

ABA Financial Services Bulletin

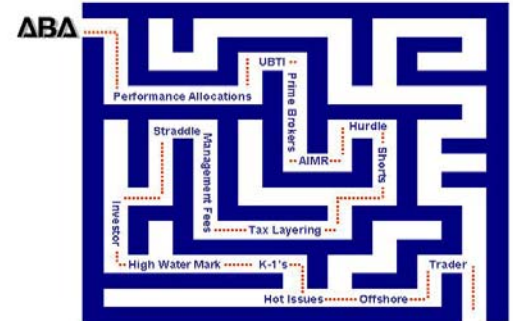
December 2004

TAX PLANNING ALERT

Distribution of Appreciated Securities in Redemption of a Partner's Interest

Part II

We Know Our Way Around
Investment Partnerships



Since the new tax law concerning distributions of appreciated property is so complex, several illustrations of its probable application are shown below:

Example I

Facts:

- 1) Partner A requests a distribution in complete redemption of an interest in ABC Partners, LP ("ABC") at December 31, 2004. Partner A has a capital account at such date of \$ 3.5 million. Partner A's tax basis in ABC is also \$ 3.5 million. This investment is a break-even for partner A.
- 2) ABC distributes XYZ securities to Partner A in redemption of the interest in the partnership. XYZ is worth \$ 3.5 million, but only cost ABC \$ 3.25 million. Immediately prior to the distribution, ABC has a \$ 250,000 unrealized gain in these securities.
- 3) Partner A sells XYZ securities for \$ 3.5 million.

Results

- a) Partner A does not recognize any gain on the sale of XYZ securities. (The proceeds of the sale, \$3.5 million, less the tax basis of the shares, \$3.5 million. The tax basis of the shares is equal to the tax basis of ABC – a substituted basis.)
- b) ABC does not incur any tax on the distribution of XYZ securities and is not required to make any adjustment to the bases of the other securities it owns. (The difference between A's tax basis in the partnership [\$ 3.5million] and the basis of XYZ securities to ABC prior to distribution [\$ 3.25 million] does not exceed \$ 250,000. The remaining partners of ABC have a deferral with respect to \$ 250,000 of appreciation.

Anchin, Block & Anchin, LLP

1375 Broadway, New York, NY 10018

Phone: (212) 840-3456 Fax: (212) 840-7066 www.anchin.com

Example II

Facts:

- 1) Same facts as example I, except that Partner A's tax basis in the ABC is \$ 2.5 million. Partner A has an unrealized gain of \$ 1 million on this investment.
- 2) ABC distributes GGG securities to Partner A in redemption of the interest in the partnership. GGG securities are worth \$ 3.5 million, but only cost the partnership \$ 2.25 million. Immediately prior to the distribution, the partnership has a \$ 1.25 million unrealized gain on these securities.
- 3) Partner A sells the securities for \$ 3.5 million.

Results

- a) Partner A recognizes a \$ 1 million gain on the sale of XYZ securities. (The proceeds of the sale [\$3.5 million] less the tax basis of the shares [\$ 2.5 million]. The tax basis of the shares is equal to the tax basis of ABC – a substituted basis.)
- b) ABC does not incur any tax on the distribution of GGG securities and is not required to make any adjustment to the basis of the other securities it owns. (The difference between A's tax basis in the partnership [\$ 2.5 million] and the basis of GGG securities to ABC prior to distribution [\$ 2.25 million] does not exceed \$ 250,000. The remaining partners of ABC have a deferral with respect to \$ 1.25 million of appreciation.

Observation

The amount of unrealized appreciation that a partnership may still defer under the new law seems to be limited to the total of \$ 250,000 **plus** the amount of the redeeming partner's unrealized appreciation in the partnership. Thus, the amount of unrealized gain which can be distributed, without causing an adjustment to the tax basis of the other securities in position, will vary depending on the individual partner that redeems.

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