

Practising Law Institute

Tax Planning for Domestic and Foreign Partnerships, LLCs, Joint Ventures and Other Strategic Alliances;

Adjustments to the Basis of Partnership Assets:
Sections 734, 743 and 754

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Poll: 1. IRS has recently applied the partnership anti-abuse rule to deny basis step-ups under Section 743 on related party transactions. Do you support broad use of the general anti-abuse rule in Treas. Reg. §1.701-2 to police basis adjustments?



Overview

Basis Adjustment Rules

Section 734 and Section 743 basis adjustments are designed to create parity among partners' outside basis and their share of inside basis

Theory is essentially corollary of aggregate approach to partnerships

- Each partner is effectively treated as though owner of an interest in each and every partnership asset

Historically, the basis adjustment regime of Sections 734 and 743 was elective

- A partnership had to affirmatively make a Section 754 election to apply the basis adjustment rules under Sections 734 and 743

Basis adjustments are now mandatory in circumstances where rules would require basis reduction.



Overview

Treatment Of Contributed Property With Built-in Loss

Section 704(c)(1)(C):

- Built-in loss on contributed property taken into account only in determining the amount of items allocated to the contributing partner.
- In determining the amount of items allocated to other partners, the adjusted basis of contributed built-in loss property is treated as equal to its FMV at the time of contribution, thus preventing loss shifting.
- No minimum built-in loss threshold.



Overview

Election

Election may be made in two circumstances:

- Sale or exchange of partnership interest, including transfer on death or non-taxable transfer (e.g. transfer to another partnership or corporation where there is a carryover basis).
- Distribution of partnership property and/or cash.
 - Adjustment is made only if gain or loss is recognized or if distributed property has substituted basis in the distribute partner's hands.

Once made, the election is permanent and applies to all subsequent transfers (Section 743) and distributions (Section 734)

- For this reason, taxpayers were historically often reluctant to make the Section 754 election until election appeared to be advantageous.



Overview

Optionality as Tax Avoidance Technique

Election was historically optional, not mandatory and therefore offered taxpayers inappropriate planning opportunities.

- Elective nature of regime could be used to duplicate losses.

Santa Monica Pictures (TCM 2005-104) illustrate the duplication potential.

- *Santa Monica Pictures*. Taxpayer wanted to buy high-basis, low-value assets. To facilitate the transaction, taxpayer formed a partnership with the seller contributing the target assets to the partnership and immediately thereafter, an entity related to the taxpayer purchased the seller's partnership interest. Seller had a loss on the sale of the interest. The partnership did not make a Section 754 election. The partnership later sold the assets and claimed a loss. (Taxpayer lost on economic substance and step transaction grounds).



Overview

Congress believed that the partnership rules allowed for the inappropriate transfer of losses among partners as well as the associated duplication of a single “economic” loss.

Optionality allowed partnerships to be created and used to aid tax-shelter transactions

- 2004 Amendments (“JOBS Act”) limited the ability to transfer losses among partners and to duplicate the tax benefits associated with a single economic loss while preserving the simplification aspects of the Section 754 rules for transactions involving smaller amounts.
- Codification of the “economic substance doctrine” strengthens the anti-abuse regime.



Overview

The new rules are a trade-off between increased complexity and the need to limit abuse through specific statutory provisions. Would it be better to simply make election mandatory in all cases?

- Failure to apply in all cases may still yield unintended results.
- Smaller partnerships can be carved out for simplicity and less potential for abuse.
- Senator Wyden's proposed partnership tax reform would make adjustments to basis mandatory for both partnership distribution and sales or exchanges of partnership interests.
- Senator Wyden's proposal to make basis adjustments mandatory is not included in President's Budget Proposal



Overview

Special Rules For Transfers Of Partnership Interest If There Is Substantial Built-in Loss

Section 743(b) provides that basis of partnership property must be adjusted in connection with a transfer of an interest in a partnership that has a “substantial built-in loss”.

- Under Section 743(d), built-in loss is substantial if, in the aggregate, basis of all partnership property exceeds value by more than \$250,000 or a transferee partner would be allocated a loss of more than \$250,000.

Adjustment is the same as if a Section 754 election were in place.

Exceptions for Electing Investment Partnerships and Securitization Partnerships.



Overview

Special Rules For Distribution If There Is Substantial Basis Reduction

Section 734(b) provides that basis of partnership property must be adjusted in connection with a distribution that would result in a “substantial basis reduction”.

- Under Section 734(d) “substantial basis reduction” means a reduction to the basis of partnership assets in excess of \$250,000 if a Section 754 election had been made.

A securitization partnership (as defined for Section 743 purposes) is treated as not having a substantial basis reduction.

No exception under Section 734 for investment partnerships, in contrast to the Section 743 rules.



Overview

No Reduction Of Basis Under Section 734 In Stock Held By Partnership In Corporate Partner

Section 755(c) provides a downward basis adjustment under Section 734(b) may not be allocated to stock in a corporation (or any person related to such corporation) that is a partner in the partnership.

Designed to prevent avoidance of Section 732(f) through step down of inside stock basis—a strategy highlighted in the JCT report on Enron transactions.

Downward adjustment must be allocated to other partnership property to the extent of basis in such property.

- If adjustment exceeds the basis of the other partnership property, excess is gain to the partnership



Overview

Electing Investment Partnership

An electing investment partnership is not treated as having a substantial built-in loss and, therefore, is not required to make basis adjustments to partnership property when a partnership interest is transferred.

A partner-level loss limitation rule applies instead of the partnership basis adjustments.

The transferee partner's distributive share of losses from the sale or exchange of partnership property is not allowed, except to the extent it is established that the partner's share of such losses (determined without regard to gains) exceeds the loss recognized by the transferor partner (or any prior transferor to the extent not fully offset by a prior disallowance).



Overview

Electing Investment Partnership

- Losses disallowed under this rule do not decrease the transferee partner's basis in its partnership interest.
- An affirmative election, once made, is generally irrevocable.



Overview

Electing Investment Partnership

The term 'electing investment partnership' means any partnership if —

- A. the partnership makes an election to have Section 743(e) apply
- B. the partnership would be an investment company under section 3(a)(1)(A) of the Investment Company Act of 1940 but for an exemption under paragraph (1) or (7) of section 3(c) of such Act
- C. such partnership has never been engaged in a trade or business
- D. substantially all of the assets of such partnership are held for investment
- E. at least 95 percent of the assets contributed to such partnership consist of money
- F. no assets contributed to such partnership had an adjusted basis in excess of fair market value at the time of contribution
- G. all partnership interests of such partnership are issued by such partnership pursuant to a private offering before the date which is 24 months after the date of the first capital contribution to such partnership
- H. the partnership agreement of such partnership has substantive restrictions on each partner's ability to cause a redemption of the partner's interest
- I. the partnership agreement of such partnership provides for a term that is not in excess of 15 years.



Overview

Tax Cuts and Jobs Act (TCJA) added issues and complexity on treatment of Section 755 adjustments

Expanded definition of substantial built-in loss under Section 743(d).

Introduced uncertainty in treatment of basis adjustments for purposes of immediate expensing under Section 168(k) and deduction for unincorporated business activities under Section 199A.

Created challenges and opportunities under partnership level interest limitation under Section 163(j).



Basic Rules: Section 743 — Sale or Exchange

Theoretical Framework

- Purpose is to match tax consequences of partnership transactions with economic situation underlying purchase.
- Super-aggregate theory:
 - Essentially treats purchasing partner as if purchased an interest in each and every asset.
 - Interest in each asset is determined by allocations of gain or loss as provided in partnership agreement.



Basic Rules: Section 743 — Sale or Exchange

1. Adjustment equals difference between transferee's outside basis for partnership interest and transferee's share of the partnership's inside basis for assets
 - a. If outside basis exceeds share of inside basis, then increase basis in partnership assets.
 - b. If outside basis is less than share of inside basis, then decrease basis in partnership assets.
2. Any adjustment is applicable only to transferee partner – not to other partners.
3. Any basis adjustment on depreciable or amortizable property is treated as new property for some, but not all, purposes.
4. This basis adjustment tracks through in the case of tiered partnerships on a look through basis where each tier has made a Section 754 election, and in all cases where the mandatory basis adjustment rules apply.



Basic Rules: Section 743 — Sale or Exchange

5. Section 704(c) and Section 743 basis adjustments operate independently, unless remedial method is used.
 - Therefore, Section 743 increase allocated over life of new property, unless remedial method is used, in which case basis adjustment is recovered over remaining life.
6. Once aggregate amount of Section 743 adjustment is determined, total is allocated among the partnership's specific assets under rules in Section 755.
7. Rules generally try to allocate aggregate increase or decrease and result in positive and negative adjustments for different assets, even if the net Section 743 adjustment is zero.



Section 743: Sale or Exchange — Mechanics: Outside Basis

- Transferee's outside basis is determined under normal rules:
 - purchase price for partnership interest plus transferee's share of liabilities
 - Generally cost under Section 741.
 - May also be carryover basis if transfer under Section 721 or Section 351.
 - Would be fair market value in case of death: conform to estate tax value?



Section 743: Sale or Exchange — Mechanics: Inside Basis

- Transferee's share of inside basis – not so easy – equals the transferee's share of the partnership's after-tax (or previously taxed) capital plus transferee's share of liabilities.
 - Generally tax basis capital account is share of after-tax capital.
 - Easy to determine in simple cases – regulations require indirect computation.
 - Theoretical foundation is sound: result is the same as if partner owned individual interest in the assets outside of partnership.
 - Basis would equal net after-tax investment plus share of liabilities adjusted for depreciation or amortization.



Section 743: Sale or Exchange — Mechanics: Inside Basis

(cont.)

- Rather than direct computation, regulations start at the end: How much cash a distributee would get and then adjust for gain or loss to derive after-tax capital.
 - After-tax capital is determined using a hypothetical sale of all partnership assets at a price equal to fair market value (determined using sales price for partnership interest).
 - Formula: After-tax capital equals cash received upon liquidation less tax gain that would be allocated plus tax loss that would be allocated.
- Amount of gain or loss includes amount that would be allocated under Section 704(c) and, specifically, includes adjustments that would be made under remedial method.



Section 755 Allocation: Sale or Exchange

- Divide assets into ordinary assets and capital gain assets.
- Allocate adjustment first to ordinary income assets to eliminate potential character issues.
- Allocate within each class to match and offset gain or loss that would be realized on each asset.
 - Thus: even if adjustment might net to zero, basis of each asset in class could be adjusted.
- Computation is based upon hypothetical sale similar to hypothetical sale used to determine amount of the adjustment.



Section 743 Proposed Regulations

Proposed Regulations under Section 743 issued in 2014 (and on the current Treasury/IRS Priority Guidance Plan) provide guidance on:

- How to measure a substantial built in loss (“SBIL”);
- Circumstances in which a transferee inherits any Section 743 adjustments of the transferor;
- How to apply Section 743 in tiered partnership situations; and
- New anti-abuse rule targeting efforts to avoid mandatory step down rule.



Section 743 Proposed Regulations

SBIL

- Measured by reference to value of the partnership assets—thus if all of the partnership assets have a value equal to basis there is no built-in loss, even if the partnership interest is sold at a discount to asset value.
- Under TCJA, revised Section 743(d) treats partnership as having substantial built-in loss if transferee partner would be allocated loss of more than \$250,000 if all partnership assets were sold.
- In tiered partnerships, the value of a lower tier partnership (“LTP”) is deemed to be the amount the upper-tier partnership (“UTP”) would receive upon liquidation of the LTP plus the UTP’s share of LTP’s liabilities—valuation ignores fact that LTP interest might sell at greater or lesser value than net asset value.



Section 743 Proposed Regulations

Treatment of Transferee Partner

- Reg. § 1.743-1(f) provides general rule that transferee of a partnership interest determines its Section 743 basis adjustments independent of any prior transferee's basis adjustments.
- Proposed Reg. § 1.743-1(f)(2) provides special rule for substituted basis transactions: transferee takes over transferor's Section 743 basis adjustments attributable to the transferred interest; retained basis adjustment is taken into account in determining additional Section 743 basis adjustments.



Section 743 Proposed Regulations

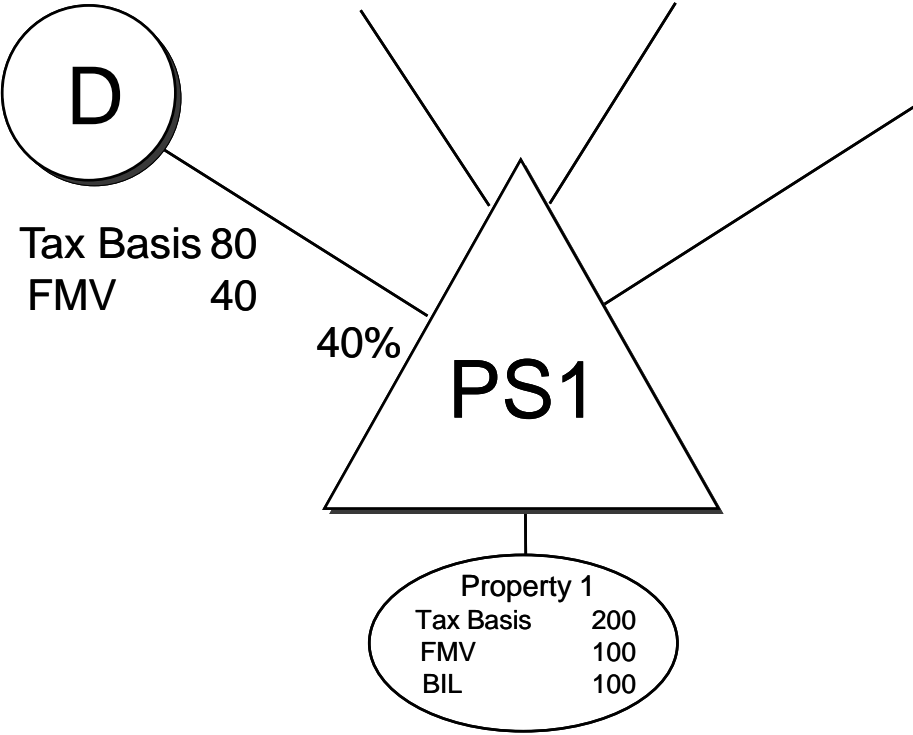
- Proposed Reg. § 1.743-1(l) provides rules governing when tiered partnerships are required to make adjustments under Section 743.
- Consistent with Rev. Rul. 87-115, basis adjustments are required if both the UTP and LTP have made Section 754 elections.
- Additionally, if there is a transfer of an interest in a UTP which has a SBIL, each indirect and direct LTP is required to adjust the basis of their assets as if the LTP had a Section 754 election in effect.
 - Rule applies even if the LTP has a built-in gain and no built-in loss.
 - Rule applies to all LTPs in which UTP has an interest (directly or indirectly)—presents enormous complexity and difficulty with compliance.



Example 1 – Stage #1

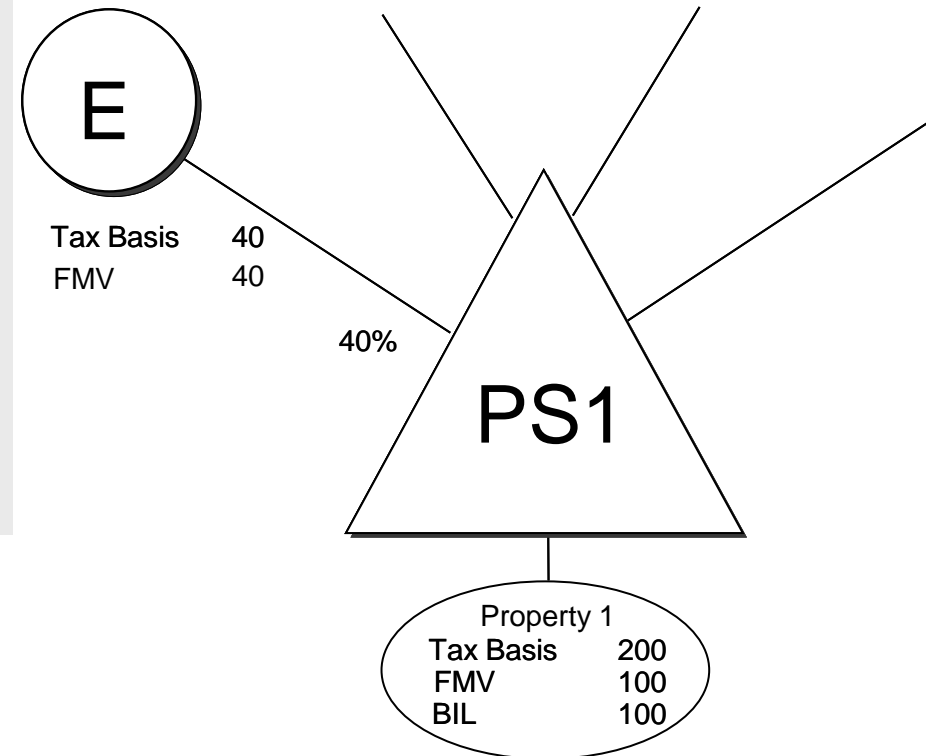
PS with Built-in Loss Property

- 1. Partner D sells to Partner E for 40.
- 2. Partner D has 40 loss.
- 3. No Section 754 election in effect.



Example 1 – Stage #2

1. Partner E's outside basis = 40.
2. Partner E's share of inside basis = 80.
3. For pre-JOBS Act years, Partner E had opportunity for duplicated loss upon sale of Property 1 similar to *Long Term Capital* and *Santa Monica Pictures*.

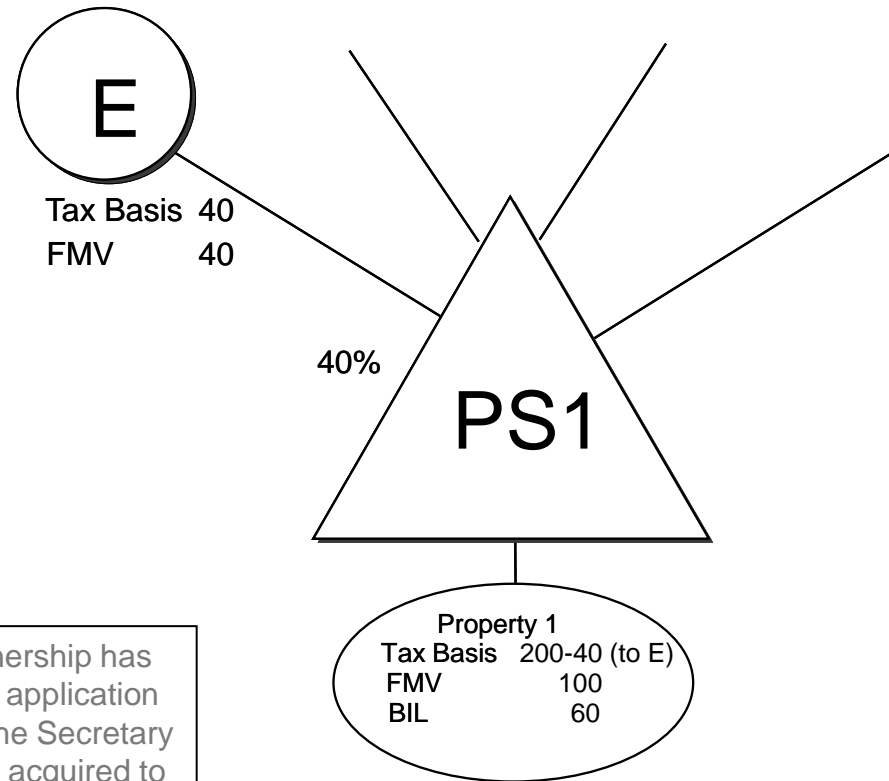




Example 1 – Stage #2

1. Under amended Section 743, PS1 would be required to decrease the basis of Property 1 by 40, even though no Section 754 election has been made, because of the existence of a SBIL.
2. Basis adjustment applicable to Partner E only.
3. No opportunity for duplicated loss upon sale of Property 1.

* This and the following examples assume that the Partnership has the more than \$250,000 overall loss required to trigger application of the Section 743 mandatory step-down provisions. The Secretary has authority to issue regulations to disregard property acquired to avoid these rules (an anti-stuffing provision).

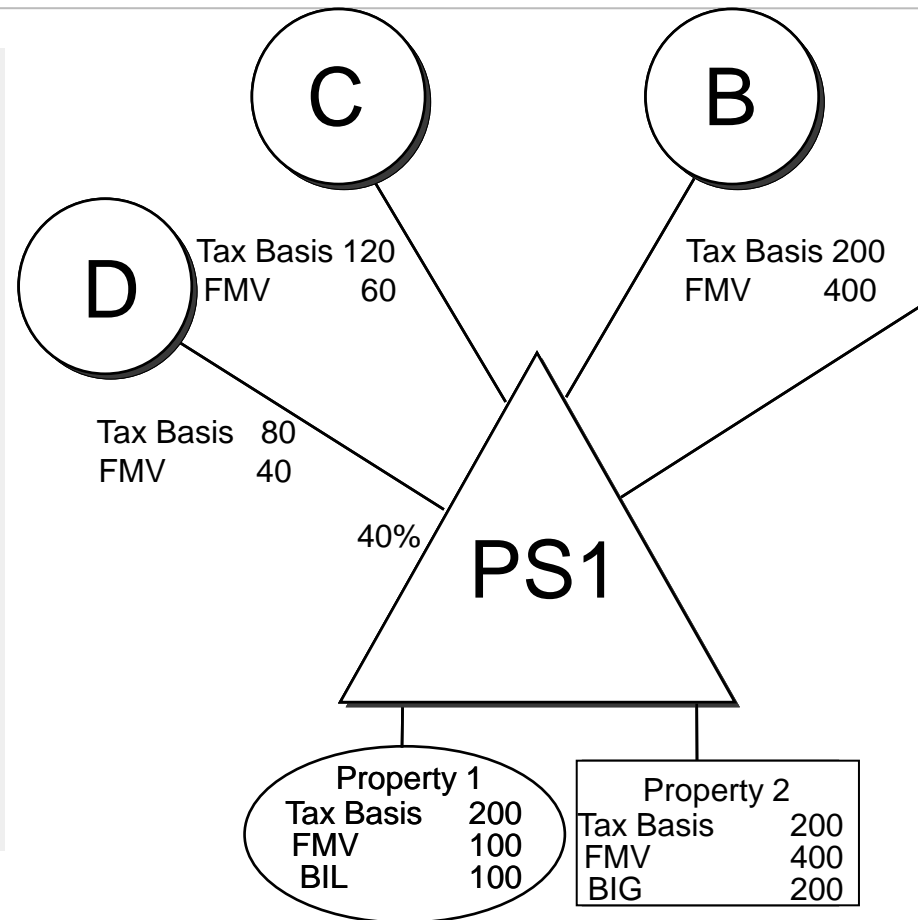


Example 1 – Stage #1

(Alternative)

PS with Built-in Loss/Built-in-Gain Property

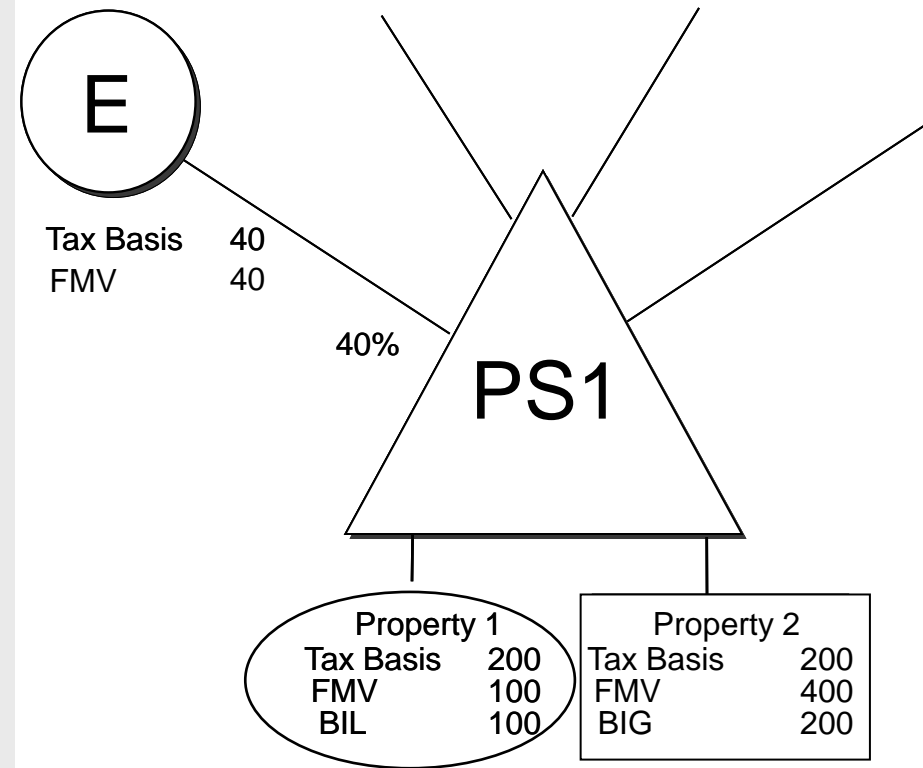
1. All assets were originally purchased by PS1 for cash.
 - Partnership allocations and changes in value caused the BIG/BIL to be as indicated.
 - Property 2 is specially allocated to B.
2. Partner D sells to Partner E for 40.
3. Partner D has 40 loss.
4. No Section 754 election in effect.





Example 1 – Stage #2 (Alternative)

1. Partner E's outside basis = 40.
2. Partner E's share of inside basis = 80.
3. Prior to TCJA, Partner E would have had opportunity for duplicating loss upon sale of Property 1 similar to *Long Term Capital* and *Santa Monica Pictures*.
 - Under TCJA revised Section 743(d) if the loss allocated to E exceeds \$250,000, then mandatory basis step-down, even though partnership has overall built-in gain.

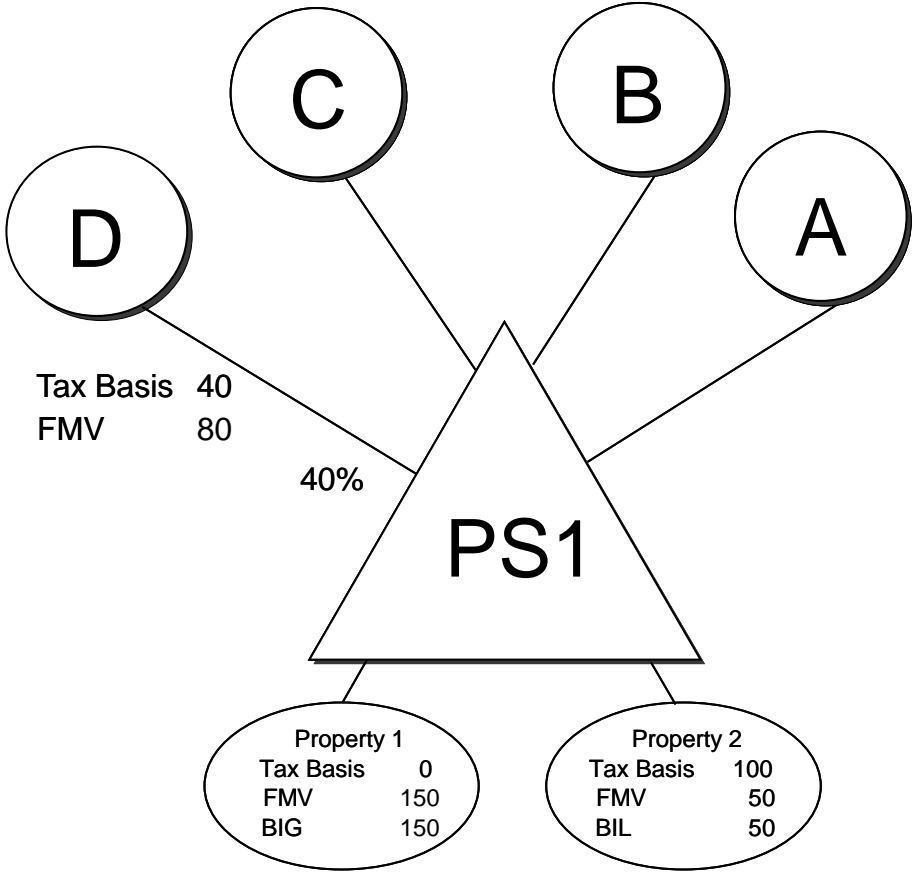




Example 2 – Stage #1

PS with Built-in Gain/Loss Property

- 1. Partner D sells to Partner E for 80.
- 2. Section 754 election in effect.
- 3. Partner E's share of inside basis equals 40.
 - Partner E's outside basis equals 80.
- 4. Partner E's share of pre-adjustment inside gain is 60 and share of inside loss is 20.





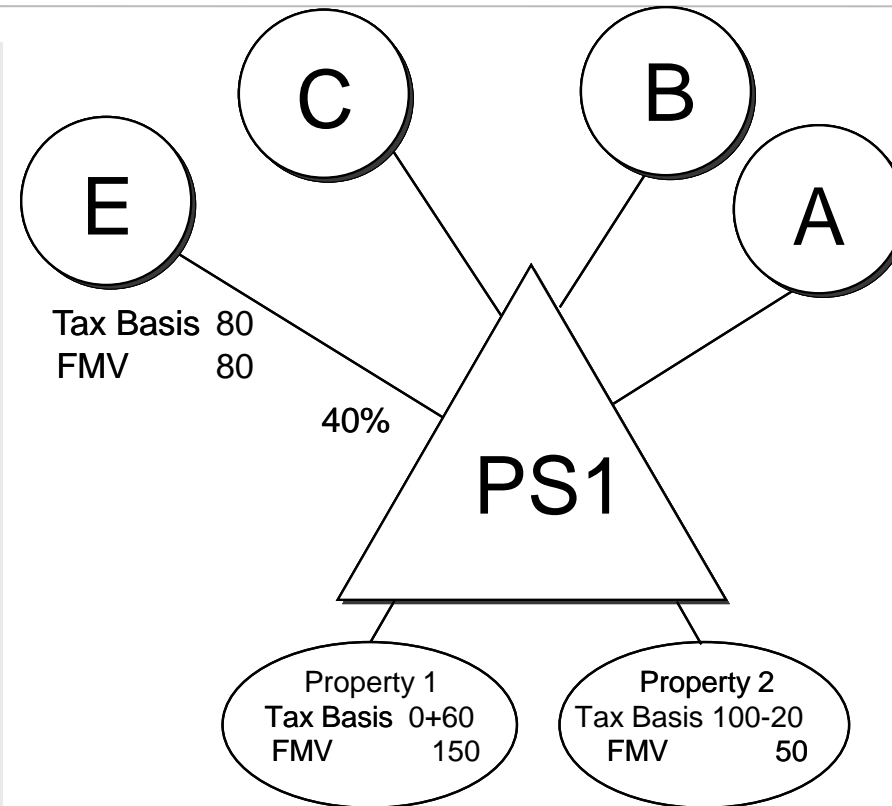
Example 2 – Stage #2

Calculation of Basis Adjustment

(1) Partner E's Outside Basis		80
LESS:		
(2) Partner E's Share of Inside Basis [Reg. § 1.743-1(d)(1)], <i>which equals</i>		
(a) Liability Share, <i>plus</i>	N/A	
(b) Previously Taxed Capital [Reg. § 1.743-1(d)(1)(i-iii)]		
(i) Hypothetical Liquidation Cash, <i>plus</i>	80	
(ii) Hypothetical Liquidation Loss, <i>minus</i>	20	
(iii) Hypothetical Liquidation Gain, <i>equals</i>	<u>60</u>	
(iv) (i) + (ii) - (iii)	40	
(c) Share of Inside Basis: (2)(a) + (2)(b)(iv)		40
(3) RESULT: Section 743(b) Basis Adjustment: (1) - (2)(c) [Reg. § 1.743-1(b)(1)]		40

Example 2 – Stage #3

1. Section 743(b) net adjustment is 40
 - See Reg. § 1.743-1(b)
 - Regulations compute the Section 743(b) adjustment as a 60 increase and a 20 decrease to the respective assets
 - See Reg. §§ 1.755-1(b)(1), (3)
2. Result is pure aggregate.



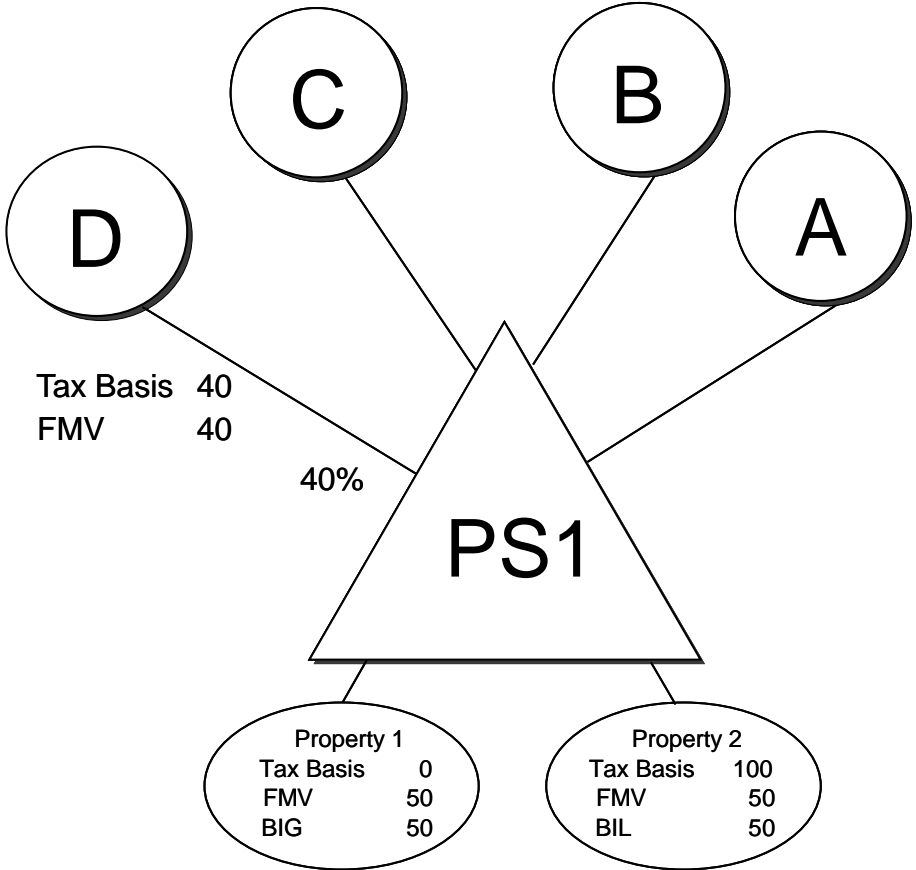
[adjustments applicable to Partner E only]



Example 3 – Stage #1

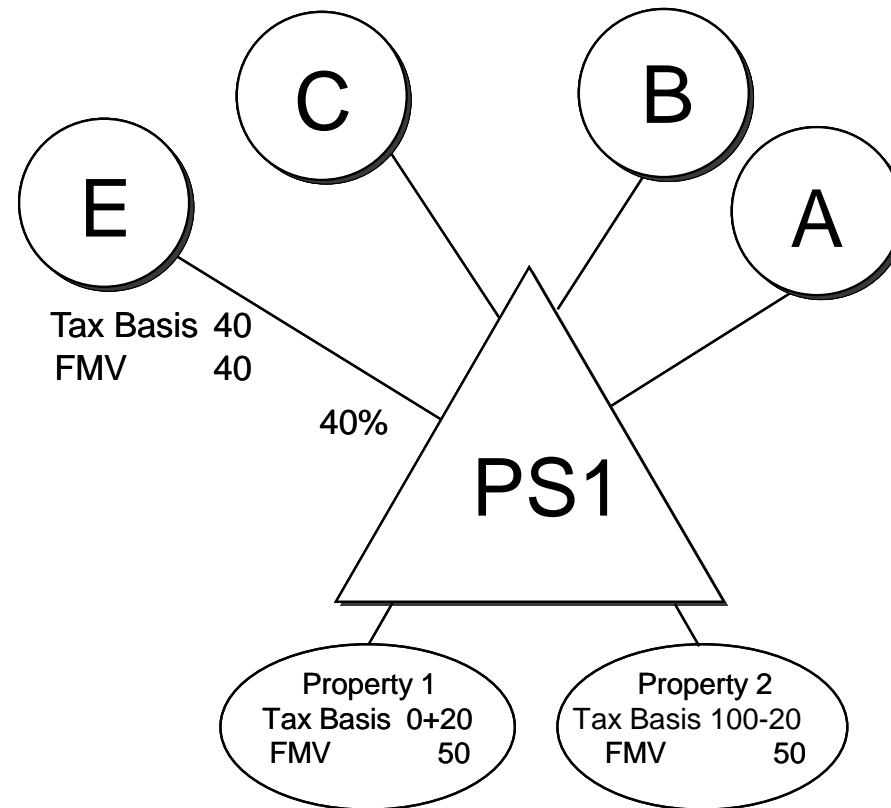
PS with Built-in Gain/Loss Property

- 1. Partner D sells to Partner E for 40.
- 2. Section 754 election in effect.
- 3. Partner E's share of inside basis equals 40.
 - Partner E's outside basis equals 40.
- 4. Partner E's shares of pre-adjustment inside gain and inside loss are 20 each.



Example 3 – Stage #2

1. Section 743(b) net adjustment is 0.
2. If D had transferred its PS1 interest to E in a nonrecognition transaction (*i.e.*, a “transferred basis exchange”), the Section 743(b) adjustment would be 0.
 - See Reg. § 1.755-1(b)(5).
3. Same result for transferred basis exchange applies, under Reg. § 1.755-1(b)(5), to substituted basis transactions.
 - (*i.e.*, transferred basis and exchanged basis transactions)
4. Proposed Regulations do not change “no adjustment” rules, but alter allocations among assets if there is a positive or negative adjustment.

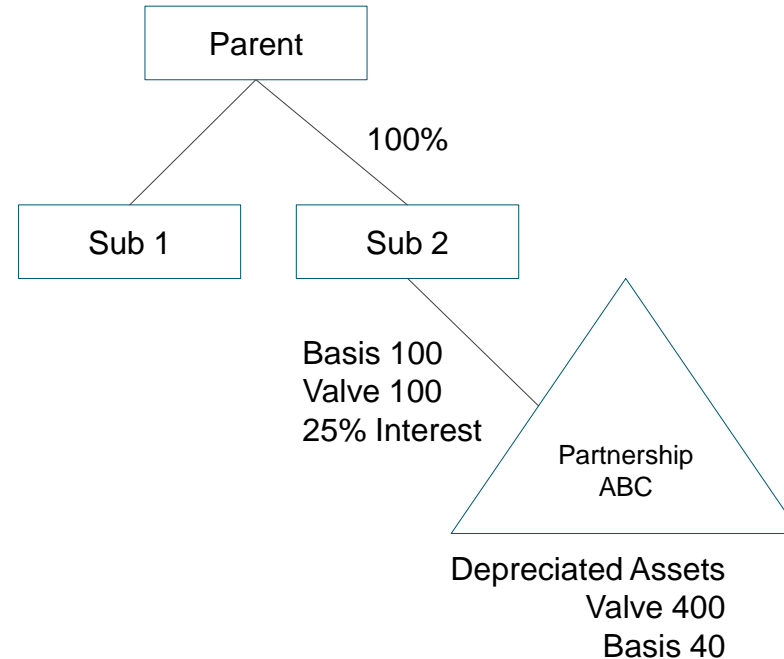


[adjustments applicable to Partner E only]



Example 4 – Related Party Non-taxable Transfers

1. Parent, Sub 1 and Sub 2 file consolidated return.
2. Sub 2 merges into Sub 1 qualifying under section 368(a)(i)(A) as tax free.
3. Transaction is non-taxable transfer of Sub 2's interest in ABC. Transfer is sale or exchange.
4. Under literal rules of section 743, Sub 1 would have basis step-up.
5. ILM 202240017 and 201726012 disallow step-up under matching rule in Reg. § 1.1502-13.
6. Similar issue in *Otay* involving Section 721 transfer; IRS has asserted in pending litigation that partnership anti-abuse rule applies to disallow step-up.



Example 5 – Section 743 and TCJA - Stage #1

PS1 Balance Sheet


	Tax Basis	FMV			
Section 1245 Property*	300	500	Debt	100	
Intangibles	0	600			
				<u>Capital</u>	<u>FMV</u>
			A	100	500
			B	50	250
			C	50	250

*Original Cost: 400



Example 5 – Section 743 and TCJA - Stage #2

1. Partner C sells PS1 interest to D.
2. Section 754 election in effect.
3. Partner D has a basis increase of 50 for Section 1245 Property and 150 for the Intangible Assets.



Example 5 – Section 743 and TCJA - Stage #3

Additional First Year Depreciation

4. Basis increase would be considered new property for purposes of section 168(k)-additional depreciation.
5. Treas. Reg. § 1.168(k)-2(b)(3)(iv)(D).
6. Allows election for additional depreciation if specified conditions are met.
 - Purchasing and Selling Partner must be unrelated: tested at partner level.
 - Purchasing partner must not have had prior depreciable interest in property.
 - Property must be acquired by purchase-transfer at death not eligible.
7. Election to claim additional depreciation may be made for Section 743(b) adjustment even if partnership had not claimed additional depreciation when property first acquired.
8. Partner D would be able to claim \$50 of additional first year depreciation for basis adjustment on Section 1245 Property. Intangible property only if eligible intangibles under Section 168(k)(2)(A).



Example 5 – Section 743 and TCJA - Stage #4

Section 199A: Qualified Business Income

9. Reg. § 1.199A-2(a)(3)(iv) permits a partner to treat the partners' "excess Section 743(b) basis adjustment" as qualified property.
10. "Excess Section 743(b) basis adjustment" is determined by computing a hypothetical Section 743(b) adjustment using the UBIA of all qualified property instead of actual basis.

If hypothetical computation is positive adjustment, that amount is treated as UBIA of that partner.

If hypothetical computation is negative, a partner's UBIA of qualified property is reduced, but not below zero.
11. In Example 4, hypothetical adjustment would be 25, which would be treated as UBIA of qualified property for D.



Example 5 – Section 743(b) and TCJA

Section 163(j): Interest Limitations

Section 163(j) applies at partnership level for interest incurred at partnership level and then again at partner level for interest incurred by partner other than through partnership.

Reg. § 1.163(j)-6(d)(2) provides that Section 743(b) adjustments are not taken into account in the partnership level determination.

Instead, Section 743(b) basis adjustments are taken into account by the partner in its separate determination of Section 163(j) limitation.

Similar treatment for remedial items.

Section 734(b) basis adjustments are taken into account by partnership.

House version of Build Back Better would have changed section 163(j) to partner level determination.



Example 6: Stage #1

Section 163(j)

	Basis	Value	Debt 1000		<u>Capital</u> Value
Intangibles	0	9000			
Receivables	0	1000			
				A	(500) 4500
				B	(250) 2250
C	(250)	2250			

A sells to D for 4500. Under Section 743, D has basis adjustment of 4500 for Intangible and 500 for Receivables.



Example 6: Stage #1

Section 163(j)

1. Assume interest expense of 100 and 500 income from receivables. Interest is fully deductible.
2. All items are allocated pro rata. After 11 step formula, deductible interest is allocated 50 to D and 25 to each a B and C.
3. Even though D has loss from partnership after Section 754 election, D has share of interest deduction.



Basic Rules: Section 734 — Distribution

Adjustment under Section 734 applies in two cases:

- Partner receives distribution of money (or money and/or assets) and gain or loss is recognized; and
- Partner receives distribution of property and basis of property in distributee partner's hands is determined by reference to partner's basis for interest in partnership.

Unlike adjustments under Section 743(b) which apply only to the transferee partner, Section 734(b) adjustments apply to the basis of the partnership assets and thus, relate to all continuing partners.



Basic Rules: Section 734 — Distribution

If gain or loss recognized on distribution then adjustment is equal to gain or loss recognized.

If basis of distributed assets in hands of distributee differs from basis in partnership hands, then adjust:

- Increase partnership basis to the extent basis is “lost” – transferee has lower basis.
- Decrease partnership basis to the extent basis is “gained” – transferee has higher basis.
- Adjustment applies to partnership assets and impacts all partners.

The increase in basis is allocated among the partnership assets.



Basic Rules: Section 734 — Distribution

Section 704(c) and Section 734 basis adjustments operate independently.

- Failure to take Section 704(c) into account in making Section 734(b) or Section 755 basis adjustments reflects the conflicting goals of the two statutory provisions. The result can undermine the principles of Section 704(c) in certain situations.

Adjustments among partnership assets are made based on the difference between the value of the property and the property's basis.

Adjustment to the basis of undistributed property must generally be allocated to property that is similar in character to the property distributed.

The regulations limit the Section 734 increase or decrease in a class to only those assets possessing that characteristic, i.e., an increase in a class is allocated only to those assets with unrealized appreciation.



Basic Rules: Section 734 – Distribution

Senator Wyden's legislative proposals would change approach to Section 734

- General Approach: Basis would be adjusted to provide that distributee partner and remaining partners would have the same amount of built-in gain or loss immediately after distribution as each partner had immediately before the distribution
- Rules would apply both to liquidating distributions and non-liquidating distributions.
 - For liquidating distributions, basis adjustments are made with respect to remaining partners only.
 - For non-liquidating distributions adjustments are made taking into account the position of the distributee partner and remaining partners



Basic Rules: Section 734 – Distribution

- President Biden’s Budget Proposal would impose a matching rule for basis “bumps” among related parties.
 - Rule would apply when related parties are partners in a partnership.
 - As described in the Green Book, a partner related to the partner that received the distribution would not be entitled to use the basis increase until the distributee partner sold the property in a fully taxable transaction.
 - Same proposal as in Build Back Better bill



Section 734 Proposed Regulations

- Proposed Section 734 regulations define when a partnership is considered to have a substantial basis reduction (“SBR”).
- Proposed regulations also address the treatment of tiered partnerships and specify when basis adjustments are required to be made.
- Proposed regulations address interaction between Section 734 adjustments and any special Section 704(c)(1)(C) basis adjustment.



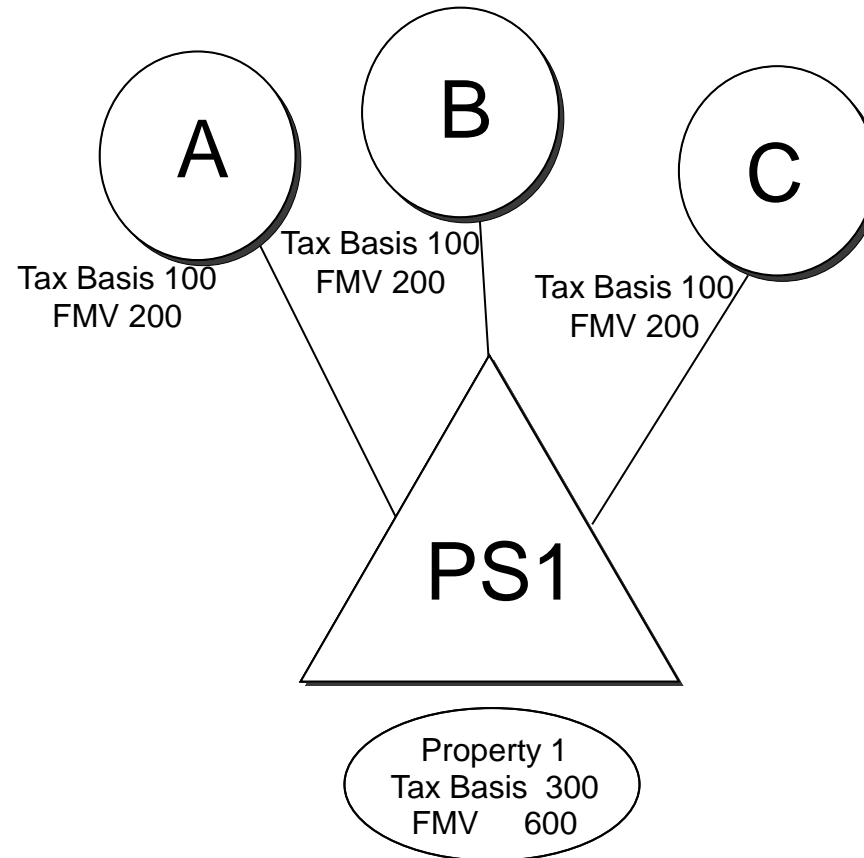
Section 734 Proposed Regulations

SBR

- SBR occurs when a partnership would have reduced the basis of its assets by more than \$250,000 as a result of a distribution of property to a partner if a Section 754 election was effective.
- Proposed regulations provide that SBR is measured on a partner by partner basis by reference to all properties distributed to the partner “as part of the same distribution”.
- Tiered Partnerships
 - Like proposed regulations under Section 743, proposed regulations under Section 734 issued in 2014 (and on the current Treasury/IRS Priority Guidance Plan) provides that each direct and indirect LTP will be treated as having made a Section 754 election when there is a SBR with respect to a distribution by a UTP.

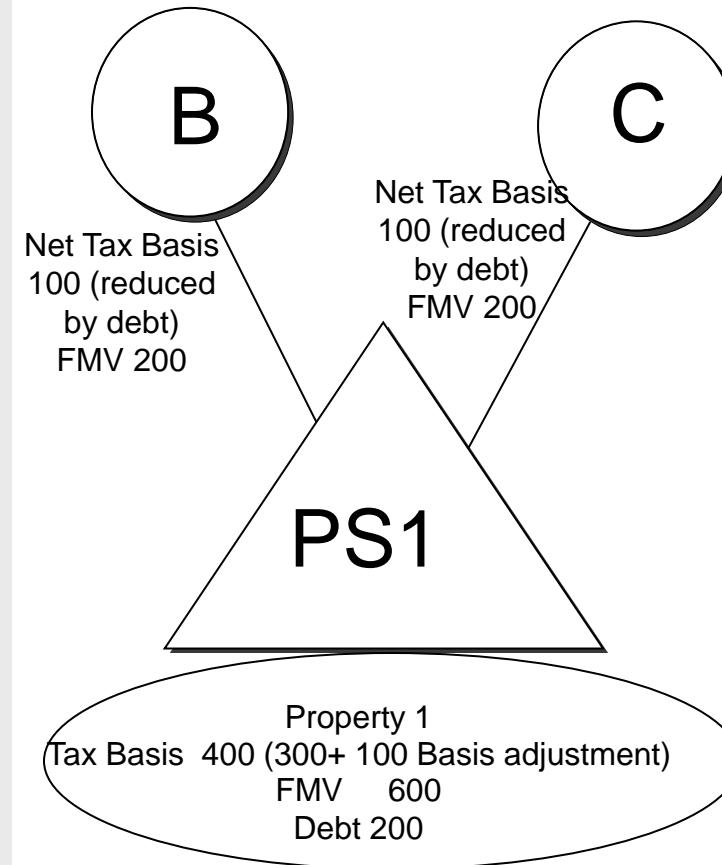
Example 7: Section 734 Rules: Stage #1


1. A, B and C each contribute \$100 each to purchase Property 1.
2. Property 1 appreciates in value to \$600.



Example 7: Section 734 Rules: Stage #2

3. PS1 borrows \$200 and uses proceeds to purchase Property 2, which is then distributed to A in liquidation of A's interest in PS1.
4. A has substituted basis for Property 2 of 100, which is less than basis of distributed property to PS1. As a result of "lost" basis, PS1 is entitled to increase basis of other assets of same character as Property 2.
5. What if Property 2 was of a different character than Property 1?






Example 7: Stage #3 Section 734 and TCJA

- Reg. § 1.168(k)-2(b)(3)(iv)(C) provides that Section 734(b) adjustments do not meet the tests of qualified property for additional first year depreciation. Although the adjustment is treated as new property for certain tax purposes, the adjustment does not qualify as either original use or as the purchase of used property from a person that did not hold an interest in the property.
- Reg. § 1.199A-2(c)(1)(iii) similarly makes clear Section 734(b) adjustments are not taken into account in determining qualified property.
- Reg. § 1.163(j)-6(d)(2) provides, in contrast to the other rules, that Section 734(b) adjustments are taken into account by the partnership in determining its Section 163(j) limitation.




Example 7: Stage #4

- President Biden's Budget Proposal:
 - Under Biden Proposal if Parties A and B are related, then the basis increase with respect for B will not be recognized until A sells Property 2
 - Limitation would apply to depreciation deductions.




Interaction between Section 734 and Section 704(c) [Other than Section 704(c)(1)(C)]

- The purpose of Section 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss (Reg. §1.704-3(a)(1)).
- Built-in gain is defined as being (i) measured by the excess of a property's Section 704(b) book basis over its tax basis at the time of its contribution and (ii) reduced by subsequent decreases in the difference between the property's book basis and tax basis (Reg. §1.704-3(a)(3)(ii)).
- Built-in loss is similarly defined as being (i) measured by the excess of a property's tax basis over its Section 704(b) book basis at the time of its contribution and (ii) reduced by subsequent decreases in the difference between the property's tax basis and book basis (Reg. §1.704-3(a)(3)(ii)).



Interaction between Section 734 and Section 704(c) [Other than Section 704(c)(1)(C)]

- Reg. § 1.704-3(a)(3)(ii) makes two critical points:
 - The built-in gain on Section 704(c) property is first measured by the excess of the property’s book basis over its tax basis at the time of contribution, and
 - Such built-in gain is reduced by subsequent decreases in the difference between the property’s book basis and tax basis (the latter rule of clause (ii) referred to as the “**subsequent modification rule**”).
- Accordingly, built-in gain is reduced by:
 - The impact of book versus tax depreciation (*i.e.*, book basis being decreased by greater amounts of book depreciation than tax basis is being decreased by tax depreciation);
 - Decreases in the book-tax difference resulting from increases in tax basis that are not accompanied by increases in book basis (*e.g.*, by Section 734 basis adjustments).



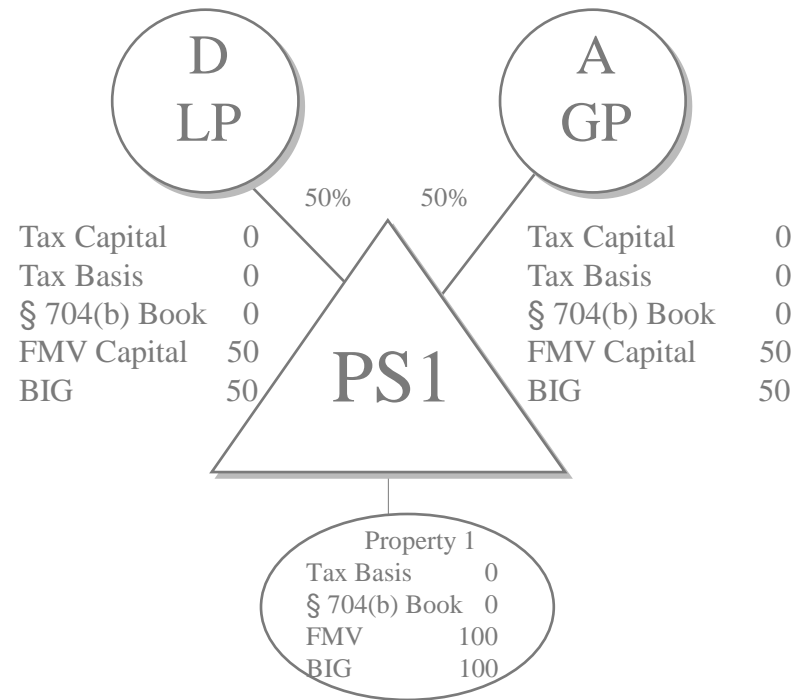
Interaction between Section 734 and Section 704(c) [Other than Section 704(c)(1)(C)]

- As a property's Section 704(c) difference is reduced, each partner's share of such property's built-in gain or loss is also reduced.
- To the extent a Section 734 adjustment exceeds the Section 704(c) gain inherent in a property, such adjustment will increase the book basis of such property (*i.e.*, the additional tax basis from a positive Section 734 adjustment will not create a built-in loss in a property). See Reg. § 1.704-1(b)(2)(iv)(m)(4)-(5).

Example 8 – Stage #1

Section 734 and Section 704(c) Netting

Distributed and Retained Properties Have the Same Character (e.g., Capital)

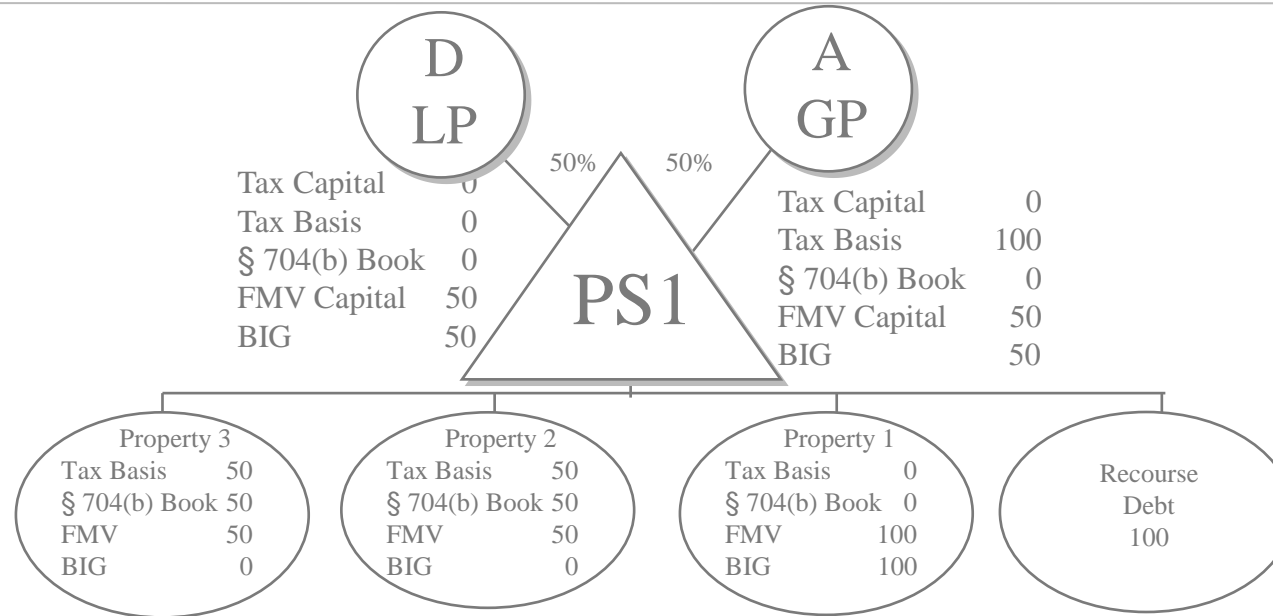


1. PS1 holds Property 1 with a Section 704(b) book basis and tax basis of 0.
2. Property 1 has a FMV of 100.

Example 8 – Stage #2

Section 734 and Section 704(c) Netting

Distributed and Retained Properties Have the Same Character (e.g., Capital)

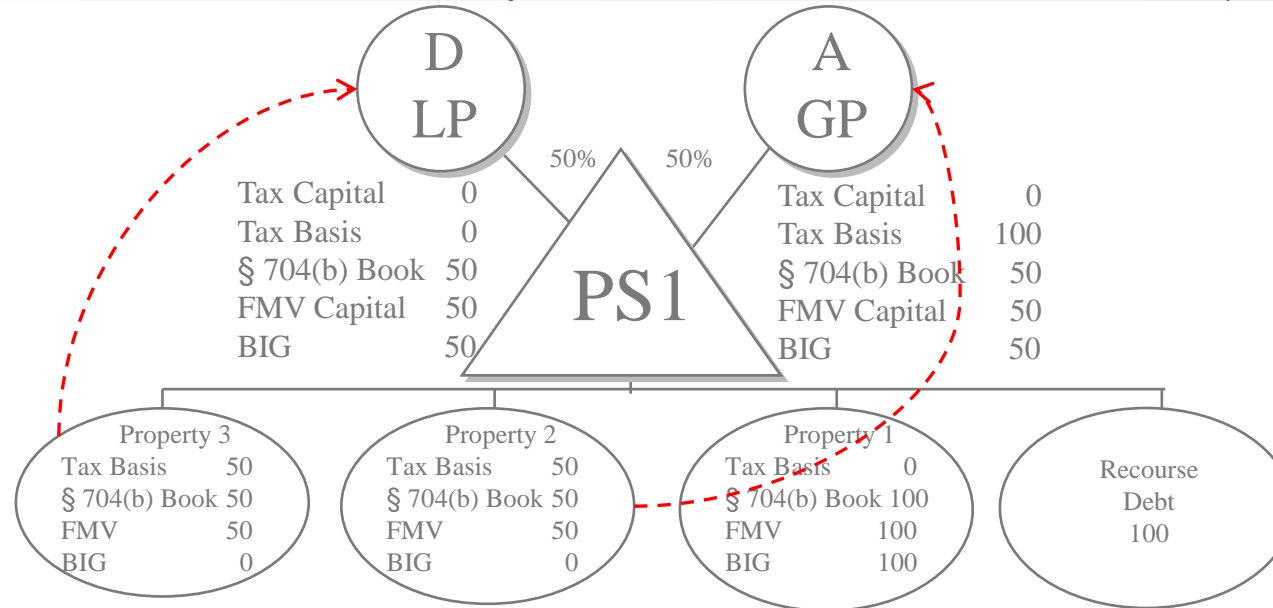


1. PS1 borrows 100 on a recourse basis and purchases Property 2 and Property 3 for 50 each.
2. The 100 recourse debt is allocable solely to Partner A.
3. Properties 1, 2, and 3 are all capital assets.

Example 8 – Stage #3

Section 734 and Section 704(c) Netting

Distributed and Retained Properties have the same Character (e.g., Capital)

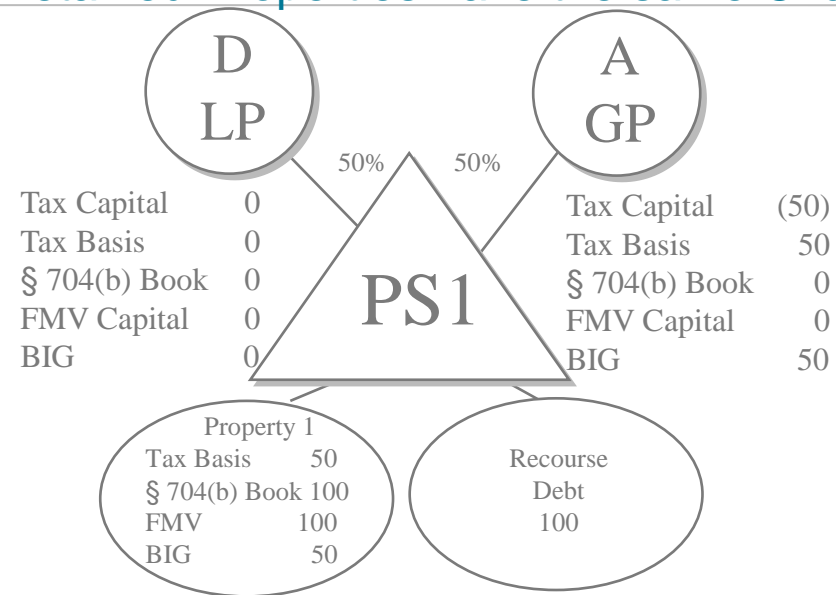


1. Section 754 election is in effect for PS1.
2. In nonliquidating distribution, Property 2 is distributed to Partner A and Property 3 is distributed to Partner D.
3. **Immediately prior to current distributions to Partners A and D, Section 704(b) book-up causes reverse Section 704(c) shares to A and D of 50 each.**
4. Partner D takes 0 basis in Property 3.
5. Partner A takes 50 basis (because Partner A's pre-distribution outside basis is 100 due to the recourse debt) in Property 2.
6. Basis step-down to D of 50 in Property 3 (from PS1 basis of 50 to 0 in Partner D's hands) causes PS1 to step-up by 50 basis in Property 1.

Example 8 – Stage #4

Section 734 and Section 704(c) Netting

Distributed and Retained Properties have the same Character (e.g., Capital)



- Section 734(b) step-up is “common basis” and should reduce the Section 704(c) gain inherent in Property 1. How should this reduction in Property 1’s gain be reflected in each of A and D’s share of such Section 704(c) layer? Is the reduction:
 - Allocated to the partner who “created” the basis adjustment (*i.e.*, all to D)?
 - Proportionate across the layer (*i.e.*, 1/2 each, in accordance with the revaluation gain sharing ratios)?
 - Some other ratio?

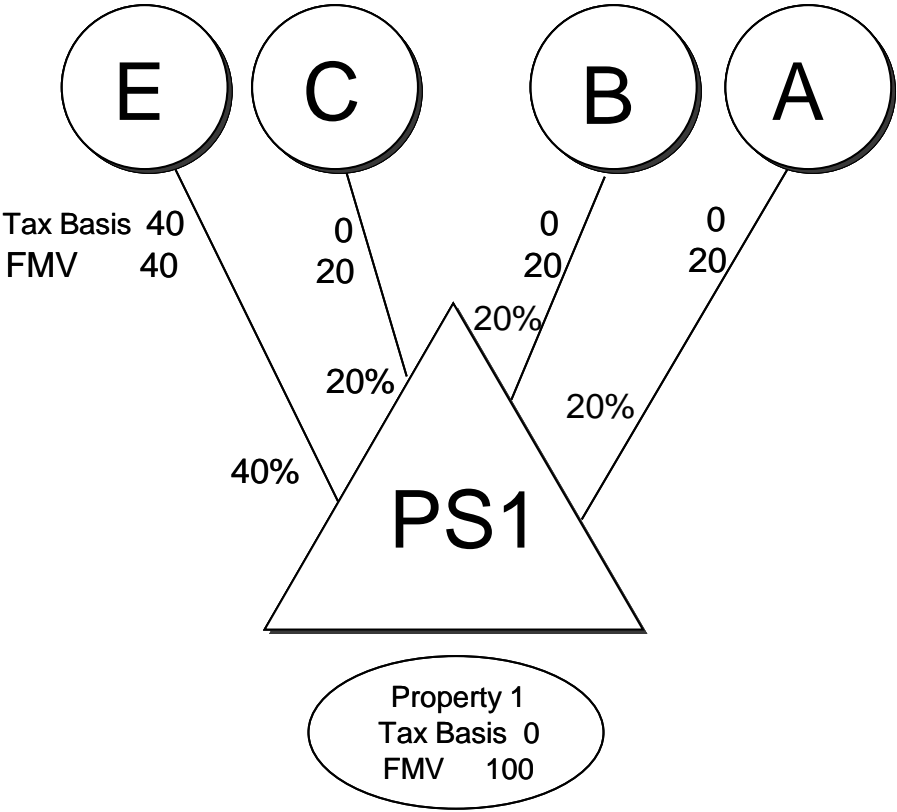
See Reg. § 1.704-1(b)(4)(i); -1(b)(5), Example 14 (vii); -1(b)(3)(ii); -1(b)(2)(iv)(m)(4) and (m)(5)

- What gain is allocable to Partners D and A on a sale of Property 1?



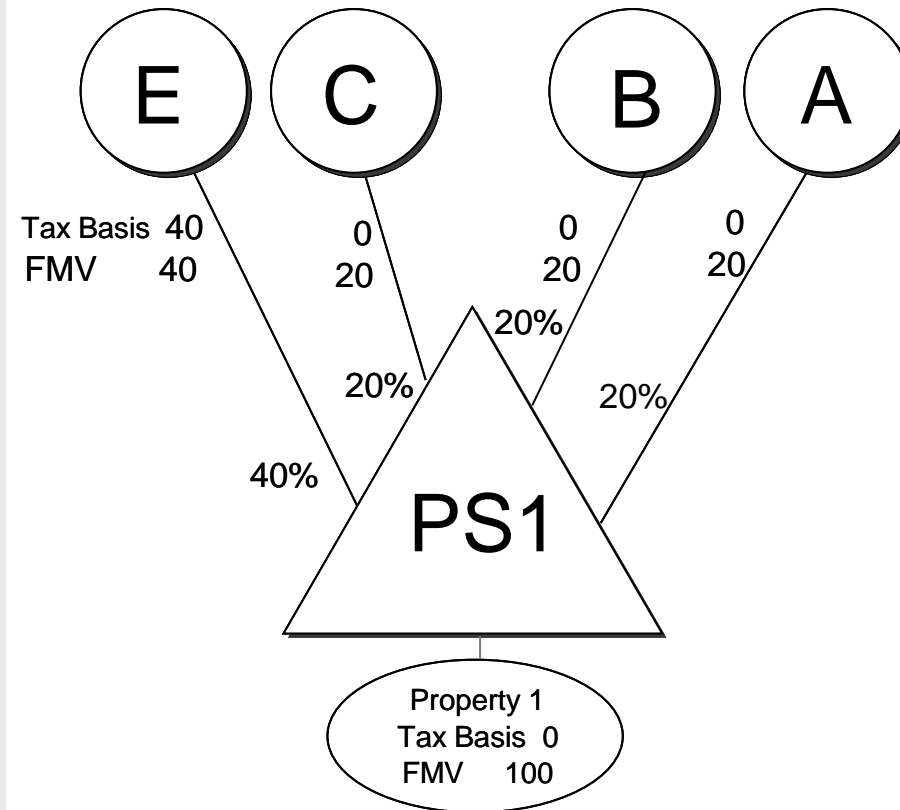
Example 9 – Stage #1 PS with Built-in Gain Property

- 1. Partner D sells to Partner E for 40.
- 2. Partner D has 40 gain.
- 3. No Section 754 election in effect.
- 4. No basis step-up to Property 1.



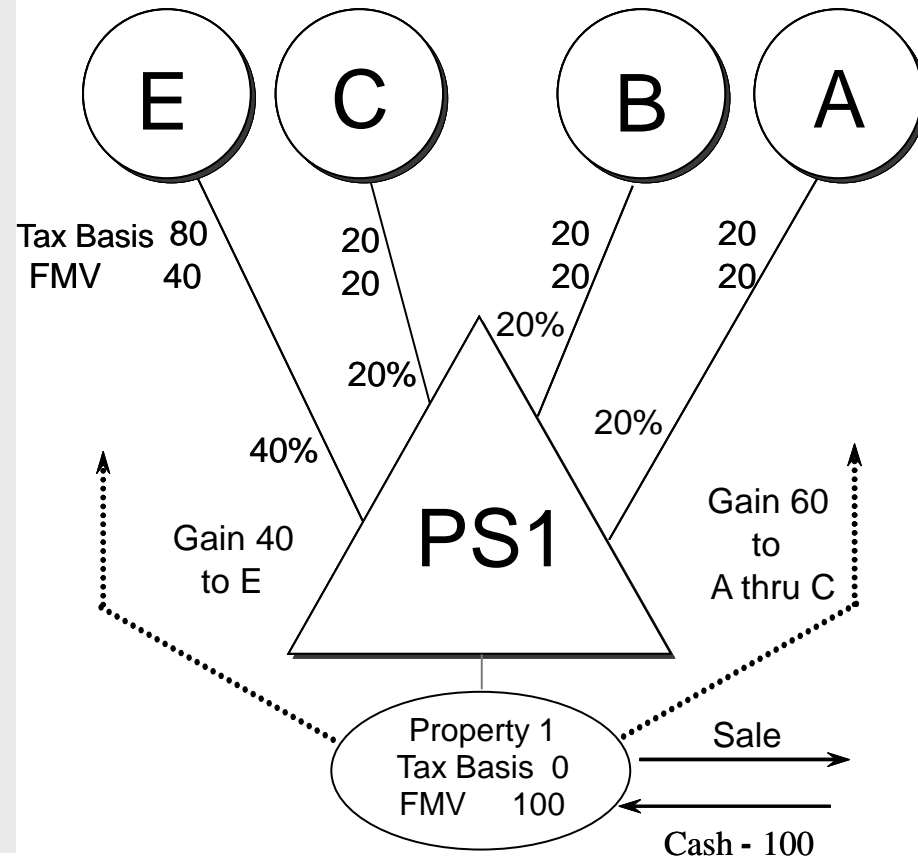
Example 9 – Stage #2

1. Partner E's tax basis in its PS1 interest is 40.
2. Partner E's share of Property 1's basis is 0, absent a Section 754 election.
3. The following illustrates some of the incongruous results resulting from the absence of a Section 754 election and the new Section 734 substantial basis reduction rules.



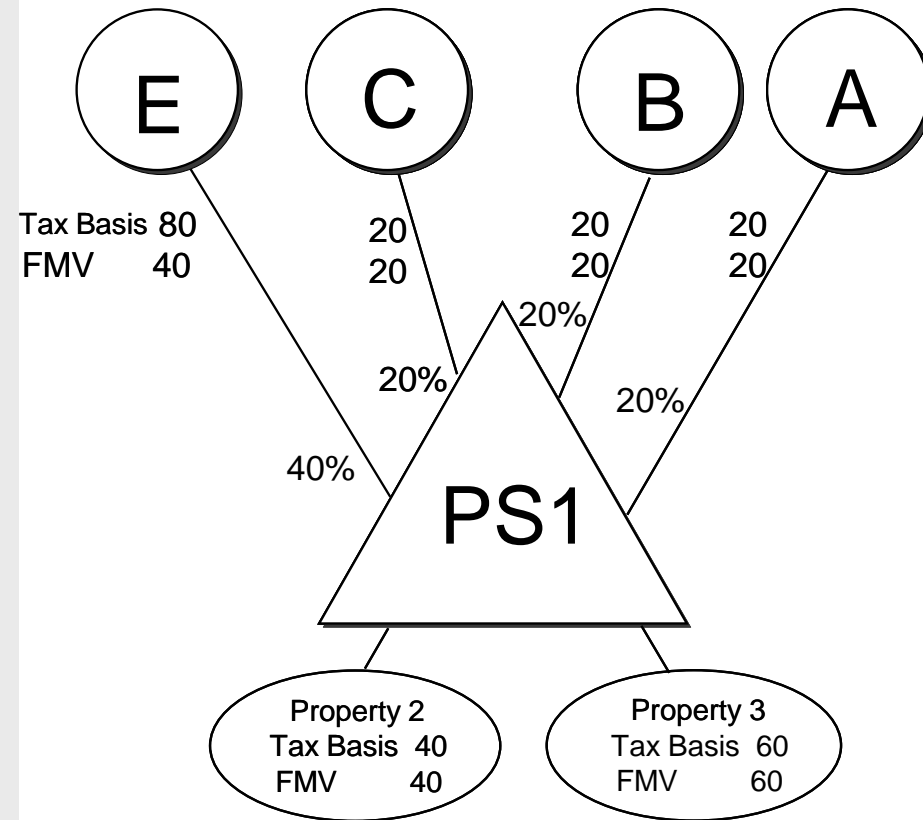
Example 9 – Stage #3

1. PS1 sells Property 1 for 100.
2. Partner E has artificial tax gain of 40.
3. Partner E's PS1 interest has a 40 artificial built-in loss.
4. What if Partner E has expiring capital losses, NOLs, or SRLY limited losses?
5. What if Partner E has carryforward passive losses usable against the gain?
6. Note availability of built-in loss in Partner E's PS1 interest.
7. Transfer to Corporation: "Imported or Duplicated Loss?" Section 362(e).



Example 9 – Stage #4

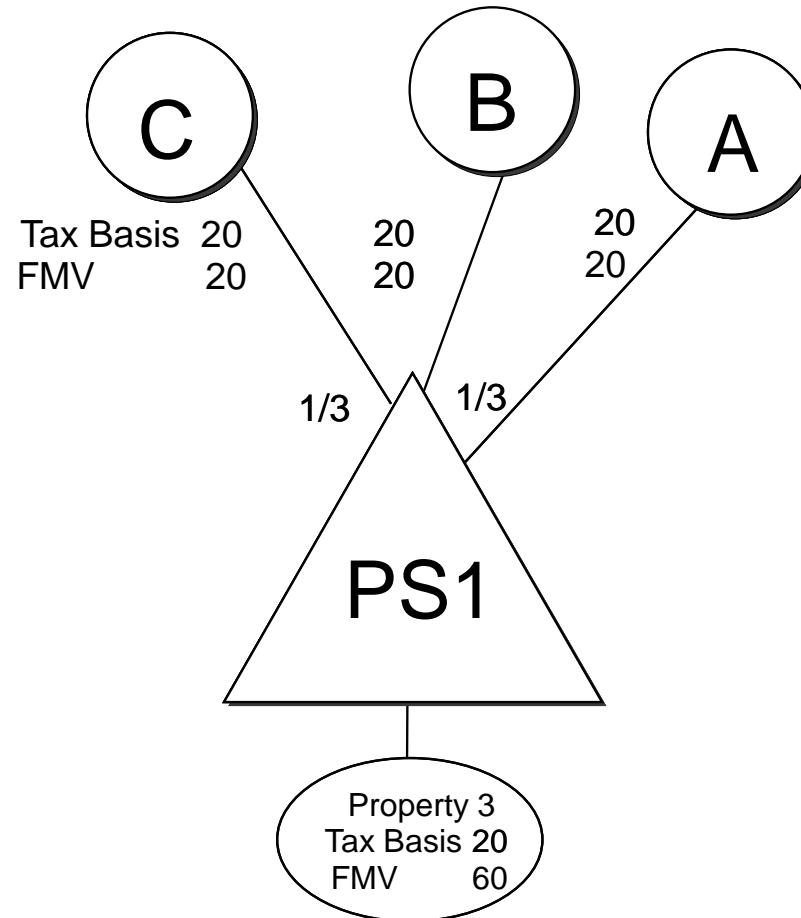
1. \$40 Cash or Property 2 (Section 1231 property) is distributed to Partner E, liquidating E's interest in PS1.
2. Opportunity for Section 1231 loss.
3. Note:
 - Section 1231 loss is not a passive loss.
4. Note effect, under amended Section 734, of partner level loss or basis step-up to Property 2. Mandatory Section 734 adjustment for PS1.



Example 9 – Stage #5

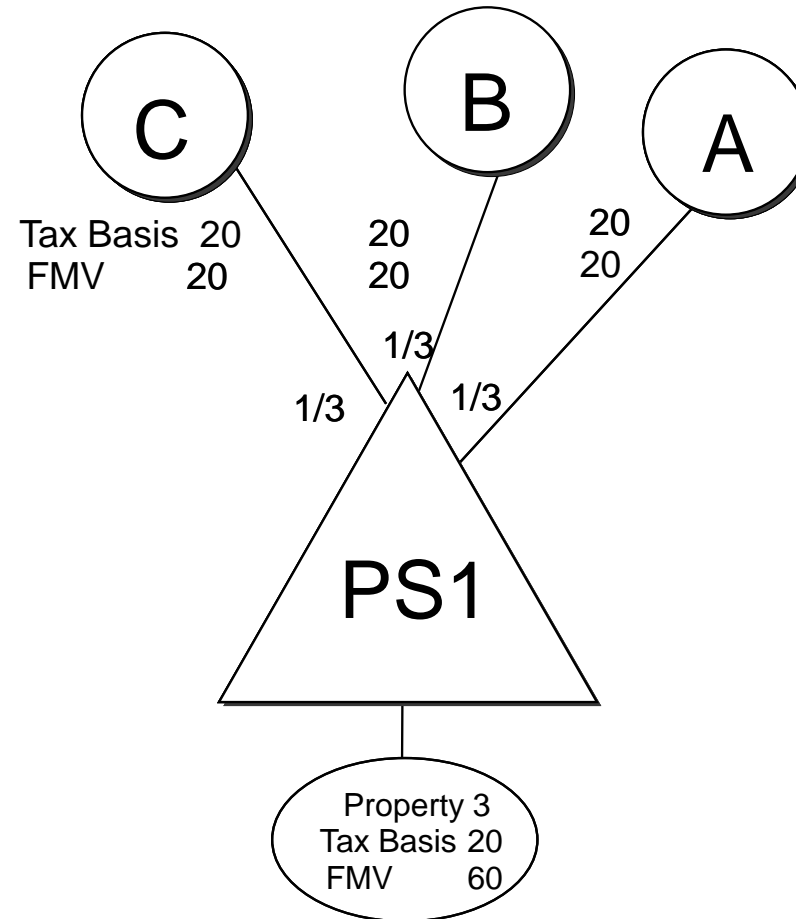
1. Assume Property 2 distributed with a step-up of 40 to redeemed Partner E*.
2. Note:
 - No Section 754 election
3. But, under amended Section 734, basis step-down of 40 occurs in the remaining property.
4. Thus, an artificial inside gain of 40 is imposed upon the remaining partners.

* All examples assume statutory “threshold” amounts are exceeded, except as expressly indicated.



Example 9 – Stage #5

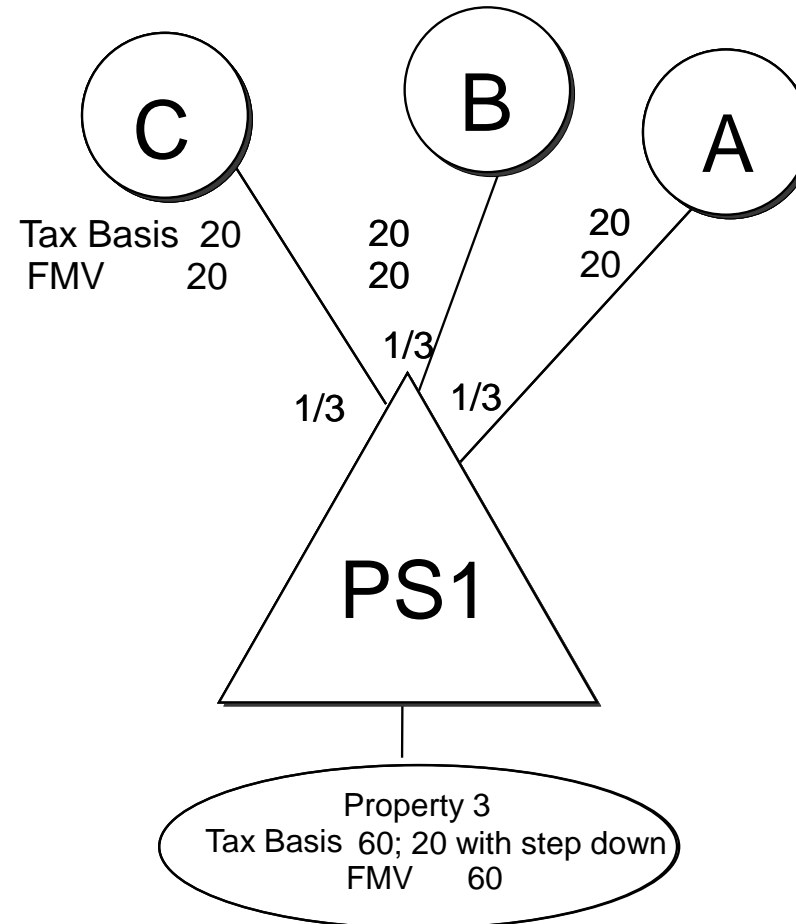
5. Incongruous result under amended Section 734 – Due to basis step-down of 40 in Property 3.
 - a. An artificial inside gain of 40 is imposed upon A, B, and C
 - A, B, and C incur an inside-outside basis disparity, where A, B, and C had no basis disparity previously.
 - b. Proposed Regulations confirm that step-down is required.



Example 9 – Stage #5

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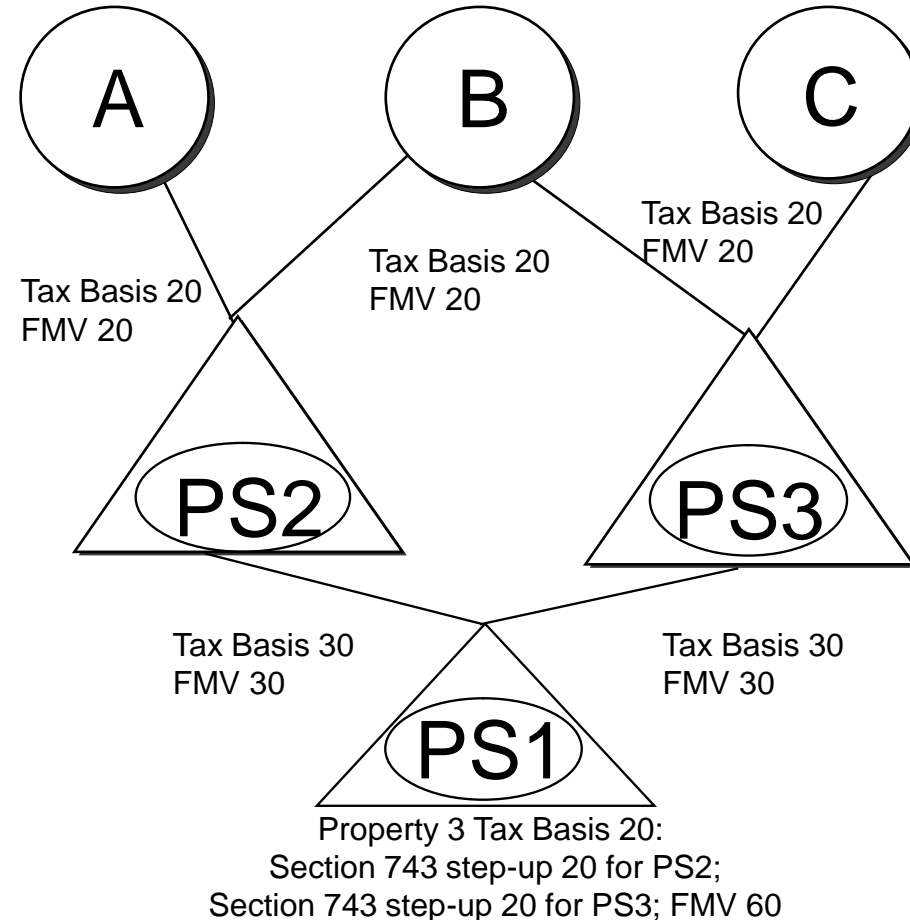
6. Bad result avoided if E not completely liquidated.
 - a. Partner E incurs redemption loss only upon complete redemption for cash.
 - b. Partner E incurs loss upon sale of interest:
 - PS1 does not incur basis step-down, since there is no overall partnership level loss.



Example 9 – Stage #5

Alternative Self-Help

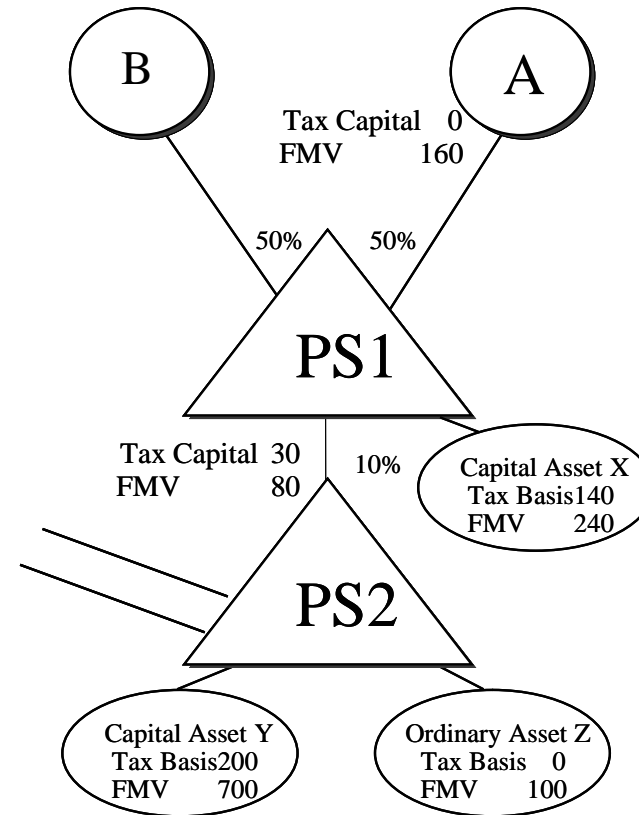
1. Each of A, B and C transfer their interests in Partnership PS1 to two new partnerships.
2. Under Treas. Reg. § 1.755–1(b)(5), A, B and C would each be entitled to a positive Section 743 adjustment equal to the excess of their basis for PS1 over their share of inside basis.
3. Should this transaction be subject to anti-abuse rule?



Example 10 – Stage #1

Rev. Rul. 92-15

1. Both PS1 and PS2 have Section 754 elections in effect
2. No assets of either partnership are “hot assets” under Section 751
3. PS1’s share of inside basis of the assets of PS2 is 20
4. Assume Section 732(d) is inapplicable
5. Note that Asset Z would represent a Section 751 “hot asset” under current law, since the 10% of value rule of Section 751(d) was amended subsequent to Rev. Rul. 92-15

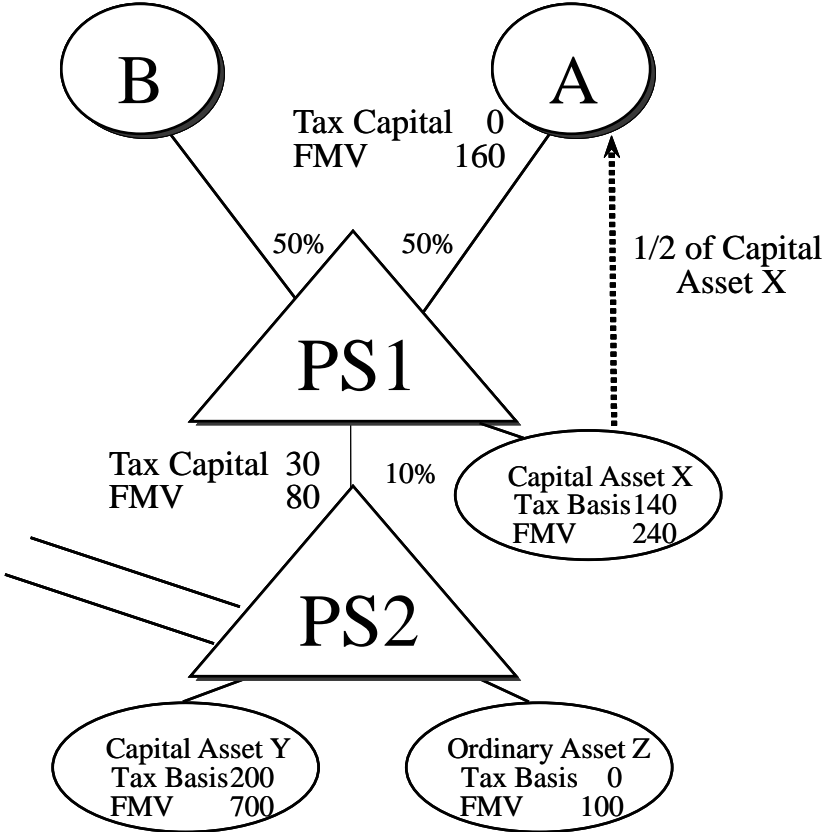




Example 10 – Stage #2

Rev. Rul. 92-15

1. PS1 distributes 1/2 of Capital Asset X to Partner A
2. Partner A reduces its percentage in PS1 to 20%, and that partnership interest's FMV is reduced to 40
3. Partner B's percentage in PS1 increases to 80%
4. A's tax basis in its 1/2 of Capital Asset X reduced to 0
5. Interest in PS2 treated entirely as a Capital Asset – basis in PS2 and Capital Asset X are stepped-up by 35 each
6. PS2 allowed to step-up basis in turn – but only to Capital Asset Y – by 35
7. The step-up by PS2 in Capital Asset Y is per Section 734 – but only for the benefit of PS1
8. Similar step-down results could occur on different facts

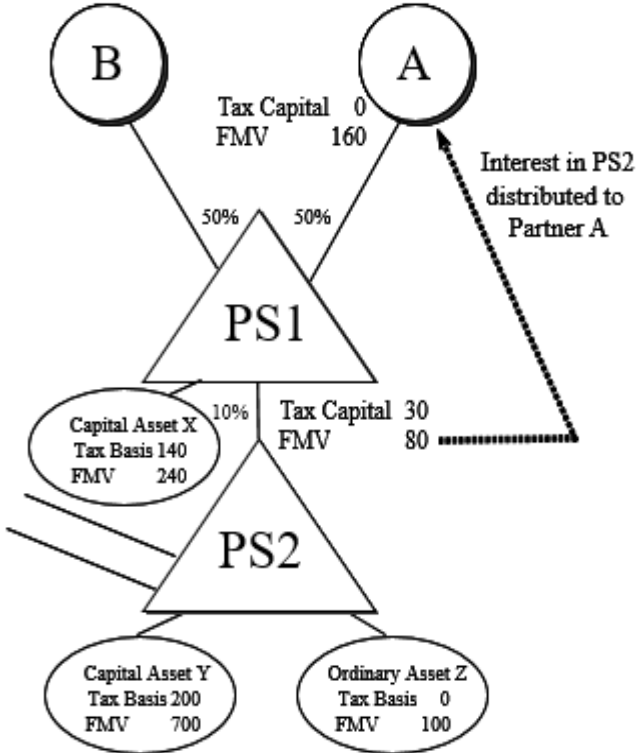





Example 11 – Stage #1

Rev. Rul. 92-15

- 1. Assume similar facts to prior example
- 2. PS1 distributes its entire interest in PS2 to Partner A
- 3. Partner A's percentage in PS1 is reduced to 33%, and the FMV of that interest is reduced to 80
- 4. Partner A's basis in its PS2 interest is reduced to 0
- 5. PS1's basis in Capital Asset X is increased by 30, since (a) PS2 interest is treated as capital asset in its entirety, and (b) both partnerships have Section 754 elections in effect
- 6. Query whether the entire step-up should be treated as a capital asset, rather than part ordinary/part capital due to Section 751 look-through to Asset Z
- 7. Note that there would be a step-down in PS2's assets under the flush language of Section 734(b)





Example 12--Section 6418 Purchase of Energy Credits

1. Partnership IRA was formed for the purpose of purchasing energy credits.
2. Partnership IRA entered into a contract with Energy Supplier to purchase up to \$5,000,000 of production credits for \$.60 per credit. Term of the contract is 5 years. Aggregate maximum amount of credits is \$25,000,000 and aggregate maximum purchase price is \$15,000,000.
3. Partner A is a 50% partner and has contributed \$7,500,000 in capital to Partnership IRA to fund maximum purchase.
4. Year 1: Energy Supplier generates sufficient energy to enable Partnership IRA to purchase maximum amount of credits.
5. Year 2: Partner A sells 40% of its interest in Partnership IRA to Partner B for \$3,200,000, or effectively \$.80 per credit.
6. Partnership makes a Section 754 election and Partner B would accordingly be entitled to a basis step up.

Issues:

- Should all or any portion of the basis step up be treated as non-deductible?
- Is the result different if Partnership IRA is able to purchase fewer than \$5,000,000 credits?

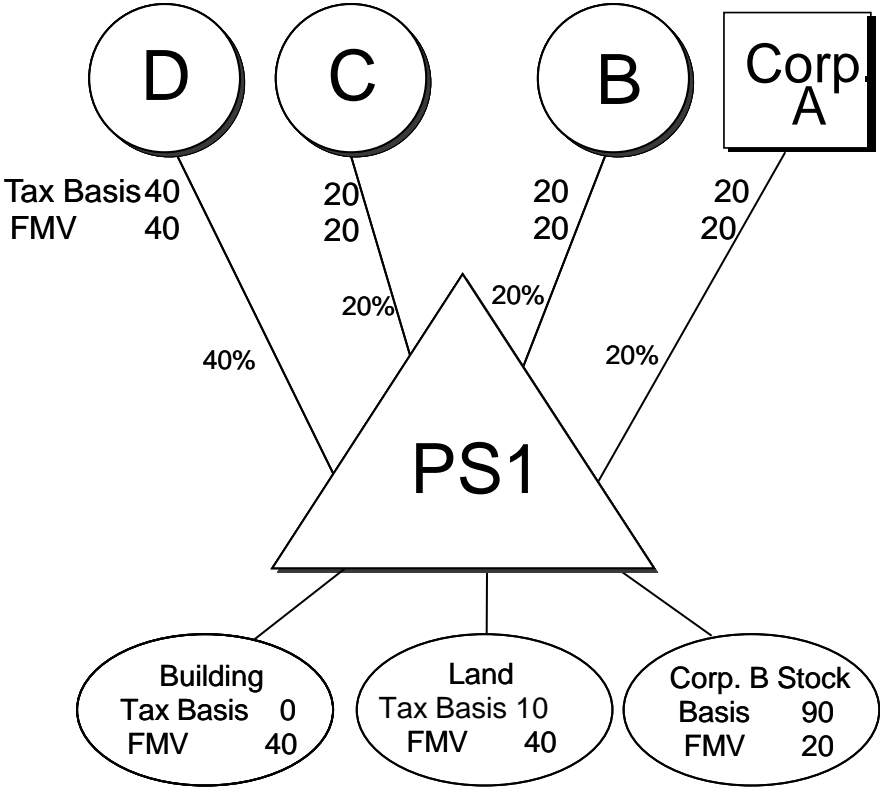


Example 13 – Stage #1

No Step-Down to Certain Stock

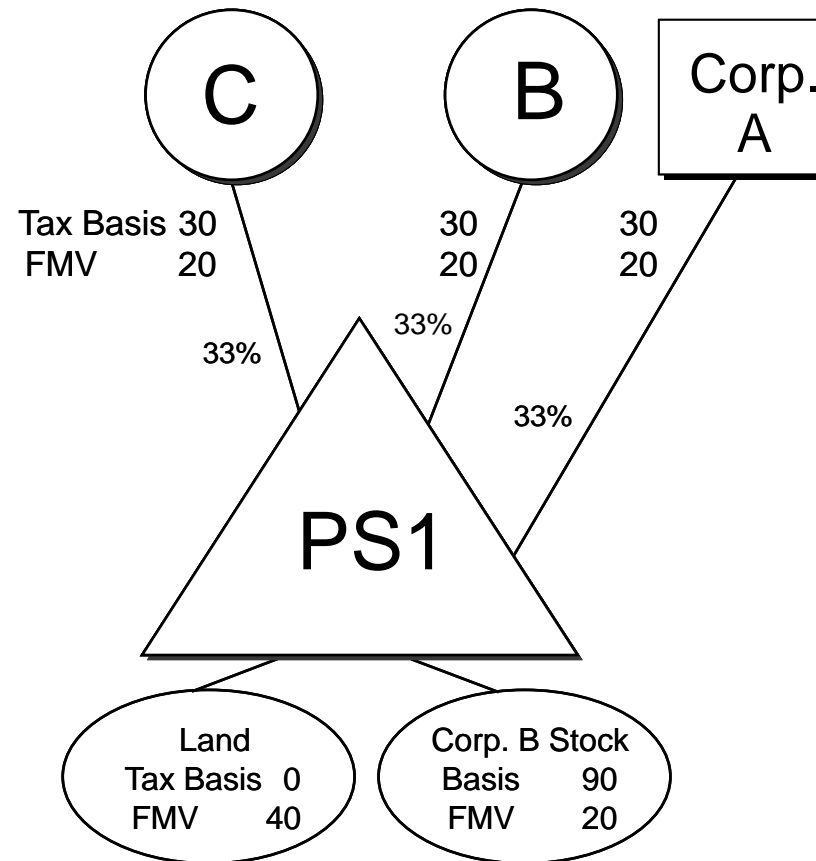
1. PS1 distributes Building to Partner D in complete liquidation of its PS1 interest.
2. Partner D's basis in Building is stepped-up to 40.
3. PS1 must make a 40 downward adjustment to the basis of its remaining properties under amended Section 734.
4. Corp. A owns sufficient stock in Corp. B so that these two entities are "related"*.

* For simplicity of presentation, the ownership of Corp. A in Corp. B is not depicted, and the amounts reflected as to Corp. B relate only to PS1's share in Corp. B.

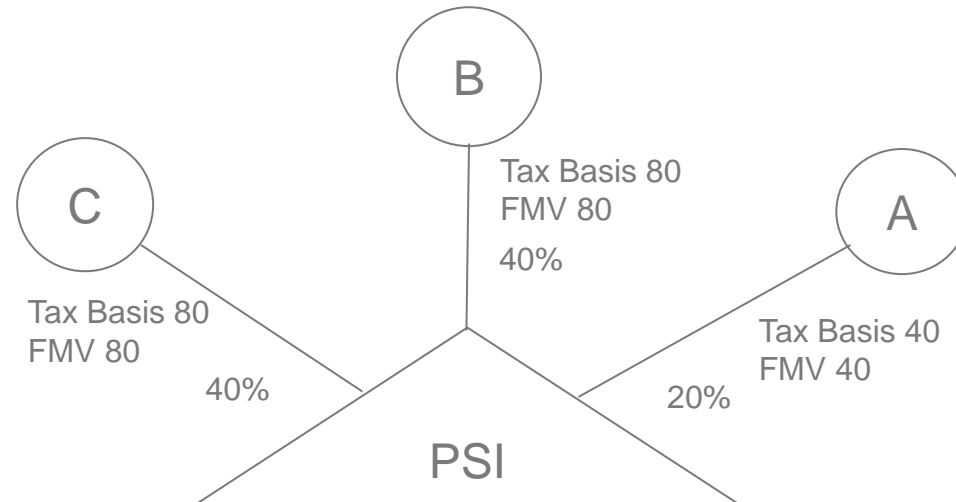


Example 13 – Stage #2

1. Section 755(c) prevents a basis reduction to the Corp. B Stock since Corp. B is related to a partner in PS1 (Corp. A).
2. Section 755(c) requires:
 - a. The 40 step-down to be allocated to other partnership property (*i.e.*, other than the Corp. B Stock) to the extent of the basis in such property
 - b. PS1 must recognize any excess basis reduction as gain
3. Thus, the following results:
 - a. The basis of the land is reduced by 10 to zero;
 - b. PS1 recognizes the remaining 30 of basis reduction as gain that is allocated 10 to each of Corp. A, B, and C; and
 - c. Query the character of the \$30 gain.
4. Compare results to that which would have occurred if the Corp. B Stock (assume subject to Section 732(f)) had been distributed to Corp. A.



Example 14: Net Investment Income



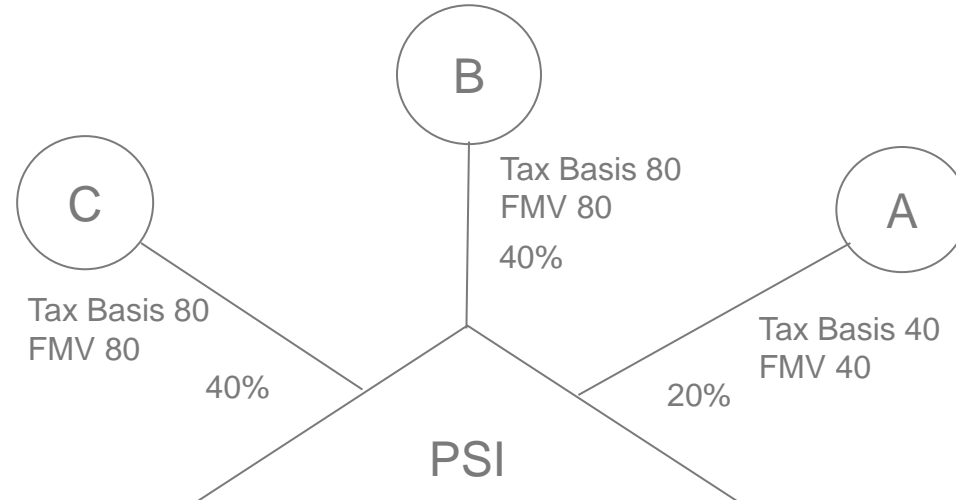
Active Business	
Tax Basis	100
FMV	50

Passive Business	
Tax Basis	100
FMV	150

A sells 20% interest in PSI to D for 40, a full-time employee of the active business, who continues to work full time.

No section 754 election is made.

Example 15: Net Investment Income



Active Business	
Tax Basis	100
FMV	100

Passive Business	
Tax Basis	100
FMV	150

Active business appreciates in value to 100.

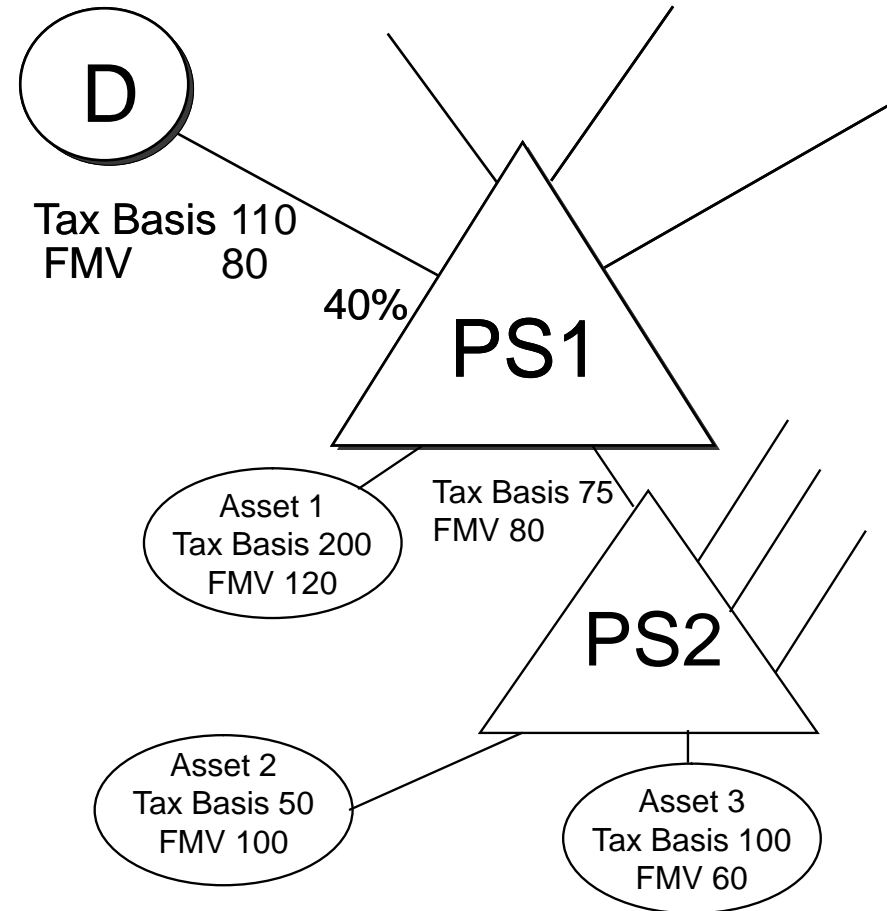
D Sells 20% interest in PS1 to E for \$50, recognizing \$10 of gain

Under Prop. Reg. § 1.1411-7, all of the gain is included in Net Investment Income, even though gain is attributable to appreciation in active business.

Example 16 – Stage #1

PS with Built-in Loss Property/Tiered Partnerships

1. Partner D sells to Partner E for 80.
2. Partner D has 30 loss.
3. No Section 754 election in effect.
4. PS1 has SBIL taking into account its assets and its 50% share of PS2 assets.

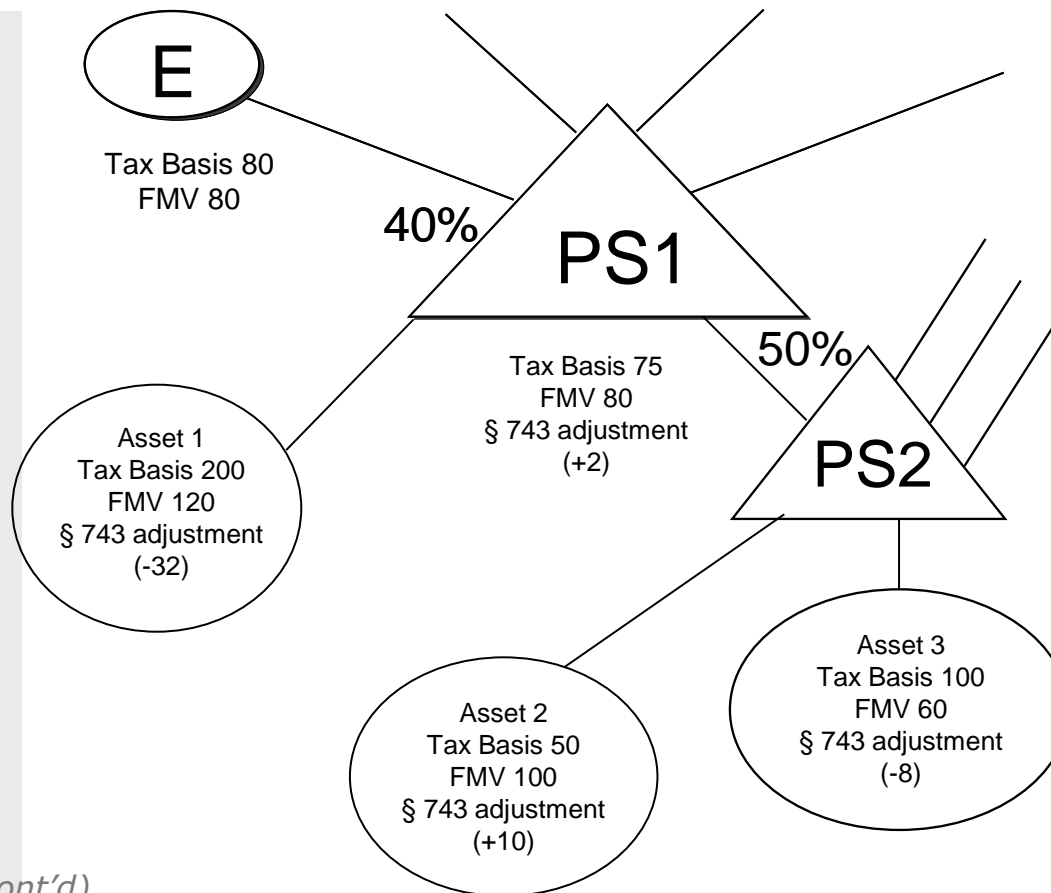


Example 17 – Stage #1

PS with Built-in Loss Property/Tiered Partnerships

1. Partner E's outside basis = 80.
2. Partner E's share of inside basis = 110.
3. Mandatory Step Down in Basis of Assets Required under Section 743(d): But applied how?
4. Prop. Reg. § 1.743-1(l)(1) provides that PS1 adjusts the basis of all of its assets, including its interest in PS2.
5. Under Prop. Reg. § 1.755-1(b) basis of Asset 1 is reduced while basis of PS2 is increased.

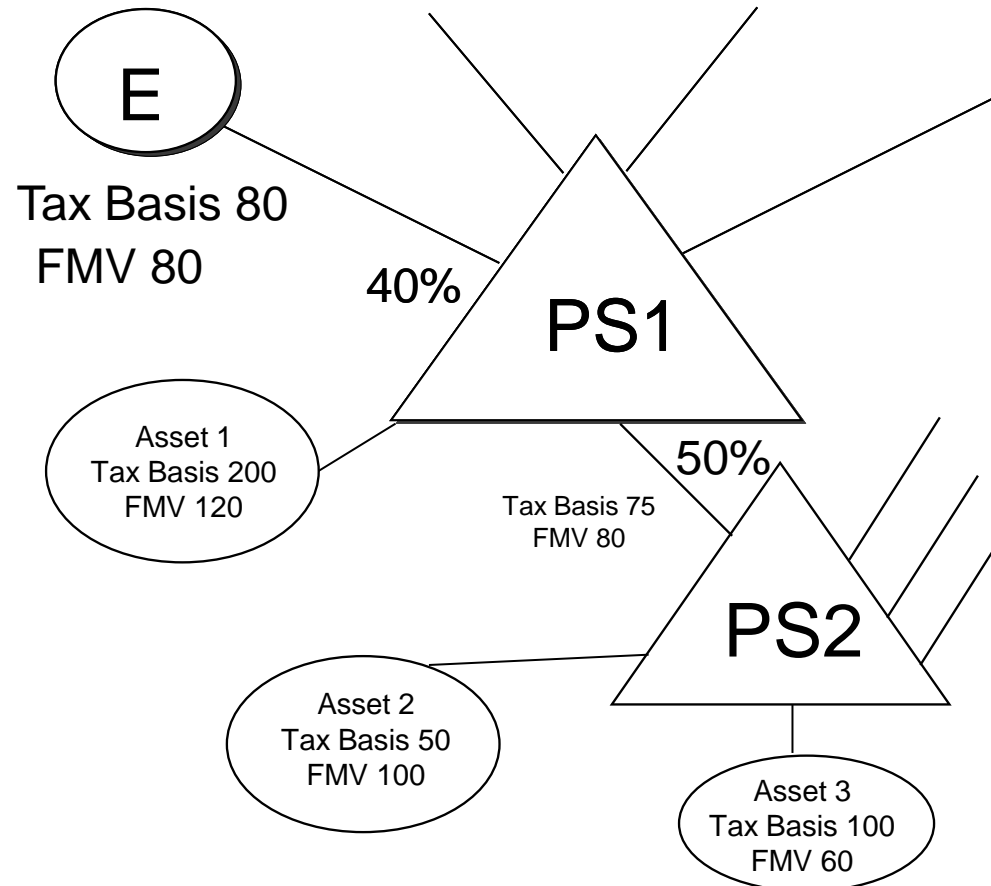
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Example 18 – Stage #2

PS with Built-in Loss Property/Tiered Partnerships (cont.)

6. Prop. Reg. § 1.743-1(l)(1) also provides that “each lower-tier partnership is treated, solely with respect to the transfer, as if it had made a Section 754 election for the taxable year of the transfer”.
7. Prop. Regs. require PS2 to adjust basis of its assets even if PS2 has no SBIL or even any built in loss.
8. Result under the Prop. Regs. is a step up in basis of PS2 assets but only with respect to PS1.
9. Is this the right policy answer?
10. Is result different if D’s partnership interest is redeemed for cash or property instead of sold to E?



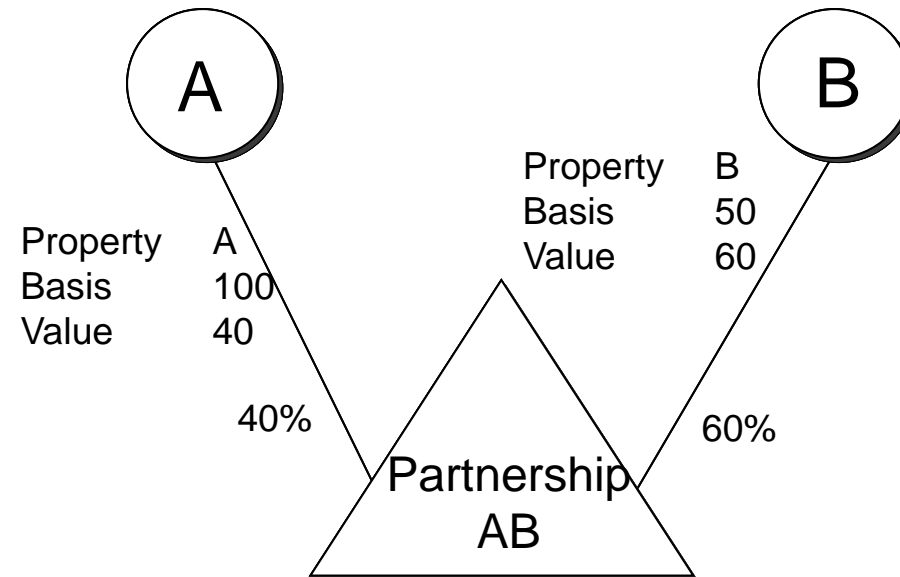


Relationship with Section 704(c)(1)(C) Rules

- JOBS Act amended Section 704(c) to insure that any built-in loss on contributed property would be allocated only to the contributing partner.
- Specific provision requires that for all other partners the partnership treat the contributed property as having a basis equal to its fair market value on the date of contribution.
- Proposed Regulations treat excess basis (“SBA”) like a Section 743 adjustment to the contributing partner.

Example 19 – Basic Operation

1. Property A contributed. Partner A is considered to have SBA of \$60, Partnership AB is considered to have basis of \$40 for Property A for other partner.
2. If Property A sold for \$40: then \$60 loss allowed solely to A.
3. Property A sold for \$100: B should have \$36 gain and A \$24 gain for book purposes.
4. For tax purposes, Partnership AB has gain of \$60. B is allocated \$36 of gain. A has offset of \$60 to gain of \$24, with result of \$36 loss.

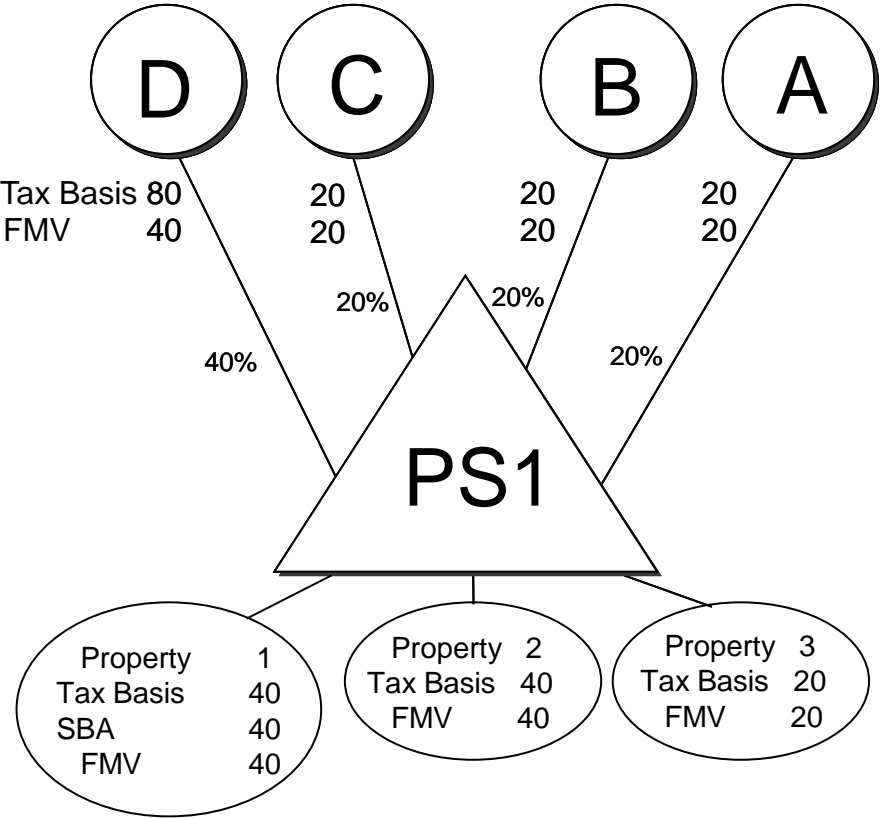




Example 20 – Stage #1 PS with Built-in Loss Property

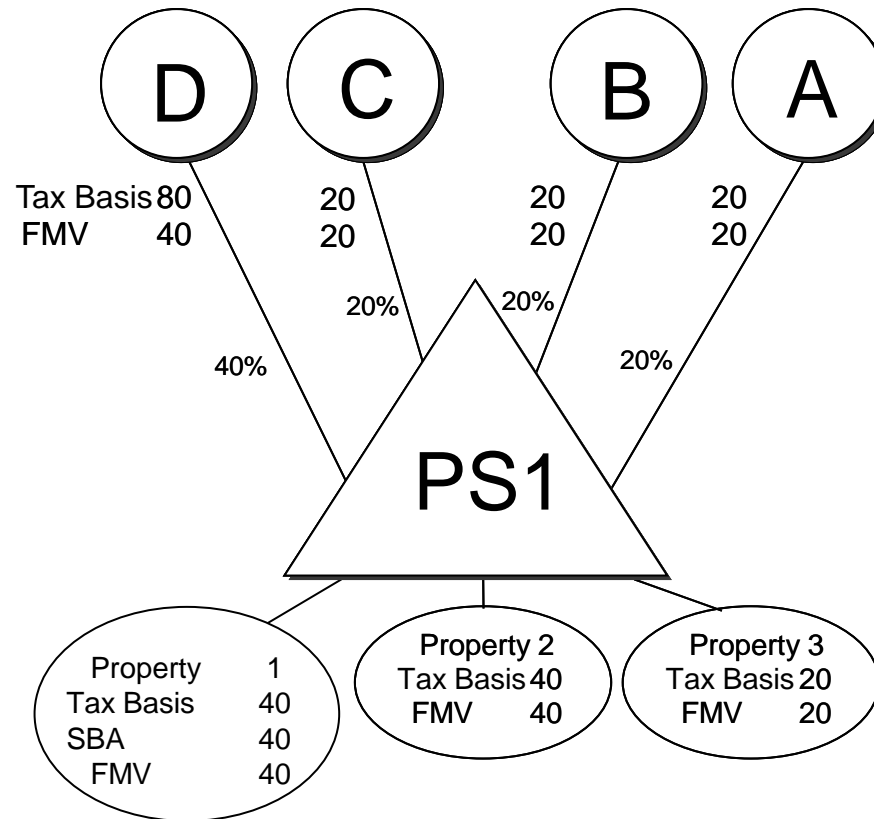
- 1. Partner D contributes loss asset – Property 1 – to PS1.
- 2. Under Section 704(c)(1)(C):
 - Built-in loss of 40 treated as SBA to Partner D.
- 3. SBA should not be taken into account for partnership level Section 163(j) computation.
- 4. SBA should be in BEAT determination only for Partner D.

* No minimum loss threshold needed to trigger the applicability of Section 704(c)(1)(C).



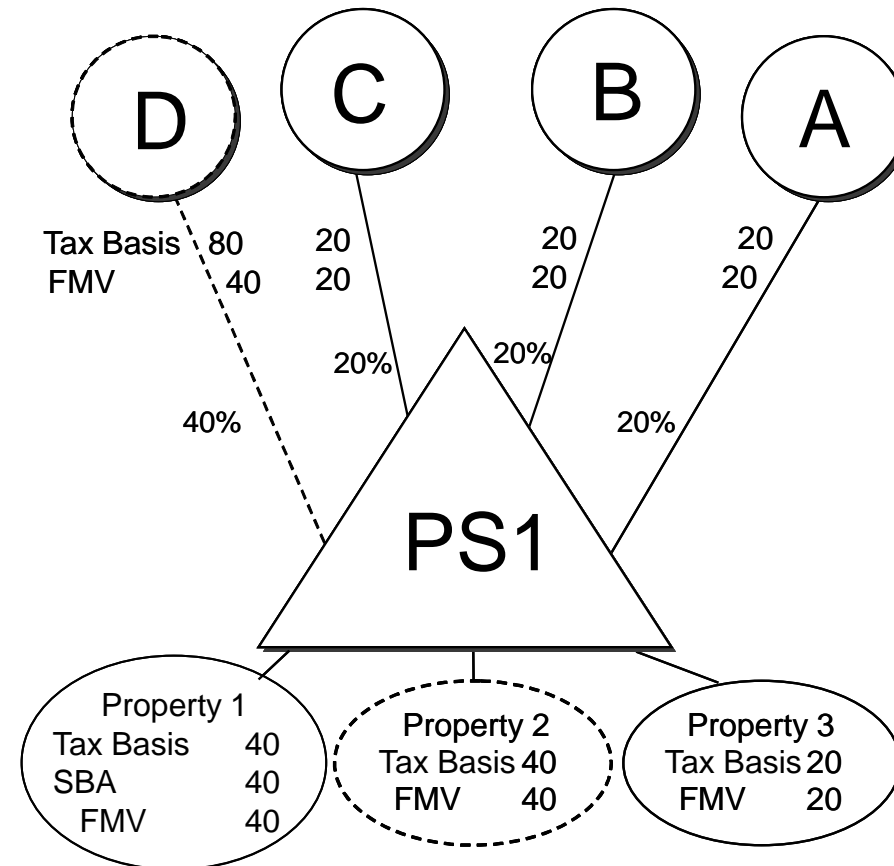
Example 20 – Stage #2

1. PS1 later redeems Partner D for 40 cash (Property 2 is sold).
2. Partner D has 40 loss on PS1 interest redemption.
3. Under Section 704(c)(1)(C) and proposed regulations, Property 1's adjusted basis is 40, its FMV upon contribution to PS1.
4. SBA is now considered a positive Section 734(b) adjustment and is netted against negative Section 734(b) adjustment arising from loss recognized by Partner D.



Example 20 – Stage #3

1. PSI distributes Property 2 to Partner D in redemption of Partner D's interest. Partner D has 80 basis for Property 2.
2. Under proposed regulations, if Property 2 is "like" property to Property 1, SBA shifts to Property 2 and there is no inside/outside basis disparity with respect to distributed property.
3. If Property 2 is not "like" property to Property 1, Section 704(c)(1)(C) basis adjustment becomes a Section 734(b) positive adjustment and is netted against equal negative Section 734(b) adjustment resulting from distribution.

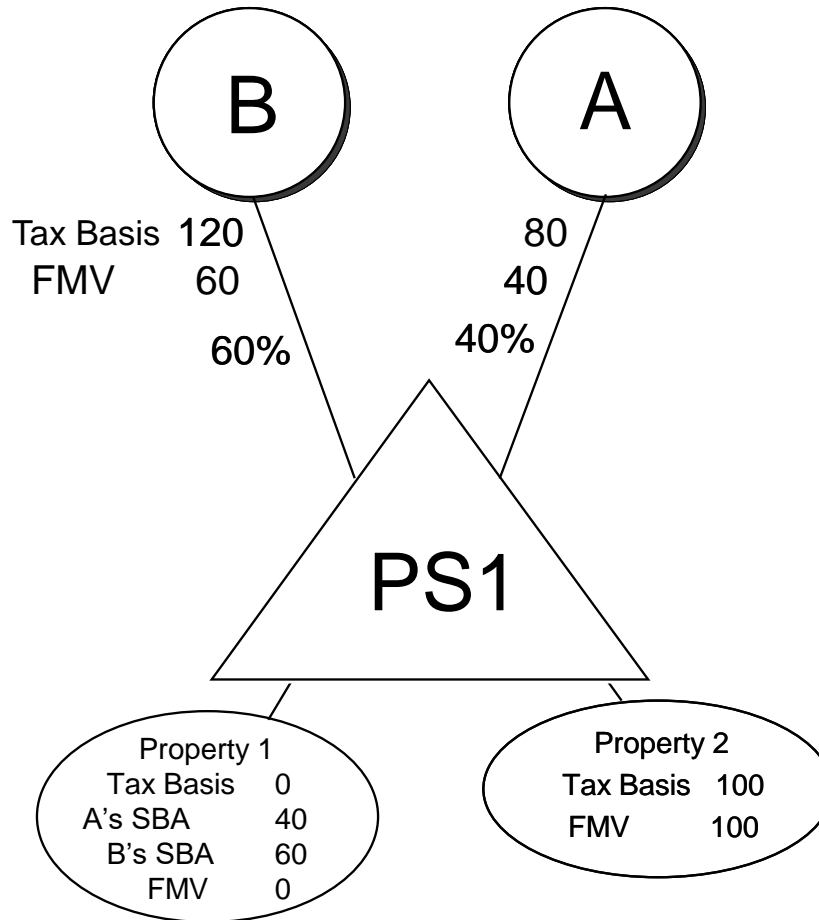


Example 21 – Stage #1

Interests Transfers After Contribution of Built-In Loss Property

1. Partners A and B contributed pro rata shares of Property 1 and Property 2.
2. Partner A sells its PS1 interest to C for 40.
3. No Section 754 election in effect.

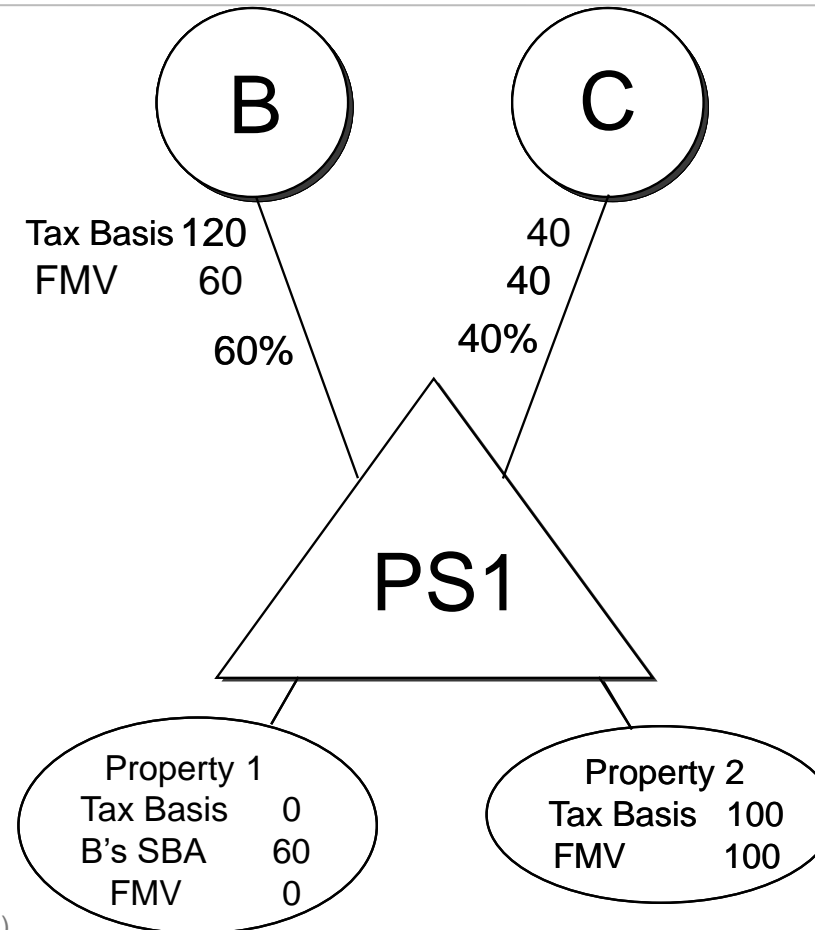
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Example 21 – Stage #2

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- Under proposed regulations, the SBA for A is eliminated as a result of the transfer of the partnership interest.
- Partner B would retain its SBA and this would not be taken into account in determining whether the partnership has a SBIL.
- As a result, even if Section 754 election were made there would be no adjustment to the basis of the assets.



* 60 Tax Basis applicable only to B under new Section 704(c)(1)(C).

Example 21

(Alternative)

1. Partner A transfers its interest in PS1 to Corp. in a Section 351 nonrecognition transaction.
2. Proposed regulations provide that A's SBA would be transferred to the Corporation.
3. Interaction with Section 362(e): SBA would be taken into account in determining whether basis exceeds fair market value for purposes of basis step-down under Section 362(e). Proposed regulations should consider election to adjust basis of stock?

