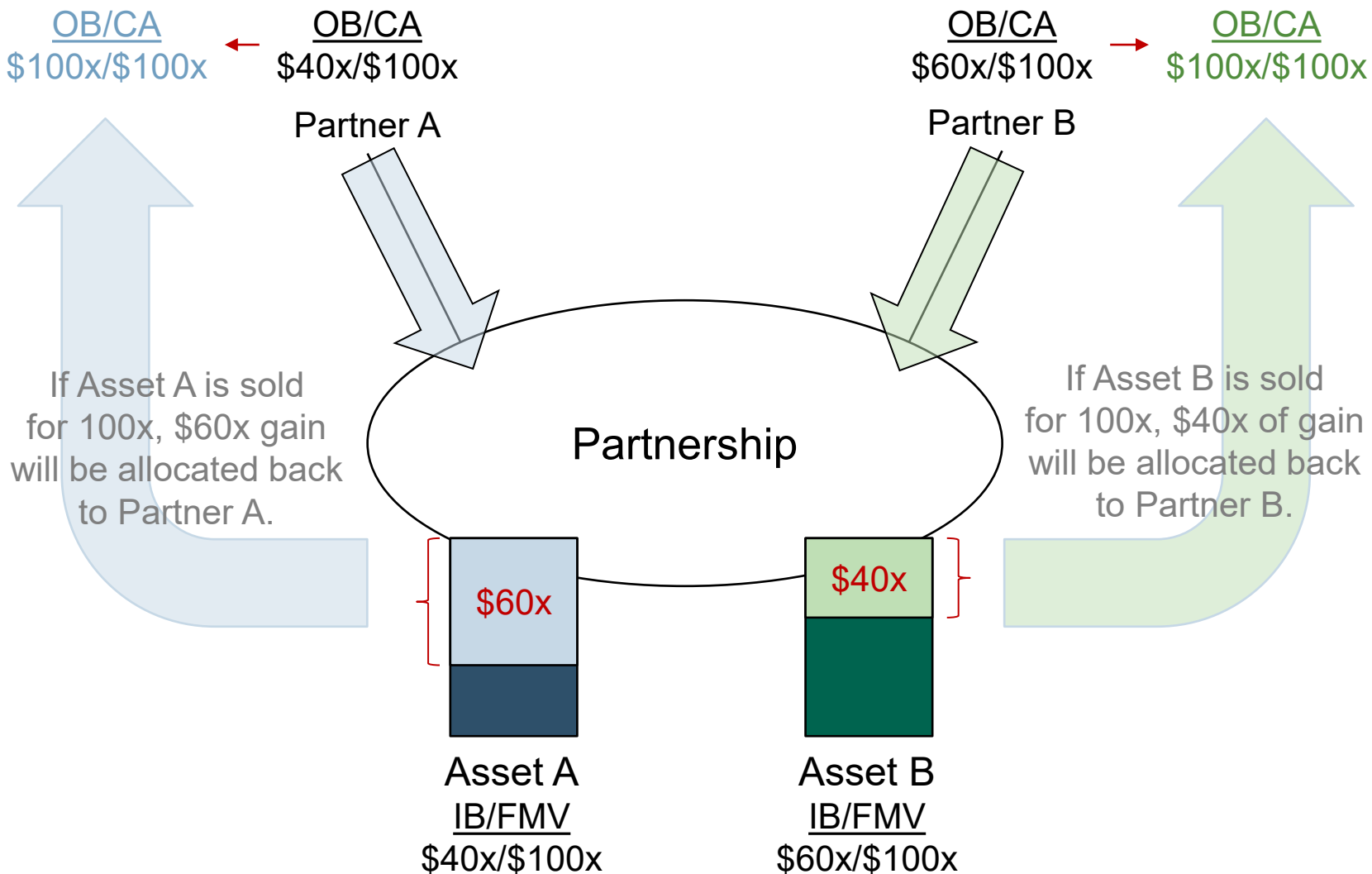
Allocation Does Not Mean Cash Flow

- 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

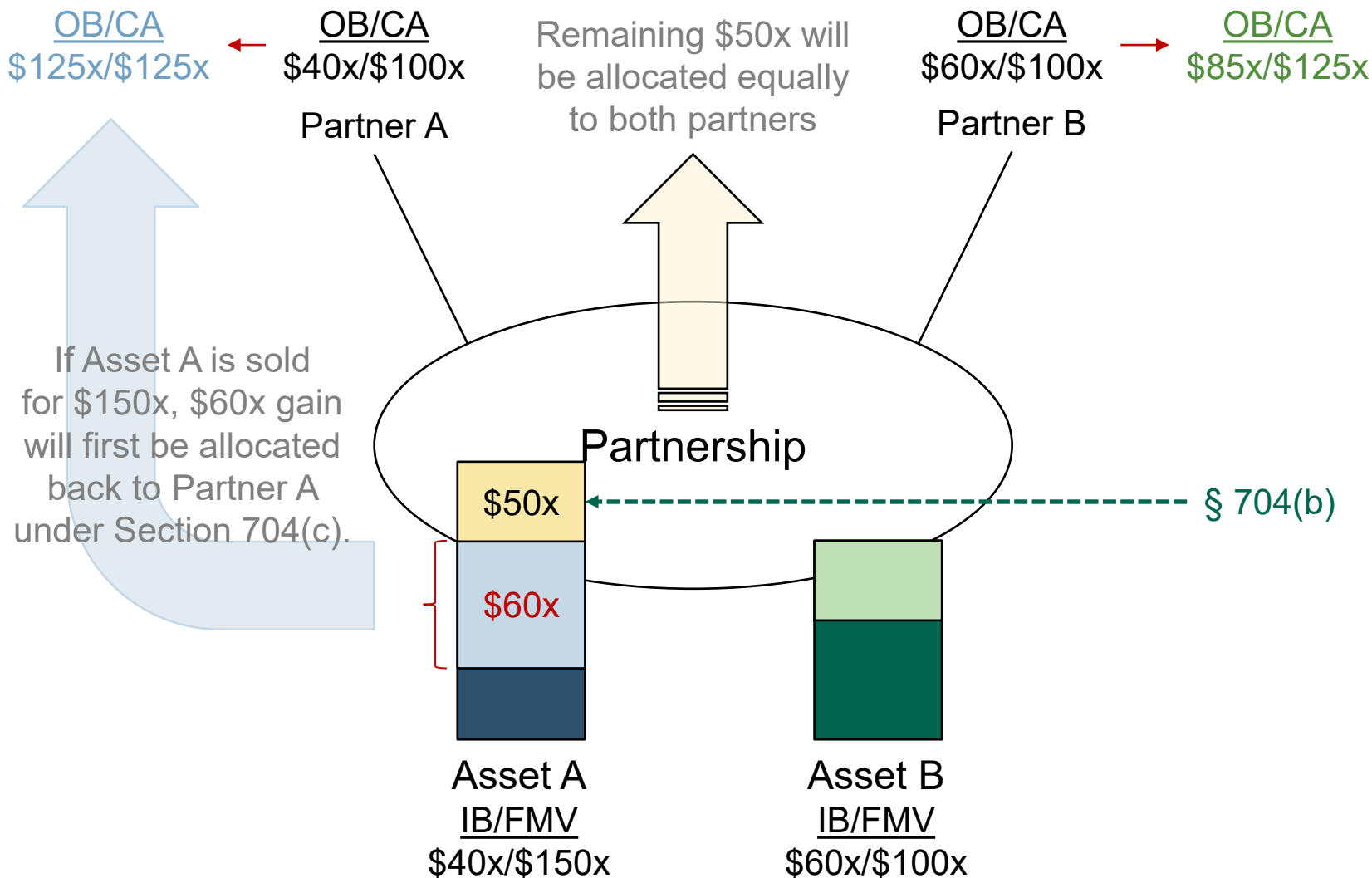
Assets			Liabilities		
	Basis	Book			
Asset A	\$40x	\$100x	None		\$0x
Asset B	<u>\$60x</u>	<u>\$100x</u>			
Total Assets	\$100x	\$200x	Total Liabilities		\$0x
			Capital Accounts		
				Tax	Book
			Partner A	\$40x	\$100x
			Partner B	<u>\$60x</u>	<u>\$100x</u>
			Total Equity	\$100x	\$200x

“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.



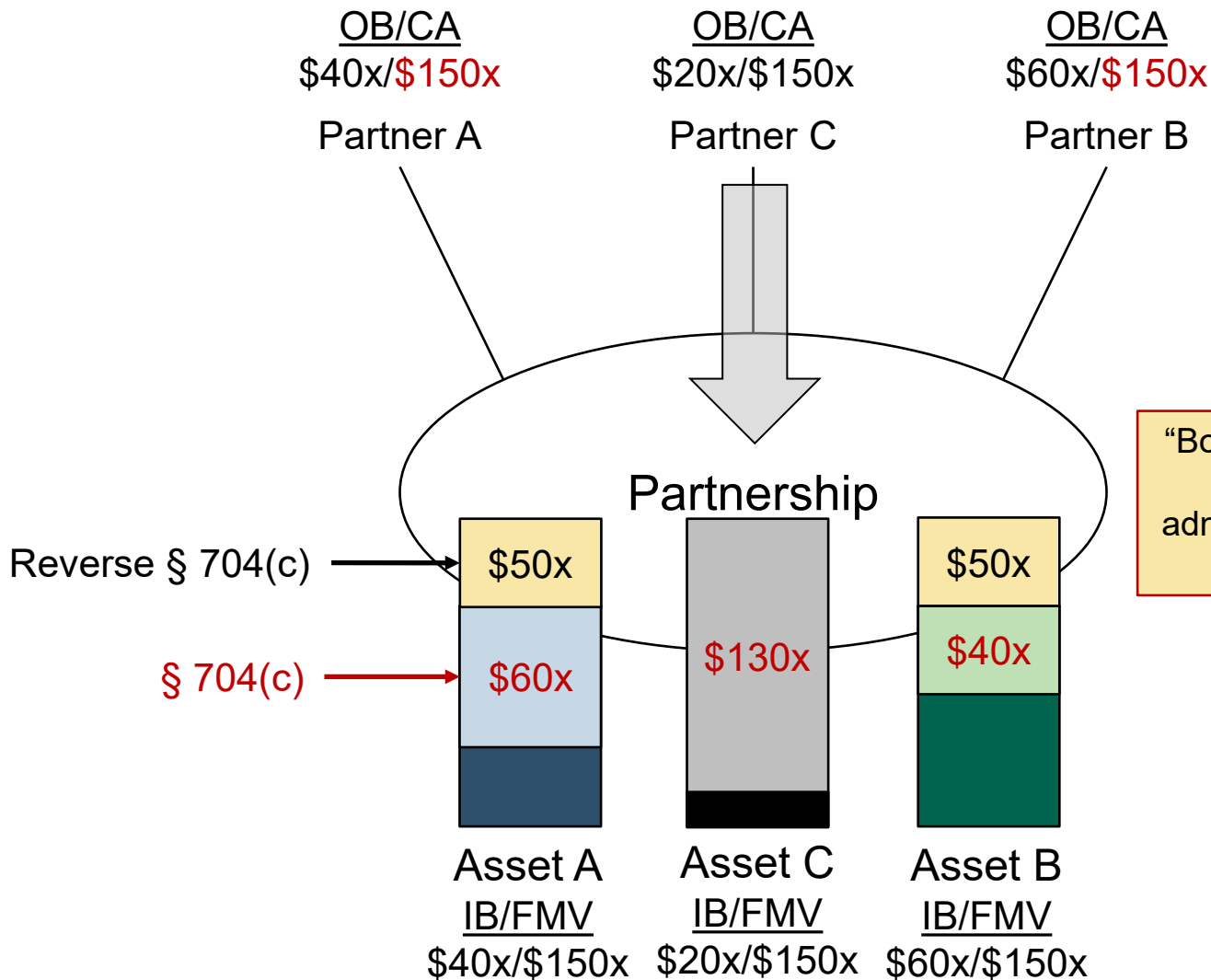
What Is Section 704(c)?





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

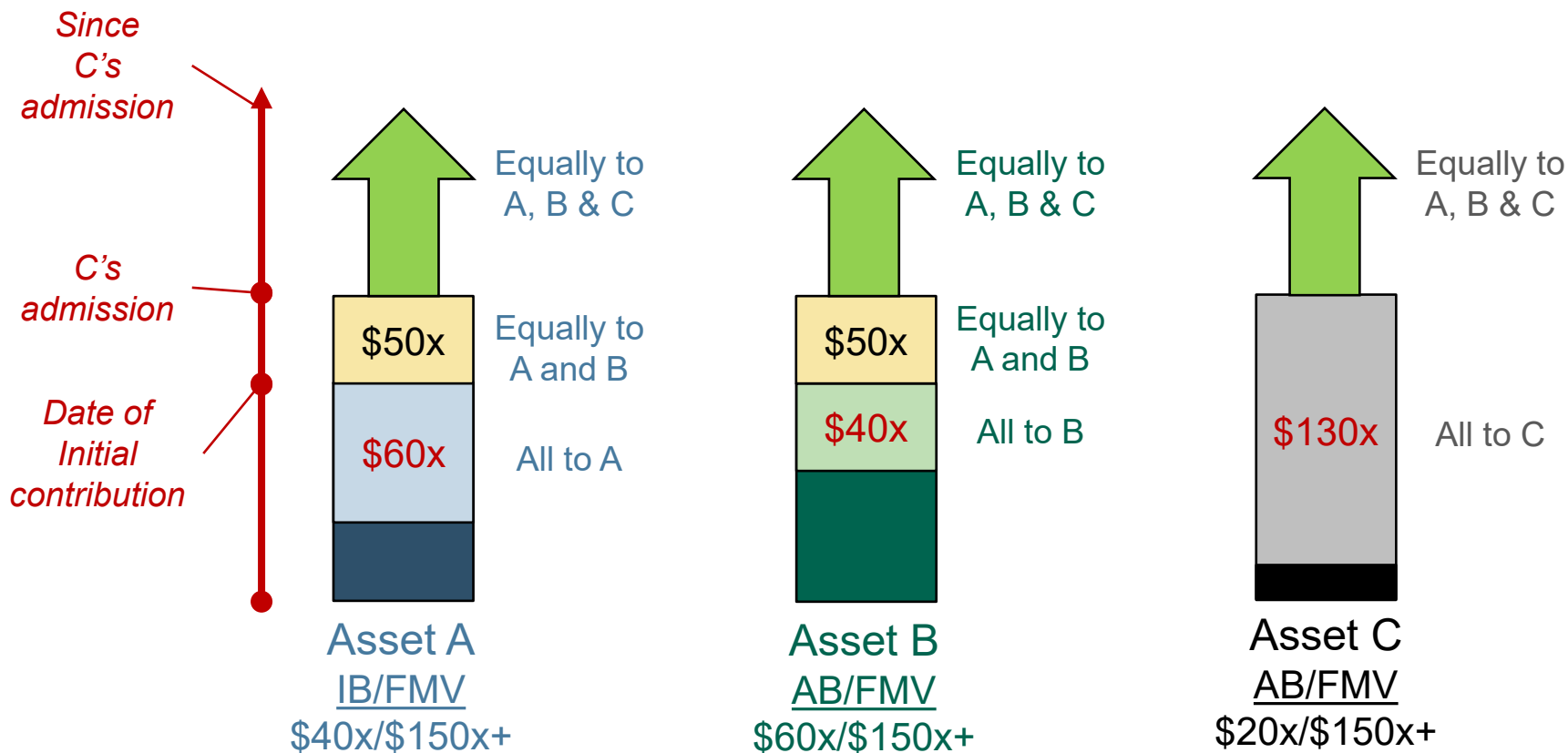
Example: Asset A and B both appreciate to \$150x in value. At that time, Partner C is admitted as an equal 1/3 partner and contributes Asset C with an adjusted basis of \$20x and a fair market value of \$150x.





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.

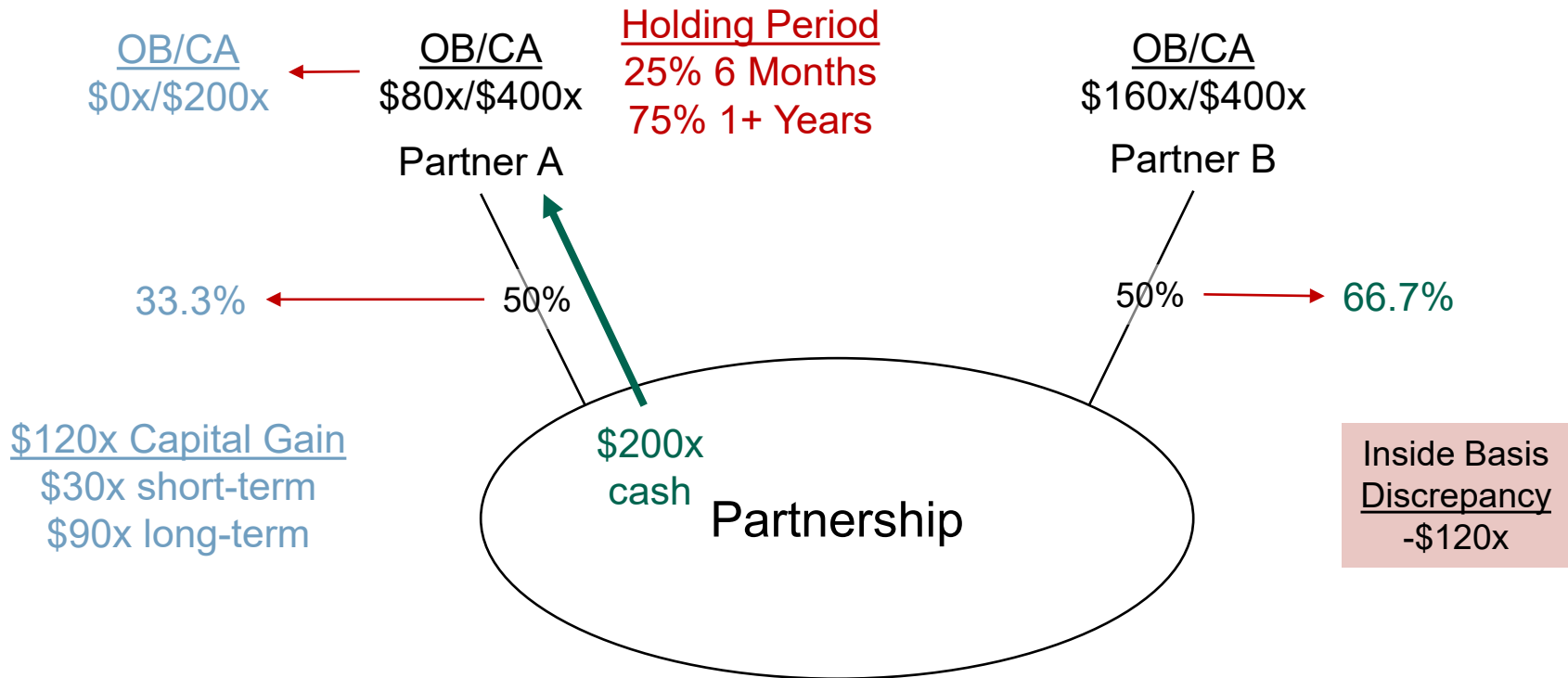




Cash Distributions: Tax Free Up to Outside Basis

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

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

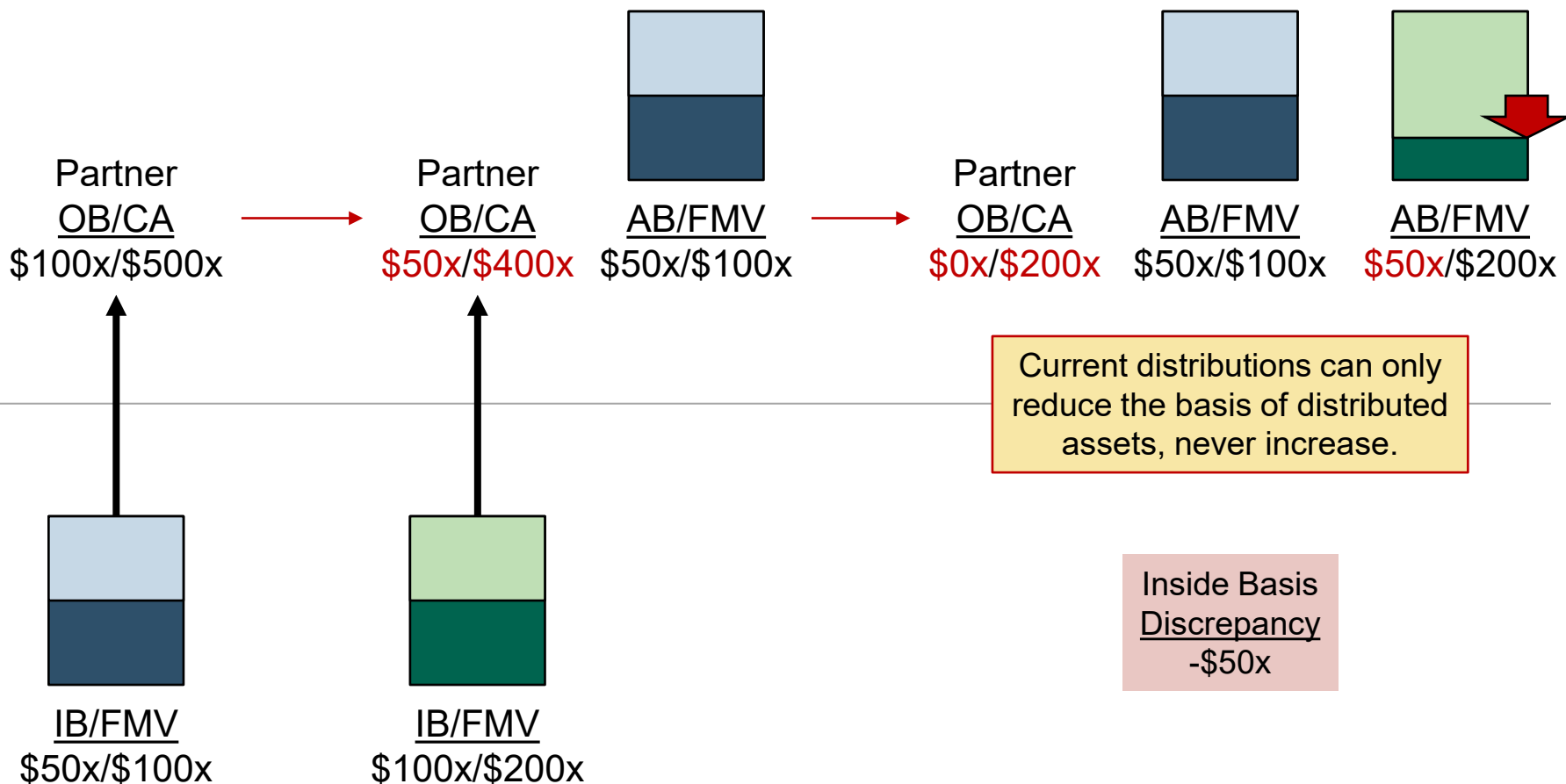


With “pro rata” family partnerships, to maintain a single class share, distributions of cash must be pro rata, or if there is a disproportionate distribution, then percentage interests (e.g., capital account balances) must be adjusted



Current Distributions of Property Are Generally Non-Taxable

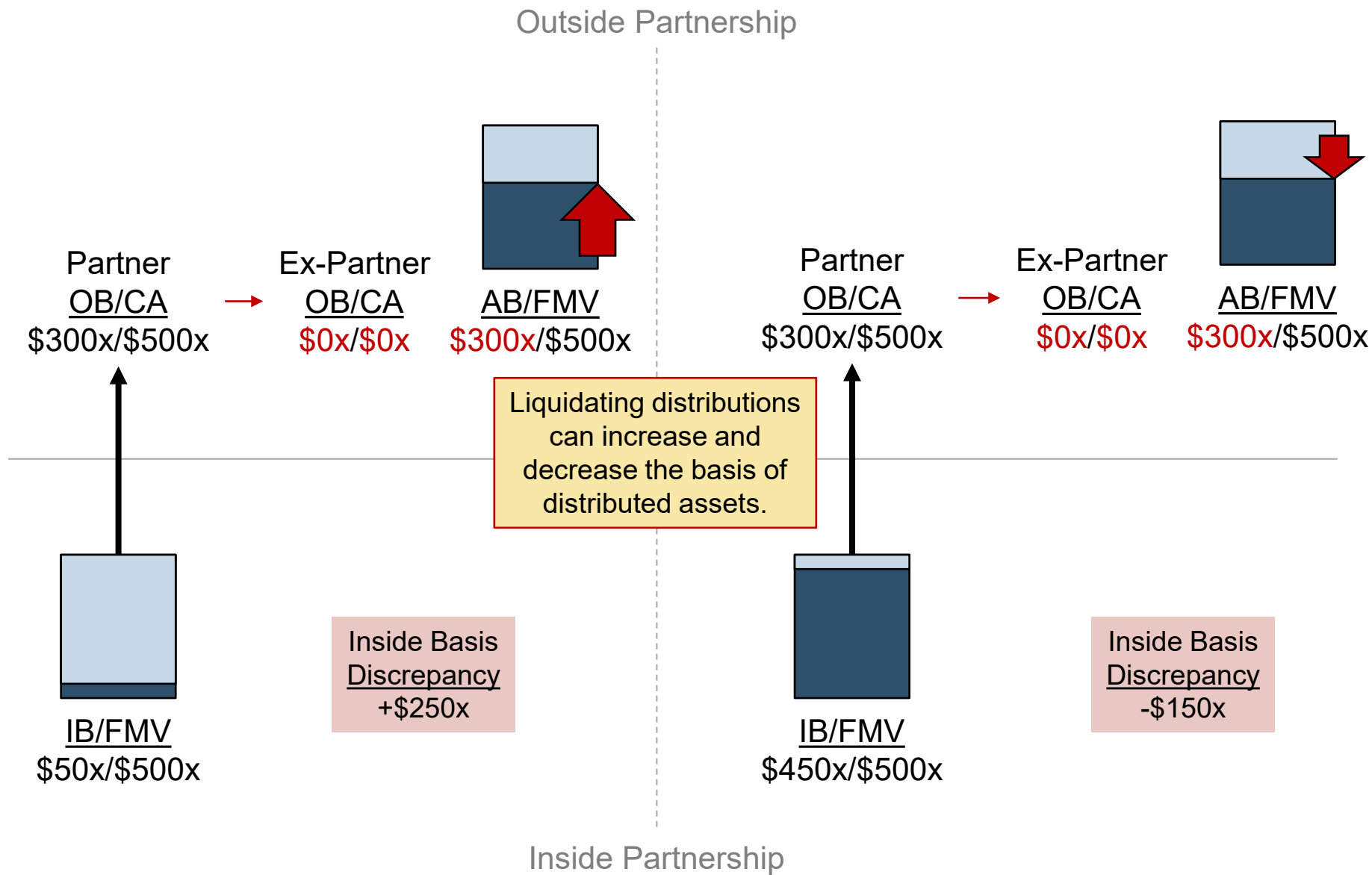
Outside Partnership



Inside Partnership



Liquidating Distributions of Property Are Different

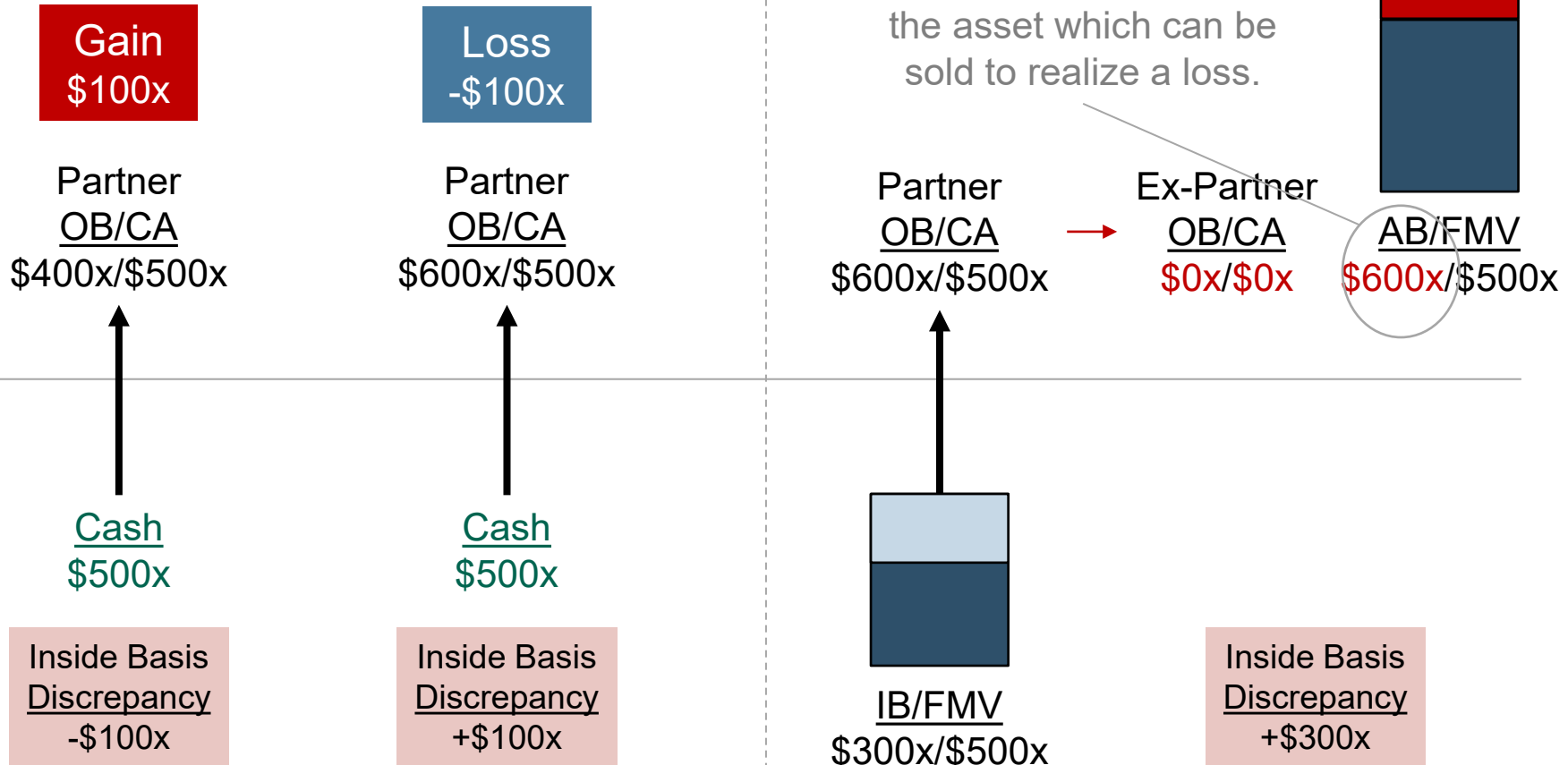




Liquidating Distributions Can Create Gain or Loss

Outside Partnership

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



Inside Partnership



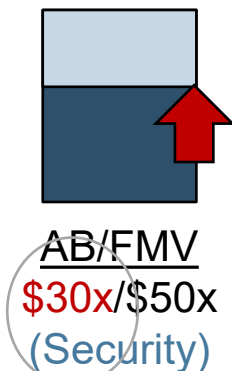
Exception: Distributions of Marketable Securities

Outside Partnership

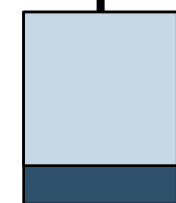
Gain
\$20x

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

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



AB/FMV
\$30x/\$50x
(Security)



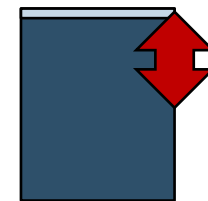
IB/FMV
\$10x/\$50x
(Security)

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

Gain
\$20x

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

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



AB/FMV
\$50x/\$50x
(Security)



IB/FMV
\$40x/\$50x
(Security)

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

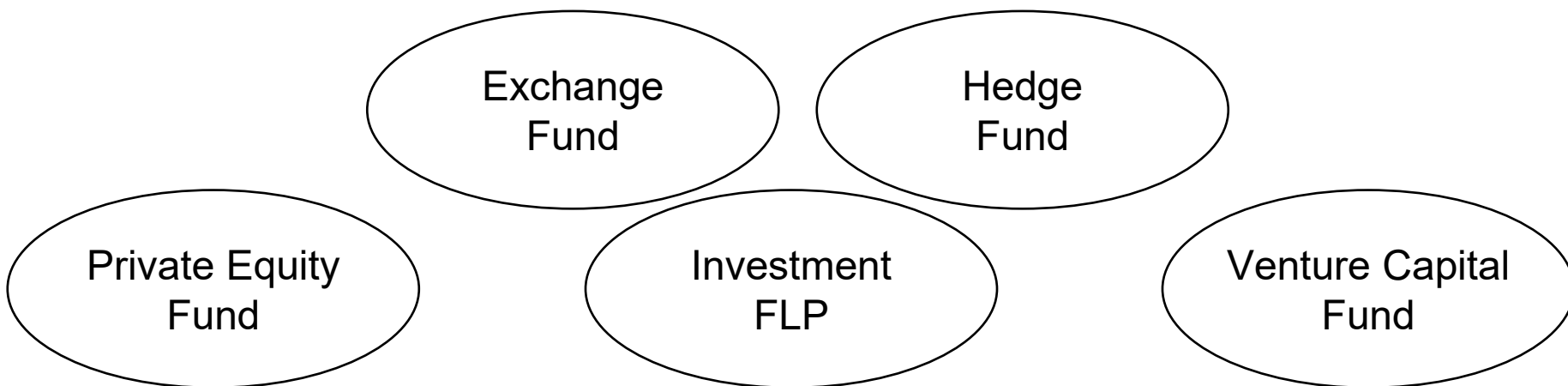
Inside Partnership



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.”



Even if fail to be an “investment partnership,” the amount of marketable securities treated as cash is reduced in a way that if the partnership only holds marketable securities, there will be no gain. Treasury Regulations do not limit it to “same class and issuer as the distributed security.”



Exception: Disguised Sale Rules

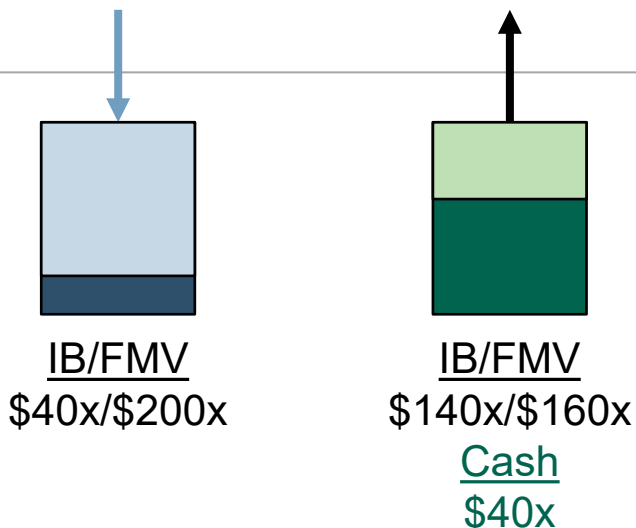
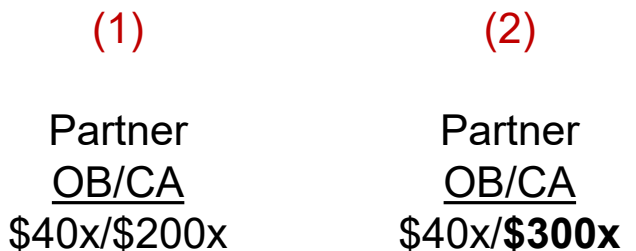
Elements of a "Disguised Sale" (Facts and Circumstances):

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

3 Types of Disguised Sales:
 Sale by partner to partnership
 Sale by partnership to partner
 Sale of partnership interest between partners

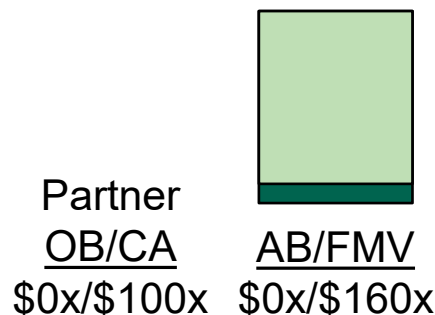
2-Year Rebuttable Presumption

Outside Partnership

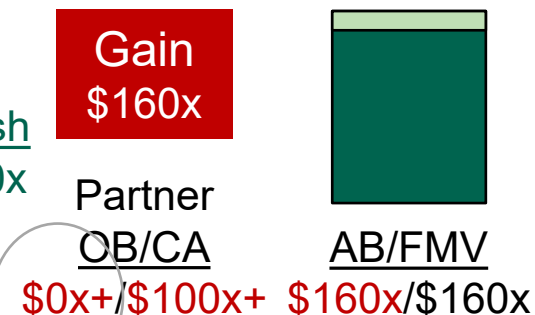


Inside Partnership

No Disguised Sale



Disguised Sale



Sale of "contributed" asset by partner (NOT in capacity as such). Partner has no OB or CA because there is no contribution.

Partnership level gain on exchanged asset which may or may not be allocated to partner

Distributions of current profits will not trigger a disguised sale.



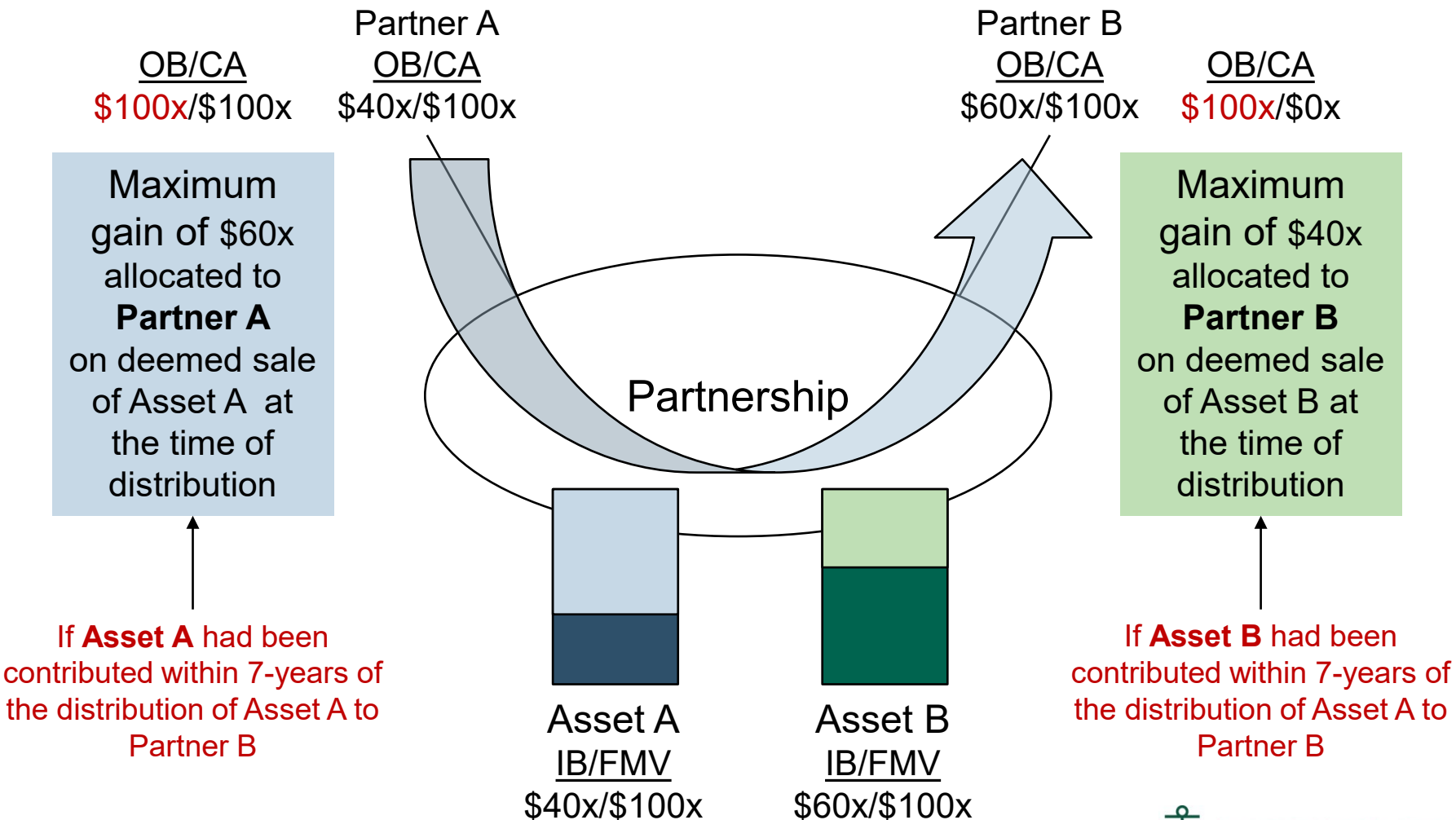
Exception: Mixing Bowl Rules

2 Forms of "Mixing Bowl" Transactions:

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

7-Year Rule

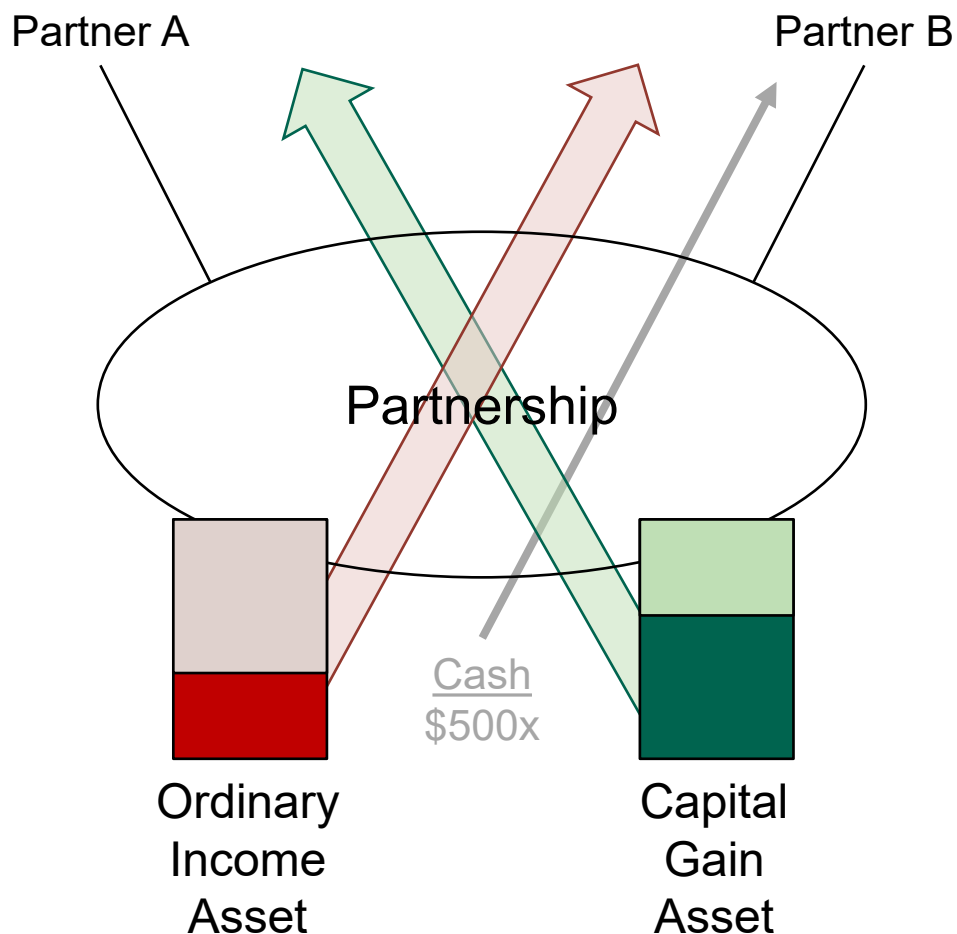
Distribution back to contributing partner is not a "mixing bowl" transaction.





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.

Partnership division can be a critical planning tool.



Taxable Sale of Partnership Interests: "Look-Through"

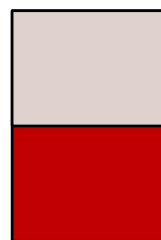
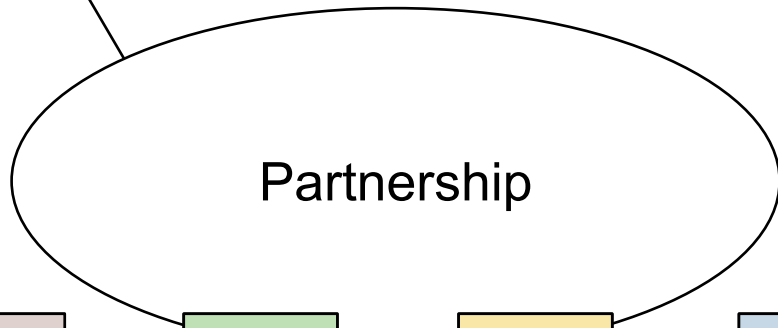
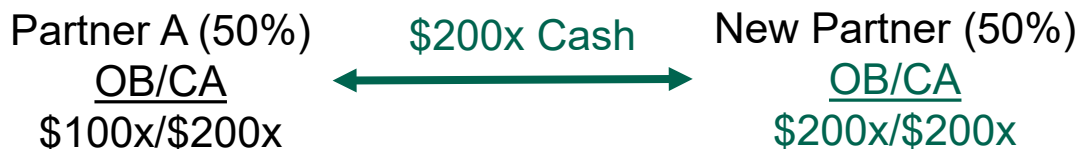
Holding Period: 100% 1+ Years

Total Gain = \$100x

A's Share of:	Amount	Tax Rate
§751(a) Income	\$25x	37%
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.

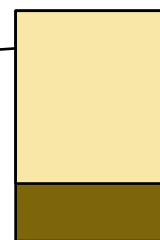
Inside Basis Discrepancy of Partnership Assets
-\$100x



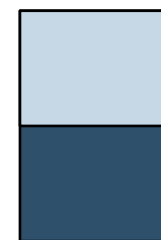
§751 Asset
IB/FMV
\$50x/\$100x



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



§1250 Asset
IB/FMV
\$20x/\$100x



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



Partnership Debts and Liabilities: Nonrecourse

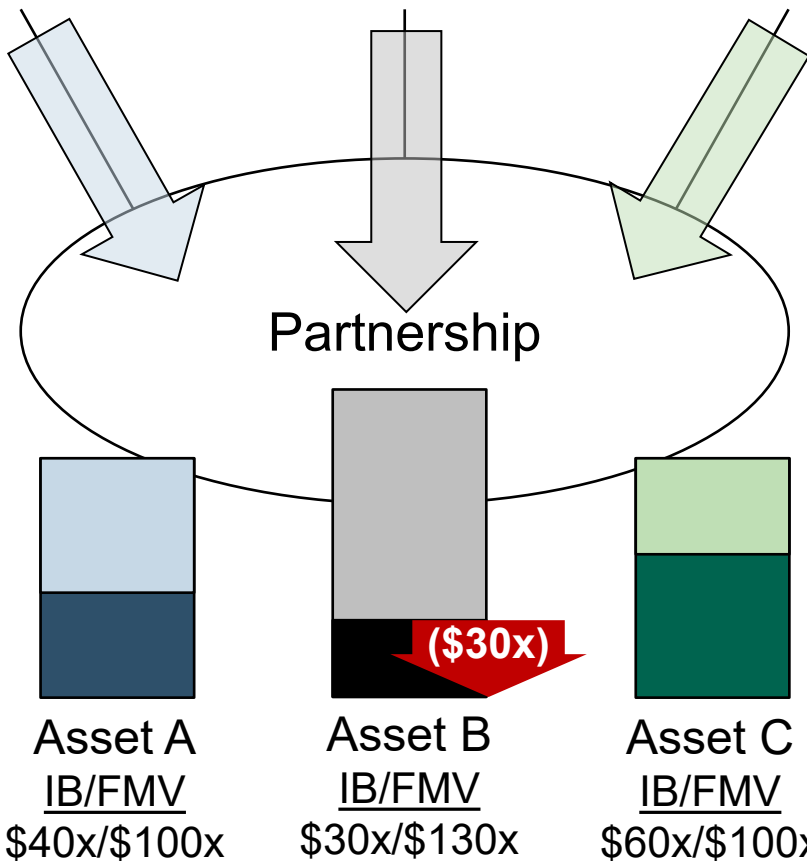
Example: A, B, and C create a partnership by contributing assets. Partnership takes Asset B subject to -30x debt. Debt is nonrecourse. No guarantees or other agreements. A, B, and C are equal partners.

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

OB/CA
\$10x/\$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	\$30x	\$60x
§752(b)	\$0x	(\$30x)	\$0x
§752(a)	\$10x	\$10x	\$10x
Ending OB	\$50x	\$10x	\$70x

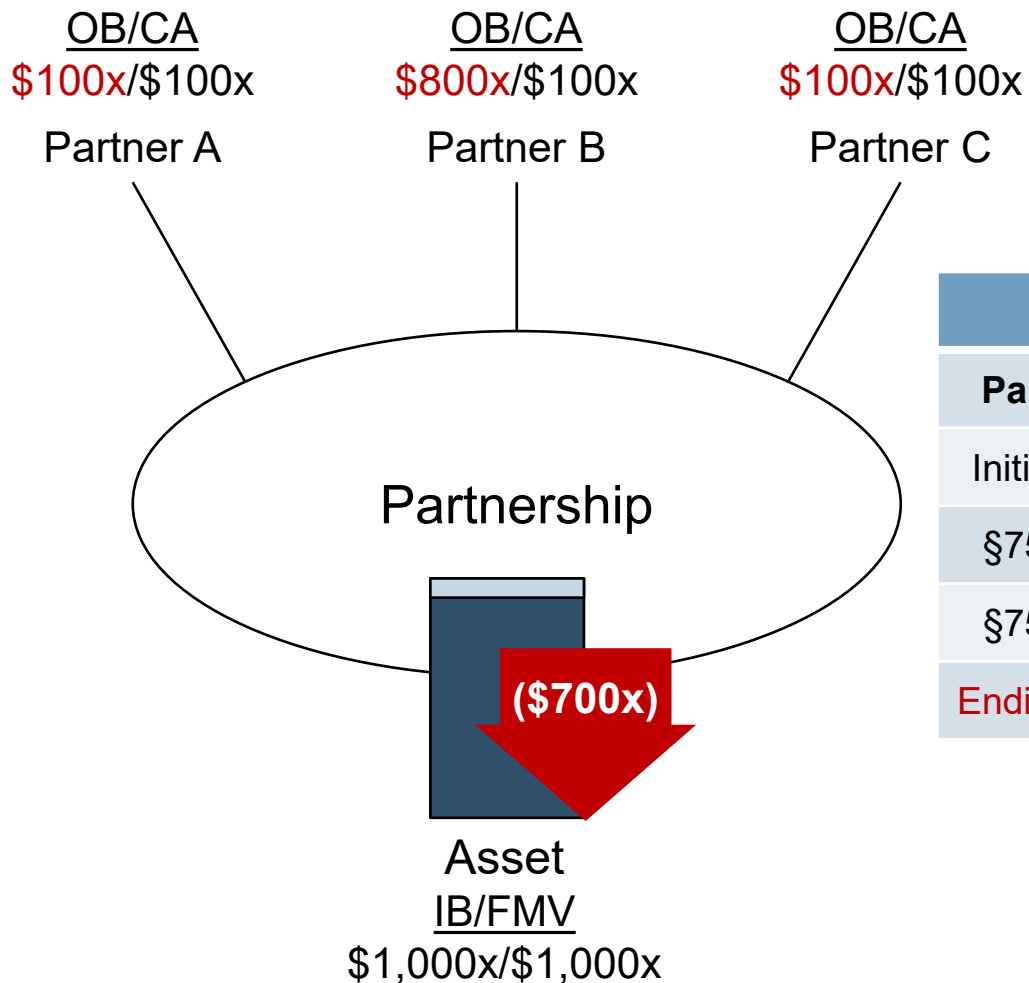
§ 752(a): **Increase** in partner's share of liabilities is considered a **contribution** of money by partner.

§ 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

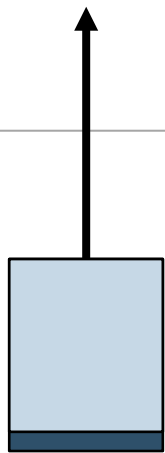
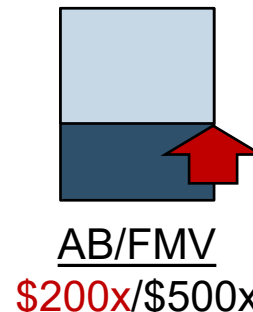
Outside Partnership

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

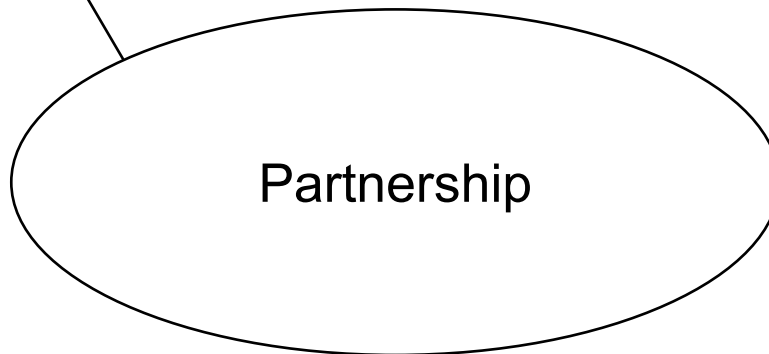


New Partner (50%)

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



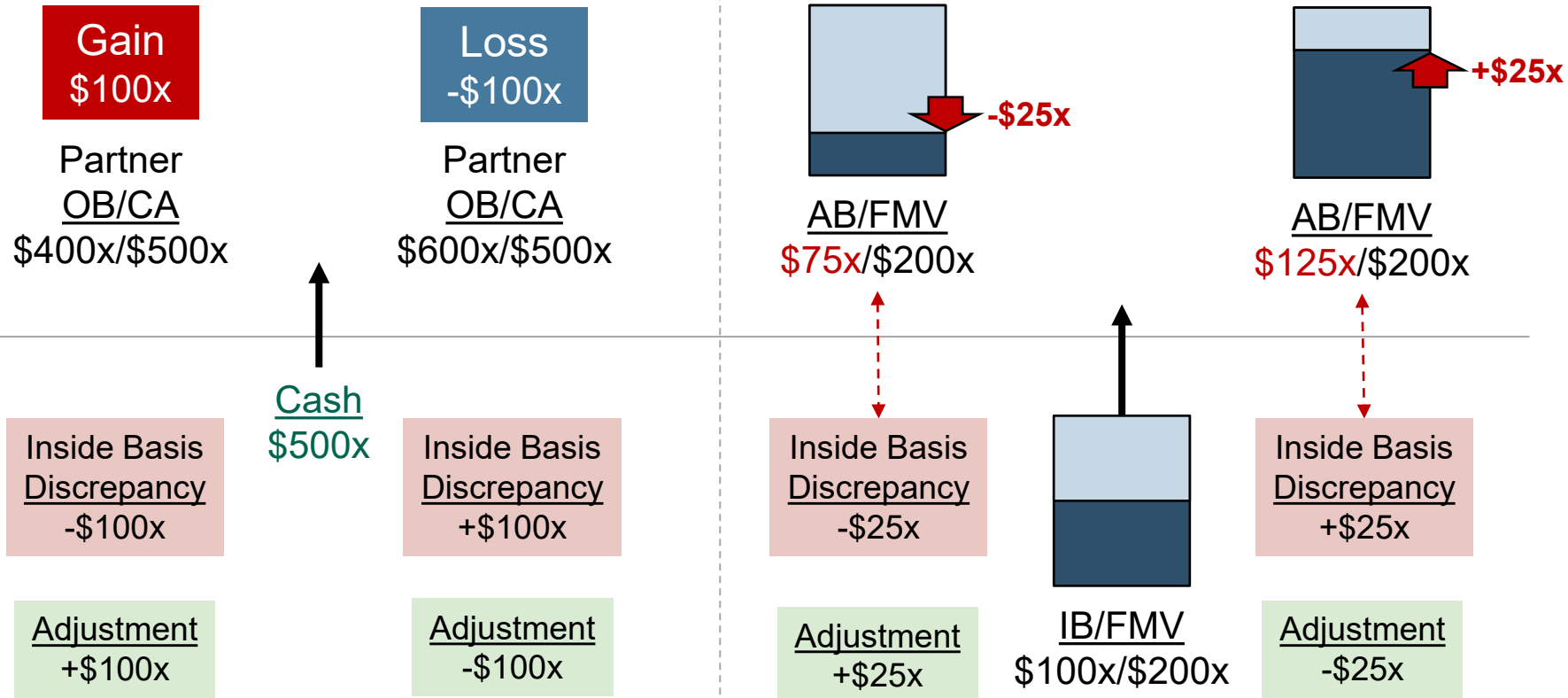
Section 754 and Section 734 Inside Basis Adjustments

Section 754 election allows the partnership to adjust the inside basis of assets under **Section 734** to cure discrepancies with the outside bases of the partners when there is:

- **Distribution** of cash resulting in gain or loss; and
- **Distribution** of property resulting in a change of basis;

Election Is Irrevocable Without IRS Consent

Outside Partnership



Inside Partnership

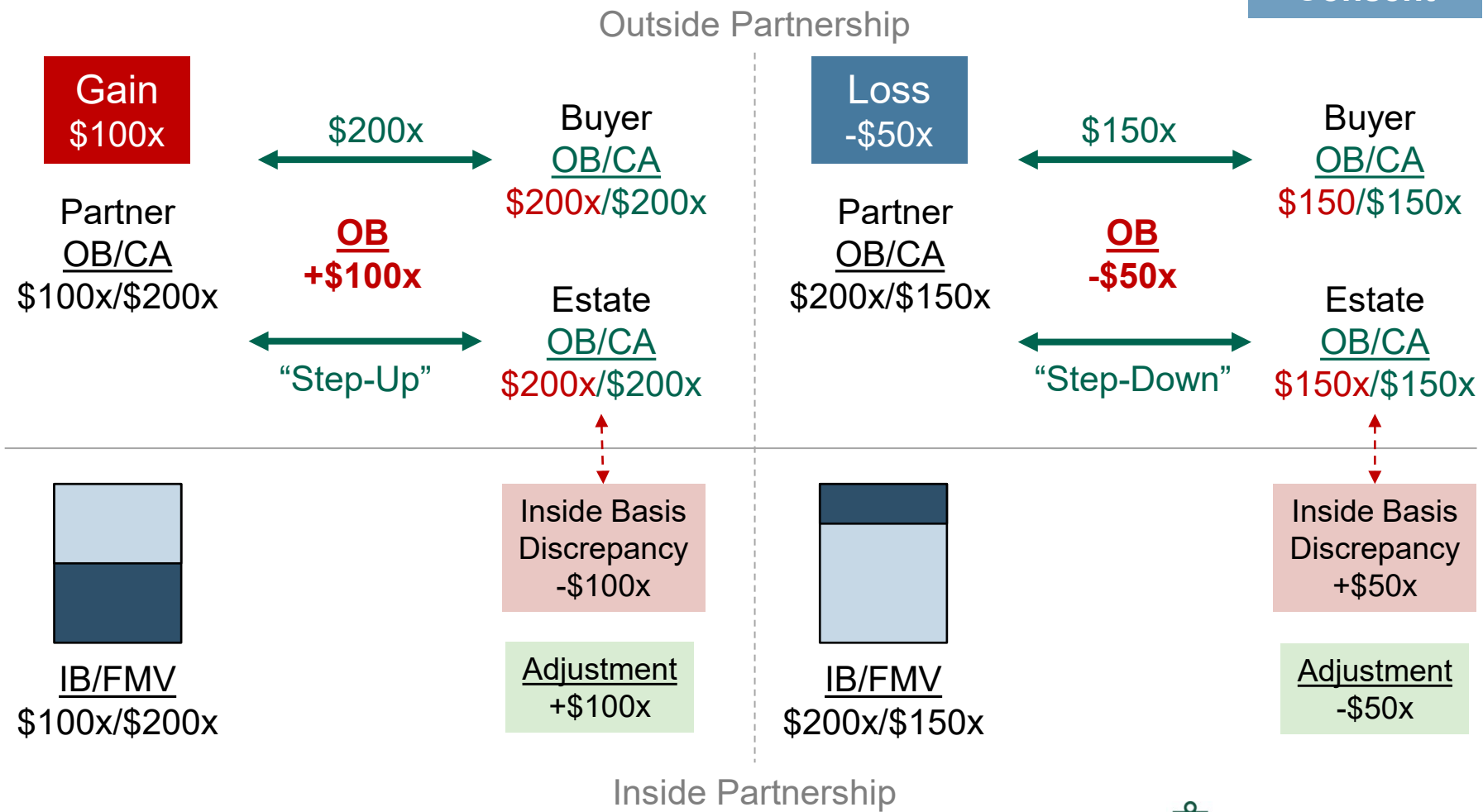


Section 754 and Section 743 Inside Basis Adjustments

Section 754 election allows the partnership to adjust the inside basis of assets under **Section 743** to cure discrepancies with the outside bases of the partners when there is:

- **Sale** of a partnership interest; and
- **Death** of a partner.

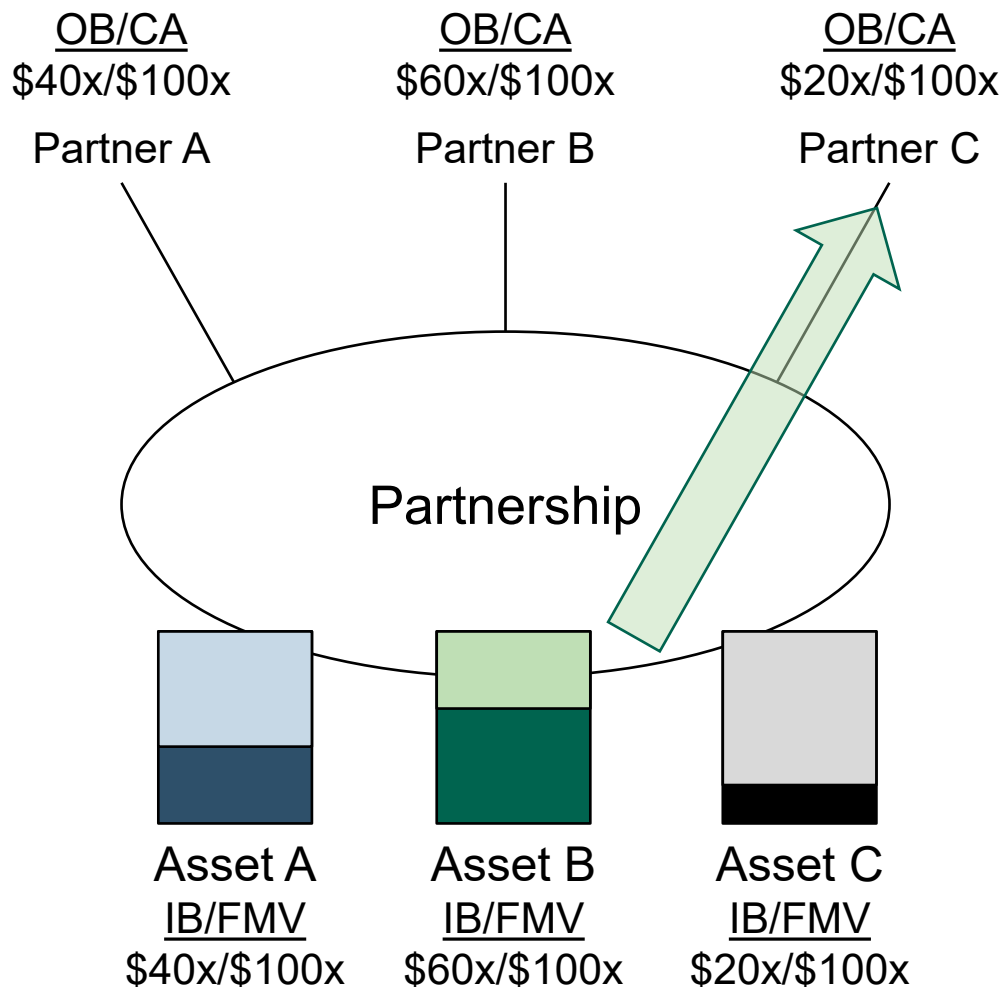
Election Is Irrevocable Without IRS Consent





Section 734 Inside Basis Adjustments

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.

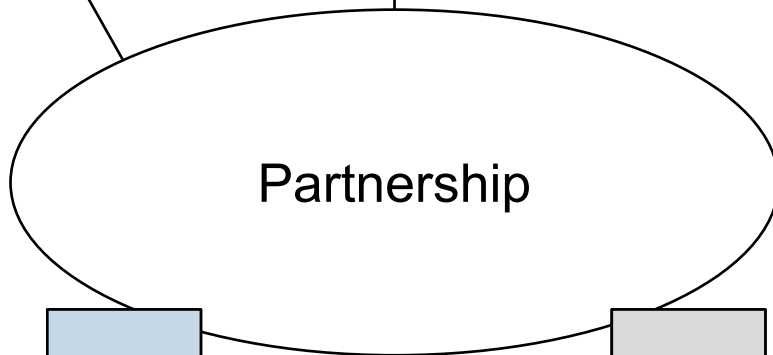




Section 734 Inside Basis Adjustments

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

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



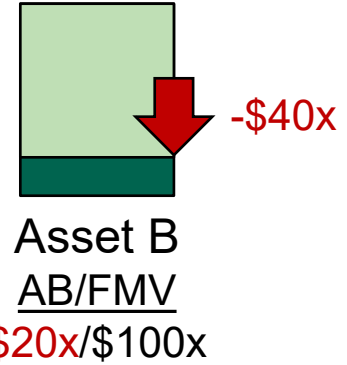
Asset A
IB/FMV
\$57x/\$100x

+\$17x

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

+\$23x

Ex-Partner C



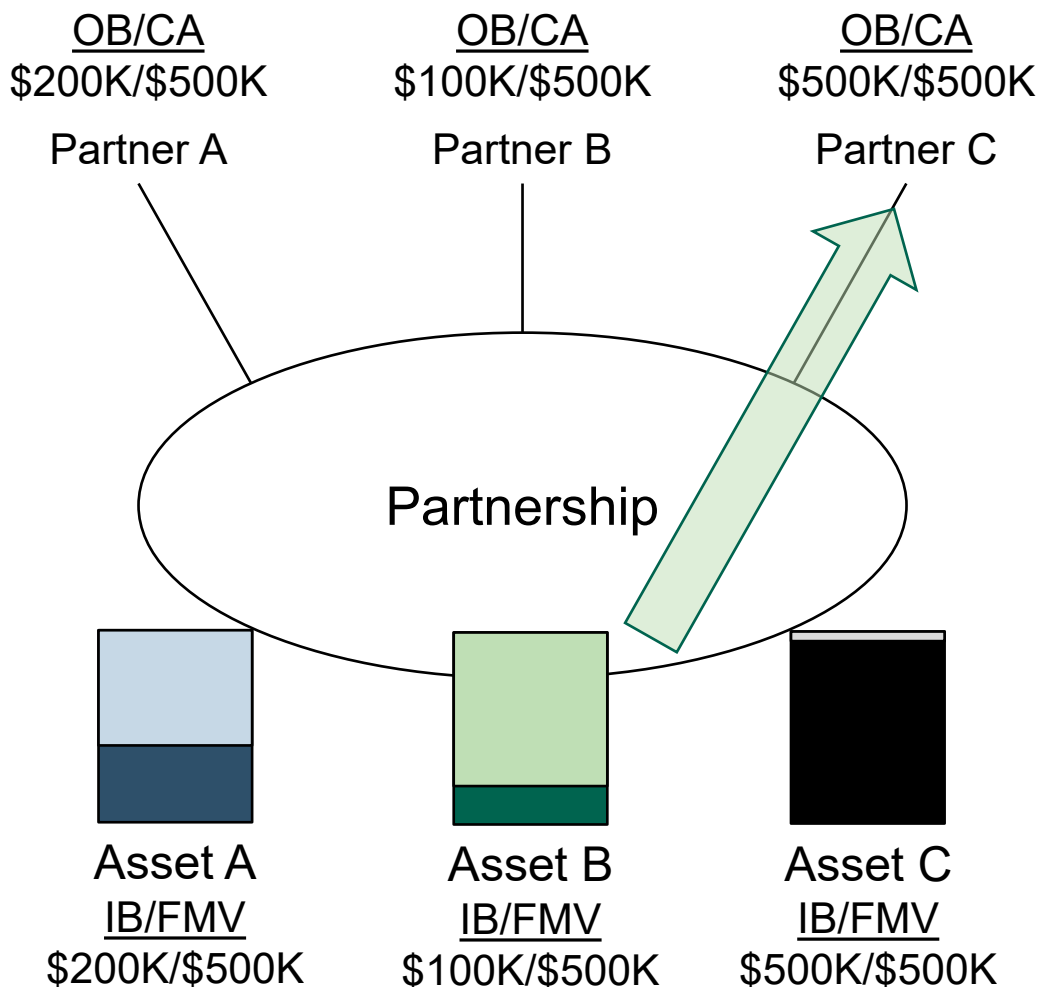
Asset A	Asset B	Asset C	Basis of A	Basis of C
Capital	Capital	Capital	57x	43x
Capital	Capital	Ordinary	80x	20x
Capital	Ordinary	Capital	Suspended	

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



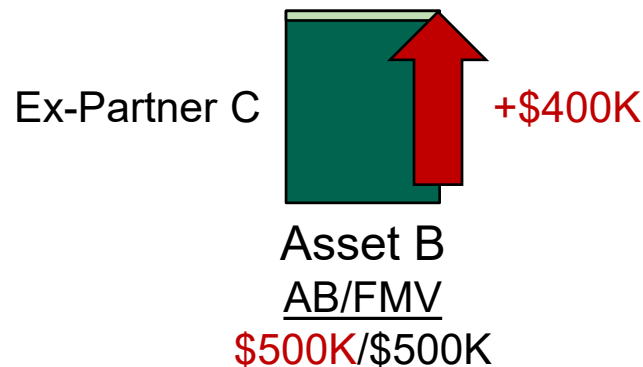
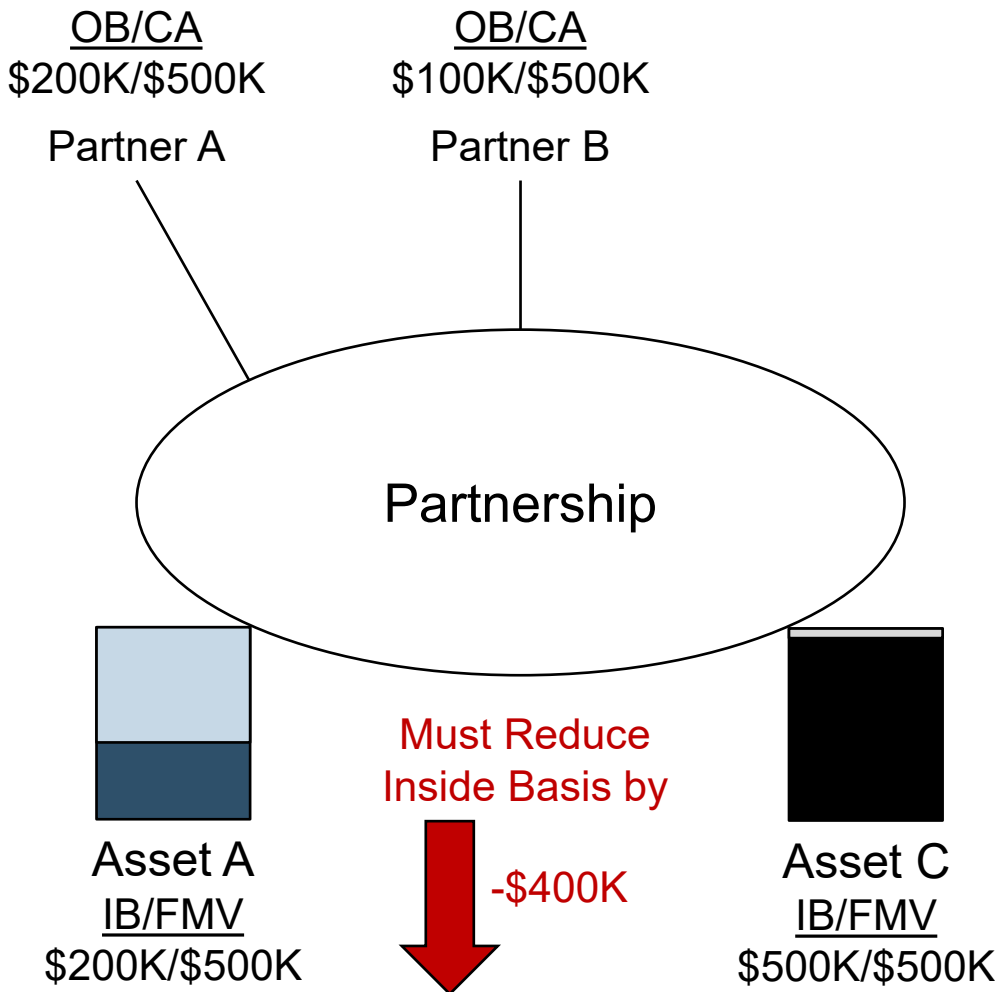
Mandatory Adjustments: Substantial Basis Reductions

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 only with **liquidating distributions**, and if:

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

Inside Basis Discrepancy
+\$400k



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.

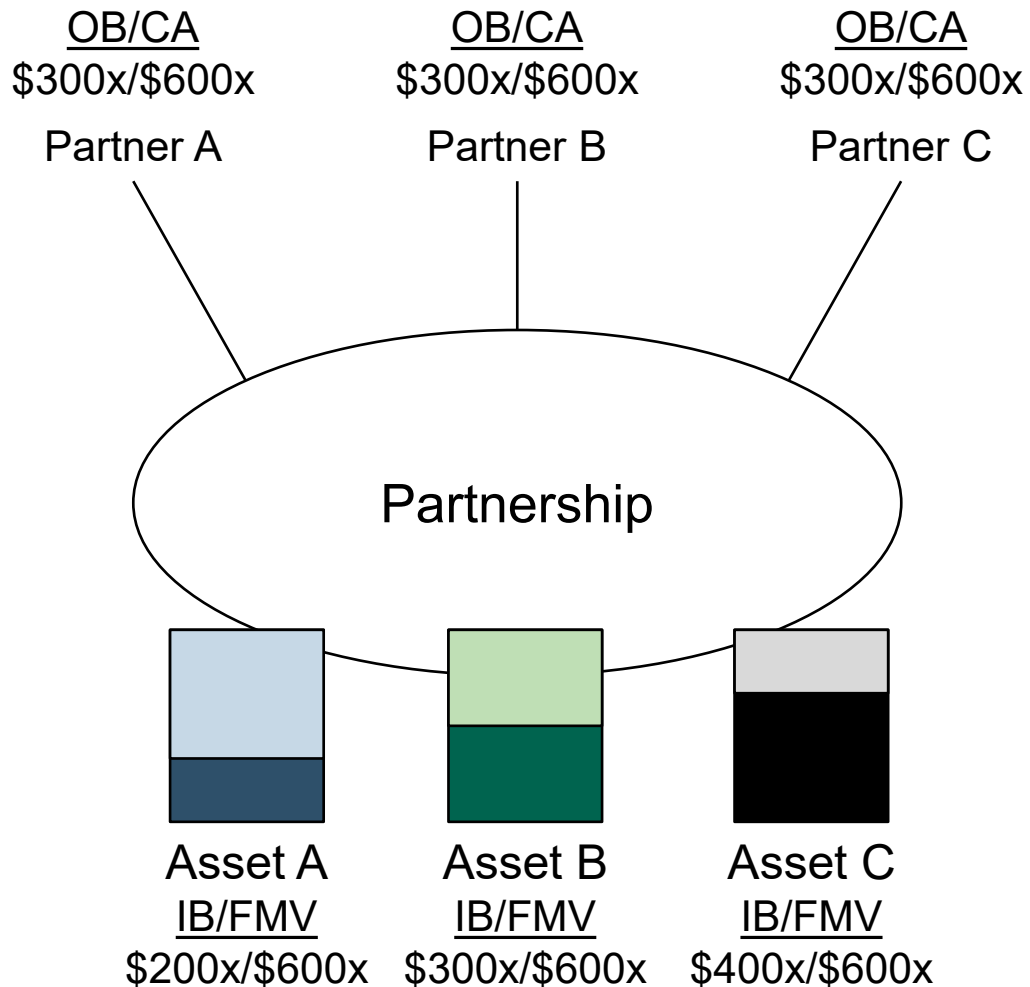
Liquidating Distributions

- 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 743 Inside Basis Adjustments

Example: Partner C is going to sell his or her 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

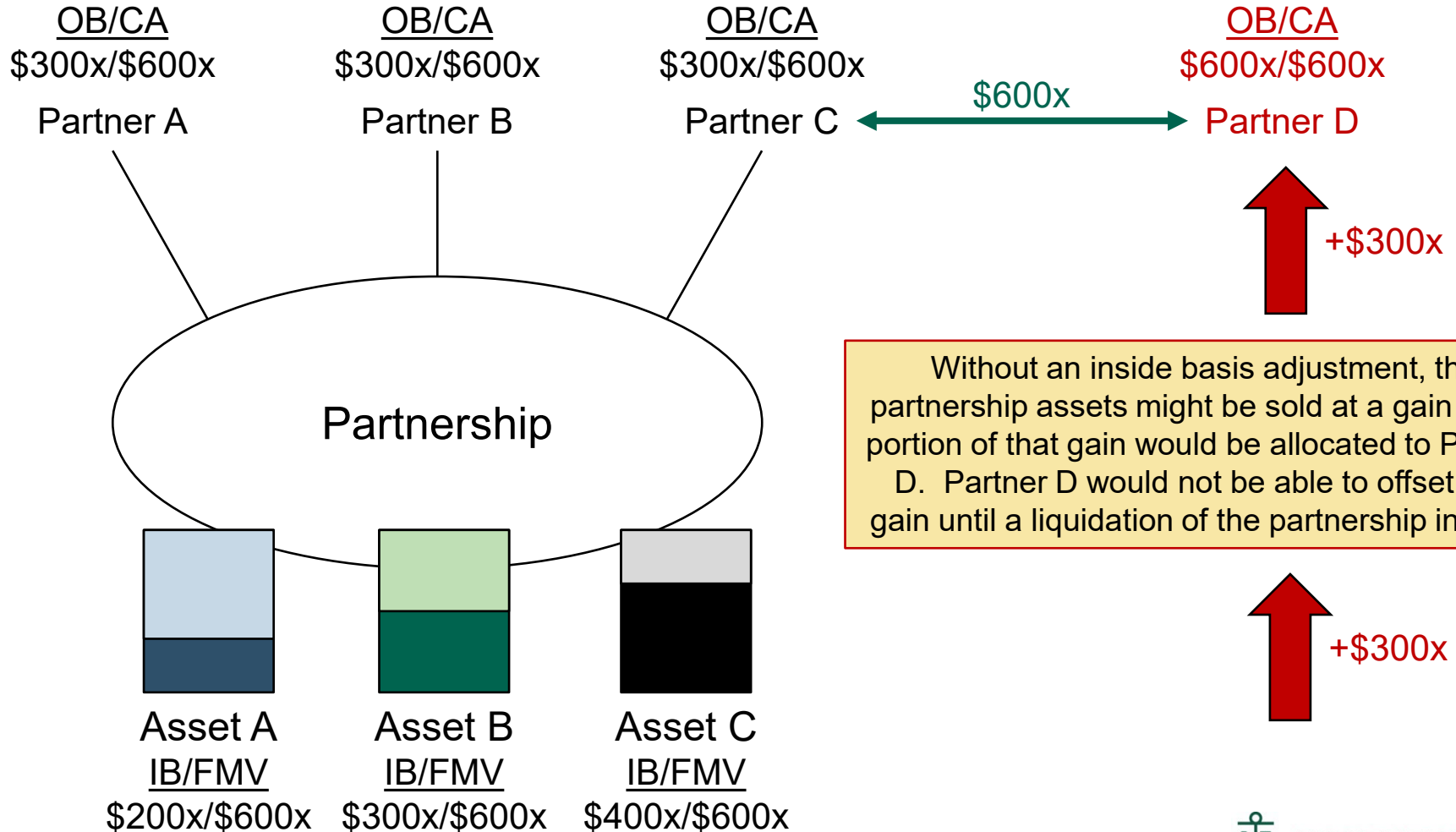
EACH PARTNER'S SHARE OF UNREALIZED GAIN

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



Section 743 Inside Basis Adjustments

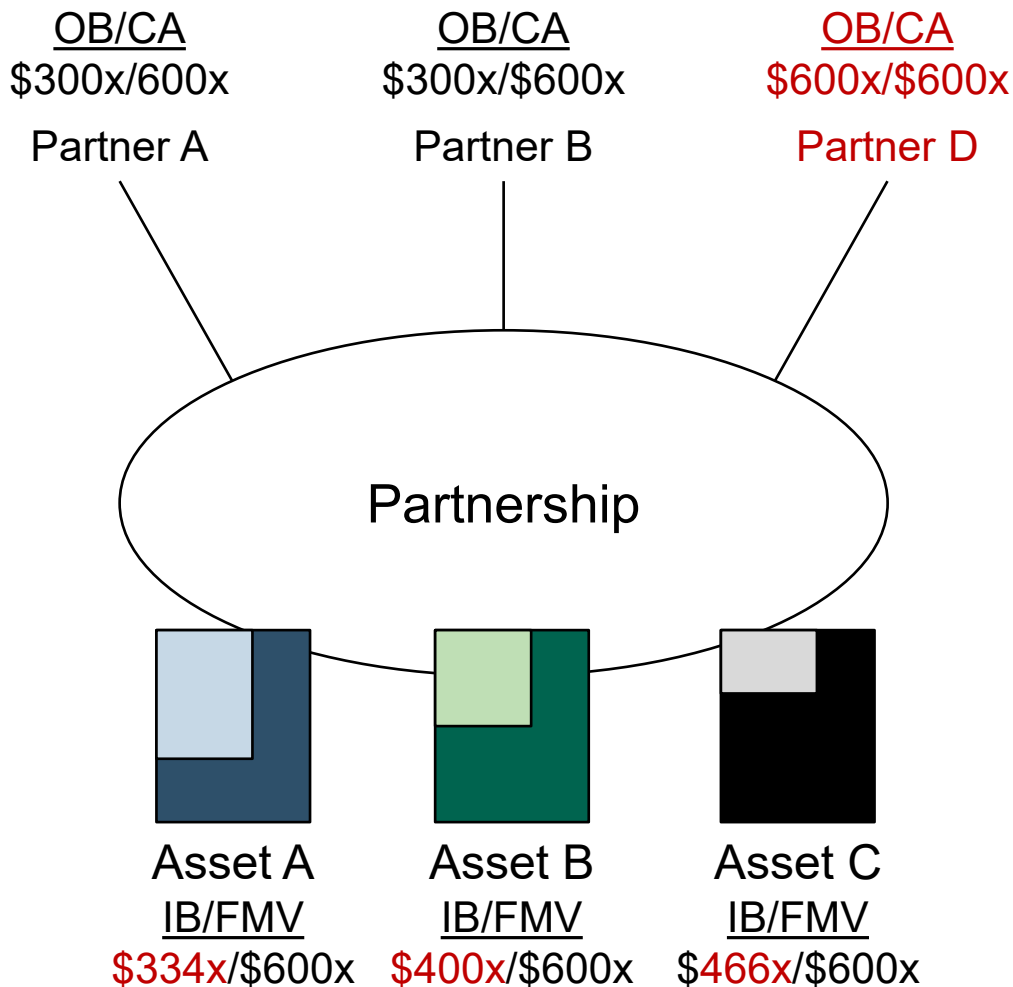
- Inside basis adjustments under Section 734 are actual basis adjustment to partnership property for the benefit of all of the partners.
- Inside basis adjustments under Section 743 (transfers upon sale or death) are “notional” and are specific only to the transferee (purchaser or estate/heirs of the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





Section 743 Inside Basis Adjustments

- 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

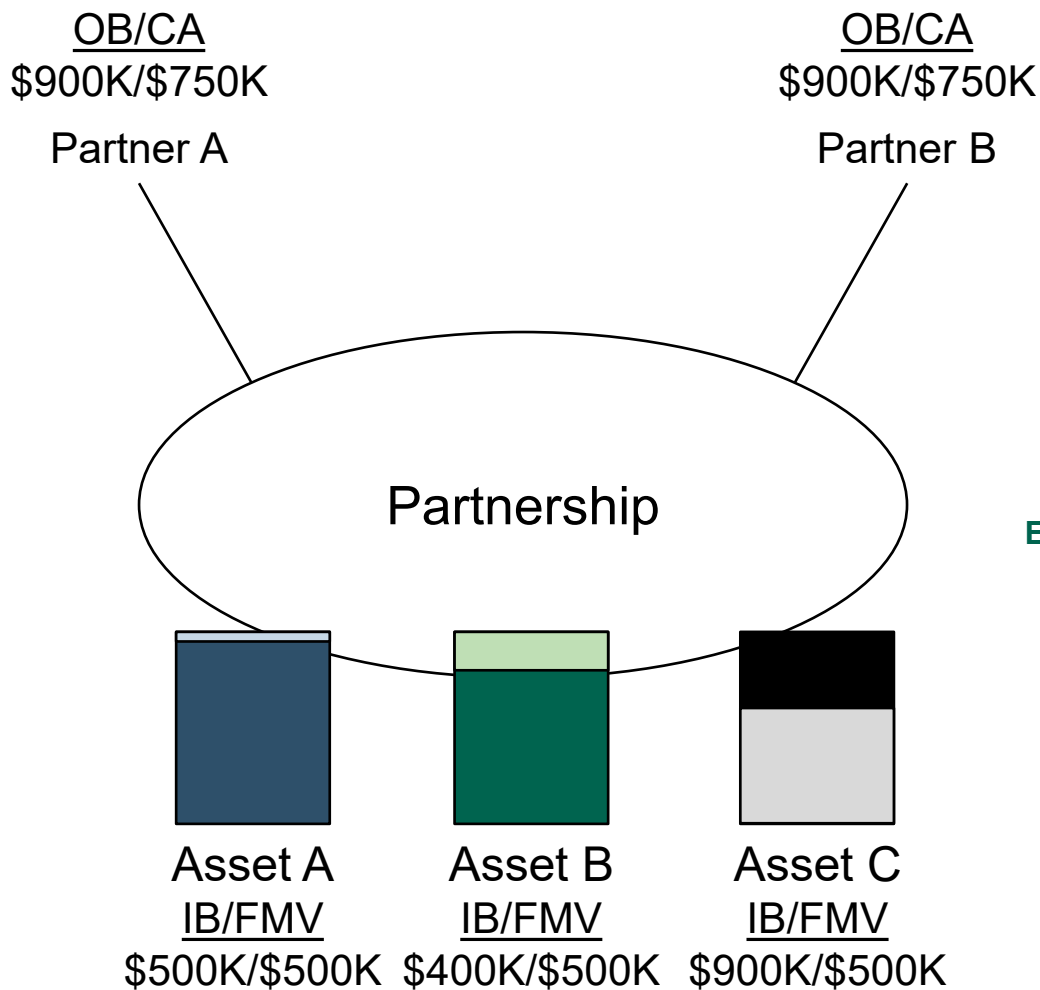
EACH PARTNER'S SHARE OF UNREALIZED GAIN

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 Built-In Loss

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

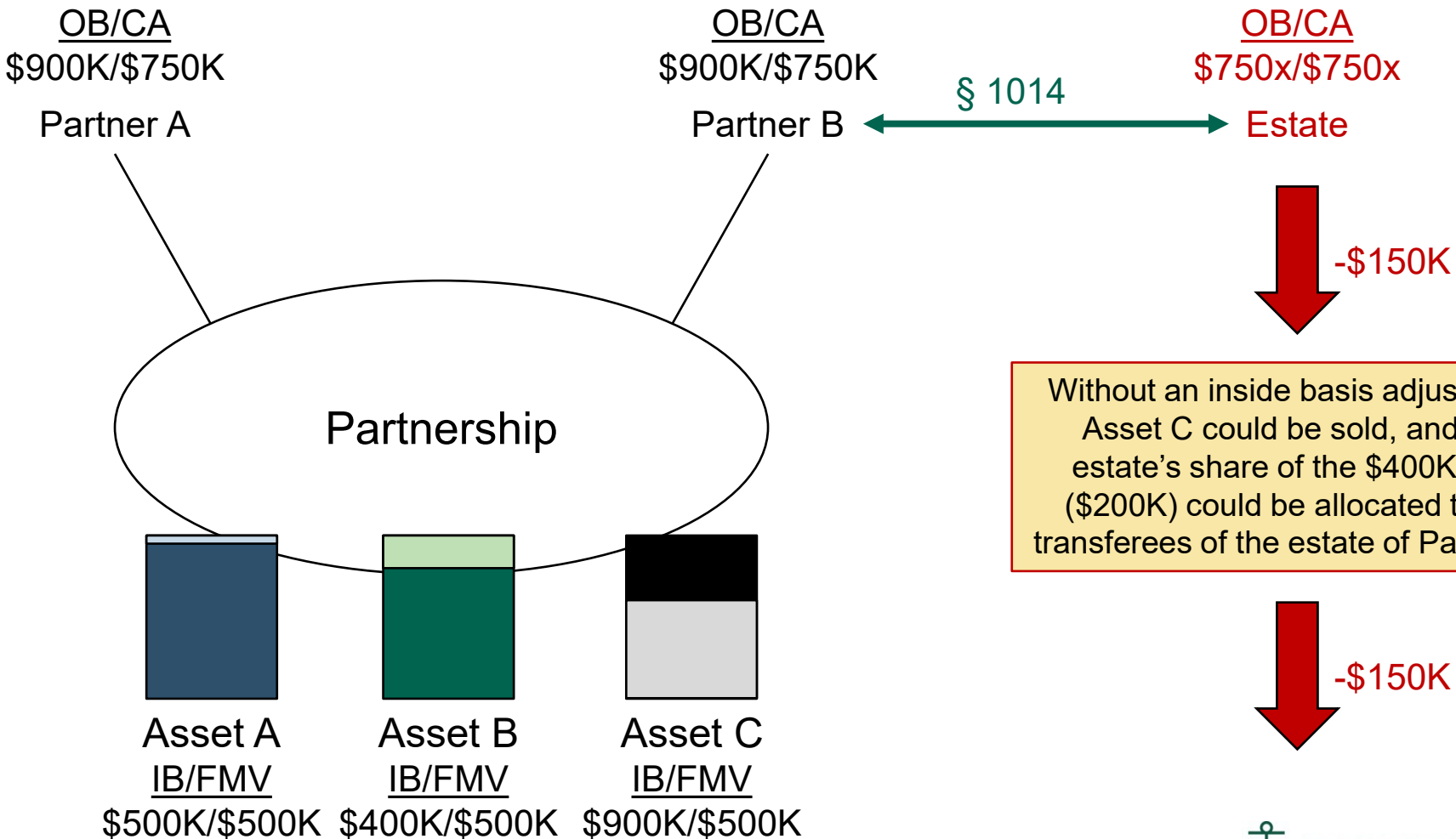
GAIN OR LOSS	Partner A	Partner B	Totals
Gain A	\$0	\$0	\$0
Gain B	\$50K	\$50K	\$100K
Gain C	(\$200K)	(\$200K)	(\$400K)
Totals	(\$150K)	(\$150K)	(\$300K)



Mandatory Basis Adjustments: Substantial Built-In Loss

A partnership has a “substantial built-in loss” if, immediately after a transfer of a partnership interest:

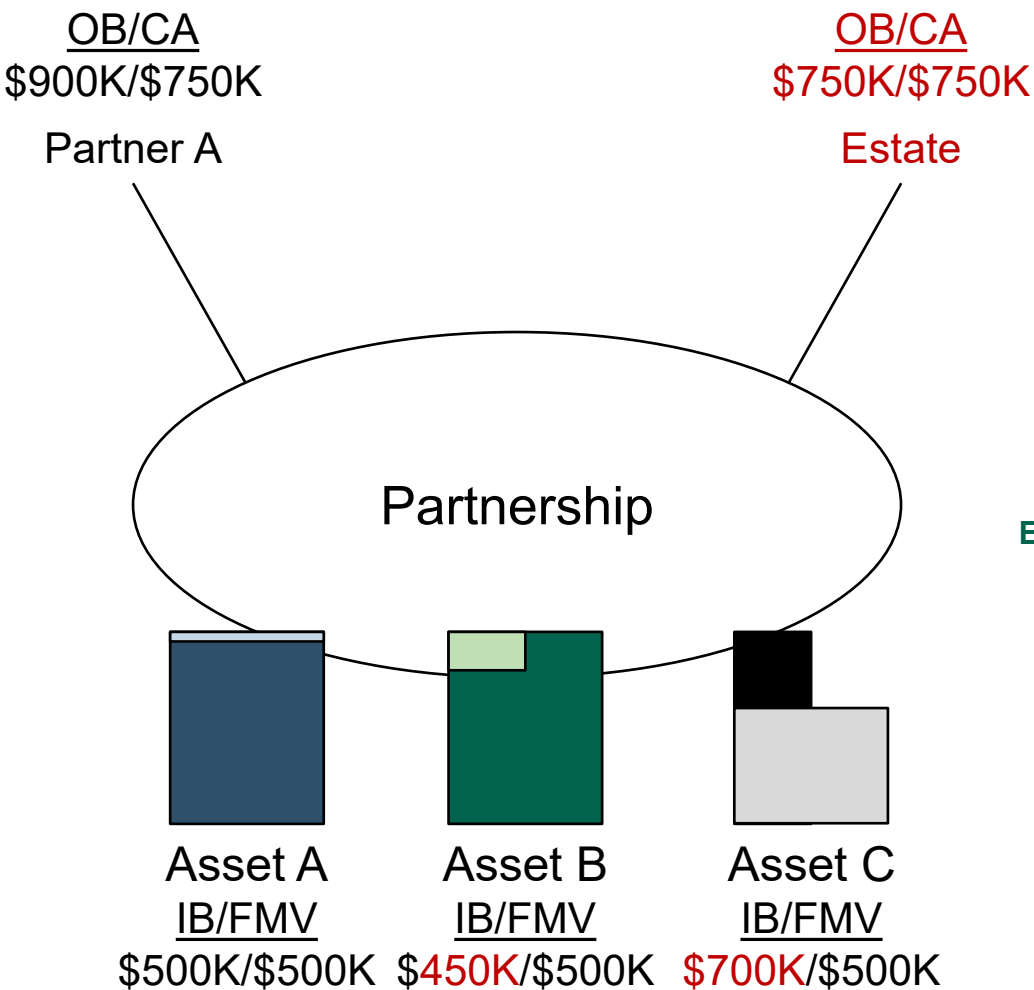
- Partnership’s total inside bases in partnership property exceeds by more than \$250,000 the total fair market value of such properties; or
- Transferee would be allocated more than \$250,000 in loss if assets sold for fair market value.





Mandatory Basis Adjustments: Substantial Built-In Loss

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

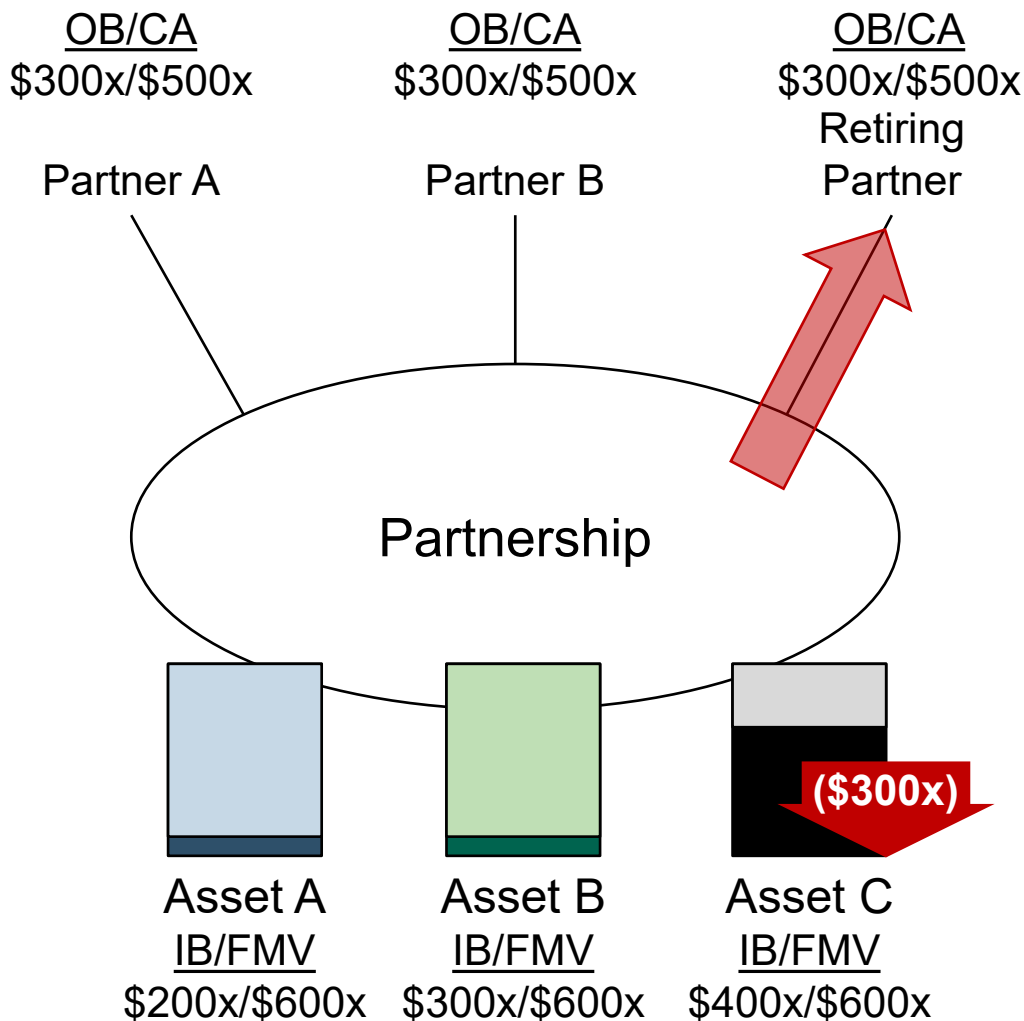
EACH PARTNER'S SHARE OF UNREALIZED GAIN/LOSS

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	\$100x capital gain
Year 5	\$100x	\$200x capital gain (\$100x reduction in liability under Section 752(b))
Totals	\$500x	\$300x capital gain

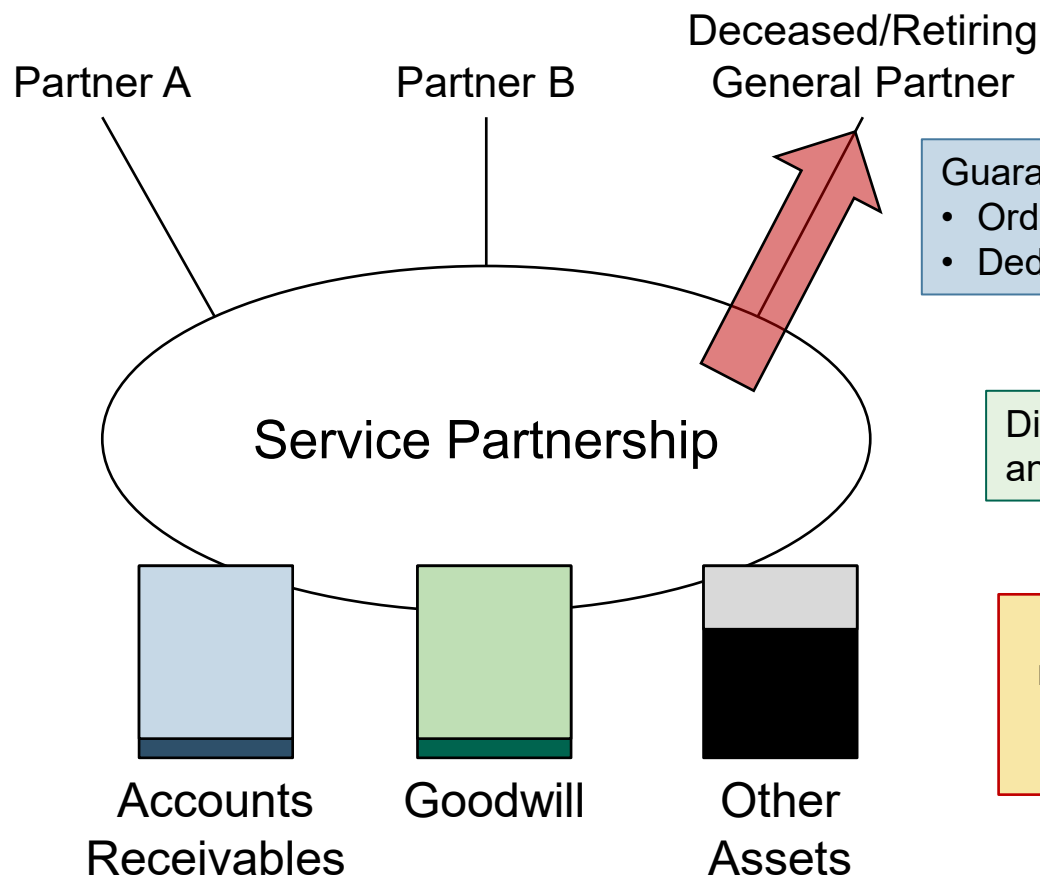
Deferred liquidation payments do not need to comply with the requirements of installment sales under Section 453 and do not need to provide for a minimum interest rate.



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):

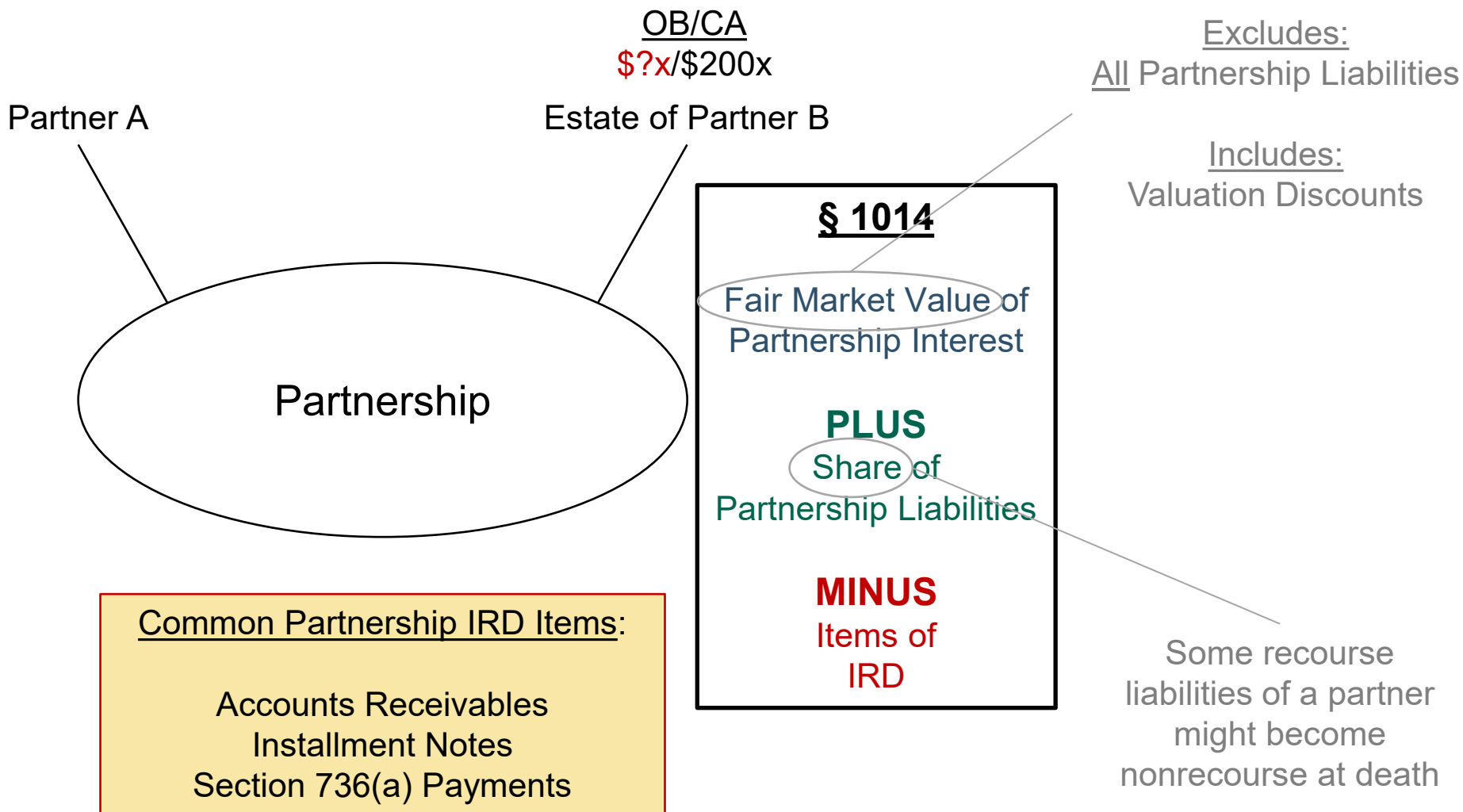
- Ordinary income to partner.
- Deductible by the partnership under Section 162(a).

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).



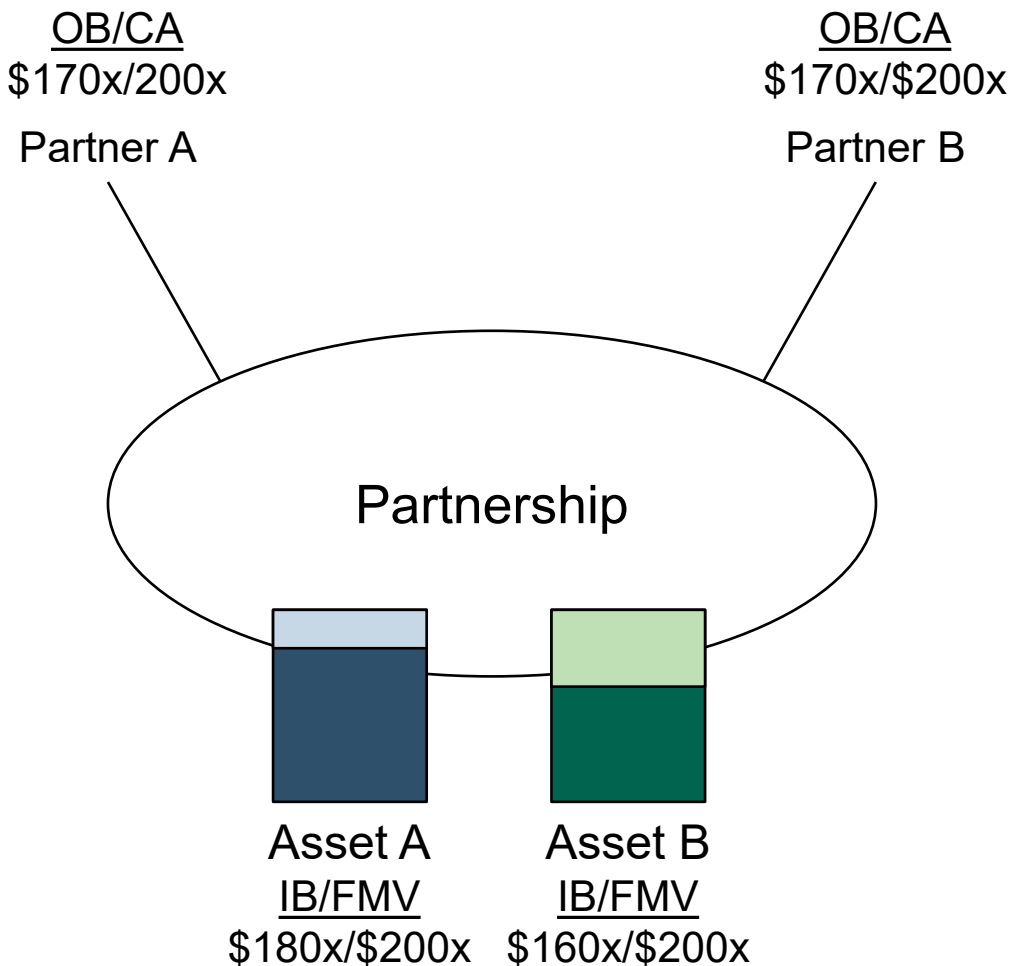
Death of a Partner and the “Step-Up” in Basis





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

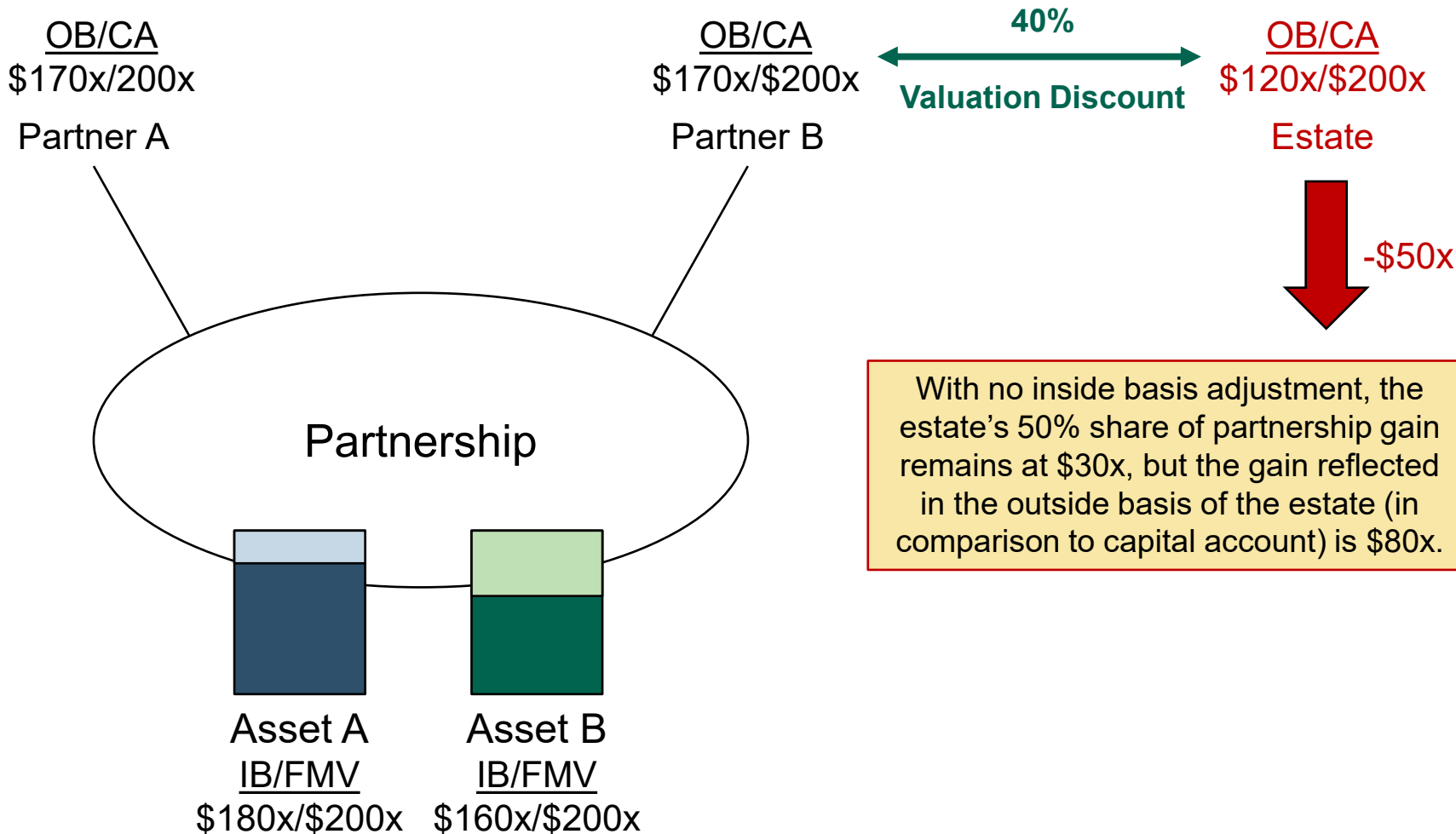
EACH PARTNER'S SHARE OF UNREALIZED GAIN

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

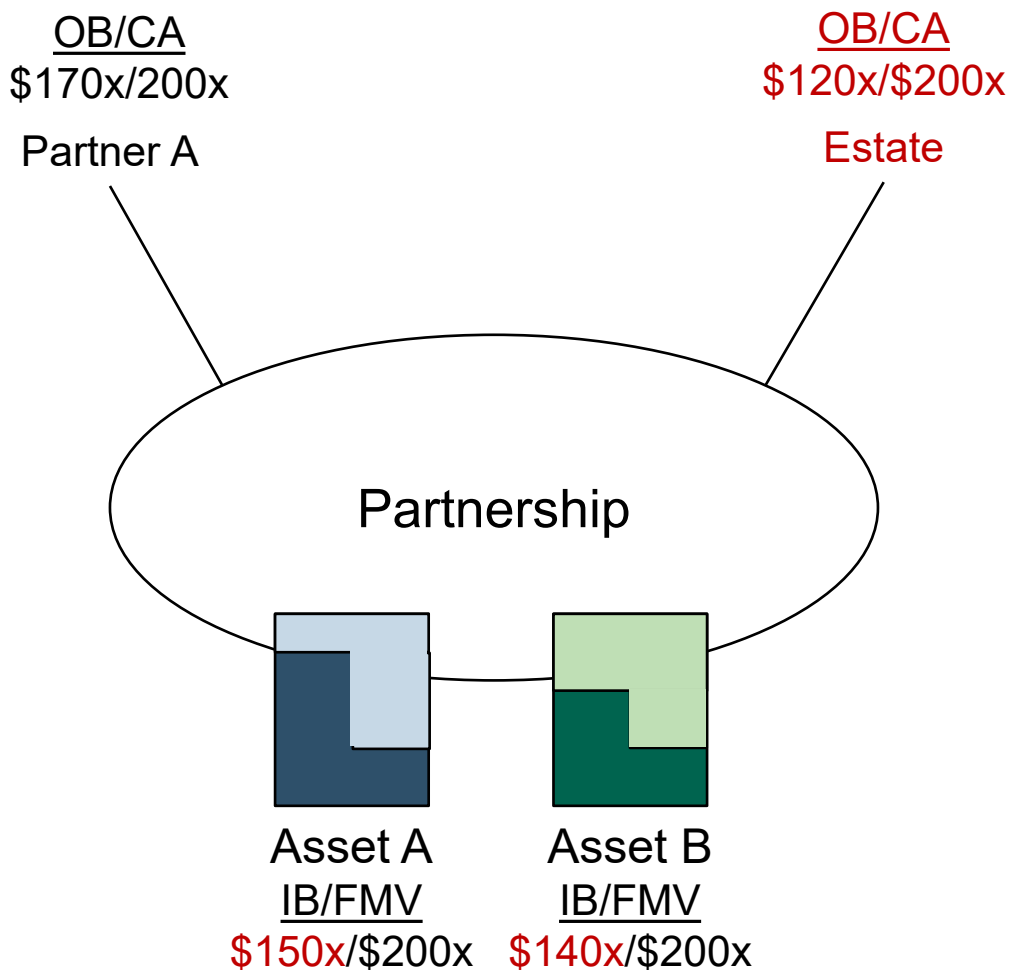
Example: Partner B passes away. Partnership does NOT have a Section 754 election in place.





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

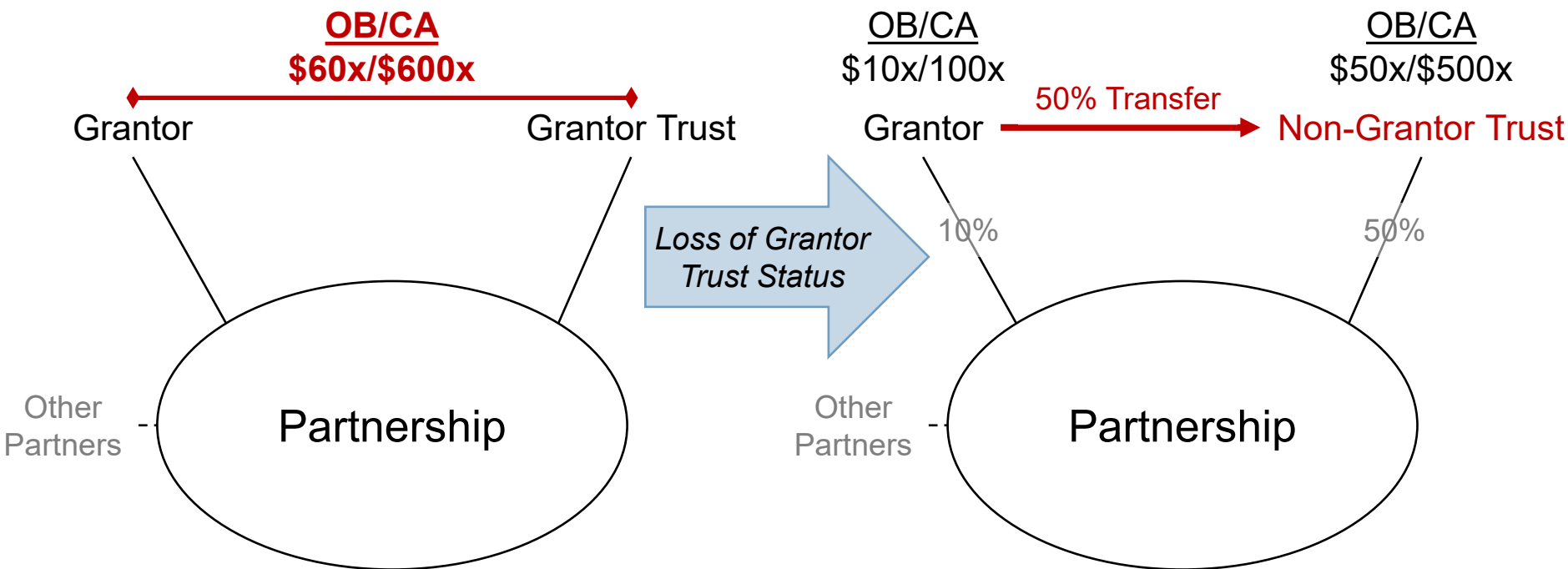
GAIN	Partner A	Estate	Totals
Gain A	\$10x	\$40x	\$50x
Gain B	\$20x	\$40x	\$60x
Totals	\$30x	\$80x	\$110x



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.



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