

“754 Does Not Mean 6 Minutes to 8”

Elliott M. Friedman, CPA, JD

The Basics

Inside basis versus outside basis

- Inside basis is the partnership's adjusted basis in its individual assets.
- Outside basis is the partner's adjusted basis in his partnership interest. Partners have a single outside basis.
- Subject to certain exceptions, the total outside basis of all the partners equals the total inside basis of the partnership in its assets.

What causes disparity between inside and outside basis?

- The death of a partner
- The sale or exchange of partnership interest
- Distributions to a partner resulting gain or loss recognition

§754 Election

Generally, the basis of partnership assets is not adjusted as a result of a transfer of partnership interest or distribution of partnership assets unless a §754 election is in effect.

Under §754, a partnership elects to adjust the basis of the partnership's assets to reconcile a partner's outside basis with his share of the partnership's inside basis.

- Partnership must adjust basis pursuant to §743(b) and §734(b).
- §743(b) – basis adjustment upon a transfer of a partnership interest by a sale or exchange, or upon the death of a partner. The basis adjustment is allocated between ordinary income assets and capital gain assets under §755 rules.
- §734(b) – basis adjustment upon a distribution of assets. The basis adjustment is also allocated between ordinary income assets and capital gain assets under §755 rules.

§754 Election (cont)

The election is made in a written statement filed with the partnership return for the taxable year during which the distribution or transfer occurs.

For the election to be valid, the return must be filed not later than the due date (including extension) for filing the return.

The election statement must:

- Set forth the name and address of the partnership making the election.
- Be signed by any of the partners.
- Contain a declaration that the partnership elects under §754 to apply the provisions of IRC §734(b) and §743(b).

§754 election applies to all transfers and distributions during the tax year with respect to which the election is initially filed and for all such transactions in any subsequent tax years.

New Development

Under new Proposed Rule (82 FR 47,408 – 10/12/2017), the partner's signature would no longer be required for making a §754 election.

- The amendments to the regulation are proposed to apply to taxable years ending on or after the date of publication of the Treasury decision adopting these rules as a final regulation.
- However, taxpayers may rely on this proposed regulation for periods preceding the proposed applicability date.
- Partnerships that filed a timely partnership return containing an otherwise valid §754 election statement, but for the missing signature of a partner on the statement, will not need to seek 9100 relief.

Disclosure of §743(b) and §734(b) Adjustment

Partnership is required to disclose that it has made a §734(b) and §743(b) adjustment on Form 1065, Schedule B, line 12b.

The regulation and Form 1065 instructions require the partnership to attach a statement to the return showing the computation and allocation of the basis adjustment.

The statement must include the transferee partner's name, FEIN or SSN, the adjustment computation, and must identify the adjusted properties.

Example #1 - Facts

Kris and Ryan form an equal partnership K&R, LLC. They each contribute \$1,000 cash which the partnership uses to purchase Assets 1, 2, 3 and 4. After one year, Kris sells his partnership interest to Josh for \$1,000.

Immediately after the transfer of the partnership interest to Josh, the adjusted basis and fair market value of K&R LLC's assets are as follows:

	Adjusted Basis	Fair Market Value
Capital Gain Property:		
Asset 1	\$500	\$750
Asset 2	\$500	\$500
Ordinary Income Property		
Asset 3	\$500	\$250
Asset 4	\$500	\$500
Total	\$2,000	\$2,000

Example #1 – Without §754 Election

Assuming K&R sold all of its assets without making the §754 election, Josh is allocated \$125 of capital gain and \$125 of ordinary loss.

	Adjusted Basis	Fair Market Value	Allocation of Adjustment	Gain/Loss
Capital Gain Property:				
Asset 1	\$250	\$375	None	\$125 - Capital
Asset 2	\$250	\$250	None	None
Ordinary Income Property				
Asset 3	\$250	\$125	None	(\$125) - Ordinary
Asset 4	\$250	\$250	None	None
Total	\$1,000	\$1,000	None	None

Example #1 – With §754 Election

Assuming K&R sold all of its assets after making the §754 election, Josh has no gain or loss on the sale.

	Adjusted Basis	Fair Market Value	Allocation of Adjustment	Gain/Loss
Capital Gain Property:				
Asset 1	\$250	\$375	+ \$125	None
Asset 2	\$250	\$250	None	None
Ordinary Income Property				
Asset 3	\$250	\$125	- (\$125)	None
Asset 4	\$250	\$250	None	None
Total	\$1,000	\$1,000	None	None

Example #1 (cont)

Josh's basis adjustment under §743(b) is zero

- Josh's outside basis = the amount he paid Kris for the interest (\$1,000) + share of debt (\$0).

Josh's share of K&R LLC's inside basis = share of previously taxed capital (\$1,000) + share of debt (\$0)

§743(b) adjustment = \$0 (outside basis – inside basis).

*Previously taxed capital equals cash on sale plus loss on hypothetical sale less gain on hypothetical sale.

If, immediately after the transfer of the partnership interest to Josh, K&R, LLC sold all of its assets in a fully taxable transaction at fair market value:

- Josh would be allocated a loss of \$125 from the sale of the ordinary income property. Thus, the amount of the basis adjustment to ordinary income property is (\$125).
- The amount of the basis adjustment to capital gain property is \$125 (zero, the amount of the basis adjustment under §743(b), less (\$125), the amount of the basis adjustment allocated to ordinary income property).

Late Election - Relief Under Reg.301-9100

Automatic Extension – Reg. 301-9100-2

- The partnership can get an automatic 12 months extension to make the §754 election provided corrective action is taken within 12 months of the original deadline for make the election.
- The document filed to obtain an automatic extension must contain the statement “Filed Pursuant to Reg.301-9100-2” at the top and must be sent to the same address as the filing to make the election would have been sent.
- No user fees apply.

If the automatic 12 months extension deadline has passed, the partnership may be able to obtain a private letter ruling granting for relief under Reg. 301-9100-3.

- Must prove that the partnership acted reasonably and in good faith.
- The relief must not prejudice the interest of the government.
- User fees apply.
- Example: PLR 201510024

The IRS has been remarkably generous in granting relief where the failure was inadvertent.

Mandatory Basis Adjustments

Under §743(d), a basis adjustment must be made if the partnership has a substantial built-in loss immediately after the transfer of partnership interest by sale or exchange or upon the death of a partner.

Substantial built-in loss exists when the adjusted basis of partnership assets exceeds its fair market value by more than \$250,000.

It is mandatory – Even without a §754 election present.

Exceptions:

- Securitization partnerships (very rare)
- Electing investment partnerships (very rare)

Tiered Partnerships

In Rev. Ruls. 92-15 and 87-115, both upper-tier partnership and lower-tier partnership must have §754 election in effect to trigger a basis adjustment at the lower-tier partnership as a result of a transfer of partnership interest or distribution at the upper-tier partnership level.

If only the lower-tier partnership makes a §754 election, no basis adjustment is available at either the upper-tier or the lower-tier partnership level.

Valuation Discounts

Family Limited Partnerships:

- Used to centralize the family's assets under a common management.
- Allows for the shift in investment management responsibilities from one generation to the next.
- Utilization of valuation discounts – lack of marketability & control.

Valuation Discounts (cont)

The typical valuation discount utilized for estate tax purposes on a limited family partnership interest is between 20% and 50%.

This generally results in savings to the taxpayer for the difference between the estate tax rates and the income tax rates (most likely capital gains rates).

The higher the valuation discount, the less beneficial the §754 election becomes on the decedent's successor in interest.

The valuation discount is allocated to partnership's capital gain assets based on relative fair market value of each property.



Example #2

Josh died when his 50% partnership interest is valued for estate tax purpose at \$28,000. A 20% discount is applied for lack of marketability and control. The adjusted basis and fair market value of the partnership's assets are as follows:

	Adjusted Basis	Fair Mark Value
Capital Assets		
Asset 1	\$400	\$14,000
Asset 2	\$7,200	\$36,800
Asset 3	\$13,200	\$11,200
Asset 4	\$24,000	\$8,000
Total	\$44,800	\$70,000

Example #2 (cont)

The estate's basis adjustment under §743(b) is \$5,600

- The estate's outside basis = discounted value of partnership interest on date of death (\$28,000) + share of debt (\$0)
- The estate's share of partnership's inside basis = share of previously taxed capital (\$22,400) + share of debt (\$0)
- §743(b) adjustment = \$5,600 (outside basis – inside basis), all allocated to capital gain assets.

	Adjusted Basis	Fair Market Value	Allocation of Adjustment	Allocation of Discount	Adjusted Basis
Capital Assets					
Asset 1	\$200	\$7,000	\$6,800	-\$1,400	\$5,600
Asset 2	\$3,600	\$18,400	\$14,800	-\$3,680	\$14,720
Asset 3	\$6,600	\$5,600	-\$1,000	-\$1,120	\$4,480
Asset 4	\$12,000	\$4,000	-\$8,000	-\$800	\$3,200
Total	\$22,400	\$35,000	\$12,600	-\$7,000	\$28,000

Considerations for Making the §754 Election

- When the discounted value of the partnership interest (outside basis) is greater than the partner's share of inside basis of partnership's assets.
- When the partnership plans to sell appreciated assets soon after the partnership interest is transferred.
- §754 election might be beneficial if a partnership holds real estate that increased in value by increasing the amount of allowable depreciation deduction for the affected partner.

Considerations for Not Making the §754 Election

- The discounted value of the partnership interest (outside basis) is less than the partner's share of inside basis of partnership's assets.
- A valuation discount should only be utilized when the decedent has a taxable estate (estate value is greater than \$5,490,000 for 2017 or greater than \$5,600,000 for 2018). Otherwise, basis is lost with no benefit received.
- When the administrative burden (e.g. additional recordkeeping and accounting) of making the §754 election is greater than the benefit derived from making the election.
- When it will not produce immediate and significant benefits (e.g. the partner's interest in the partnership is insignificant and there is no plan to sell the assets of the partnership in the near-term).

Impact to Other Partners

If a §754 election is in effect, the partnership is required to adjust the basis of its assets when it makes certain types of distributions, which could ultimately affect every partner.

- A partner receives money in excess of the basis of his partnership interest.
- A partner receives only hot assets in complete liquidation of his interest, and the total of the hot assets is less than his remaining basis in his partnership interest.
- A partner receives property that has an adjusted basis in excess of the partner's basis in his partnership interest.
- A partner receives property in a liquidating distribution and the property's basis is less than the partner's basis in his partnership interest.

Uncertainty Regarding Making §754 Election

Uncertainty often exists when deciding whether or not to make the §754 Election.

This is especially true when a valuation discount is applied to a partnership interest and the decedent's Form 706 is selected for audit.

Will the potential valuation discount reduction as a result of the audit cause the fair market value of partnership assets to exceed the basis in those assets? If so, making the §754 election may become the preferred route.

In PLR 200626003, a late §754 election was not allowed when the transferor of a partnership interest retained the right to income from the partnership. During audit of the estate, the entire value of the partnership interest was included in the taxpayer's gross estate under §2036(a).

Revocation of the §754 Election

The §754 election is revocable only with the approval of the District Director in which the partnership's returns are filed. However, it is often very difficult to have the IRS revoke the election.

- A request for revocation must be filed within 30 days after the close of the partnership year for which the revocation is intended to take effect.
- The request should state the reason for the revocation.

Some examples of acceptable reasons:

- A change in the nature of the partnership's business.
- A substantial increase in the assets of the partnership.
- A change in the character of partnership assets.
- An increased frequency of retirements or shifts of partnership interests, which increases the administrative burden of the election.

Revocation of the §754 Election (cont)

If the 30 day revocation window has passed, the partnership may still be able to obtain a private letter ruling granting for a late filed revocation.

- User fees apply

A sale or exchange of 50% or more of the total interest in a partnership's capital and profits within a 12 month period would cause a §708(b) technical termination.

- This would effectively terminate the existing partnership as well as the §754 election and create a new partnership.
- The newly formed partnership would not be bound by the prior §754 election.