

## MEMORANDUM

**TO:** Board of Managers of ML Manager LLC  
**FROM:** Gregg Hanks  
**DATE:** April 16, 2012  
**RE:** Reporting of Theft Losses By MP Funds and Tax Procedures  
Relating to MP Funds, Loan LLCs and their Members

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**IRS CIRCULAR 230 DISCLOSURE: IN ACCORDANCE WITH 31 C.F.R. SECTION 10.35(b)(4), THIS MEMORANDUM HAS NOT BEEN PREPARED, AND MAY NOT BE RELIED UPON BY ANY PERSON, FOR PROTECTION AGAINST ANY FEDERAL TAX PENALTY. ALTHOUGH FENNEMORE CRAIG, P.C. HAS CONSENTED TO THIS MEMORANDUM BEING MADE AVAILABLE TO INVESTORS IN MORTGAGES LTD., THE BOARD OF ML MANAGER LLC IS THE CLIENT OF FENNEMORE CRAIG, P.C. NEITHER THAT BOARD NOR FENNEMORE CRAIG, P.C. IS ADVISING INVESTORS WITH RESPECT TO THEIR PERSONAL TAX MATTERS. ACCORDINGLY, INVESTORS ARE STRONGLY ENCOURAGED TO CONSULT WITH THEIR OWN TAX ADVISORS REGARDING THE MATTERS ADDRESSED IN THIS MEMORANDUM.**

1. Background. There have been a number of prior communications with investors regarding theft losses associated with investments in Mortgages Ltd. This memorandum does not attempt to summarize those prior communications. However, the following facts are pertinent to the discussions in this memorandum:

(a) PWC Opinion. ML Manager LLC received an opinion letter from PricewaterhouseCoopers LLP (the "PWC Opinion")<sup>1</sup> that generally concludes it is more likely than not<sup>2</sup> that losses incurred by the MP Funds<sup>3</sup> as a result of acquiring interests in loans originated by Mortgages Ltd. ("Loan Interests") qualify for treatment as theft losses as provided in Revenue Procedure 2009-20, as modified by Revenue Procedure 2011-58 (together, the "Theft Loss Revenue Procedure")<sup>4</sup>, and that the discovery year for such theft losses is the year ended December 31, 2009 (the "2009 Tax Year").<sup>5</sup> The PWC Opinion also concludes that the Loan LLCs<sup>6</sup> did not qualify for theft loss treatment under the Theft Loss Revenue Procedure. Pass-Through Investors<sup>7</sup> who hold interests in the Loan LLCs were advised to discuss with their own advisors whether or not they qualified for theft loss treatment under the Theft Loss Revenue Procedure or otherwise (and regarding the discovery year of any theft losses for which they qualified).

(b) Original Tax Returns; Administrative Adjustment Requests. The MP Funds originally filed tax returns for the 2009 Tax Year that did not claim theft losses.<sup>8</sup> Based on the PWC Opinion, ML Manager LLC has filed an administrative adjustment request ("AAR")<sup>9</sup> with respect to each of the MP Funds, claiming a theft loss under the Theft Loss

Revenue Procedure and proposing other adjustments to tax items that were previously reported on the MP Funds' tax returns for the 2009 Tax Year.<sup>10</sup>

(c) No AARs Have Been Filed With Respect to Loan LLCs. Because the PWC Opinion concluded that the Loan LLCs do not qualify for theft loss treatment under the Theft Loss Revenue Procedure, ML Manager has no current plans to file AARs claiming theft losses with respect to the Loan LLCs. However, as described in greater detail in paragraph 3 below, ML Manager may file AARs with respect to the Loan LLCs to reflect changes to gain or loss reported by them on their 2009 and 2010 tax returns with respect to trustees' sales (foreclosures) on the deeds of trust that secured the Loan Interests held by the Loan LLCs.

(d) Investor-Specific Items. The tax issues and procedures relating to theft losses are complex. ML Manager has repeatedly encouraged investors in the MP Funds and Pass-Through Investors in the Loan LLCs to consult their own tax advisors regarding tax issues relating to their direct and indirect investments in Loan Interests, including the manner in which they process claims for theft losses, if any. This memorandum includes a discussion of various procedural and other matters that investors should discuss with their tax advisors now that the MP Funds have filed AARs.

2. Matters Relating to AARs Filed by MP Funds and Amended Schedules K-1.

(a) Information Returns of MP Funds. Because the MP Funds are treated as partnerships for federal income tax purposes,<sup>11</sup> they are not subject to income tax at the entity level. Instead, the MP Funds file information returns (Form 1065) with the IRS, reflecting the MP Funds' "partnership items",<sup>12</sup> and issue Schedules K-1 to their respective members, showing the members' allocable shares of such partnership items. As noted above, the MP Funds did not report theft losses on the Forms 1065 filed for the 2009 Tax Year.

(b) Filing of AAR by MP Funds to Request Adjustments to Partnership Items for 2009 Tax Year; Delivery of Informational Schedules K-1 to Members of MP Funds. If a partnership, such as an MP Fund, wants to change a partnership item from what was reported on a Form 1065 filed with the IRS, the partnership can request a change only by filing an AAR with the IRS, signed by the partnership's tax matters partner. An AAR includes an explanation of any requested adjustments and must include drafts of amended Schedules K-1 showing the partners' shares of partnership items, taking into account the adjustments proposed in the AAR. ML Manager LLC, as the tax matters partner designated in the MP Funds' operating agreements, has recently filed an AAR for each of the MP Funds with respect to the 2009 Tax Year that includes, among other matters, the following primary adjustments:

(i) a theft loss for the 2009 Tax Year in accordance with the Theft Loss Revenue Procedure, generally equal to approximately 75% of the MP Fund's investment in each Loan LLC in which the MP Fund holds an interest; and

(ii) a reduction in the amount of the capital loss, if any, previously reported by the MP Fund as a result of any foreclosures that occurred during the 2009 Tax Year on deeds of trust held by Loan LLCs in which the MP Fund holds an interest.<sup>13</sup>

The amounts by which the MP Funds' capital losses from foreclosures are reduced are generally in the same range as the amounts of the theft losses reflected on the AARs, but there is no exact correlation.<sup>14</sup> Neither the adjustments to partnership items requested in MP Funds' AARs nor the accompanying amended Schedules K-1 will become effective until they are approved by the IRS or a court.<sup>15</sup> Partners in a partnership generally have the opportunity to participate in administrative and judicial proceedings relating to the AAR.<sup>16</sup> To the extent the AARs result in any adjustment of partnership items with respect to the MP Funds, the IRS should make computational adjustments and issue refunds without the need for further filings by members of the MP Funds. ML Manager has elected to provide members of the MP Funds with informational copies of amended Schedules K-1, in the forms filed with the IRS as part of the MP Funds' AARs, reflecting what the members' respective shares of the MP Funds' partnership tax items would be if all of the adjustments requested in the AAR were approved. **The MP Funds' members should not file amended tax returns based on the informational amended Schedules K-1 they receive.**

(c) Members' Reporting Obligations; Consistency Requirement. Members of the MP Funds are required to file their own tax returns reporting their shares of partnership items consistently with the Schedules K-1 that they received from the MP Funds, unless the members file a statement with the IRS disclosing any inconsistency or requesting an administrative adjustment.<sup>17</sup> There is potential for inconsistent treatment between the Schedules K-1 that were previously issued by an MP Fund to its members, if any of those members claimed theft losses relating to Loan Interests held by the MP Fund without filing a Form 8082 disclosing the inconsistency.<sup>18</sup>

3. Foreclosure Losses Reported by Loan LLCs and Relationship to Theft Losses Claimed by MP Funds and Pass-Through Investors. For the reasons described below, the amount of gain or loss properly recognized by the Loan LLCs as a result of foreclosures on their deeds of trust will be affected by whether or not the members of the Loan LLCs (i.e., the MP Funds and Pass-Through Investors) have claimed or may yet claim theft or other losses relating to Loan Interests held by the Loan LLCs.

(a) Tax Consequences of Foreclosure. There are multiple tax consequences to a note holder upon foreclosure of a deed of trust securing repayment of a note:

(i) The holder of the note is generally entitled to a loss (not to exceed the holder's basis in the note) equal to any uncollectible portion of the note that remains unsatisfied after the foreclosure.<sup>19</sup> This result is the same whether the holder of the note or another person is the purchaser at the foreclosure sale. In the case of taxpayers, such as the Loan LLCs, that are not engaged in the trade or business of lending money, the amount that would otherwise be treated as a bad loss deduction arising from the foreclosure is treated as a capital loss.<sup>20</sup>

(ii) If the note holder is the purchaser of property at a foreclosure sale, the note holder generally recognizes gain or loss equal to the difference between the bid price at the foreclosure sale and the fair market value of the property. For purposes of computing this gain or loss, in the absence of clear and convincing proof to the contrary, the fair market value of the property is presumed to equal the bid price.<sup>21</sup>

(iii) The purchasing note holder has a basis in the property equal to its fair market value as of the date of foreclosure.<sup>22</sup>

(b) Capital Losses Reported by Loan LLCs on Foreclosures. Based on the rules described above, any Loan LLCs that foreclosed on deeds of trust during 2009 or 2010 have already filed tax returns for those years on which they have reported significant capital losses from the foreclosures. The Loan LLCs have issued Schedules K-1 to their members (including the MP Funds) reflecting their allocable shares of these capital losses, and the MP Funds have issued Schedules K-1 to their members reflecting their shares of such capital losses. The capital losses reported by the Loan LLCs were generally a large percentage of the face amount of the applicable Loan Interests. The Loan LLCs reported basis in their Loan Interests equal to the face amount thereof<sup>23</sup> and generally bid a relatively small amount at the foreclosure sales (e.g., 15% to 25% of the face amount of the Loan Interests that were associated with the foreclosure sale), resulting in capital losses in the range of 75% to 85% of the face amount of the Loan Interests.

(c) Potential Corrections to Loan LLCs' Tax Basis and Foreclosure Losses. To the extent any members of the Loan LLCs claimed theft or other losses with respect to their Loan Interests for 2009 or earlier tax years (whether on original or amended returns), those losses should have reduced the members' bases in their Loan Interests, with the result that the Loan LLCs would have succeeded to the reduced basis rather than having a basis equal to the face amount of the Loan Interests at the time of contribution.<sup>24</sup> Even though a member's basis in its Loan Interest is determined by reference to information that is exclusively in that member's possession or control, a partnership, such as a Loan LLC, is required to determine, as a partnership item, the partnership's basis in contributed property and to make any necessary preliminary determinations, such as a partner's basis in the contributed property.<sup>25</sup> The difficulty of making basis determinations for the Loan LLCs is compounded by the following known factors, and other presently unknown factors may arise:

(i) Members of the Loan LLCs have not reported to the Loan LLCs the members' respective bases in their Loan Interests.

(ii) Some members of the Loan LLCs have claimed theft or other losses with respect to their Loan Interests on various theories (e.g., disposition losses, abandonment losses, bad debt losses, theft losses not in reliance on the Theft Loss Revenue Procedure, theft losses based on the Theft Loss Revenue Procedure, etc.) and for various tax years (e.g., 2008, 2009 or 2010), and some of these losses may ultimately be disallowed in whole or part by the IRS. Accordingly, even though members may think they know what their bases in the Loan Interests were in 2009, their belief may be inaccurate.

(iii) Members who have not yet claimed theft losses may still file amended tax returns claiming theft losses for 2009 (the year in which Loan Interests were contributed to the Loan LLCs) because, as noted above, theft losses are reported in the discovery year rather than the year in which the theft losses actually occurred.

The foregoing factors make a permanent, accurate determination of the Loan LLCs' bases in their Loan Interests a virtual impossibility, because the members' bases may continue to be adjusted until no further amendments to members' tax returns can be filed and all potential audits of

members' tax returns, including appeals, have been finally concluded. We have been advised that notwithstanding the foregoing difficulties, ML Manager LLC plans to request basis information from the Loan LLCs' members to make as accurate a determination as possible of the Loan LLCs' bases in their Loan Interests. At a minimum, the Loan LLCs will seek the best available basis information for purposes of reporting the Loan LLCs' gains or losses on foreclosures that have not yet been reported on the Loan LLCs' tax returns (i.e., foreclosures for the 2011 and subsequent tax years). Because a Loan LLC's basis in its Loan Interests is a partnership item, it appears that the basis adjustments can only be made through AARs. Accordingly, the Loan LLCs are likely to file AARs to adjust their basis to reflect the effect of their members' theft and other losses. These AARs may include adjustments to the capital losses reported on prior year's tax returns with respect to foreclosure sales, because the basis adjustments referred to above will affect the calculation of the previously reported capital losses. Mandatory basis adjustments may also be required with respect to membership interests in the Loan LLCs and MP Funds that have been transferred as a result of a sale of a membership interest or death of a member.<sup>26</sup>

(d) Tax Allocations that Address Differences Between Credited Contributions and Basis in Contributed Assets. If there is a difference between the amount credited to a partner's capital account in exchange for contributing property to a partnership and the partner's basis in the contributed property, special allocations of tax items are required to take into account the difference.<sup>27</sup> These allocations are designed to ensure that if one partner contributes cash or has a high basis in contributed property and another partner has a low basis, the benefits of the high basis (or detriments of low basis) will not be shifted between or among contributing partners. Each member of the Loan LLCs received a credit to that member's capital account equal to the face amount of the Loan Interest that member contributed to the Loan LLC. If the members' bases in the Loan Interests were correctly reported to the Loan LLCs, then upon a foreclosure with respect to the Loan Interests, members of the Loan LLCs who did not claim theft losses would generally have capital losses equal to their economic losses from the foreclosure (measured by their shares of the difference between the face amount of the Loan Interests and the bid price at the foreclosure sale), while members who claimed theft losses would generally have a relatively small or no capital losses from the foreclosure (or possible income that offsets in part their theft losses).<sup>28</sup>

(e) Risk of Multiple Claims of Same Losses; Actions Taken by MP Funds to Address Potential Loss Issue. Members of the Loan LLCs should not be able to claim both a theft loss and a foreclosure/capital loss with respect to the same economic loss.<sup>29</sup> To avoid duplicative claims for losses, the MP Funds reported theft losses in their AARs but also reported that the MP Funds were eliminating or reversing all or part of the capital losses previously reported on the MP Funds' tax returns with respect to their shares of capital losses attributable to foreclosures by the Loan LLCs (to the extent the MP Funds received Schedules K-1 from the Loan LLCs reflecting the MP Funds' shares of such capital losses).<sup>30</sup> The effect of the MP Funds' AARs is generally to produce tax results for the MP Funds, in their capacities as members of the Loan LLCs, that are consistent with the results that would have occurred under paragraph 3(d) above if the Loan LLCs had been in a position to determine the MP Funds' bases in their Loan Interests.<sup>31</sup>

(f) Caution to Investors. Investors in the MP Funds and Pass-Through Investors in the Loan LLCs should consult their tax advisors to ensure that they have not claimed

both theft losses and foreclosure losses with respect to the same economic loss, whether in reliance on a Schedule K-1 received from an MP Fund or Loan LLC, or otherwise. Investors and their advisors may want to consider following the same approach that was used by the MP Funds in its AARs, as described in paragraph 3(e) above to reverse the effect of claiming tax losses in excess of the investors' economic losses. Investors' duplicative claims of theft and foreclosure/capital losses could result in penalties, which could be substantial. To facilitate investors' evaluation of their potential duplicative loss claims, ML Manager LLC has posted on its webpage a calculation of the capital loss originally reported by each Loan LLC for its foreclosure sale, reflecting the amount of the applicable Loan Interest, the bid amount at the foreclosure sale and the resulting capital loss.<sup>32</sup>

4. Penalties. The applicability of penalties that relate to the adjustment of any partnership item is determined at the partnership level.<sup>33</sup> For example, basis misstatements are determined at the partnership level for purposes of the 20% penalty under Code Section 6662(e)(1)(A) (which includes reporting of basis that exceeds 150% of the basis ultimately determined to be the correct amount) and the 40% penalty under Code Section 6662(h)(2)(A)(i) (which includes reporting of basis that exceeds 200% of the basis ultimately determined to be the correct amount). In view of the substantial adjustments to the Loan LLCs' bases in their Loan Interests that may result from theft losses claimed by the members of the Loan LLCs, there is a substantial risk that significant penalties (potentially including the 20% or 40% penalties for basis misstatements referred to above) could apply to any underpayments of taxes by investors that arise from matters relating to the MP Funds or Loan LLCs, particularly if the investors have claimed both foreclosure/capital losses and theft losses with respect to the same economic losses that are associated with investments in Loan Interests. Investors may be able to avoid penalties by filing qualified amended returns or AARs that correct any prior underpayment of tax, if the returns are filed before the investors are first contacted by the IRS concerning any examination with respect to their returns.<sup>34</sup> An investor's good faith efforts to comply with correct reporting, in reliance on recommendations of a professional tax advisor, may also be relevant in determining whether penalties are imposed.<sup>35</sup>

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<sup>1</sup> A copy of the PWC Opinion has been posted at ML Manager LLC's webpage at mtgltd.com.

<sup>2</sup> The clause "more likely than not" is a term of art under tax law, meaning generally that if a taxpayer's position is challenged by the IRS, there is a greater likelihood that the position will be sustained than that the position will not be sustained (i.e., there is better than a 50/50 chance that the taxpayer will prevail). Accordingly, while the PWC Opinion supports the positions being taken by the MP Funds and may provide some amount of protection with respect to penalties, the PWC Opinion does not guaranty the outcome of the MP Funds' claim of theft losses for the 2009 Tax Year under the Theft Loss Revenue Procedure, if the claim is challenged by the IRS.

<sup>3</sup> Several pooled funds were formed to acquire Loan Interests from Mortgages Ltd. Nine of these pooled funds are still in existence and, for ease of reference, are referred to as the "MP Funds".

<sup>4</sup> Copies of Revenue Procedures 2009-20 and 2011-58 have been posted at ML Manager LLC's webpage at mtgltd.com.

<sup>5</sup> Theft losses are deductible in the year in which they are discovered by a taxpayer, rather than in the year in which the theft actually occurs. See Code § 165(e).

<sup>6</sup> In connection with the bankruptcy of Mortgages Ltd., forty-eight separate limited liability companies (for ease of reference, referred to as "Loan LLCs") were formed to hold Loan Interests and to administer collection of loan proceeds, foreclosures through trustee sales and operation and disposition of properties received by the Loan LLCs from foreclosures. Each of the Loan LLC's holds Loan Interests in a single loan that was originated by Mortgages Ltd. The Loan LLCs acquired their Loan Interests as capital contributions from their members, which include any

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MP Funds that held Loan Interests in an applicable loan as well as any Pass-Through Investors (defined in footnote 7 below) who held Loan Interests in such loan and who elected to become members of the applicable Loan LLCs. Some Loan Interests in each loan are held by individual investors outside of the Loan LLCs.

<sup>7</sup> "Pass-Through Investors" are investors who acquired Loan Interests and elected to contribute such Loan Interests to Loan LLCs in accordance with the Mortgages Ltd. bankruptcy plan and applicable bankruptcy court orders.

<sup>8</sup> When Revenue Procedure 2009-20 was originally issued, a taxpayer was eligible for theft loss treatment under Revenue Procedure 2009-20 if, among other matters, a lead figure was indicted for a crime that constituted theft under state law. The death of Scott Coles precluded an indictment of Mr. Coles. Accordingly, it was concluded that the MP Funds did not qualify for theft loss treatment under Revenue Procedure 2009-20 at the time their tax returns were filed for the 2009 Tax Year. As more fully described in the PWC Opinion, Revenue Procedure 2009-20 was modified by Revenue Procedure 2011-58 in a manner that resulted in the conclusions set forth in the PWC Opinion regarding the applicability of the Theft Loss Revenue Procedure to the MP Funds for the 2009 Tax Year.

<sup>9</sup> The MP Funds and Loan LLCs are treated as partnerships for federal income tax purposes and are subject to the complex reporting and audit requirements of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"). In order to change the treatment of any items reported on their tax returns, partnerships that are subject to TEFRA are required to file AARs with the IRS, rather than simply amending their tax returns. AARs are generally filed on IRS Form 8082. Beginning in 2012, partnerships may make an administrative adjustment request by manually filing a new Form 1065X. However, partnerships that are required to file returns electronically, such as the MP Funds and Loan LLCs, are still required to file administrative adjustment requests on Form 8082. There are complex rules and procedures regarding partners' rights to participate in TEFRA proceedings, which depend in part on the partners' percentages of ownership in a partnership. Further discussion of these rules is beyond the scope of this memorandum.

<sup>10</sup> See discussion in paragraph 2(a) of this memorandum for a more detailed description of the contents of the Forms 8082 filed by the MP Funds.

<sup>11</sup> Although the MP Funds and Loan LLCs have been organized as limited liability companies under Arizona law, they are treated as partnerships for federal income tax purposes under the so-called "check-the-box" regulations. See Reg. § 301.7701-2.

<sup>12</sup> "Partnership items" generally include a partnership's income, gain, loss, deduction or credit and matters that are taken into account in determining the foregoing. See Code § 6231(a)(3) and associated Regulations. Partnership items are reported on a partnership's information return and the partners' shares of such partnership items are reported to them on Schedules K-1. Theft losses incurred by a partnership are a partnership item, whereas theft losses incurred by a partner are not. The distinction between the two is not always easy to make. The PWC Opinion effectively concludes that it is more likely than not that the MP Funds incurred theft losses as a partnership item as a result of their investment in Loan Interests. Some investors in the MP Funds have taken the position that losses relating to the Loan Interests held by the MP Funds are partner items, resulting from a fraudulent scheme that induced investors to invest in the Loan LLCs. The question of whether theft losses associated with the Loan Interests acquired by MP Funds are partnership or partner items is likely to be addressed relatively quickly as the IRS processes the MP Funds' AARs. If the IRS were to determine that the theft losses are a partner item, investors in the MP Funds would need to file amended individual tax returns if they desired to claim theft losses. The PWC Opinion also effectively concludes that there were no theft losses reportable as partnership items on the Loan LLCs' tax returns, and that Pass-Through Investors should make their own determination as to whether or not they have incurred theft losses with respect to the Loan Interests they transferred to the Loan LLCs.

<sup>13</sup> See discussion in paragraph 3(a) of this memorandum. The MP Funds received comparable allocations of capital losses with respect to foreclosures that occurred in 2010 on deeds of trust held by Loan LLCs in which the MP Funds hold interests.

<sup>14</sup> See examples included in footnote 30 below.

<sup>15</sup> Following receipt of an appropriately-filed AAR for a partnership, the IRS can elect to do any of the following: (i) treat the AAR as a correction of mathematical errors; (ii) allow credits or make refunds with respect to some or all of the items in the AAR; (iii) conduct a partnership-level proceeding; or (iv) take no action. See Code § 6227(c). If the IRS conducts a partnership proceeding and disallows the adjustments requested in the AAR or fails to take any action within six months following filing of an AAR, the tax matters partner (and, in certain circumstances, other partners) may file a petition for readjustment with an appropriate court. See generally Code §§ 6221 through 6234 and accompanying Regulations.

<sup>16</sup> See generally Code §§ 6221 through 6234 and accompanying Regulations.

<sup>17</sup> See Code § 6222. Notices of inconsistent treatment and administrative adjustment requests are made on Form 8082. If a taxpayer files a tax return that reports partnership items in a manner that is inconsistent with the Schedule

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K-1 received by the taxpayer from a partnership, without filing a Form 8082, the IRS can adjust the taxpayer's tax return to be consistent with what was reported on the Schedule K-1.

<sup>18</sup> The consequences of any potential inconsistent treatment are unclear, now that the MP Funds have filed AARs reporting theft losses as partnership items for the 2009 Tax Year. If the IRS/court ultimately determines that theft losses with respect to Loan Interests that were acquired by the MP Funds are partnership (and not partner) items and if the discovery year for theft losses is 2009, then members of the MP Funds that claimed theft losses for earlier years could be subject to penalties. In addition, if an MP Fund member claimed theft losses or other deductions in excess of those ultimately allowed to the MP Fund under the AAR process, penalties could potentially apply to that member. If the IRS/court ultimately determines that any theft losses claimed by the MP Funds with respect to their Loan Interests are a partner item, rather than partnership item, the AARs filed by the MP Funds would be ineffective with respect to the theft losses claimed thereon and members of the MP Fund that had not already done so would need to file amended individual tax returns if they desired to claim theft losses. The treatment of theft losses as a partnership or partner item will likely be addressed relatively early in the AAR process.

<sup>19</sup> See generally Reg. § 1.166-6(a).

<sup>20</sup> See Reg. § 1.166-5.

<sup>21</sup> See Reg. § 1.166-6(b).

<sup>22</sup> See Reg. § 1.166-6(c).

<sup>23</sup> See Code § 723, which reads in applicable part as follows: "The basis of property contributed to a partnership by a partner shall be the adjusted basis of such property to the contributing partner at the time of the contribution . . ." When the Loan LLCs' tax returns were filed for 2009 (the year in which the Loan Interests were contributed to the Loan LLCs), it was apparently assumed that the members of the Loan LLCs had bases equal to the face amounts of their contributed Loan Interests.

<sup>24</sup> Because the Loan LLCs bases in their Loan Interests is measured as of the date of contribution of the Loan Interests to the LLC in 2009, it is unclear what effect, if any, a member's deduction of theft losses in 2010 or thereafter would have on the Loan LLCs' bases in their Loan Interests. Further discussion of this topic is beyond the scope of this memorandum.

<sup>25</sup> Reg. § 301.6231(a)(3)-1(c)(i)(iv).

<sup>26</sup> If a partnership has a built in loss of more than \$250,000 and a partner sells or exchanges (in this case the death of a partner is an exchange), the partnership must reduce its tax basis in the new partner's share of the partnership's assets so that the benefit of the loss is not taken twice. It is likely that each of the Loan LLCs and MP Funds has more than \$250,000 of built in losses. Any member who sells or exchanges an interest in the MP Funds or Loan LLCs is required to provide notice of the transaction (including all information necessary to make the basis adjustment) within 30 days of a sale and the person who receives a membership interest because of the death of a member has one year to provide the required notification. See generally Code §§ 743(b) and (d).

<sup>27</sup> See Code § 704(c) and the Regulations thereunder.

<sup>28</sup> The tax principles described in this paragraph are best illustrated by a simplified example. Assume that members of a Loan LLC contributed Loan Interests to the Loan LLC with a face amount of \$1,000,000 and that one of the members, who owned a 10% interest in the Loan LLC, claimed a theft loss of \$75,000 for the 2009 Tax Year, and none of the other members claimed theft losses for the 2009 tax year. Under the Loan LLC's operating agreement, the members of the Loan LLC would have capital accounts totaling \$1,000,000. The Loan LLC would have a tax basis of \$925,000 (\$900,000 carried over from members who did not claim theft losses and \$25,000 carried over from the member that claimed a theft loss, which equals that member's 10% share of the \$1,000,000 face amount of the Loan Interests, or \$100,000, reduced by that member's \$75,000 theft loss). If the Loan LLC foreclosed on its deed of trust and bid \$250,000 at the foreclosure sale, the Loan LLC would have an economic loss of \$750,000 (the \$1,000,000 face amount of the Loan Interests minus the \$250,000 bid amount), of which \$675,000 (90% of the \$750,000 economic loss) is attributable to members that did not claim theft losses and \$75,000 (10% of the \$750,000 economic loss) is attributable to the investor that claimed a theft loss. For tax purposes, the Loan LLC would have a capital loss of \$675,000 (the \$925,000 tax basis minus the \$250,000 bid amount), all of which would be allocated to the members who did not claim a theft loss, to match their \$675,000 economic loss. None of the Loan LLC's \$675,000 tax loss would be allocated to the member that claimed a theft loss, because that member already claimed a \$75,000 theft loss that is equal to that member's \$75,000 economic loss. See the discussion in footnote 30 below for examples of how a portion of a member's tax loss could be partially offset income from a foreclosure and how a member may have some foreclosure/capital losses in addition to a theft loss.

<sup>29</sup> Using the same facts as set forth in footnote 28, it is readily apparent that the member that claimed a \$75,000 theft loss should not be permitted to claim an additional \$75,000 foreclosure loss. The member invested \$100,000 to acquire a Loan Interest in that face amount. After claiming a \$75,000 theft loss, the member would have a \$25,000



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basis in its interest in the Loan LLC, which equals the member's 10% share of the Loan LLC's property that has both a \$250,000 value and basis (Regulation Section 1.166-6 indicates a taxpayer acquires a basis in property acquired through a foreclosure equal to the property's fair market value and presumes that the bid amount at a foreclosure sale equals the fair market value of the property). No loss is allowed for tax purposes where a corresponding economic loss did not occur. Moreover, the member that claimed the theft loss would only have \$25,000 of basis in its membership interest which could not fully absorb a \$75,000 loss, even if such a loss were allowed.

<sup>30</sup> The results of the MP Funds' AARs can best be illustrated by continuing the example from footnote 28, assuming for this purpose that an MP Fund was the member that claimed the theft loss. In this case, the Loan LLC would have filed a 2009 tax return reporting a basis of \$1,000,000 in its Loan Interest (because the Loan LLC would not have known that it needed to take into account MP Fund's yet unclaimed \$75,000 theft loss for purposes of determining the Loan LLC's basis in the Loan Interest it received from the MP Fund). Accordingly, the Loan LLC's 2009 tax return would have reflected a \$750,000 capital loss from its foreclosure (\$1,000,000 of basis minus the \$250,000 bid amount) and the Loan LLC would have issued to the MP Fund a Schedule K-1 reflecting its 10% share (\$75,000) of the capital loss. The MP Fund would have filed a 2009 tax return reflecting its \$75,000 capital loss. If the MP Fund were to now file an AAR claiming a \$75,000 theft loss, without reversing the \$75,000 capital loss described above, the MP Fund would be claiming a total of \$150,000 of tax losses for a single \$75,000 economic loss (the MP Fund originally invested \$100,000 in its Loan Interests and following the Loan LLC's foreclosure, the MP Fund would have a 10% interest in the Loan LLC that held \$250,000 worth of property, so the MP Fund would have an economic loss of only \$75,000). To avoid claiming \$150,000 of tax losses for a single \$75,000 economic loss, the MP Fund's AAR would indicate that it is reversing the \$75,000 capital loss previously claimed by the MP Fund with respect to the Loan LLC's foreclosure (i.e., the MP Fund would now report \$0 of capital loss with respect to the foreclosure), and that it is now reporting a \$75,000 theft loss, producing a net \$75,000 of losses. Note that if the bid amount at the foreclosure sale in the foregoing example were \$300,000, rather than \$250,000, the results would be a bit different, because the MP Fund's 10% share of the Loan LLC's \$300,000 of property (\$30,000) would exceed the MP Fund's remaining \$25,000 of basis in its interest in the Loan LLC by \$5,000. Under these circumstances, the MP Fund would have \$5,000 of income, which would partially offset the \$75,000 theft loss and would be reported as an additional item of income on the MP Fund's AAR. Similarly, if the bid amount at the foreclosure sale were \$200,000, rather than \$250,000, the MP Fund's 10% share of the Loan LLC's \$200,000 of property (\$20,000) would be \$5,000 less than the MP Fund's remaining \$25,000 basis in its interest in the Loan LLC, and the MP Fund would have an economic loss of \$80,000 (its \$100,000 initial investment in the Loan Interest minus the \$20,000 share of the Loan LLC's property value). In order to have its tax losses match its economic losses, the MP Fund's AAR would report \$5,000 of the MP Fund's original \$75,000 share of the Loan LLC's capital loss plus the \$75,000 theft loss, resulting in total tax losses of \$80,000 that match the \$80,000 economic loss.

<sup>31</sup> As noted in the text of this memorandum, the MP Funds are just now claiming theft losses that, if allowed, will reduce the bases of their interests in the Loan Interests contributed by them to the Loan LLCs, retroactively to 2009. When the Loan LLCs filed their tax returns for the 2009 Tax Year, it was impossible to take into account the basis adjustments that may arise from the AARs on which the MP Funds are claiming theft losses.

<sup>32</sup> As noted in the text of this memorandum, the AARs filed by the MP Funds for the 2009 Tax Year reverse the capital losses reflected on the Schedules K-1 they received from the Loan LLCs to avoid having their claim of theft losses create duplicative losses. Additional AARs may be filed by the MP Funds to make comparable adjustments with respect to foreclosure losses previously reported for the 2010 tax year. If investors in the MP Funds have filed tax returns that affected the bases of their interests in the MP Funds, they should consult their tax advisors to determine whether further adjustments may be required on their tax returns.

<sup>33</sup> See Code § 6221.

<sup>34</sup> See Reg. § 1.6664-2(c)(2).

<sup>35</sup> See Reg. § 1.6664-4.