

IRC Section 734 Adjustments: Applying the 754 Election to Distributions of Partnership Property

An Advanced Case Study of Calculations and Considerations

THURSDAY, AUGUST 11, 2016, 1:00-2:50 pm Eastern

IMPORTANT INFORMATION FOR THE LIVE PROGRAM

This program is approved for 2 CPE credit hours. To earn credit you must:

- **Participate in the program on your own computer connection (no sharing)** - if you need to register additional people, please call customer service at 1-800-926-7926 x10 (or 404-881-1141 x10). Strafford accepts American Express, Visa, MasterCard, Discover.
- Listen on-line via your computer speakers.
- Respond to five prompts during the program plus a single verification code. You will have to write down only the final verification code on the attestation form, which will be emailed to registered attendees.
- To earn full credit, you must remain connected for the entire program.

WHO TO CONTACT DURING THE LIVE EVENT

For Additional Registrations:

-Call Strafford Customer Service 1-800-926-7926 x10 (or 404-881-1141 x10)

For Assistance During the Live Program:

-On the web, use the chat box at the bottom left of the screen

If you get disconnected during the program, you can simply log in using your original instructions and PIN.

Tips for Optimal Quality

FOR LIVE PROGRAM ONLY

Sound Quality

When listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, please e-mail sound@straffordpub.com immediately so we can address the problem.

IRC Section 734 Adjustments

Aug. 11, 2016

David Patch, Senior Director, National Tax Office Partnership Group

BDO USA, McLean, Va.

dpatch@bdo.com

Dina A. Wiesen, Senior Manager, National Tax Office, Passthroughs

Deloitte Tax, New York

dwiesen@deloitte.com

Notice

ANY TAX ADVICE IN THIS COMMUNICATION IS NOT INTENDED OR WRITTEN BY THE SPEAKERS' FIRMS TO BE USED, AND CANNOT BE USED, BY A CLIENT OR ANY OTHER PERSON OR ENTITY FOR THE PURPOSE OF (i) AVOIDING PENALTIES THAT MAY BE IMPOSED ON ANY TAXPAYER OR (ii) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY MATTERS ADDRESSED HEREIN.

You (and your employees, representatives, or agents) may disclose to any and all persons, without limitation, the tax treatment or tax structure, or both, of any transaction described in the associated materials we provide to you, including, but not limited to, any tax opinions, memoranda, or other tax analyses contained in those materials.

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 under Section 734

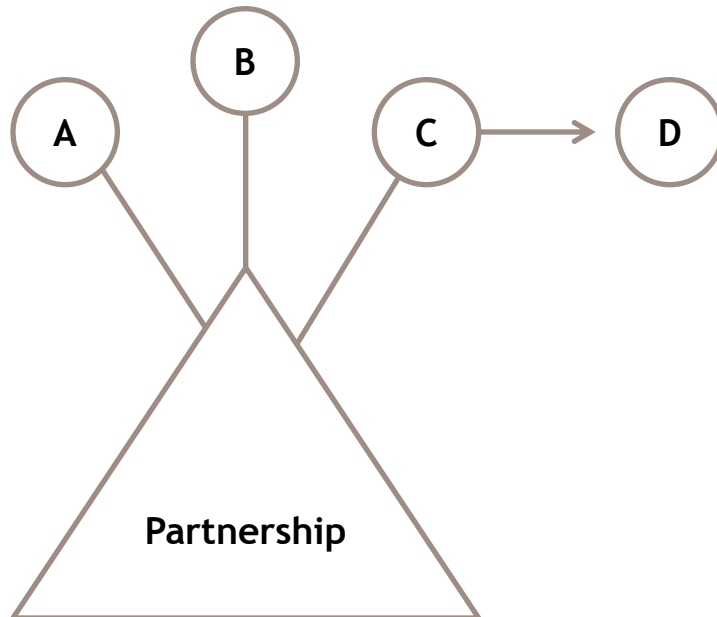
David Patch
BDO USA LLP

Agenda

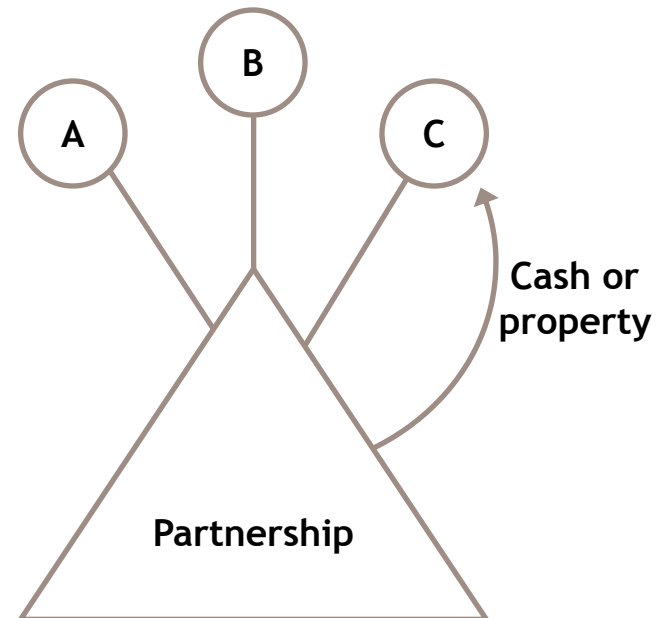
- Purpose of the adjustment
- Computation
- Making a section 754 election
- Mandatory adjustments
- Allocation of the adjustment
- Effect on taxable income
- Special Rules

Section 734 vs. 743

Section 743: Sale or exchange of a partnership interest



Section 734: Distribution by a partnership



Partnership ABC

	Tax Basis	Value
Cash	300,000	300,000
Investment	300,000	600,000
	<hr/>	<hr/>
	600,000	900,000
	<hr/> <hr/>	<hr/> <hr/>
Partner A	200,000	300,000
Partner B	200,000	300,000
Partner C	200,000	300,000
	<hr/>	<hr/>
	600,000	900,000
	<hr/> <hr/>	<hr/> <hr/>

Partnership ABC

	Tax Basis	Value
Cash	300,000	300,000
Investment	300,000	600,000
	<hr/>	<hr/>
	600,000	900,000
	<hr/> <hr/>	<hr/> <hr/>
Partner A	200,000	300,000
Partner B	200,000	300,000
Partner C	200,000	300,000
	<hr/>	<hr/>
	600,000	900,000
	<hr/> <hr/>	<hr/> <hr/>

Partnership ABC distributes \$300,000 to Partner A in liquidation of its interest

Partnership ABC

	Tax Basis	Value
Investment	300,000	600,000
	<u>300,000</u>	<u>600,000</u>
Partner B	200,000	300,000
Partner C	200,000	300,000
	<u>400,000</u>	<u>600,000</u>

Tax basis balance sheet is unbalanced

Partnership ABC

	Tax Basis	Value
Cash	600,000	600,000
Investment	300,000	600,000
	<hr/> 600,000	<hr/> 600,000
Partner B	350,000	300,000
Partner C	350,000	300,000
	<hr/> 700,000	<hr/> 600,000

ABC Sells Investment for \$600,000 and recognizes \$300,000 gain allocated \$150,000 to each of B and C increasing their bases to \$350,000

Partnership ABC

	Tax Basis	Value
Real Estate	300,000	300,000
Investment	300,000	600,000
	<hr/>	<hr/>
	600,000	900,000
	<hr/> <hr/>	<hr/> <hr/>
Partner A	200,000	300,000
Partner B	200,000	300,000
Partner C	200,000	300,000
	<hr/>	<hr/>
	600,000	900,000
	<hr/> <hr/>	<hr/> <hr/>

Partnership ABC distributes the **Real Estate** to Partner A in liquidation of its interest

Partnership ABC

	Tax Basis	Value
Investment	300,000	600,000
	<u>300,000</u>	<u>600,000</u>
Partner B	200,000	300,000
Partner C	200,000	300,000
	<u>400,000</u>	<u>600,000</u>

Tax basis balance sheet is unbalanced

Section 734

- If a partnership distributes property (including cash); and either:
 - A section 754 is in effect; or
 - There is a “substantial basis reduction”
- Then the partnership must...

Section 734

- **Increase** the adjusted basis of partnership property by:
 - The amount of any gain recognized to the distributee partner under section 731(a)(1), and
 - 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

Section 734

- **Decrease** the adjusted basis of partnership property by:
 - The amount of any loss recognized to the distributee partner under section 731(a)(2), and
 - The excess of:
 - The basis of the distributed property to the distributee as determined under section 732, over
 - The adjusted basis of the distributed property to the partnership immediately before the distribution.

Section 731

- Upon a distribution by a partnership to a partner:
 - 731(a)(1): Gain is recognized by the partner to the extent that any *money* distributed exceeds the basis of the partner's interest in the partnership
 - 731(a)(2): Loss is recognized if:
 - No property other than money and hot (ordinary income) assets are distributed to such partner,
 - In liquidation of the partner's interest, and
 - Only to the extent that the adjusted basis of such partner's interest in the partnership exceeds the basis assigned to such distributed money and assets

Section 732

- In a NON-liquidating distribution:
 - The basis of distributed property (other than money) equals its adjusted basis to the partnership immediately before the distribution,
 - But not in excess of the basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.
- In a LIQUIDATING distribution:
 - The basis of distributed property (other than money) equals the adjusted basis of the partner's interest in the partnership reduced by any money distributed in the same transaction.
 - Basis of hot assets may not be increased

Partnership ABC

	Tax Basis	Value
Cash	300,000	300,000
Investment	300,000	600,000
	<hr/>	<hr/>
	600,000	900,000
	<hr/> <hr/>	<hr/> <hr/>
Partner A	200,000	300,000
Partner B	200,000	300,000
Partner C	200,000	300,000
	<hr/>	<hr/>
	600,000	900,000
	<hr/> <hr/>	<hr/> <hr/>

Partnership ABC distributes \$300,000 to Partner A in liquidation of its interest
Partner A recognizes \$100,000 of gain under section 731

Partnership ABC

	Tax Basis	Value
Investment	<u>300k+100k</u>	600,000
	<u>400,000</u>	600,000
Partner B	200,000	300,000
Partner C	<u>200,000</u>	300,000
	<u>400,000</u>	600,000

If Partnership ABC makes a section 754 election, it increases its basis in the Investment by A's \$100,000 gain

Partnership ABC

	Tax Basis	Value
Real Estate	300,000	300,000
Investment	300,000	600,000
	<hr/>	<hr/>
	600,000	900,000
	<hr/> <hr/>	<hr/> <hr/>
Partner A	200,000	300,000
Partner B	200,000	300,000
Partner C	200,000	300,000
	<hr/>	<hr/>
	600,000	900,000
	<hr/> <hr/>	<hr/> <hr/>

Partnership ABC distributes the **Real Estate** to Partner A in liquidation of its interest
A takes a basis of \$200,000 in the Real Estate

Partnership ABC

	Tax Basis	Value
Investment	<u>300k+100k</u>	600,000
	<u>400,000</u>	600,000
Partner B	200,000	300,000
Partner C	<u>200,000</u>	300,000
	<u>400,000</u>	600,000

If Partnership ABC makes a section 754 election, it increases its basis in the Investment by the excess of the basis of the real estate in the hands of the partnership (\$300K) over its basis to A (\$200K)

Making the Section 754 Election

- Written statement attached to the partnership return
 - For the taxable year during which the distribution or transfer occurs
 - Activates *both* section 734 and 743 (relating to transfers of interests)
 - Check the appropriate box on schedule B of the 1065
- The return on which the election is made must be filed by its due date (including extensions)
- Once made the election remains in effect unless revoked
 - No additional election required upon later distributions or transfers

The Election Statement

- **Name** and **Address** of the partnership making the election
- **Signature** of any one of the partners
- **Declaration** that “the partnership elects under section 754 to apply the provisions of section 734(b) and section 743(b)”

Missed Elections

- Automatic relief
 - Treas. Reg. Section 301.9100-2
 - 12 month extension from the due date of the return with which the election was due
 - Including extensions if the return was extended, regardless of when filed or if timely filed
 - File an amended return or AAR with the election attached
 - Write “Filed Pursuant to Section 301.9100-2” on top of first page
 - No user fee
- Nonautomatic relief
 - Private letter ruling
 - Evidence of reasonable action and good faith required
 - User fee

Substantial Basis Reduction

- Generally, a section 734(b) basis adjustment (positive or negative) is made only if there is a section 754 election in place for the year in which the distribution is made
- A *downward* section 734(b) basis adjustment is mandatory if there is a “substantial basis reduction”
- A substantial basis reduction exists if the amount of the downward adjustment exceeds \$250,000

Partnership ABC

	Tax Basis	Value
Cash	10,000	10,000
Investment	890,000	20,000
	<hr/>	<hr/>
	900,000	30,000
	<hr/> <hr/>	<hr/> <hr/>
Partner A	300,000	10,000
Partner B	300,000	10,000
Partner C	300,000	10,000
	<hr/>	<hr/>
	900,000	30,000
	<hr/> <hr/>	<hr/> <hr/>

Partnership ABC distributes \$10,000 to Partner A in liquidation of its interest

Partnership ABC

	Tax Basis	Value
Cash	10,000	10,000
Investment	890,000	20,000
	<hr/>	<hr/>
	890,000	20,000
	<hr/> <hr/>	<hr/> <hr/>
Partner A	300,000	10,000
Partner B	300,000	10,000
Partner C	300,000	10,000
	<hr/>	<hr/>
	600,000	20,000
	<hr/> <hr/>	<hr/> <hr/>

A has a section 731 loss of \$290,000
ABC MUST reduce its basis in Investment by \$290,000

Allocation of the Adjustment

- Section 755 and Reg. §1.755-1(c)
- First Allocate Between Classes
 - Capital Gain Property: Capital and section 1231 assets
 - Ordinary Income Property: Everything else (including recapture potential)
- Then Allocate Within Classes
- Operating Rules
 - Adjustments due to distributions of property must be allocated to undistributed property of a similar character to the distributed property
 - Adjustments due to distributions of cash must be allocated solely to Capital Gain Property
 - For distributions that cause ordinary gain see section 751(b)

Allocation of the Adjustment Within Classes

- Increases:
 - First in proportion to and to the extent of unrealized appreciation
 - Then in proportion to fair market values
- Decreases:
 - First in proportion to and to the extent of unrealized depreciation
 - Then in proportion to remaining adjusted bases
- Basis cannot be adjusted below zero
 - Excess carries over and reduced the basis of subsequently acquired property of the proper character

Statement of Adjustment

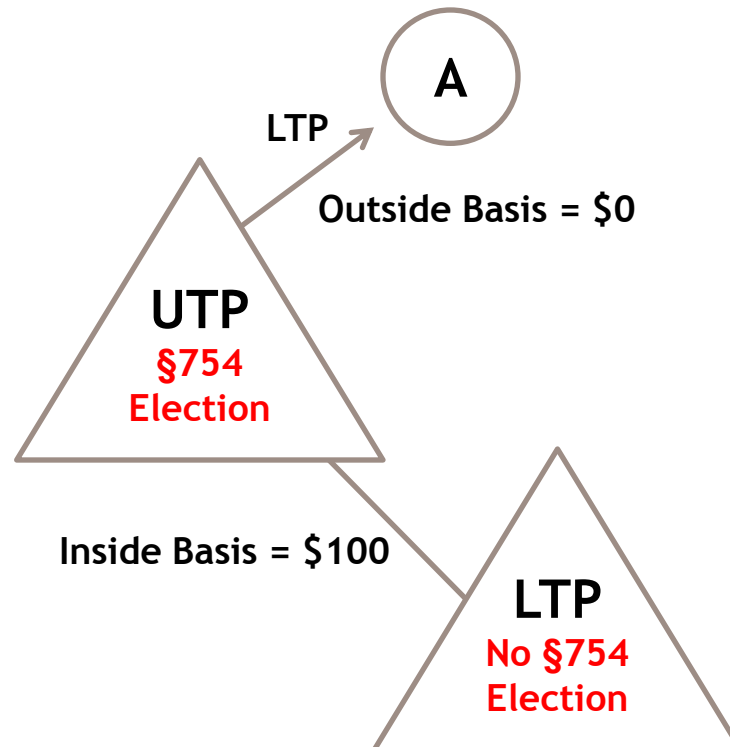
- Attached to return for the year of the distribution
- Computation of the adjustment
- Properties to which the adjustment is allocated

Effect of the Adjustment

- Common basis - no tracking (unlike 743 adjustments)
- Affects gain / loss, cost recovery
- Increases in basis of depreciable property
 - The increase is treated as newly-purchased property placed in service when the distribution occurs.
 - Any applicable recovery period and method may be used for the increased portion of the basis.
 - No change is made with respect to the existing basis
- Decreases in basis of depreciable property
 - Reduces depreciation over the remaining recovery period of the adjusted property
- Similar rules should apply for amortization / depletion

Special Rule #1

- Section 734 does not apply to any distributed property which is an interest in another partnership with respect to which the election provided in section 754 is not in effect

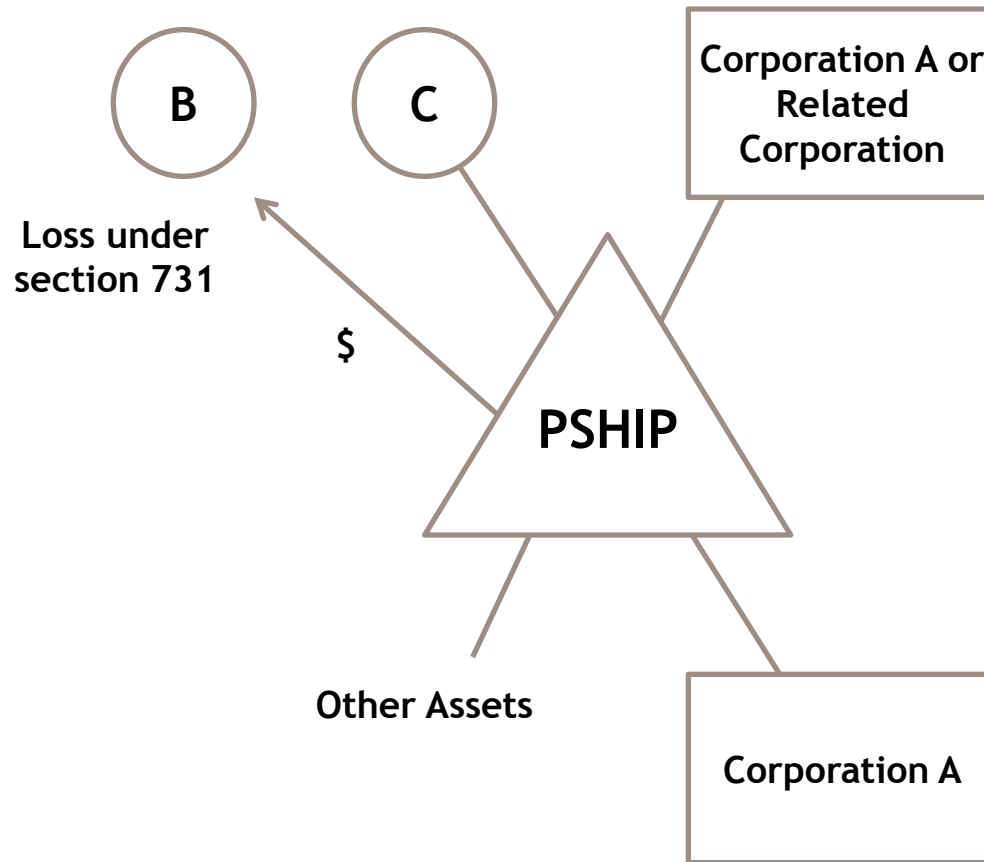


Special Rule #2

- A decrease in the adjusted basis of partnership property under section 734 may NOT be allocated to the stock of a corporate partner (or a related person)
- Allocated to other partnership property instead
- Gain is recognized to the partnership to the extent it has insufficient basis in other property

Special Rule #2

PSHIP's basis in Corporation A stock cannot be reduced

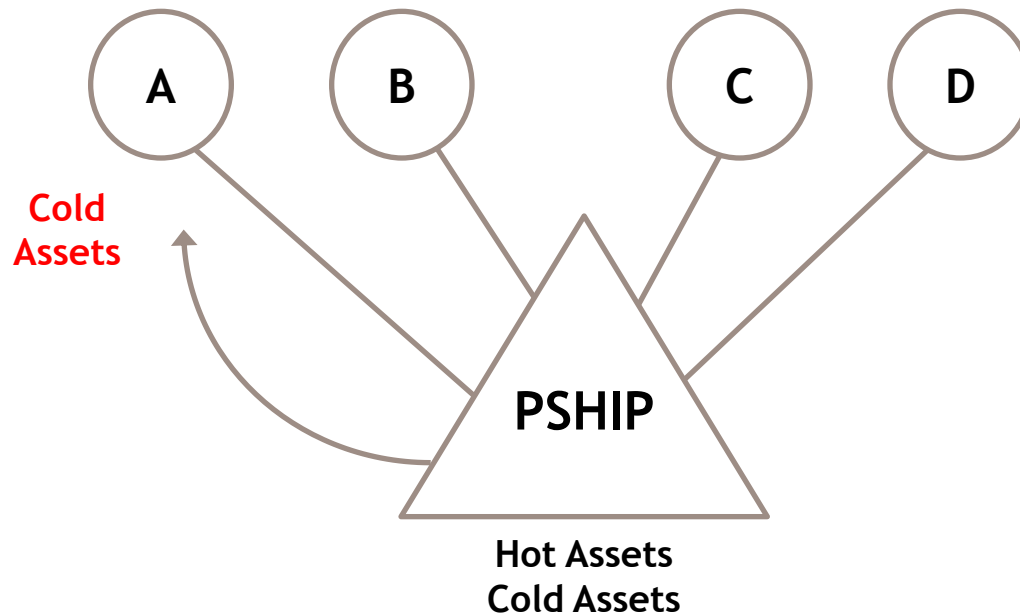


Payments to partners that do not trigger section 734

- Distributions that don't trigger gain or loss or change the basis of distributed property
- Sales or exchanges of interests (see section 743)
- Guaranteed payments
- Section 707(a) payments
- Disguised Sales
- Section 751(b) exchanges

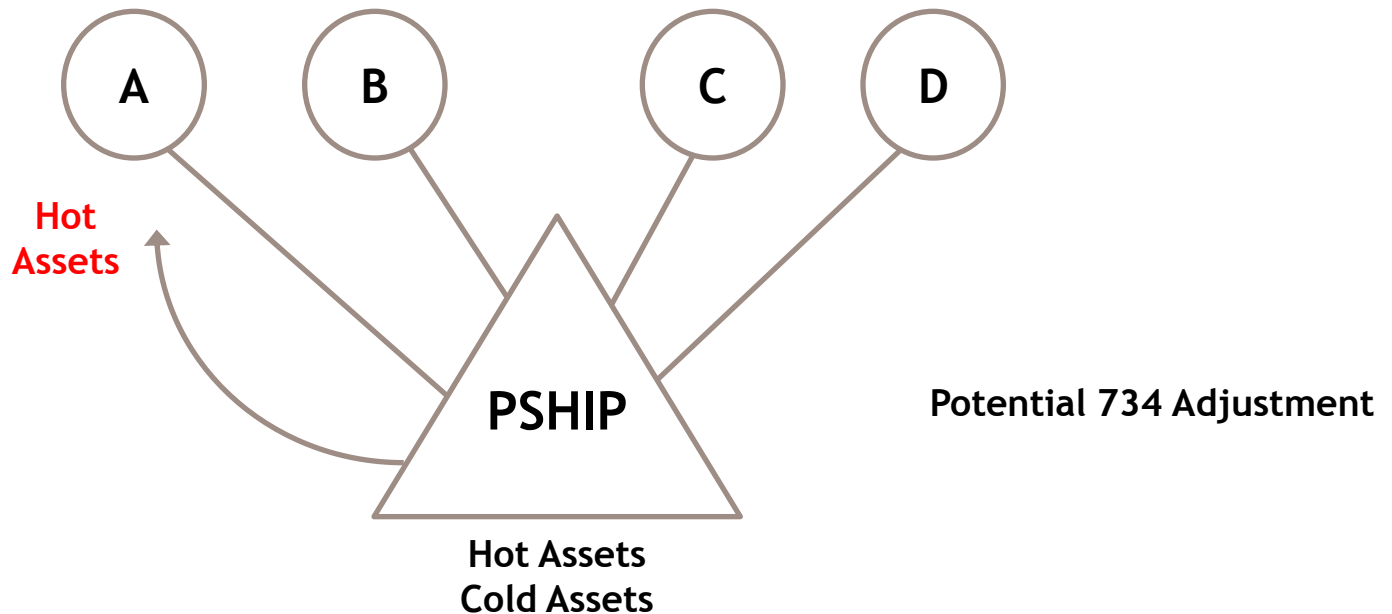
Section 751(b) Exchanges

Disproportionate distribution of Cold Assets to A in liquidation



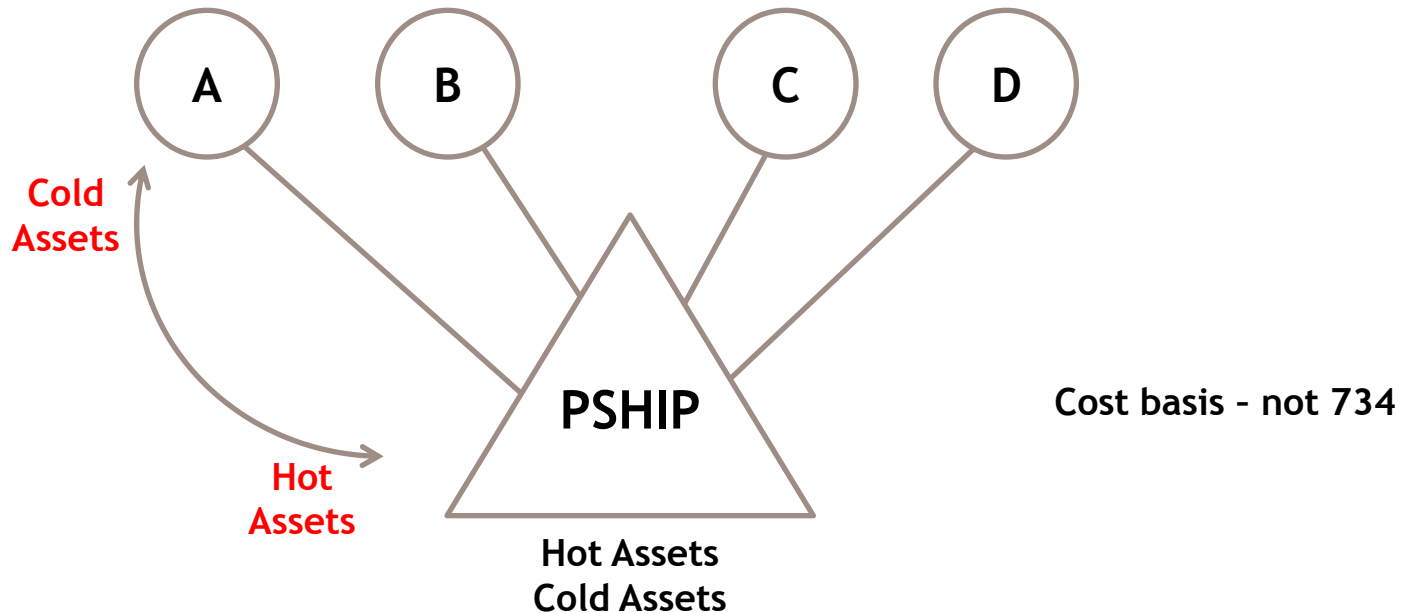
Section 751(b) Exchanges

Recast as: (1) Distribution of A's share of Hot Assets



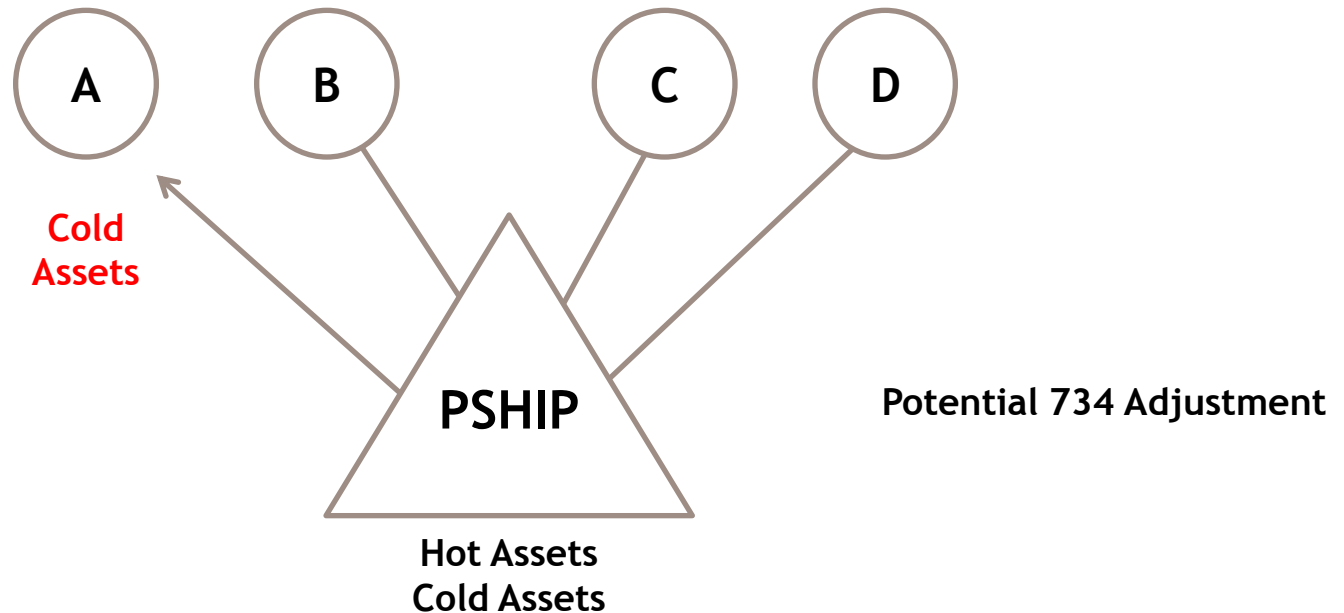
Section 751(b) Exchanges

(2) Taxable exchange of those Hot Assets for Cold Assets



Section 751(b) Exchanges

(3) Distribution of more Cold Assets





Strafford Continuing Education Webinar: Section 734(b) Adjustments

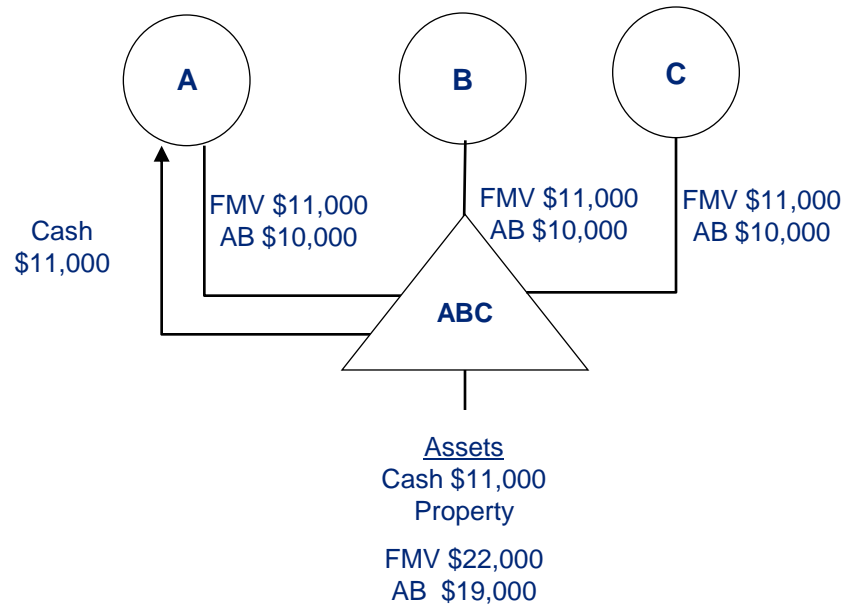


Dina A. Wiesen - Deloitte Tax LLP

August 11, 2016

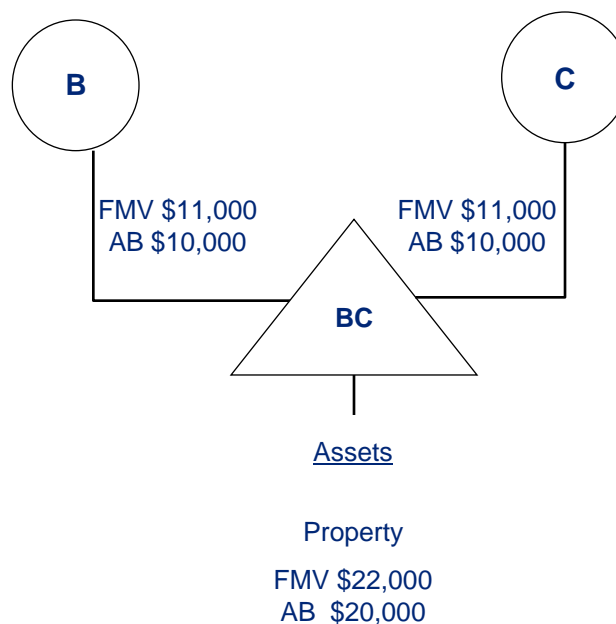
Case Study and Illustrations

Increase in Basis Ex. 1



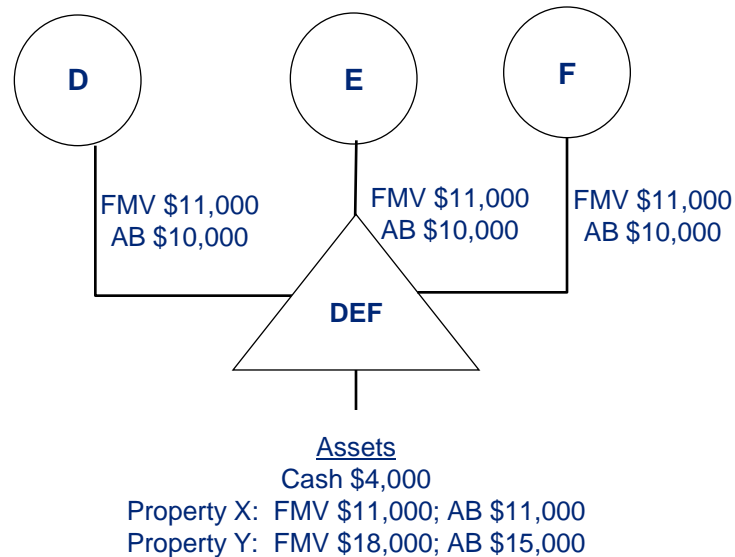
- Partner A has a basis of \$10,000 for his one-third interest in partnership ABC. The partnership has no liabilities and has assets consisting of cash of \$11,000 and property with a partnership basis of \$19,000 and a value of \$22,000.
- A receives \$11,000 in cash in liquidation of his entire interest in the partnership. He has a gain of \$1,000 under section 731(a)(1).

Increase in Basis Ex. 1 (cont'd)



- If the election under section 754 is in effect, the partnership basis for the property becomes \$20,000 (\$19,000 plus \$1,000).

Increase in Basis Ex. 2



- Partner D has a basis of \$10,000 for his one-third interest in partnership DEF. Before the distribution, the partnership balance sheet shows the following:

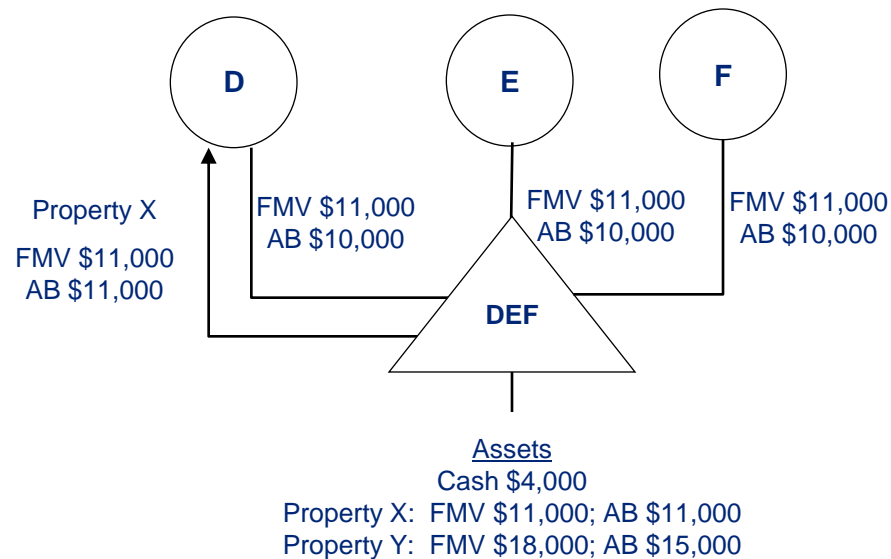
Assets

	Adjusted basis	Value
Cash	\$4,000	\$4,000
Property X	11,000	11,000
Property Y	15,000	18,000
Total	30,000	33,000

Liabilities and Capital

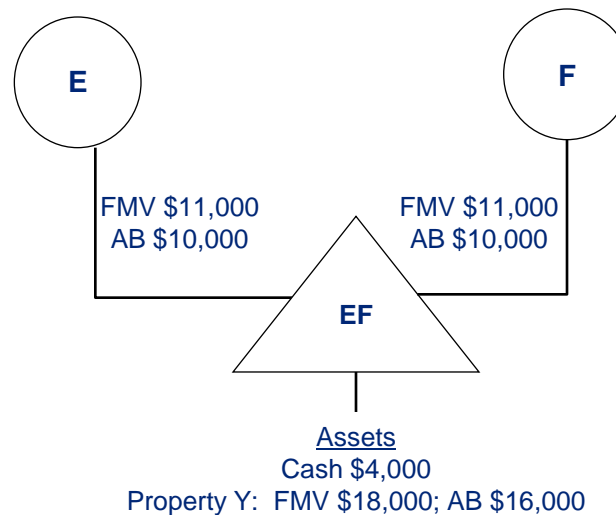
Liabilities	\$0	\$0
Capital:	Basis	Value
D	10,000	11,000
E	10,000	11,000
F	10,000	11,000
Total	30,000	33,000

Increase in Basis Ex. 2 (cont'd)



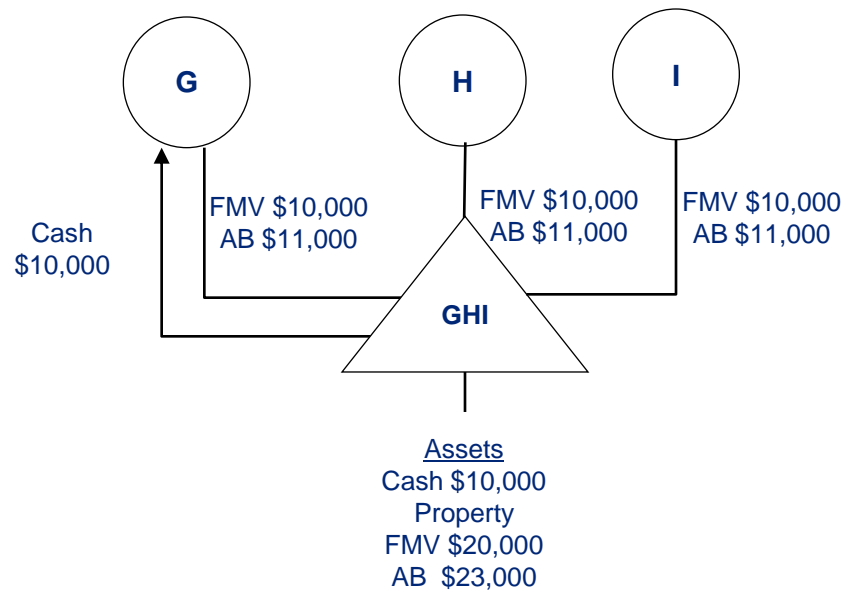
- In liquidation of his entire interest in the partnership, D received property X with a partnership basis of \$11,000. D's basis for property X is \$10,000 under section 732(b).

Increase in Basis Ex. 2 (cont'd)



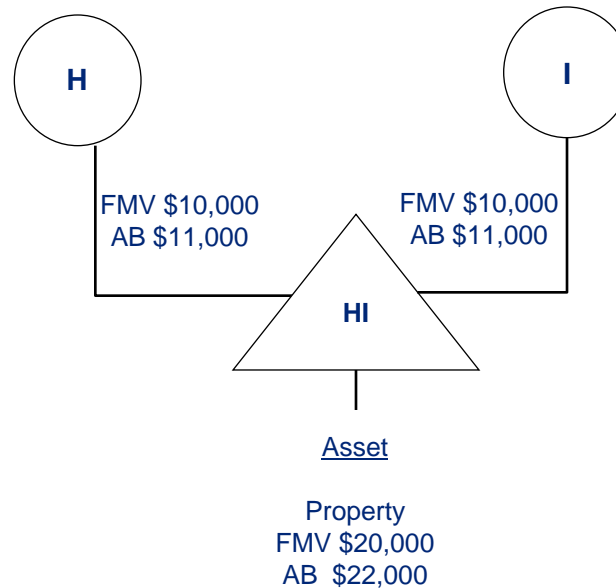
- Where the election under section 754 is in effect, the excess of \$1,000 (the partnership basis before the distribution less D's basis for property X after distribution) is added to the basis of property Y. The basis of property Y becomes \$16,000 (\$15,000 plus \$1,000).

Decrease in Basis Ex. 1



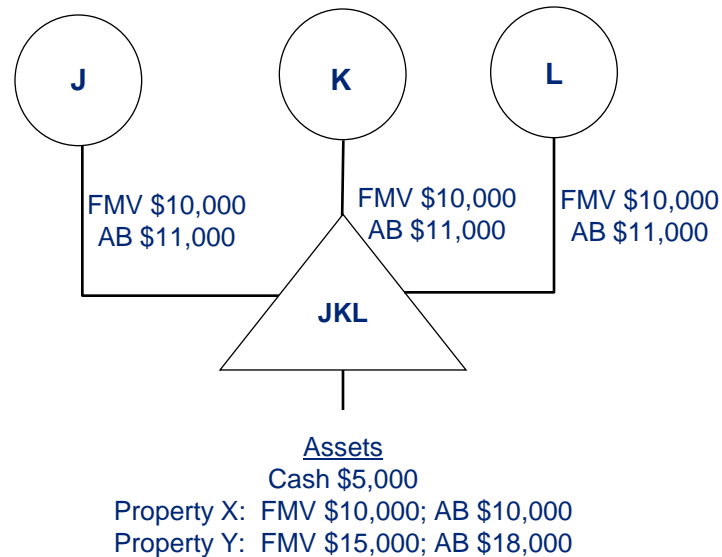
- Partner G has a basis of \$11,000 for his one-third interest in partnership GHI. The partnership has no liabilities and has assets consisting of cash of \$10,000 and property with a partnership basis of \$23,000 and a value of \$20,000.
- G receives \$10,000 in cash in liquidation of his entire interest in the partnership. He has a loss of \$1,000 under section 731(a)(2).

Decrease in Basis Ex. 1 (cont'd)



- If the election under section 754 is in effect, the partnership basis for the property becomes \$22,000 (\$23,000 minus \$1,000).

Decrease in Basis Ex. 2



- Partner J has a basis of \$11,000 for his one-third interest in partnership JKL. Before the distribution, the partnership balance sheet shows the following:

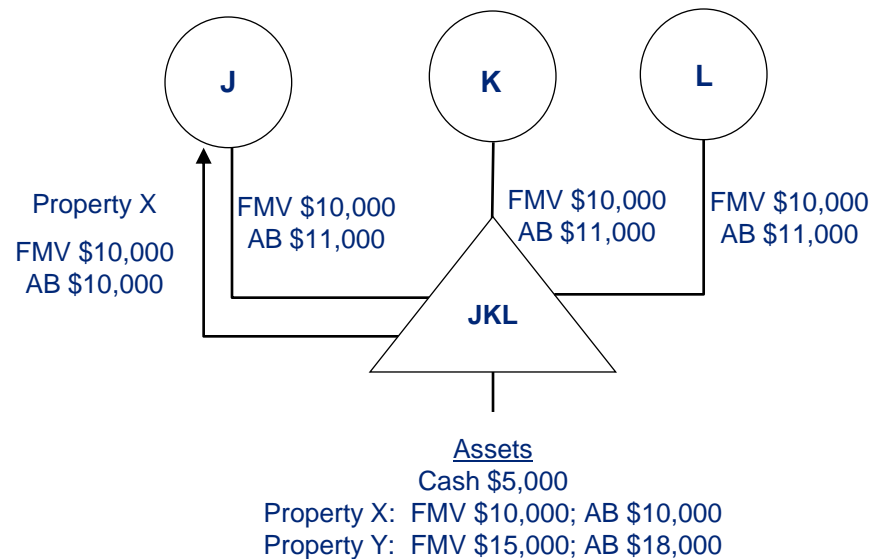
Assets

	Adjusted basis	Value
Cash	\$5,000	\$5,000
Property X	10,000	10,000
Property Y	18,000	15,000
Total	33,000	30,000

Liabilities and Capital

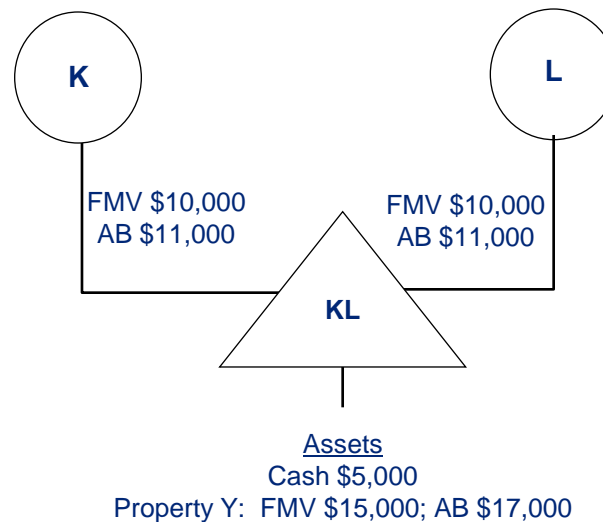
Liabilities	\$0	\$0
Capital:		
J	11,000	10,000
K	11,000	10,000
L	11,000	10,000
Total	33,000	30,000

Decrease in Basis Ex. 2 (cont'd)



- In liquidation of his entire interest in the partnership, J received property X with a partnership basis of \$10,000. J's basis for property X is \$11,000 under section 732(b).

Decrease in Basis Ex. 2 (cont'd)



- Where the election under section 754 is in effect, the excess of \$1,000 (J's \$11,000 basis in property X after the distribution minus the \$10,000 partnership's basis in property X before the distribution) decreases the basis of property Y. The basis of property Y becomes \$17,000 (\$18,000 minus \$1,000).

Special Rules and Issues

Section 734 – Background

- Neither a partner nor the partnership generally recognizes gain or loss as a result of a distribution.
- The basis of property received generally is carryover or substituted basis.
- The principal effect of section 734(b) is to prevent a partnership distribution from causing a, or altering an existing, disparity between the remaining partners' aggregate outside tax basis and the partnership's inside basis.
- Because of the electivity of section 734(b) before the AJCA, liquidating distributions could result in the duplication of losses or transfer of losses to the remaining partners.

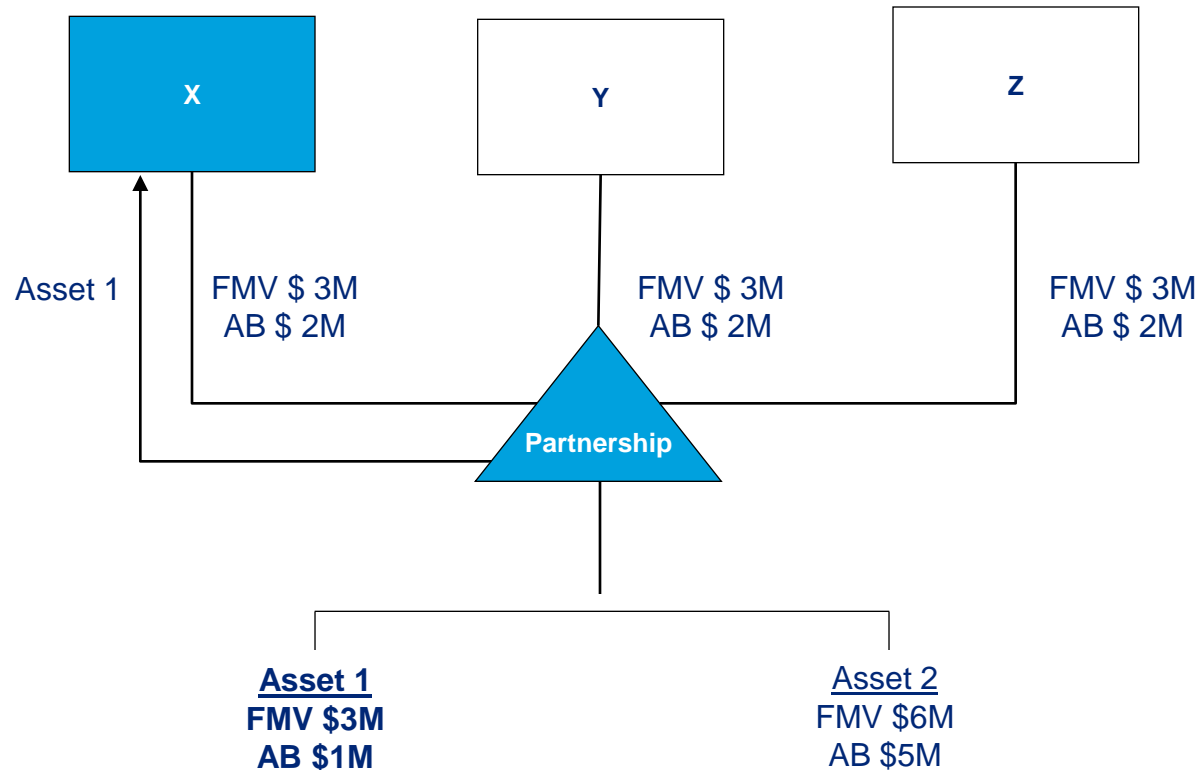
The AJCA and Section 734

- Section 734(d) – mandatory basis adjustments from certain distributions

Section 734 and Substantial Basis Reductions

- The AJCA made section 734(b) applicable not only if an election under section 754 is in effect, but also if there is a “substantial basis reduction” with respect to the distribution.
- There is a “substantial basis reduction” for purposes of section 734 if the application of section 734(b)(2) to the distribution would give rise to a decrease in the adjusted basis of partnership property in an amount that exceeds \$250,000.
- Regulations to carry out the purpose of section 734(d).
- Exception for securitization partnerships.

Substantial Basis Reductions



- X, Y, and Z each contributed \$2 million to partnership. Partnership purchases Asset 1 and Asset 2, both of which are capital assets, for \$1 million and \$5 million, respectively.
- The FMV of Asset 1 increases to \$3 million, and the FMV of Asset 2 increases to \$6 million.
- Partnership distributes Asset 1 to X in liquidation of X's interest. Partnership does not have an election under section 754 in effect, but there is a substantial basis reduction with respect to the distribution.

Proposed AJCA Regulations

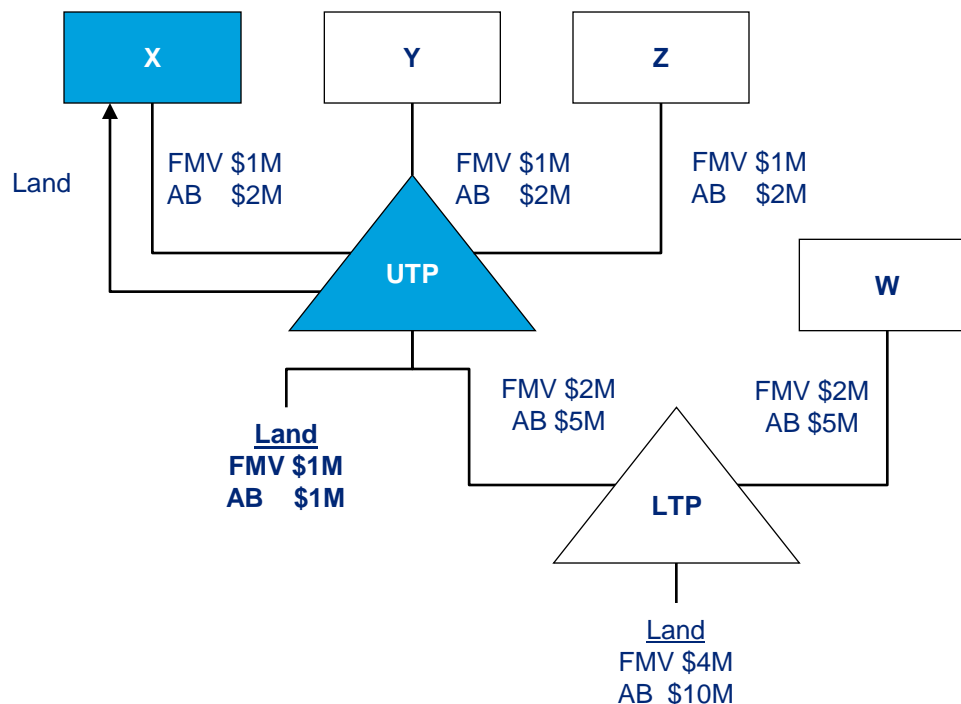
- On January 16, 2014, the IRS and Treasury published proposed regulations that would provide guidance on provisions of the AJCA
- The proposed regulations would revise Treas. Reg. § 1.734-1 to incorporate the changes made by the AJCA to section 734 and provide guidance with respect to those changes.
- The main guidance that the proposed regulations would provide concerns (i) the determination of a substantial basis reduction, (ii) the effect of a substantial basis reduction, and (iii) section 734(b) adjustments in tiered partnerships.

Tiered Partnerships

- In Rev. Ruls. 92-15 and 87-115, basis adjustments were made at a lower-tier partnership as a result of transactions that occurred at the upper-tier partnership only if both partnerships had section 754 elections in effect.
- Rev. Ruls. 92-15 and 87-115 were published more than a decade before the AJCA.
- What if a mandatory adjustment under section 734 or 743 is made at the upper-tier partnership and is allocated to the upper-tier partnership's interest in the lower-tier partnership?

Proposed regulations treat lower-tier partnership, solely with respect to the transfer or distribution, as if it had made a section 754 election for the taxable year of the transfer or distribution.

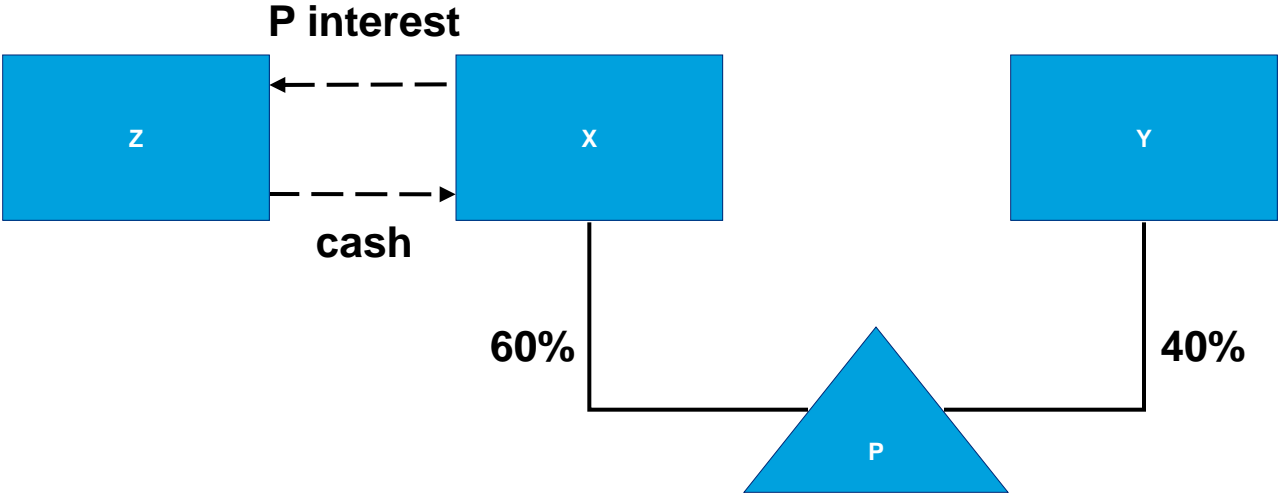
Tiered Partnerships (cont.)



- UTP distributes Land to X in liquidation of X's interest at a time when neither UTP nor LTP has an election under section 754 in effect.
- X takes a \$2 million substituted basis in Land under section 732(b).
- The liquidating distribution results in a mandatory negative section 734(b) adjustment of \$1 million that is allocated to UTP's remaining asset, UTP's interest in LTP.
- LTP would be required to adjust the basis of its property under the proposed regulations.

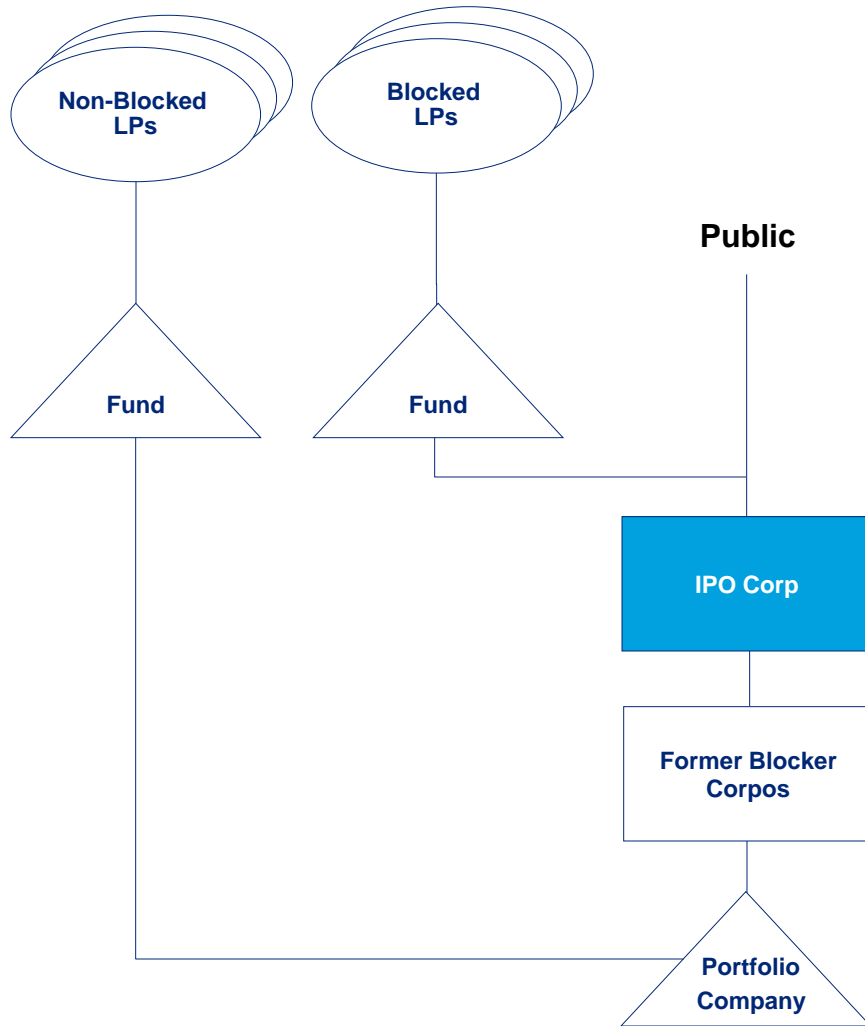
Planning Considerations

Technical Terminations



- **Section 708(b)(1)(B)**

IPO Exit of Operating Partnership with TRA



- Non-Blocked LPs
 - Continue to own in pass-through from until exit
 - Upon exit, exchange units for stock of public company and TRA
- Blocked LPs
 - Transfer stock of Blocker to IPO Corp in exchange for stock of IPO Corp (if blocker corp at NOLs or the like) a TRA
 - Supercharged IPOs
- TRAs
 - Tax Receivable Agreement
 - As a tax benefit is used, holder of the TRA receives 85-90% of the resulting tax savings
 - Ordering rules
 - Treatment of payment