DICKINSONLAW

SALES, GIFTS & DEVISES OF LLC INTERESTS—SPECIAL PROBLEMS

72nd Annual Bloethe Tax School
November 30, 2011
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Atticus Finch always arrived at the office each morning promptly at 8:15 and would eat a muffin in the break room while glancing over the day's headlines in the newspaper. Today was different because it was Monday. "Triage Monday," he called it. That morning, the phone was already ringing as he stepped into his office. Atticus set his muffin down and answered. A woman caller disclosed that her husband had not filed their tax returns for seven years and wondered what the penalties might be. Atticus wondered what set of events must have occurred for them to suddenly realize, after seven years, that they needed to file their tax returns.

Atticus glanced at the clock on the lower right corner of his computer screen. "9:45 and I haven't billed a single minute," he uttered to himself. Thirty-three emails, two faxes, three meeting reminders and a half-finished bar association seminar article awaited Atticus's attention. A subtle rumble emerged from Atticus's stomach. No sooner had he reached for his muffin than the phone rang again. The caller ID listed a name he did not recognize, but the number was within the local calling area. He hesitated, but set the muffin back down and answered.

> "Mr. Finch?"
> **"Yes, may I help you?"**
> "I own 200 units of Farmland Ethanol, LLC, that I bought 5 years ago for $200,000. My Schedule K-1s show that it's lost more than $300,000. How is that possible? It's lost so much money that I figure that with the money I saved from the Schedule K-1 tax losses and all the tax credits I got from it, I'm actually ahead!"
> **"Uh, that's too bad, or I mean that's good to hear. Ah, so how may I help you?"**
> "Well, I've been told ethanol's making a lot of money this year. Since I'm already money ahead, I want to dump it before I have to start reporting all that income. If I can't sell it, I want to give it to my nephew. Hey, what if I gave it to charity; can I take a tax deduction? What do you think, . . . can you help me?"
> **"Damn, I don't know a thing about partnership taxation."**[1]

[1] My apologies to Harper Lee, author, "To Kill a Mockingbird" (1962).

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Note: This material is designed and intended for general informational purposes only, and is not intended, nor should it be construed or relied upon, as legal advice. Please consult with your attorney if specific legal information is desired.

I. TAXATION OF SALES OF LLC INTERESTS

A. Distinguishing Capital Accounts and Basis

Partnership tax law is an accountant's dream (or nightmare depending on the context). Multiple sets of books and records are required to be kept for the same partnership assets:

- The fair market value and tax basis of appreciated property contributed by a partner must be accounted for separately in case it is later sold.[2]

- If a 754 election is in place, each new partner that has succeeded to the interest of a former partner will have a separate basis in the partnership assets (called the "**inside basis**") equal to the new partner's basis in the partnership interest (called the "**outside basis**").[3]

Accountants must also keep track of a partner's interest in the partnership using a modified historical cost system and tax basis system.

Capital Accounts. Capital accounts are used to keep track of a partner's equity in the partnership. Tax law requires capital accounts to be maintained.[4] Partner capital accounts are increased or decreased for partner contributions and distributions. Likewise, capital accounts are increased or decreased for a partner's share of partnership income or loss.[5]

> **KNOWELEDGE POINT: Capital accounts represent the amount each partner would receive if the partnership sold all of its assets at book value, paid off its creditors, and distributed the remainder to the partners.**

Illustration: A and B form a partnership with A contributing $400 and B contributing equipment with a tax basis of $100 and a value of $400. Book capital accounts are blind to tax consequences. So, the $100 tax basis in the

[2] IRC § 704(c)(1)(A). The contributing partner is first allocated the gain equal to the built in gain that was present when the property was contributed to the partnership. The remaining gain is allocated among the partners in accordance with the partnership agreement.

[3] IRC § 743(b). This Section only applies to transfers of partnership interests. A transfer in this context includes a sale, exchange or a transfer at death, but it does not include a transfer by gift. IRC § 743(a). Transfers do not include either the admission of a new partner or the liquidation of an old partner. *Id.*

[4] Treas. Reg. § 1.704-1(b)(2)(iv).

[5] Treas. Reg. § 1/704-1(b)(2)(iv)(b)

equipment is not relevant for capital account maintenance purposes. The partnership's balance sheet and capital accounts are as follows:

Assets		***Liabilities & Capital***
	Book	
Cash	$400	
equip	$400	
	$800	***Capital Accounts***

	Book
A	$400
B	$400
	$800

Unfortunately, capital accounts alone are insufficient to monitor and keep track of the 704(c) problem. Under IRC § 704(c), if appreciated or depreciated property is contributed to a partnership, the built-in gain or loss (when realized by the partnership) must be taken into account for tax purposes by the contributing partner. Thus, separate accounts to reflect the tax basis for the partnership's assets must be created as well as separate accounts for the partners to reflect their share of the tax basis in the partnership assets contributed by the partners.[6]

Assets			***Liabilities & Capital***
	basis	Book	
Cash	$400	$400	
equip	$100	$400	
	$500	$800	***Capital Accounts***

	Tax	Book
A	$400	$400
B	$100	$400
	$500	$800

KNOWLEDGE POINT: Tax capital accounts are required to show the tax/book disparities and to help keep track of Section 704(c) allocation problems.

Partnership liabilities are not important when maintaining capital accounts (tax or book) because capital accounts reflect an owner's equity in the partnership which does not change

[6] The Regulations refer to this tax capital account as "previously taxed capital." IRC § 1.743-1(d).

when a liability is added.[7] However, liabilities will increase a partner's inside basis and outside basis.[8] This is important for at least two reasons: (1) a partner can deduct losses only to the extent of the partner's outside basis in the partnership,[9] and (2) a partner will recognize gain if the partner receives a distribution of cash in excess of his or her outside basis.[10] Thus, another set of books should be maintained to keep track of outside basis. Assume that the partnership borrows $700 and uses the proceeds and excess partnership cash to purchase a building for $1,000.

	Assets			***Liabilities & Capital***	
	basis	Book			
Cash	$100	$100		mortgage	$700
equip	$100	$400			
Bldg	$1,000	$1,000			
	$1,200	$1,500		***Capital Accounts***	

	Tax	Book	Outside Basis
A	$400	$400	$750
B	$100	$400	$450
	$500	$800	$1,200

Note that the tax/book capital accounts did not change as a result of the added liability. This is so because the capital accounts reflect the partners' equity in the partnership that did not change as a result of the borrowing. The partners' combined outside basis equals the inside basis. This will change when a partner transfers an interest in the partnership or if a new partner is added.

B. Income Tax Consequences to Selling Partner

A selling partner must recognize gain or loss on the sale of a partnership interest equal to the difference between the amount realized and the partner's outside basis.[11] The character of the gain or loss will be capital, but if the partnership contains unrealized receivables or inventory

[7] For example, if a partnership borrows cash, the liability will offset exactly the added cash leaving equity intact.

[8] IRC § 722.

[9] IRC § 704(d).

[10] IRC § 731(a)(1).

[11] IRC § 741.

items, then a pro rata portion of the gain or loss attributable to the unrealized receivables or inventory items will be taxed at ordinary income tax rates.[12]

> ***Illustration:*** A and B form a partnership with A contributing $400 and B contributing equipment with a tax basis of $100 and a value of $400. After a year of operations in which revenues exactly equaled expenses, A decides to sell her partnership interest to X for $500. A has a gain of $100 and if the partnership contains no unrealized receivables or inventory, the character of the gain is capital (not ordinary). If the partnership had appreciated inventory, a portion of the sale will be taxed as ordinary income. Consider the following balance sheet and capital accounts:

	Assets			***Liabilities & Capital***
	basis	Book	FMV	
Cash	$300	$300	$300	
Invent	$100	$100	$150	
equip	$100	$400	$550	
	$500	$800	$1,000	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
A	$400	$400	$400	$500
B	$100	$400	$100	$500
	$500	$800	$500	$1,000

From A's perspective, there exists $50 of inventory appreciation and $150 of equipment appreciation (not subject to depreciation recapture). Therefore, one-fourth of A's gain ($25) from the sale of her partnership interest will be ordinary income and three-fourths ($75) will be capital gain. Had B, rather than A, sold the interest to X for $500, the result would be slightly different. B's total partnership gain is $400. $300 of the gain will be capital gain[13] to rectify the original Section 704(c) special allocation to B. As for the remaining $100 of gain, $25 will be ordinary and $75 will be capital.[14]

Now, assume the same facts except the partnership borrowed $900 several years ago and used the borrowed proceeds to fund the partnership's operations, all of which resulted in losses flowing through to the partners. The partners increase their outside basis (but not their capital

[12] IRC § 751(a); Treas. Reg. § 1.751-1(a)(2).

[13] Assume that there is no depreciation recapture under IRC § 1245(a)(1).

[14] Treas. Reg. § 1.751-1(a)(2).

accounts) by $450 each,[15] but because of the $900 of operating expenses, each partner's capital account and outside basis is reduced by $450. The partnership's balance sheet is now as follows:

	Assets			***Liabilities & Capital***	
	basis	Book	FMV		
Cash	$300	$300	$300	mortgage	$900
Invent	$100	$100	$150		
equip	$100	$400	$550		
	$500	$800	$1,000	***Capital Accounts***	

	Tax	Book	Outside Basis	FMV
A	($50)	($50)	$400	$50
B	($350)	($50)	$100	$50
	($400)	($100)	$500	$100

Because of the liability, X is only willing to pay $50 for A's partnership interest. If only the outside basis of A's interest were looked at to determine A's gain or loss on the sale, it would appear that A would have a $350 loss to report ($400 less $50). This would be wrong. A's "amount realized" not only includes the $50 she will receive from X, but will also include half of the $900 liability, or $450.[16] Why? The borrowing allowed A to take deductions of $450 solely as a result of the borrowing—a borrowing that A will not be obligated to pay back. Viewed another way, A has been discharged from liability and is the equivalent to discharge of indebtedness income.[17] Therefore, to compute A's gain or loss, her amount realized is $500, the $50 paid to her by X plus A's share of the partnership's liabilities ($450). A's outside basis is $400 so A has a taxable gain of $100 which is exactly the same result that occurred in the prior example with no mortgage liability. By virtue of Section 751, $25 of the gain will be ordinary and $75 will be capital gain.

The same result occurs to B if B had sold her interest to X for $50. B's gain will be $400 measured by the amount realized of $500 ($50 + $450 discharge of indebtedness) less B's outside basis of $100. As in the previous example, $25 will be ordinary and $375 will be capital gain.

[15] IRC § 722.

[16] IRC § 752(b) & (d); *Crane v. Commissioner*, 331 US 1 (1947); *Commissioner v. Tufts*, 461 U.S. 300 (1983). This applies to gifts as well such that a donor partner will be deemed to have received a distribution of money in the amount of the partner's share of partnership liabilities. This has not been applied to deceased partners.

[17] See IRC § 61(a)(12).

C. Income Tax Consequences to Buying Partner

In the previous illustration, X purchased A's partnership interest for $500. X succeeds to A's capital accounts, both tax and book.[18] The partnership's inside basis remains the same, but X's outside basis is his purchase price. The balance sheet of the partnership now is as follows:

Assets				***Liabilities & Capital***
	basis	Book	FMV	
Cash	$300	$300	$300	
Invent	$100	$100	$150	
equip	$100	$400	$550	
	$500	$800	$1,000	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
X	$400	$400	$500	$500
B	$100	$400	$100	$500
	$500	$800	$600	$1,000

There is a disparity of tax accounting caused by this result that will eventually require X to report phantom gain as a result of the built-in gain inherent in the inventory and equipment. If immediately after X purchases A's interest, the partnership decides to sell the inventory at its fair market value, X will have to report $25 of the gain. The resulting balance sheet will be as follows:

Assets				***Liabilities & Capital***
	basis	Book	FMV	
Cash	$450	$450	$450	
equip	$100	$400	$550	
	$550	$850	$1,000	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
X	$425	$425	$525	$500
B	$125	$425	$125	$500
	$550	$850	$650	$1,000

The disparity can be resolved in one of three different ways. **First**, X can negotiate a discount in the purchase price of the interest with A to accommodate the built-in gains. **Second**, X can wait until he sells the partnership interest to someone else, or until the partnership

[18] Treas. Reg. § 1.704-1(b)(2)(iv)(l).

liquidates, in which case he will have an offsetting $25 loss to report. **Third**, he can negotiate with B to make a section 754 election.[19] Under section 754, the partnership adjusts the basis in its assets whenever there is a transfer of a partnership interest.[20] However, the basis adjustment applies only to the buying partner and not the other partners and thus requires much more meticulous recordkeeping. If a section 754 election had been made, the balance sheet immediately after the sale would have been as follows:

	Assets			***Liabilities & Capital***
	basis	Book	FMV	
Cash	$300	$300	$300	
Invent	$125	$125	$150	
equip	$175	$475	$550	
	$600	$900	$1,000	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
X	$500	$500	$500	$500
B	$100	$400	$100	$500
	$600	$900	$600	$1,000

X's capital accounts and his outside basis are the same indicating X's share of inside basis equals his outside basis. A review of the assets accounts will confirm this. If the partnership sells the inventory for $150, X would be entitled to A's original share of the inventory basis of $50 (1/2 of $100) plus $25 of basis resulting from the Section 754 election for a total basis of $75. The $75 basis exactly equals one half of the sale proceeds of the inventory resulting in no gain allocated to X. With respect to the equipment, X inherited A's book capital account basis of $200 plus the $75 Section 754 election basis increase for a total basis of $275 which equals exactly half the sale proceeds of the equipment. B would be allocated all of the $375 gain on the sale of the equipment, $300 of which was allocated to him as pre-contribution gain under Section 704(c).

[19] The partnership must file the 754 election and the buying partner may have no control over that. Once a partnership makes a 754 election, the election remains in effect with respect to all future transactions, and it can only be revoked with the consent of the IRS. Treas. Reg. §1.754-1(c). Notwithstanding whether an election under 754 has been made, if the partnership has a "substantial built-in loss," the partnership must adjust the basis of the partnership property as if a 754 election had been made. IRC § 743(a). A "substantial built-in loss" is defined as when the partnership's adjusted basis in its property exceeds the property's fair market value by more than $250,000. IRC § 743(d). Presumably, for purposes of determining "substantial built-in loss," the loss must occur after the formation of the partnership (and thus excludes any Section 704(c) loss).

[20] The amount of the adjustment is determined under IRC Section 743(b), and it is equal to the difference between the buyer's outside basis and her share of inside basis.

What if X had purchased B's interest rather than A? If no Section 754 election had been in place, X would inherit B's capital accounts and her pre-contribution gain under 704(c).[21] The balance sheet would be as follows:

Assets				***Liabilities & Capital***
	basis	Book	FMV	
Cash	$300	$300	$300	
Invent	$100	$100	$150	
equip	$100	$400	$550	
	$500	$800	$1,000	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
A	$400	$400	$400	$500
X	$100	$400	$500	$500
	$500	$800	$900	$1,000

In this example, X inherited B's tax liability of $400 of gain consisting of B's $300 Section 704(c) pre-contribution gain plus $100 of partnership gain. This gain will eventually be reversed with an offsetting loss when X sells his partnership interest or if the partnership liquidates.[22] Thus, the absence of a Section 754 election creates nothing more than a timing problem for X. The Section 754 election, of course, resolves the tax timing problem by stepping up the inside basis of the assets upon X's purchase of the partnership interest from B. The balance sheet of the partnership would be as follows:

Assets				***Liabilities & Capital***
	basis	Book	FMV	
Cash	$300	$300	$300	
Invent	$125	$125	$150	
equip	$475	$475	$550	
	$900	$900	$1,000	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
A	$400	$400	$400	$500
X	$500	$500	$500	$500
	$900	$900	$900	$1,000

[21] Treas. Reg. §1.704-1(b)(2)(iv)(l); Treas. Reg. §§1.704-3(a)(7) and 1.743-1(j)(2).

[22] This result occurs because the $400 gain would increase X's outside basis to $900 which is $400 more than the fair market value of X's partnership interest.

Notice that the Section 704(c) pre-contribution gain of $300 was eliminated as a result of the Section 754 election.

> **KNOWLEDGE POINT: Section 754 eliminates the timing problem associated with the taxation of partnership profits when a new partner succeeds to a former partner's interest.**

II. TAXATION OF DEVISES OF LLC INTERESTS

A partnership interest transferred at death has a stepped-up basis, to estate tax value, plus the estate's share of partnership liabilities.[23] However, a successor to a decedent's partnership interest does not get a step-up in basis to the extent that partnership assets include accounts receivable (for a cash basis partnership) and other items of income in respect of a decedent.[24]

A person succeeding to a deceased partner's interest will inherit the deceased partner's capital accounts (both tax and book) as well as the deceased partner's pre-contribution Section 704(c) built-in gain or loss, unless a Section 754 election is in place.[25]

Consider the same facts as in the previous illustration except the cash-basis partnership has $100 of accounts receivable. The balance sheet is as follows:

	Assets			***Liabilities & Capital***
	basis	Book	FMV	
Cash	$300	$300	$300	
A/R	$0	$0	$100	
Invent	$100	$100	$150	
equip	$100	$400	$550	
	$500	$800	$1,100	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
A	$400	$400	$400	$550
B	$100	$400	$100	$550
	$500	$800	$500	$1,100

[23] IRC § 1014; IRC § 742; Treas. Reg. § 1.742-1.

[24] IRC § 1014(c).

[25] IRC § 734(a). Notwithstanding whether an election under 754 has been made, if the partnership has a "substantial built-in loss," the partnership must adjust the basis of the partnership property as if a 754 election had been made. IRC § 743(a). A "substantial built-in loss" is defined as when the partnership's adjusted basis in its property exceeds the property's fair market value by more than $250,000. IRC § 743(d).

B dies leaving her interest to B jr. B's estate reports B's interest in the partnership at $550 on B's Federal estate tax return even though B jr. will only receive a tax basis in the partnership interest of $500. This is because $50 reflects accounts receivable which is income in respect of a decedent.[26] B jr. steps into the shoes of B, but with a new outside basis of $500. The partnership's balance sheet now is as follows:

	Assets			***Liabilities & Capital***
	basis	Book	FMV	
Cash	$300	$300	$300	
A/R	$0	$0	$100	
Invent	$100	$100	$150	
equip	$100	$400	$550	
	$500	$800	$1,100	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
A	$400	$400	$400	$550
B jr.	$100	$400	$500	$550
	$500	$800	$900	$1,100

KNOWLEDGE POINT: A decedent is entitled to a full step-up (or step-down) to fair market value for purposes of reporting the partnership interest on the decedent's Federal estate tax return, but the decedent's stepped-up basis in the partnership interest will be reduced by the deceased partner's share of income in respect of a decedent.[27]

B jr. will later report gain on the partnership's collection of accounts receivable and the sale of inventory and equipment. The gain on the inventory and equipment will eventually be reversed with an offsetting loss when B jr. sells her partnership interest or if the partnership liquidates.[28] Thus, the absence of a Section 754 election creates a timing problem for B jr. just like it did for X in the previous illustration in the context of a sale. The Section 754 election, of

[26] IRC § 1014; IRC § 742; Treas. Reg. § 1.742-1. Of course, B's estate may also be allowed a valuation discount for lack of control or lack of marketability. For illustration purposes, this example assumes no such discount applies.

[27] IRC § 1014(c).

[28] This result occurs because the $400 gain would increase B jr.'s outside basis to $900 which is $400 more than the fair market value of B jr.'s partnership interest (without considering the accounts receivable).

course, resolves the tax timing problem by stepping up the inside basis of the assets upon B's demise. The balance sheet of the partnership would be as follows:

	Assets			***Liabilities & Capital***
	basis	Book	FMV	
Cash	$300	$300	$300	
A/R	$0	$0	$100	
Invent	$125	$125	$150	
equip	$475	$475	$550	
	$900	$900	$1,100	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
A	$400	$400	$400	$550
B jr.	$500	$500	$500	$550
	$900	$900	$900	$1,100

The other partners of a partnership can also benefit by the step-up caused by the death of a partner. To illustrate, first assume that the accounts receivable are realized and that the inventory is sold for cash. Further assume no 754 election is in effect. The balance sheet now looks as follows:

	Assets			***Liabilities & Capital***
	basis	Book	FMV	
Cash	$550	$550	$550	
equip	$100	$400	$550	
	$650	$950	$1,100	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
A	$475	$475	$475	$550
B jr.	$175	$475	$550	$550
	$650	$950	$1,025	$1,100

Now, assume C joins the partnership by contributing $550 of cash. The balance sheet now is as follows:

	Assets			***Liabilities & Capital***
	basis	Book	FMV	
Cash	$1,100	$1,100	$1,100	
equip	$100	$400	$550	
	$1,200	$1,500	$1,650	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
A	$475	$475	$475	$550
B jr.	$175	$475	$550	$550
C	$550	$550	$550	$550
	$1,200	$1,500	$1,575	$1,650

If the partnership terminates B jr.'s interest by distributing the equipment to B jr., B jr. will take the distributed property at B jr.'s outside basis of $550 even though the partnership's basis in the equipment is only $400.[29] The partnership is left with cash of $1,100 which is shared equally by A and C. A has received the benefit of B jr.'s step-up in basis because A will not have to report as gain any of the appreciation of the equipment. This is only temporary, though, as A will report an offsetting gain when the partnership liquidates or when A sells her interest to a third party. The balance sheet of the partnership is not as follows:

	Assets			***Liabilities & Capital***
	basis	Book	FMV	
Cash	$1,100	$1,100	$1,100	
equip	$0	$0	$0	
	$1,100	$1,100	$1,100	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
A	$550	$550	$475	$550
C	$550	$550	$550	$550
	$1,100	$1,100	$1,025	$1,100

[29] IRC § 732(c). Also note that if any partner other than B jr. received the equipment as a liquidating distribution, then B jr. would be taxed on the pre-contribution 704(c) built-in gain, unless seven years had passed since the contribution of the equipment. IRC §§ 704(c)(2)(B) & 737.

Notice that A's tax and book capital accounts increased by $75 reflecting what would have been A's share of the appreciation in the equipment distributed to B jr. This is required in order to make the balance sheet balance and also because the regulations so demand.[30]

> **KNOWLEDGE POINT: Property distributed to a partner in a liquidating distribution of a partner's interest will have a basis equal to the partner's outside basis.[31]**

III. TAXATION OF GIFTS OF LLC INTERESTS

Generally, under Code Section 1015, the donee of a gift receives a basis in the gifted property equal to the lesser of the fair market value of the property or the donor's basis.[32] The same is true for gifts of partnership interests. The donee inherits the donor's capital accounts and pre-contribution Section 704(c) gain or loss.[33] In other words, the donee steps into the shoes of the donor. Following through with the previous illustration in which A and B formed a partnership:

	Assets			***Liabilities & Capital***
	basis	Book	FMV	
Cash	$300	$300	$300	
Invent	$100	$100	$150	
equip	$100	$400	$550	
	$500	$800	$1,000	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
A	$400	$400	$400	$500
B	$100	$400	$100	$500
	$500	$800	$500	$1,000

[30] Revaluations of the capital accounts are required by Treas. Reg. § 1.704-1(b)(2)(iv)(f) when a new or existing partner contributes money or property and when money or property is distributed to a partner in liquidation of all or part his interest.

[31] IRC § 732(b). Beware, however, of IRC §§ 704(c)(2)(B) & 737 which requires recognition of pre-contribution built-in gain if the property is distributed within seven years of contribution. Also beware that the distribution of unrealized receivables and appreciated inventory may result in a recognition event. IRC §§ 751(b) & 732(e).

[32] IRC § 1015(a); Treas. Reg. § 1.1015-1(a)(2). Thus, if the fair market value of the gifted property is less than the donor's basis, the donee's basis floats such that the donee recognizes no gain or loss if the gifted property is subsequently sold by the donee at a price between the fair market value of the property at the time of the gift and the donor's basis.

[33] Treas. Reg. §1.704-1(b)(2)(iv)(l); Treas. Reg. §§1.704-3(a)7 and 1.743-1(j)(2).

If B decides to gift her interest to B jr., B jr. will essentially replace B and succeed to B's tax and book capital accounts. Because B's basis is less than the fair market value of B's partnership interest, B jr. will succeed to B's outside basis of $100. The balance sheet will appear as follows:

Assets				***Liabilities & Capital***
	basis	Book	FMV	
Cash	$300	$300	$300	
Invent	$100	$100	$150	
equip	$100	$400	$550	
	$500	$800	$1,000	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
A	$400	$400	$400	$500
B jr.	$100	$400	$100	$500
	$500	$800	$500	$1,000

The following year, after the partnership's equipment lost $250 in value, A decides to gift her partnership interest to A jr. A's outside basis is now $25 higher than the fair market value of A's partnership interest. A jr. takes an outside basis equal to the lesser of A's basis ($400) or the fair market value of A's interest ($375). The balance sheet now appears as follows:

Assets				***Liabilities & Capital***
	basis	Book	FMV	
Cash	$300	$300	$300	
Invent	$100	$100	$150	
equip	$100	$400	$300	
	$500	$800	$750	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
A jr.	$400	$400	$375	$375
B jr.	$100	$400	$100	$375
	$500	$800	$475	$750

Because A's outside basis was $400, A jr.'s basis will essentially float between $375 and $400 such that if A jr.'s partnership interest were sold or liquidated within that range, A jr. would recognize no gain or loss.[34]

[34] IRC § 1015(a); Treas. Reg. § 1.1015-1(a)(2).

Now, assume the same facts except the partnership borrowed $900 several years ago and used the borrowed proceeds to fund the partnership's operations, all of which resulted in losses flowing through to the partners. Partners A and B increase their outside basis (but not their capital accounts) by $450 each,[35] but because of the $900 of operating expenses, each partner's capital account and outside basis is reduced by $450. The partnership's balance sheet is now as follows:

	Assets			***Liabilities & Capital***	
	basis	Book	FMV		
Cash	$300	$300	$300	mortgage	$900
Invent	$100	$100	$150		
equip	$100	$400	$550		
	$500	$800	$1,000	***Capital Accounts***	

	Tax	Book	Outside Basis	FMV
A	($50)	($50)	$400	$50
B	($350)	($50)	$100	$50
	($400)	($100)	$500	$100

If B gifts her interest to B jr., several things happen. First, B is relieved of $450 of partnership liabilities and such debt relief is equivalent to a distribution of money to B.[36] B will recognize gain to the extent money distributed to her exceeds her basis which in this situation requires B to recognize $350.[37] This result makes sense because B was the beneficiary of $450 of previous deductions due to the $900 partnership borrowing, and now B is being relieved of her obligation to pay the $450 back.

Second, B jr. will take a transferred basis from B which will be $0 because B used her $100 basis to apply against the deemed distribution of $450 to her. However, B jr. will be allowed to increase his outside basis by one-half of the partnership liabilities.[38]

Third, B jr. will succeed to B's tax and book capital accounts and pre-contribution 704(c) built-in gain adjustment.[39]

[35] IRC § 722.

[36] IRC § 752(b); IRC § 752(d); *Crane v. Commissioner*, 331 US 1 (1947); *Commissioner v. Tufts*, 461 U.S. 300 (1983).

[37] IRC § 731(a)(1).

[38] IRC § 722.

[39] Treas. Reg. §1.704-1(b)(2)(iv)(l); Treas. Reg. §§1.704-3(a)7 and 1.743-1(j)(2).

After the gift, the partnership's balance sheet will be as follows:

	Assets			***Liabilities & Capital***	
	basis	Book	FMV		
Cash	$300	$300	$300	mortgage	$900
Invent	$100	$100	$150		
equip	$100	$400	$550		
	$500	$800	$1,000	***Capital Accounts***	

	Tax	Book	Outside Basis	FMV
A	($50)	($50)	$400	$50
B jr.	($350)	($50)	$450	$50
	($400)	($100)	$850	$100

KNOWLEDGE POINT: In the absence of a Section 754 election, the donee of a partnership interest will step into the shoes of the donor and inure to the attributes of the donor's tax and book capital accounts as well as the donor's pre-contribution Section 704(c) built in gain or loss.

IV. TAXATION OF GIFTS OF LLC INTERESTS TO CHARITY

If B were to gift her partnership interest to a charity, the same result would occur as if the gift had been made to a person with two exceptions: First, B's basis is allocated between the part that is considered a sale and the part that is considered a gift.[40] Second, B is entitled to a charitable contribution deduction in an amount equal to the fair market value of the partnership interest ($50).[41] Charity will succeed to B's tax and book capital accounts and pre-contribution 704(c) built-in gain adjustment.[42] Charity will also be allowed to increase its outside basis by one-half of the partnership liabilities ($450).[43] B's gain would equal $350 ($450 debt relief less $100 basis). The partnership balance sheet will be as follows:

[40] IRC § 1011(b); Treas. Reg. § 1.1011-2(b); Rev. Rul. 75-194; Rev. Rul. 81-163 (stating that the adjusted basis for determining the gain from the sale is the portion of the adjusted basis of the entire property that bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the entire property).

[41] Treas. Reg. § 1.170A-4(c).

[42] Treas. Reg. §1.704-1(b)(2)(iv)(l); Treas. Reg. §§1.704-3(a)7 and 1.743-1(j)(2).

[43] IRC § 722.

	Assets			***Liabilities & Capital***	
	basis	Book	FMV		
Cash	$300	$300	$300	mortgage	$900
Invent	$100	$100	$150		
equip	$100	$400	$550		
	$500	$800	$1,000	***Capital Accounts***	

	Tax	Book	Outside Basis	FMV
A	($50)	($50)	$400	$50
charity	($350)	($50)	$450	$50
	($400)	($100)	$850	$100

If the fair market value of B's partnership interest were $900 (rather than $50), then B's outside basis would be allocated half to the sale and half to the charity.[44] B's gain would be $400 ($450 debt relief less $50 basis). The Charity's outside basis would consist of $50 of B's basis plus $450 (half of the $900 debt). B would have a charitable contribution deduction of $200. The balance sheet would now appear as follows:

	Assets			***Liabilities & Capital***	
	basis	Book	FMV		
Cash	$300	$300	$300	mortgage	$900
Invent	$100	$100	$150		
equip	$100	$400	$2,250		
	$500	$800	$2,700	***Capital Accounts***	

	Tax	Book	Outside Basis	FMV
A	($50)	($50)	$400	$900
charity	($350)	($50)	$500	$900
	($400)	($100)	$900	$1800

KNOWLEDGE POINT: When a partner's share of partnership liabilities exceeds the partner's outside basis, the partner will always have taxable gain on a gift of the partnership interest.

[44] IRC § 1011(b); Treas. Reg. § 1.1011-2(b); Rev. Rul. 75-194; Rev. Rul. 81-163 (stating that the adjusted basis for determining the gain from the sale is the portion of the adjusted basis of the entire property that bears the same ration to the adjusted basis as the amount realized bears to the fair market value of the entire property). Based on Rev. Rul. 81-163, the amount realized is $450 and the fair market value of the property is $900. Thus, B's basis of $100 is split in half (450/900) with $50 allocated to B to apply against her gain and the other $50 given to the charity.

V. INVESTMENT TAX CREDIT RECPATURE FROM FORMER PARTNERS

If B were the beneficiary of any tax credits that flowed through the partnership to B, B would continue to be liable for repayment of such tax credits if a later default occurred notwithstanding the fact that B gifted her partnership interest to B jr.[45]

KNOWLEDGE POINT: Substituted partners are not liable for a former partner's share of tax credit recapture.

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[45] Treas. Reg. § 1.48-6(b), ex 2.