

## Section 743(b) Adjustments in Multi-Tier Partnerships: Applying Rev. Rul. 87-115 to Upper- and Lower-Tier Entities

TUESDAY, JUNE 20, 2017, 1:00-2:50 pm Eastern

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# Section 743(b) Adjustments in Multi-Tier Partnerships

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June 20, 2017

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Jeffrey N. Bilsky, Partner, National Tax Office  
BDO USA, Atlanta  
[jbilsky@bdo.com](mailto:jbilsky@bdo.com)

Thomas A. Orr, CPA, Tax Manager  
BDO USA, Anchorage, Alaska  
[torr@bdo.com](mailto:torr@bdo.com)

David Patch, Senior Director, National Tax Office Partnership Group  
BDO USA, McLean, Va.  
[dpatch@bdo.com](mailto:dpatch@bdo.com)

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# Section 743(b) Adjustments in Multi-Tier Partnerships

Jeff Bilsky, Partner, BDO USA LLP

David Patch, Managing Director, BDO USA LLP

Tommy Orr, Manager, BDO USA LLP

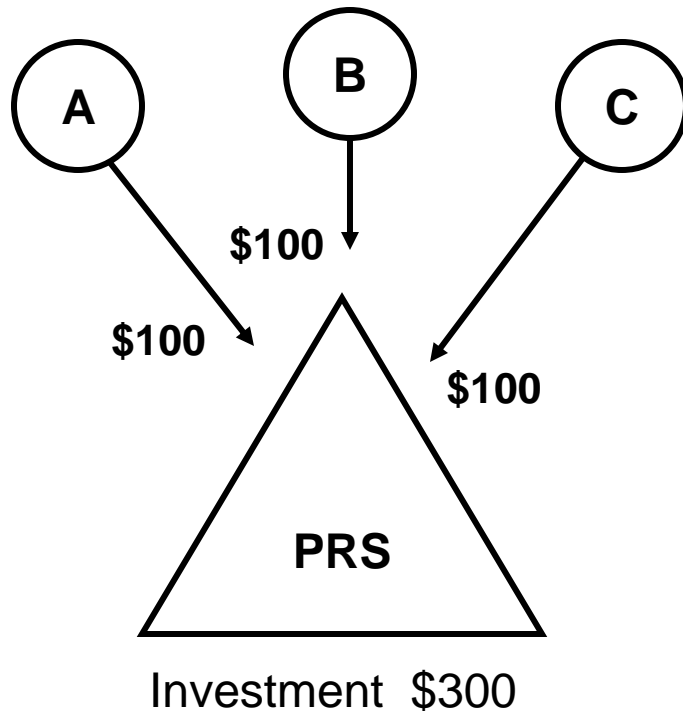
# Agenda

- Overview of the section 743(b) adjustment
- Section 743(b) adjustment example
- Basis allocations under section 755 & effect of the adjustment
- Making a section 754 election and mandatory adjustments
- Section 743(b) Adjustments in Tiered Structures - Detailed Rules
- Section 743(b) Adjustments in Tiered Structures - Other Considerations

# Overview of the Section 743(b) Adjustment

Jeff Bilsky, BDO National Tax Office

# Purpose of the Adjustment

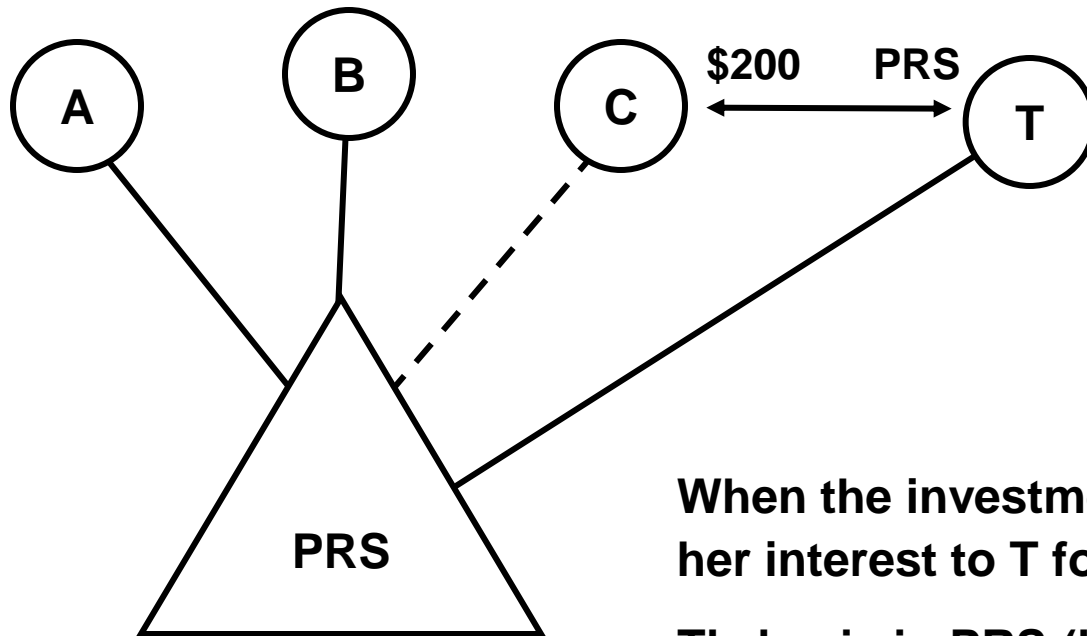


**A, B and C each contribute \$100 to equal partnership PRS.**

**PRS purchases an investment for \$300.**



# Purpose of the Adjustment

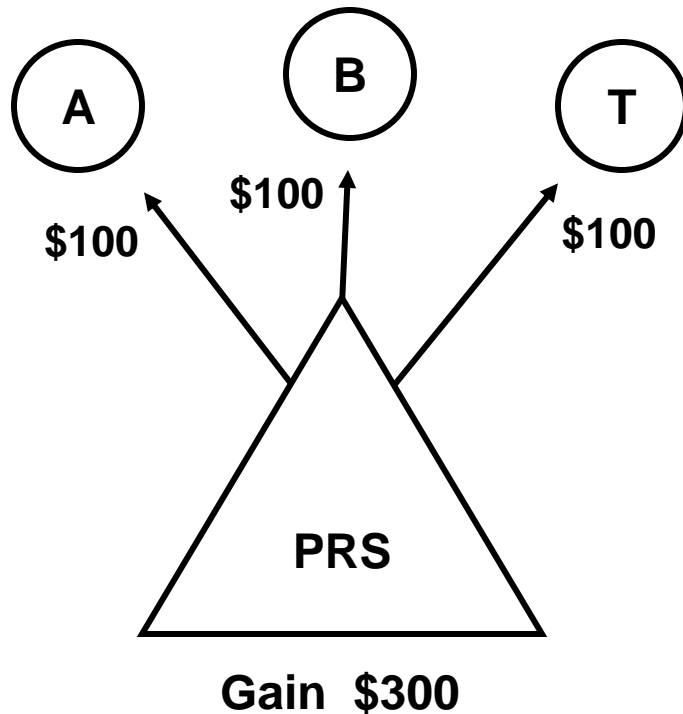


Investment  
Basis = \$300  
Value = \$600

When the investment is worth \$600, C sells her interest to T for \$200.

- T's basis in PRS (his *outside* basis) is \$200
- T's share of PRS's basis in the Investment (his *inside* basis) is \$100

# Purpose of the Adjustment

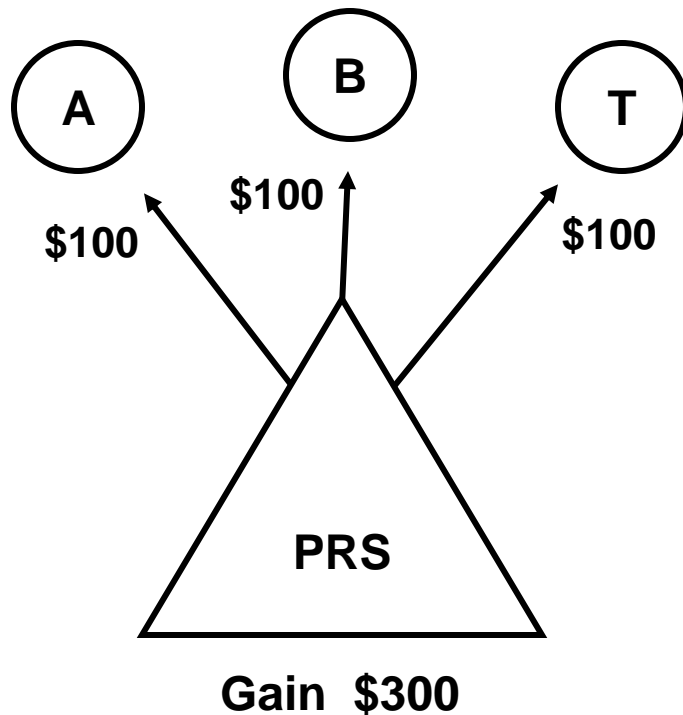


PRS sells the investment for \$600.

Taxable gain of \$300 is allocated equally to A, B and T

T has no *economic* gain so why does he have tax gain?

# Purpose of the Adjustment



PRS sells the investment for \$600.

Taxable gain of \$300 is allocated equally to A, B and T

T has no *economic* gain so why does he have tax gain? ***Because T is recognizing C's share of the partnership's gain.***

# The Section 743 Adjustment

- Section 743(b) allows a partnership to adjust the tax basis of its assets to reflect a sale or exchange of a partnership interest (or transfer at death)
  - Equalizes inside and outside basis for the transferee
  - May be a positive or negative adjustment
- Section 754 provides an election to apply section 743(b)
  - No positive adjustment without election
  - Binding election - revocable only with permission
  - Also activates section 734(b), relating to distributions
- Adjustment is mandatory if the partnership has a “substantial built-in loss”

# Calculating the Adjustment

- The 743(b) adjustment is equal to the difference between:
  - The basis to the transferee partner in his partnership interest (his outside basis), and
  - His *proportionate share of the adjusted basis of the partnership property* (his share of the inside basis)
- The transferee's proportionate share of adjusted basis of the partnership property is equal to:
  - The transferee's interest in the partnership's *previously taxed capital*, plus
  - The transferee's share of partnership liabilities (Treas. Reg. section 1.743-1(d)(1))

# Calculating the Adjustment

- A transferee's interest in the partnership's *previously taxed capital* is equal to:
  - The amount of cash that the transferee would receive on a liquidation of the partnership following a hypothetical sale of all its assets at FMV plus
  - The loss (or minus the gain) that would be allocated to the transferee from the hypothetical sale of the partnership's assets (to the extent attributable to the acquired partnership interest)

# Amount of the Adjustment

## Purchaser's Basis

Consideration Paid	+XXXX
Liabilities Assumed	+XXXX

## Less: Inside Basis

Previously  
Taxed Capital

Cash on Liquidation @FMV	-XXXX
-Gain/+Loss Allocation	+/-XXXX
Liabilities Assumed	-XXXX

## Section 743 Adjustment

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XXXX

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# Amount of the Adjustment

Purchaser's Basis	
Consideration Paid	+XXXX
<del>Liabilities Assumed</del>	<del>+XXXX</del>
Less: Inside Basis	
Cash on Liquidation @FMV	-XXXX
-Gain/+Loss Allocation	+/-XXXX
<del>Liabilities Assumed</del>	<del>-XXXX</del>
Section 743 Adjustment	<hr/> XXXX <hr/>



# Amount of the Adjustment

Purchaser's Basis

~~Consideration Paid~~ ~~+XXXX~~

~~Liabilities Assumed~~ ~~+XXXX~~

Less: Inside Basis

~~Cash on Liquidation @ FMV~~ ~~-XXXX~~

-Gain/+Loss Allocation +/-XXXX

~~Liabilities Assumed~~ ~~-XXXX~~

Section 743 Adjustment

XXXX

# Amount of the Adjustment

Purchaser's Basis	
<del>Consideration Paid</del>	<del>—+XXXX</del>
<del>Liabilities Assumed</del>	<del>—+XXXX</del>
Less: Inside Basis	
<del>Cash on Liquidation @ FMV</del>	<del>—XXXX</del>
<b>-Gain/+Loss Allocation</b>	<b>+/-XXXX</b>
<del>Liabilities Assumed</del>	<del>—XXXX</del>
Section 743 Adjustment	<hr/> XXXX <hr/>

# Section 743(b) Adjustment - Example

Tommy Orr, BDO National Tax Office

# Section 743(b) Example

- A is a member of partnership PRS, a three-person partnership, in which the partners have equal interests in capital and profits. The partnership has made an election under section 754, relating to the optional adjustment to the basis of partnership property. A sells its interest to T for \$22,000. The balance sheet of the partnership at the date of sale shows the following:

	<b>Adjusted Basis</b>	<b>Fair Market Value</b>
<b>Cash</b>	<b>\$5,000</b>	<b>\$5,000</b>
<b>Accounts Receivable</b>	<b>10,000</b>	<b>10,000</b>
<b>Inventory</b>	<b>20,000</b>	<b>21,000</b>
<b>Depreciable Assets</b>	<b><u>20,000</u></b>	<b><u>40,000</u></b>
<b>Total</b>	<b>55,000</b>	<b>76,000</b>
<b>Liabilities</b>	<b>\$10,000</b>	<b>\$10,000</b>
<b>Capital – A</b>	<b>15,000</b>	<b>22,000</b>
<b>Capital – B</b>	<b>15,000</b>	<b>22,000</b>
<b>Capital – C</b>	<b><u>15,000</u></b>	<b><u>22,000</u></b>
<b>Total</b>	<b>55,000</b>	<b>76,000</b>

# Section 743(b) Example

1. T's Basis in PRS is equal to his cost of \$22,000 cash plus his assumption of liabilities of \$3,333 = \$25,333
2. Upon liquidation of the partnership, T would receive 1/3 of the net proceeds:  $1/3 \times (\$76,000 - \$10,000) = \$22,000$ .
3. Upon sale of its assets PRS would have a gain of \$21,000 (\$76,000 FMV - \$55,000 basis). T's share would be 1/3<sup>rd</sup> or \$7,000
4. T's share of previously taxed capital is \$22,000 - \$7,000 = \$15,000
5. T's share of liabilities is  $1/3 \times \$10,000 = \$3,333$
6. T's 743 adjustment is  $\$25,333 - (\$15,000 + \$3,333) = \underline{\underline{\$7,000}}$

# Section 743(b) Example

<b>Purchaser's Basis</b>	
<b>Consideration Paid</b>	<b>\$22,000.</b>
<b>Liabilities Assumed</b>	<b>3,333.</b>
<b>Less: Inside Basis</b>	
<b>Cash on Liquidation @FMV</b>	<b>(22,000)</b>
<b>-Gain/+Loss Allocation</b>	<b>7,000</b>
<b>Liabilities Assumed</b>	<b>(3,333)</b>
<b>Section 743 Adjustment</b>	<hr/> <b>\$7,000</b> <hr/>

# Section 743(b) Example

What is A's gain from the sale of the partnership interest?

- A's proceeds on the sale are \$22,000 plus his relief from PRS liabilities of \$3,333 = \$25,333.
- A's basis in his PRS interest is his tax basis capital, \$15,000, plus his share of liabilities, \$3,333 = \$18,333.
- A's gain on the sale is \$25,333 - \$18,333 = \$7,000

If A's outside basis is equal to his share of the inside basis, then his gain should equal T's section 743(b) adjustment





# Allocation of Basis Adjustment under Section 755 & Effect of Adjustment

David Patch, BDO National Tax Office

# Allocation of the Adjustment

- Section 755 provides the mechanical rules
- Generally allocates adjustment based on relative unrealized gain or loss
- Basis adjustments may be positive for some assets and negative to others
- For substituted basis transactions basis adjustments are in one direction only

# The Section 755 Process

- Determine the value and basis of each partnership asset
  - Partnerships with an active trade or business must use the residual method under section 1060 for assigning value
  - Reasonable determination otherwise
- Divide partnership assets into 2 classes:
  - Ordinary income property (“Hot” assets)
  - Capital and 1231 assets (“Cold” assets)
- Allocate the adjustment between the classes
- Allocate the adjustment to specific assets within each class

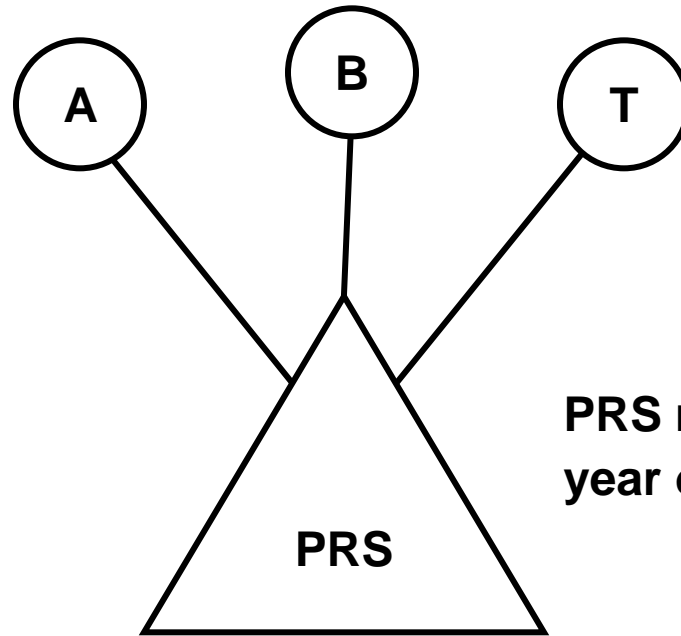
# Reporting Requirements

- Partnership Statement in Year of Adjustment
  - The name and taxpayer identification number of the transferee
  - The computation of the adjustment
  - The partnership properties to which the adjustment has been allocated
- Transferee Notification Requirements
  - The transferee must provide information to the partnership to compute the adjustment
  - The partnership does not have to report the adjustment otherwise

# Effect of Section 743 Adjustments

- A section 743(b) basis adjustment relates to a specific partner and does not effect the partnership's common basis or taxable income computations (Treas. Reg. section 1.743-1(j))
  - The partnership first computes income without regard to the section 743 adjustment and allocates it in accordance with section 704
  - The partnership then adjusts the transferee's distributive share to reflect the effects of the transferee's basis adjustment under section 743(b).
  - The transferee's share of gain or loss on sale of the adjusted asset, depreciation, amortization and depletion may be affected by the adjustment
- ***The adjustments must be reflected on Schedules K and K-1 of the partnership's return (Form 1065).***
- Section 743(b) adjustments are NOT reflected in capital accounts for purposes of section 704

# Effect of the Adjustment



**PRS makes a 754 election for the year of the sale**

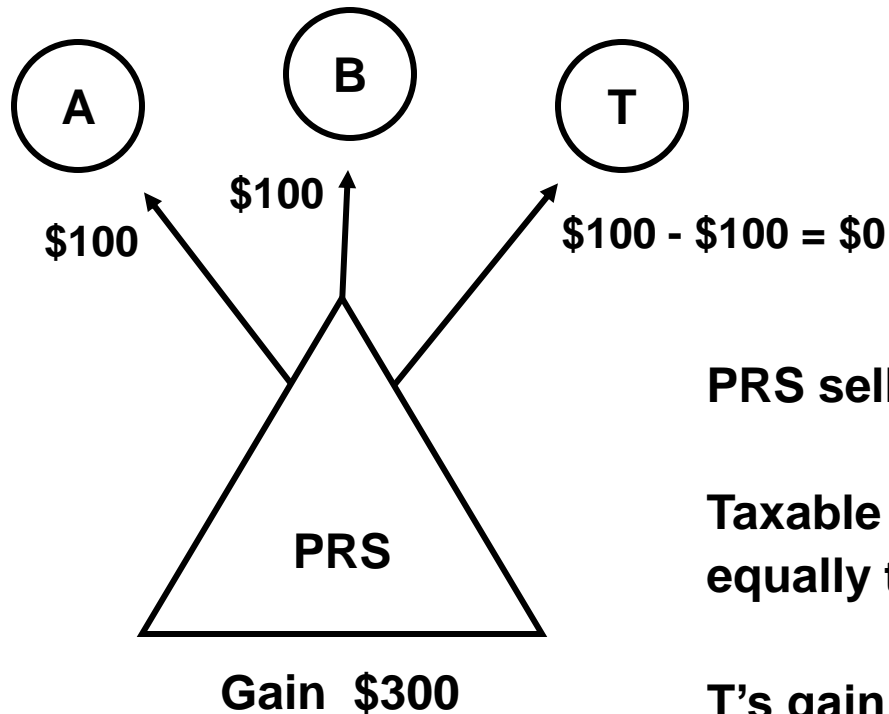
**Investment**

**“Common” Basis = \$300**

**Value = \$600**

**Section 743(b) basis adjustment for T’s  
use only - \$100**

# Effect of the Adjustment



**PRS sells the investment for \$600.**

**Taxable gain of \$300 is allocated equally to B, C and T**

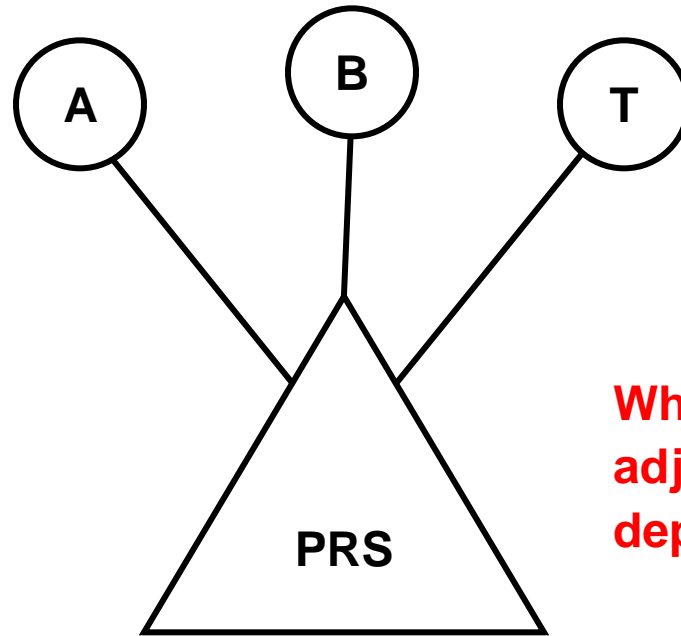
**T's gain is reduced by his section 743 basis adjustment**

# Cost Recovery of Section 743 Adjustments

- **Basis increases**
  - Treated as newly-purchased property placed in service when the transfer occurs.
  - Any applicable recovery period and method may be used to determine depreciation, amortization or depletion.
  - Exception
    - If adjustment relates to 704(c) property, and
    - The remedial method is being used for that property
    - The related section 743(b) adjustment is recovered over the same period as the 704(c) effects
- **Basis decreases**
  - Recovered over remaining useful life of adjusted property



# Effect of the Adjustment



**What if the section 743 adjustment is allocated to depreciable property?**

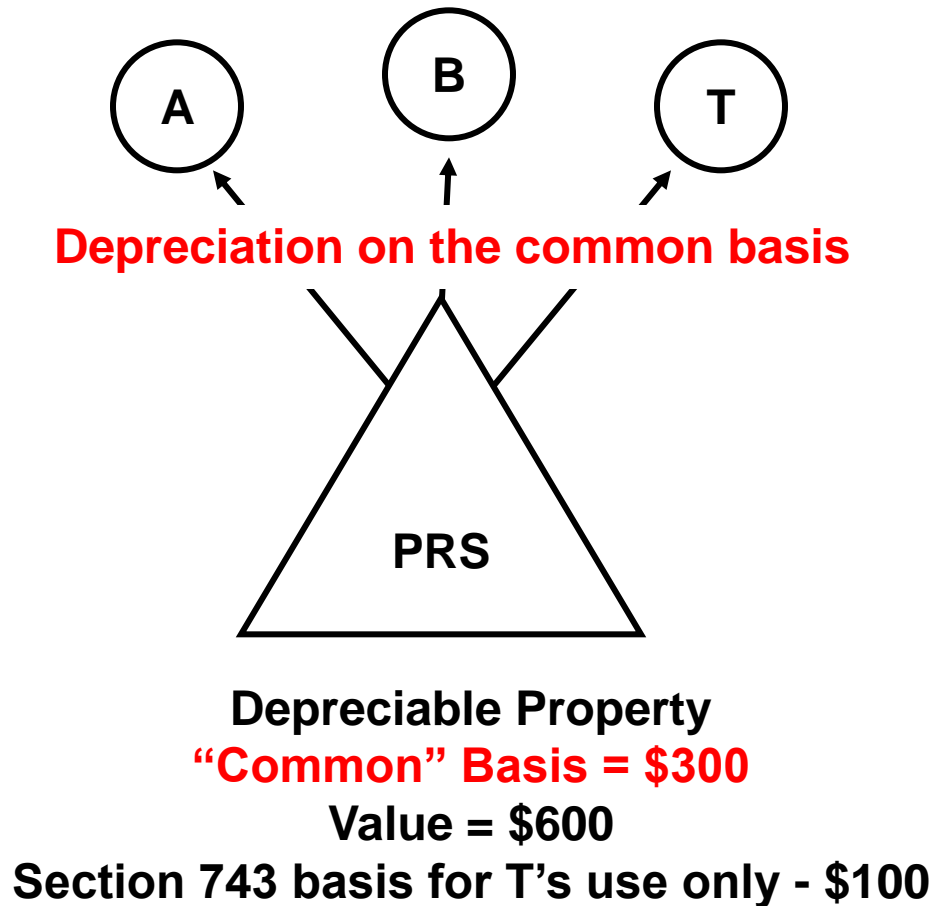
**Depreciable Property**

**“Common” Basis = \$300**

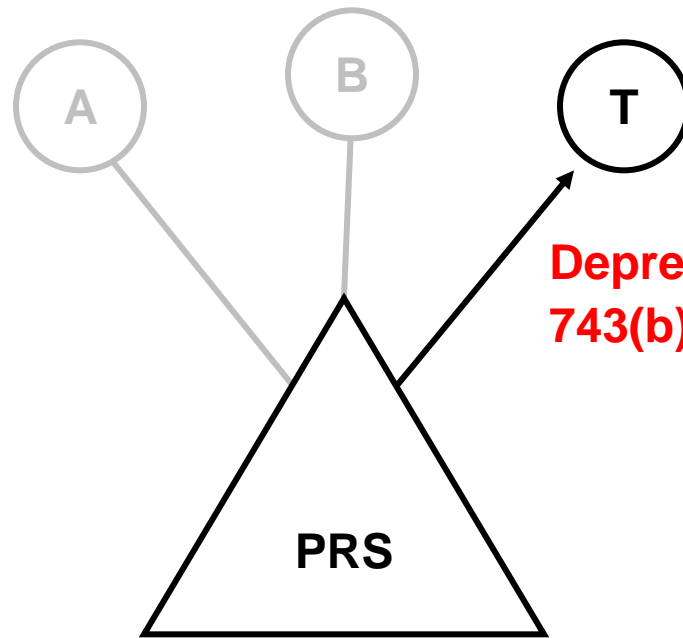
**Value = \$600**

**Section 743 basis for T’s use only - \$100**

# Effect of the Adjustment



# Effect of the Adjustment



**Depreciation on the section 743(b) basis adjustment**

**Depreciable Property  
"Common" Basis = \$300  
Value = \$600**

**Section 743 basis for T's use only - \$100**

# Making the Section 754 Election & Mandatory Adjustments

David Patch, BDO National Tax Office

# 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

# Mandatory Adjustments

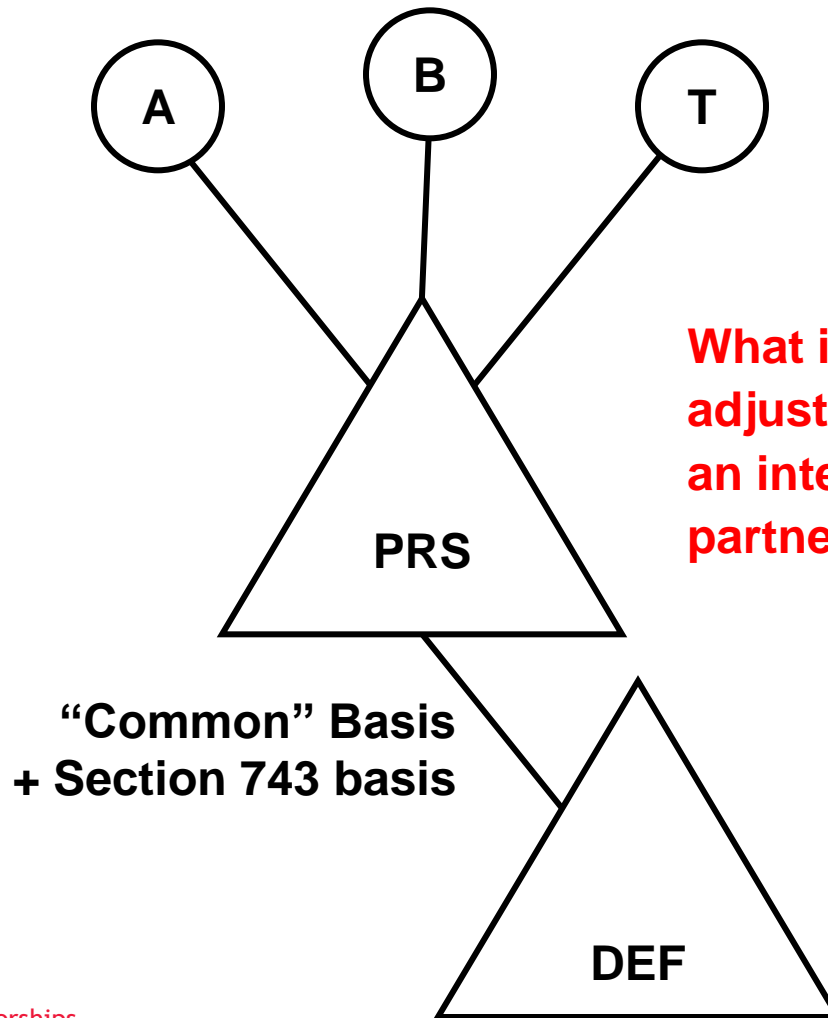
- Generally, a section 743 basis adjustment (positive or negative) is made only if there is a section 754 election in place for the year in which the distribution is made
- A section 743 basis adjustment is mandatory if there is a “substantial built-in loss” on the partnership’s assets
- A substantial built-in loss exists if the basis of the partnership’s assets (in total) exceed their basis by more than \$250,000



# Section 743(b) Basis Adjustment in Tiered Partnership Structures

Jeff Bilsky, BDO National Tax Office

# Tiered Partnerships



**What if the section 743 adjustment is allocated to an interest in another partnership?**

# Tiered Partnership Example

Partner C is a member of partnership PRS in which the partners have equal interests in capital and profits. The partnership has made an election under Sec. 754. C sells its interest to T for \$22,000. The tax basis and FMV of PRS's assets attributable to T's interest are summarized in the following table.

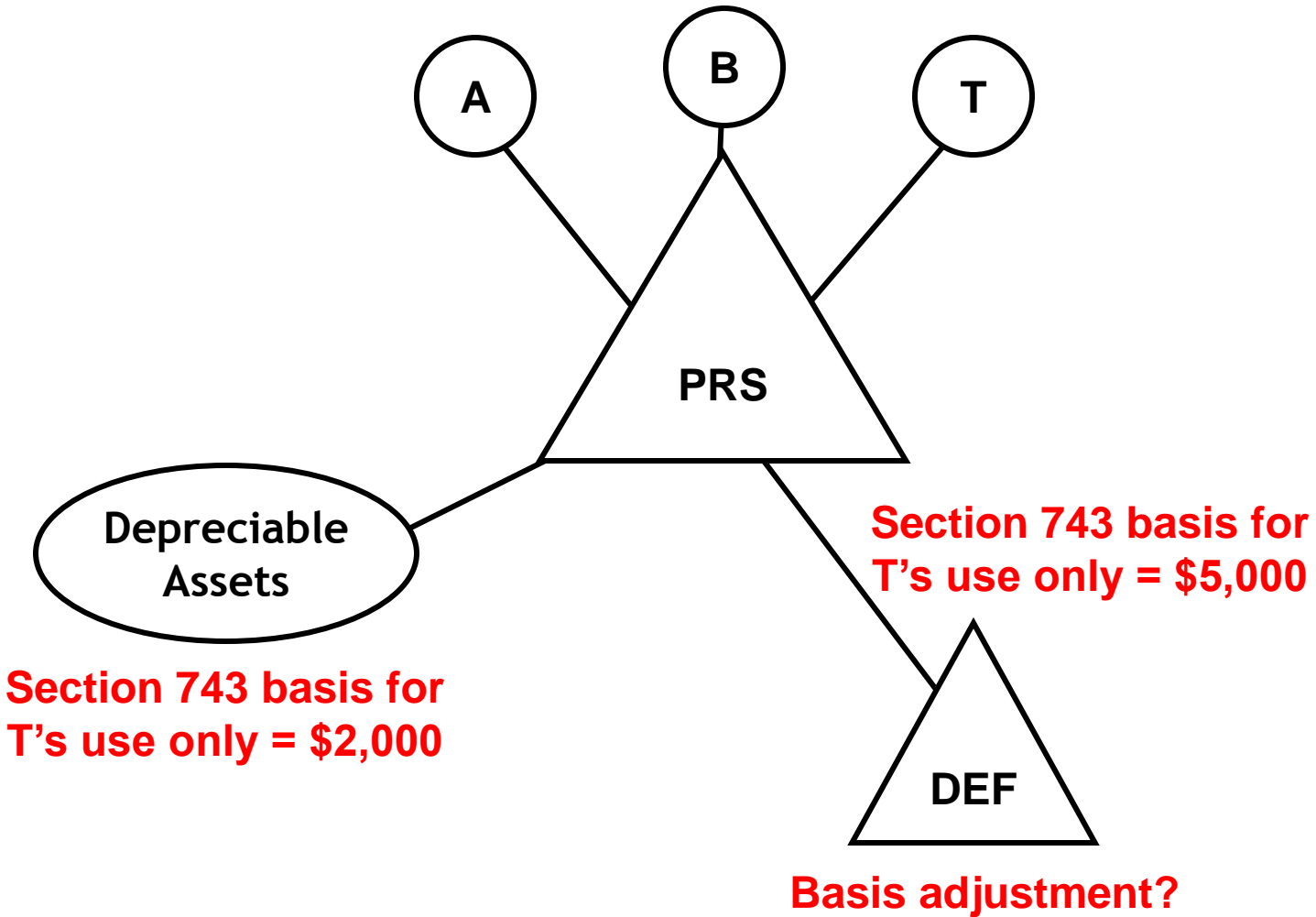
# Example Facts

	Tax Basis	Value	U/R Gain (Loss)	T's 1/3 <sup>rd</sup> Interest
Cash	\$7,500	7,500	0	0
Fixed Assets	\$15,000	21,000	6,000	2,000
Interest in DEF	\$21,500	37,500	15,000	5,000
Total	\$45,000	66,000	21,000	7,000

# Adjustment to PRS' Assets

- T's total basis step-up is \$7,000, the difference between T's purchase price of \$22,000 and T's share of the tax basis of PRS's assets of \$15,000.
- The \$7,000 step-up is assigned to PRS' assets based on their relative appreciation.
  - Depreciable assets have total appreciation of \$2,000
  - The interest in partnership DEF has appreciation of \$5,000

# Example



# Adjustment Allocated to DEF

- How and when does the section 743 adjustment allocated to PRS's interest in DEF affect the taxable income of DEF? ...of PRS? ...of Partner T?
- What are the implications of PRS making or failing to make a Sec. 754 election?
- What are the implications of DEF making or failing to make a Sec. 754 election?

# Rev. Rul. 87-115\*

- If PRS makes a 754 election:
  - PRS adjusts the basis of its assets under section 743, and some of that adjustment may be allocated to its interest in DEF
  - If DEF also makes 754 election, DEF must make a corresponding adjustment to the basis of its assets
  - If DEF does not make a 754 election then there is no corresponding adjustment
- If PRS does NOT make a 754 election
  - Then there is no basis adjustment for either PRS or DEF unless there is a substantial built-in loss at PRS
- The effect of the adjustment, if any, is specially allocated to T

\* See also Prop. Reg. section 1.743-1(l)



# PRS and DEF Both Make Section 754 Elections

- The making of a Sec. 754 election by PRS manifests an intent to be treated as an aggregate for purposes of section 743. Consequently, the sale of an interest in PRS is viewed as a sale of interests in all assets held by PRS, including DEF.
- The deemed sale of an interest in DEF triggers the application of Section 743 to DEF. Since DEF has a section 754 election in place, it must adjust the basis in its assets under section 743.
- *Will the adjustment to PRS' basis in DEF always equal DEF's adjustment to the basis of its assets?*

# PRS and DEF Both Make Section 754 Elections

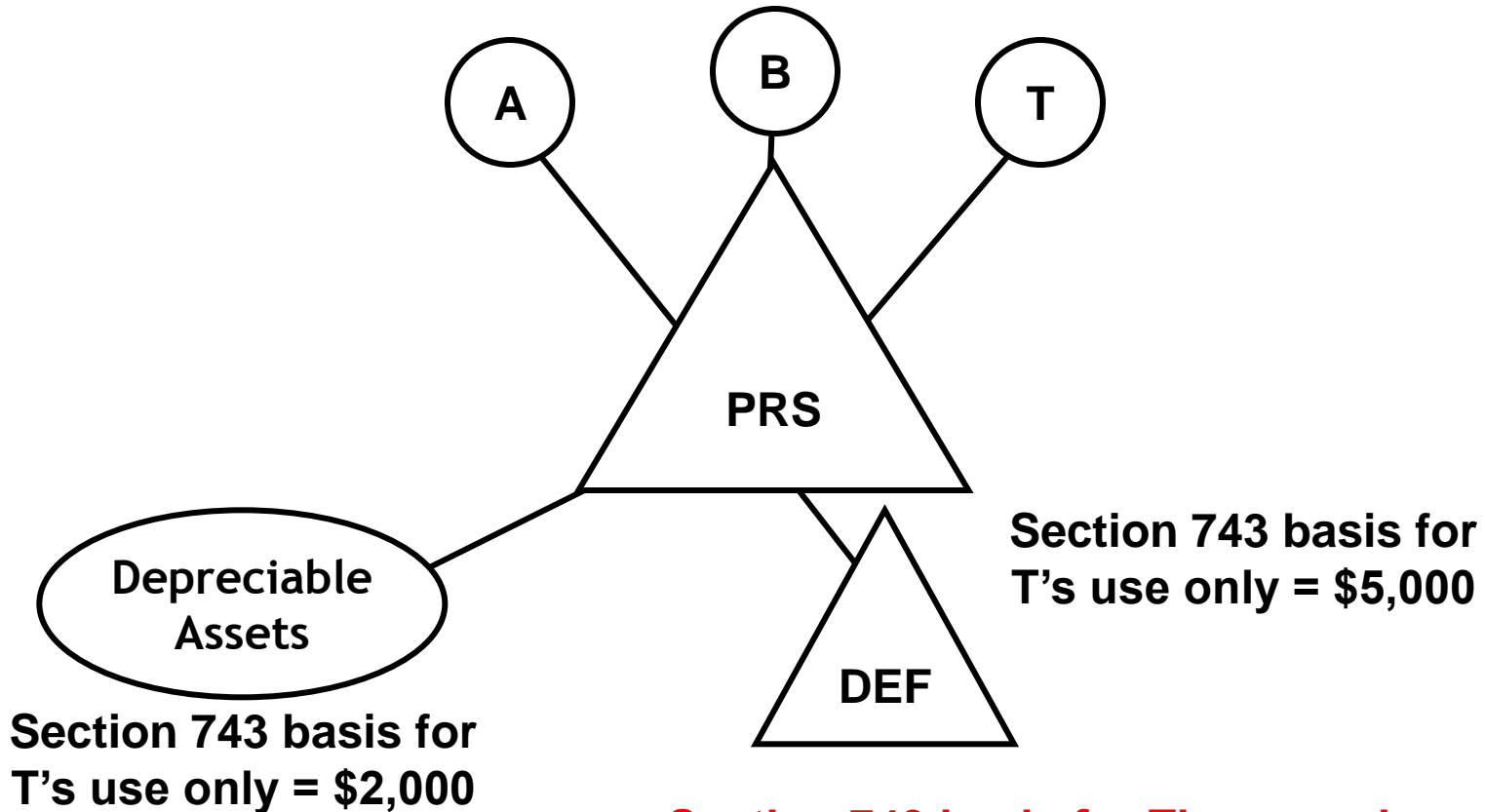
The tax basis and FMV of DEF's assets attributable to PRS's interest are summarized in the following table:

	Tax Basis	Value	U/R Gain (Loss)	T's 1/3 <sup>rd</sup> Interest
Cash	5,500	5,500	0	0
Cash Basis A/R	0	6,000	6,000	2,000
Fixed Assets	17,000	14,000	(3,000)	(1,000)
Goodwill	0	12,000	12,000	4,000
<b>Total</b>	<b>22,500</b>	<b>37,500</b>	<b>15,000</b>	<b>5,000</b>

# Adjustment to DEF' Assets

- T's total basis step-up is \$5,000, the difference between T's deemed purchase price of \$12,500 and T's share of the tax basis of PRS's assets of \$7,500.
- The \$5,000 step-up is assigned to DEF's assets based on their relative appreciation.
  - Cash Basis A/R have total appreciation of \$2,000
  - Fixed Assets have total depreciation of \$(1,000)
  - Goodwill has appreciation of \$4,000

# Both Make 754 Elections



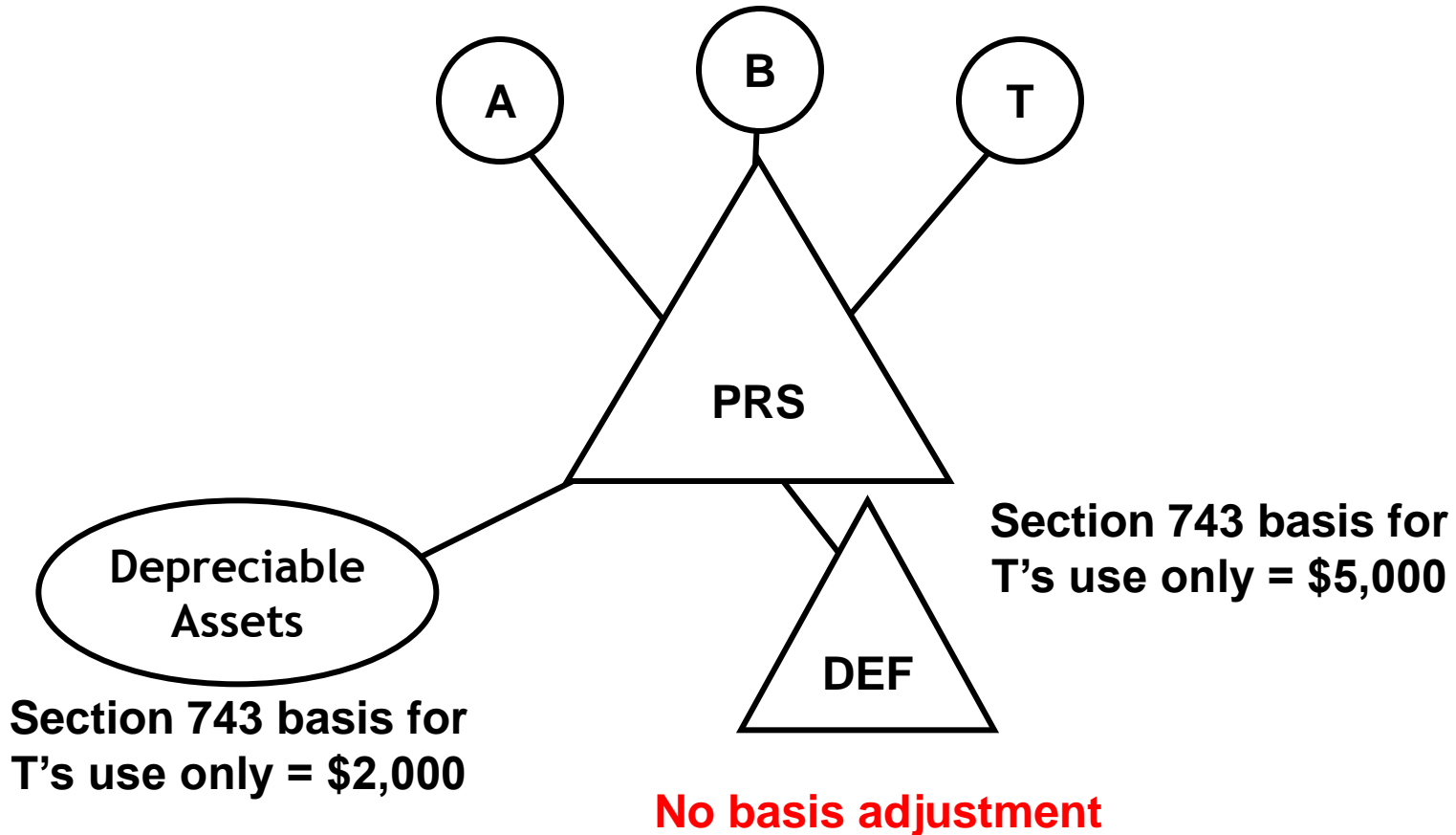
**Section 743 basis for T's use only**

Cash Basis A/R	\$ 2,000
Fixed Assets	\$(1,000)
Goodwill	\$ 4,000

# Only PRS Makes a Section 754 Election

- PRS adjusts the basis of its interest in DEF
- No Sec. 743(b) adjustment is made to DEF's assets
- The adjustment will still effect income items related to PRS's basis in its DEF interest:
  - Sales of DEF interests
  - Distributions in excess of the basis of its DEF interest

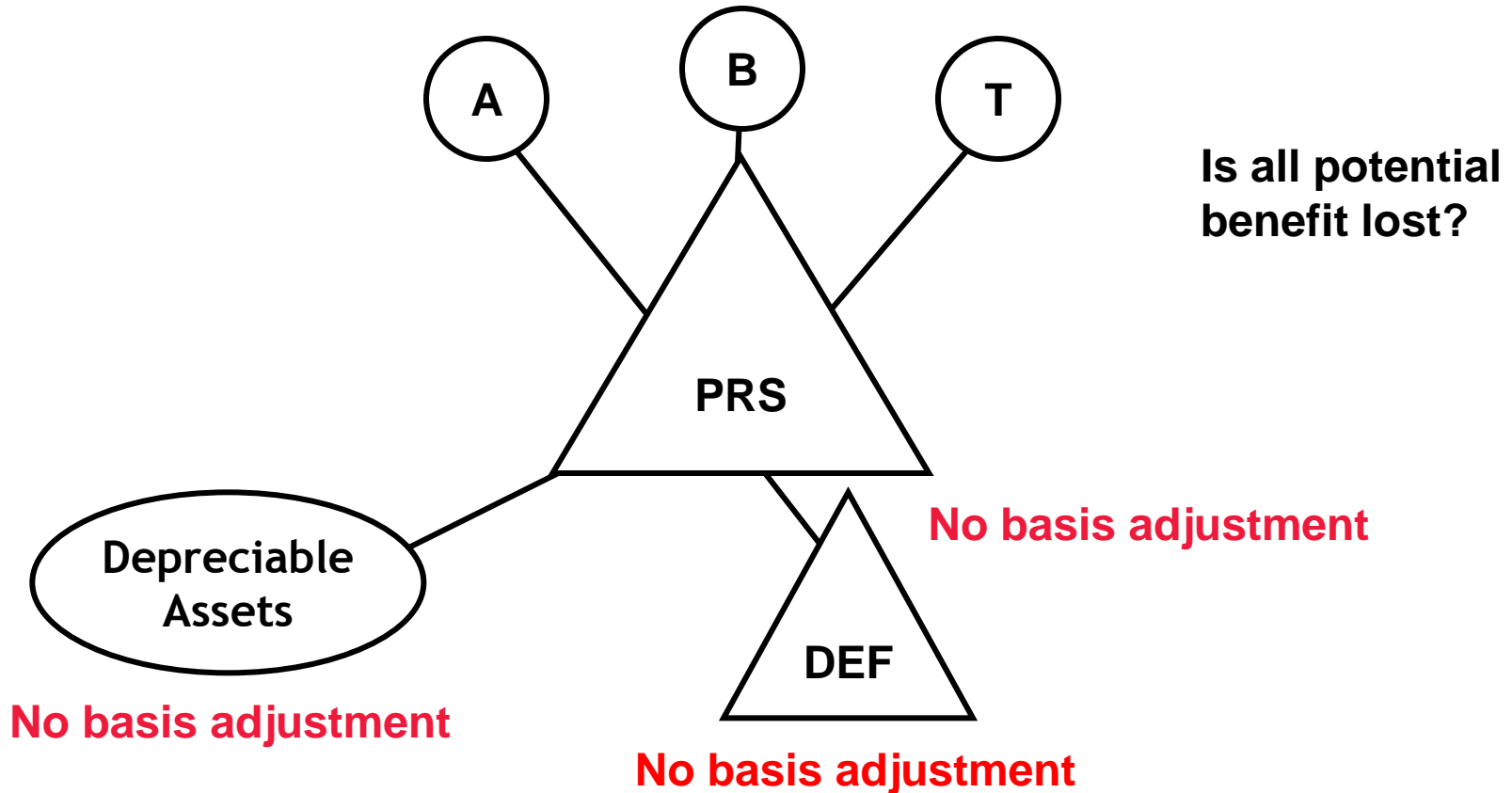
# Only PRS Makes the Election



# Only DEF Makes a Section 754 Election

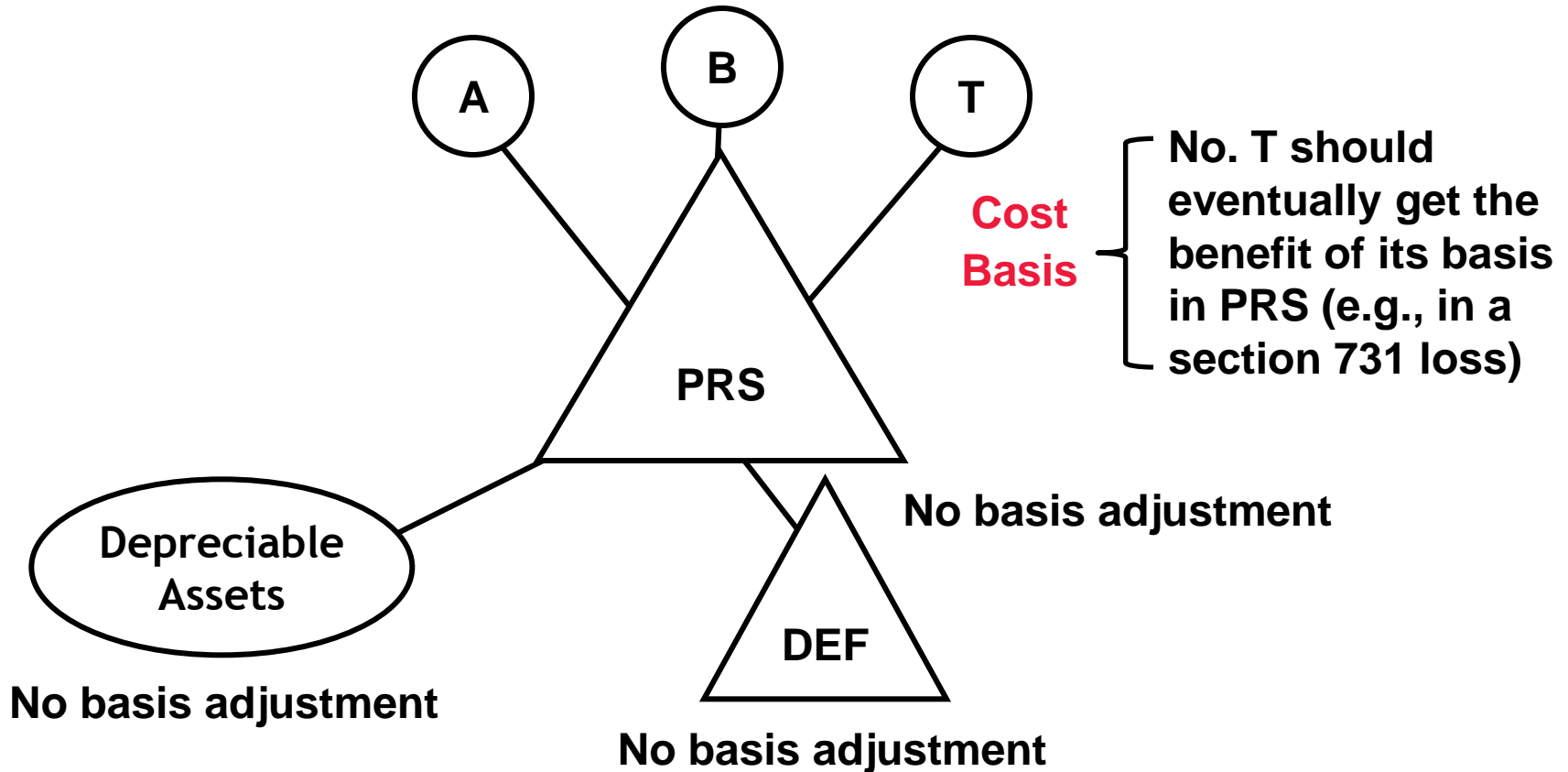
- By not making a Sec. 754 election, PRS manifests an intent to be treated as an entity for purposes of section 743.
- Consequently, the sale of an interest in the PRS is not treated as a sale of PRS' interest in DEF.
- Thus, the sale of an interest in PRS does not trigger a section 743(b) adjustment within either PRS or DEF.
- Same result if neither PRS nor DEF make a section 754 election

# Only DEF Makes the Election





# Only DEF Makes the Election





# Section 743(b) Basis Adjustment in Tiered Partnership Structures - Other Considerations

Tommy Orr, BDO National Tax Office

# Mandatory Adjustments

- PRS would be required to make a basis adjustment in the absence of a section 754 election if there is a substantial built-in loss ( $> \$250,000$ )
- If PRS is required to make a section 743 adjustment to DEF as a result of this rule, must DEF make a corresponding basis adjustment regardless of whether it makes a section 754 election?

# Mandatory Adjustments

- Prop. Reg. section 1.743-1(l):
  - If an interest in an upper-tier partnership that holds (directly or indirectly through one or more partnerships) an interest in a lower-tier partnership is transferred by sale or exchange or on the death of a partner,
  - And the upper-tier partnership has a substantial built-in loss with respect to the transfer,
  - Then each lower-tier partnership is treated, solely with respect to the transfer, as if it had made a section 754 election for the taxable year of the transfer.
- Effective for transfers on or after the date regulations are finalized

# Pros and Cons of the Election

- Generally, making the section 754 election at all levels is favorable since it maximizes the ability to recover positive basis adjustments more quickly
- Negative basis adjustments are unfavorable for the same reason, but...
  - Because Sec. 743(d) requires negative basis adjustments even without a Sec. 754 election in certain circumstances, the downside risk of making the election is limited.
- Reporting can be complex and costly

# Compliance Complexity

- The tiered rules should apply to each partnership in a chain of ownership
- Computing section 743(b) adjustments requires complex calculations, and multitier partnership structures only exacerbate that complexity
- Rev. Rul. 87-115 does not provide a de minimis threshold, so if all partnerships in a chain have valid section 754 elections, the basis adjustments are mandatory at all levels
- Annual tracking of the adjustments can be cumbersome

# Feasibility and Cost

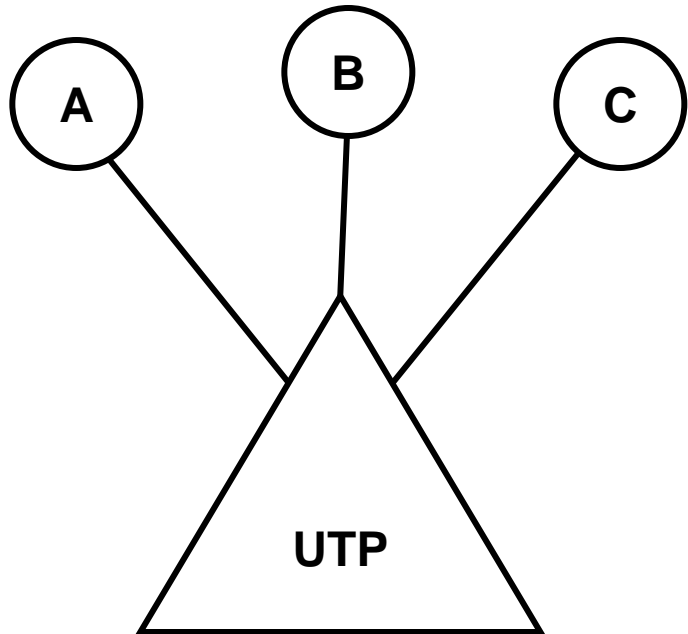
- A UTP that is a minority owner or a non-manager member of an LTP may have difficulty inducing the LTP to make a section 754 election or to properly allocate the adjustment and report its effects
- Even if the UTP is a majority owner of the LTP, getting the LTP to dedicate the time and resources necessary may be a struggle
  - Some partnerships charge the affected partner a fee for the added administrative costs
  - Can the UTP calculate and track the adjustment itself?



# Eliminating a Section 754 Election

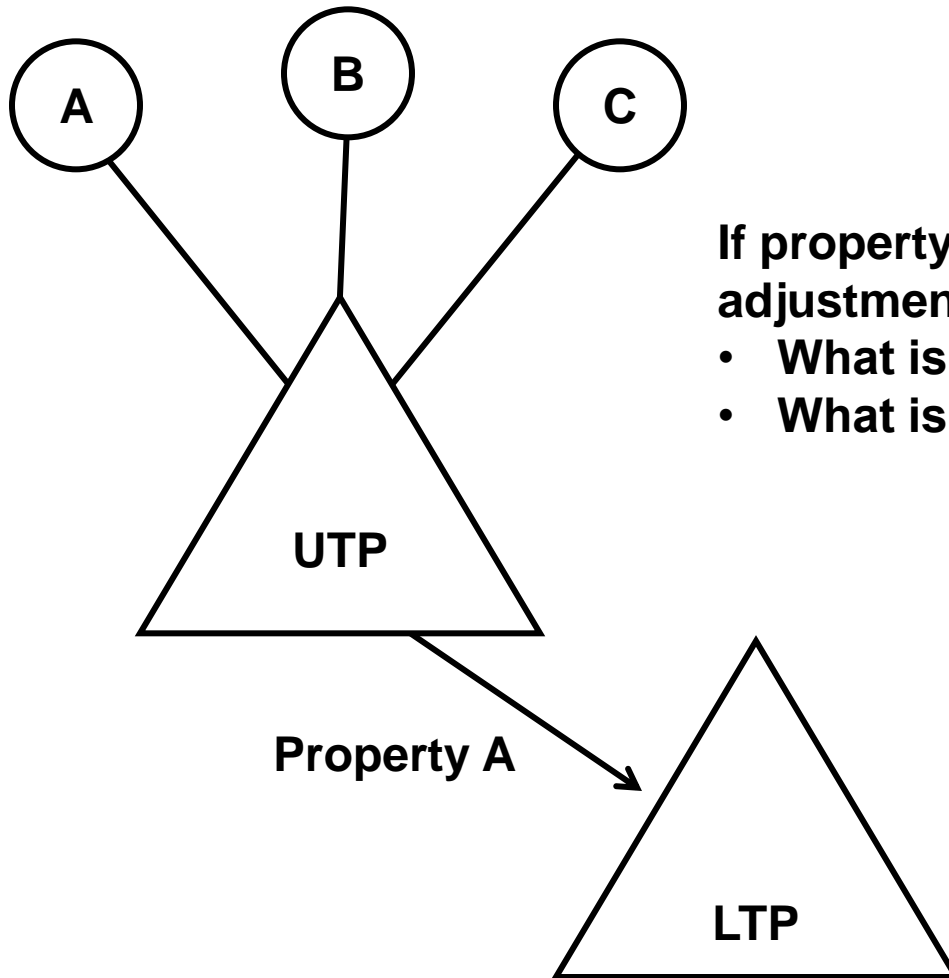
- Revocation is by permission only and is unlikely
- Consider causing a technical termination of the partnership
  - Sale or exchange of 50% or more of the capital and profits interests
  - Non-taxable exchanges (e.g. contributions to other partnerships) are exchanges that may cause a termination
  - Consider other consequences
    - Restarting of MACRS depreciation
    - Need for additional returns
    - Acceleration of certain deferred income

# Contributed Property



Property A  
Common Basis  
+ Section 743 adjustment for C

# Contributed Property



If property with a section 743(b) basis adjustment is contributed to an LTP

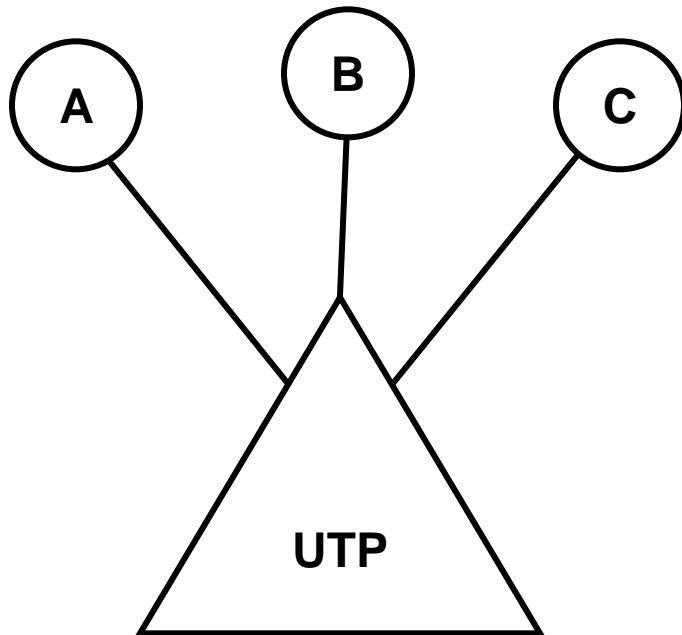
- What is PRS's basis in LTP?
- What is LTP's basis in Property A?

# Contributions to LTP's

If, a UTP contributes property with respect to which a basis adjustment has been made to an LTP:

- The basis adjustment is treated as contributed to the lower-tier partnership
- The LTP's basis in the contributed assets and the UTP's basis in the partnership interest received in the transaction are determined with reference to the basis adjustment.
- That portion of the basis of the UTP's interest in the LTP attributable to the adjustment must be segregated and allocated solely to the transferee partner for whom the basis adjustment was made.
- That portion of the LTP's basis in its assets attributable to the adjustment must be segregated and allocated solely to the UTP and the transferee.

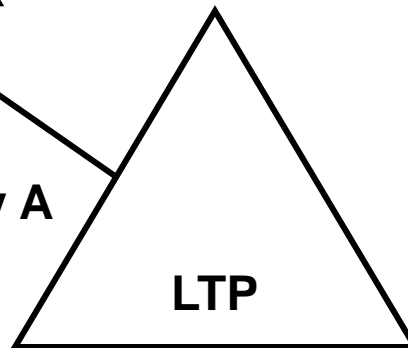
# Contributed Property



Any tax effect attributable to the section 743 basis adjustment must be allocated to C:

- UTP's basis in LTP
- LTP's basis in Property A

UTP's basis in LTP includes the basis adjustment to Property A



LTP's basis in Property A includes the basis adjustment