



LB&I Transaction Unit

Unit Name	Sale of a Partnership Interest	
Primary UIL Code	741.00-00	Recognition and Character of Gain or Loss on Sale or Exchange

Library Level	Title
Knowledge Base	Partnership Knowledge Base
Shelf	Dispositions, Divisions and Mergers
Book	Dispositions
Chapter	Sale or Exchange of Partnership Interest

Document Control Number (DCN)	PAR-T-006
Date of Last Update	02/19/21

Table of Contents

(View this PowerPoint in “Presentation View” to click on the links below)

[General Overview](#)

- [Issue and Transaction Overview](#)
- [Transaction and Fact Pattern](#)

[Summary of Potential Issues](#)

[Index of Referenced Resources](#)

[Training and Additional Resources](#)

[Glossary of Terms and Acronyms](#)

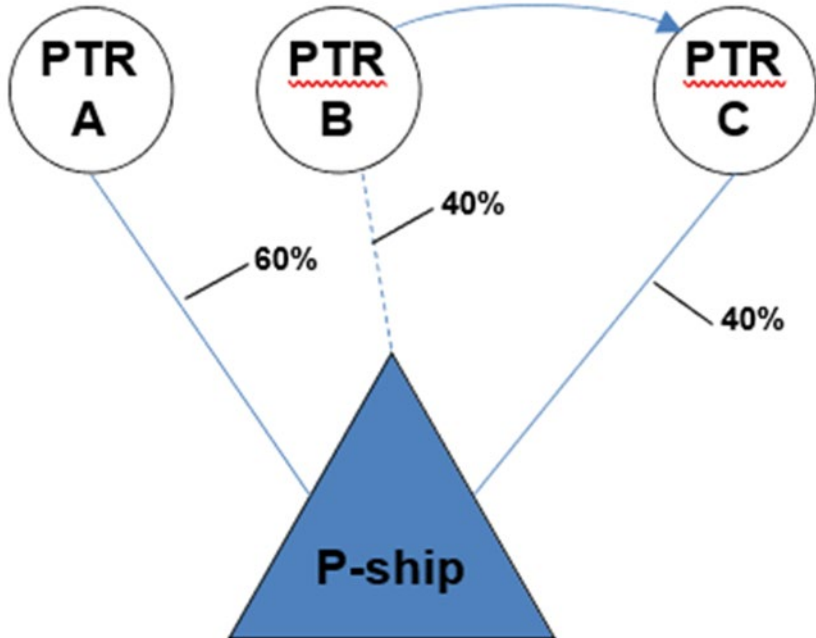
[Index of Related Practice Units](#)

Sale of a Partnership Interest

- When a sale of a partnership interest occurs, the entity theory is the underlying concept, not the aggregate theory. This means the ownership interest a partner has in a partnership is treated as a separate asset that can be purchased and sold.
- The general rule is the selling partner treats the gain or loss on the sale of the partnership interest as the sale of a capital asset (see IRC 741).
- An exception to the general rule exists when the partnership entity holds certain types of assets. The aggregate rule comes into play and the look-through concept is applied where the partner may have to characterize part of the gain or loss on the sale of the interest as subject to different tax rates based on the types of assets owned by the partnership entity.
- When the partnership owns IRC 751 assets, the selling partner must recognize ordinary gain or loss respecting the partner's share of those assets.
- The same type of exception applies for assets subject to unrecaptured Section 1250 gain treatment. Like for IRC 751 assets, the selling partners must allocate the gain or loss based on the partner's share of the IRC 1250 assets as subject to unrecaptured Section 1250 gain. Section 1250 gain has a higher tax rate than the capital gain tax rate.
- Because fair market value (FMV) tends to change over time, when the buying partner acquires the partnership interest at FMV, its outside basis in the partnership interest likely differs from its share of the partnership's inside basis in its assets. If the partnership elects under IRC 754 to make a special IRC 743(b) basis adjustment, the difference goes away.

Transaction and Fact Pattern

Sale of a Partnership Interest

Diagram of Transaction	Facts
 <p>The diagram illustrates the ownership structure of a partnership, labeled 'P-ship' in a blue triangle at the bottom. Above the triangle are three circles representing partners: 'PTR A', 'PTR B', and 'PTR C'. PTR A is connected to the P-ship by a solid line labeled '60%'. PTR B is connected to the P-ship by a dashed line labeled '40%'. PTR C is connected to the P-ship by a solid line labeled '40%'. Additionally, a curved arrow points from PTR B to PTR C, indicating the sale of the partnership interest.</p>	<ul style="list-style-type: none"> ▪ This example illustrates how a partner computes the gain or loss on the sale of a partnership interest where the partnership has IRC 751 assets and assets having unrecaptured IRC Section 1250 gain. It also shows how the partnership computes the IRC Section 743(b) amount. ▪ Partner A owns 60% of the partnership and Partner B owns 40%. ▪ Partner B sells his 40% interest in the partnership to Partner C. ▪ Partner C paid \$480,000 directly to Partner B.

Transaction and Fact Pattern (cont'd)

Sale of a Partnership Interest

Facts

- The \$480,000 Partner C paid to Partner B represents 40% of the FMV of the partnership on the date of the sale.
- The FMV of the partnership is \$1,200,000 (total assets have a FMV of \$2,000,000 less debt of \$800,000).

The partnership had the following balance sheet at the time of the sale:

		<u>Inside Basis</u>	<u>FMV</u>
Cash		\$ 10,000	\$ 10,000
Accounts Receivable		82,000	30,000
Inventory		80,000	100,000
Equipment Cost	\$ 100,000		
Accumulated Depreciation	<u>(52,000)</u>	48,000	80,000
Building Cost	1,560,000		
Accumulated Depreciation	<u>(80,000)</u>	1,480,000	\$1,670,000
Land		<u>100,000</u>	<u>110,000</u>
Total Assets		1,800,000	2,000,000
Debt		800,000	800,000
Partner A Capital		600,000	720,000
Partner B Capital		<u>400,000</u>	<u>480,000</u>
Total Liabilities and Capital		1,800,000	2,000,000

Summary of Potential Issues

Sale of a Partnership Interest

<u>Issue 1</u>	Did an ownership change occur where one partner sold an interest in the partnership to a new or existing partner?
<u>Issue 2</u>	Did the partner who sold an interest in the partnership properly report the gain or loss?
<u>Issue 3</u>	Did the selling partner consider whether the partnership has any IRC 751 assets and treat any of the gain or loss on the sale of the partnership interest as ordinary income?
<u>Issue 4</u>	Did the selling partner consider whether the partnership has any IRC 1250 assets and treat any of the gain or loss on the sale of the partnership interest as being subject to tax at the unrecaptured IRC 1250 gain tax rate?
<u>Issue 5</u>	Did the partnership have an IRC 754 election in place? If so, did the partnership correctly compute the IRC 743(b) adjustment?

All Issues, Step 1: Initial Factual Development

Sale of a Partnership Interest

A sale of a partnership interest occurs when one partner sells their ownership interest to another person or entity. The partnership is generally not involved in the transaction. However, the buyer and seller will notify the partnership of the transaction. When the partnership files its Form 1065 tax return, there are indicators on the return that a sale of a partnership interest occurred. The following elements will assist you in identifying a sale.

Fact Element	Resources
<ul style="list-style-type: none"> ▪ Determine whether the partnership issued a final K-1 to any of the partners. 	<ul style="list-style-type: none"> ▪ Form 1065, Schedule K-1, Final K-1 box
<ul style="list-style-type: none"> ▪ Determine whether any partner's share of profit, loss, or capital was reduced to zero at the end of the year. The fact that a partner's share of profit, loss, or capital was reduced to zero does not necessarily mean that there was a sale of a partnership interest. While there likely has been a sale of a partnership interest if a partner's share of profit, loss, and capital are all reduced to zero, a partner's share of any one of those items can fall to zero as a result of routine partnership operations that are entirely unrelated to partnership interest sales. 	<ul style="list-style-type: none"> ▪ Form 1065, Schedule K-1, Part II, item J - Partner's share of profit, loss, and capital
<ul style="list-style-type: none"> ▪ Determine if a partner's capital account was reduced to zero and a new partner's capital account was increased from zero in similar amounts. This indicates a sale of a partnership interest. A departing partner's capital account will normally be zero at year-end. A reduction of a partner's capital account to an amount other than zero may indicate a partial sale. If a partner left the partnership through a sale, the partnership transfers the selling partner's capital account to the buyer. 	<ul style="list-style-type: none"> ▪ Form 1065, Schedule K-1, Part II, item L - Partner's capital account analysis

All Issues, Step 1: Initial Factual Development (cont'd)

Sale of a Partnership Interest

Fact Element	Resources
<ul style="list-style-type: none">▪ Tax return preparers normally use one of two methods to record the change of ownership on the Form 1065, Schedule M-2.<ul style="list-style-type: none">– In the first method, on lines 2 and 6 of Schedule M-2 the preparers record the change in ownership as a capital contribution and distribution between the two partners.– In the second, on lines 4 and 7 of Schedule M-2 the preparers record the change in ownership as other increase and other decrease.	<ul style="list-style-type: none">▪ Form 1065, page 5, Schedule M-2 - Analysis of Partners' Capital Accounts
<ul style="list-style-type: none">▪ Normally when an amount is recorded as a distribution on Schedule K and Schedules K-1, the partner received an actual cash or property distribution. However, as described in the previous Fact Element, if the tax return preparer records the change in ownership as a contribution and distribution, this could be a tax preparation software issue. Many software packages show the reduction in the selling partner's capital account as a distribution on Schedule K-1 when in fact the partnership did not make a distribution to the selling partner.	<ul style="list-style-type: none">▪ Form 1065, Schedule K-1's, Part III, line 19 - Distributions
<ul style="list-style-type: none">▪ If the partnership files a final return reporting a technical termination, this indicates that a sale or exchange of a partnership interest occurred. A technical termination occurs when within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in the partnership capital and profits. Partnership technical terminations were eliminated for partnership tax years beginning after December 31, 2017.	<ul style="list-style-type: none">▪ Form 1065, page 1, item G (2) - Final return indicator, and item G (6) - Technical termination indicator (on returns prior to 2018)

All Issues, Step 1: Initial Factual Development (cont'd)

Sale of a Partnership Interest

Fact Element	Resources
<ul style="list-style-type: none">▪ Review the partnership return for a Form 8308. This form is attached when a sale has taken place and the partnership holds IRC 751 assets. IRC 751 assets are referred to as hot assets. They generate ordinary income instead of capital gain or loss.	<ul style="list-style-type: none">▪ Form 8308 - <i>Report of a Sale or Exchange of Certain Partnership Interests</i>

Issue 1, Step 2: Review Potential Issues

Sale of a Partnership Interest

Issue 1

Did an ownership change occur where one partner sold an interest in the partnership to a new or existing partner?

Explanation of Issue	Resources
A partner may dispose of an interest in a partnership in different ways - sale, exchange, gift, death or abandonment. This transaction unit focuses on the tax issues related to the sale of a partnership interest.	
<p>Ensure the transaction was a sale of a partnership interest and not some other transaction such as a liquidation or non-taxable exchange. While not an exhaustive list, these three questions help determine whether there was a sale of a partnership interest.</p> <ul style="list-style-type: none"> ▪ Did the benefits and burdens of ownership transfer to the buyer? ▪ Which partner has the right to present and/or future partnership profits under the partnership agreement? ▪ Assuming that there was a clearly-established partnership, what was the intent of the parties involved in the transaction? 	

Issue 1, Step 2: Review Potential Issues (cont'd)

Sale of a Partnership Interest

Issue 1

Explanation of Issue	Resources
<ul style="list-style-type: none">▪ Review the selling partner's tax return to determine whether the seller reported the sale transaction.<ul style="list-style-type: none">– Review Schedule D, Form 8949 and Form 4797 to determine the amount of gain or loss the partner reported on the sale of the partnership interest.– When a seller's tax return is silent about sale transactions, it doesn't necessarily mean there was no sale. Seller's non-inclusion could point to a fraudulent intent and/or tax evasion motive.	<ul style="list-style-type: none">▪ Form 8949 - <i>Sales and Other Dispositions of Capital Assets</i>▪ Form 4797 - <i>Sales of Business Property</i>

Issue 1, Step 3: Additional Factual Development

Sale of a Partnership Interest

Issue 1

Fact Element	Resources
<p>After determining a partner sold its interest in the partnership, establish other relevant facts that can impact the tax treatment of this transaction.</p> <ul style="list-style-type: none">▪ Determine if there was a partial or complete sale of the partnership interest.▪ Determine the identities of the buying and selling parties, including their entity types and whether they are related.▪ Review how the partnership allocated its income/loss between the buyer/seller in the year of the sale.<ul style="list-style-type: none">– Remember that different partnerships use different accounting methods and that an accrual method taxpayer may allocate income/loss differently from a cash method taxpayer.▪ For partnership tax years beginning before January 1, 2018, determine if the sale caused a technical termination.	<ul style="list-style-type: none">▪ Rev. Rul. 84-53▪ IRC 706▪ Treas. Reg. 1.706-4▪ IRC 708(b)

Issue 1, Step 4: Develop Arguments

Sale of a Partnership Interest

Issue 1

Explanation of Adjustment	Resources
<ul style="list-style-type: none"> ▪ Determine whether a partner sold its interest in the partnership then consider potential circumstances which might impact the tax treatment of the transaction. The following items should be considered: 	
<u>Related Party Sale</u> <ul style="list-style-type: none"> ▪ It is important to identify if the sale is to a related party. There are differences in the tax treatment of sales of partnership interests to a related party versus an unrelated party. For example, a loss on a sale of a partnership interest to a related party is not allowed and gains recognized are ordinary. ▪ 707(b) solely applies to controlled partnerships. 	<ul style="list-style-type: none"> ▪ IRC 267(b) ▪ IRC 707(b)
<u>Technical Termination for Partnership Tax Years Beginning Before January 1, 2018</u> <p>After January 1, 2018, TCJA (Tax Cuts and Jobs Act), Partnership Technical Terminations were eliminated. For technical terminations prior to TCJA, consider whether the following impact tax treatment:</p> <ul style="list-style-type: none"> ▪ A partnership's technical termination can result in favorable or unfavorable tax results. ▪ The new partnership's depreciable property is considered new property which restarts the recovery period for the property's remaining basis. ▪ The new partnership can choose new accounting and inventory methods. 	<ul style="list-style-type: none"> ▪ IRC 708(b) ▪ IRC 168(i)(7)

Issue 2, Step 2: Review Potential Issues

Sale of a Partnership Interest

Issue 2

Did the partner who sold an interest in the partnership properly report the gain or loss?

Explanation of Issue	Resources
<ul style="list-style-type: none"> ▪ The gain or loss from the sale of a partnership interest is the difference between the sales proceeds received and the partner's tax basis in the interest at the time of the sale. The sales proceeds include the amount of cash and the FMV of any property received, plus the amount by which the partner's share of partnership liabilities decreased. <ul style="list-style-type: none"> – If a partner is selling his entire partnership interest, then his share of partnership liabilities will be reduced to zero and thus his amount realized will increase by at least the entire amount of his former share of partnership liabilities. – If a partner is only selling a portion of his partnership interest, then his amount realized will increase by at least a value equal to the product of the interest percentage being sold and his former share of partnership liabilities. 	<ul style="list-style-type: none"> ▪ IRC 1001 ▪ Treas. Reg. 1.1001-1 ▪ Treas. Reg. 1.1001-2 ▪ Treas. Reg. 1.741-1 ▪ Form 8949 - <i>Sales and Other Dispositions of Capital Assets</i> ▪ Form 4797 - <i>Sales of Business Property</i>
<p><u>Initial Questions for Sale of a Partnership Interest</u></p> <ul style="list-style-type: none"> ▪ Did the selling partner report the sale of the partnership interest? <ul style="list-style-type: none"> – Capital gain or loss is reported on Schedule D and Form 8949. – Ordinary gain or loss is reported on Form 4797. – Unrecaptured Section 1250 gain is reported on Schedule D or Schedule K. 	<ul style="list-style-type: none"> ▪ IRC 1001 ▪ IRC 752 ▪ IRC 705

Issue 2, Step 2: Review Potential Issues (cont'd)

Sale of a Partnership Interest

Issue 2

Explanation of Issue	Resources
<p><u>Initial Questions for Sale of a Partnership Interest (cont'd)</u></p> <ul style="list-style-type: none">▪ Does the overall amount of the gain or loss appear correct?<ul style="list-style-type: none">– Does the amount realized include all cash proceeds received, FMV of any property received and the amount by which the seller's liabilities decreased?– Does the selling partner's outside basis appear reasonable? Add together tax capital and liabilities from Schedule K-1 to approximate outside basis.▪ What were the filing requirements of the selling partner? The tax consequences for the sale of a partnership interest vary depending upon what type of return is filed by the selling partner. Consider the following:<ul style="list-style-type: none">– C-Corporations are not subject to long-term capital gains tax rates. Capital losses can only be deducted from capital gains. Therefore, C-Corporations with large capital loss carryforwards set to expire may try to classify income from the sale of a partnership interest as capital gains to offset these losses.– If the selling partner is a foreign partner, did it have a filing or withholding requirement?	<ul style="list-style-type: none">▪ Form 1065, Schedule K-1, Part II, item I-1▪ Form 1065, Schedule K-1, Part II, item H▪ Rev. Rul. 91-32▪ International Knowledge Base - IRS Virtual Library

Issue 2, Step 2: Review Potential Issues (cont'd)

Sale of a Partnership Interest

Issue 2

Explanation of Issue			Resources
Example 1: Computation of Gain or Loss from Sale of a Partnership Interest (See facts from Slide 5 of this transaction unit.)			
Amount Realized:	\$480,000	Cash	
	<u>320,000</u>	Partner B's Share of Liabilities (\$800,000 X 40%)	
	800,000	Amount Realized	
Outside Basis:	400,000	Partner B's Tax Capital Account	
	<u>320,000</u>	Partner B's Share of Liabilities (\$800,000 X 40%)	
	720,000	Partner B's Approximate Outside Basis	
	800,000	Amount Realized	
	<u>(720,000)</u>	Partner B's Approximate Outside Basis	
	80,000	Expected Gain on Sale	
As the computation shows above, Partner B has an \$80,000 gain on the sale of his partnership interest. You need to review Partner B's tax return to determine if the gain on the sale of his partnership interest was reported. Whether the gain is ordinary or capital is determined later.			

Issue 2, Step 3: Additional Factual Development

Sale of a Partnership Interest

Issue 2

Fact Element	Resources
<ul style="list-style-type: none">▪ Request a copy of the partnership agreement.▪ Request a copy of the sales agreement.<ul style="list-style-type: none">– It is used to determine the seller's proceeds and whether the seller's liabilities were transferred to the buyer.▪ Request the selling partner's outside basis computation and determine if the computation seems reasonable.<ul style="list-style-type: none">– Inspect prior year tax returns/K-1's to verify the basis computation is accurate. Obtain the tax returns by using Employee User Portal (EUP), LB&I Image Net (LIN) or request them from the partner.▪ Review the selling partner's tax return to determine if the amount/character of the gain/loss reported from the sale is correct.	

Issue 2, Step 3: Additional Factual Development (cont'd)

Sale of a Partnership Interest

Issue 2

Fact Element	Resources
<ul style="list-style-type: none">▪ Determine if any of the following situations exist with the selling partner:<ul style="list-style-type: none">– Did the selling partner have any suspended losses that impact the gain/loss computation?– Did the partner report any gain using the installment sale method via Form 6252?– Was any portion of the selling partner's interest held for less than one year? If so, then gains resulting from the sale are short-term capital gains and hence ordinary income rates apply.– Do carried interests impact the character of the gain? Carried interests are ownership interests that share in the partnership's net profits. Carried interests are often issued to investment managers for their services. Holders often receive capital gains which are taxed at a lower rate than ordinary income. TCJA extended the holding period for certain carried interests to three years.	<ul style="list-style-type: none">▪ Form 6252 - <i>Installment Sale Income</i>▪ IRC 1061

Issue 2, Step 4: Develop Arguments

Sale of a Partnership Interest

[Issue 2](#)

Explanation of Adjustment	Resources
<p><u>Facts You Should Determine When Examining the Selling Partner's Return</u></p> <p><u>Seller Reported the Gain</u></p> <ul style="list-style-type: none">▪ Inspect the selling partner's tax return to determine if he reported the gain/loss on the sale of the partnership interest. Since the sale often results in more than one character of recognized gain/loss, it is important to determine the total amount of gain/loss reported by the selling partner.▪ Determine if both the total gain/loss and character of the gain/loss reported by the seller appear accurate.	

Issue 2, Step 4: Develop Arguments (cont'd)

Sale of a Partnership Interest

[Issue 2](#)

Explanation of Adjustment	Resources
<p><u>Facts You Should Determine When Examining the Selling Partner's Return (cont'd)</u></p> <p><u>Determine the Amount Realized</u></p> <ul style="list-style-type: none"> ▪ The selling partner's amount realized equals the amount of cash and FMV of any property received, plus the amount by which the selling partner's share of partnership liabilities are decreased. <ul style="list-style-type: none"> – The sales agreement should contain the information needed to determine the amount realized by the selling partner. Is the FMV of property received by the seller reasonable? Does the amount realized include all of the seller's share of relieved partnership liabilities? – Whether the buyer assumed the selling partner's share of liabilities is a factual issue that must be determined during a partnership audit. While the buyer may assume a seller's liability, the lender may not be willing to release the seller from liability. Ask about partnership loan agreements and loan guarantee agreements in effect at the sale date. 	<ul style="list-style-type: none"> ▪ IRC 1001(a) ▪ Treas. Reg. 1.752-1(d)

Issue 2, Step 4: Develop Arguments (cont'd)

Sale of a Partnership Interest

[Issue 2](#)

Explanation of Adjustment	Resources
<p><u>Facts You Should Determine When Examining the Selling Partner's Return (cont'd)</u></p> <p><u>Determine the Partner's Basis</u></p> <ul style="list-style-type: none">▪ Inspect the partner's basis computation and ensure it is correct.<ul style="list-style-type: none">– Include all years since the partner became a partner in the partnership.– Include items that reduce basis such as partnership losses and distributions. <p><u>Other Considerations</u></p> <ul style="list-style-type: none">▪ Determine if additional circumstances from the sale transaction impact the reporting to the selling partner.<ul style="list-style-type: none">– Ensure any gain reported using the installment sale method on Form 6252 is allowable. For example, certain recapture income from IRC 1245 and 1250 property must be reported in the year of the sale.– Even if a selling partner receives payment for his partnership interest in installments, any gains that are not eligible for installment method treatment must be recognized in the year of the sale.– Losses from the sale of a partnership interest to a related party are not deductible.	<ul style="list-style-type: none">▪ IRC 705▪ Issue Snapshot - Determining Basis in a Partnership Interest (Outside Basis)▪ Audit Tool - Partner's Basis Computation Spreadsheet▪ IRC 453(i)▪ IRC 267▪ IRC 707

Issue 3, Step 2: Review Potential Issues

Sale of a Partnership Interest

Issue 3

Did the selling partner properly consider the IRC 751 property of the partnership and correctly report any of the gain or loss on the sale of the partnership interest as being subject to ordinary income rates?

Explanation of Issue	Resources
<p>If a partnership holds IRC 751(a) property at the time of the sale, the partner recognizes gain or loss from its share of IRC 751(a) assets. The ordinary gain or loss is subtracted from the total gain or loss. The result is the partner's capital gain or loss from the sale. Ordinary income assets are known as hot assets and include unrealized receivables and inventory items as defined in IRC 751. Determine the selling partner's gain or loss from a partnership interest:</p> <ol style="list-style-type: none"> 1. Compute the total gain or loss realized by the selling partner. This is \$80,000 as shown on Slide 16. 2. Compute the ordinary gain or loss that would have been allocated to the partner for its share of section 751(a) assets if the partnership had sold all of its assets in a taxable transaction for cash at their FMV immediately prior to the partner's transfer of his partnership interest. 3. Compute the difference between the total gain or loss and gain or loss attributable to the IRC 751(a) assets. The difference is the gain or loss attributed to the sale of capital assets. This capital gain must be further broken down using the look-through rule. 	<ul style="list-style-type: none"> ▪ IRC 751 ▪ Treas. Reg. 1.751-1 ▪ Treas. Reg. 1.1(h)-1

Issue 3, Step 2: Review Potential Issues (cont'd)

Sale of a Partnership Interest

Issue 3

Explanation of Issue	Resources																																																
<p>The gain from this sale of a partnership interest is \$80,000 as calculated on Slide 16. The next step is to determine which assets are IRC 751(a) assets and the amount of any gain/loss that would be allocated to Partner B for these assets.</p> <table><tr><td></td><td></td><td></td><td>Partner B's</td><td>Partner B's</td><td></td></tr><tr><td><u>Inside Basis</u></td><td><u>FMV</u></td><td><u>Difference</u></td><td><u>Share</u></td><td><u>Share 751(a)</u></td><td><u>Asset</u></td></tr><tr><td>82,000</td><td>30,000</td><td>(52,000)</td><td>(20,800)</td><td>(20,800)</td><td>Accounts Rec.</td></tr><tr><td>80,000</td><td>100,000</td><td>20,000</td><td>8,000</td><td>8,000</td><td>Inventory</td></tr><tr><td>48,000</td><td>80,000</td><td>32,000</td><td>12,800</td><td>12,800</td><td>Equipment</td></tr><tr><td>1,480,000</td><td>1,670,000</td><td>190,000</td><td>76,000</td><td>-</td><td>Building</td></tr><tr><td><u>100,000</u></td><td><u>110,000</u></td><td><u>10,000</u></td><td><u>4,000</u></td><td><u>-</u></td><td>Land</td></tr><tr><td>1,790,000</td><td>1,990,000</td><td>200,000</td><td>80,000</td><td>-</td><td></td></tr></table> <p>Step 1: Total Gain is \$80,000</p> <p>Step 2: Net IRC 751(a) Gain is \$0</p> <p>Step 3: \$80,000 Total Gain</p> <p> <u>\$0</u> IRC 751(a) Gain</p> <p> \$80,000 Gain Attributable to Sale of Capital Assets</p>				Partner B's	Partner B's		<u>Inside Basis</u>	<u>FMV</u>	<u>Difference</u>	<u>Share</u>	<u>Share 751(a)</u>	<u>Asset</u>	82,000	30,000	(52,000)	(20,800)	(20,800)	Accounts Rec.	80,000	100,000	20,000	8,000	8,000	Inventory	48,000	80,000	32,000	12,800	12,800	Equipment	1,480,000	1,670,000	190,000	76,000	-	Building	<u>100,000</u>	<u>110,000</u>	<u>10,000</u>	<u>4,000</u>	<u>-</u>	Land	1,790,000	1,990,000	200,000	80,000	-		<ul style="list-style-type: none">IRC 751(a)
			Partner B's	Partner B's																																													
<u>Inside Basis</u>	<u>FMV</u>	<u>Difference</u>	<u>Share</u>	<u>Share 751(a)</u>	<u>Asset</u>																																												
82,000	30,000	(52,000)	(20,800)	(20,800)	Accounts Rec.																																												
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1,790,000	1,990,000	200,000	80,000	-																																													

Issue 3, Step 2: Review Potential Issues (cont'd)

Sale of a Partnership Interest

[Issue 3](#)

Explanation of Issue	Resources
<ul style="list-style-type: none">▪ Accounts Receivable, Inventory and Equipment are all identified as IRC 751(a) assets. The gain on the sale of equipment is considered IRC 1245 depreciation recapture which is taxed at ordinary income rates.▪ The \$76,000 is considered unrecaptured section 1250 gain which is subject to a special 25% capital gain rate.	<ul style="list-style-type: none">▪ IRC 1245

Issue 3, Step 3: Additional Factual Development

Sale of a Partnership Interest

Issue 3

Fact Element	Resources
<ul style="list-style-type: none">▪ Review the selling partner's return for a statement attached as required by Treas. Reg. 1.751-1(a)(3), including the following:<ul style="list-style-type: none">– The date of the sale.– The amount of the gain/loss attributable to IRC 751 property.– The amount of the gain/loss attributable to capital gain/loss from the sale of the partnership interest.▪ Review the partnership's return for Form 8308. This form must be filed when a partner sold or exchanged its partnership interest and the partnership held IRC 751 assets. Investigate differences between Form 8308 and the statement attached to the partner's return.▪ If the partnership and/or partner have not attached the required statements, request in another format the information required by Treas. Reg. 1.751-1(a)(3) and Form 8308. Review for accuracy.<ul style="list-style-type: none">– Ensure that all IRC 751 assets are accounted for and their FMV appears reasonable.	<ul style="list-style-type: none">▪ IRC 751▪ Treas. Reg. 1.751-1▪ Form 8308 - <i>Report of a Sale or Exchange of Certain Partnership Interests</i>▪ Treas. Reg. 1.6050K-1

Issue 3, Step 4: Develop Arguments

Sale of a Partnership Interest

Issue 3

Explanation of Adjustment	Resources
After all the relevant facts are gathered, consider whether the selling partner properly reported gain under IRC 751. Issue number two on Slide 14 of this Transaction Unit considered whether the amount of the gain/loss on the sale of the partnership interest was correct. Issue number three determines whether the character of the gain/loss was reported correctly by the selling partner.	<ul style="list-style-type: none"> ▪ IRC 751 ▪ Treas. Reg. 1.751-1
<ul style="list-style-type: none"> ▪ Review Form 1065, Schedule L (or taxpayer asset schedule) to determine if there were additional IRC 751(a) assets not accounted for by the partnership in the IRC 751 gain/loss computation. Some common IRC 751 assets are: <ul style="list-style-type: none"> – Depreciable assets: Form 1065, Schedule L, lines 9(a),(b) – Intangible assets: Form 1065, Schedule L, lines 12(a),(b) – Accounts Receivable: Form 1065, Schedule L, lines 2(a),(b) – Inventory: Form 1065, Schedule L, line 3 	<ul style="list-style-type: none"> ▪ Form 1065 - <i>U.S. Return of Partnership Income</i>

Issue 3, Step 4: Develop Arguments (cont'd)

Sale of a Partnership Interest

Issue 3

Explanation of Adjustment	Resources
<ul style="list-style-type: none"> ▪ Determine whether the FMV assigned to the IRC 751 assets was reasonable. <ul style="list-style-type: none"> – How did the partnership determine the FMV of the IRC 751 assets? – Did the partnership obtain an appraisal? – If there are significant IRC 751 assets, consider requesting a valuation expert (engineer, appraiser). 	
<ul style="list-style-type: none"> ▪ Consider the partnership's business operations. <ul style="list-style-type: none"> – If the partnership is a land developer, the developed land is considered inventory (an IRC 751 asset). – If the partnership is a manufacturer with a significant amount of depreciated equipment, the equipment is likely subject to IRC 1245 recapture which is taxed at ordinary income rates. – A right to be paid for services or goods which are not capital assets is considered income subject to IRC 751 is an unrealized receivable. <ul style="list-style-type: none"> ▪ For example, a law firm's unbilled fees for past services are subject to IRC 751. Therefore, ensure any ordinary income the selling partner would have been entitled to but for the sale of the partnership interest is included in the IRC 751 computation. 	<ul style="list-style-type: none"> ▪ IRC 751 ▪ Treas. Reg. 1.751-1 ▪ IRC 1245

Issue 4, Step 2: Review Potential Issues

Sale of a Partnership Interest

Issue 4

Did the selling partner properly consider any Section 1250 property of the partnership and correctly report the portion of the gain or loss on the sale of the partnership interest as being subject to the unrecaptured Section 1250 gain tax rate?

Explanation of Issue	Resources																						
<p>Slide 23 previously computed Partner B’s capital gain to be \$80,000 from the sale of his partnership interest. However, the look-through rule of Treas. Reg. 1.1(h)-1 explains not all capital gains are taxed at the same rates. Certain types of capital gains are taxed at rates higher than the normal long-term capital gain rates. To determine if any of the gain on the sale of the building would be taxed at the higher unrecaptured Section 1250 capital gain rate, the following computation is needed:</p> <table><tr><th><u>Building Cost</u></th><th><u>Accumulated Depreciation</u></th><th><u>Inside Basis</u></th><th><u>FMV</u></th><th><u>Difference</u></th></tr><tr><td>\$ 1,560,000</td><td>(80,000)</td><td>\$ 1,480,000</td><td>\$ 1,670,000</td><td>\$ 190,000</td></tr></table> <p>Unrecaptured Section 1250 gain is the amount of the depreciation taken on the property – limited to actual gain on the sale. The total gain on the sale of the building would be \$190,000. Therefore, the potential Unrecaptured Section 1250 gain is limited to the previous depreciation deductions of \$80,000. Since Partner B was a 40% partner in the partnership his share of the gain from the building is as follows:</p> <table><tr><td>\$80,000</td><td>Total Unrecaptured Section 1250 Gain</td><td>\$110,000</td><td>Total Remaining Gain</td></tr><tr><td>X 40%</td><td>Percentage to Partner B</td><td>X 40%</td><td>Percentage to Partner B</td></tr><tr><td>32,000</td><td>Partner B’s Unrecaptured Section 1250 Gain</td><td>44,000</td><td>Partner B Capital Gain</td></tr></table>	<u>Building Cost</u>	<u>Accumulated Depreciation</u>	<u>Inside Basis</u>	<u>FMV</u>	<u>Difference</u>	\$ 1,560,000	(80,000)	\$ 1,480,000	\$ 1,670,000	\$ 190,000	\$80,000	Total Unrecaptured Section 1250 Gain	\$110,000	Total Remaining Gain	X 40%	Percentage to Partner B	X 40%	Percentage to Partner B	32,000	Partner B’s Unrecaptured Section 1250 Gain	44,000	Partner B Capital Gain	<ul style="list-style-type: none">▪ Treas. Reg. 1.1(h)-1
<u>Building Cost</u>	<u>Accumulated Depreciation</u>	<u>Inside Basis</u>	<u>FMV</u>	<u>Difference</u>																			
\$ 1,560,000	(80,000)	\$ 1,480,000	\$ 1,670,000	\$ 190,000																			
\$80,000	Total Unrecaptured Section 1250 Gain	\$110,000	Total Remaining Gain																				
X 40%	Percentage to Partner B	X 40%	Percentage to Partner B																				
32,000	Partner B’s Unrecaptured Section 1250 Gain	44,000	Partner B Capital Gain																				

Issue 4, Step 2: Review Potential Issues (cont'd)

Sale of a Partnership Interest

Issue 4

Explanation of Issue						Resources
This slide summarizes Partner B's total gain/loss from the sale of his partnership interest.						
			Partner B's	Partner B's		
Inside Basis	FMV	Difference	Share-40%	Share 751(a)	Asset	
\$ 82,000	\$ 30,000	\$ (52,000)	\$ (20,800)	\$ (20,800)	Accounts Rec.	
80,000	100,000	20,000	8,000	8,000	Inventory	
48,000	80,000	32,000	12,800	12,800	Equipment	
1,480,000	1,670,000	190,000	76,000	-	Building	
100,000	110,000	10,000	4,000	-	Land	
\$ 1,790,000	\$ 1,990,000	\$ 200,000	\$ 80,000	\$ -		
\$ -	Net IRC 751(a) Gain					
32,000	Unrecaptured Section 1250 Gain					
48,000	IRC 1231 Capital Gain (\$48,000 1231 gain = \$44,000 (B's share of the capital gain from the 1250 property after subtracting the unrecaptured 1250 gain of \$32,000 (\$76,000 - \$32,000 = \$44,000)) plus \$4,000 (B's share of the capital gain from the land))					
80,000	Total Gain Recognized by Partner B					
Partners who sell a partnership interest and are affected by the look-through rules for unrecaptured Section 1250 gains must provide information regarding the sale on their tax returns.						▪ Treas. Reg. 1.1(h)-1(e)

Issue 4, Step 3: Additional Factual Development

Sale of a Partnership Interest

Issue 4

Fact Element	Resources
<ul style="list-style-type: none">▪ Determine whether the selling partner is subject to the higher capital gains tax rate for unrecaptured Section 1250 gain. These partners are not subject to the 25% tax rate:<ul style="list-style-type: none">– C-Corporations– Exempt Organizations– Individual Retirement Accounts– Foreign Government	<ul style="list-style-type: none">▪ IRC 1250
<ul style="list-style-type: none">▪ Different taxpayers report their unrecaptured Section 1250 gains on different schedules. Look at the following schedules to determine if the selling partner reported unrecaptured Section 1250 gain:<ul style="list-style-type: none">– Individual (Form 1040): Schedule D, line 19– Trust (Form 1041): Schedule D, line 18b– S-Corporation (Form 1120S): Schedule K, line 8c– Partnership (Form 1065): Schedule K, line 9c▪ Verify the selling partner properly identified all assets subject to the unrecaptured Section 1250 gain tax rate. Generally, buildings result in unrecaptured Section 1250 gain recognition.	<ul style="list-style-type: none">▪ Form 1065, item E - Date Business Started▪ Form 1040 - <i>U.S. Individual Income Tax Return</i>▪ Form 1041 - <i>U.S. Income Tax Return for Estates and Trusts</i>▪ Form 1120S - <i>U.S. Income Tax Return for an S-Corporation</i>

Issue 4, Step 4: Develop Arguments

Sale of a Partnership Interest

Issue 4

Explanation of Adjustment	Resources
Ensure the selling partner is subject to the unrecaptured Section 1250 gain tax rate (Slide 30). Then you should determine whether the selling partner reported any unrecaptured Section 1250 gain on its tax return.	
<ul style="list-style-type: none">▪ Determine whether all unrecaptured Section 1250 assets were identified. Then, determine whether the selling partner properly reported all unrecaptured Section 1250 gain, you first need to use the following items to identify unrecaptured Section 1250 assets:<ul style="list-style-type: none">– Review the Form 1065 balance sheet, Schedule L, lines 9(a) and 9(b) to identify assets potentially subject to unrecaptured Section 1250 gain.– Review real estate partnerships with North American Industry Classification System (NAICS) codes that begin in 53. These are more likely to have unrecaptured Section 1250 gain assets.– Look at the date the partnership started operations. This gives you an idea of how long the partnership might have held the building.▪ Does the FMV assigned to the unrecaptured Section 1250 gain property appear reasonable?<ul style="list-style-type: none">– Determine how the partnership came up with the FMV that was used. Was an appraisal obtained to determine the FMV?	<ul style="list-style-type: none">▪ Form 1065, Schedule L - Balance Sheets per Books▪ Form 1065, page 1, item C – Business code number

Issue 5, Step 2: Review Potential Issues

Sale of a Partnership Interest

Issue 5

Did the partnership correctly compute the IRC 743(b) adjustment related to the selling partners recognition of gain or loss on the sale of the partnership interest?

Explanation of Issue	Resources
<ul style="list-style-type: none"> ▪ In general, no adjustment is made to the basis of partnership assets because of a sale or exchange of a partnership interest. Therefore, the purchasing partner receives the selling partner's share of inside basis in each asset of the partnership. ▪ A purchasing partner obtains a cost basis in a partnership interest acquired by sale. The purchasing partner's new outside basis in its partnership interest often reflects unrealized gains and losses in partnership property. This creates a discrepancy between inside and outside basis that can temporarily distort the purchasing partner's tax consequences. If the transferor partner had contributed built in gain or loss property, the transferee partner must be allocated built-in gain or loss the same way. ▪ IRC 743(b) provides an avenue to correct the disparity that occurs between inside and outside basis because of a sale of a partnership interest. If a partnership makes an IRC 754 election or has a substantial built-in loss at the time of the sale, a special basis adjustment that applies to the transferee partner only will remedy the disparity between inside and outside basis. 	<ul style="list-style-type: none"> ▪ IRC 743(a) ▪ IRC 742 ▪ Treas. Reg. 1.704-3(a)(7) ▪ IRC 743(b) ▪ IRC 743(d)

Issue 5, Step 2: Review Potential Issues (cont'd)

Sale of a Partnership Interest

[Issue 5](#)

Explanation of Issue	Resources
<p><u>Sale of a Partnership Interest - Potential IRC 743(b) Issues</u></p> <ul style="list-style-type: none">▪ Did the partnership have an IRC 754 election in place? An IRC 754 election is made by attaching a statement to the timely filed partnership return. Once this election is made, it applies to the year of the election and all subsequent years unless permission to revoke the election is secured from the IRS. After the election is made, adjustments under IRC 743(b) are required.	<ul style="list-style-type: none">▪ Form 1065, Schedule B, question 10(a)▪ Treas. Reg. 1.754-1

Issue 5, Step 2: Review Potential Issues (cont'd)

Sale of a Partnership Interest

Issue 5

Explanation of Issue	Resources
<p><u>Sale of a Partnership Interest - Potential IRC 743(b) Issues (cont'd)</u></p> <ul style="list-style-type: none">▪ Was the IRC 743(b) basis adjustment amount correct?<ul style="list-style-type: none">– The partnership must increase the basis of partnership property by the amount that the buyer's outside basis exceeds his proportionate share of inside basis (a "positive adjustment"); or– The partnership must decrease the basis of partnership property by the amount that the buyer's proportionate share of inside basis exceeds his outside basis (a "negative adjustment").– The buyer's outside basis is the amount paid for his interest in the partnership plus his share of partnership liabilities.– The buyer's share of partnership inside basis is his share of previously taxed capital plus his share of partnership liabilities. A partner's share of previously untaxed capital is equal to cash received in a hypothetical liquidation transaction in which all partnership assets were sold for their FMVs PLUS taxable loss allocated to the partner from the hypothetical transaction MINUS taxable gain allocated to the partner as a result of the hypothetical transaction.	<ul style="list-style-type: none">▪ IRC 742▪ IRC 743(b)▪ Treas. Reg. 1.743-1(d)▪ Issue Snapshot - Basis Adjustment to Partnership Property when a Partnership Interest is Sold or Exchanged

Issue 5, Step 2: Review Potential Issues (cont'd)

Sale of a Partnership Interest

Issue 5

Explanation of Issue	Resources
<p><u>Sale of a Partnership Interest - Potential IRC 743(b) Issues (cont'd)</u></p> <ul style="list-style-type: none">▪ Was there a correct allocation of the IRC 743(b) adjustment to the partnership's assets?<ul style="list-style-type: none">– The partnership determines what it would allocate if it sold all its assets for FMV in cash in a taxable transaction immediately after the transfer. Based on this determination, it allocates income, gain or loss to the buying partner for each item of property.– Did the partnership ignore increases in FMV of non-depreciable assets such as land or assets with a longer life such as buildings?▪ Was the IRC 743(b) basis adjustment correctly allocated only to the purchasing partner? The IRC 743(b) adjustment puts the buyer in the same position as if he had purchased an undivided interest in each partnership asset.▪ Was there a substantial built-in loss at the time of the sale of the partnership interest? If a substantial built-in loss exists at the time of the sale of the partnership interest, an adjustment under IRC 743(b) is required. The required adjustment will reduce the acquiring partner's share of basis in the partnership assets by his allocable share of the built-in loss.	<ul style="list-style-type: none">▪ IRC 755▪ Issue Snapshot - Allocation of Basis Adjustment to Partnership Property when Interest is Sold or Exchanged▪ <i>Sale of Partnership Interest</i> - ITM 49436▪ Treas. Reg. 1.743-1(j)(1)▪ IRC 743(d)

Issue 5, Step 2: Review Potential Issues (cont'd)

Sale of a Partnership Interest

Issue 5

Explanation of Issue	Resources																									
<p><u>Example 1 – IRC 743(b) Adjustment</u></p> <p>The following example uses the facts from the example on the Transaction and Fact Pattern Slides 5, 16, 23, 29:</p> <table><tr><td>\$480,000</td><td>(40% X NFMV of \$1,200,000 (\$2,000,000 FMV of Total Assets - \$800,000 of Total Liabilities))</td></tr><tr><td>(80,000)</td><td>(40% X \$200,000 (\$2,000,000 FMV of Total Assets – \$1,800,000 Inside Basis of Total Assets))</td></tr><tr><td><u>320,000</u></td><td>(40% X \$800,000 Liabilities)</td></tr><tr><td>720,000</td><td>Partner C’s Share of Inside Basis</td></tr><tr><td>480,000</td><td>Partner C’s Cash Received in Hypothetical FMV Sale of Assets</td></tr><tr><td>(80,000)</td><td>Partner C’s Gain Allocated to Buyer from Hypothetical Sale</td></tr><tr><td><u>320,000</u></td><td>Partner C’s Share of Liabilities</td></tr><tr><td>720,000</td><td>Partner C’s Share of Inside Basis</td></tr></table> <table><tr><td>Partner C’s Outside Basis:</td><td>\$800,000</td><td>(\$480,000 Cash Paid + \$320,000 Liabilities Assumed)</td></tr><tr><td>Partner C’s Share Inside Basis:</td><td><u>\$720,000</u></td><td>(\$1,800,000 Total Assets X 40% Ownership)</td></tr><tr><td>IRC 743(b) Basis Adjustment:</td><td>\$80,000</td><td></td></tr></table>	\$480,000	(40% X NFMV of \$1,200,000 (\$2,000,000 FMV of Total Assets - \$800,000 of Total Liabilities))	(80,000)	(40% X \$200,000 (\$2,000,000 FMV of Total Assets – \$1,800,000 Inside Basis of Total Assets))	<u>320,000</u>	(40% X \$800,000 Liabilities)	720,000	Partner C’s Share of Inside Basis	480,000	Partner C’s Cash Received in Hypothetical FMV Sale of Assets	(80,000)	Partner C’s Gain Allocated to Buyer from Hypothetical Sale	<u>320,000</u>	Partner C’s Share of Liabilities	720,000	Partner C’s Share of Inside Basis	Partner C’s Outside Basis:	\$800,000	(\$480,000 Cash Paid + \$320,000 Liabilities Assumed)	Partner C’s Share Inside Basis:	<u>\$720,000</u>	(\$1,800,000 Total Assets X 40% Ownership)	IRC 743(b) Basis Adjustment:	\$80,000		<ul style="list-style-type: none">▪ <i>Practitioners Publishing Company (PPC) -1065 Deskbook Ch.32</i>▪ Issue Snapshot - Basis Adjustment to Partnership Property when a Partnership Interest is Sold or Exchanged▪ Issue Snapshot - Allocation of Basis Adjustment to Partnership Property when Interest is Sold or Exchanged
\$480,000	(40% X NFMV of \$1,200,000 (\$2,000,000 FMV of Total Assets - \$800,000 of Total Liabilities))																									
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Partner C’s Outside Basis:	\$800,000	(\$480,000 Cash Paid + \$320,000 Liabilities Assumed)																								
Partner C’s Share Inside Basis:	<u>\$720,000</u>	(\$1,800,000 Total Assets X 40% Ownership)																								
IRC 743(b) Basis Adjustment:	\$80,000																									

Issue 5, Step 2: Review Potential Issues (cont'd)

Sale of a Partnership Interest

Issue 5

Explanation of Issue	Resources
<p><u>Example 1 – IRC 743(b) Adjustment (cont'd)</u></p> <ul style="list-style-type: none">▪ Purchasing partner's share of inside basis equals buyer's share of previously untaxed capital plus buyer's share of partnership liabilities.▪ Buyer's share of previously untaxed capital equals amount of cash that a partner would receive upon liquidation in a hypothetical transaction in which all partnership assets were sold for their FMV (net of partnership liabilities) PLUS the amount of any taxable loss allocated to the partner from the hypothetical transaction MINUS the amount of any taxable gain allocated to the partner as a result of the hypothetical transaction. A simple way to illustrate the formula for a partner's share of inside basis is:<ul style="list-style-type: none">Cash to partner from sale (Partner's percentage interest multiplied by net fair market value of partnership assets)Less Tax Gain from sale ((FMV of Assets less inside basis) multiplied by Partner's percentage interest)Plus Tax LossPlus Partner's share of liabilities	

Issue 5, Step 2: Review Potential Issues (cont'd)

Sale of a Partnership Interest

Issue 5

Explanation of Issue	Resources
<p><u>Example 1 – IRC 743(b) Adjustment (cont'd)</u></p> <ul style="list-style-type: none">▪ The amount of cash a partner receives from a hypothetical liquidation transaction in which all partnership assets are sold for their FMV less the partnership liabilities minus (the total proceeds from the hypothetical FMV liquidation transaction MINUS the partnership's liabilities) multiplied by the partner's percentage interest in the partnership.▪ Taxable gain a partner receives from a hypothetical FMV liquidation transaction equals (the difference between the total FMV and inside basis (book value) of all partnership assets) multiplied by the partner's percentage interest in the partnership.▪ Partner C's share of inside basis after accounting for the 743(b) adjustment is \$800,000.	

Issue 5, Step 2: Review Potential Issues (cont'd)

Sale of a Partnership Interest

Issue 5

Explanation of Issue						Resources																																																						
<u>Example 1 – IRC 743(b) Adjustment (cont'd)</u>						<ul style="list-style-type: none">▪ <i>Practitioners Publishing Company (PPC) -1065 Deskbook Ch.32</i>▪ Issue Snapshot - Basis Adjustment to Partnership Property when a Partnership Interest is Sold or Exchanged▪ Issue Snapshot - Allocation of Basis Adjustment to Partnership Property when Interest is Sold or Exchanged▪ Section 755▪ Treas. Reg. 1.755-1(b)(2)																																																						
The following facts are taken from the example on the Transaction and Fact Pattern Slides 5, 16, 23, 29:																																																												
<table><tr><td></td><td></td><td></td><td>Partner C's</td><td>Partner C's</td><td></td></tr><tr><td><u>Inside Basis</u></td><td><u>FMV</u></td><td><u>Difference</u></td><td><u>743(b) Adj.</u></td><td><u>Inside Basis</u></td><td><u>Asset</u></td></tr><tr><td>\$ 10,000</td><td>\$ 10,000</td><td>\$ -</td><td>\$ -</td><td>\$4,000</td><td>Cash</td></tr><tr><td>82,000</td><td>30,000</td><td>(52,000)</td><td>(20,800)</td><td>12,000</td><td>Accounts Rec.</td></tr><tr><td>80,000</td><td>100,000</td><td>20,000</td><td>8,000</td><td>40,000</td><td>Inventory</td></tr><tr><td>48,000</td><td>80,000</td><td>32,000</td><td>12,800</td><td>32,000</td><td>Equipment</td></tr><tr><td>1,480,000</td><td>1,670,000</td><td>190,000</td><td>76,000</td><td>668,000</td><td>Building</td></tr><tr><td><u>100,000</u></td><td><u>110,000</u></td><td><u>10,000</u></td><td><u>4,000</u></td><td><u>44,000</u></td><td><u>Land</u></td></tr><tr><td>1,800,000</td><td>2,000,000</td><td>200,000</td><td>80,000</td><td>800,000</td><td>Total Assets</td></tr></table>										Partner C's	Partner C's		<u>Inside Basis</u>	<u>FMV</u>	<u>Difference</u>	<u>743(b) Adj.</u>	<u>Inside Basis</u>	<u>Asset</u>	\$ 10,000	\$ 10,000	\$ -	\$ -	\$4,000	Cash	82,000	30,000	(52,000)	(20,800)	12,000	Accounts Rec.	80,000	100,000	20,000	8,000	40,000	Inventory	48,000	80,000	32,000	12,800	32,000	Equipment	1,480,000	1,670,000	190,000	76,000	668,000	Building	<u>100,000</u>	<u>110,000</u>	<u>10,000</u>	<u>4,000</u>	<u>44,000</u>	<u>Land</u>	1,800,000	2,000,000	200,000	80,000	800,000	Total Assets
			Partner C's	Partner C's																																																								
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1,800,000	2,000,000	200,000	80,000	800,000	Total Assets																																																							
The IRC 743(b) adjustment increases the buyer's (Partner C) share of inside basis in partnership assets from \$720,000 to \$800,000 (\$720,000 plus \$80,000 equals \$800,000).																																																												
Partner C's 743(b) adjustment for each item is the difference between inside basis and FMV for each partnership asset times partner C's partnership interest share percentage of 40%.																																																												

Issue 5, Step 2: Review Potential Issues (cont'd)

Sale of a Partnership Interest


Issue 5

Explanation of Issue	Resources
<p><u>Example 1 – IRC 743(b) Adjustment (cont'd)</u></p> <ul style="list-style-type: none">▪ The total 743(b) adjustment for a purchasing partner must be allocated between the partnership's capital assets and ordinary income property.▪ Steps:<ul style="list-style-type: none">– Determine total amount of the 743(b) adjustment;– Determine the portion of the 743(b) adjustment that is allocated to capital gain assets versus to ordinary income assets;<ul style="list-style-type: none">▪ Net each separately (note this means that there can be net gain on one class and net loss on another);– Determine how the allocation to the ordinary income assets is divided between each of the individual ordinary income assets by determining the buyer's share of the appreciation/depreciation in each of such assets;– Repeat but with capital gain property.	

Issue 5, Step 3: Additional Factual Development

Sale of a Partnership Interest

Issue 5

Fact Element	Resources
 DECISION POINT: Depending upon which specific IRC 743(b) issue exists in your case, the following facts might be relevant: <ul style="list-style-type: none">▪ Verify the partnership has a valid IRC 754 election that has not been revoked.▪ Determine if the year under examination is the year of the sale transaction or a subsequent year.▪ Review the IRC 743(b) optional basis statement attached to the partnership return.<ul style="list-style-type: none">– In the year of the transfer, the partnership must attach a statement that contains the information required by Treas. Reg. 1.743-1(k)(1).– If the partnership did not attach a statement, request it with an IDR.▪ Determine whether the amount of the IRC 743(b) optional basis adjustment is correct.<ul style="list-style-type: none">– In determining the previously taxed capital formula, a hypothetical sale of partnership assets occurs. Ensure the correct FMV of partnership assets is used for this computation.– Generally, previously taxed capital is the same as the selling partner's tax capital account▪ Verify the partnership's allocation of the IRC 743(b) adjustment to the partnership's assets makes sense.<ul style="list-style-type: none">– Did the partnership obtain an appraisal of its assets in order to allocate the basis adjustment?	<ul style="list-style-type: none">▪ IRC 754▪ Form 1065▪ IRC 743(b)▪ Treas. Reg. 1.743-1

Issue 5, Step 4: Develop Arguments

Sale of a Partnership Interest


Issue 5

Explanation of Adjustment	Resources
<p>After understanding the facts, determine whether the partnership calculated the IRC 743(b) optional basis adjustment correctly.</p> <p><u>IRC 754 Election</u></p> <ul style="list-style-type: none">▪ If an IRC 754 election was in place, the partnership should have checked yes to Schedule B, question 10(a) of Form 1065. Additionally, the IRC 754 election should be attached to the tax return for the year the election was made. If there was not an IRC 754 election in place, then no IRC 743(b) basis adjustment can be made unless there was a substantial built-in loss.<ul style="list-style-type: none">– If there was an IRC 754 election in place, then an IRC 743(b) basis adjustment is mandatory. <p><u>Amount of IRC 743(b) Optional Basis Adjustment</u></p> <ul style="list-style-type: none">▪ Determine if the amount of the IRC 743(b) adjustment is correct. In the year in which the transfer occurs, the partnership must attach a statement to its return that contains the information required by Treas. Reg. 1.743-1(k)(1). IRC 743(b) optional basis adjustments are generally shown on Schedule K-1 line/box 11 (code F) and line/box 13 (code W). The buyer's IRC 743(b) adjustment amount should closely match the gain reported by the selling partner. Investigate any material differences.	<ul style="list-style-type: none">▪ IRC 754▪ Form 1065, Schedule B, question 10(a)▪ Treas. Reg. 1.743-1▪ Form 1065, Schedule K-1 - <i>Partner's Share of Income, Deductions, Credits, etc.</i>▪ IRC 743(b)

Issue 5, Step 4: Develop Arguments (cont'd)

Sale of a Partnership Interest

[Issue 5](#)

Explanation of Adjustment	Resources
<p><u>Allocation of IRC 743(b) Adjustment</u></p> <ul style="list-style-type: none"> Is the allocation of the IRC 743(b) optional basis adjustment reasonable? <ul style="list-style-type: none"> Ensure the allocation given to non-depreciable assets (land) and assets with a long recovery period (39-year real property) is reasonable compared to the value placed on inventory and depreciable assets with a shorter recovery period. <p> CONSULTATION: If you believe there are material problems with the way the partnership allocated the IRC 743(b) adjustment to partnership assets using the methodology under IRC 755, you may want to make a referral to an engineer or a valuation expert.</p>	<ul style="list-style-type: none"> IRC 755 Treas. Reg. 1.755-1

Issue 5, Step 4: Develop Arguments (cont'd)

Sale of a Partnership Interest

[Issue 5](#)

Explanation of Adjustment	Resources
<p><u>Correct Partner Allocated the IRC 743(b) Adjustment</u></p> <ul style="list-style-type: none">▪ Determine if the IRC 743(b) adjustment was allocated to any partner besides the purchasing partner. Existing partners who remain in the partnership after the transfer of a partnership interest should not receive a basis adjustment. <p><u>Substantial Built-In-Loss</u></p> <ul style="list-style-type: none">▪ Determine if there was a substantial built-in loss at the time of the sale of the partnership interest. If a substantial built-in loss is present, an adjustment under IRC 743(b) is required.<ul style="list-style-type: none">– The required adjustment reduces the purchasing partner's share of basis in the partnership assets by his allocable share of the built-in loss.	<ul style="list-style-type: none">▪ Form 1065, Schedule K-1 - <i>Partner's Share of Income, Deductions, Credits, etc.</i>

Index of Referenced Resources

Sale of a Partnership Interest

IRC 167(i)

IRC 267

IRC 453

IRC 705

IRC 706

IRC 707

IRC 708(b)

IRC 741

IRC 742

IRC 743

IRC 751

IRC 752

IRC 754

IRC 755

IRC 1001

IRC 1245

Index of Referenced Resources (cont'd)

Sale of a Partnership Interest

IRC 1250

Treas. Reg. 1.1(h)

Treas. Reg. 1.706-4

Treas. Reg. 1.743-1

Treas. Reg. 1.751-1

Treas. Reg. 1.754-1

Treas. Reg. 1.755-1

Treas. Reg. 1.1001-1

Treas. Reg. 1.1001-2

Treas. Reg. 1.6050K-1

Rev. Rul. 84-53

Rev. Rul. 91-32

Form 706 - *U.S. Estate Tax Return*

Form 1040 - *U.S. Individual Income Tax Return*

Form 1041 - *U.S. Income Tax Return for Estates and Trusts*

Form 1065 - *U.S. Return of Partnership Income*

Form 1065, Schedule D - *Capital Gains and Losses*

Index of Referenced Resources (cont'd)

Sale of a Partnership Interest

Form 1065, Schedule K-1 - *Partner's Share of Income, Deductions, Credits, etc.*

Form 1120-S - *U.S. Income Tax Return for an S-Corporation*

Form 4797 - *Sales of Business Property*

Form 6252 - *Installment Sale Income*

Form 8308 - *Report of a Sale or Exchange of Certain Partnership Interests*

Form 8949 - *Sales and Other Dispositions of Capital Assets*

Training and Additional Resources

Sale of a Partnership Interest	
Type of Resource	Descriptions
Saba Meeting Sessions	<ul style="list-style-type: none">▪ <i>Sale of a Partnership Interest</i> - ITM 76248r▪ <i>Sale of Partnership Interest</i> - ITM 49436
Databases / Research Tools	<ul style="list-style-type: none">▪ International Knowledge Base - IRS Virtual Library
Reference Materials	<ul style="list-style-type: none">▪ <i>Practitioners Publishing Company (PPC) - 1065 Deskbook Ch. 32</i>
Other Training Materials	<ul style="list-style-type: none">▪ Issue Snapshot - Allocation of Basis Adjustment to Partnership Property when Interest is Sold or Exchanged▪ Issue Snapshot - Basis Adjustment to Partnership Property when a Partnership Interest is Sold or Exchanged▪ Issue Snapshot - Determining Basis in a Partnership Interest (Outside Basis)▪ Audit Tool - Partner's Basis Computation Spreadsheet

Glossary of Terms and Acronyms

Term/Acronym	Definition
EUP	Employee User Portal
FMV	Fair Market Value
IRC	Internal Revenue Code
LIN	LB&I Image Net
NAICS	North American Industry Classification System
Rev. Rul.	Revenue Ruling
TCJA	Tax Cuts and Jobs Act
Treas. Reg.	Treasury Regulation

Index of Related Practice Units

Associated UIL	Related Practice Unit
741.0	<i>Overview of Sale or Exchange of Partnership Interest Tax Issues</i>