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IRC 732(d) Partnership and LLC Basis Adjustments for Tax Counsel

Mastering Elective and Mandatory Basis Adjustments on Distributed Property Absent a Partnership 754 Election

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1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Agenda

- Overview/Introduction to Basis Adjustments
- Section 754, 734, 743
  - Common issues, allocation, and example
- When does Section 732(d) apply?
- Impact of Section 732(d)
- Mechanics of Section 732(d) election

Section 754

- Partnership election to adjust basis of partnership property under sections 734 and 743
- Partnership makes election on a timely filed partnership return. *See* Treas. Reg. § 301.9100-2 for 12-month extension of time to file election
- Once made, election is effective for all future years unless revoked with approval of IRS
- Mandatory adjustments possible, even without section 754 election in effect

Section 734(a) – General Rule

The basis of partnership property shall not be adjusted as the result of a distribution of property to a partner unless the election, provided in section 754 (relating to optional adjustment to basis of partnership property), is in effect with respect to such partnership or unless there is a substantial basis reduction with respect to such distribution.

Partnership Distributions

- Current Distributions (section 732(a)(1) and (a)(2))
  - Any distribution if, after the distribution, the distributee remains a partner
  - Gain or loss recognized by distributee?
    - Generally, no gain or loss recognized
    - Exception: gain recognized if amount of cash distributed exceeds partner's outside basis
  - Basis considerations
    - Distributee generally takes a carryover basis in the distributed property, but basis is limited to the distributee's outside basis
    - Distributee partner reduces its outside basis by basis taken in distributed property

Partnership Distributions

- Liquidating Distributions (section 732(b))
  - Any distribution if, after the distribution, the distributee is no longer a partner
  - Gain or loss recognized by distributee?
    - Generally, no gain or loss recognized
    - Gain recognized if cash distributed exceeds partner's outside basis
    - Loss recognized if:
      - Only cash, unrealized receivables, and/or inventory are distributed, and
      - Amount of money and inside basis of assets distributed are less than distributee's outside basis
  - Distributee takes a substituted basis in distributed property after its outside basis has been reduced for any cash received

Section 743(a) – General Rule

The basis of partnership property shall not be adjusted as the result of a transfer of an interest in a partnership by sale or exchange or on the death of a partner unless the election provided in section 754 (relating to optional adjustment to basis of partnership property) is in effect with respect to such partnership or unless the partnership has a substantial built-in loss immediately after such transfer.

Basis Adjustments - Overview

- Section 754 – Election/mandatory
- Section 734(b) – Distribution of property/cash
- Section 743(b) – Transfers of partnership interest

Mandatory Basis Adjustments

- Where there is a "substantial basis reduction" or a "substantial built-in loss," sections 734(d) and 743(d) require basis adjustments under sections 734(b) and 743(b)
  - A substantial basis reduction for purposes of **section 734(b)** is a downward adjustment of more than $250,000
  - A substantial built-in loss for purposes of **section 743(b)** exists when the partnership's basis in its assets exceeds the assets' fair market value by more than $250,000
  - Rules under sections 734(b) and 743(b) do not apply to securitization partnerships
  - Section 743(b) basis adjustments to partnership assets do not apply to certain electing investment partnerships

Section 734(b) Example

X, Y, and Z are equal partners in partnership XYZ Capital Partners LP. On January 1, 2011, XYZ's balance sheet was as follows (amounts are in thousands):

Assets

	Book	Tax	FMV
Cash	$300	$300	$300
Securities	$1500	$1500	$600
Total	$1800	$1800	$900

Capital Accounts

	Book	Tax	FMV
X	$600	$600	$300
Y	$600	$600	$300
Z	$600	$600	$300
Total	$1800	$1800	$900

Section 734(b) Example (cont.)

On January 1, 2011, XYZ Capital Partners LP redeems Z for $300,000. XYZ does not have a section 754 election in place.

•The redemption of Z is a liquidating distribution.

•Z redeems his partnership interest for $300,000 and has an outside basis of $600,000. Therefore, Z recognizes a loss of ($300,000).

•XYZ does not (or cannot) allocate Z losses in a fill-down allocation.

•XYZ must reduce the basis of partnership assets due to the substantial basis reduction under section 734(b).

Section 734(b) Example (cont.)

Immediately after Z's redemption, XYZ Capital Partners LP's balance sheet is as follows (amounts are in thousands):

	Assets				Capital Accounts		
	Book	Tax	FMV		Book	Tax	FMV
Cash	$0	$0	$0	X	$300	$600	$300
Securities	$600	$1500	$600	Y	$300	$600	$300
Securities 734(b)		$(300)*					
Total	$600	$1200	$600	Total	$600	$1200	$600

*the basis adjustment would be allocated to the securities according to section 755

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 (e.g., building)

- Corporate shareholders have similar considerations
- Partnerships have special rules

OUTSIDE BASIS

- A partners has a single outside basis in its equity interest in a partnership
  - Determines gain/loss on sale
  - Affects consequences of partnership distributions
  - Determines deductibility of losses
  - Compare to a corporate shareholder that has a separate basis for each block of equity in the corporation

Section 705

- Outside basis is increased by share of income, contributions, and liabilities
- Decreased (not below zero) by share of losses and distributions
- Balance is often present
- Basis determined without reference to capital account

OFF BALANCE

- Sale of a partnership interest – purchaser's outside basis is initially cost

- Death of a partner – step-up in outside basis

EXAMPLE 1

- Partner A: $50,000 for 50%
- Partner B: $50,000 for 50%

AB purchases building for cost of $100,000

The building doubles in value to $200,000

C purchases B’s interest for $100,000

EXAMPLE 1 (continued)

- B reports $50,000 gain
- C's outside basis is $100,000
- A's outside basis remains $50,000

Partnership's total inside basis: $100,000

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

EXAMPLE 1 (continued)

OUT OF BALANCE

- Section 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 section 734(a))

Section 742

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

ENTITY APPROACH

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

BALANCE

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

Section 743(b) BASIS ADJUSTMENT

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

Basis of distributed property – Section 732

Basis of Distributed Property Other than in Liquidation

– Current Distributions

- Section 732(a)(1): The basis of property (other than money) distributed by a partnership to a partner other than in liquidation of the partner's interest shall, except as provided in section 732(a)(2), be its adjusted basis to the partnership immediately before such distribution.
- Section 732(a)(2): The basis to the distributee partner of property to which section 732(a)(1) is applicable shall not exceed the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.
- Special allocation rules under section 732(c) apply when multiple properties are distributed to a partner.

Basis of Distributed Property In Liquidating Distributions

– Liquidating Distributions
  - Section 732(b): The basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner’s interest shall be an amount equal to the adjusted basis of such partner’s interest in the partnership reduced by any money distributed in the same transaction.
  - Special allocation rules under section 732(c) apply when multiple properties are distributed to a partner.

Basis Allocation Under Section 732(c)

- First, allocate basis to unrealized receivables and inventory (Treas. Reg. § 1.732-1(c)(1)(i)).
  - Allocation is equal to each such property's adjusted basis in the hands of the partnership immediately before the distribution.
  - If the basis to be allocated is less than the sum of the partnership's basis in the unrealized receivables and inventory, then the basis of the distributed property is adjusted under Treas. Reg. § 1.732-1(c)(2)(i).

Basis Allocation Under Section 732(c) (continued)

– Second, allocate basis to other property received in the distribution (Treas. Reg. § 1.732-1(c)(1)(ii)).
  - Assign each distributed property an amount equal to such property's adjusted basis in the hands of the partnership immediately before the distribution.
  - If the sum of the adjusted bases in the hands of the partnership does not equal the basis to be allocated among the distributed property, any increase or decrease required to make the amounts equal is allocated among the distributed property as provided in Treas. Reg. § 1.732-1(c)(2).

Basis Allocation Under Section 732(c) (continued)

- Decreases in basis under Treas. Reg. § 1.732-1(c)(2)(i)
  - Allocated first to distributed property with unrealized depreciation in proportion to each property's respective amount of unrealized depreciation (and only to the extent of each property's unrealized depreciation).
  - Any excess decrease is allocated to the distributed property in proportion to the adjusted bases of the distributed property (after being adjusted as described above).

Basis Allocation Under Section 732(c) (continued)

- Increases in basis under Treas. Reg. § 1.732-1(c)(2)(ii)
  - Allocated first to distributed property (other than unrealized receivables and inventory items) (“Other Distributed Property”) with unrealized appreciation in proportion to each property’s respective amount of unrealized appreciation before any increase (but only to the extent of each property’s unrealized appreciation).
  - Any excess increase is allocated to the Other Distributed Property in proportion to the fair market value of the Other Distributed Property.

Basis Allocation Under Section 732(c) (continued)

– If the basis to be allocated upon a distribution in liquidation of the partner's entire interest in the partnership is greater than the adjusted basis to the partnership of the unrealized receivables and inventory items distributed to the partner, and there is no other property distributed to which the excess can be allocated, the distributee partner sustains a capital loss under section 731(a)(2) to the extent of the unallocated basis of the partnership interest.

Application of Section 732(d)

Section 732(d) - Overview

– Section 732(c) provides special rules for determining a partnership's basis in property (other than money) when that property is distributed to a partner that acquired all or part of its partnership interest by sale, exchange, or upon the death of a partner at a time when the partnership did not have a section 754 election in effect.
– Section 732(d) can have an **elective** or **mandatory** application.

Section 732(d) – Overview (continued)

– Section 732(d) applies to situations in which a partnership does not have a section 754 election in effect and a partner
  - who would have a positive section 743(b) adjustment
  - if the partnership had a section 754 election in effect
  - receives a current or liquidating distribution of property from the partnership

Section 732(d) – Elective Regime

- Section 732(d) provides, in part, the following (emphasis added):
  - For purposes of computing a distributee's basis in distributed assets under sections 732(a), (b), and (c), a partner who acquired all or a part of its interest by a transfer with respect to which the election provided in section 754 is not in effect, and to whom a distribution of property (other than money) is made with respect to the transferred interest within 2 years after such transfer, **may elect**, under regulations prescribed by the Secretary, to treat as the adjusted partnership basis of such property the adjusted basis such property would have if the adjustment provided in section 743(b) were in effect with respect to the partnership property.

Section 732(d) – Mandatory Regime

- Section 732(d) provides, in part, the following (emphasis added:
  - The Secretary **may by regulations require** the application of this subsection in the case of a distribution to a transferee partner, whether or not made within 2 years after the transfer, if at the time of the transfer the fair market value of the partnership property (other than money) exceeded 110 percent of its adjusted basis to the partnership.
  - As discussed later, regulations issued under section 732(d) require other conditions to be met before there can be a mandatory application of section 732(d).
- Allocation of the section 732(d) adjustment
  - The section 732(d) adjustment is allocated according to the rules described in section 755.

Section 732(d) – Allocation of the section 732(d) adjustment

– The section 732(d) adjustment is allocated according to the rules described in section 755.

Section 732(d) - History

- Section 732 became part of the Code when subchapter K was enacted in 1954.
  - As originally enacted, section 732(c) required that the basis of a liquidated partnership interest (or the basis of a partnership interest to which section 732(a)(2) applied) be first allocated to any unrealized receivable and inventory items in an amount equal to the adjusted basis of each property to the partnership and then to other distributed assets in proportion to their predistribution basis to the partnership.
  - Because taxpayers could use this simple allocation method to shift basis from non-depreciable property to depreciable property, Congress enacted section 732(d) to reduce the opportunity for basis shifts.

Section 732(d) – History (continued)

- The example in the legislative history is as follows.
  - Partnership AB owns 2 parcels of land which have a basis to the partnership of $5,000 each and are worth $55,000 each, and depreciable property with a basis and value of $90,000.
  - C purchases A's partnership interest for $100,000, and shortly thereafter the partnership is dissolved. C receives 1 of the 2 parcels of land which had a basis to the partnership of $5,000 and half the depreciable property which had a basis to the partnership of $45,000.
  - If C's basis for his interest, $100,000, were allocated to the properties received by him in proportion to their respective bases to the partnership, the basis to him for the distributed land would be $10,000 and the basis of the depreciable property would be $90,000.

Section 732(d) – History (continued)

- As a result, C would, in effect, apply as the basis of depreciable property the amount which he had paid for nondepreciable property.
- To prevent this result, the regulations may require C to allocate to the land that portion of the basis of his interest properly allocable thereto, $55,000.
- The depreciable property will then take a basis of $45,000.

Section 732(d) – History (continued)

– In 1997, section 732(c) was amended to reflect the current basis allocation rules.
– The current rules under section 732(c) reduce the opportunity to shift basis to depreciable assets.
– Despite these changes, the Treasury and IRS decided to retain the mandatory aspect of section 732(d).

Section 732(d) – Elective Regime

- Example
  - XYZ is an equal partnership with two assets –
    - (1) cash of $6,000 and
    - (2) inventory with a basis of $5,700 and a fair market value of $6,000.
  - X sells his interest to A for $4,000.
  - XYZ did not have an election in effect for the taxable year in which the sale occurred.
  - If the partnership were to sell the inventory for $6,000, the partnership would allocate $100 of ordinary income to A.

- This result can be avoided, however, if the partnership distributes A’s portion of the inventory (1/3 of $2,000) to A, and A makes an election under section 732(d).
- As a result, A would receive $2,000 worth of inventory with a basis of $2,000.

Section 732(d) – Elective Regime

- Advantages
  - A section 732(d) election can provide the benefit of a basis step-up without committing the partnership to make future adjustments under sections 743(b) and 734(b).
  - Unlike the 732(c) basis allocation rules, a section 743(b) adjustment can increase the basis of unrealized receivables and inventory.
- Disadvantages
  - If the distribution of the property is closely followed by a sale of that distributed property, the transaction may be vulnerable to attack.
  - It may be difficult for the other partners to agree on a distribution of an asset.

Section 732(d) – Mechanics of the Election

- How is the election made?
  - A transferee partner must make the election with his tax return (1) for the year of the distribution, if the distribution includes any property subject to the allowance for depreciation, depletion, or amortization, or (2) for any taxable year not later than the first year in which the basis of distributed property is pertinent to the distributee’s income tax liability, if the distribution does not include any property subject to the allowance for depreciation, depletion or amortization.
  - The election must include a statement setting for the following: (1) that the distributee elects to adjust the basis of distributed property under section 732(d), and (2) the computation of the special basis adjustment for the property distributed and the properties to which the adjustment has been allocated under section 755.

Section 732(d) – Mechanics of the Election

- Required Statements.
  - If a transferee partner notifies a partnership that it plans to make a 732(d) election, the partnership is required to provide the transferee with the information necessary for the transferee to property compute the transferee's basis adjustments under section 732(d). Treas. Reg.
  - The requirement also applies if the application of section 732(d) is mandatory.

Section 732(d) – Mandatory Regime

- A partner who acquired any part of its partnership interest in a transfer to which the election provided in section 754 was not in effect, is <u>required</u> to apply the special basis rule contained in section 732(d) to a distribution to it, whether or not made within 2 years after the transfer, if at the time of its acquisition of the transferred 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 his interest immediately after the 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.

Section 732(d) – Mandatory Regime

- When might section 732(d) be mandatory?
  - The partnership distributes appreciated inventory and depreciable property to the partner. The basis allocation rules of section 732(c) limit the basis allocated to the inventory causing additional basis to be allocated to depreciable property.
  - If the inventory is expected to be sold quickly, the mandatory application of section 732(d) may be beneficial.
- When is the application of section 732(d) not mandatory?
  - If the basis allocation rules of section 732(c) shift basis from depreciable property with longer lives to depreciable property with shorter lives. However, there must be a business purpose for the transaction. *See* TAM 9734003 (April. 14, 1997).

Section 732(d) – Amount of the Adjustment

– If an election under section 732(d) is made upon a distribution of property to a transferee partner, the amount of the adjustment with respect to the transferee partner is not diminished by any depletion or depreciation of that portion of the basis of partnership property which arises from the special basis adjustment under section 732(d), since depletion or depreciation on such portion for the period prior to distribution is allowed or allowable only if the optional adjustment under section 743(b) is in effect.

Section 732(d) – Distribution of Other Property

- What if the property distributed is not property with respect to which the distributee partner would have been entitled to a special basis adjustment under section 743(b)?
- Treas. Reg. § 1.732-1(d)(1)(v) provides that the special basis adjustment will apply to any like property received in the distribution, provided that the transferee, in exchange for the property distributed, has relinquished his interest in the property with respect to which he would have had a special basis adjustment. This rule applies whether the property in which the transferee has relinquished his interest is retained or disposed of by the partnership.

Section 732(d) – Interaction with Section 751(b)

- Treas. Reg. § 1.732-1(e) provides that section 732 (including subsection (d)) applies in determining the partner's basis of the property which it is treated as having sold or exchanged with the partnership (as constituted after the distribution).
  - The partner is considered as having received such property in a current distribution and, immediately thereafter, as having sold or exchanged it.
  - However, section 732 does not apply in determining the basis of that part of property actually distributed to a partner which is treated as received by it in a sale or exchange under section 751(b).
  - Consequently, the basis of such property shall be its cost to the partner.
- Special basis adjustments, including section 732(d), are excluded from the determination of whether a partnership's inventory items are substantially appreciated.

Section 732(d) – Other Issues

- Amortizable Intangibles
  - The anti-churning rules do not apply to an increase in the basis of a section 197(f)(9) intangible under section 732(d) if, had an election been in effect under section 754 at the time of the transfer of the partnership interest, the distributee partner would have been able to amortize the basis adjustment made pursuant to section 743(b).
- Section 734(b)
  - Under Treas. Reg. § 1.734-2(a), any adjustment to basis under section 732(d) is taken into account for purposes of computing the amount of the section 734(b) adjustment.

The Marketable Securities Exception – 731(c)

Rule: Distribution of marketable securities is treated like a distribution of cash

- Marketable securities are financial instruments and foreign currencies that are actively traded
- Gain recognized by partner if FMV exceeds outside basis
- Partner’s basis is 732 basis plus gain recognized by partner
- Amount deemed distributed to partner reduced by decease in partner’s distributive share of net gain in partnership’s marketable securities

WHAT HAPPENS UNDER Section 732(d)?

Example

- Partnership Assets:
  - Land: Basis of $5,000 and a FMV of $55,000
  - Depreciable Property (*e.g.* Equipment): $45,000 and a FMV of $45,000
- The partnership's basis in the depreciable property ($45,000) was substantially higher than the partnership's basis in the land ($5,000), though the value of the land ($55,000) was higher than the value of the depreciable property ($45,000), the bulk of *C*'s basis in its partnership interest of $100,000 would be allocated to the depreciable property ($90,000)

Example (continued)

- Partnership Assets:
  - Land: Basis of $5,000 and a FMV of $55,000
  - Depreciable Property (*e.g.* Equipment): $45,000 and a FMV of $45,000
- Partner C's Basis
  - W/O Sec. 732(d):
    - Land - $10,000 & Depreciable Property - $90,000
  - With Sec. 732(d):
    - Land - $55,000 & Depreciable Property - $45,000

Partnership Property Distributions – section 732(d)

– Consequences

- No gain or loss to partnership or partner
- Partner's basis in distributed property equals partnership's basis, but cannot exceed partner's basis in partnership reduced by money realized in same transaction
- Partner Election: If partner who receives property distribution acquired partnership interest within last 2 years by purchase, exchange or inheritance, may elect to increase such partnership's inside basis in property allocable to such partner to equal partner's outside basis
  - Election only good for determining basis of distributed property (732(d), 743(b))
- Partner's outside basis reduced by 732 basis of property to partner

Example

Facts:

- New Partner (D) buys 1/3 interest for $40,000
- Partnership has:
  - receivables (basis $0, value $30,000)
  - land (basis $60,000, value $90,000)
- $10,000 of receivables distributed to each partner

Section 732(d) – Restores Balance

- D's impact on the receivable distribution without a Sec. 732(d) election?
  - D takes zero basis in receivables, retains $40,000 outside basis, and recognizes $10,000 ordinary income on collections per Section 735
- Receivable distribution impact if D makes a Sec. 732(d) election?
  - 743(b) adjustment would give D $10,000 basis in receivables so no income on D's collection of those receivables
- D's outside basis after $10,000 AR distribution if Sec. 732(d) election made?
  - Outside basis goes from $40,000 to $30,000 per Sec. 733
- Partnership approval required for Sec. 732(d) election?
  - No. It is a partner election (Very different than a section 754, a partnership election)
- Sec. 732(d) election impact on land basis?
  - No immediate impact on basis. If land distributed to NP within 2 years of acquisition, then election would affect basis.

PRACTICE POINTS

- Evaluate whether a section 732(d) election is beneficial for your client.
- Read partnership agreement or operating agreement.
- Prepare statement to attach to tax return.

Thank You

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