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A Review of Code Section 754 and Its Tax Consequences

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OVERVIEW

The purpose of this article is to provide a review of the election provided partnerships under §754.¹ Understanding §754 requires an understanding of three other Code sections. Those three sections are: §743(b), §734(b) and §755. Section 754, a very short provision, simply states that if the partnership makes a §754 election, then the basis of partnership property is adjusted under §734(b) in the case of a distribution of partnership property and §743(b) in the case of a transfer of a partnership interest. These two sections provide when a §754 election can be made and the amount of the adjustment caused by the §754 election. Once the amount of the adjustment is determined, the adjustment is allocated to partnership assets under §755.

PURPOSE AND APPLICABILITY OF §754

Subchapter K, governing the taxation of partnerships and partners, sometimes treats a partnership as a separate *entity*, which is distinct from its partners, and other times treats a partnership as an *aggregate* of individuals, each of whom owns an undivided interest in partnership assets.² Because of this dichotomy, a vocabulary has been developed to express these two different concepts. That vocabulary consists, in part, of two terms: outside basis and inside basis. “Outside basis” reflects the “entity” concept of a partnership.

It refers to a partner’s tax basis in his partnership interest itself. The partnership is treated as an entity separate from its partners and the partnership interest as an intangible asset that is separate and distinct from partnership assets. This is similar to a shareholder’s tax basis in a share of stock. “Inside basis” reflects the “aggregate” concept of a partnership. It refers to the tax basis of the assets held by the partnership, and, in particular, a *partner’s inside basis* refers to the partner’s share of the tax basis of the assets held by the partnership. The concept of a partner having a share of the tax basis of assets held by the partnership treats partners like owners of undivided interests in the assets of the partnership, i.e., as an aggregate of individuals.³ The idea that a partner has a share of the tax basis of the assets of the partnership does not have a direct analog in the Subchapter C or Subchapter S world; that is, a shareholder is not considered to have a share of the inside tax basis of a corporation’s assets.

When a partner sells his partnership interest, the general rule is that the partnership is treated like an entity, i.e., just like a corporation, and there is no change to the inside bases of the partnership assets.⁴ Likewise, when a partnership makes a distribution of cash or property to a partner, the general rule is there is no change to the inside bases of the partnership assets, i.e., the entity approach prevails just as with corporate distributions.⁵ However, a partnership is not a separate taxable entity. Its income is allocated and taxed to its partners. For example, the purchase price paid by a buyer for his partnership interest reflects the fair market value of the property held by the partnership. Let’s say all of the assets of the partnership have appreciated. When the partnership sells one of its appreciated assets, gain will be allocated to the purchasing partner even though part or all of the gain has been reflected in the purchase price the buyer paid for his partnership interest. Under an aggregate approach to partnership taxation, the purchasing partner is

¹ Unless otherwise stated, references to “§” are to sections of the Internal Revenue Code of 1986, as amended, and references to “Reg. §” are to sections of the Treasury regulations issued under the Internal Revenue Code.

² This article discusses the application of the rules to partnerships. These rules also apply to limited liability companies (LLCs) because LLCs are taxed as partnerships.

³ Similarly, §704(c) implements an aggregate approach by allocating to a contributing partner tax consequences that reflect the difference between the tax basis and the fair market value of contributed property at the time of its contribution to the partnership. G. Marich & W. McKee, *Sections 704(c) and 743(b): The Shortcomings of Existing Regulations and the Problems of Publicly Traded Partnerships*, 41 Tax L. Rev. 627 (Summer 1986).

⁴ §743(a).

⁵ §734(a).

treated as having a special adjustment to the basis of the appreciated partnership asset, which adjustment applies only to him. The purpose of the adjustment is to treat the buyer as if he had purchased an undivided interest in the asset itself rather than purchasing a partnership interest.⁶

Section 754 is the provision that gives a partnership the option to avoid being taxed solely under an entity concept of taxation and that allows the partnership to be treated like an aggregate of individuals. A §754 election can be made only if either the requirements set forth in §743(b) or §734(b) are met. Section 743(b) requires the sale or exchange of partnership interest, including transfer on death. Section 734(b) requires that the distributee partner recognizes gain or loss upon the distribution of partnership property or that the distributee partner takes a substituted basis in property distributed by the partnership, i.e., a basis which is different from the basis the property had inside the partnership. Section 743(b) allows a “partner’s inside basis” to be adjusted to equal his “outside basis.” This adjustment applies only to the partner to which it is applicable; that is, the adjustment applies outside of the partnership. In contrast, §734(b) applies to all partners because under §734(b) the “inside bases of the partnership assets” are adjusted.

Whether to Make the §754 Election

When a partnership makes a §754 election, both §743(b) and §734(b) apply. In other words, the partnership cannot elect to have only one section or the other apply. Once the election is made, it is a “blanket election”; §743(b) applies every time a partner dies and to every sale or exchange of a partnership interest and §734(b) applies to every distribution made by a partnership when the distributee partner recognizes gain or loss or the basis of the partnership asset distributed is different to the distributee partner than it was to the partnership. Even though the §754 election can theoretically be revoked by the IRS, it seems that no one has heard of this revocation ever being done.⁷ Consequently, once a §754 election is made by the partnership, it stays in effect unless there is a change at the partnership level such as a constructive termination. As you can see, making a §754 election is a serious decision. It is great when the partnership holds appreciated assets because the transferee-partner enjoys a step-up in basis. Likewise, the partnership may be able to step up the basis of its assets if a partner recognizes gain from a partnership distribution to the partner, or the tax basis of the distributed asset is decreased in the hands of the distribute partner. However, what happens when the partnership holds assets that have decreased in value? Who wants to have a decrease in the tax basis of partnership assets or a decrease to the basis of a transferee partner? It is hard to predict the future and, therefore, whether a §754 elec-

tion should be made. Furthermore, even though it may be beneficial to a transferee partner or the estate of a partner, often partnerships will not agree to make the election because of the additional accounting costs to keep track of adjustments. This is especially true when the partnership has many assets because the §743(b) adjustment has to be determined and tracked for each individual asset. The election must be made by the partnership, not an individual partner.

How to Make the §754 Election

Assuming that there is an event triggering either §743(b) or §734(b), the §754 election is made by attaching a statement to the partnership return setting forth (i) the name and address of the partnership making the election, (ii) signed by any one of its partners, and (iii) containing a declaration that the partnership elects under §754 to apply the provisions of §734(b) and §743(b).⁸ An example of the election is set forth below:

EHE, L.P.

[Address]

EIN 65-999999999

EHE, L.P. hereby elects under Internal Revenue Code §754 and pursuant to Reg.

§1.754-1(b), to apply the provisions of §734(b) and §743(b), with respect to distributions of property by EHE, L.P. to partners, and sales and exchanges of interests in EHE, L.P., beginning with the calendar year 20xx.

The tax return for 20xx is filed with, and attached to, this election statement.

/s/ _____

General Partner

The election should be filed with the partnership tax return for the partnership tax year during which the distribution or transfer occurs on or before the due date (including extensions) of the partnership tax return.⁹

There is an automatic 12-month extension from the due date of the partnership return or from the extended due date of the partnership return if the partnership takes “corrective action” during this 12-month extension period.¹⁰ “Corrective action” means filing an amended return for the year in which the election should have been made and attaching to the amended return the required election statement. The statement “FILED PURSUANT TO §301.9100-2” must be written at the top of the amended return.

If the terms of the automatic extension have not been met, a discretionary extension of time to file the §754 election may still be requested from the IRS and will generally be granted if the requirements of Reg.

⁶ H.R. Rep. No. 1337, 83d Cong., 2d Sess. 70 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 97 (1954).

⁷ Reg. §1.754-1(c)(1).

⁸ Reg. §1.754-1(b).

⁹ Reg. §1.754-1(b).

¹⁰ Reg. §301.9100-2(a)(2)(vi)

§301.9100-3 are met. These discretionary extensions are granted frequently in private letter rulings.¹¹

A partnership that makes adjustments to bases of partnership properties under §743(b) must attach a statement to the partnership return for the year of the transfer, setting forth the name and taxpayer identification number of the transferee as well as the computation of the adjustment and the partnership properties to which the adjustment has been allocated.¹² Likewise, a partnership that makes adjustments to the bases of partnership properties under §734(b) must attach a statement to the partnership return for the year of the distribution, setting forth the computation of the adjustment and the partnership properties to which the adjustment has been allocated.¹³

If a transferee acquires a partnership interest in a partnership with a §754 election in effect, the transferee must notify the partnership in writing within 30 days of the sale or exchange stating the name and address of transferee, identification number, relationship (if any) between transferor and transferee, and the amount of the purchase price, the amount of any liabilities assumed or taken subject to, and any other information necessary for the partnership to compute the transferee's basis.¹⁴ If a partner dies, the transferee has one year to notify the partnership.¹⁵ If the partnership is not notified of the transfer, then it is not required to make any adjustments under §743(b).¹⁶ Upon notification, the partnership must display the following statement on the first page of the partnership return for that year and on the first page of the Schedule K-1 issued to the transferee: RETURN FILED PURSUANT TO §1.743-1(k)(5). The partner-

ship may report the transferee's share of partnership items without adjustment until the partnership receives the required information from the transferee. At that time, the partnership must take into account the adjustments on any amended return otherwise filed by the partnership or in the next annual partnership return. The partnership also must provide the transferee with the necessary information for the transferee to amend its prior returns to properly reflect the adjustment under §743(b).¹⁷

Mandatory Adjustments

In 2004, Congress passed the American Jobs Creation Act of 2004 (the "Jobs Act"), in part to prevent tax-motivated transactions. The Jobs Act included provisions making §743(b) and §734(b) mandatory even though the partnership has no §754 election in effect.¹⁸

An example of one of the tax-motivated transactions that Congress wanted to stop by making the §734(b) adjustment and the §743(b) adjustment mandatory is set forth below:¹⁹

<u>Balance Sheet</u> <u>Before Sale</u>	<u>Tax Basis</u>	<u>FMV</u>	<u>Loss</u>
Property	200	100	(100)
Partner A	100	50	(50)
Partner B	100	50	(50)

A sells 50% partnership interest to X for \$50; therefore, A recognizes a \$50 loss.

¹¹ *E.g.*, PLR 201641012.

¹² Reg. §1.743-1(k)(1)(i).

¹³ Reg. §1.734-1(d).

¹⁴ Reg. §1.743-1(k)(2)(i).

¹⁵ Reg. §1.743-1(k)(2)(ii).

¹⁶ Reg. §1.743-1(k)(4).

¹⁷ Reg. §1.743-1(k)(5).

¹⁸ Pub. L. No. 108-357 (Oct. 22, 2004).

¹⁹ S. Rosow, P. Furci, D. Shulman, A. Needham, W. Wasserman, *Partnership Tax Strategies and Pitfalls Using (And Avoiding The Use Of) The Section 754 Election*, Practising Law Institute Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures, and Other Strategic Alliances, Ex. 1 (2014).

Balance Sheet After Sale			
Property	200	100	(100)
Partner X	50	50	-0-
Partner B	100	50	(50)

If the partnership sells the property for \$100, it recognizes \$100 of loss, \$50 of which is allocated to X. A recognized the same \$50 loss; hence, there is a duplication of the same loss.

The Jobs Act amended §743(a) to require a mandatory adjustment if the partnership has a “substantial built-in loss” immediately after the transfer.²⁰ Section 743(d) states that a “substantial built-in loss” occurs if the total of the partnership’s tax bases in its assets exceeds the total fair market value of its assets by more than \$250,000 immediately after the transfer.²¹ In the above example, assume that the partnership has a substantial built-in loss immediately after the transfer; thus, a §743(b) adjustment must be made regardless of whether the partnership has made a §754 election. The amount of the §743(b) adjustment is a negative adjustment of \$50 applicable only to X. The \$50 negative adjustment will offset the \$50 loss allocated to X by the partnership, preventing the duplication of the \$50 loss. If a partnership is required to adjust the basis of partnership property following the transfer of a partnership interest pursuant to the substantial built-in loss rules, proposed regulations would require the partnership and the transferee to comply with the tax return reporting, notification, and information provision requirements that would otherwise apply to an elective §743 basis adjustment.²²

The Jobs Act amended §734(a) to require a mandatory adjustment to the tax bases of partnership assets if the distribution of partnership property would cause a “substantial basis reduction” under §734(b)(2).²³ Section 734(d) states that a “substantial basis reduction” occurs if a partnership distribution causes the distributee partner to recognize a loss or to receive property, which takes a stepped-up basis in the hands of the distributee partner, and the sum of the loss and the basis step-up exceeds \$250,000. For example, if a partner has an outside basis of \$1,000,000 and he receives, in liquidation of his partnership interest, a partnership asset with a basis to the partnership of \$500,000, then the partnership must reduce the aggregate basis of its assets by \$500,000 because the step-up in basis of the asset to the distributee partner exceeds \$250,000. The adjustment made under

§734(d) must be reported under the rules for reporting a §734(b) adjustment.²⁴

The mandatory adjustments do not have blanket application like the §754 election does. They apply only to the sale or exchange of a partnership interest when the partnership has, in fact, a substantial built-in loss immediately after the transfer or to the distribution of assets when there is, in fact, a substantial basis reduction under §734(d).²⁵

ADJUSTMENTS UNDER §743(b) AND §734(b)

Section 743(b) Requirements

As noted above, §743(b) applies upon a *sale or exchange* of a partnership interest or upon the death of a partner. It does not apply to the acquisition of a partnership interest by the transfer of money or property to the partnership.²⁶ A “sale or exchange” includes a substituted basis transaction such as a contribution of a partnership interest to a corporation under §351. In contrast, transfers by gift do not trigger a §754 election because transfers by gift are not sales or exchanges.²⁷

Section 761(e)(2) provides the exchange requirement when a partnership distributes an interest in a partnership by stating that an “exchange” has occurred for purposes of §743 when a partnership distributes any interest in a partnership (not otherwise treated as an exchange). For example, if an upper-tier partnership liquidates a partner’s interest by distributing to that partner an interest in a lower-tier partnership, then the distribution will be considered an “exchange” by the upper-tier partner of its interest in the upper-tier partnership for an interest in the lower-tier partnership. The “exchange” allows the upper-tier partner to compare its outside tax basis in the lower-tier partnership where it is now a partner with its inside tax basis in the lower-tier partnership to see whether it would like the lower-tier partnership to make a §743(b) election. The “constructive termination” rules also illustrate how §761(e) provides the “exchange” required for the application of §743(b). When there is a “constructive termination” under §708(b)(1)(B), i.e., sale or exchange of 50% or more of the total interest in partnership capital and profits within a period of 12 consecutive months, the terminated partnership is deemed to contribute all of its assets and liabilities to a new partnership for an interest in the new partnership, and immediately thereafter, the terminated partnership distributes interests in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests in the terminated partnership in liquidation.

²⁰ Special rules apply to “electing investment partnerships,” as set forth in §743(e), and to “securitization partnerships,” as set forth in §743(f).

²¹ Prop. Reg. §1.743-1(a)(2) would make clear that it is the aggregate of partnership assets that is used in determining whether the partnership has a “substantial built-in loss” immediately after the transfer.

²² Prop. Reg. §1.743-1(k)(1)(iii), §1.743-1(k)(2)(iv).

²³ Special rules apply to “securitization partnerships,” as set forth in §734(f).

²⁴ Prop. Reg. §1.734-1(d).

²⁵ Prop. Reg. §1.734-1, §1.743-1.

²⁶ Reg. §1.743-1(a).

²⁷ Reg. §1.743-1(f).

tion of the terminated partnership.²⁸ The deemed distribution of interests in the new partnership by the terminated partnership is treated as an *exchange* by the partners in the terminated partnership of their interests in the terminated partnership for interests in the new partnership. The new partnership can make a §754 election because the *exchange* requirement of §743(b) is satisfied. Likewise, if there is a division of a partnership using an assets-over form and a resulting partnership (none of the members of the resulting partnership own an interest of more than 50% in the capital and profits of the prior partnership), there will have been an *exchange* of partnership interests in the prior partnership for interests in the resulting partnership, which allows the resulting partnership to make a §754 election.

Amount of §743(b) Adjustment

Section 743(b) states that the adjustment to the basis of partnership property to the transferee equals the *difference* between (i) the transferee's tax basis in his partnership interest or his "outside tax basis," which is the purchase price of the interest or its fair market value at date of death plus his share of partnership liabilities, and (ii) the transferee's "proportionate share of the adjusted basis of partnership property" or his share of the partnership's "inside tax basis." The determination of the "outside tax basis" is easy. The challenging question is how to determine the transferee's "proportionate share of the adjusted basis to the partnership of partnership property" or his "inside basis" in the partnership. A transferee's "proportionate share of the adjusted basis of partnership property" equals the sum of the transferee's interest as a partner in the partnership's "previously taxed capital" plus his share of partnership liabilities.²⁹ The regulations provide the following methodology to calculate "previously taxed capital": First, determine the amount of cash the transferee would receive if the partnership sold all of its assets in a hypothetical sale immediately after the transfer using the fair market value of its assets and then distributed all of its cash in complete liquidation. Second, subtract from that amount the unrealized tax gain that would be allocated to the transferee from the hypothetical transaction, and add to that amount the unrealized tax loss that would be allocated to the transferee from the hypothetical transaction.³⁰ Generally, the transferee's interest in the partnership's "previously taxed capital" equals the

²⁸ Reg. §1.708-1(b)(4).

²⁹ Reg. §1.743-1(d)(1). Because a transferee-partner's share of partnership liabilities is included both in the cost basis of his partnership interest (his outside basis) and in the computation of his share of the tax basis of partnership property, the manner in which a transferee-partner's share of partnership liabilities is computed cannot affect the amount of his basis adjustment. Consequently, the partnership liabilities can be ignored in the computation of the transferee's basis adjustment.

³⁰ Reg. §1.743-1(d)(1). The amount of any tax loss and any tax

"tax capital account" that the transferee inherits from his transferor.³¹ In that case, the §743(b) adjustment equals the difference between the transferee's tax capital account and the transferee's outside tax basis.

The "hypothetical transaction" approach makes clear that special allocations valid under §704(b) are taken into account just as pre-contribution gain allocations required under §704(c) are taken into account.³² Section 704(c)(1)(C), which was added to the Code by the Jobs Act, changed the treatment of pre-contribution loss. Under that provision, pre-contribution loss stays with the partner contributing the property with the built-in loss, and the partnership takes a tax basis in the property equal to its fair market value at the time of contribution. When the contributing partner sells his partnership interest, the built-in loss is eliminated.³³

The §743(b) adjustment must be allocated among the partnership assets, and the rules for that allocation are set forth in §755. Adjustments to partnership assets apply only to the transferee.³⁴ No adjustment is made to the common basis of partnership property.³⁵ The transferee's gain or loss from the sale or exchange of a partnership asset is thus equal to the transferee's share of partnership gain or loss (including remedial allocations) *minus* the amount of any positive adjustment (which can convert a partnership gain to a partner loss) or *plus* the amount of any negative adjustment (which can convert a partnership loss to a partner gain).³⁶ With regard to deductions attributable to depreciation, the transferee partner treats a positive §743(b) adjustment as if it were newly purchased property placed in service when the transfer occurs.³⁷ Consequently, any applicable recovery period and method may be used to determine the recovery allowance with respect to the positive §743(b) adjustment. The partnership continues to depreciate its

gain include any remedial allocation that would be allocated to the transferee as a result of the hypothetical transaction. Reg. §1.743-1(d)(1)(ii), §1.743-1(d)(1)(iii).

³¹ Rosow, S. Rosow, P. Furci, D. Shulman, A. Needham, W. Wasserman, *Partnership Tax Strategies and Pitfalls Using (And Avoiding The Use Of) The Section 754 Election*, Practising Law Institute Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures, and Other Strategic Alliances (2014). The term "tax capital account" used in this context refers to an account maintained in accordance with the principles applicable to book capital accounts, except that a tax capital account reflects only the tax basis of partnership property and does not reflect book-ups and book-downs made pursuant to revaluations of partnership property. Therefore, the tax capital account maintained with respect to a partnership interest generally reflects only recognized tax consequences, in the form of partnership allocations or the basis of contributed or distributed property.

³² W. McKee, W. Nelson, R. Whitmire, *2 Federal Taxation of Partnerships and Partners* at ¶24.02[2] (4th ed. 2007).

³³ Prop. Reg. §1.704-3(f)(3)(ii).

³⁴ Reg. §1.743-1(j)(1).

³⁵ Reg. §1.743-1(j)(1).

³⁶ Reg. §1.743-1(j)(3) & McKee, n. 32 above, at ¶24.02[1].

³⁷ Reg. §1.743-1(j)(4)(B)(1).

common tax basis as it did before the transfer. These rules are modified if the partnership has been depreciating an asset under the remedial method.³⁸ The Treasury regulations explain how to decrease the depreciation allocated to the transferee partner if the §743(b) adjustment to the depreciable asset is negative.³⁹

The examples set forth in the §743 regulations illustrate how to calculate the §743(b) adjustment. Ex-

³⁸ Reg. §1.743-1(j)(4)(B)(2).

³⁹ Reg. §1.743-1(j)(4)(ii).

ample 1 of Reg. §1.743-1(d)(3) illustrates the calculation of the §743(b) adjustment when the book capital accounts and the tax capital accounts of the partnership are equal. In this example, the partnership has a §754 election in effect. Partner A sells his partnership interest to T for \$22,000, an amount equal to T's share of the liquidating proceeds of the partnership if the partnership had sold its assets for their fair market values. T's outside tax basis equals \$22,000 plus his share of the liabilities. It is necessary to determine T's previous taxed capital. The balance sheet of the partnership on the date of sale is as follows:

	<u>Adjusted Basis</u>	<u>Fair Market Value on Date of Sale by A</u>	<u>Section 743(b) Adjustment</u>
Cash	\$ 5,000	\$ 5,000	
Accounts Receivable	\$10,000	\$10,000	
Inventory	\$20,000	\$21,000	\$ 333.33
Depreciable Assets	\$20,000	\$40,000	\$6,666.67
Total	<u>\$55,000</u>	<u>\$76,000</u>	<u>\$7,000.00</u>
Liabilities	\$10,000	\$10,000	
Capital			
A	\$15,000	\$22,000	
B	\$15,000	\$22,000	
C	\$55,000	\$22,000	

From this balance sheet, we can see that T would receive \$22,000 upon the hypothetical liquidation of the partnership, and T would be allocated a total of \$7,000 of income, \$333.33 of which came from the hypothetical sale of inventory and \$6,666.67 of which came from the hypothetical sale of depreciable assets. Thus, T's previously taxed capital is \$15,000 (\$22,000 – \$7,000), and his share of the inside basis of the partnership assets is \$15,000 plus his share of the partnership liabilities. Because his outside tax basis is also \$22,000 plus his share of the liabilities, his §743(b) adjustment is \$7,000. (\$22,000 – \$15,000). T has a positive §743(b) adjustment allocated to the depreciable assets in the amount of \$6,666.67 and a positive adjustment allocated to inventory in the amount of \$333.33. What do these adjustments mean to T? Assume, for example, that the partnership sold the depreciable assets for \$40,000, the \$6,666.67 of gain allocated to T by the partnership is reduced by \$6,666.67, the amount of T's positive adjustment in the asset. Hence, T recognizes no gain from the partnership's sale of the depreciable assets. These adjustments to income must be shown on Schedule K and

T's Schedule K-1 of the partnership tax return; they do not affect T's capital account.⁴⁰

If no §754 election had been in effect and the partnership had sold its depreciable assets for \$40,000, T would have had \$6,666.67 of income allocated to him, without an offsetting adjustment, even though the cost of his partnership interest reflected a fair market value for the depreciable assets of \$40,000. The §743(b) adjustment is designed to eliminate this dichotomy between tax and economics.

Example 2 of Reg. §1.743-1(d)(3) illustrates how to calculate the §743(b) adjustment when the tax capital accounts and the book capital accounts are not equal. In this example, Partner A contributed land to the partnership with a tax basis of \$400 and a fair market value of \$1,000, i.e., the land has a pre-contribution built-in gain of \$600 under §704(c). The other two partners each contribute cash in the amount of \$1,000. When the land has appreciated to \$1,300,

Partner A sells his partnership interest to T for \$1,100, an amount equal to T's share of the liquidating proceeds of the partnership if the partnership had sold its assets for their fair market values. T's outside tax basis also equals \$1,100. The balance sheet of the partnership on the date of sale is as follows:

⁴⁰ Reg. §1.743-1(j)(2).

	Adjusted Basis	Fair Market Value on Contribution Date	Fair Market Value on Date of Sale	Section 743(b) Adjustment
Land	\$ 400	\$1,000	\$1,300	\$700
Cash	\$2,000	\$2,000	\$2,000	
Total	\$2,400	\$3,000	\$3,300	
Capital				
A	\$ 400	\$1,000	\$1,100	
B	\$1,000	\$1,000	\$1,100	
C	\$1,000	\$1,000	\$1,100	

To determine T's previously taxed capital, it is necessary to calculate the amount of tax gain that would be allocated to T upon a hypothetical liquidation of the partnership based upon the fair market values of its assets. The amount of tax gain that would be allocated to T is the §704(c) amount of his transferor, which is \$600, plus his share of the tax gain in excess of the §704(c) amount, which is \$100. Thus, the total amount of tax gain that would be allocated to T upon a hypothetical liquidation immediately after the sale at the fair market value of the partnership's assets is \$700; therefore, T's previously taxed capital is \$400, his share of the liquidating proceeds of \$1,100 less his share of the hypothetical tax gain of \$700. Because his outside tax basis is \$1,100, his §743(b) adjustment is \$700, i.e., \$1,100 (outside tax basis) less \$400 (inside tax basis). The theory is that if the partnership sold its property for \$1,300, T should not have to recognize the \$700 of gain allocated to him because that gain is reflected in the amount he paid for his partnership interest; he has no economic gain to match the tax gain allocated to him. The §743(b) adjustment of \$700 allocated to the land will eliminate tax gain of \$700 allocated to T by the partnership from the sale of the land.

What happens to a partner's §743(b) adjustments when the partner sells his partnership interest? Do those adjustments carry over to the purchaser? When there have been multiple transfers of a partnership interest, the general rule is each transferee must calculate its own basis adjustment under §743(b) without regard to any prior transferee's basis adjustment; that is, the basis adjustments do not carry over to the transferee.⁴¹ For instance, in Example 2 of Reg. §1.743-1(d)(3) set forth above, assume that T sells his partnership interest to T1 for \$1,400, which reflects one-third of the fair market value of the land at the date of sale. T1's §743(b) adjustment is \$1,000, which is determined without regard to any §743(b) basis adjustment that T had in the interest.⁴² However, in the case of a gift of an interest in the partnership, the donor is treated as transferring, and the donee as receiving, that portion of the basis adjustment attributable to the

gifted partnership interest.⁴³ As discussed below, Prop. Reg. §1.743-1(f)(2) would change the rule of ignoring §743(b) adjustments in transfer situations where the subsequent transfer is a substituted basis transaction.⁴⁴

Section 734(b) Requirements

Section 734(b) adjustments, which cause the inside basis of partnership assets to be adjusted for all partners of the partnership, occur only with respect to two types of distributions: (i) gain or loss is recognized by the distributee partner under §731; or (ii) under the §732 basis rules, the distributee partner has a different tax bases in the assets than the partnership had in the assets. Because the adjustment applies to the partnership assets, it is not necessary to maintain separate special adjustments for transferee partners that are required under §743(b). The partnership reports a §734(b) adjustment by attaching a statement to the partnership return for the year of the distribution setting forth the computation of the adjustment and the partnership properties to which the adjustment has been allocated.⁴⁵

Amount of §734(b) Adjustment

The amount of the §734(b) adjustment is the amount of gain or loss recognized by the distributee partner or the amount of the change in the basis of the distributed partnership assets. If the distributee partner has recognized a gain on the distribution under §731(a)(1), e.g., the cash received exceeds his tax basis in his partnership interest, then the bases of the assets held by the partnership must be increased. Similarly, if the distributee partner has recognized a loss on the distribution in liquidation of his interest under §731(a)(2), e.g., cash plus other property received is less than the tax basis in his partnership interest, then

⁴³ Reg. §1.743-1(f).

⁴⁴ A "substituted basis transaction" is a transaction in which basis adjustments under §743(b) result from exchanges in which the transferee's basis in the partnership interest is determined in whole or in part by reference to the transferor's basis in the interest. Reg. §1.755-1(c)(5)(i).

⁴⁵ Reg. §1.734-1(d).

⁴¹ Reg. §1.743-1(f).

⁴² Reg. §1.743-1(f) Ex. (ii).

the bases of the assets held by the partnership must be decreased. If the adjusted basis of the distributed partnership asset to the distributee partner is decreased under either §732(a)(2), i.e., a nonliquidating distribution, or §732(b), i.e., a liquidating distribution, the bases of partnership assets will be increased under §734(b)(1)(B). If the property distributed is an interest in another partnership, then no adjustment can be made under §734(b)(1)(B) even if the distributing partnership has a §754 election in effect if the distributed interest is in a partnership that does not have a §754 election in effect.⁴⁶ If the adjusted basis of the distributed partnership asset is increased to the distributee partner in a liquidating distribution under §734(b)(2), then the bases of partnership assets must be decreased under §734(b)(2)(B). With respect to §734(b), as with §743(b), §755 sets forth how to allocate the adjustment to the partnership assets.

HOW TO ALLOCATE ADJUSTMENTS UNDER §755

The overall scheme for allocating §743(b) adjustments and §734(b) adjustments among partnership assets is outlined in Reg. §1.755-1(a)(1). First, the partnership must determine the fair market value of its assets.⁴⁷ After fair market values are assigned to partnership assets, the basis adjustment must be allocated between two classes of property; namely, capital assets and §1231(b) assets (capital gain property) and any other property of the partnership (ordinary income property).⁴⁸ For purposes of classifying partnership property, Reg. §1.755-1(a)(1) specifically states

⁴⁶ §734(b).

⁴⁷ If the assets of the partnership constitute a trade or business under Reg. §1.1060-1(b)(2), then the partnership must use the residual method to assign values to the partnership's §197 intangibles, as determined under Reg. §1.755-1(a)(2). The rules on how to calculate the values to be assigned to §197 intangibles are set forth in Reg. §1.755-1(a)(4) and §1.755-1(a)(5).

⁴⁸ §755(b); Reg. §1.755-1(a)(1).

that “properties and potential gain treated as unrealized receivables under section 751(c) and the regulations thereunder shall be treated as separate assets that are ordinary income property.” The portion of the basis adjustment allocated to each class is then allocated among the assets within the class.⁴⁹ How these allocations are done depends on (i) whether the adjustment has been calculated in a §743(b) transaction that is not a substituted basis transaction, (ii) whether the adjustment has been calculated in a §743(b) transaction that is a substituted basis transaction, or (iii) whether the adjustment has been calculated in a §734(b) transaction. The rules for allocation of the adjustment for each of these three transactions are set forth, respectively, in Reg. §1.755-1(b)(2) through §1.755-1(b)(4), Reg. §1.755-1(b)(5), and Reg. §1.755-1(c).

Section 743(b) Nonsubstituted Basis Transactions

If a partnership interest is sold and the purchase price for the partnership interest equals the fair market value of the assets, then the adjustment to the basis of each partnership asset with respect to the transferee-partner is the same as the gain or loss adjustment allocated to that asset under Reg. §1.743-1(d), which was determined in calculating the transferee's previously taxed capital.⁵⁰ This is illustrated by Example 1 under Reg. §1.755-1(b)(2)(ii). In this example, Partner A contributes cash equal to \$50,000 and Asset 1 with a tax basis of \$25,000 and a fair market value of \$50,000 giving him a tax capital account of \$75,000 and a book capital account of \$100,000. B, his equal partner, contributes \$100,000 cash. The partnership takes its \$150,000 of cash and buys three additional assets. Partner A sells its 50% partnership interest to T for \$120,000 when the balance sheet of the partnership is as follows:

⁴⁹ Reg. §1.755-1(b) states the rules for §743(b) adjustments and Reg. §1.755-1(c) states the rules for §734(b) adjustments.

⁵⁰ Reg. §1.755-1(b)(1)(ii).

	Adjusted Basis	FMV at Time of Sale	Basis Adjustment to Assets Resulting from §743(b) Adjustment of \$45,000
Capital Gain Property:			
Asset 1	\$ 25,000	\$ 75,000	\$37,500
Asset 2	\$100,000	\$117,500	\$ 8,750
			\$46,250
Ordinary Income Property:			
Asset 3	\$ 40,000	\$ 45,000	\$ 2,500
Asset 4	\$ 10,000	\$ 2,500	(\$ 3,750)
	\$175,000	\$240,000	(\$ 1,250)

T's previously taxed capital amount is \$75,000, calculated as follows: The amount T would receive on a hypothetical liquidation of the partnership based upon a fair market value of the assets, which amount equals

\$120,000. That amount is decreased by his share of the taxable gain that would be allocated to him of \$46,250 and is increased by his share of the taxable loss that would be allocated to him of \$1,250. The

§743(b) adjustment is the difference between T's purchase price for the partnership interest of \$120,000 and T's previously taxed capital of \$75,000, an amount equal to \$45,000. Because the purchase price of A's partnership interest equals A's share of the fair market value of the partnership assets, the adjustment in each asset used to determine T's previously taxed capital is exactly how the §743(b) adjustment of \$45,000 is allocated among the assets under §755.

Assume that T paid \$110,000 for his partnership interest.⁵¹ Now, the §743(b) adjustment will be \$35,000, the difference between the amount paid for the partnership interest of \$110,000 and A's previously taxed capital of \$75,000. Section 755 and Reg. §1.755-1(a)(1) provide that the adjustment must be divided between the capital gain assets and the ordinary income assets. Reg. §1.755-1(b)(2) states that the allocation to the class of ordinary income assets is based upon their fair market value.⁵² Consequently, there is a negative adjustment of \$1,250 to the ordinary income class, which means that the adjustment to

⁵¹ This fact situation is illustrated in Reg. §1.755-1(b)(3)(iv) Ex. 1.

⁵² This approach allocates any overpayment or underpayment to the basis of capital gain property.

	<u>Adjusted Basis</u>	<u>FMV at Time of Sale</u>	<u>Basis Adjustment to Assets Resulting from §743(b) Adjustment of \$35,000</u>
Capital Gain Property:			
Asset 1	\$ 25,000	\$ 75,000	\$33,604
Asset 2	\$100,000	\$117,500	\$ 2,646
			<u>\$36,250</u>
Ordinary Income Property:			
Asset 3	\$ 40,000	\$ 45,000	\$ 2,500
Asset 4	\$ 10,000	\$ 2,500	(\$ 3,750)
Total	\$175,000	\$240,000	(\$ 1,250)

No part of the basis adjustment can be allocated to assets representing income in respect of a decedent.⁵⁵ Except for substituted basis adjustments, adjustments can be made to individual assets even through the total amount of the §743(b) adjustment is zero.⁵⁶ How

⁵⁵ Reg. §1.755-1(b)(4).

⁵⁶ Reg. §1.755-1(b)(1)(i).

the class of capital gain assets must be \$36,250, i.e., \$35,000 plus \$1,250. This means we have to decrease the amount of the adjustment to the class of capital gain assets by \$10,000 from the adjustment of \$46,250 based on a purchase price of \$120,000. To allocate the \$10,000 decrease among the capital gain assets, the fair market value of each asset is decreased by an amount equal to the total decrease of \$10,000 times a fraction, the numerator of which is the fair market value of the asset and the denominator is the fair market value of all of the capital gain assets.⁵³ In other words, the underpayment of \$10,000 is allocated among the capital gain assets in proportion to their relative fair market values. Based on this formula, the decrease to the fair market value adjustment of Asset 1 is \$3,896 and the decrease to the fair market value adjustment to Asset 2 is \$6,104, for a total decrease of \$10,000.⁵⁴ The balance sheet with the §743(b) adjustments allocated to the assets with regard to T is as follows:

⁵³ Reg. §1.755-1(b)(3)(ii).

⁵⁴ Asset 1: \$37,500 (adjustment based upon fair market value) – \$10,000 × (\$75,000 / (\$75,000 + \$117,500)) = \$33,604.

Asset 2: \$8,750 (adjustment based upon fair market value) – \$10,000 × (\$117,500 / (\$75,000 + \$117,500)) = \$2,646.

this can happen is illustrated by the Example 2 of Reg. §1.755-1(b)(2)(ii). In this example, T buys Partner A's interest for \$1,000, its fair market value. T's outside basis of \$1,000 equals his previously taxed capital of \$1,000. T's previously taxed capital is \$1,000 because the gain of \$250 allocated to T equals the loss allocated to him upon the hypothetical liquidation of the partnership. The balance sheet of the partnership is as follows:

	<u>Adjusted Basis</u>	<u>Fair Market Value</u>	<u>Basis Adjustment</u>
Capital Gain Property			
Asset 1	\$ 500	\$ 750	\$250
Asset 2	\$ 500	\$ 500	\$0
Ordinary Income Property			
Asset 3	\$ 500	\$ 250	(\$250)
Asset 4	\$ 500	\$ 500	\$0
Total	\$2,000	\$2,000	\$0

Prop. Reg. §1.743-1(l) would add a specific rule for tiered partnerships. It would adopt the principles of Rev. Rul. 87-115.⁵⁷ That ruling sets forth the IRS approach concerning how §743(b) adjustments work in tiered partnership settings under various circumstances. Prop. Reg. §1.743-1(l) specifically provides that if an interest in an upper-tier partnership that holds an interest in a lower-tier partnership is transferred by sale or exchange or upon the death of a partner, and the upper-tier partnership and the lower-tier partnership each have a §754 election in effect, then an interest in the lower-tier partnership will be deemed similarly transferred in an amount equal to the portion of the upper-tier partnership's interest in the lower-tier partnership that is attributable to the interest in the upper-tier partnership. These principles are extended to cover the situation where the upper-tier partnership has a substantial built-in loss with respect to the transfer. In that case, each lower-tier partnership is treated, solely with respect to the transfer, as if it had made a §754 election for the tax year of the transfer. The example set forth in Prop. Reg. §1.743-1(l)(2) illustrates this rule.

Section 743(b) Substituted Basis Transactions

When a “substituted basis exchange” has occurred, the §743(b) adjustment is allocated under an entirely different set of rules than those discussed above. A “substituted basis exchange” is defined to be one in which basis adjustments under §743(b) result from an exchange in which the transferee's basis in the partnership interest is determined in whole or in part by reference to the transferor's basis in that interest.⁵⁸ A “substituted basis exchange” also includes basis adjustments under §743(b) resulting from an exchange in which the transferee's basis in the partnership interest is determined by reference to other property held at any time by the transferee.⁵⁹ Examples of substituted basis transactions include the contribution of a partnership interest to a corporation in a transaction in which §351 applies, the contribution of a partnership interest to a partnership in which §721 applies,

or if a partnership interest is distributed by a partnership in a transaction to which §731(a) applies.⁶⁰ Another example of a substituted basis transaction is the constructive termination transaction discussed earlier. The rules are tedious to understand; thus, it is necessary to read them and to study the examples set forth in Reg. §1.755-1(b)(5)(iv) whenever a §743(b) adjustment must be allocated in a substituted basis transaction. In addition, Prop. Reg. §1.755-1(b)(5)(iv) would add more examples, which help to understand the rules.

Unlike the nonsubstituted basis transaction discussed above, if the total amount of the §743(b) basis adjustment arising from a substituted basis exchange is zero, then no adjustment to the basis of partnership property can be made.⁶¹ If the basis adjustment is positive, under the present rules an adjustment can be made only if the hypothetical sale of the partnership's assets results in a net gain or net income to the transferee.⁶² The increase is allocated between classes of assets, ordinary and capital, in proportion to the net income or gain of each class allocable to the transferee.⁶³ Note how this allocation of the §743(b) adjustment between the two classes of assets differs from the allocation used in a §743(b) nonsubstituted basis adjustment. Not only is the allocation of the adjustment between the two classes different, the allocation within a class is also different. Under the substituted basis rules, an increase in basis must be allocated to properties with unrealized appreciation in proportion to the transferee's share of such unrealized appreciation until the transferee's share of the appreciation is eliminated; any remaining amount is allocated among assets in the class according to the transferee's share of the amount realized from the hypothetical sale of each asset in the class.⁶⁴ Likewise, if the basis adjustment is negative, under the present rules an adjustment can be made only if the hypothetical sale results in the allocation of a net loss to the transferee. The decrease is allocated between asset classes in proportion to the net loss allocable to the transferee from the hypothetical sale of all assets in

⁵⁷ 1987-2 C.B. 163

⁵⁸ Reg. §1.755-1(b)(5)(i).

⁵⁹ Reg. §1.755-1(b)(5)(i).

⁶⁰ Reg. §1.755-1(b)(5)(i).

⁶¹ Reg. §1.755-1(b)(5)(ii).

⁶² Reg. §1.755-1(b)(5)(ii).

⁶³ Reg. §1.755-1(b)(5)(ii).

⁶⁴ Reg. §1.755-1(b)(5)(iii)(A).

each class.⁶⁵ Within each class, the decrease is allocated to properties with unrealized depreciation in proportion to the transferee's shares of such unrealized depreciation until they are eliminated; remaining decreases are allocated among the properties within the class in proportion to the transferee's shares of their adjusted bases (as adjusted under the previous sentence).⁶⁶

Current Reg. §1.755-1(b)(5)(iii)(C) limits the amount of the decrease in basis to the transferee's share of the partnership's adjusted basis in all "depreciated assets" in that class. If a transferee's negative basis adjustment cannot be allocated to any asset because the adjustment exceeds the transferee's share of the adjusted basis to the partnership of all depreciated assets in a particular class, the negative adjustment is suspended until the partnership subsequently acquires property of like character to which an adjustment can be made.⁶⁷

Conditioning the basis increase on whether the transferee has net gain or net loss from the hypothetical sale places a great deal of pressure on the valuation of the partnership's assets because the hypothetical sale has no consequences other than permitting or denying the basis adjustment.⁶⁸ Prop. Reg. §1.755-1(b)(5)(ii)(B) and §1.755-1(b)(5)(ii)(C) would remove the requirements of net gain and net loss, respectively. Prop. Reg. §1.755-1(b)(5)(ii)(B) provides:

If there is an increase in basis to be allocated to partnership assets, the increase must be allocated between capital gain property and ordinary income property in proportion to, and to the extent of, the gross gain or gross income (including any remedial allocations under §1.704-3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all property in each class. Any remaining increase must be allocated between the classes in proportion to the fair market value of all property in each class.

Prop. Reg. §1.755-1(b)(5)(ii)(C) provides:

If there is a decrease in basis to be allocated to partnership assets, the decrease must be allocated between capital gain property and ordinary income property in proportion to, and to the extent of, the gross loss (including any remedial allocations under §1.704-3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all property in each class. Any remaining

decrease must be allocated between the classes in proportion to the transferee's shares of the adjusted bases of all property in each class (as adjusted under the preceding sentence).

The limitation set forth in Reg. §1.755-1(b)(5)(iii)(C) limiting the decrease in basis to the transferee's share of the partnership's adjusted basis to depreciated assets in that class would be removed under the proposed regulations. Prop. Reg. §1.755-1(b)(5)(iii)(C) and §1.755-1(b)(5)(iii)(D) provide that if, as a result of a substituted basis transaction, a negative adjustment must be allocated to capital gain assets, ordinary income assets, or both, and if also the amount of the step down otherwise allocable to a particular class exceeds the transferee's share of the adjusted basis to the partnership of "all assets in that class," the basis of the property is reduced to zero (but not below zero), and any remaining unallocated adjustment is held in suspense. In other words, the proposed regulations would no longer limit a negative basis adjustment to the transferee's share of the partnership's adjusted basis in all of the "depreciated assets of the class."

Prop. Reg. §1.743-1(f)(2) would change the rule of ignoring §743(b) adjustments in transfer situations in which the subsequent transfer is a substituted basis transaction. The IRS was concerned that after the acquisition of a partnership interest, transferee partners were using the subsequent transfer rule under Reg. §1.743-1(f), discussed above, in concert with a substituted basis transfer to change the way the initial §743(b) adjustment was allocated to the partnership assets.⁶⁹ This possibility exists because the allocation rules for substituted basis transactions are different than for nonsubstituted basis transactions. Prop. Reg. §1.743-1(f)(2) provides that if a transferor of a partnership interest has a §743(b) basis adjustment with respect to the transferred interest that is allocated under the allocation scheme set forth in Reg. §1.755-1(b)(2) through §1.755-1(b)(4) and that interest is subsequently transferred in a substituted basis exchange, then the prior §743(b) adjustments are not ignored; rather, the transferee succeeds to that portion of the transferor's existing basis adjustments that are attributable to the transferred partnership interest. Furthermore, to determine the amount of the §743(b) adjustment that the transferee has resulting from the secondary substituted basis transaction, the proposed regulations would require that the transferee take into account the transferor's basis adjustment to which it succeeds when determining the transferee's share of the adjusted basis to the partnership of the partnership property. An example in the proposed regulations illustrates this rule.

⁶⁵ Reg. §1.755-1(b)(5)(ii).

⁶⁶ Reg. §1.755-1(b)(5)(iii)(B).

⁶⁷ Reg. §1.755-1(b)(5)(iii)(D).

⁶⁸ McKee, above, at Supplement to Page 24-21-24-22.

⁶⁹ P. Mahoney, *The Proposed Regulations Under Sections 704(c)(1)(C), 734, 743, and 755 at 1-798*, 1 Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances (PLI 2015).

A constructive termination also illustrates the application of Prop. Reg. 1.743-1(f)(2). If the terminated partnership has a §754 election in effect for the tax year (including one made by the terminated partnership on its final return), the §754 election applies with respect to the incoming partner; hence, the bases of partnership assets are adjusted pursuant to §743(b) and Reg. §1.755-1(b)(2) through §1.755-1(b)(4) before their deemed contribution to the new partnership.⁷⁰ Reg. §1.743-1(h)(1) provides that the transferee partner with a basis adjustment in property held by the terminated partnership will continue to have the same basis adjustment with respect to property deemed contributed by the terminated partnership to the new partnership “regardless of whether the new partnership makes a §754 election.” The phrase “regardless of whether the new partnership makes a §754 election” creates ambiguity, because if the new partnership does in fact make a §754 election, then the rules on substituted basis transactions set forth in Reg. §1.755-1(b)(5) govern the allocation of the §743(b) adjustment.⁷¹ The substituted basis rules apply because the tax basis of the partners in the new partnership are determined by their tax basis in the terminated partnership under §732(b). Thus, what adjustment does the incoming partner have to his inside basis? Is it the adjustment made under the §754 election in effect for the terminating partnership, or is it the adjustment in effect made by the new partnership under its §754 election? Prop. Reg. 1.743-1(f)(2) would resolve this conflict by providing that the basis adjustment made by the terminated partnership is the one that controls.

Section 755: How to Allocate Section 734(b) Adjustment to Assets

Just as in making the allocations under a §743(b) adjustment, the allocation of the §734(b) adjustment requires the partnership first to determine the fair market value of its assets and divide the assets into capital gain assets and ordinary income assets.⁷² To allocate the §734(b) adjustment to the proper class of assets, Reg. §1.755-1(c)(1)(i) states that if the §734(b) adjustment arises from a change in basis of the distributed assets under either §734(b)(1)(B) or §734(b)(2)(B), the adjustment must be allocated to remaining partnership property of a character similar to that of the distributed property. Note that this allocation to a class is completely different than under the §743(b) rules for either nonsubstituted basis transactions or substituted basis transactions. Thus, when the partnership’s adjusted basis of capital gain property immediately before the distribution exceeds the basis of the property to the distributee partner (as determined under §732), the basis of the undistributed capital gain property remaining in the partnership

must be increased by the amount of the excess. If the basis of the property to the distributee partner (as determined under §732) of distributed capital gain property exceeds the partnership’s adjusted basis of such property immediately before the distribution, the basis of undistributed capital gain property remaining in the partnership is decreased by the amount of the excess. The same rules apply to ordinary income property. If the §734(b) adjustment is because the distributee partner has recognized gain under §731(a)(1), i.e., distribution of cash in excess of basis, or loss under §731(a)(2), i.e., loss upon complete liquidation of partnership interest solely in exchange for money, unrealized receivables and inventory, then the adjustment is allocated *only* to capital gain property.⁷³

Allocations within the class are determined under rules set forth in Reg. §1.755-1(c)(2). If there is an increase in basis to be allocated within a class, the increase must be allocated first to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation before such increase (but only to the extent of each property’s unrealized appreciation). Any remaining amount of increase must be allocated among the properties within the class in proportion to their fair market values.⁷⁴ If there is a decrease in basis to be allocated within a class, the decrease must be allocated first to properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation before such decrease (but only to the extent of each property’s unrealized depreciation). Any remaining decrease must be allocated among the properties within the class in proportion to their adjusted bases (as adjusted under the preceding sentence).⁷⁵ The adjustments decreasing basis cannot cause the basis of the property to go below zero.⁷⁶ The allocation within a class resembles the allocation within a class under the substituted basis rules for a §743(b) adjustment.

Under these rules, there is no fair market value limitation; hence, it is possible to increase the basis of property to more than its fair market value and to decrease the basis of property to less than its fair market value. Under these rules if there is an increase to a class, only basis increases are permitted, and if there is a decrease to a class, only basis decreases are permitted. Contrast this to the §743(b) rules in a nonsubstituted basis situation under which the bases of some properties in a class can be increased at the same time as the bases of other properties in the class can be decreased.⁷⁷ Where, in the case of a distribution, an increase or a decrease in the basis of undistributed property cannot be made because the partnership does not own property of the character required to be adjusted, or because the basis of all property of a like character has been reduced to zero, the adjustment is suspended

⁷⁰ Reg. §1.708-1(b)(5).

⁷¹ McKee, above, at ¶24.04[1][a][iv] (4th ed. 2007).

⁷² Reg. §1.755-1(a)(1).

⁷³ Reg. §1.755-1(c)(1)(ii).

⁷⁴ Reg. §1.755-1(c)(2)(i).

⁷⁵ Reg. §1.755-1(c)(2)(ii).

⁷⁶ Reg. §1.755-1(c)(3).

⁷⁷ McKee, above, at ¶ 25.02[1][a].

and carried forward indefinitely until the partnership subsequently acquires property in the class, the basis of which can be adjusted.⁷⁸

Prop. Reg. §1.734-2 would add detailed rules covering how §704(c)(1)(C), contributed built-in loss property, and §734 interact. Prop. Reg. §1.734-1(f) would add a specific rule for tiered partnerships. It would adopt the principles of Rev. Rul. 92-15,⁷⁹ which sets forth the IRS approach concerning how §734 adjustments are recorded in tiered partnership settings under various circumstances. The proposed regulation specifically provides that if an upper-tier partnership allocated a §734(b) basis adjustment to a lower-tier partnership interest and the lower-tier partnership has a §754 election in effect, then the lower-tier partnership must make a corresponding basis adjustment to the upper-tier's partnership's share of the lower-tier partnership's assets. The amount of the adjustment made by the lower-tier partnership to the basis of its assets is equal to the adjustment made by the upper-tier partnership to the basis of the lower-tier partnership interest it owns. These principles are extended to apply to a tiered partnership situation when there is a mandatory substantial basis reduction. Each

⁷⁸ Reg. §1.755-1(c)(4).

⁷⁹ 1992-1 C.B. 215.

lower-tier partnership is treated, solely with respect to the distribution, as if it had made an election under §754 for the tax year in which the distribution occurs. An example set forth in Prop. Reg. §1.734-1(f)(2) illustrates this rule.

CONCLUSION

The adjustments that can be made under §734(b) and §743(b) are, indeed, unique to partnerships and offer powerful advantages to having assets owned by a partnership or a limited liability company rather than a corporation. As the above discussion illustrates, however, the task of calculating an adjustment and then determining how to allocate the adjustment to the bases of partnership assets is not easy. After the adjustments and allocations are made, it is necessary to keep track of the §743(b) adjustment and to determine what happens to the adjustment upon a transfer of a partnership interest. Also, these adjustments can be a double-edged sword — they can produce decreases as well as increases to partnership assets. In order to properly advise your client, it is important to understand when these adjustments are mandatory and the consequences of making or not making a §754 election.