

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

THURSDAY, AUGUST 9, 2018, 1:00-2:50 pm Eastern

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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

# OFF BALANCE

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

# EXAMPLE 1

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 1 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 1

- **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)

# § 754 Election

- Timely Filed Partnership Return
- Late Election §301.9100-2
- 12 Month Extension
- Binding All Future Years
- Revoked – District Director Approval

# 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

# EXAMPLE 1 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

# 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

# PRACTICE POINTS

- Send request letter
- Read partnership agreement or operating agreement

# TRANSFeree 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

# 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.
- TCJA – if Transferee receives Net Loss on Hypothetical Liquidation.

# 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)

# 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 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





# Strafford Continuing Education Webinar: Section 734(b) Adjustments

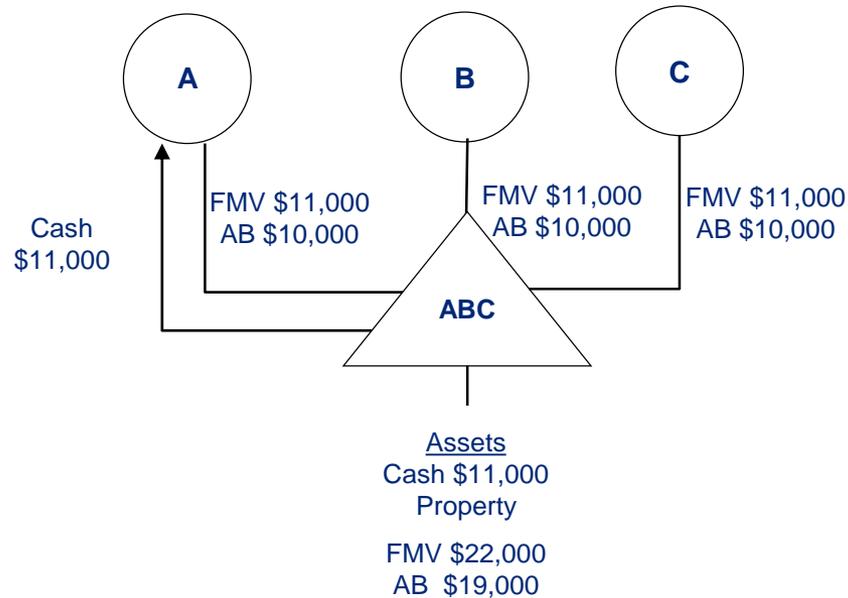


**Dina A. Wiesen - Deloitte Tax LLP**

August 9, 2018

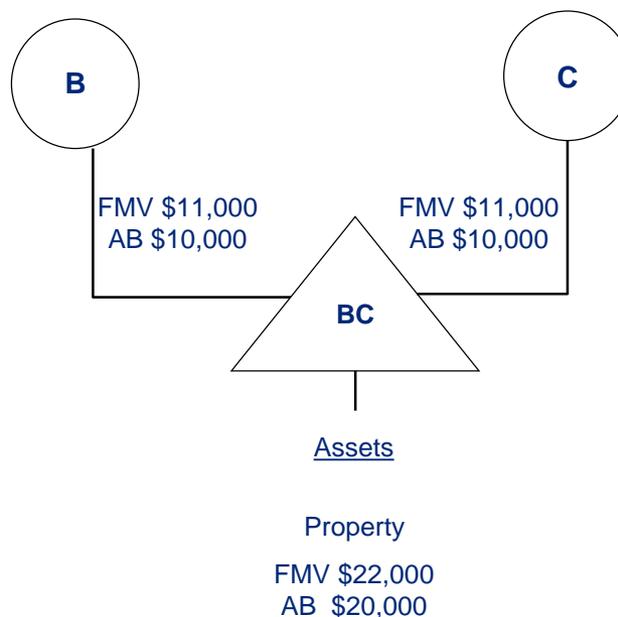
# Case Study and Illustrations

# Increase in Basis Ex. 1



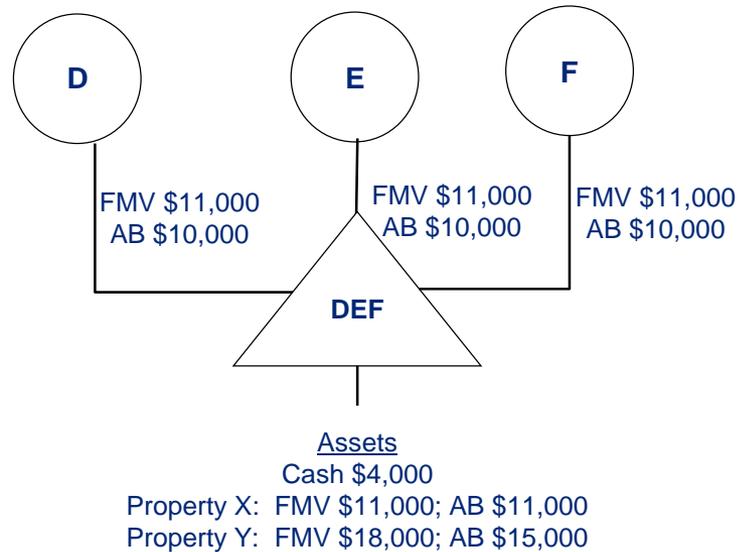
- Partner A has a basis of \$10,000 for his one-third interest in partnership ABC. The partnership has no liabilities and has assets consisting of cash of \$11,000 and property with a partnership basis of \$19,000 and a value of \$22,000.
- A receives \$11,000 in cash in liquidation of his entire interest 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:

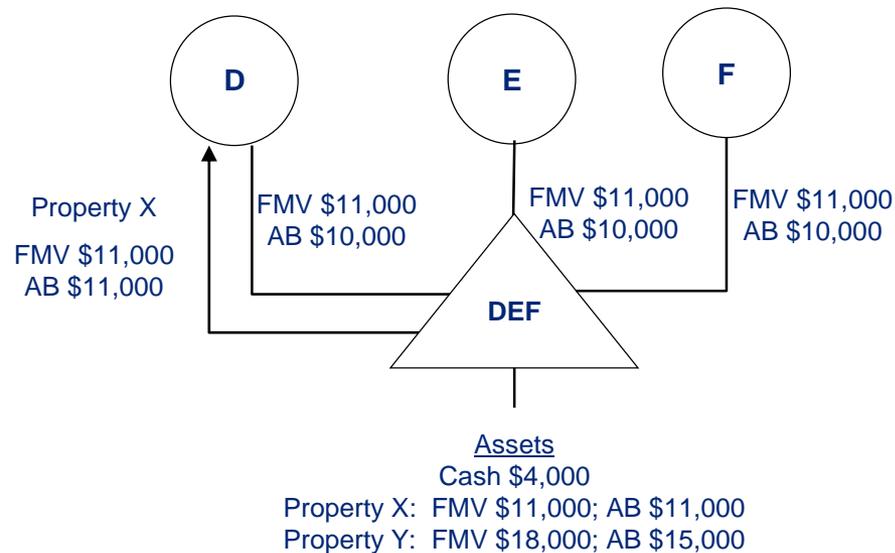
## Assets

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

## Liabilities and Capital

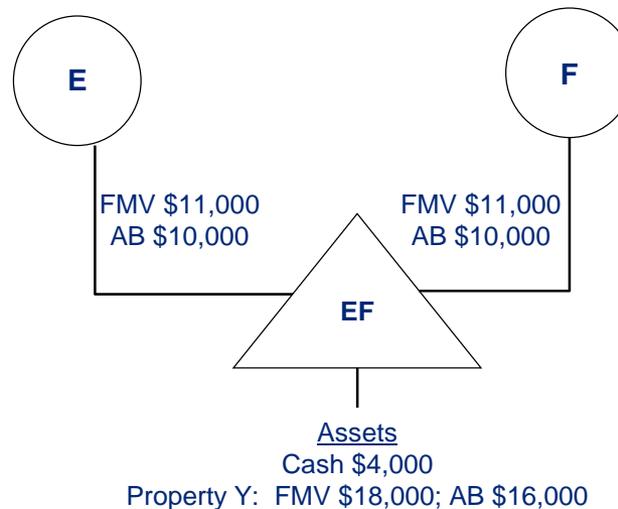
Liabilities	\$0	\$0
<b>Capital:</b>	<b>Basis</b>	<b>Value</b>
D	10,000	11,000
E	10,000	11,000
F	10,000	11,000
<b>Total</b>	<b>30,000</b>	<b>33,000</b>

## Increase in Basis Ex. 2 (cont'd)



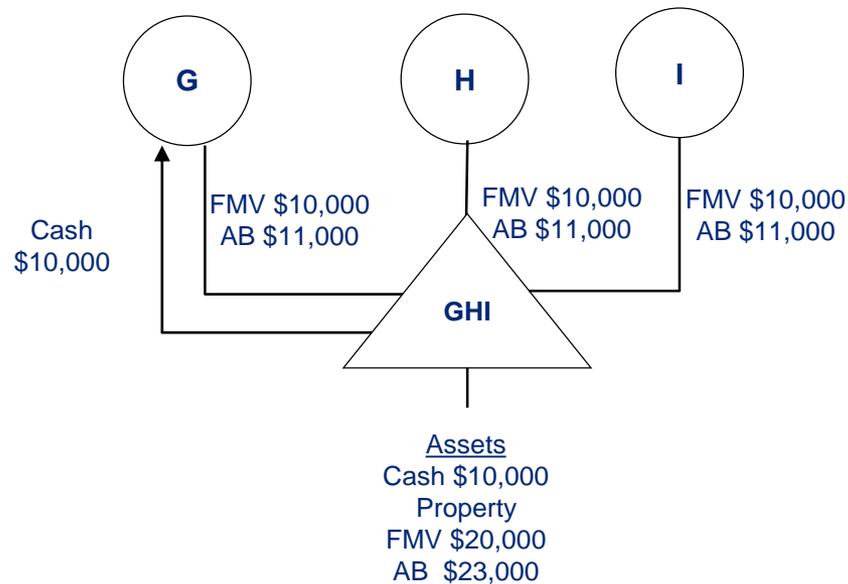
- In liquidation of his entire interest in the partnership, D received property X with a partnership basis of \$11,000. D's basis for property X is \$10,000 under section 732(b).

## Increase in Basis Ex. 2 (cont'd)



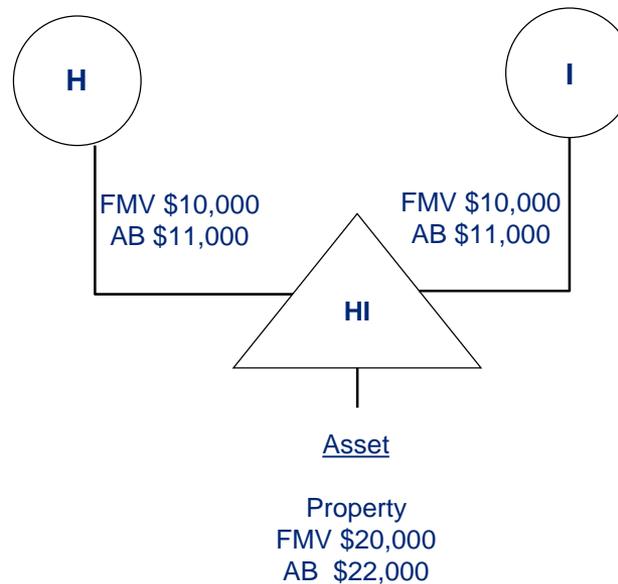
- Where the election under section 754 is in effect, the excess of \$1,000 (the partnership basis before the distribution less D's basis for property X after distribution) is added to the basis of property Y. The basis of property Y becomes \$16,000 (\$15,000 plus \$1,000).

# Decrease in Basis Ex. 1



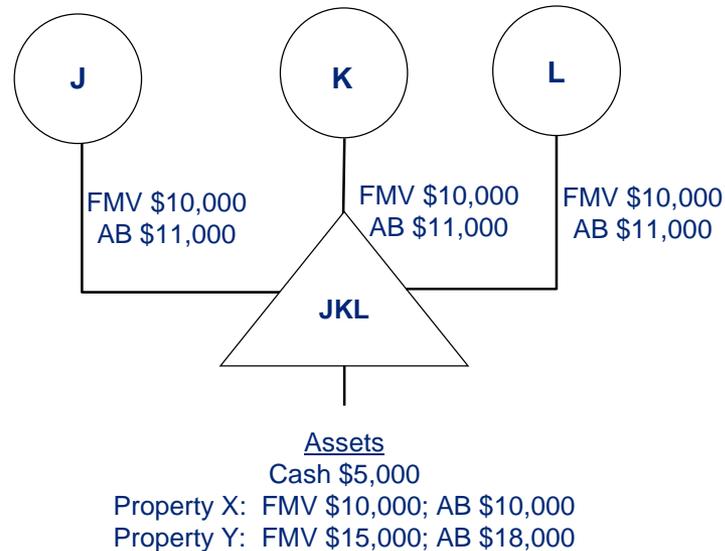
- Partner G has a basis of \$11,000 for his one-third interest in partnership GHI. The partnership has no liabilities and has assets consisting of cash of \$10,000 and property with a partnership basis of \$23,000 and a value of \$20,000.
- G receives \$10,000 in cash in liquidation of his entire interest 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:

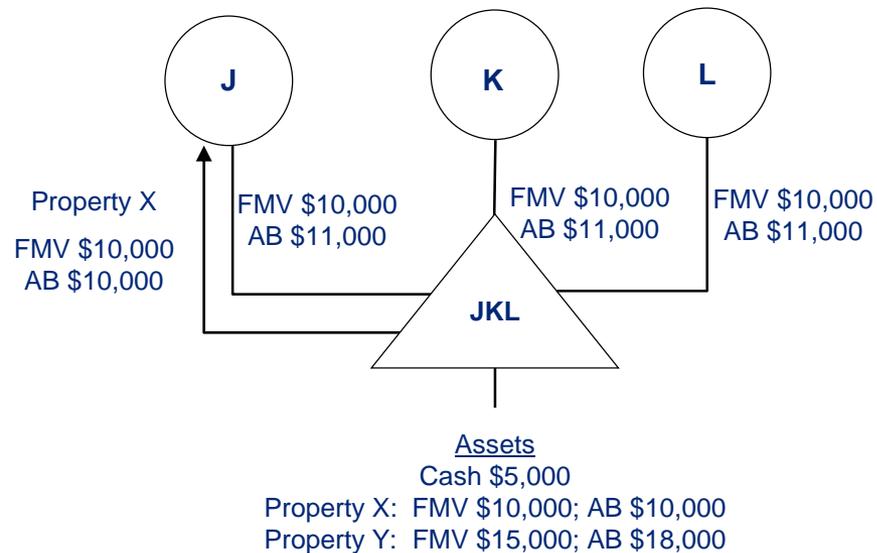
## Assets

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

## Liabilities and Capital

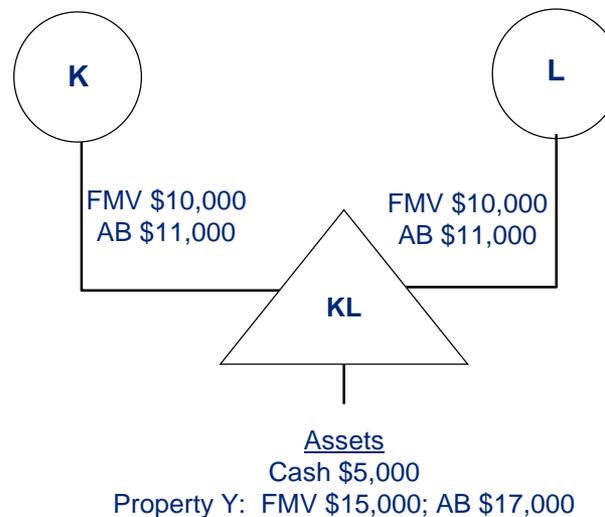
Liabilities	\$0	\$0
<b>Capital:</b>		
J	11,000	10,000
K	11,000	10,000
L	11,000	10,000
<b>Total</b>	<b>33,000</b>	<b>30,000</b>

## 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.

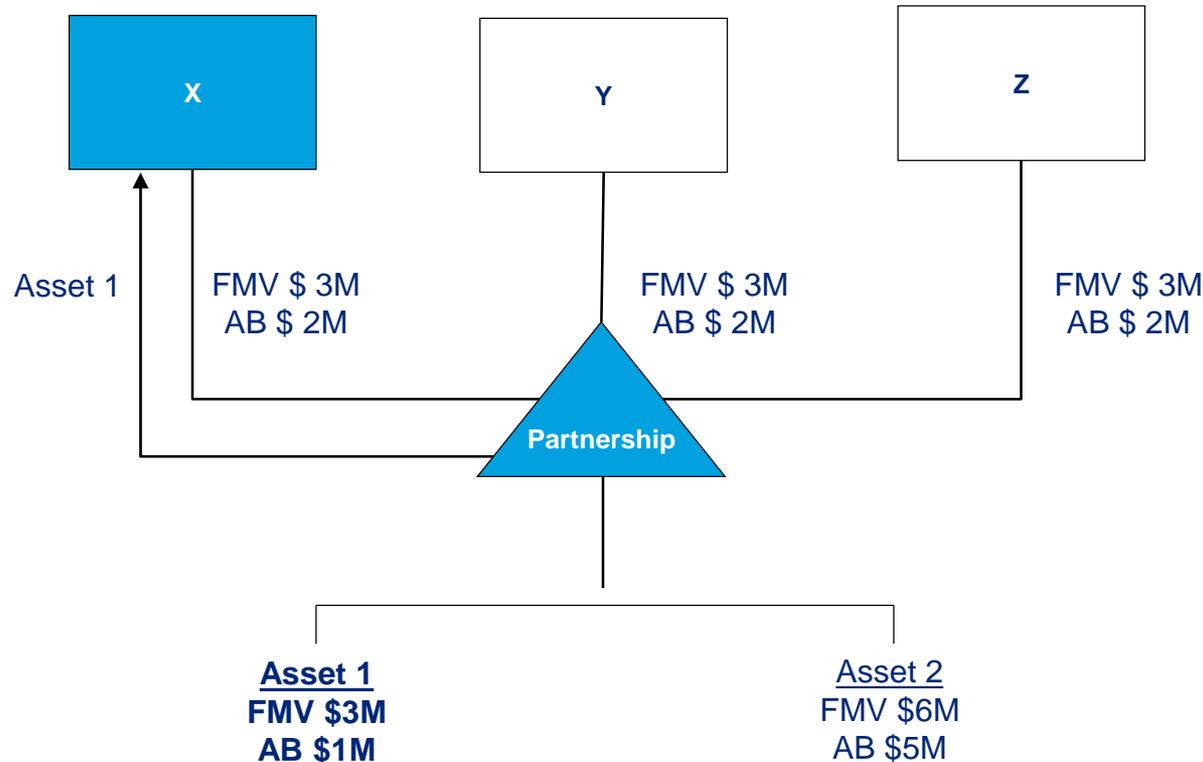
# The AJCA and Section 734

- 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

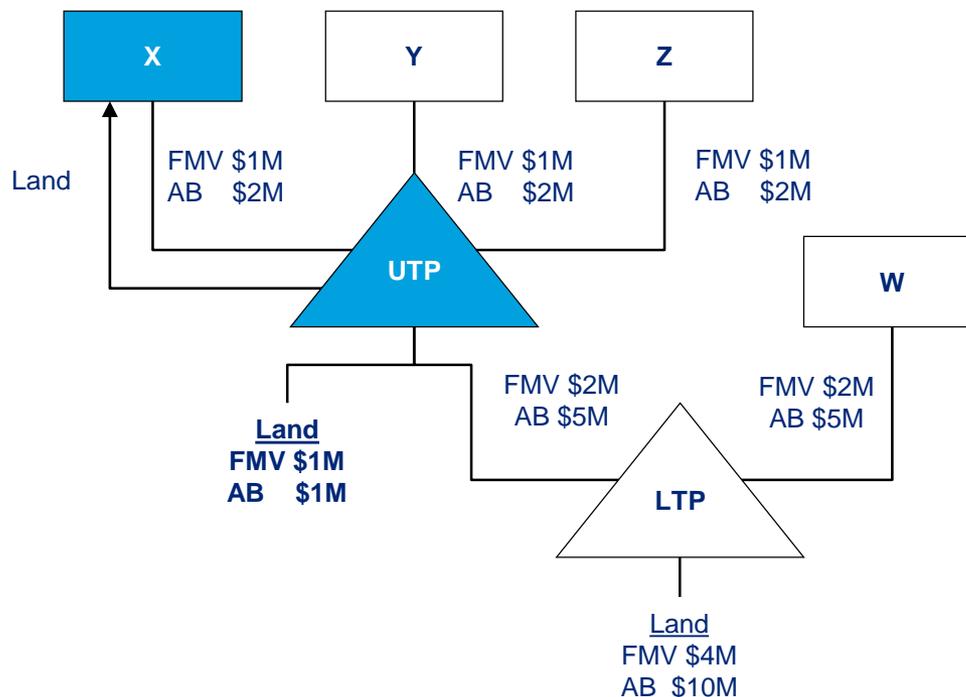
- On January 16, 2014, the IRS and Treasury published proposed regulations that would provide guidance on provisions of the AJCA
- The proposed regulations would revise Treas. Reg. § 1.734-1 to incorporate the changes made by the AJCA to section 734 and provide guidance with respect to those changes.
- 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.

# Bonus Depreciation and Section 734(b) Adjustments

Changes post-tax reform:

- Increased bonus depreciation percentages for purposes of section 168(k).
- Expanded definition of “Qualified Property”
- Uncertainties in application to common partnership transactions
  
- Bonus depreciation percentage is generally increased to 100 percent for property placed in service after September 27, 2017 and before 2023
  
- Issue: whether section 168(k) as amended applies to adjustments to the basis of depreciable partnership property under section 734(b) that otherwise meets the requirements of section 168(k)(2)(A)(i) and section 168(k)(2)(A)(iii).