# Basis Adjustments to Partnership Property

Course #33153B

Taxes

2 Credit Hours

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# BASIS ADJUSTMENTS TO PARTNERSHIP PROPERTY

Understand how to classify and treat distributions to a retiring partner under Code Sec. 736. Learn to distinguish between Code Sec. 736(a) payments (guaranteed or distributive share) and 736(b) payments (property distributions), including their tax implications. Identify how capital, goodwill, and unrealized receivables affect classification. Recognize the effect of partnership agreements, elections, and installment structures on gain recognition, deductions, and basis adjustments.

## LEARNING ASSIGNMENTS AND OBJECTIVES

*As a result of studying each assignment, you should be able to meet the objectives listed below each individual assignment.*

**SUBJECTS**

**Basis Adjustments to Partnership Property**

Study the course materials

Complete the review questions at the end of each chapter

Answer the exam questions 1 to 10

**Objectives:**

- Recall the acceptable reasons for revoking a Code Sec. 754 election.

**NOTICE**



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## EXAM OUTLINE

- **TEST FORMAT:** The final exam for this course consists of 10 multiple-choice questions and is based specifically on the information covered in the course materials.

- **ACCESS FINAL EXAM:** Log in to your account and click Take Exam. A copy of the final exam is provided at the end of these course materials for your convenience, however you must submit your answers online to receive credit for the course.

- **LICENSE RENEWAL INFORMATION:** This course qualifies for **2** CPE hours.

- **PROCESSING:** You will receive the score for your final exam immediately after it is submitted. A score of 70% or better is required to pass.

- **CERTIFICATE OF COMPLETION:** Will be available in your account to view online or print. If you do not pass an exam, it can be retaken free of charge.

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# BASIS ADJUSTMENTS TO PARTNERSHIP PROPERTY— CODE SECS. 734(B), 743(B)

## Objective

**After completing this course, you should be able to:**

- Recall the acceptable reasons for revoking a Code Sec. 754 election.

## ¶301 BASIS ADJUSTMENT TO PARTNERSHIP PROPERTY—CODE SEC. 743(B) BASIS ADJUSTMENTS

Under an aggregate approach to partnership taxation, a partner who acquires a partnership interest by purchase would receive a cost basis in his or her share of the partnership assets. The partner's position would be similar to that of a tenant-in-common.

Under an entity approach to partnership taxation, however, the price paid by the purchasing partner affects only the partner's adjusted basis in the partnership interest, not the basis of his or her share of the partnership assets. A shareholder's acquisition of corporate stock is an example of the operation of the entity approach.

Prior to 1954, neither the aggregate nor the entity approach had been completely accepted by the courts, but the weight of authority came down on the side of the entity approach. The rationale for not allowing a change in the adjusted basis of the partnership assets on the transfer of a partnership interest was that the purchasing partner had not acquired an interest in the partnership property itself, but only in the partnership as an entity. Code Sec. 743(a) codified this approach.

Code Sec. 743(b), however, provides that if an election under Code Sec. 754 is in effect for the year of sale or if the partnership has a substantial built-in loss (as defined in Code Sec. 743(d)) immediately after the transfer, the entity rules of Code Sec. 743(a) give way to the modified aggregate rules of Code Sec. 743(b). In such cases, the transfer of a partnership interest will trigger a required adjustment to the basis of partnership assets. This adjustment affects the transferee partner only, effectively giving the transferee a FMV basis in his or her share of each of the partnership's assets.

### *.01 Code Sec. 743(b) Transfers*

Code Sec. 743(b) applies to the sale, exchange, or transfer of a partnership interest upon death. It applies to any transfer considered a sale or exchange, but also to certain distributions of an interest in a partnership even if not otherwise treated as an exchange.[1] For example, Code Sec. 743(b) applies

*1.With respect to a transfer of the economic rights to a partnership interest when the new owner of the economic rights is not formally admitted to the partnership, the IRS has ruled that the economic owner is the partner for tax purposes. Although there is no authority directly on this point, such a transfer should qualify as a sale of a partnership interest for Code Sec. 743(b) purposes.*

to distributions of a partnership interest by a corporation or a partnership.[2] It does *not* apply to the gift of a partnership interest, nor to the contribution of cash or property to a partnership in exchange for an interest in that partnership.

**Partner dies with community property partnership interest.** When property is held as community property and either the husband or wife dies, the decedent's share of the partnership interest is includable in his or her gross estate at its value on the applicable valuation date.[3] The devisee will take a tax basis for the partnership interest equal to its value plus his or her share of the partnership's debt.[4] The surviving spouse's community property portion of the partnership interest is not included in the decedent's gross estate and is not transferred to the surviving spouse by reason of the decedent's death. The surviving spouse's share of the partnership interest, however, also receives a basis equal to its value at the appropriate valuation date.[5] The IRS has ruled that in spite of the absence of a partnership interest being transferred, the surviving spouse's share of the assets is adjusted if the partnership has a Code Sec. 754 election in effect for the partnership year in which the decedent's death occurred.[6]

## Example 3-1

*A* was a one-third partner in the AKE partnership until his death in November. *A* was married, and lived in a community property state. His spouse, *P*, inherited his partnership interest in AKE. *A's* tax basis in the partnership interest prior to death was $375,000. The value of the partnership interest at the date of *A's* death was $1,000,000. The partnership had liabilities of $1,500,000. Although *P* was already the owner of one-half of *A's* partnership interest (due to their residence in a community property state), *P* will assume a tax basis in that interest equal to its $1,000,000 fair value plus *A's* (now *P's*) share of the partnership liabilities. Assuming that share of liabilities is one-third, *P's* tax basis in the partnership interest will be $1,500,000. If the partnership has a Code Sec. 754 election in effect, or chooses to make one, it will be required to adjust the basis of its assets to reflect the step-up in basis of the interest following *A's* death.

### *.02 Code Sec. 743(b) Adjustments—Overview*

Code Sec. 743(b) serves to protect the purchasing partner from being allocated gain or loss for tax purposes when no gain or loss has been economically realized by that partner. In effect, it prevents the purchasing partner from being allocated taxable gain or loss on the subsequent disposition of partnership assets that was previously recognized by the selling partner on the initial transfer of the partnership interest. Under Code Sec. 743(b), the partnership adjusts the tax basis of its assets, increasing or decreasing their individual bases to reflect the amount paid by the purchaser for his or her interest therein. The amount of gain, loss, depreciation, etc. reported by the partnership with respect to future use or disposition is computed taking these basis adjustments into account.

*2.Code Sec. 761(e). H.R. Rep. No. 801, 98th Cong., 2d Sess., 863-865 (1984).*
*3.Code Sec. 2031 or 2032.*
*4.Code Secs. 1014(a), 642, and 752.*
*5. Code Sec. 1014(b)(6).*
*6. Rev. Rul. 79-124, 1979-1 CB 224. Rev. Rul. 79-124, 1979-1 CB 224.*

The total amount of the adjustment to all the partnership property is the difference between the incoming partner's basis for his or her partnership interest and that partner's share of the adjusted basis of the partnership property at the time of purchase. If the purchasing partner's initial adjusted basis in the partnership interest is greater than his or her share of the adjusted basis of partnership assets, the total basis adjustment to the partnership assets is upward in an amount equal to the excess. Conversely, the adjustment is downward where the reverse is true. The adjustment thus results in the partner's adjusted basis in the partnership interest being equal to the adjusted basis of his or her share of the partnership assets. The total adjustment is then allocated among the partnership properties in accordance with rules contained in Code Sec. 755.

Code Sec. 743(b) adjustments may affect the timing, and occasionally the character, of income or loss to be recognized by the incoming partner, but they generally will not affect the total amount of income or loss ultimately reported by the partner. For example, a partner purchasing an interest in a partnership that has not made (and does not make) an election under Code Sec. 754 will not be allocated a step-up (or step-down) in the basis of partnership assets. As a result, the purchaser will be allocated lesser depreciation deductions (assuming the basis adjustment would have been positive) over the operating life of the partnership's depreciable property. One result of these reduced depreciation allocations, however, is that the partner's outside basis in his or her partnership interest will be higher than it would be had the partner received larger depreciation allocations. The partner will therefore recognize a lower gain when (s)he later disposes of the interest in the partnership.

## Example 3-2

EXAMPLE

*J* purchases a 20% interest in Buffalo Partners, a general partnership. At the date of purchase, the partnership had the following assets:

| | ***Tax Basis*** | ***FMV*** |
|---|---|---|
| Cash | $100 | $100 |
| Depreciable property | 300 | 500 |
| Other assets | 400 | 400 |
| | $800 | $1,000 |

*J* paid $200 for a 20% interest in the partnership. Her share of the tax basis of the partnership's assets is $160 (20% of $800). Thus, if the partnership has a Code Sec. 754 election in effect (or chooses to make one), it will increase its tax basis in its assets by $40 ($200 purchase price less $160 share of "inside" basis). As will be discussed later in this course, this increase will be allocated entirely to the partnership's depreciable property (its only appreciated asset) and will be made solely for *J's* benefit.