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# Getting Up to Speed on Partnership Basis Adjustments

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*cutting through complexity*

# Getting Up to Speed on Partnership Basis Adjustments

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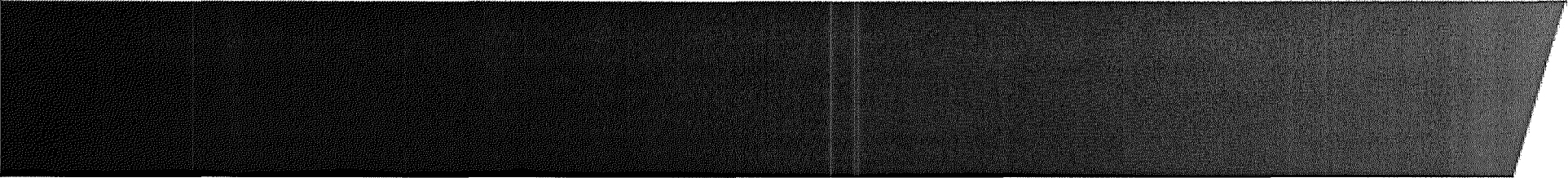
# Notice

**The following information is not intended to be “written advice concerning one or more Federal tax matters” subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230.**

**The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.**

# Basis Adjustments

- **Section 743(b) and Sales of Partnership Interests**
- **Section 734(b) and Partnership Distributions**
- **Section 704(c)(1)(C) and Contributed Built-in Loss Assets**
- **Section 732(d) and Distributions of Partnership Assets Following an Acquisition of a Partnership Interest**
- **Section 754 Elections**



# Section 743(b) Basis Adjustments

## **Basis Adjustments Under Section 743(b) – The Theory**

- **The primary intent of section 743(b) basis adjustments is to equalize a partner's share of inside basis in partnership assets and the partner's basis in its partnership interest upon the sale or exchange of a partnership interest**
- **A section 743(b) basis adjustment implements an “aggregate” view of partnerships, in essence determining the basis of the acquiring partner's share of partnership assets as if the acquiring partner directly acquired its share of the partnership's assets**

## When Does Section 743(b) Apply?

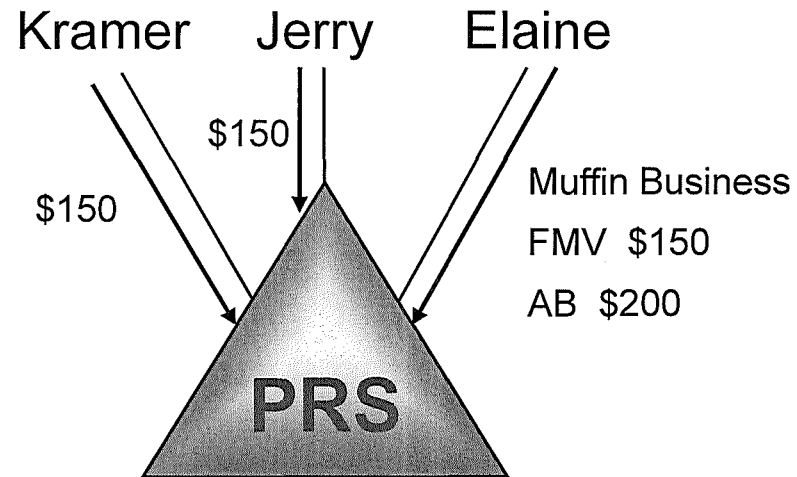
- **The basis of partnership assets will be adjusted under section 743(b) upon the sale or exchange of a partnership interest in two situations:**
  - The partnership has made a section 754 election that is effective in the year of the sale or exchange
  - The partnership has a “substantial built-in loss” immediately after the transfer
- Section 743(d)(1) provides that a partnership has a “substantial built-in loss” for purposes of section 743 if the partnership’s adjusted basis in partnership property exceeds the fair market value of the property by more than \$250,000
  - Note that the determination of a “substantial built-in loss” is made by reference to the partnership’s total assets and is not dependent on whether a transferor partner has a built-in loss in its share of partnership assets (e.g., a partner contributed built-in loss assets to the partnership and thus has a disproportionate loss in partnership assets as compared to other partners)
- If an upper-tier partnership makes a mandatory basis adjustment with respect to a lower-tier partnership interest under section 743(b), the lower-tier partnership is treated as having a section 754 election in effect so that the basis adjustment will tier down. Prop. Reg. §1.743-1(l).

# Hypothetical Partnership

- Elaine has started a business called “Top of the Muffin To You!”
- The business shows great potential, but due to certain initial missteps, the business assets reflect a built-in loss
- Elaine believes that, with additional capital and successful rebranding, the business could become very profitable
- Jerry and Kramer buy into Elaine’s philosophy and agree to contribute capital such that each will be a 1/3 partner



# Hypothetical Partnership



- Elaine contributes “Top of the Muffin” business to PRS
- Jerry and Kramer each contribute \$150 cash to provide capital for growth of the business.

# Hypothetical Partnership

## ■ Partnership Balance Sheet

<u>Assets</u>			<u>Liabilities &amp; Capital</u>		
	<u>Tax</u>	<u>FMV</u>		<u>Tax</u>	<u>FMV</u>
Cash	\$300	\$300	Liabilities	0	0
Inventory	\$50	\$50	Capital		
FF&E	\$50	\$50	Jerry	\$150	\$150
Land & Bldg	\$100	\$50	Kramer	\$150	\$150
Goodwill	<u>\$0</u>	<u>\$0</u>	Elaine	<u>\$200</u>	<u>\$150</u>
<b>Total</b>	<b>\$500</b>	<b>\$450</b>		<b>\$500</b>	<b>\$450</b>

# Hypothetical Partnership

- Five years later, Elaine's vision has played out well, and the business has become very successful
- The one misstep was Kramer's decision to institute a rickshaw delivery service for the muffin tops
- Kramer's misstep creates dissension among the partners
- In addition, a condo next to Jerry's parents at Del Boca Vista has come on the market, and Kramer needs cash to acquire the unit
- As a result, Kramer sells his 1/3 partnership interest to George for \$300

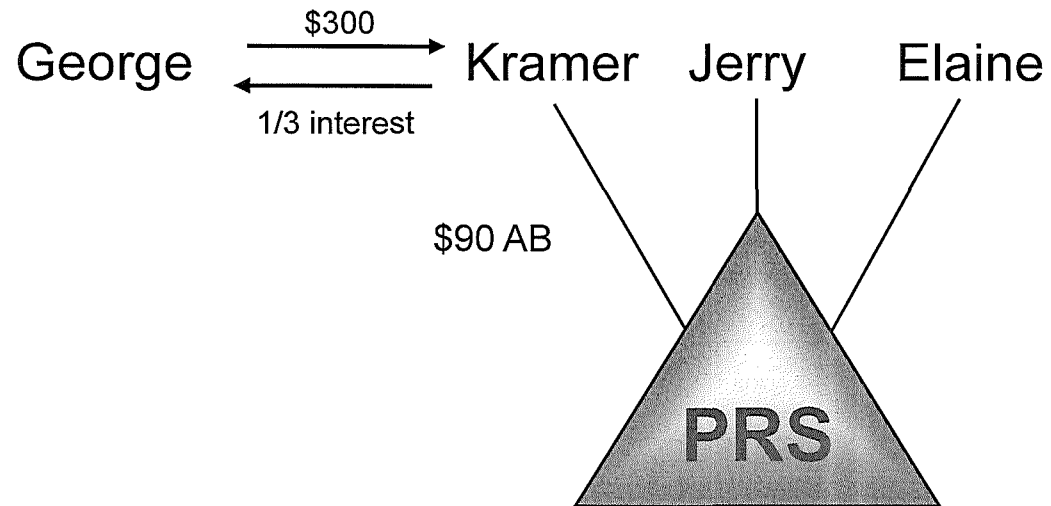
# Hypothetical Partnership

## ■ Partnership Balance Sheet

<u>Assets</u>			<u>Liabilities &amp; Capital</u>		
	Tax	FMV		Tax	FMV
Cash	\$0	\$0			
Inventory	\$90	\$120	Liabilities	0	0
FF&E	\$100	\$130	Capital		
Land & Bldg	\$100	\$50	Jerry	\$90	\$300
Rickshaws	\$30	\$10	Kramer	\$90	\$300
Goodwill	\$0	\$590	Elaine	\$140	\$300
Total	\$320	\$900	Total	\$320	\$900

- Assume building, like the land, is not depreciable – Elaine has \$50 section 704(c) loss in land and building
- Partnership has taken \$180 of depreciation with respect to FF&E (spend \$40 to build up inventory, \$30 to acquire rickshaws, and \$230 to expand FF&E)

# Sale of Partnership Interest



- Kramer sells his entire interest in PRS to George for \$300 cash.
- Gain recognized by Kramer is \$210
- PRS makes a section 754 election effective for the year of the transfer

## Steps in Determining the Section 743(b) Basis Adjustment

- **The first thing that must be done is to determine the amount of the total net basis adjustment that will be allocated among the partnership assets**
  - The amount of the basis adjustment is determined by comparing the transferee partner's basis in its partnership interest with its share of inside basis in partnership assets

## Steps in Determining the Section 743(b) Basis Adjustment

- **The partner's basis in its partnership interest is simply its basis as determined under section 742 (i.e., amount paid plus section 752 share of liabilities in a straight purchase transaction). Reg. §1.743-1(c).**
  - George's basis in his partnership interest equals \$300, the price paid for the interest

## Steps in Determining the Section 743(b) Basis Adjustment

- **The transferee partner's share of inside basis in partnership property is determined under a formula that calculates the partner's interest in the partnership's "previously taxed capital", plus the transferee's share of partnership liabilities under section 752. Reg. §1.743-1(d).**
  - A partner's interest in the partnership's "previously taxed capital" is equal to
    - The cash that the transferee would receive on a liquidation of the partnership following a hypothetical transaction (i.e., sale of all partnership assets in a fully taxable transaction at FMV), increased by
    - The amount of tax loss (including remedial allocations) that would be allocated to the transferee from the hypothetical transaction with respect to the acquired interest, decreased by
    - The amount of tax gain (including remedial allocations) that would be allocated to the transferee from the hypothetical transaction with respect to the acquired interest



## Steps in Determining the Section 743(b) Basis Adjustment

- **Note that “previously taxed capital” essentially measures a partner’s share of the after-tax investment in partnership assets – that is, the investment on which tax has already been paid**
  - The share of built-in gain represents economic value on which tax has not yet been paid
  - The share of built-in loss represents a share of post-tax investment in partnership assets (i.e., use of earned cash, etc.) that exceeds the share of economic value attributable to such assets

## Steps in Determining the Section 743(b) Basis Adjustment

- If the partnership were to sell all of its assets, George, as a 1/3 partner, would receive a liquidating distribution of \$300, and would recognize \$210 of gain (\$10 gain for inventory, \$10 gain for FF&E, \$0 with respect to land and building (all loss is section 704(c) to Elaine), \$6.66 loss for rickshaws, and \$196.66 gain for goodwill)
  - Thus, George's share of the partnership's pre-tax capital is \$90 (\$300 that would be received on liquidation, decreased by \$210 of gain that would be recognized on the hypothetical sale transaction)

## Steps in Determining the Section 743(b) Basis Adjustment

- **George's basis in his acquired partnership interest exceeds his share of the partnership's pre-tax capital by \$210, so this will represent the amount of George's positive net section 743(b) basis adjustment**
  - The goal of the basis adjustment is to match George's after tax investment in the acquired partnership interest with his share of after-tax investment in partnership assets
  - By creating a basis adjustment that is measured by the difference in the two after-tax numbers, section 743(b) effectively equalizes George's share of after tax investment in his partnership interest and the partnership assets
- **Note that the basis adjustment is equal to the amount of gain recognized by Kramer in connection with the sale of his interest.**
  - This generally will be the case if
    - There have been no prior transfers of the partnership interest;
    - There have been no basis adjustments under section 734(b); and
    - Ceiling rule distortions under section 704(c) have not created inside-outside basis disparities

## Steps in Determining the Section 743(b) Basis Adjustment

- **Note that George's share of pre-tax capital was not determined by reducing his liquidation proceeds by a 1/3 share of the partnership's overall gain (which includes the \$50 section 704(c) loss allocated to Elaine)**
  - This is a common mistake – some practitioners merely assume that the section 743(b) basis adjustment should offset 1/3 of the partnership's total gain or loss when a partner acquires a 1/3 interest in the partnership
  - The calculation must take account of section 704(c) and reverse section 704(c) allocations to properly adjust a partner's share of inside asset basis
  - Consider a partnership where partner A contributed \$100 which was used to acquire land, and partner B contributed land with a value of \$100 and basis of \$0
    - At a time when values have remained constant, partner A transfers his interest for \$100
    - Even though the partnership has \$100 of built-in gain, that gain is entirely attributable to partner B's interest
    - A purchase of partner A's interest should not affect gain allocable to partner B

## Steps in Determining the Section 743(b) Basis Adjustment

- Note that, if the partnership had liabilities, the liabilities would have to be factored into the calculation

## Steps in Allocating the Section 743(b) Basis Adjustment

- **Once the amount of the net basis adjustment is determined, it is necessary to allocate the basis adjustment among the partnership assets**
- **The allocation of the basis adjustment requires a three-step process. Reg. §1.755-1(a)**
  - Determine the value of the partnership assets
  - Allocate the basis adjustment between two classes of assets – ordinary income assets and capital gain assets
  - The portion of the basis adjustment that is allocated to each class must be allocated among the assets in that class

# Steps in Allocating the Section 743(b) Basis Adjustment

## ■ Determining the value of partnership assets

- First determine “partnership gross asset value,” which, in the case of the fully taxable purchase of a partnership interest, is equal to the amount that, if assigned to all partnership property, would result in a liquidating distribution to the transferee partner equal to the transferee’s basis in the transferred partnership interest immediately after the transferred interest. Reg. §1.755-1(b)(4)(i).
  - George has a \$300 adjusted basis in his acquired 1/3 partnership interest
  - Partnership assets would have to be worth \$900 in order for George to receive a \$300 distribution upon liquidation of his 1/3 interest, so “partnership gross asset value” must equal \$900.
  - A special rule exists where the partner’s do not share in all partnership assets in the same proportions. Reg. §1.755-1(a)(4)(i)(B).

# Steps in Allocating the Section 743(b) Basis Adjustment

## ■ Determining the value of partnership assets

- Second, in cases where the partnership’s assets constitute a trade or business, the partnership must allocate the “partnership gross asset value” among the assets using the “residual method” to assign values to the partnership’s section 197 intangibles. Reg. §1.755-1(a)(2).
  - In applying the residual method, the partnership first must determine the value of assets other than section 197 assets. Reg. §1.755-1(a)(3).
  - The value attributable to section 197 assets will equal the positive difference between “partnership gross asset value” and the value of partnership assets other than section 197 intangibles. Reg. §1.755-1(a)(5).
  - This “residual section 197 intangible value” will be allocated first to section 197 intangibles other than goodwill and going concern value based on the fair market value of such intangibles under a facts and circumstances analysis.
  - Any remaining value will be assigned to goodwill and going concern value.
- If a partnership’s assets do not comprise a trade or business (e.g., land), the partnership presumably has no section 197 intangibles and the residual method will not apply.



## Steps in Allocating the Section 743(b) Basis Adjustment

- **Looking to George's acquisition, he paid an amount that actually represents 1/3 of the total fair market value of the assets, so the amounts shown on slide 12 would properly represent the value of the assets for purposes of allocating the section 743(b) basis adjustment**
  - Note that, if George had been able to acquire Kramer's interest at a discount (due to lack of liquidity, control, etc.), the reduction in gross asset value (determined by reference to the purchase price of the partnership interest) would have resulted in a dollar-for-dollar reduction in the value assigned to goodwill

## Steps in Allocating the Section 743(b) Basis Adjustment

- **Allocating the basis adjustment between ordinary income and capital gain assets**
  - The amount of the basis adjustment that is allocated to the class of ordinary income property is equal to the total amount of income, gain, or loss (including remedial allocations) that would be allocated to the transferee (attributable to the acquired interest) from the sale of all ordinary income assets in the hypothetical transaction. Reg. §1.755-1(b)(2)(i).
    - For purposes of this rule, properties and potential gain treated as an unrealized receivable under section 751(c) (including depreciation recapture) will be treated as separate ordinary income property. Reg. §1.755-1(a)(1).
  - The amount of the basis adjustment that is allocated to capital gain property is equal to the difference between the section 743(b) basis adjustment and the amount of the basis adjustment allocated to ordinary income assets. Reg. §1.755-1(b)(2).
    - For purposes of this rule, capital gain property consists of capital assets and section 1231 assets. Reg. §1.755-1(a)(1).
    - If the decrease in basis to capital gain property exceeds the adjusted basis of such assets, the reduction must be allocated to ordinary income property.

## Steps in Allocating the Section 743(b) Basis Adjustment

- **Allocating the basis adjustment between ordinary income and capital gain assets**
  - PRS holds two ordinary income properties – inventory with built-in gain of \$30 and section 1245 depreciation recapture of \$30 with respect to FF&E.
    - George would be allocated \$10 of ordinary income with respect to each asset upon a fully taxable sale, so a \$20 section 743(b) basis adjustment will be allocated to ordinary income property.
  - The remaining \$190 of the total \$210 section 743(b) basis adjustment would be allocated to capital gain property

## Steps in Allocating the Section 743(b) Basis Adjustment

- **Allocating the basis adjustment among the properties within an asset class**
  - The amount of the basis adjustment that is allocated to an item of property within the class of ordinary income property is equal to the total amount of income, gain, or loss (including remedial allocations) that would be allocated to the transferee (attributable to the acquired interest) from the sale of the item of property, reduced by a proportionate part of reduction in the total basis adjustment to all ordinary income property because of a lack of sufficient basis in capital gain property. Reg. §1.755-1(b)(3)(i).
  - George would be allocated \$10 of ordinary income with respect to the inventory and section 1245 recapture if such assets were sold in a fully taxable transaction, so the \$20 positive basis adjustment allocated to ordinary income property will be divided equally between these two properties.

## Steps in Allocating the Section 743(b) Basis Adjustment

- **Allocating the basis adjustment among the properties within an asset class**
  - The amount of the basis adjustment that is allocated to an item of property within the class of capital gain property is equal to the total amount of income, gain, or loss (including remedial allocations) that would be allocated to the transferee (attributable to the acquired interest) from the sale of the item of property, reduced by
    - The total amount of gain or loss (including remedial allocations) that would be allocated to the transferee (attributable to the acquired interest) from the hypothetical sale of all items of capital gain property, reduced by the amount of the positive basis adjustment to all items of capital gain or property or increased by the amount of the negative basis adjustment to all items of capital gain property, multiplied by
    - A fraction, the numerator of which is the fair market value of the item of property to the partnership, and the denominator of which is the fair market value of all of the partnership's items of capital gain property. Reg. §1.755-1(b)(3)(ii).
  - George has a \$6.66 share of loss with respect to the rickshaws and a \$196.66 share of gain with respect to the goodwill. The \$190 net positive basis adjustment allocable to capital gain property results in a \$6.66 step down to the rickshaws and \$196.66 step up to the goodwill. Reg. §1.755-1(b)(1)(i) (allowing two-way adjustments).

## Steps in Allocating the Section 743(b) Basis Adjustment

- **When all is said and done, immediately after George acquired his interest in PRS, PRS could sell any asset for its FMV and the section 743(b) basis adjustment would exactly offset any gain or loss allocable to George.**
  - If George had been able to purchase Kramer’s interest at a discount to the underlying asset value, the “haircut” to value would have been reflected in a reduction in the basis adjustment
    - First, to goodwill;
    - Second, to other section 197 intangibles;
    - Third, to other capital gain property; and
    - Finally, to ordinary income property.

## Steps in Allocating the Section 743(b) Basis Adjustment

- **Note that the provisions that address the allocation of a basis adjustment within a class because there is not enough basis adjustment to match the net gain or loss within the class should have little application in the context of the taxable purchase of a partnership interest**
  - Because “partnership gross asset value” is determined by reference to the amount paid for the transferee’s partnership interest, the net gain or loss attributable to the partnership assets should reflect any discount or premium paid for the partnership interest so long as the value paid for the partnership interest produces a gross asset value that is at least equal to the value of the tangible assets. See Reg. §1.755-1(a)(6), Ex. 1(iii).

## Other Aspects of the Section 743(b) Basis Adjustment

- **A section 743(b) basis adjustment constitutes an adjustment to the basis of partnership property with respect to the transferee partner only. Reg. §1.743-1(j)(1).**
- **In calculating a partner's distributive share of income, gain, or loss:**
  - The partnership first calculates and allocates all items without regard to the section 743(b) basis adjustment.
  - The partnership then adjusts the transferee's distributive share of items to reflect the effects of the transferee's section 743(b) basis adjustment. Reg. §1.743-1(j)(3).



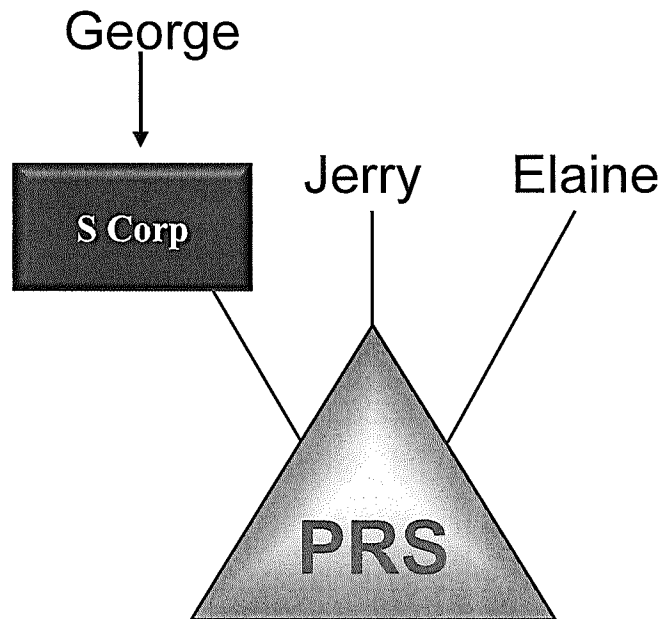
## Other Aspects of the Section 743(b) Basis Adjustment

- **A positive basis adjustment with respect to depreciable or amortizable property is recovered as newly-purchased property. Reg. §1.743-1(j)(4)(i).**
  - If the section 704(c) remedial method was elected upon contribution or revaluation of the property, the basis adjustment that matches the section 704(c) or reverse section 704(c) layer will have the same useful life as the portion of the asset that relates to the layer. Reg. §1.743-1(j)(4)(i).

## Other Aspects of the Section 743(b) Basis Adjustment

- **A negative basis adjustment is recovered over the remaining useful life of the depreciable or amortizable property for the partnership. Reg. §1.743-1(j)(4)(ii)(B).**
  - If a partner's negative adjustment to depreciation or amortization deductions with respect to a property in a particular year exceeds the partner's allocable share of deductions attributable to such property for the year, the negative adjustment will be applied to depreciation or amortization deductions allocable to such partner with respect to other property. If the negative adjustment exceeds all depreciation and amortization deductions allocable to the partner for the year, the partner will recognize ordinary income to the extent of the excess. Reg. §1.743-1(j)(4)(i).
  - Note that gain or loss related to partnership assets may be allocated differently from depreciation or amortization deductions, so the depreciation or amortization of the basis adjustment may not always correspond to the partner's share of "book" items under section 704(b) attributable to the property

# Transfer of Partnership Interest in Substituted Basis Transaction



- At a time when the value and basis of all assets have remained constant, George contributes his PRS interest to an S corporation

# Transfer of Partnership Interest in Substituted Basis Transaction

- **Under current regulations, George's basis adjustment does not carry over to the S corporation – instead, the S corporation calculates a new basis adjustment that is personal to the S corporation. Reg. §1.743-1(f).**
  - Proposed regulations issued in 2014 would change this result where a partner has a basis adjustment under section 743(b) and subsequently transfers the interest in a substituted basis transaction. Under Prop. Reg. §1.743-1(f)(2), the transferee would succeed to the portion of transferor's basis adjustment attributable to the transferred interest.

# Transfer of Partnership Interest in Substituted Basis Transaction

- **A different set of rules applies in allocating a section 743(b) basis adjustment for the transferee who receives a partnership interest in a substituted basis transaction.**
  - Under Reg. §1.755-1(b)(5)(i), a substituted basis transaction involves an exchange in which
    - The transferee's basis in the partnership interest is determined in whole or in part by reference to the transferor's basis in that interest (i.e., transferred basis); or
    - The transferee's basis in the partnership interest is determined by reference to other property held at any time by the transferee (i.e., exchanged basis).
  - In the case of a substituted basis transaction, partnership gross value equals the value of the entire partnership as a going concern, increased by the amount of liabilities at the time of the exchange. Reg. §1.755-1(b)(4)(ii).
  - If the total amount of the basis adjustment is \$0, no basis adjustment will be made with respect to partnership assets. Reg. §1.755-1(b)(5)(ii).
    - So there are no two-way basis adjustments in a substituted basis transaction.

## Transfer of Partnership Interest in Substituted Basis Transaction

- **The final regulations state that, if there is an increase in basis to be allocated, such increase may be allocated to capital gain property or ordinary income property only if the total amount of gain or loss (including remedial allocations) that would be allocated to the transferee (attributable to the transferred interest) upon a hypothetical sale of all assets would result in net gain or net income to the transferee. Reg. §1.755-1(b)(5)(ii).**
  - If there is net gain with respect to both classes of assets, the step-up will be allocated between the classes in proportion to the net gain with respect to each class that would be allocated to the transferee. *Id.*
  - If an increase is to be allocated within a class, the increase must be allocated first to properties with unrealized appreciation in proportion to the transferee's share of such unrealized appreciation (attributable to the acquired interest) but only to the extent of such unrealized appreciation. Any remaining increase will be allocated among the assets in proportion to the transferee's share of the amount that would be realized by the partnership on a hypothetical sale of the assets (i.e., in proportion to the transferee's share of the value of each asset). Reg. §1.755-1(b)(5)(iii)(A).

# Transfer of Partnership Interest in Substituted Basis Transaction

- The final regulations state that a decrease in basis may be allocated to a class of property (capital gain or ordinary income property) *only if* a net loss would result for the transferee upon a disposition of such class of property. Reg. §1.755-1(b)(5)(ii).
  - Where a net loss attributable to a transferred interest exists with respect to both classes of assets, the decrease in basis will be allocated in proportion to the net loss for each class. *Id.*
  - In allocating a decrease within a class, the decrease must be allocated first to properties with unrealized depreciation in proportion to the transferee's share of such unrealized depreciation (attributable to the acquired interest) but only to the extent of such unrealized depreciation. Any remaining decrease will be allocated among the assets in proportion to the transferee's share of the remaining adjusted basis of such assets. Reg. §1.755-1(b)(5)(iii)(B).
  - If a decrease allocable to a particular class of assets exceeds the partner's share of adjusted basis of *all depreciated assets* within that class, the decrease is limited to such amount. Reg. §1.755-1(b)(5)(iii)(C).
    - If a decrease is so limited, the excess adjustment is made to property of a like character when acquired by the partnership. Reg. §1.755-1(b)(5)(iii)(D).

# Transfer of Partnership Interest in Substituted Basis Transaction

- **Proposed regulations under section 755, which are effective for transfers of partnership interests on or after January 16, 2014, would significantly change the rules for substituted basis transactions.**
  - Under the proposed regulations, if there is an increase in basis to be allocated, such increase must be allocated to capital gain property or ordinary income property in proportion to the *gross gain or gross income* (including remedial allocations) that would be allocated to the transferee (attributable to the transferred interest) upon a hypothetical sale of all assets in each class. Prop. Reg. §1.755-1(b)(5)(ii)(A).
  - If an increase is to be allocated within a class, the increase must be allocated first to properties with unrealized appreciation in proportion to the transferee's share of such unrealized appreciation (attributable to the acquired interest) but only to the extent of such unrealized appreciation. Any remaining increase will be allocated among the assets in proportion to their fair market value. Reg. §1.755-1(b)(5)(iii)(A).



# Transfer of Partnership Interest in Substituted Basis Transaction

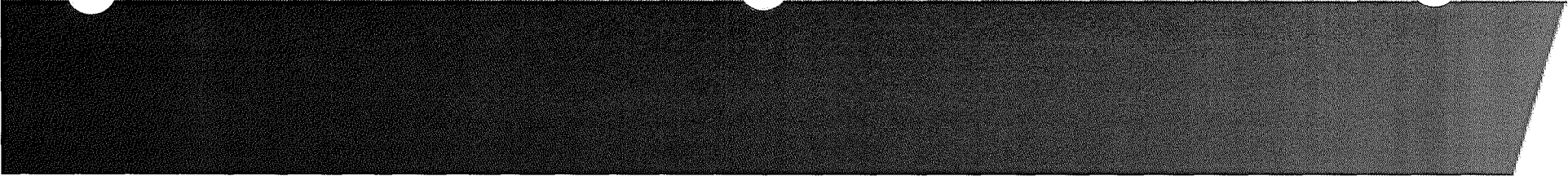
- Under the proposed regulations, a decrease in basis will be allocated between property classes (capital gain or ordinary income property) in proportion to, and to the extent of, the gross loss (including remedial allocations) that would be allocated to the transferee (attributable to the acquired interest) from the hypothetical sale of all assets. Any remaining decrease in basis must be allocated in proportion to the transferee's share of adjusted basis of all assets in each class. Prop. Reg. §1.755-1(b)(5)(ii)(C).
  - In allocating a decrease within a class, the decrease must be allocated first to properties with unrealized depreciation in proportion to the transferee's share of such unrealized depreciation (attributable to the acquired interest) but only to the extent of such unrealized depreciation. Any remaining decrease will be allocated among the assets in proportion to the transferee's share of the remaining adjusted basis of such assets. Reg. §1.755-1(b)(5)(iii)(B).
  - If a decrease allocable to a particular class of assets exceeds the partner's share of adjusted basis of *all assets* within that class, the decrease is limited to such amount. Prop. Reg. §1.755-1(b)(5)(iii)(C).
    - If a decrease is so limited, the excess adjustment is made to property of a like character when acquired by the partnership. Prop. Reg. §1.755-1(b)(5)(iii)(D).

## **Transfer of Partnership Interest in Substituted Basis Transaction**

- **The primary effect of the proposed regulations is to limit the situations in which the allocation of a basis adjustment may be avoided in connection with a substituted basis transaction.**

# Transfer of Partnership Interest in Substituted Basis Transaction

- As previously described, the S corporation would be allocated \$20 of ordinary income and \$190 of capital gain upon a fully taxable sale of all partnership assets.
  - Accordingly, the \$210 basis adjustment would be allocated \$20 to ordinary income property and \$190 to capital gain property.
  - With respect to the ordinary income property, there would be a \$10 basis adjustment with respect to the inventory and depreciation recapture relating to the FF&E, which is equal to the S corporation's relative share of appreciation in each asset.
  - With respect to the capital gain property, all \$190 of the basis adjustment would be allocated to goodwill, as that is the only appreciated capital gain asset, and the basis adjustment does not exceed the appreciation in that asset.
- Unlike in the context of the sale transaction, two-way adjustments are not permitted in substituted basis transactions, so there is no reduction in the basis of the rickshaws and greater increase in basis to the goodwill.
- By contrast, under the proposed regulations, George's basis adjustment would carry over to the S corporation, so the previous two-way adjustment resulting from the sale transaction would be preserved. Prop. Reg. §1.743-1(f)(2).



# **Section 734(b) Basis Adjustments**

## Basis Adjustments Under Section 734(b) – The Theory

- As with section 743(b) basis adjustments, the primary intent of section 734(b) basis adjustments is to preserve the equality of partners' shares of inside basis in partnership assets and partners' cumulative bases in their partnership interest upon a distribution of cash or property by a partnership
- In effect, if a low basis partner receives a distribution of high basis property (or cash), that partner has “stolen” basis away from other partners who funded that high basis – a positive section 734(b) basis adjustment is intended to “replace” the basis that was “stolen” from the partnership
- Similarly, if a high basis partner receives a distribution of low basis property in liquidation of its high basis partnership interest (or cash in a liquidating distribution that gives rise to a loss), that partner has left behind in the partnership basis in property that the other partners are not properly entitled to – a negative section 734(b) basis adjustment is intended to eliminate this “improper” benefit to the remaining partners

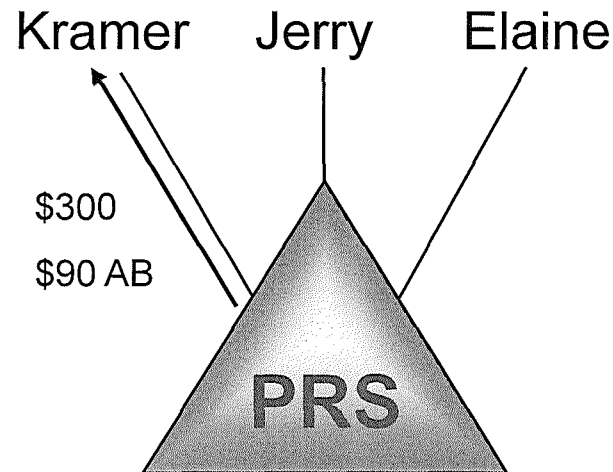
## When Does Section 734(b) Apply?

- **Partnership property will be adjusted under section 734(b) if**
  - the partnership has a section 754 election that is effective in the year of the distribution or
  - there is a substantial basis reduction with respect to such distribution.
    - There is a substantial basis reduction if the reduction in basis in connection with the distribution would exceed \$250,000
      - The preamble to the proposed regulations clarifies that the \$250,000 threshold applies separately with respect to each distributee and not with respect to the partnership's aggregate distributions for the year. REG-144468-05 (preamble).
      - Under the proposed regulations, if an upper-tier partnership makes a mandatory basis adjustment with respect to a lower-tier partnership interest under section 734(b), the lower-tier partnership is treated as having a section 754 election in effect so that the basis adjustment will tier down. Prop. Reg. §§1.734-1(f).

## Hypothetical Partnership

- Under an alternative scenario, George has moved in with his parents due to a lack of finances, and hence he is not in a position to purchase Kramer's PRS interest
- Jerry and Elaine, however, still want Kramer out of the partnership, so they arrange for PRS to borrow \$300 and distribute such proceeds to Kramer

# Hypothetical Partnership



- PRS distributes \$300 to Kramer in complete liquidation of his partnership interest
- Kramer recognizes gain of \$210
- The discussion that follows generally will ignore the application of section 751(b), except for discussion on slide 56



# Hypothetical Partnership

## ■ Partnership Balance Sheet

<u>Assets</u>			<u>Liabilities &amp; Capital</u>		
	Tax	FMV		Tax	FMV
Cash	\$0	\$0			
Inventory	\$90	\$120	Liabilities	0	0
FF&E	\$100	\$130	Capital		
Land & Bldg	\$100	\$50	Jerry	\$90	\$300
Rickshaws	\$30	\$10	Kramer	\$90	\$300
Goodwill	<u>\$0</u>	<u>\$590</u>	Elaine	<u>\$140</u>	<u>\$300</u>
Total	\$320	\$900	Total	\$320	\$900

- Assume building, like the land, is not depreciable – Elaine has \$50 section 704(c) loss in land and building
- Partnership has taken \$180 of depreciation with respect to FF&E (spend \$40 to build up inventory, \$30 to acquire rickshaws, and \$230 to expand FF&E)

## Determining the Section 734(b) Basis Adjustment

- **Under section 734(b)(1), the partnership shall increase the adjusted basis of partnership property by**
  - The amount of gain recognized by the distributee partner with respect to such distribution under section 731(a)(1), and
  - In the case of distributed property the basis of which is determined under section 732(a)(2) (current distributions) or (b) (liquidating distributions), the excess of the basis of the distributed property to the partnership immediately before the distribution over the basis of the distributed property to the distributee, as determined under section 732
- **Under section 734(b)(2), the partnership shall decrease the adjusted basis of partnership property by**
  - The amount of loss recognized by the distributee partner with respect to such distribution under section 731(a)(2), and
  - In the case of distributed property the basis of which is determined under section 732(b) (liquidating distributions), the excess of the distributee's basis in the distributed property to the distributee, as determined under section 732, over the basis of the distributed property to the partnership immediately before such distribution

## Determining the Section 734(b) Basis Adjustment

- The basis of PRS's property will be increased under section 734(b) by \$210 – the amount of gain recognized by Kramer

## Steps in Allocating the Section 734(b) Basis Adjustment

- As with section 743(b) basis adjustments, it is necessary as a first step in allocating the section 734(b) basis adjustment to determine “partnership gross asset value.”
- For section 734(b) basis adjustments, “partnership gross asset value” equals the value of the entire partnership as a going concern immediately following the adjustment, increased by the amount of partnership liabilities immediately following the distribution. Reg. §1.755-1(b)(4)(iii).
- Also as with basis adjustments under section 743(b), in cases where the partnership’s assets constitute a trade or business, the partnership must allocate the “partnership gross asset value” among the assets using the “residual method” to assign values to the partnership’s section 197 intangibles. Reg. §1.755-1(a)(2).

## Steps in Allocating the Section 734(b) Basis Adjustment

- **Allocating the basis adjustment among classes of partnership assets**
  - Where the adjustment arises as a result of gain or loss recognized under section 731 in connection with a distribution, the adjustment will be allocated only to capital gain property. Reg. §1.755-1(c)(1)(ii).
  - Where the adjustment arises in connection with the step-up or step-down of distributed property, the adjustment must be allocated to remaining partnership property of a character similar to that of the distributed property with respect to which the adjustment arose. Reg. §1.755-1(c)(1)(i).
    - E.g., If the partnership's adjusted basis of distributed capital gain property immediately prior to the distribution exceeds the basis of the property to the distributee partner (determined under section 732), the basis of the undistributed capital gain property will be increased by an amount equal to the excess.
- **Because Kramer recognized gain under section 731, the entire basis adjustment will be allocated to capital gain assets (i.e., FF&E (other than the piece treated as an unrealized receivable), land and building, rickshaws, and goodwill).**

## Steps in Allocating the Section 734(b) Basis Adjustment

- **Allocating the basis adjustment among the properties within an asset class**
  - If there is an increase in basis to be allocated within a class, the increase must be allocated first to properties with unrealized appreciation in proportion to their respective amounts of such unrealized appreciation (but only to the extent of such appreciation). Any remaining increase must be allocated among the properties within the class in proportion to their fair market values. Reg. §1.755-1(c)(2)(i).
  - If there is a decrease in basis to be allocated within a class, the decrease must be allocated first to properties with unrealized depreciation in proportion to their respective amounts of such unrealized depreciation (but only to the extent of such depreciation). Any remaining decrease must be allocated among the properties within the class in proportion to their adjusted basis (as adjusted under the preceding sentence). Reg. §1.755-1(c)(2)(ii).
  - Where a basis adjustment cannot be made because the partnership holds no property of the appropriate character, or the decrease in basis exceeds the total adjusted basis of property with the required character, the adjustment is made when the partnership subsequently acquires property of the proper character. Reg. §1.755-1(c)(4).

## Steps in Allocating the Section 734(b) Basis Adjustment

- The only appreciated capital asset held by PRS is goodwill, and that asset is appreciated by \$590
- Accordingly, the entire \$210 section 734(b) basis adjustment will be allocated to goodwill

## Steps in Allocating the Section 734(b) Basis Adjustment

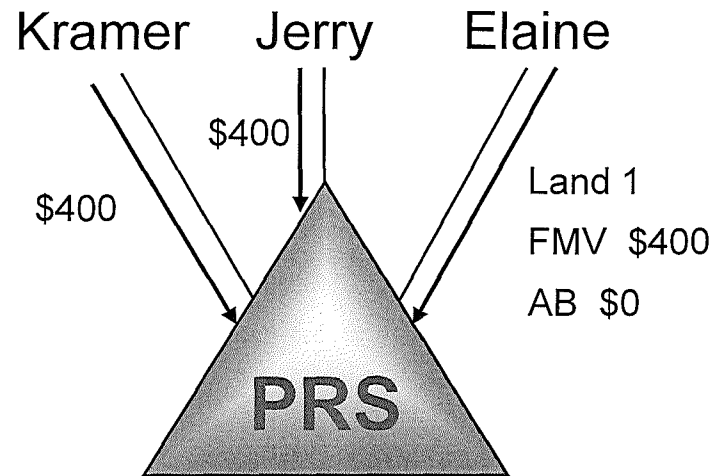
- **Note that, if we were considering section 751(b), a 1/3 share of PRS's inventory (AB \$30 and FMV \$40) and FF&E recapture (AB \$0 and FMV \$10) would be treated as distributed to Kramer immediately prior to the liquidating distribution, and such assets would be treated as sold back to PRS for the distributed cash**
  - Result would be a reduction in the basis of Kramer's PRS interest by \$30 (for the distribution of the inventory) from \$90 to \$60, recognition of \$20 of ordinary income by Kramer on the deemed sale of the assets with a basis of \$30 to the partnership for \$50, and a step-up in the "purchased" share of inventory and FF&E recapture by \$20
  - The liquidating distribution would be reduced by \$50 to account for the cash that was received in the deemed sale transaction under section 751(b)
  - So the liquidating distribution would involve a distribution of \$250 with respect to a partnership interest with an adjusted basis of \$60 and recognition of gain equal to \$190
  - Thus, the adjustment to the basis of capital assets under section 734(b) would be \$190 (gain recognized) and the basis of ordinary income asset would be increased by \$20 under section 751(b)



## Other Aspects of the Section 734(b) Basis Adjustment

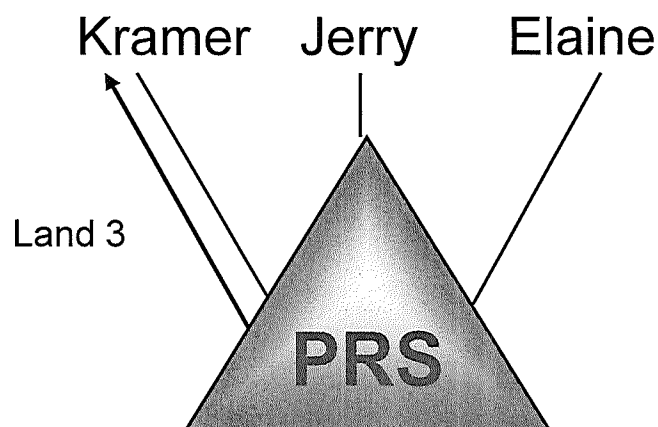
- A positive basis adjustment with respect to depreciable or amortizable property is recovered as newly-purchased property. Reg. §1.734-1(e)(1).
- A negative basis adjustment is recovered over the remaining useful life of the depreciable or amortizable property for the partnership. Reg. §1.734-1(e)(2).
- Unlike section 743(b) basis adjustments, a section 734(b) basis adjustment is made to the common basis of partnership property and is not isolated to specific partners.

# Hypothetical Partnership



- Elaine contributes Land 1 to PRS with \$0 basis and \$400 FMV
- Jerry and Kramer each contribute \$400 cash
- The \$800 invested by Jerry and Kramer is used to purchase Land 2 for \$200 and Land 3 for \$600

# Hypothetical Partnership



Land 1 FMV \$400 AB \$0  
Land 2 FMV \$800 AB \$200  
Land 3 FMV \$600 AB \$600

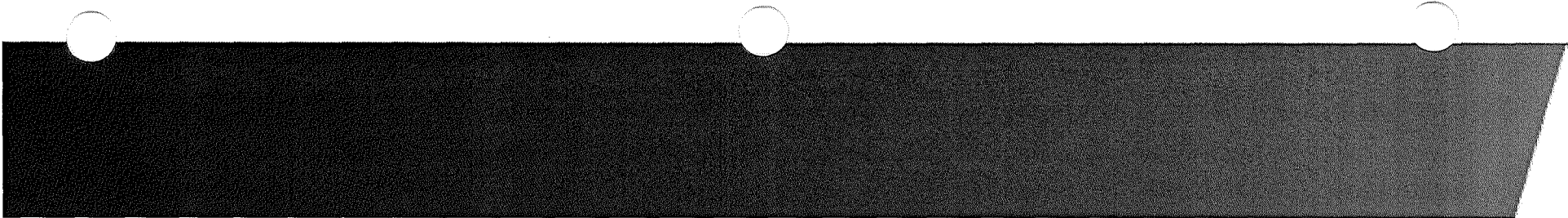
- At a time when Kramer's partnership interest has an adjusted basis of \$400 and FMV of \$600, Land 3 is distributed in liquidation of his interest
- Under section 732(b), the basis in Land 3 will be stepped down by \$200
- Under section 734(b)(1)(B), the remaining assets will be stepped up by \$200

## Allocation of Section 734(b) Basis Adjustment

- As previously discussed, the basis adjustment will be allocated in proportion to the relative appreciation in the remaining partnership assets
- Of the total \$1,000 of appreciation that exists with respect to Land 1 and 2, 40% relates to Land 1 (\$400/\$1,000) and 60% relates to Land 2 (\$600/\$1,000)
- Accordingly, \$80 is allocated to Land 1 and \$120 is allocated to Land 2
- After the basis adjustment, Land 1 has a basis of \$80 and FMV of \$400, and Land 2 has a basis of \$320 and FMV of \$800
- Before the distribution to Kramer, \$200 of built-in gain in PRS assets was allocable to Kramer and Jerry (by virtue of their 1/3 share of the \$600 of gain in Land 2), and \$600 of built-in gain was allocable to Elaine (by virtue of her 1/3 share of the \$600 gain in Land 2 and \$400 share of section 704(c) gain in Land 1)
- After the distribution to Kramer, \$240 of built-in gain in PRS asset will be allocable to Jerry (by virtue of his 1/2 share of \$480 gain in Land 2) and \$560 of built-in gain will be allocable to Elaine (by virtue of 1/2 of \$480 gain in Land 2 and all \$320 gain in Land 1)

## Allocation of Section 734(b) Basis Adjustment

- While the section 734(b) basis adjustment preserves the same amount of total gain allocable to Jerry and Elaine following the distribution, the method of allocation to common basis causes a shift in relative gain shares among the partners
  - Query whether, if a section 734(b) basis adjustment is made to an asset with section 704(c) gain and gain in excess of the section 704(c) layer, should the section 734(b) basis adjustment offset the section 704(c) layer or the other gain?
    - The preamble to the section 197 regulations relating to partnerships issued in 2000 implies that the section 734(b) basis adjustment should offset the first dollars of gain, and hence the section 704(c) gain. T.D. 8907, 2000-2 C.B. 558 (“Under §1.755-1(c)(2)(i), positive section 734(b) basis adjustments are allocated first to eliminate built-in gain (and hence section 704(c) gain) with respect to such properties”).
    - Arguably, there should be more flexibility allocating the section 734(b) basis adjustment with respect to different layers of gain. Cf. PLR 200829023 (Apr. 16, 2008) (where partnership property with section 704(c), reverse section 704(c), and further gain was transferred in a like kind exchange that included some boot, allocation of the boot gain by reference to the last layer of gain “results in an appropriate adjustment under §1.704-3(a)(8)”).



# Section 704(c)(1)(C)

# Guidance Relating to Mandatory Basis Adjustments under 2004 AJCA

- **2004 AJCA amended sections 704, 734, and 743 to address the potential for loss duplication**
  - Section 704(c)(1)(C) provides that, if any property contributed to a partnership has a built-in loss –
    - (i) such built-in loss shall be taken into account only in determining the amount of items allocated to the contributing partner, and
    - (ii) except as provided in regulations, in determining the amount of items allocated to other partners, the basis of the contributed property in the hands of the partnership shall be treated as being equal to its fair market value at the time of contribution.
  - Section 734(b) basis adjustments are mandatory if a distribution would result in a “substantial basis reduction” (*i.e.*, basis reduction would exceed \$250,000)
  - Section 743(b) basis adjustments are mandatory if the partnership has a substantial built-in loss (*i.e.*, the partnership's adjusted basis in the partnership property exceeds by more than \$250,000 the fair market value of such property)

## Section 704(c)(1)(C) Basis Adjustments – Operational Rules

- Proposed regulations issued under section 704(c)(1)(C) largely piggyback off the section 743(b) basis adjustment rules, essentially treating the BIL basis as if it was a section 743(b) basis adjustment that is personal to the contributing partner.
- Section 743(b) approach for addressing BIL allocations under section 704(c)(1)(C) incorporates the following rules. Prop. Reg. §1.704-3(f)(3)(i).
  - The excess of the adjusted basis of the contributed property over the fair market value of such property at the time of contribution (the “BIL”) is treated as basis of the property that is attributable solely to the contributing partner;
  - The partnership first determines the partners’ shares of partnership items, ignoring the BIL; and
  - The partnership then adjusts the contributor’s distributive share of partnership items to reflect the effects of the BIL (*i.e.*, adjust gain, loss, depreciation, and amortization)



## Section 704(c)(1)(C) Basis Adjustments – Operational Rules

- **Back to original example where the land and building is section 704(c) built-in loss asset with respect to Elaine, having been contributed with an adjusted basis of \$100 and FMV of \$50**
  - Assume the property increases in value and is sold for \$110
  - Applying the section 743(b) basis adjustment approach, the partnership would be treated as having a basis of \$50, so that \$60 of gain would be recognized on the sale
  - The \$60 of gain would be allocated equally between Jerry, Kramer, and Elaine
  - Elaine then would apply the \$50 section 704(c)(1)(C) basis adjustment so that she would have an overall loss of \$30 (\$20 gain - \$50 basis adjustment) on the sale
- **Use of section 743(b) approach eliminates the disappearing basis in “ceiling rule” situations**
  - Without section 743(b) approach, it is unclear that Elaine could take advantage of \$30 excess basis simply because Jerry and Kramer are denied access to the basis

## Distributions and Section 704(c)(1)(C) Property

- **Transfers of section 704(c)(1)(C) property by partnership**
  - Distributions of section 704(c)(1)(C) property by the partnership
    - If property to which a section 704(c)(1)(C) basis adjustment has been allocated is distributed to the section 704(c)(1)(C) partner, that basis adjustment will be taken into account in determining the section 704(c)(1)(C) partner's basis in the distributed property and any resulting section 734(b) basis adjustment. Prop. Reg. §1.704-3(f)(3)(v)(A).
      - If Land and Building is distributed to Elaine, the distributed property will be treated as having an adjusted basis of \$100
    - If property to which a section 704(c)(1)(C) basis adjustment has been allocated is distributed to a partner other than the section 704(c)(1)(C) partner (and section 704(c)(1)(B) does not apply), that basis adjustment will not be taken into account in determining the distributee partner's basis in the distributed property, and the section 704(c)(1)(C) basis adjustment will be reallocated among the remaining partnership property. Prop. Reg. §1.704-3(f)(3)(v)(B).
      - If Land and Building is distributed to Kramer, the distributed property will be treated as having a basis of \$50, and the section 704(c)(1)(C) basis adjustment will be reallocated to other capital gain property and allocated to Elaine

## Distributions and Section 704(c)(1)(C) Property

- **Transfers of section 704(c)(1)(C) property by partnership**
  - Distributions of section 704(c)(1)(C) property by the partnership
    - If a section 704(c)(1)(C) partner receives a distribution of property other than the section 704(c)(1)(C) property in liquidation of its partnership interest, the adjusted basis to the partnership of the distributed property immediately before distribution includes the section 704(c)(1)(C) partner's basis adjustment for the property in which the section 704(c)(1)(C) partner relinquished an interest. Prop. Reg. §1.704-3(f)(3)(v)(C).

# Contributions of Section 704(c)(1)(C) Property

- **Transfers of section 704(c)(1)(C) property by partnership**
  - Contributions under section 721
    - If a partnership, in a transaction qualifying under section 721(a), contributes to another partnership property to which a section 704(c)(1)(C) basis adjustment has been allocated, the basis adjustment is treated as contributed to the lower-tier partnership. That portion of the basis adjustment in the hands of the lower-tier partnership must be segregated and allocated solely to the section 704(c)(1)(C) partner for whom the basis adjustment was made. Prop. Reg. §1.704-3(f)(3)(v)(B).
    - The interest in the lower-tier partnership received by the upper-tier partnership also is treated as section 704(c)(1)(C) property with respect to the original contributing partner.
    - To the extent any section 704(c)(1)(C) basis adjustment is recovered in a tiered-partnership context or is otherwise reduced, conforming adjustments must be made to prevent duplication of loss.
    - If the loss with respect to contributed property has increased since the original contribution, an additional section 704(c)(1)(C) basis adjustment will be created for the upper-tier partnership's interest in the lower-tier partnership assets

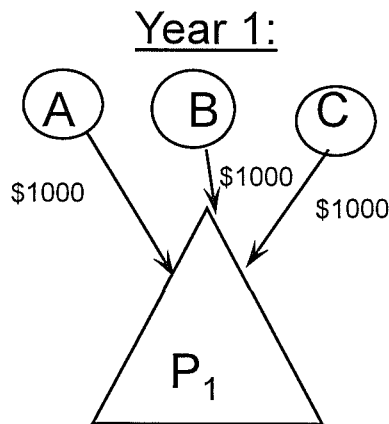
# Contributions of Section 704(c)(1)(C) Property

- **Transfers of section 704(c)(1)(C) property by partnership**
  - Contributions under section 351
    - If a partnership, in a transaction qualifying under section 351(a), contributes property to a corporation, the corporation's adjusted basis in the property transferred generally will be determined with reference to any section 704(c)(1)(C) basis adjustment to the contributed property. The section 704(c)(1)(C) basis adjustment will be reduced, however, to the extent that the adjustment reduces the gain recognized by the partner in connection with the contribution. A partner with a basis adjustment in property transferred to a corporation generally will have a section 704(c)(1)(C) basis adjustment in the stock received in the section 351 transaction. Prop. Reg. §1.704-3(f)(3)(v)(C).
      - Important to consider section 362(e) applicable to transfer of BIL assets to a corporation.

# Transfers of Section 704(c)(1)(C) Partnership Interests

- **Transfers of partnership interest by contributor of BIL property**
  - In general, if a partner with a section 704(c)(1)(C) basis adjustment transfers its partnership interest, the section 704(c)(1)(C) basis adjustment attributable to the transferred interest will be eliminated. Prop. Reg. §1.704-3(f)(3)(iii)(A).
  - If, however, the partnership interest is transferred in a nonrecognition transaction, the transferee will succeed to the transferor's section 704(c)(1)(C) basis adjustment. Prop. Reg. §1.704-3(f)(3)(iii)(B)(1).
    - This rule does not apply to transfers by gift. Prop. Reg. §1.704-3(f)(3)(iii)(B)(2).
    - In a nonrecognition transfer, the amount of any section 704(c)(1)(C) basis adjustment will be reduced to the extent the basis would be reduced if a section 754 election was in effect (regardless of whether such an election is in effect or the partnership property otherwise has a substantial built-in loss). Prop. Reg. §1.704-3(f)(3)(iii)(B)(1).

# Transfers of Section 704(c)(1)(C) Partnership Interests

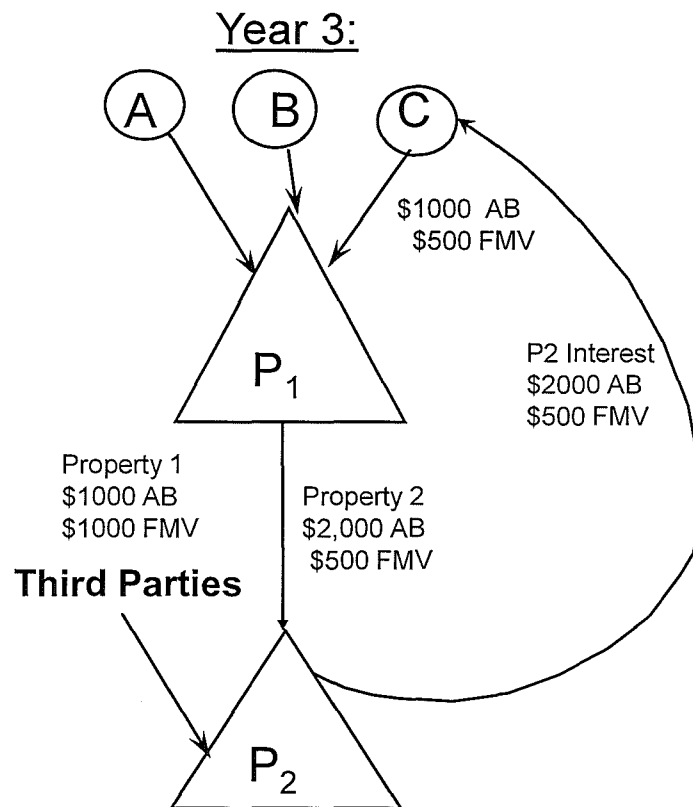


Property 1  
\$1000 AB  
\$1000 FMV

Property 2  
\$2000 AB  
\$2000 FMV

- A, B, and C each contribute \$1,000 to P<sub>1</sub>
- P<sub>1</sub> acquires two parcels of property, one for \$1,000 and one for \$2,000

# Transfers of Section 704(c)(1)(C) Partnership Interests



- At a time when Property 2 has fallen in value to \$500, P1 contributes Property 2 (still with an adjusted basis of \$2,000) to P2 in exchange for a P2 interest
- Property 2 has a \$1,500 section 704(c)(1)(C) basis adjustment with respect to P1
- When the P2 interest is distributed to C in liquidation of its interest, the \$1,500 section 704(c)(1)(C) basis adjustment generally would carry over to C
- However, because C will have a \$1,000 basis in the distributed P2 interest and a \$2,000 share of basis in P2 property, the partnership will reduce the section 704(c)(1)(C) basis adjustment in Property 2 by \$1,000 with respect to C
- For a detailed discussion of complexities in dealing with section 704(c)(1)(C) in partnership divisions, see *ABA Members Offer Detailed Comments on Proposed Regulations, 2015 Tax Notes Today 89-18 (May 8, 2015)*





# Section 732(d)

## Section 732(d) and Distributions of Partnership Assets Following the Acquisition of a Partnership Interest

- Under section 732(d), a partner who acquired all or part of its interest by a transfer with respect to which a section 754 election was not in effect, and to whom a distribution of property is made with respect to the transferred interest within two years of the transfer, may elect to treat the adjusted basis of the distributed property as if a section 743(b) adjustment existed with respect to such property
  - If the distributed property is not the same property that would have had the section 743(b) basis adjustment, the special basis adjustment may apply to any like property, provided that the distributee partner has relinquished its interest in property with respect to which it would have had a basis adjustment. Reg. §1.732-1(d)(1)(v).
- This rule can apply when the property that would have had the special basis adjustment has previously been sold or when the distributee partner is receiving a liquidating distribution and is relinquishing its interest in other property that would have had a basis adjustment

## Section 732(d) and Distributions of Partnership Assets Following the Acquisition of a Partnership Interest

- Under Reg. §1.732-1(d)(4), a partner who acquired any part of its interest by a transfer with respect to which a section 754 election was not in effect is required to apply the special basis adjustment rule in section 732(d) to a distribution, whether or not made within two years of the acquisition of the interest, if at the time of the acquisition of the interest
  - The fair market value of all partnership property (other than money) exceeded 110 percent of its adjusted basis to the partnership;
  - An allocation of basis under section 732(c) upon a liquidation of its interest immediately after a transfer of the interest would have resulted in a shift of basis from property not subject to an allowance for depreciation, depletion, or amortization, to property subject to such an allowance; and
  - A basis adjustment under section 743(b) would change the basis to the transferee partner of the property actually distributed.
    - E.g., At time of partnership interest acquisition, partnership holds depreciable assets with a built-in loss and non-depreciable assets with a built-in gain – two-way basis adjustments under section 743(b) would reduce basis in depreciable assets and increase basis in non-depreciable assets – section 732 does not have two-way basis adjustments, but section 732(d) special basis adjustment would change the result



# **Section 754 Elections**

## Section 754 Elections

- **Under Reg. §1.754-1(b), the section 754 election is made by including a statement in the partnership's timely filed income tax return which contains the following information**
  - Name and address of the partnership
  - The signature of any one of the partners
  - Declaration that the partnership elects to apply the provisions of sections 734(b) and 743(b)
- **For foreign partnerships, see Reg. §1.6031(a)-1(b)(5) and FSA 200025017**
- **There must be a distribution or sale or exchange (a “section 754 event”) in the year of the election in order for the election to be effective. Reg. §1.754-1(b) (referencing distribution of property or transfer of interest).**

## Section 754 Elections

- **If the partnership terminates under section 708(b)(1)(B) as a result of a section 754 event, the transferee partner can obtain a basis adjustment in partnership assets either by making a section 754 election on the terminating partnership's final return (Reg. §1.754-1(b) and Reg. §1.708-1(b)(5)) or on the initial return of the new partnership (Reg. §1.761-1(e)).**
  - Under Reg. §1.743-1(h)(1), a partner with a basis adjustment in property held by the partnership that terminates under section 708(b)(1)(B) will continue to have the same basis adjustment with respect to property deemed contributed by the terminated partnership to the new partnership regardless of whether the new partnership makes a section 754 election
  - If the partnership only has a section 754 election in place with respect to the new partnership, the “exchange” that justifies the section 743(b) basis adjustment is the distribution of the interest in the new partnership by the old partnership under the construct set forth in Reg. §1.708-1(b)(4).
    - Note that this distribution is a “substituted basis” transaction, which allocates the basis adjustment in a different manner than sale transactions

## Section 754 Elections

- According to the McKee treatise: “If both the terminated partnership and the new partnership make a § 754 election, it is unclear whether the basis adjustments with respect to the new partnership arising from the § 708(b)(1)(B) termination override those carried over from the terminated partnership. In order to eliminate this conflict, the application of Regulations § 1.743-1(h)(1) should probably be limited to cases in which the new partnership does not make a § 754 election.” McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, 24.04[1][a][iv] (WG&L).
- Prop. Reg. §1.743-1(f)(2) seems to clarify that, if both the terminated and new partnerships have a section 754 election in effect, the section 743(b) basis adjustment that occurs with respect to the terminated partnership will carry over to the new partnership

## Section 754 Elections

### ■ Reporting obligation of transferee partner

- In connection with a transfer to which a section 743(b) adjustment is relevant, the transferee partner must provide the partnership with written notification of the transfer within 30 days of the transfer. Reg. §1.743-1(k)(2)(i). This notification must be signed under penalties of perjury and contain the following information:
  - Names and addresses of transferee and transferor;
  - Relationship (if any) between transferee and transferor;
  - Date of the transfer;
  - The amount of any liabilities assumed or taken subject to by the transferee; and
  - The amount of money, the fair market value of any other property delivered or to be delivered for the transferred interest in the partnership, and any other information necessary for the partnership to compute the transferee's basis.
- The partnership is not required to make the adjustments until it has been notified of the transfer, but if the transferee notifies yet fails to provide the partnership with the required information, the partnership must attach a statement to the return in the year it is notified of the transfer. Reg. §1.743-1(k)(4) and (5).



# Section 754 Elections

- **What is included in the partnership return to reflecting the basis adjustment?**
  - Statement of adjustment
    - Reg. §1.743-1(k)(1)(i) requires
      - The name and EIN of the transferee partner;
      - Computation of section 743(b) adjustment; and
      - Partnership properties to which section 743(b) adjustment is allocated.
    - Reg. §1.734-1(d) requires
      - Computation of the section 734(b) adjustment; and
      - Partnership properties to which the adjustment is allocated.
    - The recovery of the adjustment must be reported on the face of the Schedule K-1 (e.g., it should not be reported solely as a footnote disclosure).

## Section 754 Elections

### ■ Section 9100 relief

- Reg. §301.9100-2 provides an automatic 12-month extension for making a section 754 election
- Must take “corrective action” in that period
  - Generally, file an original or amended return and otherwise comply with the provisions for properly making the election
- Any extension beyond the twelve-month period are subject to the general rules for section 9100 relief
  - Requires application for a private letter ruling

**Thank you**

Presentation by James B. Sowell

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