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The §754 Election

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John McDermott, practicing law for more than 40 years, is a Board Certified Tax Law Specialist, Louisiana Board of Legal Specialization, and he is a certified public accountant. John practices in business and individual income tax, payroll tax, franchise tax, excise tax, ad valorem tax, sales and use tax, and gift and estate tax. John previously chaired the IRS Advisory Council's Small Business/Self-Employed and Wage & Investment Subgroup. He is ranked among *Louisiana Super Lawyers* and *Best Lawyers* in Tax Law. In the community, John is chair of the board of governors for the Boys and Girls Club of Baton Rouge.



Ryan Gonzales is a former tax associate of the national tax practice of Ernst & Young in New York. A certified public accountant, Ryan assists clients with the tax implications of transactions, such as mergers, acquisitions, disposals, and restructurings, and he advises clients on tax planning and compliance at the federal, state and local levels with respect to various taxes including business and individual income tax, franchise tax, excise tax, ad valorem tax, sales and use tax, payroll tax, and transfer tax. Ryan was formerly an accountant with the New Orleans office of Ernst & Young.

I. The §754 Election – Summary of Presentation

A. What is the §754 election?

B. Why make the election?

C. What are the basis adjustments required by the election?

1. §734(b) – When property has been distributed to a partner.
2. §743(b) – When there has been a sale or exchange of a partnership interest or the death of a partner.
3. §755 – Allocation of the §734 and §743 adjustments to partnership property

D. How is the election made?

1. How
2. When
3. Relief for late filing

E. What are the additional effects of having made the election?

1. Additional information to include with the partnership tax return
2. Notice requirements of partners

II. What is the §754 Election?

A. Entity vs Aggregate Principles of Partnership Taxation

1. Entity Principle

- a. The partnership is a distinct entity separate from its partners
- b. The partnership owns and has tax basis in its assets
- c. Business operations are accounted for at the partnership level
- d. Partners own a partnership interest in proportionate shares

2. Aggregate Principle

- a. The partnership is the accumulated interests of its partners
- b. Each partner has a proportionate share of the operations and assets of the partnership
- c. A partnership is the purest conduit tax entity – all items of income, gain, loss and most other tax attributes flow through and are reported and recognized by the individual partners rather than by the partnership

A. Entity vs. Aggregate Principles of Partnership Taxation

3. Inside and Outside Basis

- a. Inside Basis - The partnership owns and has tax basis in its assets.
- b. Equilibrium – General principles of partnership taxation generally maintain an equilibrium between inside and outside basis.
- d. Transactions that break equilibrium:
 - i. Distributions of property to a partner – §734.
 - ii. The sale or exchange of all or part of a partnership interest – §734.
 - iii. The death of a partner – §734.
- e. Effects of unbalanced inside and outside basis:
 - i. Double taxation of gain.
 - ii. Distortion of timing and amount of income, gain or loss.

4. **§734 and §743 basis adjustments to restore equilibrium can be made only if a §754 election has been made and is in effect.**

B. §754

1. An election to adjust basis under both §734 and §743.
2. Applies to all distributions of property and all transfers of partnership interests (including upon the death of a partner).
3. Applies to the year for which the election is made and all subsequent years.
4. Can be revoked only with the approval of the IRS.

III. Why Make the Election?

A. Restore and maintain the equilibrium between inside and outside basis.

1. Avoid potential of double taxation of the same element of gain.
2. Avoid earlier than necessary recognition of income and gain.

B. Realize the benefits of estate planning.

1. 1014 automatic basis adjustment on property acquired from a decedent:
 - a. 1014 adjusts only the outside basis of a partner.
 - b. 1014 adjusts all community property – Rev Rul 79-124 - the §743(b) adjustment arising upon the death of a partner domiciled in a community property state applies to an entire partnership interest that is considered community property regardless of which spouse is admitted as a partner and regardless of which spouse dies.

c. Practice Example:

- i. 2018 death of a non-partner spouse.
- ii. 27 commercial real estate LLCs all taxed as partnerships.
- iii. Substantial §743 basis adjustments due to tax depreciation and market appreciation.
- iv. Adjustments will reduce the partner's ordinary income via additional depreciation.
- v. Adjustments will potentially reduce the amount of gain to be recognized upon the sale of partnership assets.

C. Reasons for not making the election:

- a. Administrative burden.
- b. Reg. 1.754-1(c)(1) – acceptable reasons for revoking an election are also good reasons for not making the election:
 - i. Change in the nature of the partnership business.
 - ii. A substantial increase in the partnership assets.
 - iii. A change in the character of the partnership assets.
 - iv. Increased frequency in the retirements or shifts of partnership interests and the resulting increased administrative burden.

IV. Adjustments Required by the §754 Election

A. §734 – Applies when there is a distribution of property to a partner.

1. The §734(b) basis adjustment:

- a. Increase the basis of partnership property by the amount of the gain recognized by the distributee partner under §731(a)(1) and/or by the excess of adjusted basis of distributed property over the basis of the distributed property in the hands of the distributee determined under §732, or
- b. Decrease the adjusted basis of partnership property by the amount of any loss recognized by the distributee partner under §731(a)(2) and/or by the excess of the basis of distributed property in the hands of the distributee over the adjusted basis of such property to the partnership immediately prior to the distribution.

2. The adjustment is allocated to partnership property as provided in §755.

3. The adjustment applies to the common basis of partnership property and affects every partner's proportionate share of basis in partnership property.

Adjustments Required by the §754 Election

Example 1. Partner A has a basis of \$10,000 for his one-third interest in partnership ABC. The partnership has no liabilities and has assets consisting of cash of \$11,000 and property with a partnership basis of \$19,000 and a value of \$22,000. A receives \$11,000 in cash in liquidation of his entire interest in the partnership. He has a gain of \$1,000 under §731(a)(1). If the election under §754 is in effect, the partnership basis for the property becomes \$20,000 (\$19,000 plus \$1,000).

Example 2. Partner D has a basis of \$10,000 for his one-third interest in partnership DEF. The partnership balance sheet before the distribution is shown in the chart below. In liquidation of his entire interest in the partnership, D received property X with a partnership basis of \$11,000. D's basis for property X is \$10,000 under §732(b). Where the election under §754 is in effect, the excess of \$1,000 (the partnership basis before the distribution less D's basis for property X after distribution) is added to the basis of property Y. The basis of property Y becomes \$16,000 (\$15,000 plus \$1,000).

Adjustments Required by the §754 Election

Assets

	Adjusted Basis	Value
Cash	\$4,000	\$4,000
Property X	11,000	11,000
Property Y	15,000	18,000
Total	30,000	33,000

Liabilities and Capital

	Adjusted Basis	Value
Liabilities	\$0	\$0
Capital:		
D	10,000	11,000
E	10,000	11,000
F	10,000	11,000
Total	30,000	33,000

B. §743 – Applies when there is transfer of a partnership interest by sale or exchange or by the death of a partner.

1. The §743(b) basis adjustment:

- a. Increase the basis of partnership property by the amount of the excess of the transferee partner's outside basis over his proportionate share of the partnership's inside basis in its property, or
- b. Decrease the basis of partnership property by the amount of the transferee partner's proportionate share of the partnership's inside basis over his outside basis.

2. The adjustment is allocated to partnership property as provided in §755.

B. §743 – Applies when there is transfer of a partnership interest by sale or exchange or by the death of a partner. (cont.)

3. The adjustment affects only the transferee partner's proportionate share of basis in partnership property.

4. Computation of transferee partner's distributive share of partnership items:
 - i. First, the partnership computes income, deduction, gain, or loss at the partnership level.
 - ii. Second, the partnership allocates partnership distributive share items under §704, and adjusts capital accounts.
 - iii. Third, the partnership adjusts the transferee's distributive share items to reflect the effects of the basis adjustment.
 - iv. The §743 adjustments to the transferee's distributive share items must be reflected on schedules K and K-1 (boxes 12, 13 and 20 with code AH).
 - v. The §743 basis adjustments do not affect the transferee's capital account.

Adjustments Required by the §754 Election

Example 1. (i) A is a member of partnership PRS in which the partners have equal interests in capital and profits. The partnership has made an election under §754, relating to the optional adjustment to the basis of partnership property. A sells its interest to T for \$22,000. The balance sheet of the partnership at the date of sale is shown in the chart below.

(ii) The amount of the basis adjustment under §743(b) is the difference between the basis of T's interest in the partnership and T's share of the adjusted basis to the partnership of the partnership's property. Under §742, the basis of T's interest is \$25,333 (the cash paid for A's interest, \$22,000, plus \$3,333, T's share of partnership liabilities). T's interest in the partnership's previously taxed capital is \$15,000 (\$22,000, the amount of cash T would receive if PRS liquidated immediately after the hypothetical transaction, decreased by \$7,000, the amount of tax gain allocated to T from the hypothetical transaction). T's share of the adjusted basis to the partnership of the partnership's property is \$18,333 (\$15,000 share of previously taxed capital, plus \$3,333 share of the partnership's liabilities). The amount of the basis adjustment under §743(b) to partnership property therefore, is \$7,000, the difference between \$25,333 and \$18,333.

Adjustments Required by the §754 Election

	Assets	
	Adjusted Basis	Fair Market Value
Cash	\$5,000	\$5,000
Accounts receivable	10,000	10,000
Inventory	20,000	21,000
Depreciable assets	20,000	40,000

Adjustments Required by the §754 Election

	Liabilities and Capital	
	Adjusted per books	Fair Market Value
Liabilities	\$10,000	\$10,000
Capital:		
A	15,000	22,000
B	15,000	22,000
C	15,000	22,000
TOTAL	55,000	76,000

Adjustments Required by the §754 Election

- **Example 2.** A, B, and C form partnership PRS, to which A contributes land (Asset 1) with a fair market value of \$1,000 and an adjusted basis to A of \$400, and B and C each contribute \$1,000 cash.
 - Each partner has \$1,000 credited to it on the books of the partnership as its capital contribution. The partners share in profits equally.
 - During the partnership's first taxable year, Asset 1 appreciates in value to \$1,300.
 - A sells its one-third interest in the partnership to T for \$1,100, when an election under section 754 is in effect.
 - The amount of tax gain that would be allocated to T from the hypothetical transaction is \$700 (\$600 §704(c) built-in gain, plus one-third of the additional gain).
 - Thus, T's interest in the partnership's previously taxed capital is \$400 (\$1,100, the amount of cash T would receive if PRS liquidated immediately after the hypothetical transaction, decreased by \$700, T's share of gain from the hypothetical transaction). The amount of T's basis adjustment under §743(b) to partnership property is \$700 (the excess of \$1,100, T's cost basis for its interest, over \$400, T's share of the adjusted basis to the partnership of partnership property).

C. §755 – How the 734(b) and 743(b) adjustments are allocated:

- General rule – the adjustments are to be allocated in a manner which has the effect of reducing the difference between the fair market value and the adjusted basis of partnership properties, or in any other manner as permitted by regulations.
- See Reg. 1.755-1 for extensive and comprehensive regulations.

V. How to Make the Election

A. File a written statement with the partnership tax return that sets forth the following:

1. The name and address of the partnership,
2. Signed by any partner,
3. A declaration that the partnership elects under section 754 to apply the provisions of §734(b) and §743(b).

B. The election must be filed with the timely filed partnership tax return for the taxable year during which the distribution of property or transfer of interest occurs.

C. File additional information required by Reg. 1.734-1(d) and/or 1.743-1(k).

D. Relief for late filing.

1. Automatic twelve month extension of time to file the election under Reg. 301.9100-2(2)(vi).

- a. Requires the election be filed with an amended return filed for the year in which the election should have been made.
- b. All partners affected by the late filed election must file amended returns consistent with the election for the year in which the election should have been made.
- c. All amended returns required to be filed must have the following statement at the top of the return:

“FILED PURSUANT TO §301.9100-2”

2. Request relief under Reg. 301.9100-3.

- a. Requires showing that the partnership acted reasonably and in good faith.
- b. Requires showing that relief will not prejudice the interests of the government.
- c. Requires a substantial filing fee – currently \$10,900.

**VI. Reporting Requirements
While the Election is in Effect
(including the year in which
the election is made)**

- A. Form 1065 – check schedule B, item 10.a and attach a statement showing the basis adjustment and allocation. Also show adjustments on schedule K-1.
- B. §734(b) adjustments – a statement must be attached 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.
- C. §743(b) adjustments – a statement must be attached to the return for the year of the transfer of a partnership interest with the following:
1. Name and tax identification number of the transferee partner.
 2. The computation of the adjustment.
 3. Show the allocation of the adjustment to specific properties.

D. Notification requirements when there is a §743 transfer of a partnership interest:

1. The transferee must notify the partnership within 30 days of the sale or exchange and provide the following information under penalties of perjury:
 - a. Names and addresses of the transferee and of the transferor.
 - b. The relationship between the transferee and the transferor.
 - c. The tax identification numbers of the transferee and the transferor.
 - d. The amount of any liabilities assumed by the transferee.
 - e. The amount of money, the fair market value of any other property delivered for the transferred interest.
 - f. Any other information needed by the partnership to compute the transferee's basis.

D. Notification requirements when there is a §743 transfer of a partnership interest (cont.):

2. In the event of the death of a partner, the recipient of the deceased partner's interest must notify the partnership within one year of the death of the partner and provide the following information under penalties of perjury:

- a. The names and addresses of the deceased partner and of the transferee.
- b. The tax identification numbers of the deceased partner and of the transferee.
- c. The relationship of the deceased partner and the transferee.
- d. The deceased partner's date of death.
- e. The date on which the transferee became the owner of the partnership interest.
- f. The fair market value of the partnership interest on the applicable valuation date under 1014 or 1022.
- g. The manner in which the FMV was determined.
- h. The carryover basis adjusted under §1022, if applicable.

Q&A



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