Section 754: Trap for the Unwary, Tax Planning Tool, or Both?

by

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- The equivalence of inside basis (the partnership's assets) and outside basis (the partners' interests) in Subchapter K is fundamental to the taxation of partners and partnerships. It assures that income earned through a partnership is taxed once, and only once.

- Formation – A, B, and C are equal partners and in Year 1 each contributes $6,000 to Partnership ABC which purchases Inventory and Capital Asset for $9,000 and $6,000 respectively.

- The tax balance sheet documents the equivalence of inside and outside basis:

	Adjusted Basis
Assets:	
Cash	$ 3,000
Inventory	9,000
Capital Asset	6,000
Total	$18,000
Basis:	
A	$ 6,000
B	6,000
C	6,000
Total	$18,000

Basis Equivalence

- Operations – The equivalence between inside and outside basis generally continues even with appreciation or depreciation in the value of the assets.
- In Year 2, the assets increase in value to $18,000 for Inventory and $12,000 for Capital Asset.
- The tax balance sheet would appear as follows:

Assets:	Adjusted Basis	Fair Market Value
Cash	$ 3,000	$ 3,000
Inventory	9,000	18,000
Capital Asset	6,000	12,000
Total	$18,000	$33,000
Basis:		
A	$ 6,000	$11,000
B	6,000	11,000
C	6,000	11,000
Total	$18,000	$33,000

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Basis Equivalence

- Operations – The equivalence generally continues even though the partnership engages in activity which generates income or loss.
- In Year 3, the assets are sold, generating income to the partnership of $9,000 attributable to Inventory and $6,000 to Capital Asset, which is allocable to the partners equally, i.e., $5,000 to each partner.
- Under Subchapter K, each is taxed on his share of the income and the basis for each partner in his partnership interest increases accordingly.
- At the end of Year 3, the tax balance sheet reveals the equivalence of inside and outside basis:

	Adjusted Basis	Fair Market Value
Assets		
Cash	$33,000	$33,000
Total	$33,000	$33,000
Basis:		
A	$11,000	$11,000
B	11,000	11,000
C	11,000	11,000
Total	$33,000	$33,000

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Basis Disparity - § 743(a)

- Sale, exchange, or transfer at death of a partnership interest – In contrast to much of Subchapter K which typically preserves inside and outside basis equivalence, the general rule for sales or exchanges generates an imbalance.
- Under § 743(a), the basis for the partnership's assets is unaffected by the sale or exchange of a partnership interest.
- Thus, returning to the example of Partnership ABC with appreciated assets, if C at the end of Year 2 sells her interest to D for $11,000, a gain of $5,000 will be recognized by C, i.e., her share of the assets' appreciation.
- However, due to § 743(a)'s failure to adjust the basis of the partnership's assets, inside and outside basis will differ.

Assets:	Adjusted Basis	Fair Market Value
Cash	$ 3,000	$ 3,000
Inventory	9,000	18,000
Capital Asset	6,000	12,000
Total	$18,000	$33,000
Basis:		
A	$ 6,000	$11,000
B	6,000	11,000
D	11,000	11,000
Total	$23,000	$33,000

§ 743(a)

- Sales or exchanges – The double impact of the failure to adjust results in C recognizing $5,000 of income on the sale of her partnership interest, but D having similar treatment upon the sale of the assets by the partnership.
- When sold in Year 3, the assets will generate $15,000 of gain, allocable equally, i.e., $5,000 each to partner, A, B, and D. Thereafter, the partnership's tax balance sheet will reflect a disparity between inside and outside basis.

Assets:	Adjusted Basis	Fair Market Value
Cash	$33,000	$33,000
Basis:		
A	$11,000	$11,000
B	11,000	11,000
D	16,000	11,000
Total	$38,000	$33,000

- The imbalance remains even after the sale of the assets and D will be made "whole" upon the sale or liquidation of his interest, which would generate a $5,000 loss which would offset the earlier income inclusion.

§ 743(a)

- Sales or exchanges – The disparity in basis arises in settings involving depreciated assets as well as appreciated assets.
- Assume that Partnership ABC was similar in all respects to the prior example except that the assets had depreciated in value and the tax balance sheet appears as follows:

Assets:	Adjusted Basis	Fair Market Value
Cash	$ 3,000	$ 3,000
Inventory	9,000	6,000
Capital Asset	6,000	3,000
Total	$18,000	$12,000
Basis:		
A	$ 6,000	$ 4,000
B	6,000	4,000
C	6,000	4,000
Total	$18,000	$12,000

- If C sold her partnership interest to D, she would recognize a loss of $2,000. Similarly, upon the sale of assets, D would "enjoy" a $2,000 loss as well.
- Without basis adjustments, "double taxation" occurs in the setting involving asset appreciation and "duplication of loss" arises in the context of depreciated assets.

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§ 743(b)

- Sales or exchanges of partnership interests – Eliminating the disparity is possible under the Code. Section 743(b) permits the partnership to elect basis adjustments for the partnership's assets intended to reduce, if not eliminate, disparities between inside and outside basis.
- Section § 743(b) is equally applicable to transfers by death given that the post-death basis for the partnership interest is based on fair market value, which otherwise creates a disparity.
- The partnership must elect the basis adjustment. The election is applicable to all future § 743 transfers as well as § 734 distributions until revoked. Revocation requires the consent of the Service.
- The § 743(b) basis adjustment involves a two-step process – (1) a determination of the overall adjustment under the § 743 Regulations and (2) an allocation of the overall adjustment among the assets of the partnership under the § 755 Regulations.
- The adjustment is partner specific for § 743(b) transfers. It generally does not accrue to the partnership.

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- Determination of overall adjustment under § 743(b) – Revised Regulations dictate the calculation of the overall amount of the § 743 adjustment, which equals the difference between the transferee's basis for the partnership interest and his interest in previously taxed capital of the partnership increased by his share of partnership liabilities.

- Previously taxed capital equals the transferee's share of the liquidation proceeds if all of the partnership's assets were sold at fair market value decreased by his share of any gain arising from the hypothetical sale and increased by his share of any loss so arising.

- In the example, if the partnership liquidated its assets at fair market value, there would be $33,000 of cash and D's one-third share would be $11,000. D's one-third share of the gain ($30,000 - $15,000 basis = $15,000) on the sale of the assets would be $5,000, which results in previously taxed capital of $6,000 ($11,000 - $5,000).

- Thus, the overall § 743(b) adjustment would be $5,000, i.e., the transferee's basis for the interest ($11,000) less previously taxed capital ($6,000).

- Allocation of § 743(b) adjustment among the assets of the partnership – The Regulations under § 755 mandate a two-step process. First, the assets are divided into two classes ((1) capital and § 1231 assets and (2) other property), and the § 743(b) adjustment is allocated between them based on the allocation of income, gain, or loss that the transferee would receive on the hypothetical sale of all the partnership's assets for fair market value.

- Returning to the example, D would be allocated $3,000 of gain on the hypothetical sale of Capital Asset and $2,000 of income on the hypothetical sale of Inventory (an other asset). Thus, because there is but a single asset in each class, the $5,000 basis adjustment is allocated accordingly. Upon the sale of either asset shortly after the transfer, D's share of the partnership gain will be identical to his special basis adjustment, thereby avoiding additional taxation.

- After the class allocation of the § 743(b) adjustment, those amounts are further allocated among the assets therein utilizing the same approach. In the example, there was only one asset in each class so further allocation was unnecessary.
- Where one class has appreciation and the other has depreciation or where assets in each class are not uniform in that regard, the Regulations account for such disparities and permit positive and negative adjustments between and within each class.
- Consequences of § 743(b) basis adjustment – The adjustment (1) offsets existing appreciation or depreciation allocable to transferee on subsequent sale of assets by partnership and (2) generates more or less depreciation and amortization with respect to the transferee's share of depreciable and amortizable assets.

- In cases where there is a "substantial built-in loss", i.e., the adjusted basis of the partnership's assets exceeds their value by more than $250,000, the decreased adjustment is applicable regardless of an election, thereby preventing "loss duplication."
- Assume in Year 1, M, P, and N each contributes $500,000 to Partnership MPN, which purchases Capital Asset X for $700,000 and Capital Asset Y for $800,000. In Year 2, Capital Asset Y decreases in value to $200,000 and N sells her partnership interest to Q for $300,000, sustaining a $200,000 loss, at a time when no election is in place. Nevertheless, because there is a $600,000 built-in loss which exceeds the $250,000 threshold, Q will decrease his share of the basis for Capital Asset Y by $200,000. Thus, after the adjustment, the tax balance sheet will appear as follows:

Assets:	Adjusted Basis	Fair Market Value
Capital Asset X	$ 700,000	$ 700,000
Capital Asset Y	600,000	200,000
Total	$1,300,000	$ 900,000
Basis:		
M	$ 500,000	$ 300,000
P	500,000	300,000
Q	300,000	300,000
Total	$1,300,000	$ 900,000

- Tax trap of § 743(b)
  - Failure to elect in an appreciated assets setting results in “double taxation” and loss of additional amortization and depreciation for the transferee partner.
  - Actual election has consequences for the future, not simply the initial transaction. Will impact future transferees as well as the partnership on future distributions of assets.
  - Administrative costs.

- Tax planning for § 743(b)
  - Do not elect where there is a loss in the partnership’s assets which is not a “substantial built-in loss,” i.e., less than $250,000 for the partnership as a whole, which is beneficial as it will generate “duplicate losses.”
  - Elect where partnership holds appreciated assets and avoid “double taxation” if “comfortable” about future events.

- Basis adjustments and partnership distributions – Issues similar to those that arise in the § 743(b) context for sales and exchanges of partnership interests are confronted in the context of a partnership’s distribution of assets.
- Source of the problem is § 734(a), which does not permit a basis adjustment on the distribution of assets by a partnership.
- Assume that A, B, and C in Year 1 contribute $7,000 each to Partnership ABC which purchases Capital Asset X and Capital Asset Y for $4,000 and $7,000 respectively.
- The tax balance sheet documents the equivalence of inside and outside basis as was evidenced in the earlier examples as well. In Year 2, the assets increase in value to $10,000. Again, inside and outside basis are equal.

	Adjusted Basis	Fair Market Value
Assets:		
Cash	$10,000	$10,000
Capital Asset X	4,000	10,000
Capital Asset Y	7,000	10,000
Total	$21,000	$30,000
Basis:		
A	$ 7,000	$10,000
B	7,000	10,000
C	7,000	10,000
Total	$21,000	$30,000

- As illustrated previously, inside and outside basis are equivalent during the operational phase of Partnership ABC's activity.
- However, such symmetry may not continue upon certain distributions of cash or partnership property to the partners.
- For example, assume in Year 3 that A's partnership interest is liquidated by a distribution of cash of $10,000. A recognizes a gain of $3,000.
- Partnership ABC has neither tax consequences nor basis adjustments under § 734(a). The tax balance sheet after the distribution reveals a disparity between inside and outside basis.

Assets:	Adjusted Basis	Fair Market Value
Capital Asset X	$ 4,000	$ 10,000
Capital Asset Y	7,000	10,000
Total	$11,000	$ 20,000
Basis:		
B	$ 7,000	$10,000
C	7,000	10,000
Total	$14,000	$20,000

- In the cash distribution setting, upon the sale of Capital Asset X and Capital Asset Y, $9,000 of gain (AB $11,000, FMV $20,000) will arise, allocated equally to B and C., i.e., $4,500. In essence, double taxation occurs on the $3,000 of gain attributable to A until the liquidation of B's and C's partnership interests which will generate an offsetting loss.

- Similarly, instead of liquidating A for cash, if Partnership ABC distributes Capital Asset X to A, inside and outside basis are disparate after the distribution.

Assets:	Adjusted Basis	Fair Market Value
Cash	$10,000	$ 10,000
Capital Asset Y	7,000	10,000
Total	$17,000	$ 20,000
Basis:		
B	$ 7,000	$10,000
C	7,000	10,000
Total	$14,000	$20,000

- Following the distribution of Capital Asset X, the sale by the partnership of Capital Asset Y will generate a $3,000 gain, allocable $1,500 each to B and C. Thus, B and C will recognize $3,000 less gain during the partnership's operational phase than they would have absent the distribution. As in the prior setting, this distortion will be corrected upon the liquidation of B's and C's partnership interests, when each will recognize the remaining $1,500 of gain.

§ 734(a)

- A’s share of the partnership’s gain is neither increased nor decreased by either of the distributions. In the cash distribution, A recognizes a $3,000 gain. In the distribution of Capital Asset X, A takes a basis of $7,000 for property worth $10,000, which carries the $3,000 gain forward.

- In both cases, the taxation of the remaining partners is distorted without a basis adjustment.

- The same effects occur in the case of a partnership with depreciated assets. The possibility of “loss duplication” arises with a distribution of cash and an acceleration of loss arises with a distribution of assets.

- As illustrated, without a basis adjustment, inside and outside basis may diverge and distortions arise regarding the timing of gain or loss recognition.

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§ 734(b)

- The § 734(b) adjustment – In order to minimize distortion, Congress permits an elective basis adjustment. Its goal is to eliminate these imperfections; however, the statutory and regulatory rules in the § 734(b) context are not as refined or certain as they are in the § 743(b) context.

- Similar to § 743(b), the overall § 734(b) adjustment initially must be determined. Thereafter, the overall adjustment is allocated first between the two classes of assets (capital assets and other property), and then the amount allocated to each class is allocated among the assets therein.

- In the simplest of cases, i.e., all of the partnership assets are appreciated or depreciated, the transaction involves a complete liquidation, inside and outside basis are equal, and all of the assets are in the same class (capital if a cash only distribution), the § 734(b) adjustment is on par with the § 743(b) adjustment in producing proper results.

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§ 734(b)

- In the complete liquidation for cash setting, if the distributee incurs gain, the overall basis adjustment is an increase in basis of the partnership's assets in an equal amount. In a loss setting, basis would be decreased in an equal amount. Because cash is treated as a capital asset, the $3,000 gain would yield an increased basis adjustment attributable to Capital Assets X and Y, allocated between them on the basis of relative appreciation. Thus, the $3,000 § 734(b) adjustment would result in an increased basis, for the benefit of the partnership as a whole, of $2,000 for Capital Asset X and $1,000 for Capital Asset Y.
- After the adjustments, inside and outside basis would be equal.

	Adjusted Basis	Fair Market Value
Assets:		
Capital Asset X	$ 6,000	$10,000
Capital Asset Y	8,000	10,000
Total	$14,000	$20,000
Basis:		
B	$ 7,000	$10,000
C	7,000	10,000
Total	$14,000	$20,000

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§ 734(b)

- In the complete liquidation setting involving an in-kind distribution, i.e., Capital Asset X, the adjustment, which can be positive or negative, is found by subtracting the basis of the distributed property following the distribution from its basis immediately prior to the distribution. In the example, Capital Asset X, with a basis to the partnership of $4,000, was distributed to A. The basis of Capital Asset X increased by $3,000 under § 732(b) to $7,000. Accordingly, a decrease in basis to the remaining asset, Capital Asset Y, occurs, i.e., from $7,000 to $4,000.
- In such a case, the tax balance sheet continues with an equivalence of inside and outside basis.

	Adjusted Basis	Fair Market Value
Assets:		
Cash	$10,000	$10,000
Capital Asset Y	4,000	10,000
Total	$14,000	$20,000
Basis:		
B	$ 7,000	$10,000
C	7,000	10,000
Total	$14,000	$20,000

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- Other aspects of § 734(b) – Daily Operations
  - Basis adjustments reduce gain or loss on disposition of assets by partnership.
  - Impacts the amount of depreciation or amortization available to partnership.
  - Future property distributions are potentially subject to § 734(b) adjustments.
- Other aspects of § 734(b) – Mandatory Application
  - Failure to elect may lead to "loss duplication." Congress partially remedied by mandating its application in cases of substantial basis reduction regardless of an election.
  - Assume D, E, and F form Partnership DEF with capital contributions of $1,000,000 each. The partnership purchases Capital Asset X for $1,000,000 and Capital Asset Y for $1,200,000. At the end of Year 1, the values of Capital Assets X and Y are $600,000 and $700,000 respectively. The tax balance sheet appears as follows:

Assets:	Adjusted Basis	Fair Market Value
Cash	$ 800,000	$ 800,000
Capital Asset X	1,000,000	600,000
Capital Asset Y	1,200,000	700,000
Total	$3,000,000	$2,100,000
Basis:		
D	$1,000,000	$ 700,000
E	1,000,000	700,000
F	1,000,000	700,000
Total	$3,000,000	$2,100,000

- In Year 2, F is liquidated by a distribution of $700,000, producing a $300,000 loss. The partnership has not elected under § 754.
- Without a § 734(b) basis adjustment, there would be a disparity between inside basis ($2,300,000) and outside basis ($2,000,000), permitting "loss duplication."
- Given that a "substantial basis reduction" to the distributing partner exists, i.e., in excess of $250,000, the § 734(b) basis adjustment is mandatory. Thus, after the adjustment, the tax balance sheet would appear as follows:

Assets:	Adjusted Basis	Fair Market Value
Cash	$ 100,000	$ 100,000
Capital Asset X	866,667	600,000
Capital Asset Y	1,033,333	700,000
Total	$2,000,000	$1,400,000
Basis:		
E	$1,000,000	$ 700,000
F	1,000,000	700,000
Total	$2,000,000	$1,400,000

- The mandatory basis adjustment of § 734(b) is more stringent than that of § 743(b) as it focuses on the size of the basis adjustment to the partnership while § 743(b) focuses on the difference in the value and basis of the partnership's assets.

- Difficulties with § 734(b). A prerequisite to its “proper” functioning is that inside basis and outside basis are equal prior to the property distribution.

- The Regulations require that when a distribution of property results in an adjustment to the basis of undistributed property, the adjustment is allocated to remaining property of a similar character. Thus, adjustments attributable to cash and capital assets must be allocated to capital assets. Adjustments attributable to other property must be allocated to other property. The difficulty is that the allocation is based on the character of the distributed asset instead of the character of the asset responsible for the appreciation or depreciation of the partnership assets.

- Allocations under § 734(b) between classes and within classes are only one-directional. Assume in the following case that A is liquidated for cash of $9,000.

Assets:	Adjusted Basis	Fair Market Value
Cash	$10,000	$10,000
Capital Asset X	5,000	14,000
Capital Asset Y	6,000	3,000
Total	$21,000	$27,000
Basis:		
A	$ 7,000	$ 9,000
B	7,000	9,000
C	7,000	9,000
Total	$21,000	$27,000

- While this generates a basis increase of $2,000, the Regulations dictate that the adjustment is made solely to Capital Asset X ($5,000 + $2,000 = $7,000). Upon its sale, the remaining Partnership BC will recognize $7,000 of gain ($14,000 - $7,000 = $7,000), $3,500 each. From a tax policy standpoint, the basis adjustment should have been a $3,000 increase to Capital Asset X and a $1,000 decrease to Capital Asset Y, as is the case with the revised §§ 743/755 Regulations.

- Tax trap of § 734(b)
  - Failure to elect in an appreciated assets setting results in “double taxation” and loss of additional amortization and depreciation for the partnership.
  - Actual election has consequences for the future, not simply the initial transaction. Will impact future transfers as well as the partnership on future distributions of assets.
  - Administrative costs.

- Tax planning for § 734(b)
  - Do not elect where there is a basis reduction which is not substantial, i.e., $250,000 or less. This will prove beneficial as it will generate “duplicate losses.”
  - Elect where appreciated assets and avoid “double taxation” if “comfortable” about future events.