

Strafford

Presenting a live 110-minute teleconference with interactive Q&A

Sect. 743(b) Basis Adjustments on Partnership Interests

Resolving Practical Issues Arising From Distributions Under Sections 743(b) and 734(b)

WEDNESDAY, DECEMBER 14, 2011

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Vishal Amin, Senior Manager, KPMG, Washington, D.C.

Robert Barnett, Member, Capell Barnett Matalon & Schoenfeld, Jericho, N.Y.

For this program, attendees must listen to the audio over the telephone.

Please refer to the instructions emailed to the registrant for the dial-in information. Attendees can still view the presentation slides online. If you have any questions, please contact Customer Service at 1-800-926-7926 ext. 10.

Conference Materials

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the + sign next to “Conference Materials” in the middle of the left-hand column on your screen.
- Click on the tab labeled “Handouts” that appears, and there you will see a PDF of the slides for today's program.
- Double click on the PDF and a separate page will open.
- Print the slides by clicking on the printer icon.

Continuing Education Credits

FOR LIVE EVENT ONLY

Attendees must listen to the audio over the telephone. Attendees can still view the presentation slides online but there is no online audio for this program.

Please refer to the instructions emailed to the registrant for additional information. If you have any questions, please contact Customer Service at 1-800-926-7926 ext. 10.

Tips for Optimal Quality

Sound Quality

For this program, you must listen via the telephone by dialing 1-866-873-1442 and entering your PIN when prompted. There will be no sound over the web connection.

If you dialed in and have any difficulties during the call, press *0 for assistance. You may also send us a chat or e-mail sound@straffordpub.com immediately so we can address the problem.

Viewing Quality

To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.

Sect. 743(b) Basis Adjustments on Partnership Interests Seminar

Dec. 14, 2011

Vishal Amin, KPMG
vamin@kpmg.com

Robert Barnett, Capell Barnett Matalon &
Schoenfeld
rbarnett@cbmslaw.com

Today's Program

Material Terms Of Sections 743, 755 and 734 On Basis
Adjustments
[Vishal Amin]

Slide 7 - Slide 34

Taxpayer Scenarios Involving Basis Adjustments
[Vishal Amin and Robert Barnett]

Slide 35 - Slide 62

Vishal Amin, KPMG

MATERIAL TERMS OF SECTIONS 743, 755 AND 734 ON BASIS ADJUSTMENTS

Sect. 743(b) Basis Adjustments

- General rule: Tax basis of partnership property is not adjusted after a sale or exchange of a partnership interest.
- Two exceptions:
 - *Elective adjustments*
 - If the partnership has a Sect. 754 election in effect, then the partnership must adjust the basis of its property under Sect. 743(b).
 - *Mandatory adjustments*
 - Basis adjustments are required if there is a transfer of an interest in a partnership that has a “substantial built-in-loss.”

Sect. 743(b) Basis Adjustments (Cont.)

- Protects purchasing partner from gain or loss inherent in the partnership's assets
- Treats partner as if he purchased an interest in each partnership asset
- Affects transferee partner only

Sect. 743(b) Basis Adjustments (Cont.)

- Transfers of partnership interests for Sect. 743(b) include:
 - Taxable sale or exchange
 - Death of a partner
 - Contribution to or distribution by another partnership
 - Contribution to or distribution by a corporation
 - Interests transferred in corporate mergers

Sect. 743(b) Basis Adjustments (Cont.)

- A Sect. 754 election:
 - Is made on a written statement attached to the partnership's return for the taxable year during which the distribution or transfer occurs
 - The return must be filed timely (including extensions).
 - Sect. 9100 relief is available.
 - Is binding on the partnership for the year of election and all subsequent tax years
 - May result in both an increase and decrease in the basis of partnership assets

Sect. 743(b) Basis Adjustments (Cont.)

- Sect. 743(b) basis adjustments are required if there is a transfer of an interest in a partnership that has a “substantial built-in loss.”
 - *Partnership's* aggregate basis in its assets > FMV of its property by more than \$250,000.
- Exceptions
 - Securitization partnerships
 - Sect. 743(b) is still elective.
 - Special rule for electing investment partnerships
 - Partner-level loss limitation rule instead of mandatory partnership level adjustments
 - Restrictive definition of electing investment partnership

Sect. 743(b) Basis Adjustments (Cont.)

Step 1: Determine the total amount of the basis adjustment

- Difference between inside and outside basis

Step 2: Allocate the adjustment to partnership assets

- Allocate between classes of partnership assets
- Allocate among items within each class

Sect. 743(b) Basis Adjustments (Cont.)

Step 1: Determine the total amount of the basis adjustment (Cont.)

- Transferee partner's outside basis less the transferee partner's share of inside basis
 - Attributable only to the transferred interest
- Outside basis
 - Cost + Share of debt
- Inside basis
 - Share of “previously taxed capital” + share of debt

Sect. 743(b) Basis Adjustments (Cont.)

Previously taxed capital =

- Cash on liquidation
 - How much cash would the transferee receive if the partnership sold at FMV all of its assets for cash, and then liquidated?

PLUS

- Loss on hypothetical sale
 - The amount of loss that would be allocated to the transferee partner on the hypothetical sale of the assets at FMV

LESS

- Gain on hypothetical sale
 - The amount of gain that would be allocated to the transferee partner on the hypothetical sale of the assets at FMV

Sect. 755: Allocating Basis Adjustments

- Sect. 743(b) adjustment must be allocated among each partnership asset.
- Allocation rules are designed to protect purchasing partners from the share of gain or loss in each partnership asset.
 - Hypothetical sale of each asset at FMV
 - “Two-directional adjustments”
 - FMV of any partnership Sect. 197 intangibles, including goodwill, is determined using the residual value method.

Sect. 755: Allocating Basis Adjustments (Cont.)

Step 2a: Divide the partnership's assets

- Divide the partnership's assets into two groups:
 - Ordinary income
 - Capital/Sect. 1231 assets

Step #2b: Allocate the adjustment between the two groups

- Ordinary income group:
 - An amount equal to the gain or loss that would be allocated to the partner if all assets in the group were sold for FMV
- Capital asset group:
 - Total Sect. 743(b) adjustment less adjustment allocated to ordinary income group

Sect. 755: Allocating Basis Adjustments (Cont.)

Step #2c: Allocate each group's adjustment to the assets

- Allocate based on hypothetical sale of the item at FMV
- Formula takes into account any discounts or premiums paid for the interest.
 - Discount/premium is allocated to capital asset group first.
- *Reminder:* Because Sect. 743(b) adjustments are allocated based on a hypothetical sale of the property, the adjustment may increase the basis of some property and decrease the basis of other property (“two-directional adjustments”).

Sect. 755: Allocating Basis Adjustments (Cont.)

- Sect. 743(b) adjustments are allocated to ordinary income assets before capital assets.
 - Protects purchasing partner from recognizing ordinary income first
 - If the interest is purchased at a discount, the amount of the discount will be allocated among the partnership's capital assets
- Basis adjustment is unique to the partner.
- Sect. 743(b) adjustment is a net figure.
- A zero adjustment could represent:
 - Positive allocation to one class and negative allocation to the other class
 - Positive allocation to one item in a class and negative allocation to another item in the class

Sect. 755: Allocating Basis Adjustments (Cont.)

- A and B form an equal partnership, LLC.
 - Both contribute \$1,000, which LLC uses to purchase Assets 1, 2, 3 and 4 for \$500 each.
- A year later, A sells her interest to X for \$1,000, at a time when the assets have the following values:

	Basis	FMV
<u>Capital</u>		
Asset 1	\$500	\$750
Asset 2	\$500	\$500
<u>Ordinary</u>		
Asset 3	\$500	\$250
Asset 4	\$500	\$500

Sect. 755: Allocating Basis Adjustments (Cont.)

- Will X have a Sect. 743(b) adjustment?
 - X's outside basis
 - Equals the \$1m000 he paid to A for the interest
 - X's share of LLC's inside basis
 - Previously taxed capital = \$0
 - \$1,000 (cash on liquidation) + \$125 (ord Loss) - \$125 (cap gain)
- Sect. 743(b) adj = \$0 net
 - X has negative \$125 adjustment to the basis of Asset 3, and
 - X has positive \$125 adjustment to the basis of Asset 1.

Sect. 755: Allocating Basis Adjustments (Cont.)

- Different allocation rules apply for transfers of partnership interests in non-recognition transactions.
 - E.g., transfers under sections 721, 731 or 351
- “Old” rules apply (pre-2000 rules):
 - “One-directional adjustments”
 - Positive adjustment
 - Can only increase basis of appreciated assets
 - Negative adjustment
 - Can only decrease basis of depreciated assets
 - No adjustment if Sect. 743(b) adjustment is zero

Effects Of Sect. 743(b) Basis Adjustments

- Sale of adjusted property
 - Sect. 743(b) adjustment does not affect gain recognized by the partnership on sale of its assets.
 - Adjustment affects gain recognized by the transferee partner only.
- Three basic steps
 1. Compute partnership's gain or loss from sale of property
 2. Allocate gain or loss to the partners under sections 704(b) and 704(c)
 3. Adjust transferee partner's share of gain or loss for Sect. 743(b) adjustments on the property

Effects Of Sect. 743(b) Basis Adjustments (Cont.)

- Adjustments to depreciable property
 - Positive adjustments:
 - Treated as a newly placed in service asset
 - Creates additional depreciation for the transferee partner
 - Special rule for remedial allocation method
 - Negative adjustments:
 - Recovered over remaining useful life of property
 - Reduces the transferee partner's depreciation allocation
 - May trigger ordinary income

Effects Of Sect. 743(b) Basis Adjustments (Cont.)

Reporting requirements

- The transferee partner that acquires interest in PRS that has a Sect. 754 election in effect must notify PRS of the transfer within 30 days.
 - Include names, addresses, and tax identification number of transferee and transferor (if known)
 - Date of transfer
 - Relationship, if any, of transferee and transferor
 - Other information necessary, so that the partnership can calculate transferee's basis in its acquired interest (e.g., purchase price and liabilities assumed)
- PRS must include a statement with the return for taxable year in which it acquires knowledge of the transfer.
 - Identify transferee, show basis adjustment, and show the allocation of the adjustment

Sect. 734(b) Basis Adjustments

- I. General rule: Tax basis of remaining partnership property is not adjusted after a distribution.
- II. Two exceptions:
 - A. *Elective Adjustments*
 1. If the partnership has a Sect. 754 election in effect, then the partnership must adjust the basis of remaining partnership property under Sect. 734(b).
 - B. *Mandatory adjustments*
 1. Basis adjustments are required if there is a “substantial basis reduction” as a result of the distribution.

Sect. 734(b) Basis Adjustments (Cont.)

- Elective adjustments
 - Requires the partnership to have in effect a Sect. 754 election for the taxable year of the distribution
- A Sect. 754 election:
 - Is binding for all subsequent tax years
 - May result in increases and decreases to tax basis
 - The election is not always advantageous.
 - Applies to sales and exchanges of partnership interests and also results in basis adjustments under Sect. 743

Sect. 734(b) Basis Adjustments (Cont.)

Step #1: Calculate the overall basis adjustment

- Negative adjustment
 - Loss recognized by distributee partner
 - Basis step-up to distributed property
- Positive adjustment
 - Gain recognized by distributee partner
 - Basis reduction to distributed property [watch Sect. 732(f)]

Sect. 734(b) Basis Adjustments (Cont.)

Step #2: Allocate the adjustment under Sect. 755

- Adjustment because gain/loss is recognized
 - Allocate only to remaining partnership capital assets
- Adjustment because property basis changes
 - Allocate to property of like character to the distributed property
- These are actual adjustments to the basis of partnership property

Sect. 734(b) Basis Adjustments (Cont.)

- Positive adjustments
 - Allocate first to appreciated property to extent of appreciation
 - Then, to all like character assets based on relative FMV
- Negative adjustments
 - Allocate first to depreciated assets to extent of depreciation
 - Then, to all like character assets based on relative basis

Sect. 734(b) Basis Adjustments (Cont.)

- Consider special rules
 - No like character property or capital assets
 - Carryover adjustment
 - Negative adjustments: Cannot reduce basis below zero
 - Cannot be made to stock of a corporation that is, or is related to, a partner [Sect. 755(c)]
 - Carryover excess adjustments generally
 - Special rule for excess adjustments resulting from the presence of corporate partner stock

Sect. 734(b) Basis Adjustments (Cont.)

- Liquidated in installments
 - Adjust basis as gain recognized

- Depreciable property
 - Step-up treated as new asset
 - Step-down recovered over remaining useful life

Sect. 734(b) Basis Adjustments (Cont.)

- A, B and C form an equal partnership, LLC.
 - Each contributes \$800, which LLC uses to purchase Assets 1, 2, 3 and 4 for \$600 each.
- A year later, LLC distributes Assets 3 and 4 to C in a complete liquidation, in which when the assets have the following values:

	Basis	FMV
<u>Capital</u>		
Asset 1	\$600	\$1500
Asset 2	\$600	\$500
<u>Ordinary</u>		
Asset 3	\$600	\$700
Asset 4	\$600	\$300

Sect. 734(b) Basis Adjustments (Cont.)

- Is there a Sect. 734(b) adjustment if LLC makes a 754 election?
 - C will receive assets 3 and 4 with \$400 less basis than those assets had in the LLC.
 - In C's hands, they will have a basis of \$800, vs. \$1,200 in the LLC.
 - LLC has a positive Sect. 734(b) adjustment of \$400. But, since the basis adjustment arose with respect to the distribution of ordinary assets and LLC has only capital assets left, the adjustment is carried forward.

Vishal Amin, KPMG

Robert Barnett, Capell Barnett Matalon & Schoenfeld

TAXPAYER SCENARIOS INVOLVING BASIS ADJUSTMENTS

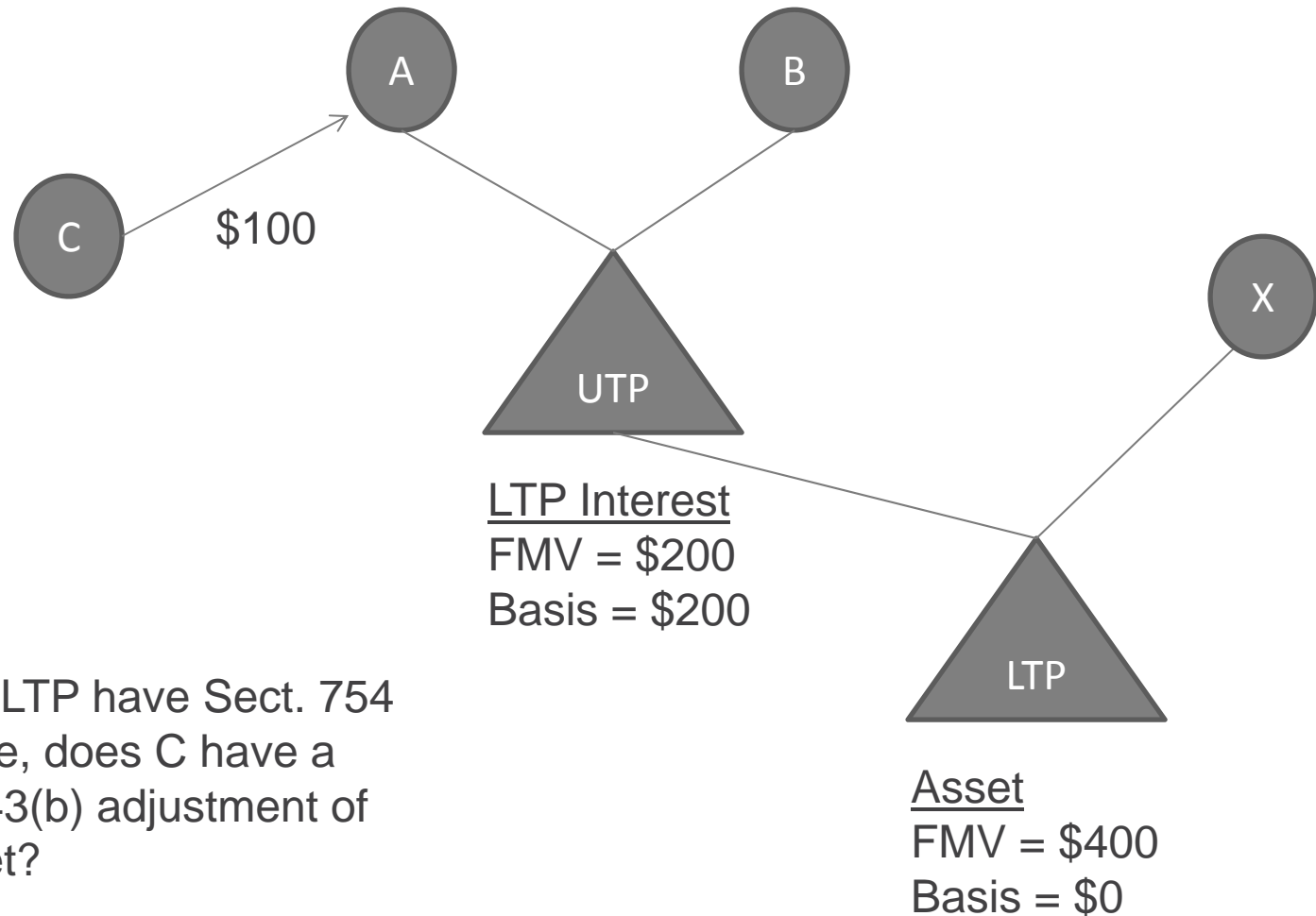
Tiered Partnerships

- How do sections 743(b) and 734(b) basis adjustments work in the context of tiered partnerships?
 - Revenue Ruling 87-115
 - Revenue Ruling 92-15

Tiered Partnerships (Cont.)

- Lower-tier partnership (LTP) owns asset with a FMV of \$400 and a basis of \$0.
- A and B form an upper-tier partnership (UTP), and both contribute \$100.
 - UTP then purchases 50% of the interest in LTP for \$200, at a time when LTP did not have a Sect. 754 election in effect.
- A then sells her interest in UTP to C for \$100.
 - At the time of the sale, both UTP and LTP have Sect. 754 elections in place.
 - Asset is still worth \$400 and has a basis of \$0.

Tiered Partnerships (Cont.)

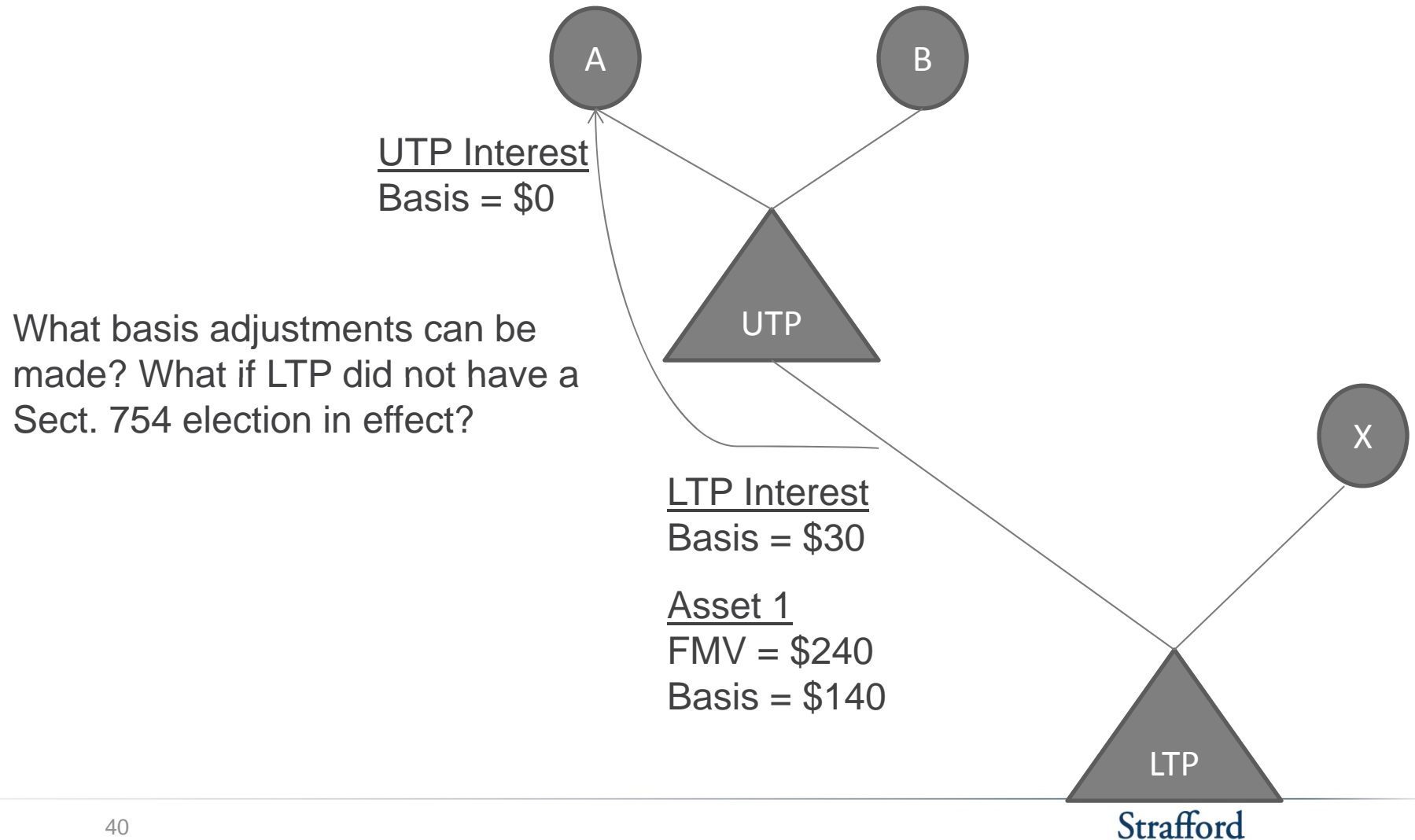


If both UTP and LTP have Sect. 754 elections in place, does C have a positive Sect. 743(b) adjustment of \$100 in the asset?

Tiered Partnerships (Cont.)

- A has a basis of \$0 in his 50% interest of UTP.
 - A receives a current distribution of an interest in LTP from UTP.
 - UTP's basis in the LTP interest is \$30.
 - UTP's only other asset is Asset 1, which is a capital asset with a FMV of \$240 and a basis of \$140.
 - Both UTP and LTP have Sect. 754 elections in effect.

Tiered Partnerships (Cont.)



Sect. 743(b) And Sect. 704(c)

- Does it matter which partnership interest you purchase, since Sect. 743(b) tries to treat the incoming partner as if he purchased an interest in each partnership asset?
 - Yes; let's take a look at the following example.

Sect. 743(b) And Sect. 704(c), Cont.

- A and B form an equal partnership, LLC.
 - A contributes Asset 1 with a FMV = \$100 and a basis = \$60.
 - Asset 1 is a 10-year straight-line depreciable asset, with five years remaining.
 - B contributes Asset 2 with a FMV = \$100 and a basis = \$100.
 - Asset 2 is non-depreciable.
 - LLC has a valid Sect. 754 election in place.
- C is interested in purchasing a 50% interest in LLC.

Sect. 743(b) And Sect. 704(c), Cont.

- C purchases B's interest for \$100.
 - Will C have a Sect. 743(b) adjustment?
 - C's outside basis
 - Equals the \$100 she paid to B for the interest
 - C's share of LLC's inside basis
 - Previously taxed capital = \$100
 - \$100 (cash on liquidation) + \$0 (loss) - \$0 (gain)
 - The \$40 gain in Asset 1 is all allocated to A under Sect. 704(c).
 - Sect. 743(b) adj = \$0
 - \$100 outside basis less \$100 share of inside basis

Sect. 743(b) And Sect. 704(c), Cont.

- Going forward, C would be allocated a \$10 deduction in accordance with her share of Asset 1's depreciation in years one through five.
 - A would be allocated the remaining \$2 of deduction in years one through five.
 - \$12 of allocable depreciation less the \$10 allocated to C

Sect. 743(b) And Sect. 704(c), Cont.

- C purchases A's interest for \$100.
 - Will C have a Sect. 743(b) adjustment?
 - C's outside basis
 - Equals the \$100 she paid to A for the interest
 - C's share of LLC's inside basis
 - Previously taxed capital = \$60
 - \$100 (cash on liquidation) + \$0 (loss) - \$40 (gain)
 - The \$40 gain in Asset 1 is all allocated to C, because she inherits A's Sect. 704(c) built in gain.
 - Sect. 743(b) adj = \$40
 - \$100 outside basis less \$60 share of inside basis

Sect. 743(b) And Sect. 704(c), Cont.

- All of the \$40 of the Sect. 743(b) positive adjustment is allocated to Asset 1, under Sect. 755.
- The adjustment is treated as a separate asset and is depreciable over 10 years.
 - $\$40/10 \text{ yrs} = \$4/\text{yr}$
- Going forward, C would be allocated \$6 of depreciation deductions in years 1-5 and \$4 in years 6-10.
 - C would be allocated the \$2 of deduction in years 1-5 that A was entitled to, plus the \$4 from the Sect. 743(b) adjustment in years 1-10.

Sect. 743(b) And Sect. 704(c), Cont.

- What happens when LLC uses the remedial method under Sect. 704(c)?
 - Sect. 1.743-1(j)(4)(i)(B)(2)

Transfer Of Partnership Interests

- Capital account of transferor carries over to the transferee.
- If a technical termination under §708(b)(1)(B) (sale or exchange of 50% or greater partnership interest), then the capital accounts of the transferee partner and of the other partners carry over to the new partnership.
- Basis adjustments take place before the deemed contribution of assets to the new partnership, and continue in effect.

§754 Elections

- §743 adjustments: In case of a transfer of all or part of an interest in a partnership, such adjustments shall not be reflected in the capital account of the transferee partner.
- Subsequent capital account adjustments for distributions, depreciation, gain/loss, etc. will disregard the effect of such a basis adjustment.

§732 Adjustments

- No §754 election
- Transfer of all or part of an interest in partnership
- Capital accounts treated AS IF a §754 election

§734 Adjustments (Cont.)

- Distribution of property **in liquidation** of partner's interest (§754 election in effect)
 - Distributee partner shall have a corresponding adjustment made to his capital account.

§734 Adjustments (Cont.)

- Distribution NOT in liquidation of partner's interest in the partnership
 - Capital accounts of the partners **shall be** adjusted.
 - By amount of adjustment to tax basis of property
 - Shared among partners in manner in which unrealized gain would have been shared (AS IF property were sold)

Limitation

- No duplicative adjustment permitted
- Treasury regulations limit the amount of capital account adjustments
- Only to extent such adjustments result in increase/decrease in book amount

Substantial Built-In Loss

- Basis of partnership property is adjusted – **even if** no §754 election
 - Transfer of partnership interest
 - Death of a partner
 - A distribution of property with a substantial basis reduction is treated similarly.

Substantial Built-In Loss (Cont.)

- If the partnership's adjusted basis in partnership property exceeds FMV by more than \$250,000
- The substantial basis reduction for distributed property is similar.
- Does not apply to securitization partnerships and electing investment partnerships
- IRC §743(d) and §734(d)

Effects Of Treasury Reg. 1.743-1(j)

- Partnership first computes income at the partnership level.
- Then allocates to partners IRC §704
- Then adjusts capital accounts accordingly
- Then, transferee's basis adjustment is reflected on K-1 as an adjustment to distribute share.
- But, adjustments do not affect capital accounts.

Example

- A & B partners: A contributes property – FMV \$50, basis \$100
- B contributes \$50 cash. A sells interest to C for \$50.
- If §754 election or substantial built-in-loss
- C negative basis adjustment \$50

Example (Cont.)

- Capital account of transferor carries over to transferee.
- Property sold for \$60
- Book gain \$10 allocated to B & C (\$5 each)
- §704(c) mandates C report tax loss: \$40
- Negative basis adjustment: \$50 income
- Result: \$10 gain – C's capital account: \$15 based on traditional method; tax basis: \$20

Depreciation Recapture

- Partner reports his/her distributive share of depreciation recapture.
- Based upon total amount of depreciation allowed or allowable allocated to that partner
- On transfer of partnership interest – depreciation recapture allocated to transferee

Effect Of §754 Election

- §743(b) basis adjustment alters result.
- Only depreciation claimed after the date of acquisition of the partnership interest is taken into effect for the recapture computation.

Example

- A & B partnership purchases equipment for \$5,000; 90% depreciation to A, 10% to B
- A receives depreciation on deduction of \$900, B \$100
- Sale of property for \$5,000
- §1245 recapture to A = \$900

Example (Cont.)

- If C purchases A's interest
- No §754 election C reports A's recapture
- If §754 election – clock starts at 0