

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

THURSDAY, AUGUST 10, 2017, 1:00-2:50 pm Eastern

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# IRC Section 734 Adjustments

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Aug. 10, 2017

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# Basis Adjustments under Section 734

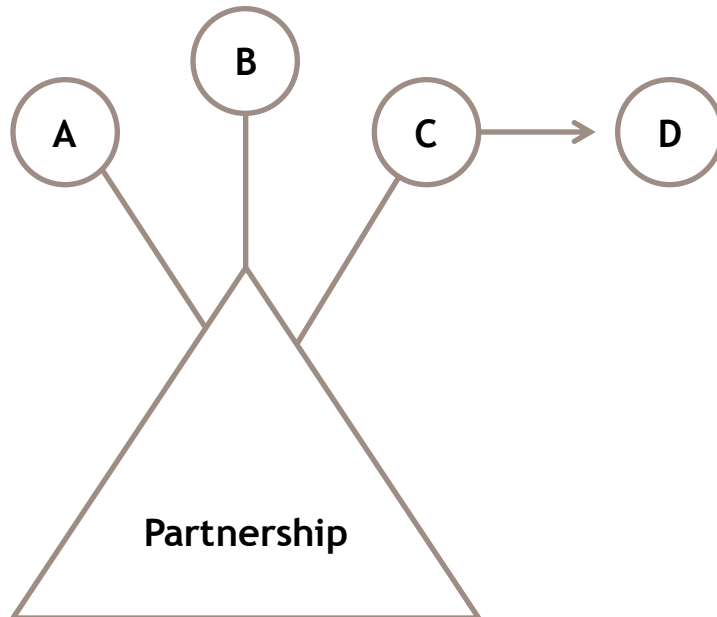
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# Agenda

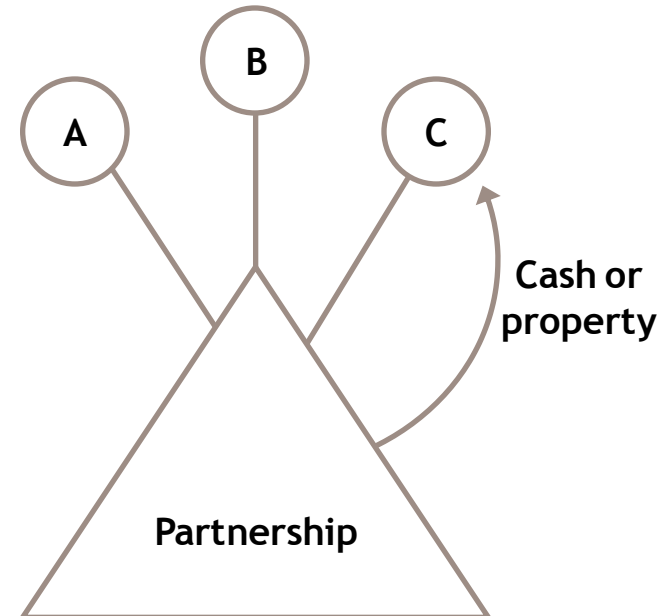
- Purpose of the adjustment
- Computation
- Making a section 754 election
- Mandatory adjustments
- Allocation of the adjustment
- Effect on taxable income
- Special Rules

# Section 734 vs. 743

Section 743: Sale or exchange of a partnership interest



Section 734: Distribution by a partnership



# Partnership ABC

	Tax Basis	Value
Cash	300,000	300,000
Investment	300,000	600,000
	<u>600,000</u>	<u>900,000</u>
Partner A	200,000	300,000
Partner B	200,000	300,000
Partner C	200,000	300,000
	<u>600,000</u>	<u>900,000</u>



# Partnership ABC

	Tax Basis	Value
Cash	<del>300,000</del>	<del>300,000</del>
Investment	300,000	600,000
	<hr/>	<hr/>
	600,000	900,000
	<hr/> <hr/>	<hr/> <hr/>
Partner A	<del>200,000</del>	<del>300,000</del>
Partner B	200,000	300,000
Partner C	200,000	300,000
	<hr/>	<hr/>
	600,000	900,000
	<hr/> <hr/>	<hr/> <hr/>

Partnership ABC distributes \$300,000 to Partner A in liquidation of its interest

# Partnership ABC

	Tax Basis	Value
Investment	<u>300,000</u>	<u>600,000</u>
	<u><u>300,000</u></u>	<u><u>600,000</u></u>
Partner B	200,000	300,000
Partner C	<u>200,000</u>	<u>300,000</u>
	<u><u>400,000</u></u>	<u><u>600,000</u></u>

Tax basis balance sheet is unbalanced

# Partnership ABC

	Tax Basis	Value
Cash	600,000	600,000
Investment	<del>300,000</del>	<del>600,000</del>
	600,000	600,000
Partner B	350,000	300,000
Partner C	350,000	300,000
	700,000	600,000

**ABC Sells Investment for \$600,000 and recognizes \$300,000 gain allocated \$150,000 to each of B and C increasing their bases to \$350,000**

# Partnership ABC

	Tax Basis	Value
Real Estate	300,000	300,000
Investment	300,000	600,000
	<hr/> 600,000	<hr/> 900,000
Partner A	200,000	300,000
Partner B	200,000	300,000
Partner C	200,000	300,000
	<hr/> 600,000	<hr/> 900,000

Partnership ABC distributes the **Real Estate** to Partner A in liquidation of its interest

# Partnership ABC

	Tax Basis	Value
Investment	<u>300,000</u>	<u>600,000</u>
	<u><u>300,000</u></u>	<u><u>600,000</u></u>
Partner B	200,000	300,000
Partner C	<u>200,000</u>	<u>300,000</u>
	<u><u>400,000</u></u>	<u><u>600,000</u></u>

Tax basis balance sheet is unbalanced

# Section 734

- If a partnership distributes property (including cash); and either:
  - A section 754 is in effect; or
  - There is a “substantial basis reduction”
- Then the partnership must...

# Section 734

- **Increase** the adjusted basis of partnership property by:
  - The amount of any gain recognized to the distributee partner under section 731(a)(1), and
  - The excess of:
    - The basis of the distributed property to the partnership immediately before the distribution, over
    - The basis of the distributed property to the distributee, as determined under section 732

# Section 734

- **Decrease** the adjusted basis of partnership property by:
  - The amount of any loss recognized to the distributee partner under section 731(a)(2), and
  - The excess of:
    - The basis of the distributed property to the distributee as determined under section 732, over
    - The adjusted basis of the distributed property to the partnership immediately before the distribution.



# Section 731

- Upon a distribution by a partnership to a partner:
  - 731(a)(1): Gain is recognized by the partner to the extent that any *money* distributed exceeds the basis of the partner's interest in the partnership
  - 731(a)(2): Loss is recognized if:
    - No property other than money and hot (ordinary income) assets are distributed to such partner,
    - In liquidation of the partner's interest, and
    - Only to the extent that the adjusted basis of such partner's interest in the partnership exceeds the basis assigned to such distributed money and assets

# Section 732

- In a NON-liquidating distribution:
  - The basis of distributed property (other than money) equals its adjusted basis to the partnership immediately before the distribution,
  - But not in excess of the basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.
- In a LIQUIDATING distribution:
  - The basis of distributed property (other than money) equals the adjusted basis of the partner's interest in the partnership reduced by any money distributed in the same transaction.
  - Basis of hot assets may not be increased

# Partnership ABC

	Tax Basis	Value
Cash	300,000	300,000
Investment	300,000	600,000
	<hr/> 600,000	<hr/> 900,000
Partner A	200,000	300,000
Partner B	200,000	300,000
Partner C	200,000	300,000
	<hr/> 600,000	<hr/> 900,000

Partnership ABC distributes \$300,000 to Partner A in liquidation of its interest  
Partner A recognizes \$100,000 of gain under section 731

# Partnership ABC

	Tax Basis	Value
Investment	<u>300k+100k</u>	600,000
	<u>400,000</u>	600,000
Partner B	200,000	300,000
Partner C	<u>200,000</u>	300,000
	<u>400,000</u>	600,000

If Partnership ABC makes a section 754 election, it increases its basis in the Investment by A's \$100,000 gain

# Partnership ABC

	Tax Basis	Value
Real Estate	300,000	300,000
Investment	300,000	600,000
	<hr/> 600,000	<hr/> 900,000
Partner A	200,000	300,000
Partner B	200,000	300,000
Partner C	200,000	300,000
	<hr/> 600,000	<hr/> 900,000

Partnership ABC distributes the **Real Estate** to Partner A in liquidation of its interest  
A takes a basis of \$200,000 in the Real Estate

# Partnership ABC

	Tax Basis	Value
Investment	<u>300k+100k</u>	600,000
	<u>400,000</u>	600,000
Partner B	200,000	300,000
Partner C	<u>200,000</u>	300,000
	<u>400,000</u>	600,000

If Partnership ABC makes a section 754 election, it increases its basis in the Investment by the excess of the basis of the real estate in the hands of the partnership (\$300K) over its basis to A (\$200K)



# 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

# Substantial Basis Reduction

- Generally, a section 734(b) 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 *downward* section 734(b) basis adjustment is mandatory if there is a “substantial basis reduction”
- A substantial basis reduction exists if the amount of the downward adjustment exceeds \$250,000

# Partnership ABC

	Tax Basis	Value
Cash	10,000	10,000
Investment	890,000	20,000
	<u>900,000</u>	<u>30,000</u>
Partner A	300,000	10,000
Partner B	300,000	10,000
Partner C	300,000	10,000
	<u>900,000</u>	<u>30,000</u>

Partnership ABC distributes \$10,000 to Partner A in liquidation of its interest

# Partnership ABC

	Tax Basis	Value
Cash	<del>10,000</del>	<del>10,000</del>
Investment	890,000	20,000
	<u>890,000</u>	<u>20,000</u>
Partner A	<del>300,000</del>	<del>10,000</del>
Partner B	300,000	10,000
Partner C	300,000	10,000
	<u>600,000</u>	<u>20,000</u>

A has a section 731 loss of \$290,000  
 ABC MUST reduce its basis in Investment by \$290,000

# Allocation of the Adjustment

- Section 755 and Reg. §1.755-1(c)
- First Allocate Between Classes
  - Capital Gain Property: Capital and section 1231 assets
  - Ordinary Income Property: Everything else (including recapture potential)
- Then Allocate Within Classes
- Operating Rules
  - Adjustments due to distributions of property must be allocated to undistributed property of a similar character to the distributed property
  - Adjustments due to distributions of cash must be allocated solely to Capital Gain Property
  - For distributions that cause ordinary gain see section 751(b)

# Allocation of the Adjustment Within Classes

- Increases:
  - First in proportion to and to the extent of unrealized appreciation
  - Then in proportion to fair market values
- Decreases:
  - First in proportion to and to the extent of unrealized depreciation
  - Then in proportion to remaining adjusted bases
- Basis cannot be adjusted below zero
  - Excess carries over and reduced the basis of subsequently acquired property of the proper character

# Statement of Adjustment

- Attached to return for the year of the distribution
- Computation of the adjustment
- Properties to which the adjustment is allocated

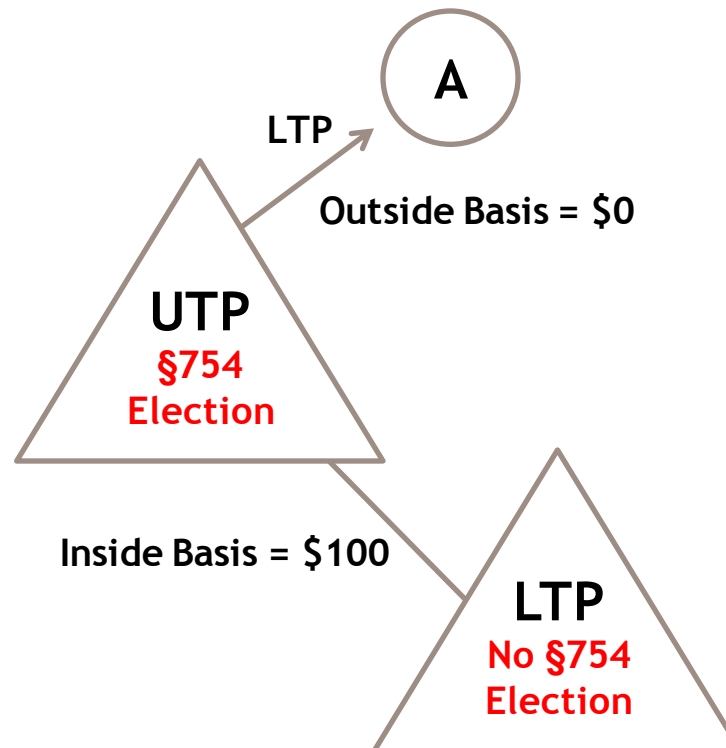


# Effect of the Adjustment

- Common basis - no tracking (unlike 743 adjustments)
- Affects gain / loss, cost recovery
- Increases in basis of depreciable property
  - The increase is treated as newly-purchased property placed in service when the distribution occurs.
  - Any applicable recovery period and method may be used for the increased portion of the basis.
  - No change is made with respect to the existing basis
- Decreases in basis of depreciable property
  - Reduces depreciation over the remaining recovery period of the adjusted property
- Similar rules should apply for amortization / depletion

# Special Rule #1

- Section 734 does not apply to any distributed property which is an interest in another partnership with respect to which the election provided in section 754 is not in effect

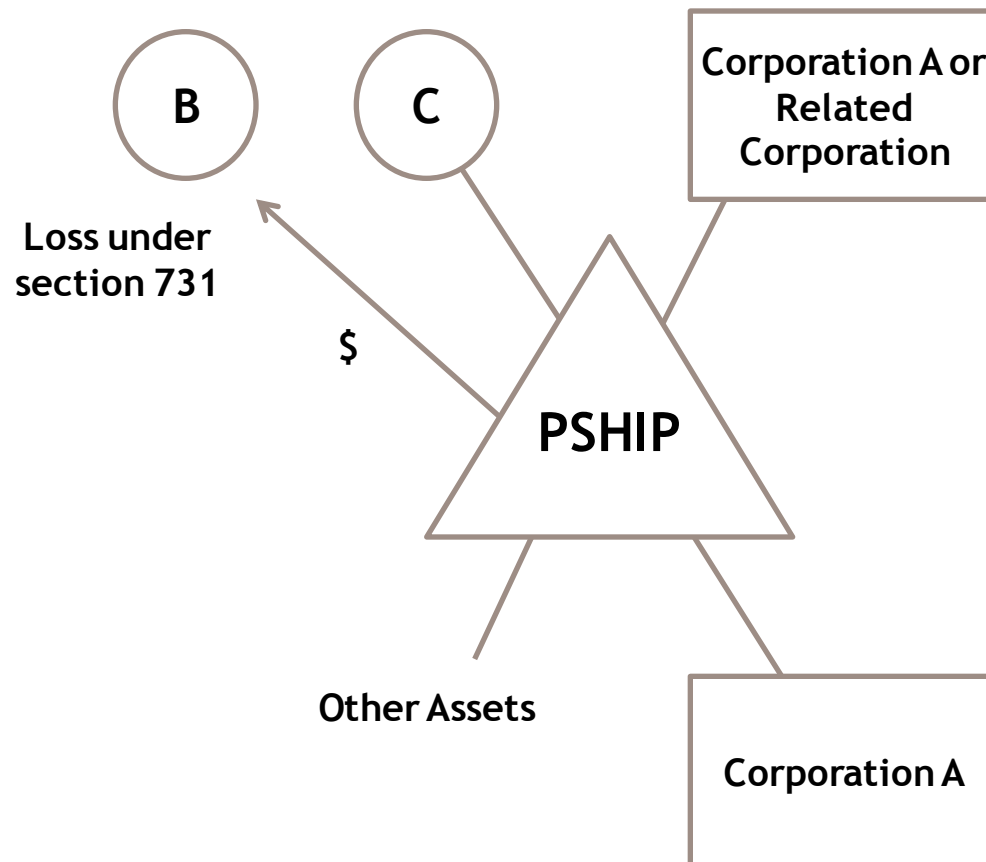


# Special Rule #2

- A decrease in the adjusted basis of partnership property under section 734 may NOT be allocated to the stock of a corporate partner (or a related person)
- Allocated to other partnership property instead
- Gain is recognized to the partnership to the extent it has insufficient basis in other property

# Special Rule #2

PSHIP's basis in Corporation A stock cannot be reduced

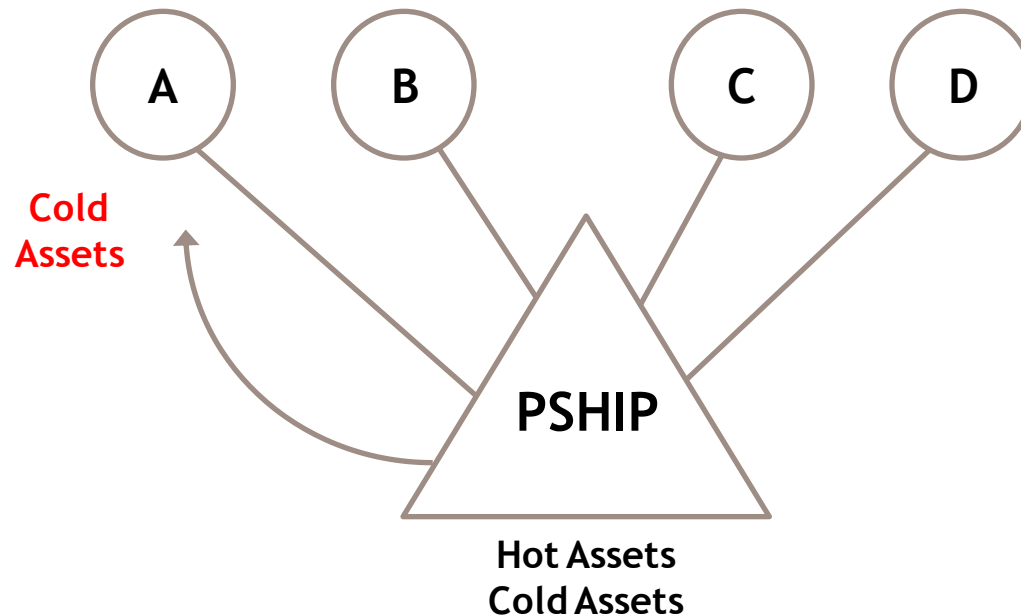


# Payments to partners that do not trigger section 734

- Distributions that don't trigger gain or loss or change the basis of distributed property
- Sales or exchanges of interests (see section 743)
- Guaranteed payments
- Section 707(a) payments
- Disguised Sales
- Section 751(b) exchanges

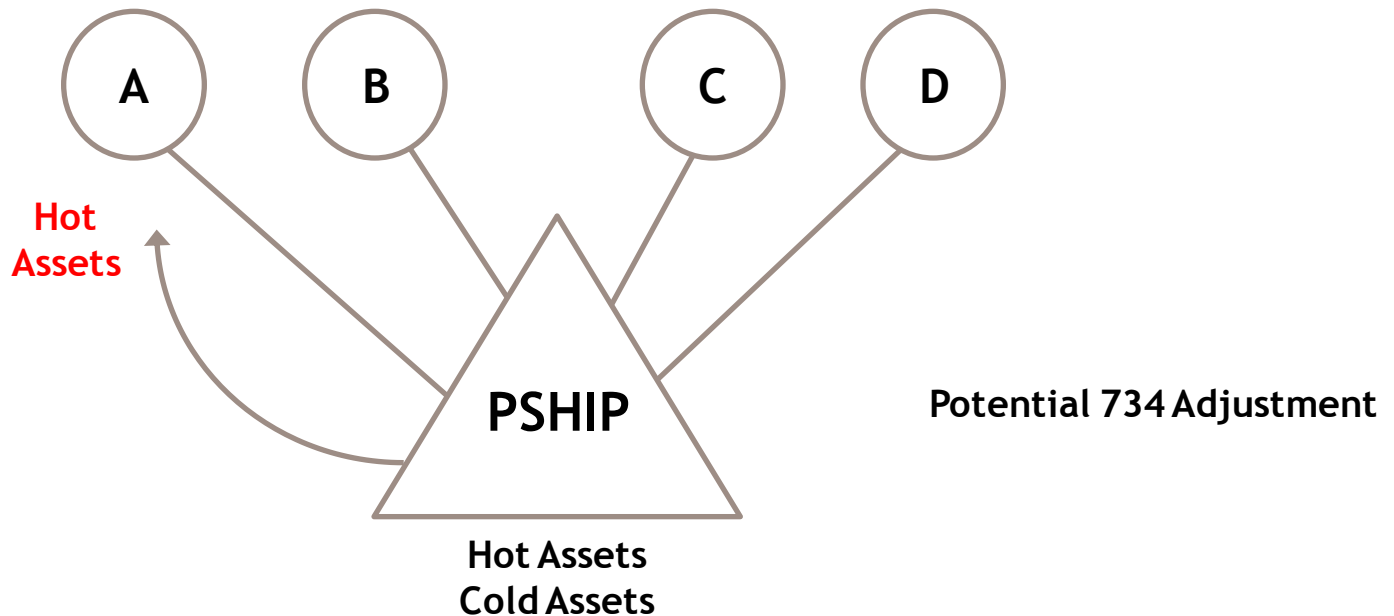
# Section 751(b) Exchanges

Disproportionate distribution of Cold Assets to A in liquidation



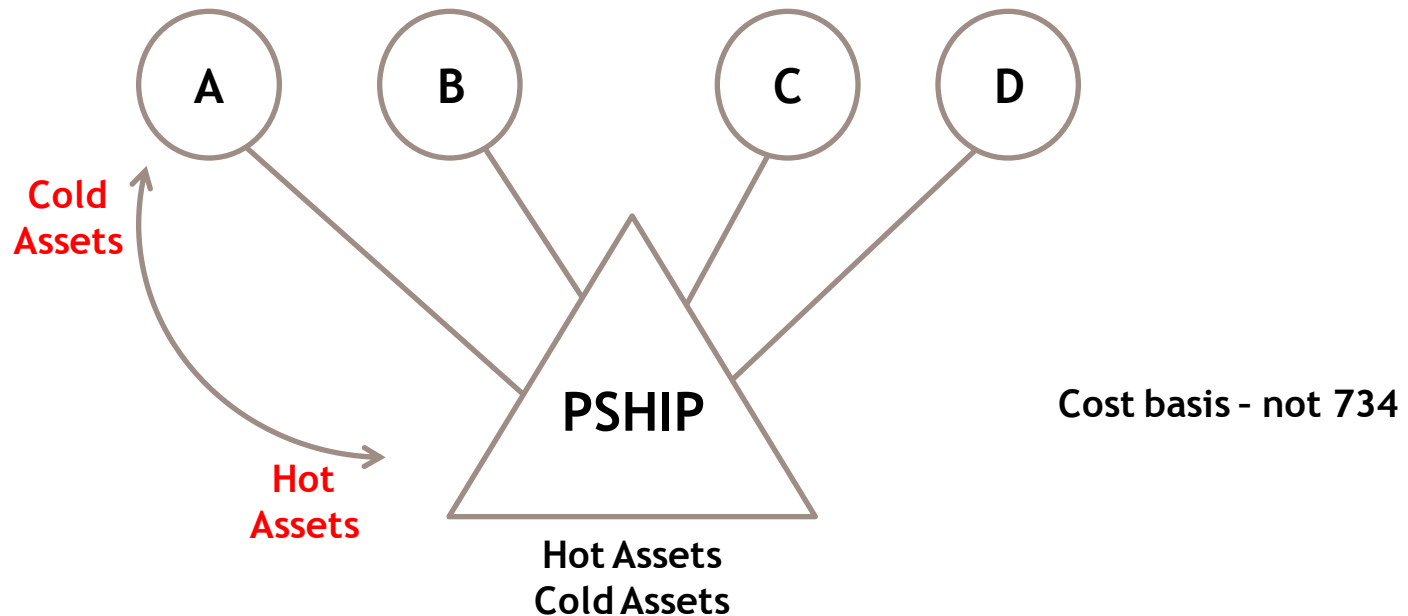
# Section 751(b) Exchanges

Recast as: (1) Distribution of A's share of Hot Assets



# Section 751(b) Exchanges

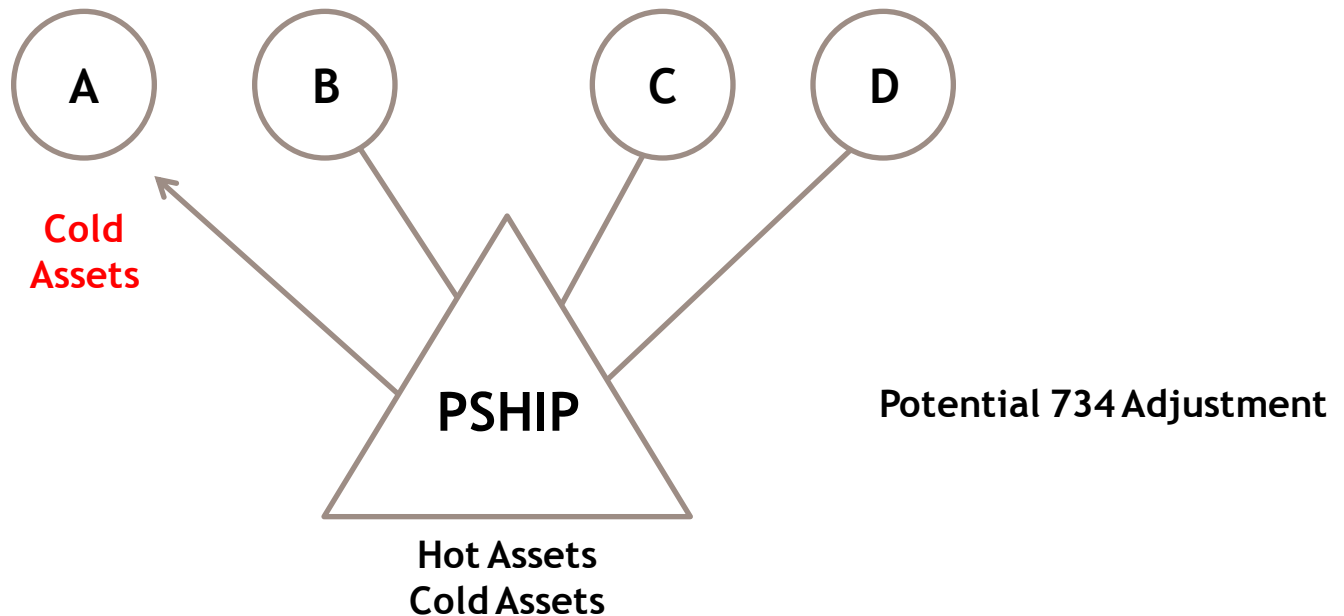
(2) Taxable exchange of those Hot Assets for Cold Assets





# Section 751(b) Exchanges

## (3) Distribution of more Cold Assets





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

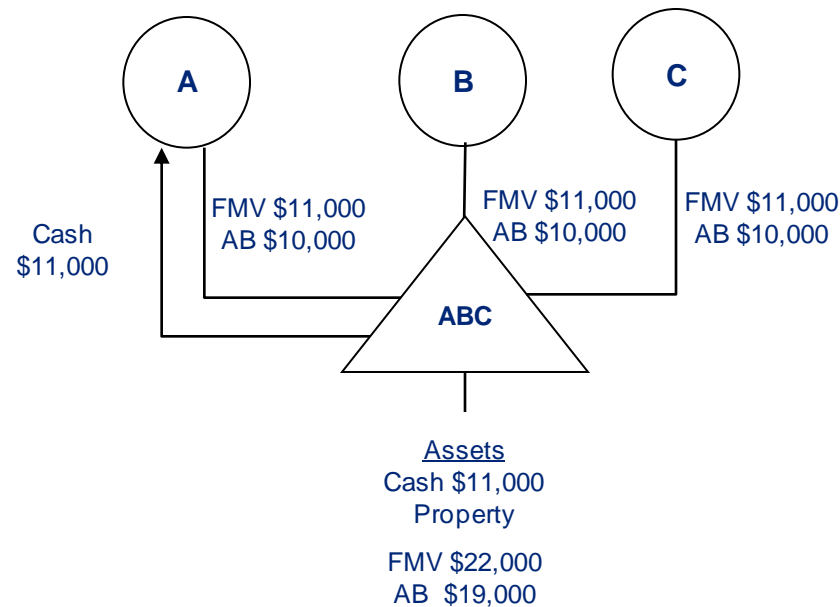


**Dina A. Wiesen - Deloitte Tax LLP**

August 10, 2017

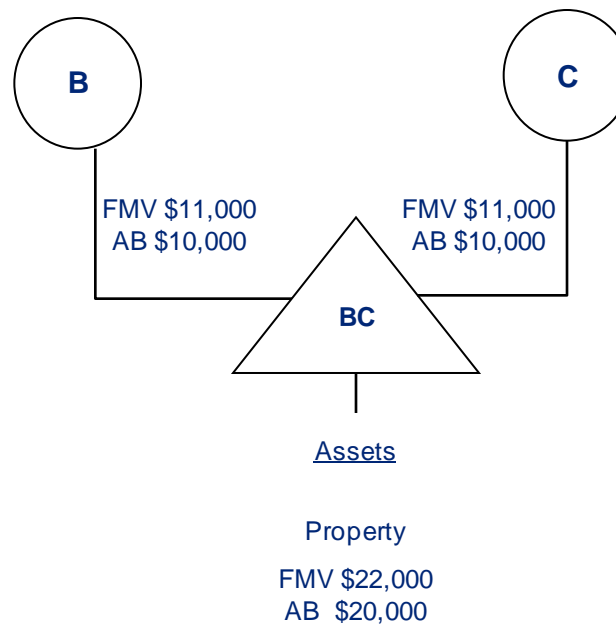
# Case Study and Illustrations

# Increase in Basis Ex. 1



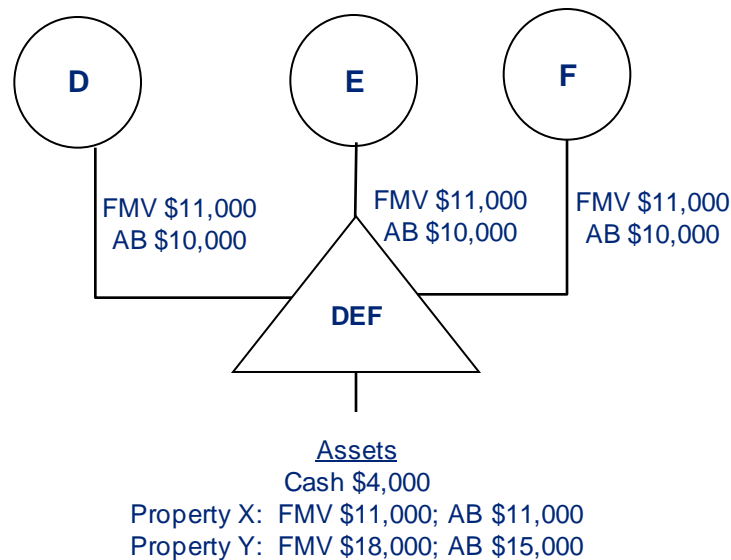
- Partner A has a basis of \$10,000 for his one-third interest in partnership ABC. The partnership has no liabilities and has assets consisting of cash of \$11,000 and property with a partnership basis of \$19,000 and a value of \$22,000.
- A receives \$11,000 in cash in liquidation of his entire interest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

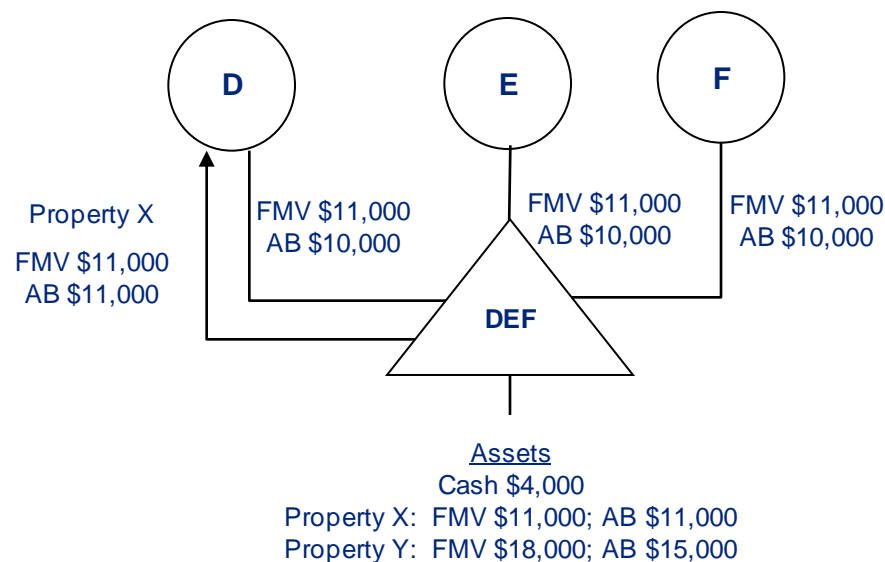


- Partner D has a basis of \$10,000 for his one-third interest in partnership DEF. Before the distribution, the partnership balance sheet shows the following:

<u>Assets</u>		
	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>

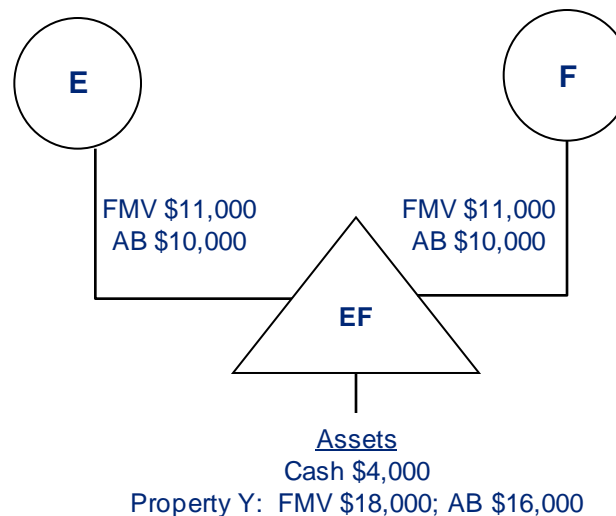
<u>Liabilities and Capital</u>		
Liabilities	\$0	\$0
Capital:	Basis	Value
D	10,000	11,000
E	10,000	11,000
F	10,000	11,000
<b>Total</b>	<b>30,000</b>	<b>33,000</b>

## 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).

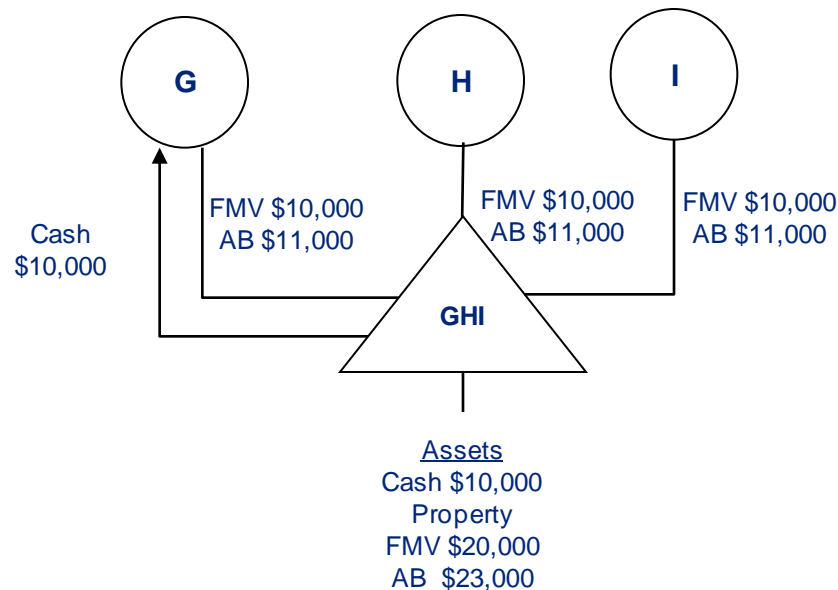
## Increase in Basis Ex. 2 (cont'd)



- 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).

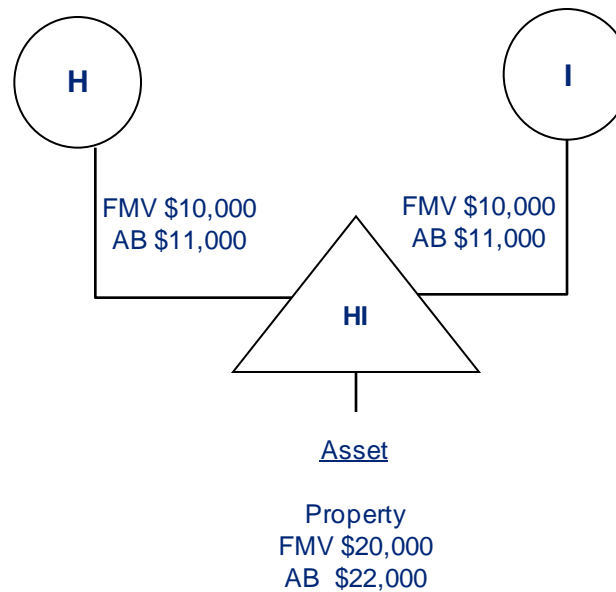


# Decrease in Basis Ex. 1



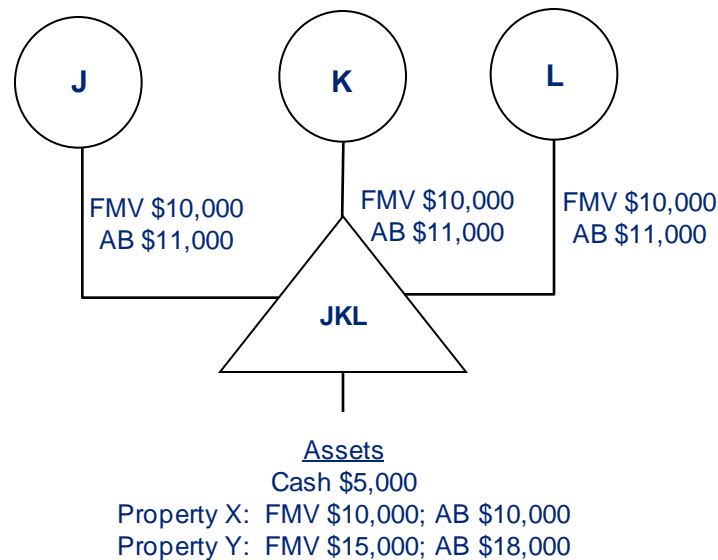
- Partner G has a basis of \$11,000 for his one-third interest in partnership GHI. The partnership has no liabilities and has assets consisting of cash of \$10,000 and property with a partnership basis of \$23,000 and a value of \$20,000.
- G receives \$10,000 in cash in liquidation of his entire interest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

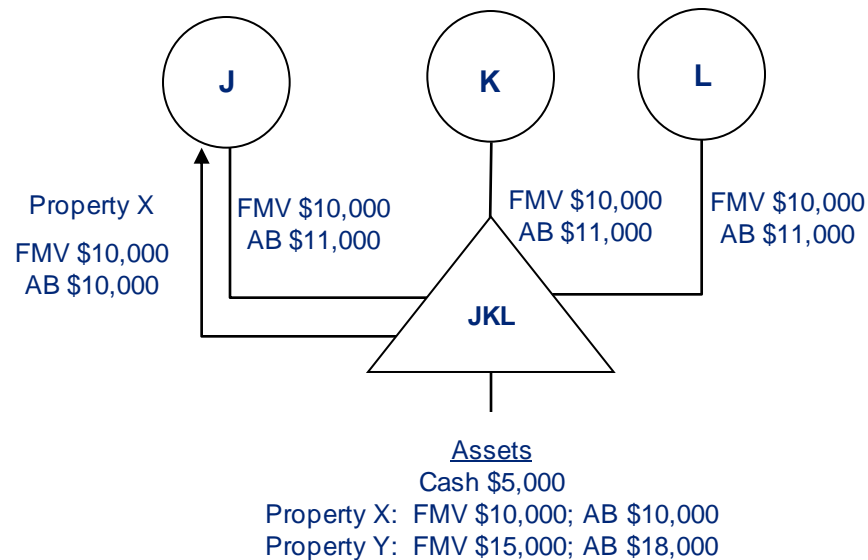
### Assets

	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

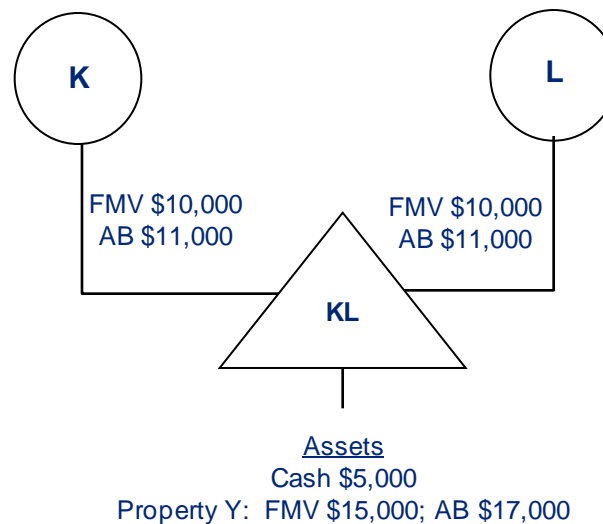
Liabilities	\$0	\$0
<b>Capital:</b>		
J	11,000	10,000
K	11,000	10,000
L	11,000	10,000
<b>Total</b>	<b>33,000</b>	<b>30,000</b>

## 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.



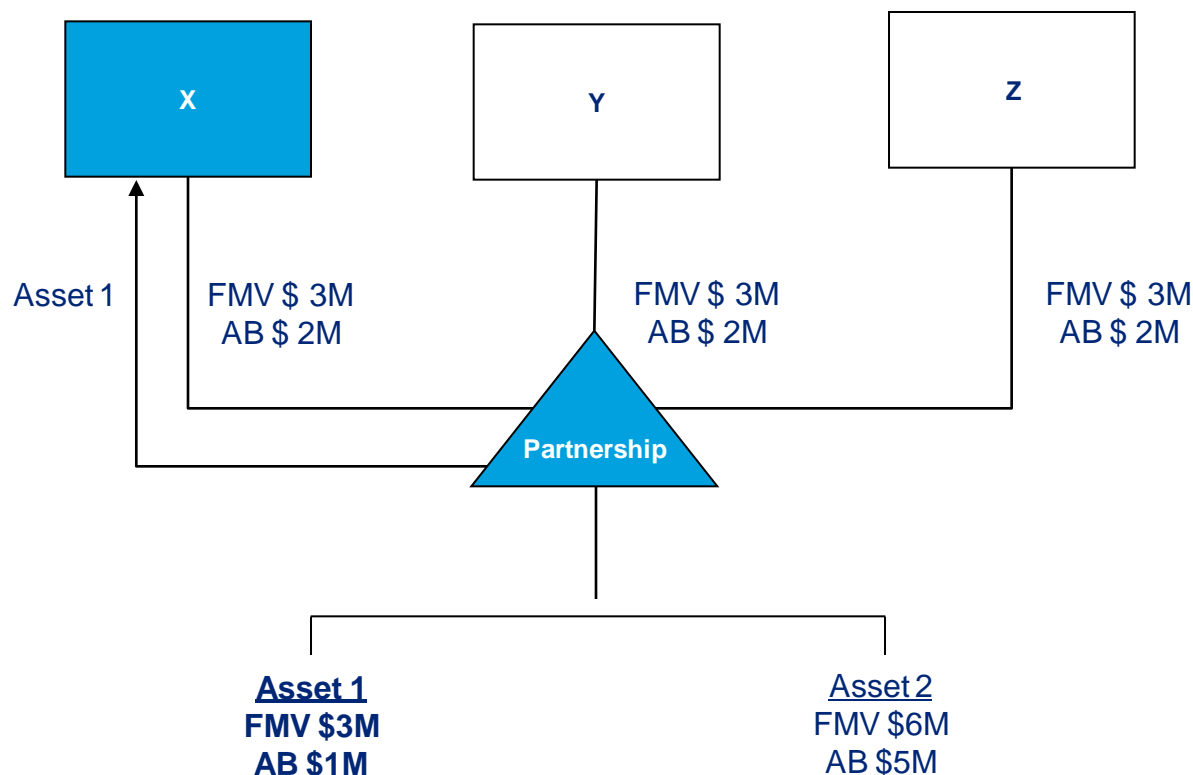
# The AJCA and Section 734

- 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

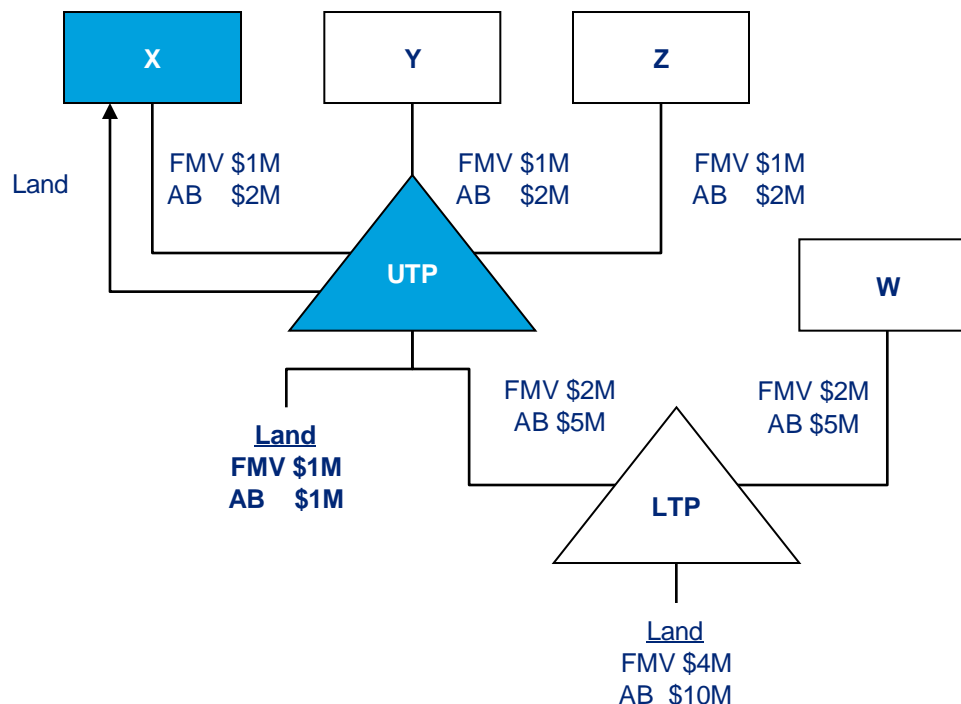
- On January 16, 2014, the IRS and Treasury published proposed regulations that would provide guidance on provisions of the AJCA
- The proposed regulations would revise Treas. Reg. § 1.734-1 to incorporate the changes made by the AJCA to section 734 and provide guidance with respect to those changes.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

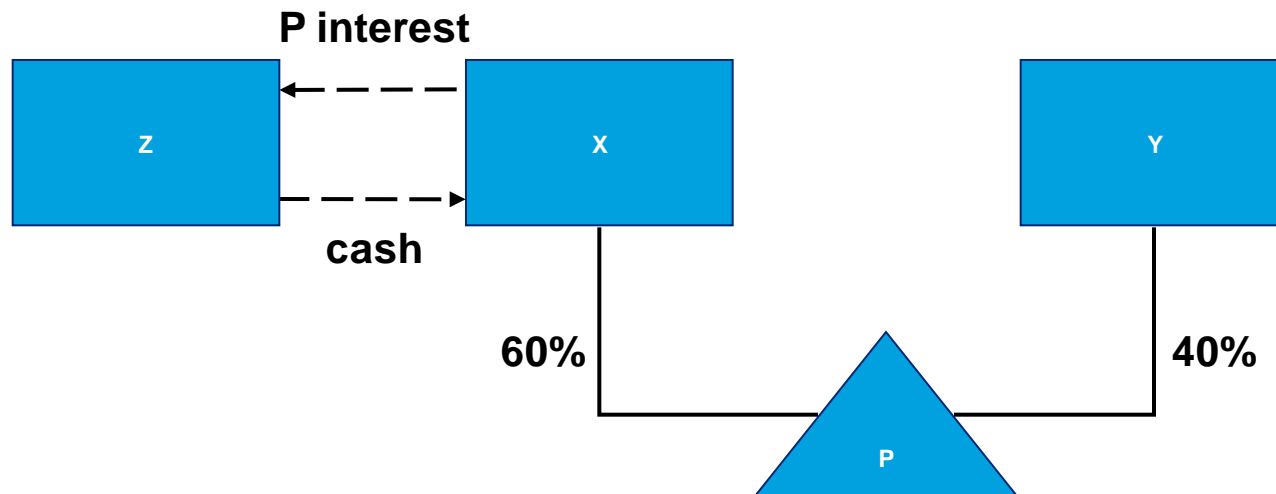
## Tiered Partnerships (cont.)



- 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.

# Planning Considerations

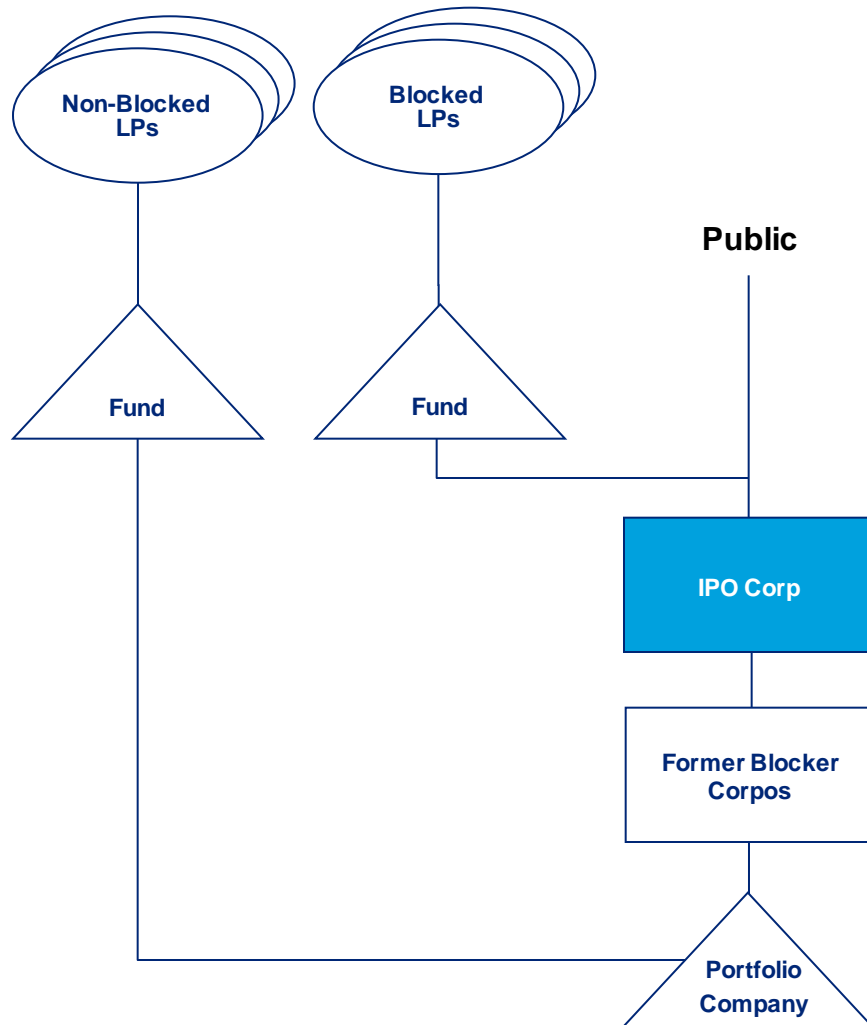
# Technical Terminations



- **Section 708(b)(1)(B)**



# IPO Exit of Operating Partnership with TRA



- Non-Blocked LPs
  - Continue to own in pass-through from until exit
  - Upon exit, exchange units for stock of public company and TRA
- Blocked LPs
  - Transfer stock of Blocker to IPO Corp in exchange for stock of IPO Corp (if blocker corp at NOLs or the like) a TRA
  - Supercharged IPOs
- TRAs
  - Tax Receivable Agreement
  - As a tax benefit is used, holder of the TRA receives 85-90% of the resulting tax savings
  - Ordering rules
  - Treatment of payment