2005

# Capturing Capital Gain While Staying in the Deal and Preserving Capital Gains in Real Estate Transactions (Related Article)

# DEALING WITH THE SERVICE'S INTERIM GUIDANCE ON DOWNWARD BASIS ADJUSTMENTS UNDER 734 AND 743

BY RICHARD M. LIPTON AND TODD D. GOLUB

If the mandatory partnership basis adjustment rule enacted in 2004 did not get the attention of practitioners, the new Notice from IRS should. The Service has provided rules on what to do and how to do it for partnerships that do not have a Section 754 election in effect, while indirectly forcing practitioners to reconsider the wisdom of that status.

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Notice 2005-32, 2005-16 IRB 895, provides interim procedures for partnerships and their partners to comply with the mandatory basis adjustments under Sections 734 and 743 as amended by the American Jobs Creation Act of 2004 (AJCA), P.L. 108-357, 10/22/04.

## BACKGROUND

One of the more sweeping changes made by the AJCA was the mandatory downward basis adjustments for partnerships and partners under Sections 734 and 743 in connection with certain distributions and transfers of partnership interests.[1]

Specifically, in order to prevent loss duplication or loss shifting, partnerships that do not have a Section 754 election in effect are required to reduce the inside basis of partnership property under Section 734(b) if the partnership makes a distribution in which there is a "substantial basis reduction." For this purpose, a substantial basis reduction occurs if a downward basis adjustment of more than $250,000 (measured on an aggregate rather than an item-by-item basis) would have to be made by the partnership under Section 754 in connection with a distribution of partnership property.[2]

Similarly, partnerships that do not have a Section 754 election in effect also are required to reduce the inside basis of partnership property under Section 743 if one of its partners transfers its partnership interest by sale, exchange, or on the death of a partner and the partnership has a "substantial built-in loss" immediately after the transfer. For this purpose, there is a substantial built-in loss in partnership property if the partnership's aggregate tax basis in its property exceeds the FMV of its property by more than $250,000.[3]

There is an exception to the mandatory basis reduction under Section 743 for "electing investment partnerships" (EIPs) with respect to any transfer of a partnership interest while the partnership is an EIP.[4] In lieu of a basis adjustment at the partnership level, Section 743(e)(2) provides that the transferee partner is not allowed to recognize its allocable share of partnership gross losses (from the sale or exchange of partnership property) to the extent that such losses exceed the loss recognized by the transferor partner on the transfer of the partnership interest by the transferor partner (or a predecessor transferor partner to the extent not fully offset by a prior loss disallowance under Section 743(e)(2)) to the transferee partner. Section 743(e)(3) provides further that losses disallowed under Section 743(e)(2) do not reduce a transferee's basis in its partnership interest.

An EIP is a partnership that satisfies the following nine requirements of Section 743(e)(6):

1. The partnership makes an election to be treated as an EIP.

2. The partnership would be an investment company under section 3(a)(1)(A) of the Investment Company Act of 1940 but for an exemption under section 3(c)(1) or 3(c)(7) of that Act.[5]

3. The partnership has never been engaged in a trade or business.

4. Substantially all of the partnership's assets are held for investment.

5. At least 95% of the assets contributed to the partnership consist of money.

6. None of the assets contributed to the partnership had an adjusted tax basis in excess of its FMV at the time of contribution.

7. All of the partnership interests are issued by the partnership pursuant to a private offering before the date that is 24 months after the date of the first capital contribution to the partnership.

8. The partnership agreement has substantive restrictions on each partner's ability to cause a redemption of the partner's interest.[6]

9. The partnership agreement provides for a partnership term that is not in excess of 15 years.[7]

Under Section 743(e)(7), the Treasury is to prescribe Regulations to carry out the provisions of Section 743(e).

Section 6031(f) provides that for an EIP, the information required to be furnished under Section 6031(b) to any partner to whom Section 743(e)(2) applies should include information necessary to enable that partner to compute the amount of losses disallowed under Section 743(e).

## THE NOTICE

The Treasury and the IRS have announced that they intend to issue Regulations that will give additional guidance on implementing the changes made by the AJCA to Sections 734 and 743, and corresponding changes made to Sections 704 and 6031. In the absence of such Regulations, the IRS issued Notice 2005-32.

### Downward Basis Adjustments

Until new Regulations are issued, the Notice provides that a partnership that is required to reduce the basis of its assets under Section 734(b) because of a distribution of partnership property that results in a substantial basis reduction must comply with Reg. 1.734-1(d) as if the partnership had a valid Section 754 election in effect at the time of the distribution. Under that Regulation, a partnership that must adjust the bases of its properties under Section 754 must attach a statement to its partnership return for the year of the distribution, setting forth the computation of the adjustment and the partnership properties to which the adjustment is being made.

The Notice further provides that a partnership that is required to reduce the basis of its assets under Section 743(b) because of transfer of a partnership interest at a time when the partnership has a substantial built-in loss must comply with Reg. 1.743-1(k)(1) as if the partnership had a valid Section 754 election at the time of the transfer. Under that Regulation, a partnership that must adjust the basis of its properties under Section 743 must attach a statement to its return for the year of the transfer setting forth the name and taxpayer identification number of the transferee partner as well as the computation of the adjustment and the partnership properties to which the adjustment is being made.

In addition, the transferee partner must comply with the reporting requirements of Reg. 1.743-1(k)(2) as if the partnership had a valid Section 754 election at the time of the transfer. Under that Regulation, the transferee partner must notify the partnership in writing within 30 days of the sale or exchange. The notice must include the names and addresses of the transferee and (if ascertainable) of the transferor, the taxpayer identification numbers of the transferee and the transferor, the date of the transfer, the amount of any liabilities assumed or taken subject to by the transferee, and the amount of any money, the FMV of any other property delivered or to be delivered for the transferred interest, and any other information necessary for the partnership to compute the transferee's basis. The notice must also be signed under penalties of perjury.

**As a practical matter, most partnerships may want to consider making a 754 election because any tax advantage from not making the election has disappeared.**

These rules will effectively prevent a partnership from shifting or duplicating losses. If a partnership has a built-in gain, however, a Section 754 election still is necessary to prevent a transferee of a partnership interest from recognizing gain that also is recognized by a transferor. Thus, as a practical matter, most partnerships may want to consider making a Section 754 election because any tax advantage from not making the election has disappeared.

### EIP Transfers

Until further guidance is issued, the Notice provides that a partnership that wants to make an EIP election must do so by attaching a statement to its tax return for the tax year in which the election is effective. The election can be made retroactively by filing an amended return. The statement must set forth the name, address, and tax identification number of the electing partnership. The statement also must contain a representation that the partnership is eligible to make an EIP election, and that the partnership must state that the partnership elects under Section 743(e) to be treated as an EIP. A partnership that has a valid Section

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[1] See Rosenberg, "AJCA Imposes New Burdens for Partnership Basis Adjustments Under Sections 734 and 743," 101 JTAX 334 (December 2004).

[2] Section 734(d)(1).

[3] Section 743(d)(1). The determination of whether there is a substantial built-in loss is made with respect to all of the partnership's property. The amount of the built-in loss allocable to the transferee partner is irrelevant.

[4] Section 743(e)(1).

[5] This effectively limits the exception for EIPs to partnerships holding stock or securities.

[6] For an EIP that was in existence on 6/4/04, this requirement does not apply. See AJCA section 833(d)(2)(B).

[7] For an EIP that was in existence on 6/4/04, the partnership term cannot be in excess of 20 years. See AJCA section 833(d)(2)(B).

754 election in effect is ineligible to make an EIP election.

An EIP election will terminate if the partnership fails to meet the definition of an EIP, which is quite possible due to the narrow statutory definition. If an election to be an EIP is terminated, the partnership will become subject to the mandatory basis adjustments promulgated under the AJCA on the first transfer of a partnership interest that occurs after the partnership ceases to meet the definition of an EIP. An EIP may also choose to terminate its EIP election by filing a Section 754 election. If the partnership wants to terminate its EIP election without filing a Section 754 election, it must get the Service's consent to do so.

**Reporting requirements.** To help enforce the loss disallowance rules of Section 743(e)(2), the Notice provides that the transferor partner is required to provide certain information to the transferee partner and to the partnership. In addition, a partnership with an EIP election in effect also must provide certain information to its partners.

If a partnership interest in an EIP is transferred via a sale or exchange or on the death of a partner, the transferor (or, in the case of a partner who dies, the partner's executor, representative, or other successor-in-interest) must notify the transferee and the EIP of the transfer in writing. The notice must be provided within 30 days after the date on which the transferor (or its executor, representative, or successor-in-interest) receives its K-1 from the EIP for the EIP's tax year in which the transfer occurs. This notice must be signed under penalties of perjury and must include the following information:

1. The name, address, and tax identification number of the transferor.

2. The name, address, and tax identification number of the transferee (if ascertainable).

3. The name of the partnership.

4. The date of the transfer (and, in the case of the death of a partner, the date of the death of the partner).

5. The amount of loss, if any, recognized by the transferor along with a computation of the loss.

6. The amount of losses, if any, recognized by any prior transferors to the extent the losses were disallowed under Section 743(e)(2) in the hands of a prior transferee and have not been offset by prior loss disallowances under Section 743(e)(2).

7. Any other information necessary for the transferee partner to compute the amount of loss disallowed under Section 743(e)(2).

**A partnership that has a valid Section 754 election in effect is ineligible to make an EIP election.**

The transferee and the EIP are required to retain the notice "as long as the contents thereof may become material in the administration of any internal revenue law."[8]

If the transferor partner fails to provide the transferee with the statement described above, the transferee partner must treat all its allocable share of the EIP's losses as disallowed losses under Section 743(e)(2) unless the transferee partner is able to obtain information necessary to determine the proper amount of losses disallowed under Section 743(e)(2) from the EIP or other sources. If the transferee cannot obtain this information but can obtain information indicating the maximum amount of losses that could be disallowed, then the transferee may treat the maximum amount of losses as the amount of losses disallowed under Section 743(e)(2). For example, if the transferee can obtain the transferor's basis in the transferred interest but is unable to obtain the transferor's amount realized, the transferee may assume that the amount realized was zero, and that the amount of disallowed losses for purposes of Section 743(e)(2) equals the transferor's tax basis.

Since the loss limitation under Section 743(e)(2) is based on gross losses, the EIP is required to separately state all of the partnership's losses to all of its partners under Reg. 1.702-1(a)(8)(ii) on the EIP's Schedules K and K-1, including losses that could be netted against partnership-level gains if Section 743(e)(2) did not apply.

In addition, until further guidance is provided, an EIP must provide an annual statement to all of its partners indicating that it has elected to be treated as an EIP, and setting forth certain information to both transferor and transferee partners setting forth the aforementioned information.[9]

These reporting requirements indicate that any time a partner acquires a partnership interest from another partner, the transferee partner will

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[8] Notice 2005-32, 2005-16 IRB 895, section 5.A.

[9] The specific statement is enumerated in Notice 2005-32, section 5.C.:

"Notice of Election. This partnership has elected to be treated as an electing investment partnership under section 743(e) of the Internal Revenue Code.

"Information for Transferors. If you transfer an interest in this partnership to another person, Notice 2005-32, 2005-16 I.R.B. [895] provides that you must, within 30 days after receiving a Schedule K-1 from this partnership for the taxable year that includes the date of the transfer, provide the transferee with certain information, including the amount, if any, of loss that you recognized on the transfer of the partnership interest, and the amount of losses, if any, recognized by prior transferors with respect to the same interest. See Notice 2005-32 for more information.

"Information for Transferees. If an interest in this partnership is transferred to you, Section 743(e)(2) requires that you reduce your distributive share of losses from this partnership, determined without regard to gains from this partnership, to the extent of any losses recognized by the transferor partner when that partner transferred the partnership interest to you (and to the extent of other losses recognized on prior transfers of the same partnership interest that have not been offset by prior loss disallowances). Each year, you must reduce your share of losses as reported to you by this partnership by the amount of any loss recognized by the transferor partner (or any prior transferor to the extent not already offset by prior loss disallowances) until you have reduced your share of partnership losses by the total amount of losses required to be disallowed. If the transferor partner, or its legal representative in the case of a transfer by death, fails to provide you with the required statement, you must treat all losses allocated from the EIP as disallowed under § 743(e)(2) unless you obtain, from the EIP or otherwise, the information necessary to determine the proper amount of losses disallowed under § 743(e)(2). See Notice 2005-32 for more information."

have to do its due diligence to find out if the partnership has a valid EIP election in place,[10] and if so, what is the amount of loss, if any, recognized by the transferor.

**Character of loss.** Until further guidance is issued, if an EIP allocates losses of a different character to a transferee partner (e.g., ordinary and capital losses) and the recognition of the losses is limited by Section 743(e)(2), then a proportionate share of the disallowed losses is to consist of each loss of a separate character that is allocated to the transferee.

**Trade or business of lower-tier partnerships.** As stated above, Section 743(e)(6) provides that a partnership that is or has previously engaged in a trade or business cannot elect to be treated as an EIP. What was not made clear by the AJCA was whether a trade or business of a lower-tier partnership would be attributed to an upper-tier partnership, preventing the upper-tier partnership from electing to be an EIP.[11] The Notice indicates that the Treasury and the Service are studying this issue, and have requested comments that are appropriate for future guidance on this issue.

The Notice further provides that until such guidance is issued, an upper-tier partnership will not be treated as engaged in the trade or business of a lower-tier partnership if, at all times during the period in which the upper-tier partnership owns an interest in the lower-tier partnership, the adjusted basis of the upper-tier partnership's interest in the lower-tier partnership is less than 25% of the total capital that is required to be contributed to the upper-tier partnership by its partners during the entire term of the upper-tier partnership. By looking to the amount that the upper-tier partnership invests in the lower-tier partnership as a percentage of its overall capital, this test is consistent with the legislative history that indicates that EIPs generally will consist of venture capital funds, buyout funds, and funds of funds.[12]

The Notice does not address situations in which the upper-tier partnership's adjusted basis in the lower-tier partnership is greater than 25% of the total amount of capital that is required to be contributed to the upper-tier partnership. The Treasury and the IRS have specifically requested comments on this issue. Factors that may be relevant to this issue include (1) the relative amount of the upper-tier partnership's investment in the lower-tier partnership as compared with the total capital that is required to be contributed to the upper-tier partnership, (2) the degree to which the upper-tier partnership participates in the management of the lower-tier partnership, and (3) the motivation for forming the upper-tier partnership when making the investments in lower-tier partnerships.

## EXAMPLES

The Service provided the following examples in Notice 2005-32.

Example 1 *(transfer of partnership interest)*: XYZ is a partnership that does not have an election under Section 754 in effect. The FMV of XYZ's assets is $4 million and the adjusted basis of XYZ's assets is $4.3 million. Under Section 743(d), XYZ has a substantial built-in loss because the adjusted basis of the partnership property exceeds the FMV of the partnership property by more than $250,000. A, a partner of XYZ, sells a 25% partnership interest in XYZ to B for its FMV of $1 million. Section 743(b) requires an adjustment to the adjusted basis of XYZ's assets with respect to B. Under Notice 2005-32, section 3, B must provide the written notice described in Reg. 1.743-1(k)(2) to XYZ within 30 days after the sale, and XYZ must attach the statement described in Reg. 1.743-1(k)(1) to the partnership return for the year of the transfer.

Example 2 *(distribution of partnership property)*: A and B each contribute $2.5 million and C contributes $5 million to a newly formed partnership, XYZ, which does not have an election under Section 754 in effect. XYZ purchases PQR stock for $3 million and UVW stock for $7 million. The value of each stock declines to $1 million. XYZ distributes PQR stock to C in complete liquidation of C's interest in XYZ. Under Section 732(b), the basis of PQR stock in C's hands is $5 million and C would recognize a loss of $4 million if the PQR stock were sold for $1 million.

**Any time an interest is acquired from another partner, the transferee will have to do its due diligence to find out if the partnership has a valid EIP election.**

There is a substantial basis reduction within the meaning of Section 734(d), because the $2 million increase in the adjusted basis of PQR stock (described in Section 734(b)(2)(B)) is greater than $250,000. Under Section 734(b), XYZ is required to decrease the basis of UVW stock by $2 million (the amount by which the basis of PQR stock was increased), leaving a basis of $5 million remaining in the UVW stock. Under section 3 of the Notice, XYZ must attach the statement described in Reg. 1.734-1(d) to the partnership return for the year of the distribution.

Example 3 *(EIP)*: XYZ, a domestic partnership with a calendar-year tax year, desires to elect to be treated as an EIP for 2004 and all succeeding tax years. Other than the making of the election, XYZ meets all other requirements to be an EIP under Section 743(e)(6). XYZ elects to be treated as an EIP by attaching a statement to its income tax return for 2004 in accordance with Notice 2005-32, section 4.

Between 10/22/04 and 12/31/04, the only transfer of a partnership interest in XYZ occurred on 11/30/04 when A transferred a 10% partnership interest to C. The purchase price for the 10%

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[10] This information should be relatively easy to obtain provided that the EIP has complied with its reporting requirements by issuing its annual EIP notice as required under Notice 2005-32.

[11] See Rosenberg, *supra* note 1.

[12] See H. Rep't No. 108-755, 108th Cong., 2d Sess. 626 (2004).

partnership interest was $3 million. A's adjusted basis in A's partnership interest on 12/31/03 was $3 million. In 2004, the partnership's only items of income, gain, loss, and deduction were $3 million of long-term capital gain and $2 million of long-term capital loss. Because XYZ has elected to be treated as an EIP, XYZ must separately state this gain and loss on its return.

If A had remained a partner for the entire year, A's distributive share of the partnership's items would have been $300,000 of long-term capital gain and $200,000 of long-term capital loss. Assume that under Section 706, A's distributive share of these items is properly determined to be 334/365 of each of these amounts, or $274,521 of long-term capital gain and $183,014 of long-term capital loss, and that C's distributive shares of these items are properly determined to be 31/365 of each of these amounts, or $25,479 of long-term capital gain and $16,986 of long-term capital loss.

**Only time will tell whether investment partnerships will decide if the least evil is (1) electing EIP status, (2) making a 754 election, or (3) living with AJCA changes.**

XYZ must provide a statement to all of its partners in accordance with section 5.C of the Notice, which must be attached to each partner's Schedule K-1 for XYZ's tax year ending 12/31/04. Assume that A received A's Schedule K-1 on 3/12/05. Within 30 days after receiving this Schedule K-1, A must provide statements to C and the EIP.

The adjusted basis in A's partnership interest on 11/30/04, $3,091,507, equals A's adjusted basis on 12/31/03 ($3 million) plus A's distributive share of partnership gain in 2004 ($274,521), less A's distributive share of partnership loss in 2004 ($183,014). The loss recognized by A on the sale of A's partnership interest is $91,507, the adjusted basis in A's partnership interest on the date of the sale less the amount realized by A. Thus, the first $91,507 of gross loss allocated to C is disallowed under Section 743(e)(2). The entire amount of C's long-term capital loss in 2004, $16,986, is disallowed under Section 743(e)(2). The first $74,521 of any gross loss allocated to C in future years also will be disallowed under Section 743(e)(2), regardless of whether XYZ is an EIP in those future years.

C's adjusted basis as of 12/31/04 is $3,025,479, the sum of what C paid for A's interest ($3 million) plus the distributive share of gain allocated to C ($25,479). Under Section 743(e)(3), the $16,986 loss allocated to C but disallowed under Section 743(e)(2) does not reduce the basis of C's partnership interest.

**Practice Notes**

Practitioners should make certain that every partnership agreement is clear as to whether and when a Section 754 election will be made by the partnership. Prior to the AJCA, it was commonly thought that a Section 754 election was not made unless necessary, because there was always the possibility that the transferee of any partner might benefit from any built-in loss inherent in partnership assets. The AJCA generally takes away that benefit, so that there can be only detrimental tax consequences from the failure to make a Section 754 election when a partnership interest is transferred or redeemed. But because the Section 754 election imposes significant administrative costs whenever an interest is transferred (and there is no built-in loss), many partnerships still may avoid the election.

## ANALYSIS

The practical effects of the Notice are several-fold. First and foremost, the Notice should call to the attention of practitioners the sweeping scope of the amendments that Congress made to Sections 734 and 743 as part of the AJCA. Some practitioners had not previously focused on the basis adjustments that will be required whenever a partnership interest is acquired (or a partner's interest is redeemed) and there is an overall built-in loss. By setting forth the basis adjustments that must be made by any partnership that has not made a Section 754 election, the Notice serves as an important reminder of the breadth of the new rules.

Practitioners also should consider whether all of the partnerships (or other entities taxable as partnerships) that they advise should make a Section 754 election. The "common wisdom" prior to the AJCA was that a Section 754 election was not made unless necessary, because there was always the possibility that the transferee of any partners in a partnership could benefit from any built-in loss inherent in partnership assets. The AJCA generally takes away that benefit, so that there can be only detrimental tax consequences from the failure to make a Section 754 election when a partnership interest is transferred or redeemed.

Nevertheless, the Section 754 election imposes significant administrative costs whenever an interest is transferred (and there is no built-in loss), so many partnerships still may avoid such elections. In any event, each practitioner should make certain that a partnership agreement is clear as to whether and when a Section 754 election will be made by the partnership.

It is likely that the exception for EIPs will not be available to many partnerships. In the first place, the nine-part test established by Congress in the AJCA is difficult to satisfy (particularly the requirement that the partnership has never been engaged in a trade or business). It is not uncommon nowadays for many investment partnerships to acquire an interest in another operating business, and the Notice does not address this issue (but seeks comments on the impact of business operations conducted through a lower-tier partnership). Until there is guidance on this issue, the "conservative" approach is to assume that an upper-tier entity that owns at least a 25% interest in a lower-tier partnership engaged in a trade or business is ineligible to be an EIP, which greatly diminishes the number of partnerships that can make an EIP election.

In addition, the requirement that all of the partnership interests must be issued in a private offering essentially excludes traditional family limited partnerships from qualifying as an EIP. Also, partnerships and partners alike will need to take the notice provisions for an EIP into account when drafting partnership agreements and partnership interest purchase agreements. These agreements will have to require that the notice provisions will be complied with. Finally, there are significant administrative costs imposed under the Notice on any partnership that elects EIP status, including particularly the annual loss statements and other notices. Partners may want to consider imposing such costs in a manner that reflects the economics of a transaction. Thus, it is possible that the election will not be widely used, although only time will tell whether investment partnerships will decide if the least evil is (1) electing EIP status, (2) making a Section 754 election, or (3) living with the consequences of the changes made in the AJCA.

## CONCLUSION

The basis adjustment rules under the AJCA prevent loss (but not gain) duplication with respect to partnership property. These basis adjustments are a radical departure from prior law and could catch many partnerships by surprise unless the partnership has made a Section 754 election. The Notice provides useful guidance covering the application of these rules.

The Treasury and the Service should be commended for providing helpful guidance. The Notice provides clear reporting guidelines that will need to be strictly adhered to by transferor partners, transferee partners, and partnerships. Partnerships that are considering making an election to be treated as an EIP should carefully consider these reporting requirements, and the impact such an election will have on its partners. ■


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