

Basis Adjustments for Partnerships and LLCs: Compliance Challenges

WEDNESDAY, DECEMBER 17, 2014, 1:00-2:50 pm Eastern

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Basis Adjustments for Partnerships and LLCs

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§754

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OVERVIEW

TWO BASIS CONSIDERATIONS

1. **OUTSIDE BASIS** – The adjusted basis of the partnership interest held by a partner
2. **INSIDE BASIS** – The adjusted basis of assets held by a partnership (ex. building)
 - Corporate shareholders have similar considerations
 - Partnerships have special rules

OUTSIDE BASIS

- Partners have a single outside basis
 - Determines gain/loss on sale
 - Affects consequences of partnership distributions
 - Determines deductibility of losses
 - Corporate shareholders have separate basis for each block

§705

- Outside basis is increased by share of income and contributions
- Decreased by share of losses/distributions
- Not Below Zero
- Balance is often present
- Basis determined without reference to capital account

EXAMPLE 1

- A contributes property adjusted basis = \$400
FMV=\$1,000
- B Contributes \$1,000
- Under agreement A's capital account is \$1,000
- But A's basis = \$400

OFF BALANCE

- Sale of a partnership – purchaser's outside basis is initially cost
- Death of a partner – step-up in outside basis

EXAMPLE 2

A \$50,000 50%

B \$50,000 50%

Purchase Building \$100,000

Building doubles in value

C Purchases B's interest for \$100,000

EXAMPLE 2 Continued

B reports \$50,000 gain

C's outside basis \$100,000

A's outside basis \$50,000

Total inside basis \$100,000

C's share of inside basis \$50,000

EXAMPLE 2

- **OUT OF BALANCE**
- §743(a) – Basis of partnership property – generally not adjusted as a result of a transfer of a partnership interest (or a distribution of partnership property §734(a))

§742

- Basis of transferee partner's interest in partnership is determined under general rules
- §1011 cost; from a decedent FMV and share of liabilities- IRD

ENTITY APPROACH

- §743(a) follows entity approach
- General rule views the partnership as an entity distinct from its partners
- Acquirer would not receive a basis adjustment in partnership assets
- Corporation is similar

§754 ELECTION

BALANCE

- Upon sale or exchange or upon death §743(b)
- §734(b) upon distribution of property to a partner
- Basis of partnership property is adjusted
- Provided §754 election is made
- Adjustment may be positive or negative

§743(b) BASIS ADJUSTMENT

- Protects purchasing partner
- “As If” purchased a pro rata interest in partnership assets
- Only for transferee partner

§754

- If partnership files an election
- In accordance with regulations
- Basis of partnership property
- Is adjusted
- As provided in §734 and §743

EXAMPLE 2 Continued

- If §754 election
- C receives inside basis in the real property of \$100,000 – C paid for the adjustment
- Binding on partnership in year of election and all subsequent years
- May result in a positive or negative basis adjustment
- **Positive adjustment:** o/s basis is $>$ adjusted basis of partnership property

WHAT HAPPENS UNDER §743(b)?

HARMONY & BALANCE

- Inside/Outside
- C gets the benefits he paid for – depreciation – less gain if asset is sold
- Estate receives ability to sell without double tax

§743 BASIS ADJUSTMENT

- **DIFFERENCE BETWEEN** transferee's initial basis for partnership interest and transferee's proportionate share of the adjusted basis of partnership property
- In our example, the \$50,000 difference
- Follows the aggregate approach

POSITIVE/NEGATIVE

- If transferee's basis in Partnership Interest $>$ share of allocable basis of partnership property, the adjustment **increases** the basis of partnership property
- The opposite results in a **decreased** basis – if values are declining and o/s basis $<$ transferee's proportional share of basis in partnership property
- **BALANCE GENERALLY ACHIEVED**

TAX EFFECT TO TRANSFEREE

- §743(b) **positive basis** adjustments will **reduce** transferee's income
- Increased depreciation deduction
- Reduced allocable gain on sale of partnership assets

EXAMPLE

- Partnership holds appreciated rental properties
- Partner A dies – no §754 election
- Outside basis step-up
- Partnership sells asset A – allocable amount of gain passes to estate – no inside basis increase
- Increases outside basis
- Timing results in future capital loss when interest is disposed of

PRACTICE POINTS

- Send request letter
- Read partnership agreement or operating agreement

DETERMINATION OF INSIDE BASIS

- Share of adjusted basis of partnership property
 - Equals sum of interest in previously taxed capital **PLUS** share of partnership liabilities

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PREVIOUSLY TAXED CAPITAL

- \$ transferee would receive on a hypothetical liquidation
 - Increased by allocated tax loss
 - Decreased by allocated tax gain

HYPOTHETICAL TRANSACTION

- Disposition of all partnership assets
- Immediately after the transfer
- In a fully taxable transaction
- At FMV

EXAMPLE: §754 ELECTION MADE

- A sells to T for \$22,000

	BASIS	FMV
CASH	\$5,000	\$5,000
A/R	\$10,000	\$10,000
INVENTORY	\$20,000	\$21,000
BUILDING	\$20,000	\$40,000
TOTAL ASSETS	\$55,000	\$76,000
LIABILITIES	\$10,000	\$10,000
CAPITAL – A	\$15,000	\$22,000
CAPITAL – B	\$15,000	\$22,000
CAPITAL – C	\$15,000	\$22,000
TOTAL LIAB/CAPITAL	\$55,000	\$76,000

EXAMPLE continued

- §743(b) basis adjustment = \$7,000
- O/S Basis = \$25,333 (cash + share of liabilities)
- T's interest in taxed capital = \$15,000 (\$22,000 liquidation interest LESS tax gain = \$7,000)
- T's share of liabilities = \$3,333

EXAMPLE continued

- O/S Basis = \$25,333
- Less share of inside basis = \$18,333
- **§743(b) BASIS ADJUSTMENT** \$ 7,000

§755 METHOD

- **STEP ONE** – Determine Inside/Outside basis adjustment
- Basis inside assets vs. outside basis
- Basis includes share of debt
- **STEP TWO** – Allocate basis adjustment
- Allocate between asset classes
- Allocate among items within class

§755 METHOD continued

1. **Must value all assets – FMV facts & Circumstances**
 - Reg. 1.755-1(a)(1)
 - Two Groups
 - Ordinary Income Assets (including §751 unrealized A/R)
 - Capital §1231 Assets
 - If trade/business residual method §197 intangibles. Reg. 1.1060-1

§ 751

- Ordinary income assets
- Form 8308 required

§755 METHOD continued

1. **Must value all assets – FMV facts & Circumstances**
 - Reg. 1.755-1(a)(1)
 - Two Groups
 - Ordinary Income Assets (including §751 unrealized A/R)
 - Capital §1231 Assets
 - Trade/business residual method §197 intangibles. Reg. 1.1060-1

§755 ALLOCATIONS

2. **Allocate basis adjustment between two asset classes**
 - One class may increase and the other decrease even if basis adjustment is zero
 - **Ordinary Income Group** – First allocate gain/loss as if sold at FMV
 - **Capital Asset Group** – Receives §743(b) adjustment less that allocated to ordinary income group
 - This order protects purchasing partner from receiving Ordinary Income

§755 ALLOCATIONS

3. Allocate among assets within group

- If a trade or business (Reg. 1.1060-1(b)(2)) use residual method to allocate to §197 Intangibles
- Special rules apply if not a trade/business

TRANSFEEE PARTNER

- Must notify the partnership of the transfer
- Within 30 days
- Names, address, TIN of transferor and transferee
- Date of transfer
- Relationship and other tax information (ex. purchase price and liabilities assumed)

PARTNERSHIP

- Also has disclosure rules
- Identify transferee
- Show basis adjustment and allocations

PARTNERSHIP REPORTING

- Identify transferee
- Transferee's TIN
- Computation of Basis Adjustment

Transferee's Basis in Partnership Interest	Transferee's Share of Basis in Partnership Property	Amount of Adjustment
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- Allocation to Partnership Properties

Asset	Basis	FMV	Adjustment Allocation
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WHAT DOESN'T HAPPEN

- **Capital account** of transferor carries over to the transferee
- §743 adjustments are not reflected in the capital account of the transferee
- Also disregard subsequent related adjustments (ex. increased depreciation)
- If purchase an interest subject to §704(c) the §754 election is imperative

Substantial Built-In Loss

- Basis of partnership property is adjusted – **even if** no §754 election
 - Transfer of partnership interest
 - Death of a partner
 - A distribution of property with a substantial basis reduction is treated similarly.

Substantial Built-In Loss (Cont.)

- If the partnership's adjusted basis in all partnership property exceeds FMV by more than \$250,000
- The substantial basis reduction for distributed property is similar.
- Does not apply to securitization partnerships and electing investment partnerships
- IRC §743(d) and §734(d)

Effects Of Treasury Reg. 1.743-1(j)

- §743 basis adjustment only affects transferee
- Partnership first computes income at the partnership level.
- Then allocates to partners IRC §704
- Then adjusts capital accounts accordingly
- **Then**, transferee's basis adjustment is reflected on K-1 as an adjustment to distributive share.
- But, adjustments do not affect capital accounts.

Example

- A & B partners: A contributes property – FMV \$500,000, basis \$1,000,000
- B contributes \$500,000 cash. A sells interest to C for \$500,000.
- If §754 election or substantial built-in-loss
- C negative basis adjustment \$500,000
- Will affect C on sale of property
- Offsets §704(c) loss allocated to C

Depreciation Recapture

- Partner reports his/her distributive share of depreciation recapture.
- Based upon total amount of depreciation allowed or allowable allocated to that partner
- On transfer of partnership interest – depreciation recapture allocated to transferee

Effect Of §754 Election

- §743(b) basis adjustment alters result.
- Only depreciation claimed after the date of acquisition of the partnership interest is taken into effect for the recapture computation.

Example

- A & B partnership purchases equipment for \$5,000; 90% depreciation to A, 10% to B
- A receives depreciation on deduction of \$900, B \$100
- Sale of property for \$5,000
- §1245 recapture to A = \$900
- If T purchases A's interest, make sure §754 election is in place
- To minimize recapture

ESTATES SPECIAL RULES

- §1014(a) – generally, basis step-up to FMV (at death or alternate valuation date)
- §1014(c) – **IRD** exception – no step-up for IRD items
- Reg. §1.742-1 – similarly excludes **IRD** and includes successor's share of Partnership liabilities
- **IRD** consists of D's right to income not received before death. Taxed to recipient (estate or beneficiary)

IRD & PARTNERSHIPS

- Treas. Reg. §1.755-1 – “if...the partnership holds assets representing [IRD], no part of the basis adjustment under §743(b) is allocated to these assets. See §1.743-1(b)
- §736(a) – liquidation payments due to D and paid to successor. Reg. 1.753-1
- D’s interest in zero basis A/R and other income rights (some disagreement exists, see §753)

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BASIS ADJUSTMENTS FOR PARTNERSHIPS AND LLCs

§ 754 – PART II

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Section 734(b)

- Section 734 provides rules to eliminate inside-outside basis disparities on distributions to partners
- Section 734(a) - no basis adjustment unless §754 election or mandatory adjustment required
- Section 734(b) - basis adjustment available if:
 - Partner recognizes gain under Section 731
 - Asset basis is increased or decreased on distribution to a partner
- Basis adjustment to the partnership can benefit any remaining partner

Computation of the Section 734 Adjustment

Positive basis adjustment

=

Capital gain recognized by partner

+

Excess of inside basis over partner's basis in property (step-down distributed property)

Negative basis adjustment

=

Capital loss recognized by partner

+

Excess of partner's basis in property over inside basis (step-up distributed property)

Allocation Rules – Section 755

- Allocating basis adjustments to assets:
 - Basis adjustment resulting from recognition of capital gain or loss by distributee partner is allocated to capital gain property
 - Basis adjustment resulting from increase or decrease in distributed property under substituted basis rules is allocated to remaining property in same class

As discussed for Section 743(b), the Section 734(b) adjustment is mandatory if there is a substantial basis reduction – that is, if the computed adjustment is negative >\$250,000.

Example

- ABC Distributes Land to A in liquidation of his interest.
- If ABC does not make a Section 754 election and later sells Cap Asset:
 - ABC's gain is \$260,000
 - B and C's combined built-in gain in their interests is \$200,000.
- A Section 734(b) adjustment of \$60,000 for the reduction of basis in the land distributed to A would correct this inequity.

		<u>Basis</u>	<u>FMV</u>
Land – Invest.		100,000	140,000
Cap. asset		<u>20,000</u>	<u>280,000</u>
		\$120,000	\$420,000
Capital			
	A	40,000	140,000
	B	40,000	140,000
	C	<u>40,000</u>	<u>140,000</u>
Total		\$120,000	\$420,000

Making the Section 754 election

- I. The election should:
 - A. Be made in writing
 - B. Be filed with the partnership return for year during which the distribution from the partnership or the transfer of the partnership interest (via sale or exchange or transfer at death) occurs
 - C. Include name and address of the partnership
 - D. Include a statement of election to apply provisions of §§734(b) and 743(b)
 - E. Include signature of a partner

The election applies until it is revoked with IRS consent or upon termination

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Section 732(d) – elective

- At the option of distributee partner and if property is distributed within two years of acquiring partnership interest, distributee partner can elect to determine his or her tax basis in distributed property as if a §754 election had been made
- Consequently, inside basis of property will include a hypothetical §743(b) adjustment

Section 732(d) – Example

- P purchased an interest in ABC partnership last year.
 - At the time of the purchase, ABC owned land with an adjusted basis of \$75,000.
 - ABC has no §754 election in effect. If the election had been in effect, P would have a \$9,000 positive basis adjustment for the land.
 - This year, ABC distributed the land to P.
- Under §732, P's basis in the land is \$75,000.
 - If P makes a §732(d) election, P's basis in the land is \$84,000 as if a §754 election were in effect.

Section 732(d) – mandatory

- If certain conditions are met, including:
 - FMV of partnership assets (excluding money) > 110% of the assets' adjusted bases when transfer occurs
 - Allocation of basis under general rules would shift basis to depreciable, depletable, or amortizable property
 - Section 743(b) adjustment would change property basis to distributee

Section 732(f) – No Reduction Under §734 to Basis in Stock of a Corporate Partner

- Amends §755
- A downward basis adjustment under §734(b) may not be allocated to stock in a corporation (or any person related to such corporation) that is a partner in the partnership
- Designed to prevent a strategy highlighted in the JCT report on Enron transactions
- Downward adjustment must be allocated to other partnership property to the extent of basis in such property
- If adjustment exceeds the basis of the other partnership property, excess is gain to the partnership

Basis Adjustments in Connection With §708(b)(1)(B) Technical Terminations

- A partnership terminates if, within twelve months, 50 percent or more of the partnership's total capital and profits are sold or exchanged
- The partnership's taxable year closes on the date of the sale
- A multi-step transaction is deemed to occur:
 - Existing partnership contributes its property to a new partnership in exchange for an interest in the new partnership
 - Existing partnership makes a liquidating distribution of new partnership interests to the purchaser (and other partners)
 - Each partner's basis in new partnership equals its basis in existing partnership

Basis Adjustments in Connection With §708(b)(1)(B) Technical Terminations

- A §754 election generally will apply in a technical termination with respect to the purchasing partner since that partner is considered to be a partner of the old partnership for the instant prior to its termination
- In addition, the deemed liquidating distribution of the partnership interests to the new partnership in a technical termination is considered an exchange for the purposes of applying §743(b)
- Thus, a §754 election should apply and can be made for either the terminating partnership or the new partnership
- What is the difference?

Contingent Liabilities

- Should the deductions stemming from a contingent obligation be taken into account in determining gain or loss recognized in the “hypothetical transaction” in Treas. Reg. § 1.743-1?
- Are contingent liabilities are property to which basis adjustments may be allocated under Section 755?

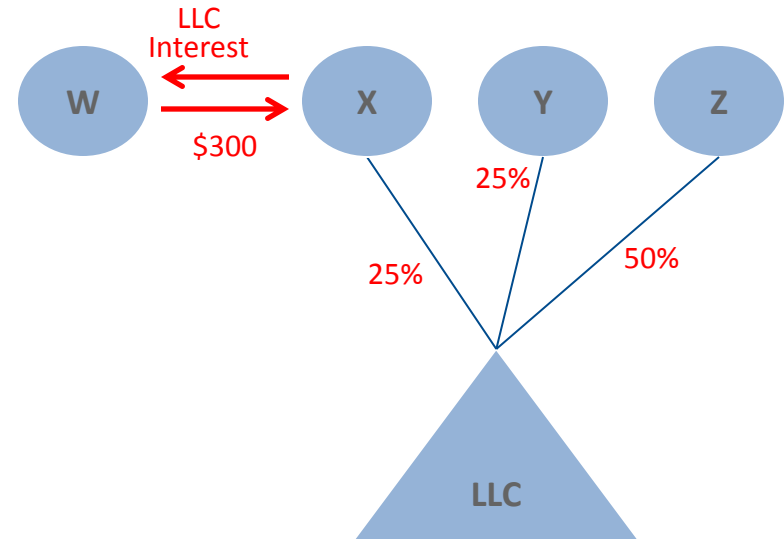
The answers are not clear

- “Treas. Reg. § 1.752-7 liabilities” are treated as Section 704(c) property under Treas. Reg. § 1.704-3(a)(12).
- The regulations under sections 743 and 755 do not expressly provide that contingent liabilities also qualify as property for purposes of sections 743 and 755.

Example 1: Section 743(b) adjustment with Contingent Liability treated as property

Year 1

- X, Y, and Z form LLC as a partnership for Federal income tax purposes.
- X contributes trade or business
 - Non-depreciable assets with FMV and tax basis \$300
 - Remedial method goodwill FMV \$200
 - Contingent Liability of \$200
- Y contributes \$300 cash
- Z contributes \$600 cash
- On Day 2, X sells its interest to W for \$300



Year 4

- LLC pays Contingent Liability of \$200

	FMV	Basis
Cash	900.	900.
Property	300.	300.
Goodwill	200.	0.
Cont. Liability	<u>(200)</u>	<u>0.</u>
Total	1,200.	1,200.

Example 1: Contingent Liability Treated As Property

W's Basis in PS Interest 300.

W's Share of Inside Basis

Cash received in hypothetical liquidation	300.
Plus hypothetical contingent deduction?	200.
Less hypothetical allocated gain	<u>(200)</u>
W's Share of Inside Basis	300.

Section 743(b) Basis Adjustment

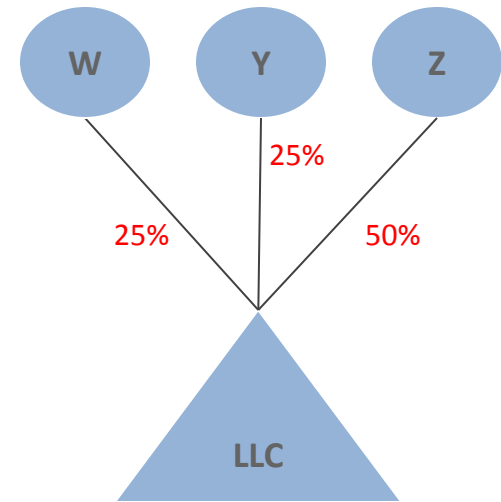
C's Basis in PS interest	300.
Less C's Share of Inside basis	<u>300.</u>
Section 743(b) Basis Adjustment	0.

Allocation of W's § 743(b) Adjustment to Assets

Goodwill	200.
Contingent Liability	<u>(200)</u>

W's annual amortization of Goodwill 13

W's Year 4 deduction for Contingent Liability 0



	FMV	Basis
Cash	900.	900.
Property	300.	300.
Goodwill	200.	0.
Cont. Liability	<u>(200)</u>	<u>0.</u>
Total	1,200.	1,200.

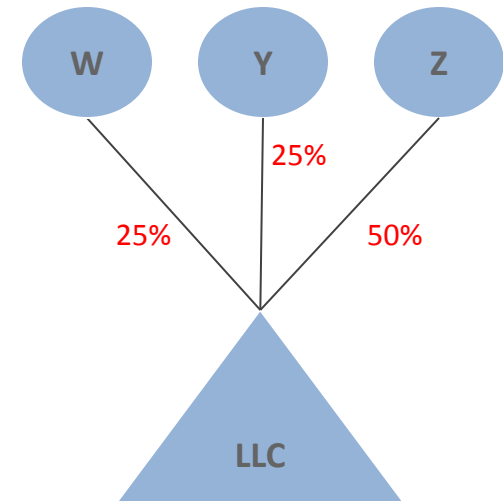
Example 2: Contingent Liability NOT Treated As Property

<u>W's Basis in PS Interest</u>	300.
<u>W's Share of Inside Basis</u>	
Cash received in hypothetical liquidation	300.
Plus hypothetical contingent deduction?	200.
Less hypothetical allocated gain	<u>(200)</u>
W's Share of Inside Basis	300.

<u>Section 743(b) Basis Adjustment</u>	
C's Basis in PS interest	300.
Less C's Share of Inside basis	<u>300.</u>
Section 743(b) Basis Adjustment	0.

<u>Allocation of W's § 743(b) Adjustment to Assets</u>	
Goodwill	0
Contingent Liability	0

<u>W's annual amortization of Goodwill</u>	0
<u>W's Year 4 deduction for Contingent Liability</u>	200



	FMV	Basis
Cash	900.	900.
Property	300.	300.
Goodwill	200.	0.
Cont. Liability	<u>(200)</u>	<u>0.</u>
Total	1,200.	1,200.

Circular 230

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