

IRC 754: Partnership and Pass-Through Entity Basis Adjustments

Mastering Election Rules and Tackling Complex Decisions for Distributions and Sales of Interests

TUESDAY, MARCH 3, 2015, 1:00-2:50 pm Eastern

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IRC 754: Partnership and Pass-Through Entity Basis Adjustments

Mar. 3, 2015

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Dina Wiesen, Deloitte

BASIS OVERVIEW, SECT. 754, 734, 743 AND TIERED PARTNERSHIPS

Agenda

- Overview/Introduction to Basis Adjustments
- Section 754
- Section 734
 - Common issues, allocation, and example
- Section 743
 - Common issues, allocation, and example
- Section 754 Tiered Partnerships

Section 754

- Election to adjust basis of partnership property
- If made, partnership must adjust basis pursuant to sections 734(b) and 743(b)
- Election is made on a timely-filed partnership return. See 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 district director
- Mandatory adjustments without section 754 election in some cases

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
 - 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
 - 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(b) and 743(b) require basis adjustments
 - 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 the 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 755 Allocation Rules: Section 734(b) Adjustment

- First apply general rule of section 755(b) and divide partnership assets into two classes:
 - (1) Capital and section 1231(b) assets, and
 - (2) All other assets
- If distributee partner recognizes gain or loss because of the distribution, the section 734(b) adjustment is allocated to the capital and section 1231(b) class of assets
- If distributee partner takes distributed asset with a basis different from partnership's basis immediately before the distribution, amount of difference is allocated to same class of asset as distributed property

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				Capital Accounts		
	<u>Book</u>	<u>Tax</u>	<u>FMV</u>		<u>Book</u>	<u>Tax</u>	<u>FMV</u>
Cash	\$300	\$300	\$300	X	\$600	\$600	\$300
Securities	<u>\$1500</u>	<u>\$1500</u>	<u>\$600</u>	Y	\$600	\$600	\$300
Total	\$1800	\$1800	\$900	Z	<u>\$600</u>	<u>\$600</u>	<u>\$300</u>
				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		
	<u>Book</u>	<u>Tax</u>	<u>FMV</u>		<u>Book</u>	<u>Tax</u>	<u>FMV</u>
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

Section 755 Allocation Rules: Section 743(b) Adjustment

- Section 743(b) basis adjustment allocated to partnership assets generally equals gain or loss that would be allocated to the transferee from a hypothetical transaction where immediately after the transfer of the partnership interest all of partnership property is sold in a fully taxable transaction for fair market value
- Basis adjustments arising from the same transfer can be positive and negative
- Special rules for substituted basis transaction under Treas. Reg. §1.755-1(b)(5)

Section 743(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				Capital Accounts		
	<u>Book</u>	<u>Tax</u>	<u>FMV</u>		<u>Book</u>	<u>Tax</u>	<u>FMV</u>
Cash	\$300	\$300	\$300	X	\$600	\$600	\$300
Securities	<u>\$1500</u>	<u>\$1500</u>	<u>\$600</u>	Y	\$600	\$600	\$300
Total	\$1800	\$1800	\$900	Z	<u>\$600</u>	<u>\$600</u>	<u>\$300</u>
				Total	\$1800	\$1800	\$900

Section 743(b) Example (cont.)

On January 1, 2011, X acquires Z's one-third interest in Capital Partners LP \$300,000. XYZ does not have a section 754 election in place.

- The sale from Z to X is a trigger event under section 743(b)
- XYZ's basis in its assets is \$1,800,000 while the FMV is \$900,000. Therefore XYZ has a substantial built-in loss immediately after the sale.
- X's proportionate share of inside basis is \$600,000 while the outside basis in the purchased partnership interest is \$300,000.
- XYZ must reduce the basis of partnership assets by \$300,000 due to the excess inside basis over outside basis of the transferred partnership interest
- The basis adjustment only impacts X

Section 743(b) Example (cont.)

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

	Assets				Capital Accounts		
	<u>Book</u>	<u>Tax</u>	<u>FMV</u>		<u>Book</u>	<u>Tax**</u>	<u>FMV</u>
Cash	\$300	\$300	\$300	X	\$1200	\$900	\$600
Securities	\$1500	\$1500	\$600	Y	\$600	\$600	\$300
Securities 743(b)		\$(300)*					
Total	\$1800	\$1500	\$900	Total	\$1800	\$1500	\$900

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

** outside basis

Section 754: Tiered Partnerships

- Rev. Rul. 87-115
 - Upper-tier and lower-tier partnership must have election “in effect” in order to push section 743(b) adjustment down to lower-tier’s assets
- Rev. Rul. 92-15
 - Upper-tier and lower-tier partnership must have election “in effect” in order to push section 734(b) adjustment down to lower-tier’s assets
- Allocation of step-up among upper-tier partnership’s assets under section 755
 - Interest in lower-tier partnership treated as a capital asset for purposes of section 755, regardless of lower-tier partnership’s asset composition

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Overview of 734(b) and 743(b)

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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

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- 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

OFF BALANCE

- Sale of a partnership – 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 (\$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

The partnerships total inside basis \$100,000

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

EXAMPLE 1 continued

- **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))

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- 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

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

EXAMPLE 1 continued

- Assume a 754 election is made
- 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 2

- Partnership holds appreciated rental properties
- Partner A dies and no 754 election is made
- 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

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 2: 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 2 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 2 continued

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

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Adjustments to Basis of Partnership Property

EFFECT ON BASIS OF REMAINING PARTNERSHIP PROPERTY

Partnership's basis in partnership property not affected by distribution unless –

- Partnership has Section 754 election in place; or
- Distribution cause a substantial basis reduction in partnership property.

I.R.C. 734(a).

Impact of No Basis Adjustment

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	2100	2100	Liabilities	600	600
Blackacre	<u>1200</u>	<u>2400</u>	A Capital	900	1300
			B Capital	900	1300
			C Capital	<u>900</u>	<u>1300</u>
Total	3300	4500	Total	3300	4500

Partnership distributes \$1300 to A in redemption of interest

Partnership has made no Section 754 election

Each partner's tax basis in partnership interest equal to tax capital account

Impact of No Basis Adjustment

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	800	800	Liabilities	600	600
Blackacre	<u>1200</u>	<u>2400</u>	A Capital	0	0
			B Capital	700	1300
			C Capital	<u>700</u>	<u>1300</u>
Total	2000	3200	Total	2000	3200

What happens if P sells Blackacre for \$2400?

P recognizes \$1200 gain

B and C each taxable on \$600 gain allocated to them

Good result for B and C?

EFFECT ON BASIS OF REMAINING PARTNERSHIP PROPERTY

Section 754 Election -

Election to adjust basis of partnership property in the event of

- Sale or exchange of partnership interest by a partner (IRC 743(b)); or
- Distribution of partnership assets to partner ((IRC 734(b));

Substantial basis reduction occurs if the sum of -

- Loss recognized by distributee partner; plus
- Any basis increase of distributed property in hands of distributee partner exceeds \$250,000

I.R.C. 734(d).

BASIS INCREASES

- Partnership increases basis in partnership property by –
 - Gain recognized by distributee partner; plus
 - Excess of A/B of partnership property in hands of partnership over A/B of partnership property in hands of distributee partner (basis step down).

I.R.C. §734(b)(1).

BASIS DECREASES

- Partnership decreases basis in partnership property by –
 - Loss recognized by distributee partner; plus
 - Excess of A/B of partnership property in hands of distributee partner over A/B of partnership property in hands of partnership (basis step up).

I.R.C. §734(b)(2).

Impact of Section 734(b) Adjustment

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	2100	2100	Liabilities	600	600
Blackacre	<u>1200</u>	<u>2400</u>	A Capital	900	1300
			B Capital	900	1300
			C Capital	<u>900</u>	<u>1300</u>
Total	3300	4500	Total	3300	4500

Partnership distributes \$1300 to A in redemption of interest

Partnership has made Section 754 election

Basis in Blackacre increased by \$400 = gain recognized by A on distribution

Impact of Section 734(b) Adjustment

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	800	800	Liabilities	600	600
Blackacre	<u>1600</u>	<u>2400</u>	A Capital	0	0
			B Capital	900	1300
			C Capital	<u>900</u>	<u>1300</u>
Total	2400	3200	Total	2400	3200

What happens if P sells Blackacre for \$2400?

P recognizes \$800 gain

B and C each taxable on \$400 gain allocated to them

Good result for B and C?

Allocation of §734(b) Adjustments

Rules for allocating basis adjustments among multiple assets
(Treas. Reg. 1.755-1(a); 1.755-1(c))

- Determine the value of each of the partnership's assets.
- Determine the character of any assets distributed.
 - Basis adjustments arising from distributions of capital gain property are generally allocated to capital assets and 1231(b) property.
 - Basis adjustments arising from distributions of ordinary income property are generally allocated to ordinary income property.
- The basis adjustment allocated to each class is allocated among the items within each class.

Allocation of 734(b) Adjustments

Allocation of basis adjustments within a class (Treas. Reg. 1.755-1(c)):

- Basis adjustment resulting from the recognition of gain or loss from the distribution must be allocated to the partnership's capital gain property.
- Basis increases due to “lost basis” are allocated first to properties with unrealized appreciation up to and in proportion with their respective unrealized appreciation. Any excess is allocated among all properties in the class in proportion to FMV.
- Basis decreases due to “acquired basis” are allocated first to properties with unrealized depreciation up to and in proportion with their respective amounts of unrealized depreciation. Any excess is allocated among all the properties within the class in proportion to their adjusted bases (after taking into account the first allocation).

Allocation of 734(b) Adjustments

Special Rules:

- If a decrease in basis is required and the basis adjustment exceeds the remaining basis in the assets in a class, the assets are reduced to zero, but not below zero.
- When an increase or decrease in the basis of undistributed property cannot be made because the partnership owns no property of the character required to be adjusted, the adjustment is made when the partnership acquires property of a like character to which an adjustment can be made.

Allocation of Basis Step Up

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	800	800	Liabilities	600	600
Blackacre	900	1200	A Capital	0	0
Whiteacre	<u>300</u>	<u>1200</u>	B Capital	900	1300
			C Capital	<u>900</u>	<u>1300</u>
Total	2000	3200	Total	3300	4500

P distributes \$1300 to A

734(b) adjustment = \$400

Allocation of Basis Step Up

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	800	800	Liabilities	600	600
Blackacre	900	1200	A Capital	0	0
Whiteacre	<u>300</u>	<u>1200</u>	B Capital	700	1300
			C Capital	<u>700</u>	<u>1300</u>
Total	2000	3200	Total	2000	3200

734(b) adjustment = \$400

Unrealized Blackacre appreciation = \$300;

Basis Adjustment equals \$100 ($\$400 \times (\$300/\$1200)$)

Unrealized Whiteacre appreciation = \$900

Basis Adjustment equals \$300 ($\$400 \times (\$900/\$1200)$)

Allocation of Basis Step Up

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	800	800	Liabilities	600	600
Blackacre	1000	1200	A Capital	0	0
Whiteacre	<u>600</u>	<u>1200</u>	B Capital	900	1300
			C Capital	<u>900</u>	<u>1300</u>
Total	2400	3200	Total	2400	3200

734(b) adjustment = \$400

Unrealized Blackacre appreciation = \$300;

Basis Adjustment equals \$100 ($\$400 \times (\$300/\$1200)$)

Unrealized Whiteacre appreciation = \$900

Basis Adjustment equals \$300 ($\$400 \times (\$900/\$1200)$)

Limitation on Step Up Allocation

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	800	800	Liabilities	600	600
Blackacre	900	600	A Capital	0	0
Whiteacre	<u>300</u>	<u>1800</u>	B Capital	700	1300
			C Capital	<u>700</u>	<u>1300</u>
Total	2000	3200	Total	2000	4500

P distributes \$1300 to A

734(b) adjustment = \$400

Limitation on Step Up Allocation

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	800	800	Liabilities	600	600
Blackacre	900	600	A Capital	0	0
Whiteacre	<u>300</u>	<u>1800</u>	B Capital	700	1300
			C Capital	<u>700</u>	<u>1300</u>
Total	2000	3200	Total	2000	3200

734(b) adjustment = \$400

Unrealized Blackacre depreciation = \$300;

No basis adjustment

Unrealized Whiteacre appreciation = \$900

Basis Adjustment equals \$400

Limitation on Step Up Allocation

ASSETS			LIABILITIES/ CAPITAL		
	TAX/BOOK	FMV		TAX/BOOK	FMV
Cash	800	800	Liabilities	600	600
Blackacre	900	600	A Capital	0	0
Whiteacre	<u>700</u>	<u>1800</u>	B Capital	900	1300
			C Capital	<u>900</u>	<u>1300</u>
Total	2400	3200	Total	2400	3200

What happens if P sells Blackacre?

What happens if P sells Whiteacre?

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IRC 755 BASIS ALLOCATION RULES & INTEREST TRANSFER REQUIREMENTS

§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

§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

TRANSFeree PARTNER REQUIREMENTS

- 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 REQUIREMENTS

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

Q&A

You may use the Chat function to ask questions, or email questions to taxpreparer@straffordpub.com.

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Tell us how we did!

After you complete a brief survey of this program, we'll send you a **free \$5 Starbucks Gift Card**.

Look for our 'Thank You' email (which you should receive shortly) for details and the survey link!

Thanks.

Please join us for our next tax conference, “Sect. 704(c): Contributions to Partnerships and LLCs - Navigating Unsettled Issues, Complex Rules and Allocation Method Elections,” scheduled on Tuesday, April 28, 2015, starting at 1pm EST.

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