

OPTIONAL BASIS ADJUSTMENTS

I. INTRODUCTION

As a general rule, a partnership's basis in property is its cost, or in the case of contributed property, the property's adjusted basis in the hands of the contributing partner. The Code specifically provides that the basis of partnership property as determined under the general rule cannot be adjusted as the result of a distribution of property to a partner or a transfer of a partnership interest due to a sale, an exchange, or the death of a partner, unless a Section 754 election is in effect.

If a transfer of a partnership interest takes place when the partnership's basis in partnership property does not equal its FMV, the general rule can result in discrepancies between a partner's basis in his partnership interest (outside basis) and his share of the partnership's basis in partnership property (inside basis). For example, assume Red Partnership's sole asset is a parcel of land that has a \$10,000 basis and \$16,000 FMV. Tom sells his 25% interest in Red Partnership to Al for \$4,000. Under the general rule, Al's outside basis is his cost, \$4,000, but his inside basis (i.e., his share of the partnership's basis in the land) is only \$2,500. If the partnership sells the land for \$16,000, under the general rule, Al would be allocated \$1,500 of gain (25% of the \$6,000 gain on the sale of the land) even though, in purchasing the partnership interest, he has already paid Tom for Tom's allocable share of appreciation with respect to the land. In other words, Tom has already recognized a \$1,500 gain from the sale of his partnership interest which relates to the appreciation in the value of the land held by the partnership. Unfortunately, Al also recognizes \$1,500 from his portion of the partnership's recognized gain.

In the case of a property distribution in liquidation of a partner's interest, the general rule can result in discrepancies in gain recognition to the remaining partners. For example, assume Blue Partnership owns \$10,000 cash and land with a \$10,000 basis and a \$14,000 FMV. The partnership agrees to liquidate Bonnie's 25% interest, which has a \$5,000 basis, for \$6,000 cash. Bonnie recognizes capital gain of \$1,000 from the liquidation (\$6,000 cash less \$5,000 basis). If the partnership then sells the land for \$14,000, the remaining partners recognize a \$4,000 gain instead of a \$3,000 gain (i.e., the total unrealized gain before the distribution). Without the optional basis adjustment, the remaining partners do not get "credit" for the gain recognized by Bonnie.

The optional basis adjustment allowed by the Section 754 election allows partners to avoid this problem (at least partially). IRC Sec. 754 provides that a partnership can make an election to adjust the basis of partnership property in the event of:

1. a transfer of a partnership interest by sale or exchange, or upon the death of a partner⁵ (this basis adjustment is computed under IRC Sec. 743), or
2. a distribution of property (including money) to a partner⁶ (this basis adjustment is computed under IRC Sec. 734).

The Section 754 election applies to all distributions and transfers during the tax year with respect to which the election is initially filed, and to all such transactions in any subsequent years.

II. TRANSFER OF A PARTNERSHIP INTEREST

As discussed above, the optional basis adjustment is allowed in the case of a transfer of a partnership interest only if the transfer is due to a sale or exchange, or the death of a partner. A property contribution (including cash) cannot result in an optional basis adjustment because it is not considered a sale or exchange of a partnership interest. Likewise, a gift of a partnership interest cannot create an optional basis adjustment. However, the distribution of a partnership interest by another partnership or corporation is deemed to be a sale or exchange which can trigger an optional basis adjustment. Practitioners should also note that a disguised sale can give rise to an optional basis adjustment because a disguised sale is treated like a sale for all tax purposes.

Purpose of the Optional Basis Adjustment. The transfer of a partnership interest can cause a discrepancy between the transferee partner's inside and outside basis when the partnership's basis in its assets does not equal FMV at the time of the transfer. One result of this discrepancy is that in the case of appreciated property, the transferee will recognize taxable gain when the partnership sells the property even though he has not realized an economic gain (i.e., because he paid for the unrealized appreciation when he acquired his interest). The transferee partner is also limited to his allocable share of depreciation based on the partnership's historical cost adjusted basis. For example, assume Ed purchases a 25% interest in Green Partnership for \$10,000. Green Partnership's sole asset is a tractor-trailer with a \$16,800 adjusted basis. Without a Section 754 election, Ed's allocable share of the remaining depreciation deductions is \$4,200 (25% of \$16,800). If Ed had purchased a 25% interest in the tractor-trailer itself, his total depreciation deductions would be \$10,000.

The optional basis adjustment election is an attempt to allow partners to correct these types of distortions by increasing (or decreasing) the transferee's allocable basis in the underlying partnership assets (to simulate the effects of a direct purchase of an undivided interest in the partnership assets by the transferee). Of course, if the partnership's basis in the property is greater than the FMV of the property, the optional basis adjustment has a negative effect. Therefore, before a practitioner recommends that the partnership make a Section 754 election, he must consider the FMV of all partnership property in relation to its basis. Since the Section 754 election applies to all transfers and property distributions made during and after the year that the election is in effect, the practitioner must also consider potential future appreciation and depreciation, and future transfers and distributions. (See section 1704 for a complete discussion of the Section 754 election.)

Transfer of a Partnership Interest upon the Death of a Partner. Generally, a beneficiary's basis in inherited property is equal to the FMV of the property at the decedent's date of death. If the estate elects to use the alternate valuation date, the beneficiary's basis in the property is equal to the FMV as of the date six months after the

decedent's death. These rules almost always result in a discrepancy between the beneficiary's share of inside basis in partnership assets and his outside basis in the partnership interest. An optional basis adjustment can increase the partnership's basis in property transferred upon a partner's death to its estate tax value. The Economic Growth and Tax Relief Reconciliation Act of 2001 (the 2001 Act) includes modified carryover basis rules that will apply to property received from a decedent dying after December 31, 2009. The basis of the property in the hands of the person acquiring the property at the date of the decedent's death will be the lesser of the decedent's adjusted basis or the FMV on the decedent's date of death. The executor can increase the basis of transferred property by \$1.3 million (but cannot increase the basis of property in excess of its FMV). A spousal property basis increase of \$3 million is also available, allowing the basis of property transferred to surviving spouses to be increased as much as \$4.3 million. To the extent the partner's heir has a carryover basis in the partnership interest transferred at death, no basis step-up will be available. However, to the extent the heir's basis is less than the decedent partner's basis (i.e., because the FMV of the interest on the date of death is less than the decedent's basis) or more than the decedent's basis (because the executor has chosen to allocate some of the available \$4.3 million adjustment to the partnership interest), an election under IRC Sec. 754 will result in a basis adjustment. (Note that the provisions of the 2001 Act, including the carryover basis provisions, are currently scheduled to sunset on December 31, 2010.)

Income in Respect of a Decedent (IRD). The increase in basis from the decedent's adjusted basis to FMV at the date of death does not apply to items considered IRD. IRD includes retirement payments payable to a partner's successor in interest and gain unrecognized because the installment method is used. Therefore, no part of an optional basis adjustment resulting from the death of a partner is allocated to IRD assets.

Community Property. Several states have community property laws providing that most property acquired during marriage is owned equally by husband and wife.¹⁴ In the case of a decedent, if at least 50% of all community property is included in the estate, the surviving spouse's 50% of the property is also deemed received from the decedent, and acquires a basis equal to FMV at the date of the decedent's death or the alternate valuation date. However, see later for a discussion of the provisions of the 2001 Act that will provide a carryover basis for many partnership interests transferred due to the death of a partner after December 31, 2009.

In the past, there was some uncertainty as to whether the surviving spouse's portion of a partnership interest meets the transfer requirement. The IRS has ruled that the optional basis adjustment applies to the entire partnership interest owned as community property, including the surviving spouse's share.

Computation of the Optional Basis Adjustment upon Transfer. If a Section 754 election is in effect, upon the transfer of a partnership interest due to a sale, an exchange, or the death of a partner, the partnership:

1. increases its basis in the assets by the excess of the transferee's outside basis (basis in the partnership interest) over the transferee's inside basis (proportionate share of the partnership property's adjusted basis), or
2. decreases its basis in the assets by the excess of the transferee partner's inside basis over the transferee's outside basis.

Under the rules governing transfers of partnership interests prior to December 15, 1999, a partner's inside basis was equal to his allocable share of partnership liabilities, capital and surplus. For transfers occurring on or after December 15, 1999, a transferee partner's inside basis is equal to the sum of his share of partnership liabilities plus his share of the partnership's previously taxed capital. A transferee partner's interest in previously taxed capital equals the sum of:

1. The amount of cash he would receive on a liquidation of the partnership in a fully taxable transaction for cash equal to the FMV of the partnership's assets, plus
2. The tax loss [including any remedial allocations under the Section 704(c) rules] he would be allocated on such a hypothetical liquidation, less
3. The tax gain [including any remedial allocations under the Section 704(c) rules] he would be allocated on such a hypothetical liquidation.

Effect of Optional Allocation Due to Contributed Appreciated Property. For property contributed to a partnership after March 31, 1984, regulations provide pre-contribution gain or loss is allocated to the contributing partner when such gain or loss is subsequently recognized.¹⁹ (For property contributed before April 1, 1984, pre-contribution gain or loss can be allocated to the contributing partner if the partnership so elects.)

In computing the optional basis adjustment, this allocation of pre-contribution gain or loss must be considered in determining the partner's basis. As a result, the amount of the optional basis adjustment will be affected when the step-up applies to appreciated property previously contributed to the partnership. Note: When a partner, who contributed appreciated or depreciated property to the partnership, sells his partnership interest, the Section 704(c) built-in gains and losses are taken into account in determining the purchaser's basis in partnership assets. If a Section 754 election is in effect, the purchaser's basis adjustment under IRC Sec. 743 may be attributable to Section 704(c) built-in gain or loss purchased from the transferor partner.

Partnership Termination. The sale or exchange of 50% or more of the interests in partnership capital and profits terminates the partnership under IRC Sec. 708(b)(1)(B). If a partnership terminates under this rule, it is deemed to contribute all of its property to a new partnership in exchange for all of the interests in the new partnership. The old partnership, the terminated partnership, in its last act distributes these partnership interests to the remaining partners and the new partner. (See Chapter 6, section 602.) If the terminating partnership had a Section 754 election in effect, the optional basis adjustment is made before the property is contributed to the new partnership. Thus, the

basis adjustment made for the benefit of the incoming partner is carried over to the new partnership.

However, if the partnership does not have a Section 754 election in effect and does not make one in its final return, the new partner DOES NOT satisfy the conditions for making a Section 732(d) election. This inability to make a Section 732(d) election is one of the few detriments of the current Section 708 regulations. This can have serious consequences for the new partner if the terminating partnership has not and will not make a Section 754 election in its final return.

When a merger of partnerships occurs, at least one of the entities must terminate. (See Chapter 6 for a full discussion of the tax effects occurring from a merger of two or more partnerships.) A question that might occur when a merger is being proposed would be, “what happens to the optional basis adjustments when the partnerships merge?” In a private letter ruling involving the merger of two identically owned real estate partnerships, the IRS held that the benefits from Section 743 adjustments continued to be allocated to the same partners in the same manner as before the merger.

III. DISTRIBUTION OF PROPERTY

The optional basis adjustment is also allowed if property, including cash, is distributed to a partner and the distribution results in gain or loss to the distributee partner.²³ In this situation, the optional basis adjustment is made to the property retained by the partnership.

Purpose of the Optional Basis Adjustment. As illustrated above, a property distribution to one partner can result in discrepancies in gain or loss recognized by the other partners on subsequent sales of partnership property. The optional basis adjustment attempts to correct these distortions by adjusting the partnership’s inside basis in the retained assets (with respect to all of the partners). After the optional basis adjustment is made, the unrealized gain or loss attached to the retained assets should equal the predistribution unrealized gain or loss allocable to the partners who did not receive a distribution. As an illustration, assume the same facts as before, except a Section 754 election is in effect. The partnership would increase its basis in the land by \$1,000 (the gain reported by Bonnie upon liquidating her partnership interest). The remaining partners would then recognize a \$3,000 gain (\$14,000 less \$11,000 adjusted basis) on the land sale, which equals the remaining partners’ share of unrealized gain before the distribution to Bonnie.

Computation of the Optional Basis Adjustment upon Distribution. If a Section 754 election is in effect upon the distribution of property to a partner, the partnership increases its basis in the remaining partnership assets by:

1. the gain recognized by the distributee partner due to cash received in excess of basis in the partnership interest,²⁴ or
2. the excess of the partnership’s basis in the distributed property over the basis of the property in the distributee partner’s hands.

The partnership must decrease its basis in the remaining assets by:

1. the loss recognized on the distribution by the distributee partner under IRC Sec. 731(a)(2) (a loss can only be recognized on a liquidating distribution consisting solely of cash, unrealized receivables, or inventory), or
2. the excess of the distributee's basis in the distributed property over the basis of the property in the partnership's hands before the distribution.

An optional basis adjustment can arise from a gain only if the gain is the result of a cash distribution in excess of basis. Thus, any gain arising under IRC Sec. 751 from a deemed sale of hot assets does not give rise to an optional basis adjustment. Also, a basis adjustment is not made when a partner recognizes gain under IRC Sec. 736(a) from a retirement payment. Likewise, an optional basis adjustment can arise from a loss only if the loss is recognized on a liquidating distribution of cash, unrealized receivables, and inventory in excess of the partner's basis in the partnership interest. Again, any loss arising from a deemed sale of hot assets under IRC Sec. 751 does not give rise to an optional basis adjustment.

IV. ALLOCATION OF THE OPTIONAL BASIS ADJUSTMENT

The Code provides that the optional basis adjustment is allocated among the partnership's assets to reduce the difference between the properties' FMV and adjusted bases. For purposes of this adjustment, the partnership's assets are divided into two property classes:

1. Capital gain property (capital assets and Section 1231 property).
2. Ordinary income property (assets other than capital assets and Section 1231 property).

Allocation Arising from a Transfer of a Partnership Interest. An optional basis adjustment that results from the transfer of a partnership interest is first allocated between capital gain property and ordinary income property.

Transfers prior to December 15, 1999. For transfers of partnership interests prior to December 15, 1999, the optional basis adjustment was allocated between the two classes of property based on the proportionate differences between the FMVs of the property in each class and their adjusted bases. Note that this does not necessarily achieve the same result as allocating the basis adjustment according to relative FMV. The optional basis adjustment allocated to a class of property was then allocated among the properties within the class in a similar manner.

For transfers prior to December 15, 1999, the optional basis adjustment allocated to a property class was allocated to the various individual assets within the class based on the difference between the FMV and basis of each property in proportion to the difference between the FMV and basis of all properties within the class. It should be noted that under these rules, a basis step-up could be allocated only to properties with FMVs in excess of basis. Similarly, a basis step-down could be allocated only to properties with FMVs less than basis.

Transfers on or after December 15, 1999. For transfers occurring on or after December 15, 1999, the allocation of the optional basis adjustment between property classes is based on the gain or loss for each class of assets that would be allocated to the transferee partner based on a hypothetical liquidation of the partnership.³¹ Accordingly, it is possible for a positive adjustment to be made to one class of property, while a negative adjustment is made to the other.

The basis adjustment allocable to ordinary income property equals the total amount of income, gain, or loss [including any remedial allocations under Reg. 1.704-3(d)] allocated to the transferee partner from the sale of all ordinary income property in a hypothetical liquidation of all of the partnership's property in a fully taxable transaction for cash in the amount equal to the FMV of such property. The IRS has indicated that it intends to issue guidance outlining rules for determining the FMV of partnership assets for this purpose. They have indicated that this guidance will provide that the FMV of an asset subject to nonrecourse debt cannot be less than the amount of that debt (Preamble to TD 8847).

For allocations within the ordinary income class of property, the basis adjustment allocable to an item of ordinary income property equals:

$$\left(\begin{array}{l} \text{The income, gain, or loss} \\ \text{[including any remedial} \\ \text{allocations under Reg. 1.704} \\ \text{-3(d)] allocated to the} \\ \text{transferee from the hypothetical} \\ \text{sale of that item} \end{array} \right) - \left(\begin{array}{l} \text{Any decrease to the basis} \\ \text{: adjustment for ordinary income} \\ \text{property because the} \\ \text{partnerships decrease} \\ \text{allocable to capital gain} \\ \text{property exceeded the basis of} \\ \text{the partnership's capital gain} \\ \text{property} \end{array} \right) \times \frac{\text{FMV of the item of property to} \\ \text{the partnership}}{\text{FMV of all items of partnership} \\ \text{ordinary income property}}$$

The basis adjustment allocable to capital gain property is the total basis adjustment less the amount allocated to the ordinary income property.³³ However, any decrease in basis allocable to capital gain property cannot exceed the partnership's basis [or in the case of property subject to the remedial allocation method, the transferee's share of any remedial loss under Reg 1.704-3(d) from the hypothetical liquidation] in that property. If the decrease allocable to capital gain property exceeds the basis of capital gain property, the excess is applied to reduce the basis of ordinary income property.

For allocations within the capital gain class of property, the basis adjustment allocable to an item of capital gain property equals:

$$\left(\begin{array}{l} \text{The income, gain,} \\ \text{or loss [including} \\ \text{any remedial} \\ \text{allocations under} \\ \text{Reg. 1.704-3(d)} \\ \text{] allocated to the} \\ \text{transferee from the} \\ \text{hypothetical sale of} \\ \text{that item} \end{array} \right) - \left(\begin{array}{l} \text{The total gain or} \\ \text{loss [including any} \\ \text{remedial} \\ \text{allocations under} \\ \text{Reg. 1.704-3(d)} \\ \text{] allocated to the} \\ \text{transferee from the} \\ \text{hypothetical sale of} \\ \text{all capital gain} \\ \text{property} \end{array} \right) - \left(\begin{array}{l} \text{The positive basis} \\ \text{adjustment to all} \\ \text{items of capital} \\ \text{gain property} \end{array} \right) \text{ OR } \left(\begin{array}{l} \text{The amount of the} \\ \text{negative basis} \\ \text{adjustment to all} \\ \text{items of capital} \\ \text{gain property} \end{array} \right) + \left(\begin{array}{l} \text{The positive basis} \\ \text{adjustment to all} \\ \text{items of capital} \\ \text{gain property} \end{array} \right) \times \frac{\text{FMV of the item of} \\ \text{property to the} \\ \text{partnership}}{\text{FMV of all items of} \\ \text{partnership capital} \\ \text{gain property}}$$

The portion of this equation in parentheses will not come into play, unless the amount of gain that would be allocated to the transferee from the sale of capital gain property exceeds the basis adjustment allocated to capital gain property.

Transferred Basis Exchanges. The final regulations issued on December 15, 1999 (and applicable to distributions on or after December 15, 1999) include special rules that apply to transferred basis exchanges. A transferred basis exchange is an exchange in which the transferee's basis in the partnership interest received is determined in whole or in part by reference to the transferor's basis in the interest.³⁴ For example, the rules apply if a partnership interest is contributed to a corporation or partnership. The new rules for transferred basis exchanges do not contain a specific anti-abuse rule. However, the preamble to the final regulations indicates that the IRS may attack abusive transfers under these rules under a variety of judicial doctrines, including substance over form and step transaction arguments.

If a transferred basis exchange occurs and the total basis adjustment is zero, no adjustment is made to the basis of partnership property. If there is an increase in basis, the increase can only be allocated to a class of property if the gain or loss [including any remedial allocations under Reg. 1.704-3(d)] on a hypothetical sale of all such property would result in the recognition of a net gain or net income by the transferee partner. If there is a decrease in basis, the decrease can only be allocated to a class of property if the gain or loss [including any remedial allocations under Reg. 1.704-3(d)] on a hypothetical sale of all such property would result in the recognition of a net loss by the transferee partner. Where an increase or decrease in basis may be allocated to both capital gain and ordinary income property, the increase or decrease is allocated between the classes in proportion to the net gain or net loss, respectively, that would be allocated to the transferee from the sale of all assets in each class.

An increase to the basis of a class of assets is allocated within the class first to properties with unrealized appreciation in proportion to the transferee's share of the respective amounts of unrealized appreciation before the increase (but only to the extent of the transferee's share of each property's unrealized appreciation). Any remaining increase is allocated among the properties within the class in proportion to the transferee's share of the amount that would be realized by the partnership upon the hypothetical sale of each asset in the class. A decrease to the basis of a class of assets is allocated within the class first to properties with unrealized depreciation in proportion to the transferee's share of the respective amounts of unrealized depreciation before the decrease (but only to the extent of the transferee's share of each property's unrealized depreciation). Any remaining decrease is allocated among the properties within the class in proportion to the transferee's share of the adjusted bases of the assets (after the adjustment for unrealized depreciation described in the preceding sentence). Where the amount of a decrease otherwise allocable to a particular class exceeds the transferee's share of the adjusted basis to the partnership of all depreciated assets in that class, the negative basis adjustment is limited to the transferee's share of the partnership's adjusted basis in all depreciated assets in that class. If a negative adjustment cannot be allocated under this

rule, the adjustment is carried forward and made when the partnership subsequently acquires property of a like character.

Subsequent Transfers. Special rules apply to property with an optional basis adjustment if it is subsequently transferred, distributed, or contributed (to a corporation or partnership). For distributions prior to December 15, 1999, the following rules applied:

1. A partner who received a distribution of property with respect to which another partner had a special basis adjustment did not take the basis adjustment of the other partner into account. The partner with the special basis adjustment reallocated the basis adjustment under the Section 755 rules to remaining partnership property of a like kind or, if he received a distribution of like property, he allocated the adjustment to the distributed property.
2. A partner who received a distribution of property with respect to which he had a special basis adjustment, took the basis adjustment into account to determine the basis of the distributed property.
3. If a partner received a distribution of property and relinquished his interest in other property of a like kind with respect to which he had a special basis adjustment, the partnership's adjusted basis in the distributed property was deemed to include the distributee partner's basis adjustment for the property in which he relinquished an interest. A partner was considered to have relinquished an interest in any remaining partnership property when his interest was completely liquidated. However, even if no liquidating distribution occurred, he was considered to relinquish his interest in any property distributed to the other partners.
4. If a partner received a distribution of property (including money) with respect to which he had no special basis adjustment in liquidation of his partnership interest, and did not use his entire basis adjustment to determine the basis of the distributed property, the partnership applies any unused basis adjustment to the basis of remaining partnership property.
5. If a partnership transferred property with respect to which there was a special basis adjustment to a corporation in a Section 351 exchange, the corporation took the basis adjustment into account when determining its basis in the transferred assets. However, to the extent the special basis adjustment reduced any gain recognized on the contribution by the transferring partnership, it was not available to increase the basis of the corporation's assets. The partnership's basis in the stock received in a Section 351 exchange was determined without reference to the special basis adjustment attached to property contributed to the corporation. However, a partner with a special basis adjustment with respect to property transferred by a partnership to a corporation in a Section 351 exchange had a special basis adjustment with respect to the stock received by the partnership.

For distributions occurring on or after December 15, 1999, the rules discussed in this paragraph apply [the rules of IRC Secs. 704(c)(1)(B), , 731, , 731, 737, and , 731, 737, and 751 apply before rules 1 through 6]:

1. Where there has been more than one transfer of a partnership interest, a transferee partner's basis is determined without regard to any prior transferee's basis adjustment.
2. A partner who gifts property with respect to which he has a special basis adjustment is treated as transferring the portion of the basis adjustment attributable to the gifted partnership interest.
3. A partner who receives a distribution of property with respect to which another partner has a special basis adjustment does not take the basis adjustment of the other partner into account. The partner with the special basis adjustment reallocates the basis adjustment under the Section 755 rules to remaining partnership property of a like kind or, if he receives a distribution of like property, he allocates the adjustment to the distributed property.
4. A partner who receives a distribution of property with respect to which he has a special basis adjustment, takes the basis adjustment into account in determining the basis of the distributed property.
5. If a partner receives a distribution of property and relinquishes his interest in other property of a like kind with respect to which he has a special basis adjustment, the partnership's adjusted basis in the distributed property is deemed to include the distributee partner's basis adjustment for the property in which he relinquished an interest. A partner is considered to have relinquished an interest in any remaining partnership property when his interest is completely liquidated. However, even if no liquidating distribution occurs, he is considered to relinquish his interest in any property distributed to the other partners.
6. If a partner receives a distribution of property (including money) with respect to which he has no special basis adjustment in liquidation of his partnership interest, and does not use his entire basis adjustment to determine the basis of the distributed property, the partnership applies any unused basis adjustment to the basis of remaining partnership property.
7. If an upper tier partnership contributes property with respect to which a special basis adjustment has been made to a lower tier partnership, the basis adjustment is considered contributed to the lower tier partnership, regardless of whether the lower tier partnership has a Section 754 election in effect. The basis adjustment of both the upper tier and lower tier partnership must be segregated and allocated solely to the transferee.
8. A partner with a basis adjustment in property held by a partnership that terminates under the Section 708 technical termination rules (see Chapter 6 for a discussion of the technical termination rules) continues to have the same basis adjustment with respect to property deemed contributed to the new partnership.
9. If a partnership transfers property with respect to which there is a special basis adjustment to a corporation in a Section 351 exchange, the corporation takes the basis adjustment into account when determining its basis in the transferred assets. However, to the extent the special basis adjustment reduces any gain recognized on the contribution by the transferring

partnership, it is not available to increase the basis of the corporation's assets. The partnership's basis in the stock received in a Section 351 exchange is determined without reference to the special basis adjustment attached to property contributed to the corporation. However, a partner with a special basis adjustment with respect to property transferred by a partnership to a corporation in a Section 351 exchange has a special basis adjustment with respect to the stock received by the partnership.

Allocation Arising from a Distribution of Property. In the case of a property distribution, the partnership's remaining assets are also divided into the two property classes described previously, capital gain property and ordinary income property.

Distributions prior to December 15, 1999. For distributions prior to December 15, 1999, the optional basis adjustment was allocated to the same property class as that in which the distributed property falls. For example, if a partnership distributed inventory, the resulting optional basis adjustment was allocated to the partnership's remaining ordinary income property. When an optional basis adjustment resulted from the partner recognizing a gain from the distribution of cash or a loss from the distribution of cash, unrealized receivables, and inventory, the optional basis adjustment was allocated to the partnership's capital gain property.

The optional basis adjustment allocated to a class of property was then allocated to the various individual properties within the class based on the difference between the FMV and basis of each property in proportion to the difference between the FMV and basis of all properties within the class. It should be noted that a basis step-up could be allocated only to properties with FMVs that are in excess of basis. Similarly, a basis step-down could be allocated only to properties with FMVs that were less than basis.

The basis of partnership assets could not be decreased below zero by an optional basis adjustment resulting from a distribution prior to December 15, 1999. Any unused adjustment was suspended until the partnership acquired property in the same class which declined in value.⁴¹ If, in the case of a distribution, the partnership did not have any remaining assets in the same class as that of the distributed property, the adjustment was suspended until the partnership acquired property within the same class.

Distributions on or after December 15, 1999. For distributions occurring on or after December 15, 1999, the optional basis adjustment is allocated to the same property class as that in which the distributed property is included. A basis adjustment resulting from the recognition of gain on a cash distribution or loss from the distribution of cash, unrealized receivables, and inventory, must be allocated to the partnership's capital gain property. These are the same rules that applied prior to December 15, 1999.

For allocations of increases within a class, the increase is allocated first to properties with unrealized appreciation in proportion to their respective unrealized appreciation (but only to the extent of each property's unrealized appreciation). Any remaining increase is allocated among the properties within that class in proportion to their FMVs.

Any decrease is allocated first to properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation (but only to the extent of each property's unrealized depreciation). Any remaining decrease is allocated among the properties within the class in proportion to their adjusted basis (taking into account the adjustment described in the preceding sentence).

If a decrease in the basis of partnership property is required and the basis adjustment exceeds the remaining basis of the partnership property in the required class, the basis of such property is reduced to zero, but never below zero. In such cases, the unused basis adjustment is carried over until such time as the partnership acquires property of the appropriate class to which an adjustment can be made. The carryover provision also applies when there is no property remaining in the partnership of the appropriate class.

Timing of Adjustment. In a revenue ruling the IRS addressed the issue of when to make the basis adjustment arising from a cash distribution in excess of basis. Under IRC Sec. 732, gain is recognized when cash distributions exceed the basis of a partner's interest. In the ruling, the IRS indicated the timing and amount of the adjustment by the partnership would correspond with the gain recognized by the partner. For example, if a partnership that has a Section 754 election in effect completely liquidates the interest of a partner by agreeing to make a series of cash payments that are treated as Section 736(b) payments for partnership property, the Section 734(b) basis adjustments should respond in timing and amount with the recognition of gain or loss by the retiring partner with respect to those payments.

MAKING THE SECTION 754 ELECTION

Once the partnership has elected IRC Sec. 754, the optional basis adjustment must be made each time a partnership interest is sold, exchanged, or transferred due to a partner's death. An adjustment must also be made if a distribution causes a partner to recognize gain or loss. An adjustment is needed when distributed property has a higher or lower assigned basis in the distributee partner's hands than it had on the partnership's books. (Note that a taxpayer was permitted a one-time-only revocation of its Section 754 election without IRS permission for the tax year that included December 15, 1999.)

The Section 754 election must be made by the due date of the return (including extensions) for the year during which the distribution of property or transfer of the partnership interest occurs. The election is made by attaching a statement to the partnership's return. The statement should include:

1. The name, address, and taxpayer identification number of the partnership.
2. A declaration that the partnership elects under IRC Sec. 754 to apply the provisions of IRC Secs. 734(b) or 743(b).

The statement should be signed by an authorized partner.

An automatic 12-month extension (from the original due date of the election) is granted for any election that has a due date prescribed by regulation or other administrative

pronouncement—including a Section 754 election. If the conditions to qualify for the automatic extension are not satisfied, the IRS will still grant an extension of time to make the Section 754 election if (1) the taxpayer provides evidence that the taxpayer acted reasonably and in good faith, and (2) granting relief would not prejudice the interests of the government. In addition, the taxpayer must show that there were “unusual and compelling circumstances” for missing the filing deadline.

Filing and Recordkeeping Requirements. The regulations contain several filing and recordkeeping requirements that must be met if a Section 754 election is in effect. These regulations were changed significantly by the final regulations issued in January 1999. In the case of a distribution to a partner that results in the partnership adjusting its basis in remaining partnership assets the partnership must attach a statement to its return for the year such distribution is made. The statement should show the computation and allocation of the optional basis adjustment.

Transfers prior to December 15, 1999. The rules for reporting basis adjustments for transfers of partnership interests were changed by final regulations effective December 15, 1999. For transfers prior to that date, when a partnership interest was transferred due to a sale, exchange, or death of a partner, the transferee partner had to attach a statement to his return for the first year the adjustment affected his taxable income. For example, in the case of nondepreciable assets, the partner attached the statement when he reported the property sale. The statement should include the computation and allocation of the optional basis adjustment. Under the prior regulations there was no guidance regarding who should maintain the records regarding an optional basis adjustment in the case of a transfer of a partnership interest.

Transfers on or after December 15, 1999. For transfers occurring on or after December 15, 1999, there is no longer a requirement for the transferee partner to attach a statement to his return for the first year the adjustment affects his taxable income. However, the final regulations require the partnership to attach a statement to the partnership return for the year of the transfer that provides the name and TIN of the transferee partner and the computation and allocation of the adjustment. Where an interest is transferred in a partnership that holds oil and gas properties that are depleted at the partner level [under IRC Sec. 613A(c)(7)(D)], the transferee must attach a statement to his return for the year of the transfer. The statement must include a computation of the basis adjustment allocable to such properties and the specific properties to which the adjustment has been allocated.

In a new requirement, a transferee partner acquiring an interest by sale or exchange in a partnership with a Section 754 election in effect will have to notify the partnership in writing within 30 days of the transfer. The written notice must contain the names and addresses of the transferor and the transferee (if ascertainable), the TINs of the transferee and the transferor (if ascertainable) the relationship (if any) between the transferor and the transferee, the date of the transfer, the amount of any liabilities assumed or taken subject to by the transferee, and the amount of money and the FMV of any property delivered or to be delivered for the transferred interest, and any other information

necessary for the partnership to compute the transferee's basis. The statement must be signed by the transferee under penalties of perjury..

In the case of a transfer upon death, the transferee partner has one year from the date of death to notify the partnership in writing. The written notice must include the names, addresses, and TINs of both the deceased and the transferee partner, the relationship (if any) between the transferee and the transferor, the date on which the transferee became owner of the partnership interest, the FMV of the partnership interest on the applicable valuation date and the method used to determine FMV. The statement must be signed by the transferee under penalties of perjury.

The partnership may rely upon these written notices to determine the transferee partner's basis adjustments. However, the partnership may not rely on a notice from the transferee partner if any partner responsible for federal income tax reporting by the partnership has knowledge that the statement is erroneous. The partnership is not required to make the adjustment until such time as it has received the written notices. However, the partnership is treated as having received written notice if any partner who has responsibility for federal income tax reporting by the partnership has knowledge that there has been a transfer of a partnership interest.

If the transferee partner does not comply by providing written notice, the partnership must attach a statement to its return when it is otherwise notified of the transfer. The statement must set forth the name and TIN, if known, of the transferee. In addition, on the first page of the partnership's return and on the first page of any schedule or information statement relating to the transferee partner's share of income, deductions, credits, etc., the following caption must prominently appear: RETURN FILED PURSUANT TO SECTION 1.743-1(k)(5). In this fashion, the partnership can report the transferee partner's share of partnership items, without any adjustment being made for the transferee partner's benefit. After written notice is received from the transferee partner, the partnership must make the applicable adjustments to adjust the basis of the partnership property, as of the date of transfer, in any amended return otherwise to be filed by the partnership or in the next regularly filed return. At such time the partnership must provide sufficient information for the transferee partner to file amended returns to properly reflect the Section 743 adjustment.

In another departure from the current regulations, the final regulations require the partnership to reflect the effect of the basis adjustments on the partnership return. The partnership first computes its taxable income under IRC Sec. 703. Next, it allocates among the partners, including the transferee partner, each partner's distributive share under IRC Sec. 704 and adjusts the capital accounts accordingly.⁶² The partnership then adjusts the transferee partner's share of the items of partnership income, deduction, gain, or loss to reflect the effects of the transferee's basis adjustment. These adjustments are reflected on Schedules K and K-1 of the partnership's income tax return, but do not affect the transferee's capital account. For example, if the partnership sells an asset, the partnership allocates to each partner the distributive share of gain or loss from the disposition of the asset, including any remedial allocation under Reg. 1.704-3(d). From

this amount the partnership subtracts any positive basis adjustment or adds a negative basis adjustment made for the benefit of the transferee partner.

Revocation of the Section 754 Election. The Section 754 election generally can be revoked only with permission from the IRS. However, see the following paragraph for a special one-time revocation election. A partnership wishing to revoke the election should file a request with the District Director within 30 days after the close of the partnership year for which the revocation is intended to take effect. The request should state the reason for the revocation. Regulations list the following acceptable reasons:

1. Change in the nature of the partnership's business.
2. Substantial increase in partnership assets.
3. Change in the character of partnership assets.
4. Increased frequency of retirements or shifts of partnership interests increasing the administrative burdens of the election.

Any partnership that had a Section 754 election in effect for its tax year that included December 15, 1999 could revoke the election by attaching a statement to the partnership's timely-filed return (including extensions) for that year. This was a one-time only opportunity to revoke the Section 754 election without IRS permission. The statement was required to include the name and address of the partnership revoking the election, be signed by any partner authorized to sign the partnership's federal income tax return, and contain a declaration that the partnership revoked its election under IRC Sec. 754 to apply the provisions of IRC Secs. 734(b) and 743(b). The first page of the partnership's federal income tax return was required to include the legend "RETURN FILED PURSUANT TO SECTION 1.754-1(c)(2)." The IRS has granted an extension of time to file the revocation where the partnership inadvertently failed to file the revocation in a timely fashion.

Tiered Partnerships. In the case of tiered partnerships, both partnerships must make the Section 754 election for a distribution or transfer of partnership interest at the upper-tier partnership to trigger an optional basis adjustment at the lower-tier partnership.

The IRS has ruled on two situations in which tiered partnerships may adjust the basis of both upper-tier and lower-tier partnership assets upon a distribution of upper-tier partnership property. In the first situation, an upper-tier partnership owning capital assets and an interest in a lower-tier partnership was allowed to adjust the basis of the lower-tier partnership interest when capital assets distributed to a partner in the upper-tier partnership were assigned a lower basis than the partnership's basis in the property. The IRS also indicated the lower-tier partnership was allowed to adjust the basis of its assets by the amount of the upper-tier step-up allocated to the lower-tier partnership interest. In a surprising move, the IRS stated that the lower-tier partnership's step-up would be solely for the benefit of the upper-tier partnership, and not the other partners in the lower-tier partnership. In the second situation addressed by the ruling, an upper-tier partnership was permitted to adjust the basis of its other assets upon a distribution of the lower-tier partnership interest to a partner whose basis in the distributed interest was less than the

partnership's basis in the interest. The lower-tier partnership then was allowed to adjust the basis of its assets based on the transfer of the upper-tier partnership's interest.

V. SPECIAL PARTNERSHIP BASIS TO TRANSFEREE PARTNER

The Code provides one other exception which allows a distributee partner to adjust the basis of distributed assets in limited situations. The partner may elect to allocate his basis as if the Section 754 election had been in effect on the date he acquired his interest, if (1) the partner purchases, exchanges, or inherits his interest, (2) no Section 754 election has been made, and (3) the property is distributed within two years after the partner acquires his interest. This election [the Section 732(d) election] provides for an allocation of the distributed property's basis to reflect more clearly the assets' FMV at the time the interest was acquired.

Although, in most cases, IRC Sec. 732(d) applies to distributed property only at the partner's election, the IRS has the authority to require the application of IRC Sec. 732(d) if the property's FMV is greater than 110% of the partnership's adjusted basis at the time of the transfer.⁸¹ The IRS may make the Section 732(d) allocation even though the distribution occurs more than two years after the partner acquired the partnership interest. Regulations provide this mandatory allocation will be made if:

1. upon liquidation of the partnership interest immediately after acquisition, the general basis allocation rules would have shifted basis from nondepreciable property to depreciable property, and
2. the basis to the transferee partner would be changed by an optional basis adjustment if a Section 754 election had been in effect.

For distributions made on or after December 15, 1999, if a transferee partner notifies a partnership that it plans to make the election under IRC Sec. 732(d) or if a partnership makes a distribution that requires the Section 732(d) adjustment be made, the partnership must provide the transferee with the information necessary to compute its basis adjustment.⁸³ In addition, if a distribution to which IRC Sec. 732(d) applies occurs on or after December 15, 1999, the provisions of the regulations in effect for transfers on or after that date should be used to calculate and allocate the basis adjustment.