IRC Section 754: Partnership and Pass-Through Entity Basis Adjustments

THURSDAY, OCTOBER 4, 2018, 1:00-2:50 pm Eastern

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Darren J. Mills, Esq., CPA, ChFC, CLU, Atty
Mills Elder Law, Red Bank, N.J.
djmills1267@gmail.com

Michael P. Spiro, Partner
Finn Dixon & Herling, Stamford, Conn.
mspiro@fdh.com

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Overview

- What is a 754 election and why is it helpful?
- When does a 754 election result in basis adjustments?
- How is the basis adjustment calculated?
  - Cross-Purchase (743(b))
  - Redemption (734(b))
- How is the basis adjustment allocated?
- Planning concerns with 754 Elections

What is a 754 election and why is it helpful?

- Election to make an optional basis adjustment to the basis of the partnership's assets in connection with certain events triggering gain or loss <u>outside</u> the partnership.
- Prevents timing and character distortions that can result in double taxation (or duplication of loss).
- Prior to 2004 was entirely optional. After American Jobs Creation Act of 2004, certain basis adjustments are required to avoid loss duplication even if no 754 election is in place.
  - "Substantial Built in Loss"--$250,000.

When does a 754 election result in basis adjustments?

- Sale of a partnership interest “over the top”
- Death of a partner
- Redemption of a partnership interest
- In-kind distributions

Function of a 754 Election

- Avoids timing and character distortions.
  - Duplication of taxable gain;
  - Duplication of taxable loss.
- Best illustrated through examples.

Avoiding Double Taxation (Cross Purchase)

- Partnership AB has two assets: a building with a tax basis of $100 and a fair market value of $300, and goodwill relating to a new business idea with a tax basis of $0.00 and a fair market value of $0.
- Partners A and B each own 50% of AB. Each has a tax basis in his AB interest of $50.00.
- B and C arrange for C to purchase B's interest in AB for $150. Upon purchasing B's interest, C has a tax basis in his AC interest of $150; B recognizes a taxable gain of $100.
- <u>However</u>, if no 754 election is in place, AB still has a $100.00 basis in its building, and a $0.00 basis in its goodwill.
- AB decides to sell the building to generate cash to invest in its business idea. The real estate is sold for $300, generating $200 in taxable gain. The gain is allocated 50% to A and 50% to C. C is thus subject to tax on $100 of gain. However, C made an after-tax investment in AB that valued the building at $300. He is thus effectively paying tax on $100 without any economic gain (i.e. on the same gain that B already paid tax on when B sold the interest to C). This distortion is remedied as follows:
  - C's basis in its partnership interest is increased to $250. C's share of total partnership property ($50% of 300 of cash plus $0 of goodwill) remains $150. Thus, if and when C's interest in AB is sold or liquidation, C will recognize a $100 loss to reverse the prior gain allocation.
  - <u>However</u>, if this loss occurs in a subsequent year, it cannot be carried back to the year of the gain allocation and, if C does not have $100 of other capital gain, may not be currently usable. In any case, because the business activity of AB is just beginning, the loss may not come for many years.
- **If a 754 election were in place, then <u>solely as to C</u>, the partnership basis in the building would have been increased under Code Section 743(b) by $100 upon C's purchase, so that C's $100 gain allocation would be reduced to $0.00 via application of the special basis adjustment.**

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Avoiding Loss Duplication (Cross Purchase)

- Partnership AB has two assets: a building with a tax basis of $300 and a fair market value of $100, and goodwill relating to a new business idea with a tax basis of $0.00 and a fair market value of $0.
- Partners A and B each own 50% of AB. Each has a tax basis in his AB interest of $150.00.
- B and C arrange for C to purchase B's interest in AB for $50. Upon purchasing B's interest, C has a tax basis in his AC interest of $50. B recognizes a $100 loss.
- <u>However</u>, if no 754 election is in place, AB still has a $300.00 basis in its building.
- AB decides to sell the building to generate cash to invest in its business idea. The real estate is sold for $100, generating $200 in tax loss. The loss is allocated 50% to A and 50% to C. C is thus able to deduct $100 of loss (utilization of which will be limited to C's $50 of basis in C's AB interest). However, C made an after-tax investment in AB that valued the building at $100. He is thus effectively able to generate a tax loss without any economic loss (i.e. the same loss suffered by B when B sold the interest to C). This distortion is remedied in the same manner as in the case of the prior example:
  - C's basis in AB is reduced to $0 (with the remaining $50 of loss suspended until such time as C has an additional $50 of basis):
  - C's share of total partnership property (50% of $100 of cash) remains $50. Thus, if and when C's interest in AB is sold or liquidated, C will recognize $50 of gain to reverse the prior loss allocation.
  - <u>However</u>, if sale or liquidation does not happen for several years, C will obtain a significant timing benefit relative to the U.S. Treasury due to C's early tax loss without corresponding economic loss.
- **If a 754 election has been in place, then <u>solely as to C</u>, the basis of the building would have been reduced under Code Section 743(b) by $100, so that C's share of loss would be reduced to $0.00.**

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Avoiding Double Taxation (Cash Redemption)

- Partnership ABC has a business with cash of $100 and goodwill with a tax basis of $0.00 and a fair market value of $200.
- A, B and C each own 33% of the capital and profits of ABC. Each has a basis in its ABC interest of $33.33.
- ABC decides to redeem C's interest for $100, and distributes the $100 of cash to C in full redemption of C's interest.
- C recognizes taxable gain on the difference between the $100 of cash C receives and his $33.33 of tax basis, for gain of $66.67.
- ABC is left with goodwill with a basis of $0.00 and value of $200. Each of A and B has basis in its partnership interest of $33.33.
- If the goodwill is subsequently sold, each of A and B will be allocated $100 of gain. Thus, prior to giving effect to the tax consequences of a liquidation of the partnership, the total taxable gain recognized by the three partners will be $266.67—<u>even though</u> the total gain inherent in the partnership was only the $200 of goodwill gain.
- This will subsequently be remedied because A and B will increase their outside bases by the $100 of gain. Upon liquidation of the partnership for $200, each will recognize a $33.33 loss.
- **If a 754 election was in place, then upon the redemption of C, the tax basis of the goodwill would have been increased under Code Section 734(b) by the $66.67 of gain recognized by C.**

Avoiding Loss Duplication (Cash Redemption)

- Partnership ABC has a business with cash of $100 and goodwill with a tax basis of $200 and a fair market value of $0.00.
- A, B and C each own 33% of the capital and profits of ABC. Each has a basis in its ABC interest of $100.
- ABC decides to redeem C's interest for $33.33, and distributes $33.33 of cash to C in full redemption of C's interest.
- C recognizes taxable loss on the difference between the $33.33 of cash C receives and his $100 of tax basis, for loss of ($66.67).
- ABC is left with goodwill with a basis of $200.00 and value of $0. Each of A and B has basis in its partnership interest of $100.
- If the goodwill is subsequently sold or abandoned, each of A and B will be allocated $100 of loss. Thus, prior to giving effect to the tax consequences of a liquidation of the partnership, the total taxable loss recognized by the three partners will be ($266.67)—<u>even though</u> the total loss inherent in the partnership was only the ($200) of goodwill loss.
- This will subsequently be remedied because A and B will reduce their outside bases by the $100 of loss. Upon liquidation of the partnership for $66.67, each will recognize a $33.33 gain.
- **If a 754 election was in place, then upon the redemption of C, the tax basis of the goodwill would have been reduced under Code Section 734(b) by the $66.67 of loss recognized by C.**

Avoiding Double Taxation (In-Kind Redemption)

- Partnership AB has cash of $150 and two pieces of equipment. Equipment 1 has a basis of $50 and a value of $150. Equipment 2 has a basis of $10 and a value of $100.
- Each of partners A and B holds a 50% interest in AB with a basis of $105 and a value of $200.
- B is redeemed for $100 of cash and the distribution in kind of Equipment 2. Under Code Section 732(b), B's basis is first reduced by the $100 cash distribution to $5. B then takes a carryover basis in Equipment 2 of $5.*
- The other $5 of basis in Equipment 2 is lost. If B sells Equipment 2, B will recognize $95 of taxable gain, and if AB sells Equipment 1, it will recognize $100 of taxable gain for total tax gain of $195. However, had AB simply sold both pieces of Equipment prior to B's redemption, it would have generated $190 of aggregate gain. Thus, an additional $5 of gain has been generated. This will be reversed upon a liquidation of AB.
- **If a 754 election was in place, AB's basis in Equipment 1 would have been increased under Code Section 734(b) by $5 (the amount of lost basis in Equipment 2 arising out of B's in-kind redemption).**

*For ease of presentation, this example ignores the fact that upon B's redemption, AB would terminate as a partnership due to A being its sole owner.

Avoiding Loss Duplication (In Kind Redemption)

- Partnership AB has cash of $150 and two pieces of equipment. Equipment 1 has a basis of $150 and a value of $50. Equipment 2 has a basis of $100 and a value of $10.
- Each of partners A and B holds a 50% interest in AB with a basis of $200 and a value of $105.
- B is redeemed for $95 of cash and the distribution in kind of Equipment 2. Under Code Section 732(b), B's basis is first reduced by the $95 cash distribution to $105. B then takes a carryover basis in Equipment 2 of $105.*
- This represents an increase in the Equipment 2 basis of $5. If B sells Equipment 2, B will recognize $95 of taxable loss, and if AB sells Equipment 1, it will recognize $100 of taxable loss for total tax gain of $195. However, had AB simply sold both pieces of Equipment prior to B's redemption, it would have generated $190 of aggregate loss. Thus, an additional $5 of loss has been generated. This will be reversed upon a liquidation of AB.
- **If a 754 election was in place, AB's basis in Equipment 1 would have been reduced under Code Section 734(b) by $5 (the amount of basis increase in Equipment 2 arising out of B's in-kind redemption).**

*For ease of presentation, this example ignores the fact that upon B's redemption, AB would terminate as a partnership due to A being its sole owner.

Calculating the Basis Step-Up/Step-Down

- In a cash redemption, the adjustment is equal to the amount of gain or loss recognized by the redeemed partner.
- In an in-kind redemption, the adjustment is equal to the basis step-up or step-down in the distributed property.
- In a cross-purchase, the calculation is equal to the difference between (x) the transferee's basis in its partnership interest <u>minus</u> (y) transferee's share of the partnership's basis in partnership property.
- Transferee's share of partnership basis is equal to the sum of (x) "previously taxed capital" and (y) transferee partner's share of liabilities.

Previously Taxed Capital

- Hypothetical Transaction: Disposition of all partnership assets for fair market value in a cash transaction.
- Previously Taxed Capital is equal to:
  - Cash that transferee partner would receive upon liquidation after the hypothetical transaction; plus
  - Tax loss that would be allocated to the transferee partner in hypothetical transaction; minus
  - Tax gain that would be allocated to the transferee partner in the hypothetical transaction.

Example Of Step-Up Calculation:

- Partnership ABC has cash of $100, property 1 with value of $100 and basis of $50 and property 2 with value of $100 and basis of $110.
- A, B and C each own a 33.33% interest in ABC with value of $100.
- D purchases C’s interest for $100.
- D’s PTC is equal to (x) $100 cash that would be distributed upon the hypothetical transaction <u>plus</u> $3.33 of loss on property 2 that would be allocated to D in hypothetical transaction <u>minus</u> $16.67 of gain that would be allocated to D in hypothetical transaction <u>equals</u> $86.66. D’s basis increase is equal to $13.34.
  - If C had an outside basis of 86.66 (1/3 of the basis of each partnership asset), this step-up corresponds to the gain recognized by C upon the sale to D.

Section 755 Allocation of Basis Adjustments (743(b)) Adjustment

- **Step One**: Assign a value to each asset using the residual method.
- **Step Two**: Divide the adjustment between
  - (i) ordinary income property; and
  - (ii) capital gain property
  - Allocate adjustment first to ordinary income property (corresponding to the ordinary income or loss that would be recognized in the hypothetical transaction and allocated to the transferee partner.
  - Thereafter, remaining step-up (or step-down) is allocated to capital gain property (but basis cannot be reduced beyond partnership basis in capital gain property. Any excess reduction is applied to ordinary income property.)
- **Step Three:** Allocate the adjustment within the classes based on the income, gain or loss that would be allocated with respect to each property in the "hypothetical transaction."

Section 755 Allocation of Adjustment (734(b)) Adjustment

Step One: Assign a value to each asset using the residual method.

Step Two: Divide the adjustment between

(i) ordinary income property; and

(ii) capital gain property

- In connection with a cash redemption, 734(b) adjustment is allocated to capital gain.
  - If there was a deemed 751(b) exchange, there may be an adjustment to ordinary income property associated with the deemed exchange.
- In connection with an in-kind redemption, adjustment is made to undistributed property with the same character as the distributed property.
  - If none, then no adjustment until the partnership acquires property of like character.

Step Three: Allocate the adjustment among the two classes.

- Positive adjustments:
  - first allocated to assets with unrealized appreciation (proportionately) to reduce or eliminate any inherent gain in the asset;
  - then the remaining amount divided among properties according to FMV.
- Negative adjustments:
  - Are first allocated to assets with unrealized depreciation effectively eliminating the inherent loss; and
  - then according to their adjusted bases (not fmv).

743(b) vs. 734(b): Common Issues

- 734(b) adjustments increase partnership basis for all remaining partners; 743(b) adjustments increase partnership basis for only the transferee partner.
  - Consider when only certain partners are funding the purchase.
- 734(b) adjustment increases partnership basis. Allocation of depreciation/amortization deductions will follow general partnership allocation rules; 743(b) adjustments are separately depreciated/amortized by transferee partner.
  - Consider when partner is acquiring preferred interest that might not generally be entitled to depreciation/amortization deductions.

Making the Election

- 754 Election is first made on regularly filed tax return.
- Once made, can only be revoked with IRS permission.
- Can result in administrative burden for some partnerships.
    - Hedge Funds
    - Private Equity Funds
    - Widely held partnerships

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IRC Section 754: Partnership and Pass-Through Entity Basis Adjustments

Darren J Mills, Esq., CPA, ChFC®, CLU®

October 04, 2018

Agenda

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- Sec. 736
- Hot Assets
- Basis adjustments

IRC § 736

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- IRC § 736:
  - Only applies to payments from the partnership and not between partners
  - Payment determined with respect to income then a distributive share of partnership income. (a)(1); PLR 9649007
  - Without regard to income then a guaranteed payment. (a)(2)
  - In exchange for the partnership interest. (b)(1).

IRC § 736 – cont'd

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- IRC § 736:
  - Decedent treated as a partner until her interest has been completely liquidated.
  - Two person partnership: partnership is not considered to have terminated until the entire interest of the decedent is liquidated. Treas. Reg. 1.736-1(a)(1)(ii); Est. of Quirk v. Comm'r, 928 F.2d 751 (6^{th} Cir. 1991)

IRC § 736 – cont'd

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- IRC § 736:
  - Need to segregate payments (736(b)) between payments in exchange for his interest in the partnership from distributive share or guarantee payment (736(a)).
  - Fixed payment over a fixed number of years: the portion of each payment to be treated as a distribution under (b) for the tax year must bear the same ratio to the total fixed agreed payments for such year (as distinguished from the amount actually received) as the total fixed agreed payments under (b) bear to the total fixed agreed payments under (a) and (b). The balance, if any, of such amount received in the same tax year is treated as a distributive share or a guaranteed payment under (a)(1) (a)(2))

IRC § 736 – cont'd

- IRC § 736:
  - "…deceased partner's successor in interest receives payments which are not fixed in amount, such payments shall first be treated as payments in exchange for his interest in partnership property under section 736(b) to the extent of the value of that interest and, thereafter, as payments under section 736(a)." Treas. Reg. § 1.736-1(b)(5)(i)

- IRD:
  - Partners: “The amount includible in the gross income of a successor in interest of a deceased partner under section 736(a) shall be considered income in respect of a decedent under section 691.” IRC § 753
    - S-Corporation: included in decedent’s tax return. IRC §1367(b)(4); Pub. 559

Hot Assets

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- IRC § 751
  - Prevents the re-characterization of OI into CG.
    - Sale or exchange of a partnership interest. (a)(1)
    - Distribution exception to IRC § 731. (b)(1)
      - Unrealized receivables and substantially appreciated inventory.
  - (b)(1) does not apply to 736(a) payments to a deceased partner. (b)(2).
    - Unrealized receivables
    - Inventory
    - Goodwill

Hot Assets – Cont'd

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- If capital is NOT a material income producing factor (think personal services) and retiring partner was a GP then unrealized receivables and goodwill are not 736(b) payments but taxed under 736(a).

Basis Adjustments Partnership Interest

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- Inside basis of PNS not adjusted upon transfer
- Decedent's successor to the partnership interest generally takes a basis equal to the FMV of the interest at time of death. IRC § 1014
  - Includes allocable share of liabilities under IRC § 752
  - Consider IRC § 754 election.
  - Generally, the basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of his death or at the alternate valuation date, increased by his estate's or other successor's share of partnership liabilities, if any, on that date, and reduced to the extent that such value is attributable to items constituting income in respect of a decedent… Treas. Reg. § 1.741-1

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- IRC § § 743(b)
  - Transferee partner only
  - Substantial BIL > $250,000
    - TCJA changes: the transferee partner would be allocated a loss of more than $250,000 if the partnership assets were sold for cash equal to their fair market value immediately after such transfer
  - Tiered partnerships
    - Rev. Rul. 87-115
    - Rev. Rul. 92-15

- Increase = OB > IB
- Decrease = OB < IB
- IB = A transferee's share of the adjusted basis to the partnership of partnership property is equal to the sum of the transferee's interest as a partner in the partnership's <u>previously taxed capital</u>, plus the transferee's share of partnership liabilities. Treas. Reg. § 1.743-1(d)(1)

Basis Adjustments Partnership Interest

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- PTC = Cash + Allocable Tax Loss – Allocable Tax Gain
  - Hypothetical Sale

Corporate/Transactional Issues in754 Elections

- Acquisitions of entities with goodwill subject to Code Section 197(f)(9)
  - 743(b) exception to the anti-churning rules
  - 734(b) vs. disguised sale
  - Structuring acquisition financing for 743(b)
- Calculating tax distributions
  - Is the adjustment taken into account?
  - Impact on buyers (current monetization of step-up)
  - Impact on sellers
  - Impact on lenders
  - 743(b) vs. 734(b)