Section 754
Making the Election or Not

2009 Fall Joint CLE Meeting
American Bar Association
Taxation Section
Trust and Estate Law Division of
The Section of Real Property, Trust and Estate Law

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The panelists are grateful to Carol Cantrell for her permission to use the Section 754 portions of her excellent outline entitled *Income Tax Problems When The Estate or Trust is a Partner* prepared in connection with her April 2009 presentation in New York City at the ALI-ABA symposium *Planning Techniques for Large Estates*.

Attached are Section III—The Section 754 Election and Exhibit B—Section 754 Decision Tree.

taxes. *** Your committee's bill agrees substantially with the House in the treatment described above but also provides that other income apart from unrealized receivables is to be treated as income in respect of a decedent. [S. Rept. No. 1622, 83d Cong., 2d Sess., p. 99 (1954)]

Less than seven months after Quick was decided, the Ninth Circuit also upheld the Tax Court in a case with facts nearly identical to those in Quick. In Woodhall v. Commissioner, the Ninth Circuit held that payments received by the estate of a general partner in a two-man partnership pursuant to a written buy-sell agreement providing that the partnership shall terminate upon the death of either partner and the survivor shall purchase the decedent's interest in the partnership were IRD. Like Quick, it relied on the legislative history of §§ 741, 743, and 751 wherein the House Report specifically states that "A decedent partner's share of unrealized receivables and fees will be treated as income in respect of a decedent."

Whether the courts will expand the scope of Quick and Woodhall to include more categories of IRD from a partnership than unrealized accounts receivable is unclear. These cases have neither been followed nor criticized by other Circuit Courts of Appeal. But they have generated considerable disagreement among commentators. In the meantime, it is not altogether clear which payments, if any, other than those under § 736(a) should constitute IRD of a deceased partner. The regulations don't mention anything other than § 736(a) payments as IRD. But the preamble to Reg. § 1.755-1(b)(4) suggests that Treasury and the IRS adopt the Quick and Woodhall holdings. Taxpayers may challenge these holdings in another circuit court someday.

2. Reporting Requirements

The estate is responsible for reporting IRD and the related estate tax deduction and allocating it between the estate and beneficiary based on the amount it retains or distributes. The instructions to Form 1041, U.S. Income Tax Return for Estates and Trusts, require an estate or trust to attach a schedule showing how the IRD deduction was calculated. However neither the § 691(c) regulations nor the instructions to the partnership Form 1065 require the partnership to identify or report IRD it pays to an estate or other successor of a deceased partner.

III. THE SECTION 754 ELECTION

When a partner dies, the basis of his partnership interest is adjusted to its fair market value on the partner's date of death or the alternate valuation date, if applicable, less any income in respect of a decedent attributable to the partnership interest. In addition, the estate or successor partner receives a long-term holding period in his partnership interest. But this only affects the decedent's or his successor's partnership interest and has no effect on the underlying

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43 Quick Trust v. Comm'r, 54 T.C. 1336, 1345, aff'd 444 F.2d 90 (8th Cir. 1971).
44 Woodhall v. Comm'r, 28 T.C.M. 1438, aff'd 454 F.2d 226 (9th Cir. 1972).
47 Reg. § 1.753-1.
48 Reg. § 1.691(c)-2.
49 IRC § 1014(a)(1); Reg. § 1.742-1; see also discussion at Section II.C infra.
50 IRC § 1223(9).
partnership property. Thus, if the partnership sells an asset immediately after a partner dies, the partner’s estate or other successor will report gain as if no basis adjustment occurred as a result of the decedent partner’s death.

However, if the partnership makes a § 754 election, the estate or successor partner adjusts his share of the inside basis of partnership assets to equal its outside basis. The successor partner acquires a basis in his share of the underlying partnership assets as if he had purchased an undivided interest in them at market value on the date of death. It has no effect on the holding period, however. Nor does it affect the basis of any other partner.51

This inside basis increase allows the successor partner to recognize a smaller share of gain or a larger share of loss than his fellow partners when the partnership sells the assets on hand at the decedent’s date of death. He can also claim higher depreciation deductions than his partners based on his higher inside depreciable basis. The increase is treated as newly-purchased recovery property placed in service when the transfer (death) occurs.52 Any applicable recovery period and method may be used. Therefore, conventional wisdom usually suggests making the § 754 election on the death of a partner.

However, the § 754 election can be a two-edged sword. First, the recordkeeping can be a burden. Second, it causes a step-down as well as a step-up in basis for the successor partner if the partnership assets are worth less than their tax basis on the date of the transfer. For example, a § 754 election is not desirable when discounts on the outside partnership interest would reduce the decedent’s share of inside basis of partnership assets to below his share of their cost basis.53 Third, the election is irrevocable without the consent of the IRS. Thus it causes inside basis adjustments at each subsequent partner’s death whether the partners desire it or not. And fourth, it requires the partnership to adjust the basis of its assets when it makes certain types of distributions.54 In short, it affects every partner from that point forward.

A. Mechanics: The Hypothetical Sale

The outside basis in the decedent’s partnership interest is adjusted to the value on the partner’s date of death, or the alternate valuation date, if applicable, regardless of whether a § 754 election is made.55 The basis increase will eventually provide a tax savings for the successor when the partnership interest is sold or liquidated. However, wanting to reap the tax benefits of a basis step-up sooner, many partnerships make the § 754 election. This pushes the outside step-up or step-down to the inside basis of the partnership assets with respect to the decedent partner’s interest. Thus, sales of property occurring fairly soon after death will result in little or no gain to the successor partner due to the § 754 basis adjustment.

51 Reg. § 1.743-1(j)(1).
52 Reg. § 1.743-1(j)(4)(i)(B); On the other hand, any decrease in the basis of depreciable property under a § 754 election is recovered over the remaining useful life of the partnership’s depreciable property under Reg. § 1.743-1(j)(4)(ii)(B).
53 See discussion at Section III.D. infra.
54 See discussion at Section III.G infra.
55 IRC § 1014(a).
The regulations provide how to allocate a transferee's basis in his partnership interest among his share of the underlying partnership assets when the partnership makes a § 754 election. The goal of § 754 is to achieve uniformity between the inside and outside basis when there has been a transfer of a partnership interest by sale or exchange or upon the death of a partner. Stated another way, a transferee partner of a partnership that made a § 754 election should have the same basis in his share of the underlying partnership assets as if he had purchased an undivided interest in them. To achieve this goal, regulations provide a three-step process.

**Step One** - Determine the difference between the partner's basis of his partnership interest and his share of the adjusted basis of partnership property. This difference is the § 743 adjustment. The basis of a purchased interest is its cost. The basis of an interest acquired from a decedent is the fair market value at the date of death or the alternate valuation date.

**Step Two** - Separate the adjustment into two classes - ordinary income and capital gain property. Apply the adjustment first to ordinary income property in an amount equal to the income that would be allocated on sale of that asset at fair market value. Apply the remaining balance of the adjustment to the capital gain class. One class may get a step-up in basis and another class may be allocated a step-down.

**Step Three** - Allocate the step-up or down for each class among the assets within each class on an asset by asset basis based on the taxable gain or loss that would be allocated to the transferee from the "hypothetical sale" of each item.

**EXAMPLE**

Joe died with an interest in partnership that has only marketable securities. His partnership interest is valued at $17,500 based on a hypothetical sale of his share of the underlying assets. His share of the basis in those assets is $11,200. The Section 743 adjustment is $6,300 ($17,500 - 11,200) and is allocated as follows:

<table>
<thead>
<tr>
<th>Stock</th>
<th>Basis before</th>
<th>743 Adj</th>
<th>FMV</th>
<th>Adj.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock A</td>
<td>6,000</td>
<td>2,000</td>
<td>-4,000</td>
<td></td>
</tr>
<tr>
<td>Stock B</td>
<td>1,800</td>
<td>9,200</td>
<td>+7,400</td>
<td></td>
</tr>
<tr>
<td>Stock C</td>
<td>3,300</td>
<td>2,800</td>
<td>-500</td>
<td></td>
</tr>
<tr>
<td>Stock D</td>
<td>100</td>
<td>3,500</td>
<td>+3,400</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$11,200</td>
<td>17,500</td>
<td>6,300</td>
<td></td>
</tr>
</tbody>
</table>

56 Regs. §§ 1.743-1, 1.755-1.
57 Reg. § 1.743-1(b)-(d).
58 Reg. § 1.742-1.
59 Reg. § 1.755-1(a).
60 Reg. § 1.755-1(b)(2).
61 Reg. § 1.755-1(b)(3).
B. Applying Partnership Discounts

A “hypothetical sale” of the underlying partnership assets will always produce a higher value than a sale of a discounted minority interest in them. Thus the question arises how to allocate valuation discounts among the partnership assets. The regulations provide an example of a partner who sells his interest for less than fair market value, which would be similar to a discount based on restrictions in the partnership agreement. In the example, the discount is allocated to the partnership’s capital gain assets based on each property’s relative fair market value as a percentage of all the capital gain assets.

EXAMPLE

Joe died with an interest in partnership that has only marketable securities. His share of the underlying assets is worth $17,500 based on a hypothetical sale of those assets. However, an appraiser values his interest at $14,000 based on discounts for lack of marketability and control. Joe’s share of the basis in those assets is $11,200. The total gain that would be allocated from a hypothetical sale of those assets is $6,300 ($17,500 - $11,200). However, this exceeds the total basis adjustment required under Section 743 by $3,500 ($17,500 - $14,000), which is the amount of the discount. Therefore, the $3,500 discount and is allocated as follows:

<table>
<thead>
<tr>
<th>Basis before 743</th>
<th>FMV Adj.</th>
<th>Discount Adjusted</th>
<th>Basis Adjusted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock A 6,000</td>
<td>2,000</td>
<td>-4,000</td>
<td>1,600</td>
</tr>
<tr>
<td>Stock B 1,800</td>
<td>9,200</td>
<td>+7,400</td>
<td>7,360</td>
</tr>
<tr>
<td>Stock C 3,300</td>
<td>2,800</td>
<td>-500</td>
<td>2,240</td>
</tr>
<tr>
<td>Stock D 100</td>
<td>3,500</td>
<td>+3,400</td>
<td>2,800</td>
</tr>
<tr>
<td>Total 11,200</td>
<td>17,500</td>
<td>6,300</td>
<td>-3,500 $14,000</td>
</tr>
</tbody>
</table>

Stated more simply, each asset derives a new basis equal to a fraction of the total discounted value based on each asset’s fair market value as it relates to the total fair market value. In the example above, Stock D comprises 20 percent of the total fair market value ($3,500/$17,500 = 20%). Therefore, Stock D has a new basis under Section 743 of $2,800, or 20 percent of $14,000.

C. Effect on Community Property

A § 754 election permits an adjustment to be made under § 743(b) to the basis of partnership property “...in the case of a transfer of an interest in a partnership by sale or exchange or on the death of a partner.” In community property states the surviving spouse’s one-half community interest in the partnership is not “transferred” upon the decedent’s death because the surviving

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62 Reg. § 1.755-1(b)(3)(iii), Ex. 2.
63 Reg. § 1.755-1(b)(3)(iii), Ex. 2.
64 Id.
65 $2000/$17,500 X $3,500 = $400.
spouse owns it to start with. However, by statutory grace, the survivor obtains a basis adjustment under §1014(b)(6). Despite that the §754 election should not literally apply to the surviving spouse's community property interest in the partnership, the IRS has ruled that the §754 optional basis adjustment applies to the entire partnership interest owned as community property, including the surviving spouse's share. The same result applies if the nonpartner spouse predeceases the partner spouse. While seemingly incorrect, the ruling is favorable to the taxpayers and solves the accounting problems that arise from a bifurcated basis attributable to the surviving spouse's partnership interest.

D. When Not to Make the Election

If the discounted value of the partnership interest is less than the partnership's cost basis in the underlying assets, the partnership should not make the §754 election. If made, the election will reduce the decedent partner's share of the cost basis of the partnership assets to the discounted amount. However, for deaths occurring after October 22, 2004 the partnership will be forced to make a downward adjustment if the cost basis of all the partnership property exceeds its fair market value by more than $250,000.

EXAMPLE

Assume that DMS partnership has marketable securities with a cost basis of $100,000 and a market value of $150,000. However, an appraisal applies a 50 percent discount, valuing the partnership at only $75,000. D, a 20 percent partner dies and DMS partnership makes §754 election. D's new basis on his date of death is $15,000, or 20 percent of $75,000. Shortly after his death, the partnership sells all of the stock for $150,000. The tax consequences to D's successor in interest are:

<table>
<thead>
<tr>
<th></th>
<th>With §754 Election</th>
<th>Without §754 Election</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales Proceeds</td>
<td></td>
<td></td>
</tr>
<tr>
<td>allocable to D</td>
<td>30,000</td>
<td>30,000</td>
</tr>
<tr>
<td>(20% X $150,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>D's Stock Basis</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(20% X $75,000)</td>
<td>-15,000</td>
<td>-20,000</td>
</tr>
<tr>
<td>(20% X $100,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gain Recognized</td>
<td>$15,000</td>
<td>10,000</td>
</tr>
</tbody>
</table>

In the above example, the §754 election brings the discount inside the partnership causing D to report an extra $5,000 in gain. But keep in mind this is only a timing difference. D's

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66 Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin are community property states.
68 Id.
69 See discussion at Section III.E. infra.
successor adds the $5,000 gain reported to his outside basis and reports less gain when he ultimately sells or liquidates his interest.

<table>
<thead>
<tr>
<th></th>
<th>With § 754</th>
<th>w/o § 754</th>
</tr>
</thead>
<tbody>
<tr>
<td>D’s Basis in Pship</td>
<td>15,000</td>
<td>15,000</td>
</tr>
<tr>
<td>Gain recognized</td>
<td>15,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Liquidation Distr.</td>
<td>-30,000</td>
<td>-30,000</td>
</tr>
<tr>
<td>Gain on Liquidation</td>
<td>5,000</td>
<td></td>
</tr>
</tbody>
</table>

However, timing differences matter, especially if the partnership does not plan to cash out the successor partner right away and the partnership will sell assets soon after the decedent’s death. The partnership should base its decision whether to make a § 754 election on how soon after the decedent’s death the assets will be sold. The more likely the partnership will sell them soon after the decedent’s death, the more likely the § 754 election will be beneficial.

But if the IRS is currently auditing or likely to audit the decedent’s Form 706, it may be difficult to decide whether to make the § 754 election. Any IRS adjustment to the partnership discount will affect the basis of partnership assets when a § 754 election is in effect. A partnership that did not make the election because the cost basis of its assets exceeded the discounted value may regret that decision if the IRS later reduces the discount such that the discounted value exceeds the inside cost basis. In that case a § 754 election would have been desirable. However, taxpayers should evaluate the § 754 election independently of the potential consequences of an IRS examination. First, it is impossible to predict in the year of death whether the Form 706 will be audited and what the outcome will be. Second, the partnership and partners can amend their income tax returns if they are within the three-year statute of limitations. Third, the partners may be entitled to relief if they are beyond the statute of limitations for amended returns.

Unless the § 754 election will produce significant short term benefits, it should probably not be made because of its impact on the remaining partners. For example, if the partnership cashes out the estate shortly after death, the estate will fully utilize its outside basis in calculating its gain or loss with no need for the inside step-up afforded by the election. Or if the partnership does not plan to sell any of its major assets anytime soon, a step-up on the inside basis from the § 754 election does not produce any immediate tax savings. In both cases, if the partnership had made the election, it might have wasted it for little or no benefit, while causing significant impact on the remaining partners for the duration of the partnership. So in cases like these where the estate’s interest is very small or assets will not be sold or depreciated, the partnership should probably not make the election. Whether or not to make the election is one of the hardest decisions a partnership can make.

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70 See Exhibit B, Section 754 Decision Tree infra.
71 Id.
72 See discussion at Section III.H.2.
73 See Exhibit B, Section 754 Decision Tree infra.
E. Mandatory Basis Adjustments for “Substantial Built-in Loss Property”

Basis adjustments under § 743 are mandatory when a partner dies or transfers by sale or exchange an interest in the partnership that has a “substantial built-in loss.” A substantial built-in loss exists if the adjusted basis of partnership property exceeds the property’s market value by more than $250,000 on the date of the death or transfer. If the partnership is required to make a mandatory basis adjustment because of a substantial built-in loss, it must check the box on new line 12c of Form 1065, Schedule B and attach a statement showing the computation and allocation of the basis adjustment.75

Note that the $250,000 is the difference between the cost and market value of the partnership property, not the partnership interest. But once this threshold is met, the required adjustment is the difference between the cost of the partnership property and the discounted value of the partnership interest, which could be significantly larger than the spread between the cost and market value of the partnership assets.

1. The $250,000 Threshold

The partnership measures the $250,000 on a “net” basis with respect to the entire partnership, rather than on a per asset basis. Thus, the partnership could have significant built-in loss property and escape the rule as long as it has sufficient built-in gains to offset the built-in losses to below $250,000. On its face, the statute applies the $250,000 test on a partnership by partnership basis. Thus, it may apply to a parent but not to its subsidiary partnership. Nonetheless, the value and basis of a parent’s partnership interest in a subsidiary partnership be part of the gain or loss measured at the parent level. Anticipating potential abuse in this area, Congress authorized the IRS to write regulations aggregating related partnerships.76 Congress also anticipated that taxpayers might be tempted to transfer appreciated property to a partnership just before a death or transfer to reduce the built-in loss and avoid these rules. Therefore, Congress also granted the IRS regulatory authority to disregard property acquired by the partnership in anticipation of a transfer or death.77

There are many unanswered questions about how to figure a partnership’s basis in its property under IRC § 743(d). For example, do § 754 adjustments count as part of the basis of the partnership assets? Also, is the basis of built-in loss property contributed after October 22, 2004 its basis or market value on the contribution date?78 And does the alternate valuation date (AVD) election under IRC § 2032 affect the basis?

The estate’s alternate valuation election does not affect the date for determining whether a partnership has a substantial built-in loss under § 743(d). Section 743(d) measures the difference between the inside basis of the partnership assets and their market value on the date of transfer, whether by death or otherwise. It makes no reference to the alternate valuation date for this purpose. But once the partnership determines that it has a substantial built-in loss on the date of death, then the amount of its mandatory basis adjustment under § 743(b) is affected by whether

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74 IRC § 743(d).
75 2008 Form 1065, Schedule B, line 12c.
76 IRC § 743(d)(2).
77 Id.
78 See discussion at Section II.B.3. infra.
the estate elects AVD or not. It is also important to note that the partnership makes the built-in loss determination, but the estate makes the AVD election. Moreover, they have different compliance deadlines. Therefore, it would be impractical to make the partnership’s determination of whether it has a substantial built-in loss hinge on whether the executor makes an AVD election or not.

2. The Mechanics

Once the partnership determines that it has a substantial built-in loss on the date of a transfer by sale or exchange or on the death of a partner, the size of the adjustment it must make depends on the distributee’s outside basis. The partnership must adjust, up or down, the basis of partnership assets with respect to the transferee to equal the transferee’s outside basis in his partnership interest. The adjustment is allocated among the assets as if the transferee purchased an undivided interest in each one. A transfer of any size, or the death of even a 1 percent partner, requires this adjustment. There is no de minimis rule. Like a § 754 election, this adjustment only affects the transferee partner. But unlike the new mandatory rules for distributions under § 734(b), basis adjustments under § 743(b) can be positive or negative.

EXAMPLE

Dad died with a 25 percent interest in a family partnership with assets worth $4,000,000 and a basis of $4,300,000. The partnership has a substantial built-in loss because the basis of its property exceeds the market value by more than $250,000.

<table>
<thead>
<tr>
<th>(a) FMV of Partnership Assets</th>
<th>(b) Cost of Partnership Assets</th>
<th>(a) – (b) Substantial Built-in Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>$ 4,000,000</td>
<td>$ 4,300,000</td>
</tr>
</tbody>
</table>

The partnership must reduce the decedent’s share of the inside basis of the partnership assets as if the partnership had made a § 754 election, even though the partnership would not have made the election voluntarily. In the example above, if the partnership sells its assets for $4,000,000 the other partners would report their share of the $300,000 loss. However, the estate’s basis has been reduced by its share of the built-in loss and therefore is not entitled to report any share of the loss.

3. Partnership Discounts and the $250,000 Threshold

The question arises how valuation discounts impact the new mandatory basis rules. Section 734(d) asks us to measure the difference between the partnership’s basis and fair market value of its property. For this purpose, it is irrelevant what the partner’s basis in his partnership interest is. However, once the partnership determines that it has a substantial built-in loss, the transferee/decedent partner’s basis in his partnership interest determines the amount of the mandatory basis adjustment made on the partnership books.\(^7^9\)

\(^7^9\) IRC § 743(b)(2).
EXAMPLE

Dad died with a 25 percent interest in a family partnership that has assets worth $4,000,000 and a basis of $4,300,000. The estate’s interest is valued at $700,000 using a 30 percent discount. The partnership has a substantial built-in loss of $300,000 [($4,300,000 - $4,000,000)]. Therefore, it is subject to the mandatory basis adjustments. It must reduce the estate’s share of the basis of the partnership assets of $1,075,000 [25% X $4,300,000] by the excess over his estate’s basis in the partnership interest, $700,000. The mandatory downward adjustment for the estate is therefore $375,000 [$1,075,000 - $700,000].

<table>
<thead>
<tr>
<th></th>
<th>(a) FMV of Partnership Assets</th>
<th>(b) Cost of Partnership Assets</th>
<th>(a) - (b) Difference</th>
<th>(c) Outside Basis of Partnership Interest</th>
<th>(b) - (c) Mandatory Step Down</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>$4,000,000</td>
<td>$4,300,000</td>
<td>(300,000)</td>
<td>$2,800,000</td>
<td></td>
</tr>
<tr>
<td>Dad’s</td>
<td>$1,000,000</td>
<td>1,075,000</td>
<td>(75,000)</td>
<td>700,000</td>
<td>$375,000</td>
</tr>
<tr>
<td>25%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Therefore, even though partnership discounts do not affect the $250,000 threshold, they may affect the size of the mandatory basis adjustments the partnership is required to make once it passes the threshold. Further, because discounts are apt to change upon an IRS audit, the partnership may not always be sure how much of an adjustment to make. For example, assume the partnership sells property and reports gain or loss to the transferee partner based on the mandatory adjustments. If the mandatory adjustments subsequently change because the discounts change, the partnership and the transferee partner(s) would need to amend their income tax returns to report the correct gain or loss. They should be careful to do so before the statute of limitations expires, which is generally three years from the extended due date of their original returns. These adjustments apply only to the transferee partner and his successors.

If a partnership has a built-in loss exceeding $250,000, and the death of a significant partner is imminent, the partnership might consider selling assets to recognize losses before the partner dies. Alternatively, the “potential decedent” partner might consider gifting all or a portion of his partnership interest to a family member to transfer his built-in losses to the donee under § 704(c). This applies to all built-in losses except on property contributed after October 22, 2004.

An estate that acquires an interest in a partnership that is subject to the new mandatory basis adjustment rules must notify the partnership in writing of its acquisition within one year of the partner’s death. A transferee by sale or exchange has only 30 days from the transfer to notify the partnership. The partnership must attach a statement to its return in the year of a death or

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81 IRC § 6511; see also Exhibit B, Section 754 Decision Tree infra.
82 Reg. §§ 1.743-1(f), (j)(1).
83 See discussion at Section II.B.2.
transfer to which these rules apply showing the computation of the adjustments and the properties to which they have been allocated.85

F. Recordkeeping Responsibility

The regulations require partnerships to attach statements to their partnership returns when they acquire knowledge of transfers subject to the optional basis adjustment rules.86 These statements must contain the partner’s name, taxpayer ID number, and the computation of the partner’s adjustment under § 743(b). Transferees (i.e. purchasers or successors in interest) are under an affirmative obligation to notify partnerships of their basis in acquired interests.87 In the case of a transfer by death, the successor partner must notify the partnership within one year of death.88 Partnerships may rely on written representations of transferee partners concerning either the amount paid or the basis in the partnership interest acquired from a decedent.89

G. Impact of § 754 on Other Partners

The § 754 basis adjustments not only affect a transferee partner’s basis, they also affect the basis of the partnership’s assets under any of the following four situations:

(a) A partner receives money (or securities) in excess of his partnership basis;90
(b) A partner receives only money (or securities), unrealized receivables, and inventory in complete liquidation of his interest and the total of these items is less than his remaining basis in his partnership interest;91
(c) A partner receives property that has an adjusted basis in excess of the partner’s basis in his partnership interest;92
(d) A partner receives property in a liquidating distribution and the property’s basis is less than the partner’s basis in his partnership interest;93

In situations (a) and (c) the partnership must increase the basis of assets remaining on its books. In situations (b) and (d), the partnership must reduce the basis of assets remaining on its books. Note that the American Jobs Creation Act of 2004 made these basis adjustments mandatory for deaths and transfers after October 22, 2004 where the partnership has a built-in loss greater than $250,000, despite the absence of a § 754 election.94 The Jobs Act also made the negative adjustments mandatory for distributions after October 22, 2004 if the amount of the adjustment required if a § 754 election had been in effect would have exceeded $250,000.95

86 Reg. § 1.743-1(k)(1).
87 Reg. § 1.743-1(k)(2).
88 Reg. § 1.743-1(k)(2)(ii).
89 Reg. § 1.743-1(k)(3).
90 IRC §§ 731(a)(1), 734(b)(1)(A).
91 IRC §§ 731(a)(2), 734(b)(2)(A).
93 IRC §§ 732(b), 734(b)(2)(B).
94 P.L. 108-457, § 833; see also discussion at Section IV.B. infra.
95 Id.
The following illustrates the adjustment to partnership property if a § 754 election is in effect when the partnership makes a liquidating distribution of property, the basis of which exceeds the partner's basis in his partnership interest (situation (c) above):

**EXAMPLE 1**

D, M, and S form DMS, a family partnership with a § 754 election in effect. D and M each contribute Properties A and B for a one-third interest in the partnership. Properties A and B each have a basis of $40 and a FMV of $100. S contributes land with a basis and fair market value of $100 for a one-third interest. Seven years later the land, still worth $100, is distributed to D in liquidation of his interest.

The partnership's basis in the land is $100. However, upon distribution, its basis to D is limited to D's $40 basis in his partnership interest. Without a Section 754 election, no adjustment is made to the partnership's remaining assets and $60 of the land's basis disappears into thin air. If, however, the partnership had a § 754 election in effect in the year of the distribution, the basis of DMS's remaining assets would be stepped-up by $60 to make up for the disappearing land basis.

Example 1 creates basis for the partnership. Contrast it with Example 2 below which eliminates partnership basis (situation (d) described above):

**EXAMPLE 2**

Assume the same facts as Example 1 except that the partnership distributes Property A to S in liquidation of his interest (instead of D). Property A, worth $100, has a basis of $40 basis, but it assumes a new basis in the hands of S equal to S’s basis in his partnership interest, or $100.

If the partnership had a § 754 election in effect in the year of the distribution, the basis of DMS's remaining assets would be stepped-up down by $60 to make up for the basis increase that S enjoyed. Absent a § 754 election in effect, no adjustment is made to the basis of the partnership’s remaining property. In effect, $60 of basis has been created for Property A with respect to S. In addition, the partnership retains the high basis land. This is exactly the type of practice the American Jobs Creation Act sought to curtail after October 22, 2004.

While these rules may sound like hocus-pocus, they are only temporary adjustments. When all partnership interests are liquidated and all assets are distributed or sold, the proper amount of gains and losses will be recognized by the proper parties regardless of whether the partnership made a § 754 election. The only difference is the timing. The main point here is to anticipate the effect of a § 754 election on all future distributions of the type described in (a)-(d) above. The partnership should weigh the current benefits to the deceased partner of a § 754 election against any potentially detrimental basis adjustments impacting the remaining partners.

96 IRC § 732(b).
97 Id.
98 P.L. 108-457, § 833; see also discussion at Section IV.B. infra.
H. Making the Election

To make the election the partnership attaches a written statement, signed by any one of the partners, to its timely filed return (including extensions thereof) for the year in which the partner died or the transfer occurred. The partnership should also check the box on new line 12a of Form 1065, Schedule B, indicating that it is making the election. It is not enough to reflect the adjustments to basis as if the election were in place. The election must actually be made.

The IRS gives independent effect to each partnership’s § 754 election (or lack thereof). Thus, a parent’s § 754 election does not grant the lower-tier partnership the right to adjust the basis in its assets under § 754, absent a separate election by the lower tier partnership. However, where a lower tier partnership inadvertently fails to make a § 754 election, the IRS has been surprisingly generous in cases where the upper tier partnership has made a timely election. If both an upper and its lower-tier partnership make a § 754 election, the upper-tier’s election causes a basis adjustment of property for both tiers. The corollary to this is that if only the lower-tier partnership makes a § 754 election, no basis adjustment is available at either the upper-tier or the lower-tier level. In other words, to adjust the basis of the lower tier partnership’s assets, both tiers must make the election.

1. Late Elections

If the due date for a § 754 election has passed, the partnership can still make the election by filing an original or amended return within twelve months of the due date, including extensions, of the return year for which the election is sought. The final extended due date for partnership returns due after 2008 is September 15. The partnership should attach the election with: “FILED PURSUANT TO REG. 301.9100-2” printed at the top. No user fees apply. Thus the partnership can make an election effective for 2008 as late as September 15, 2010, which is one year from the final extended due date of September 15, 2009.

Failure to qualify under the automatic extension provisions of Reg. § 301.9100-2 is not the last stop. But it’s the last quick or cheap stop. Taxpayers ineligible for the automatic extension may still request a late § 754 election under Reg. § 301.9100-3. Permission is not automatically granted by the Commissioner and carries an $11,500 user fee. The partnership must have acted reasonably and in good faith and the relief must not jeopardize the interest of the government. The IRS has been abundantly generous in granting relief for late Section 754 elections where the failure was inadvertent. Examples of acting in good faith include complications of administering the estate, extended litigation, reliance on accountants who failed to properly inform them,

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99 Reg. § 1.754-1(b).
100 Ltr. Ruls. 200901015, 200903068, 200901016.
102 Ltr. Ruls. 9338004, 9338005, 9338006, 9327068.
103 Id.
105 Temp. Reg. § 1.6081-12T (June 30, 2008).
106 Reg. § 301.9100-2(d).
107 Rev. Proc. 2009-1, 2009-1 IRB 1, Appendix A, category 3(c) (for requests after February 1, 2008).
108 Ltr. Ruls. 200531016, 200530015.
preparation of the election statement, but failure to attach it to the return, and simple inadvertent failure to file. While the IRS forgives many late filed elections, the process is not cheap given the $11,500 user fee and the time it takes to prepare and file the ruling request.

However, if several years are closed under the statute of limitations, the IRS has denied relief. In addition, the IRS has denied a late election where it was made after the IRS included partnership assets in the decedent's estate under § 2036. The LLC did not make the § 754 election on the original return because it stated "the benefit it provided did not outweigh the complexity of creating multiple bases."

2. Revoking the Election

Once made, the election is irrevocable without the approval of the district director for the district in which the partnership return is required to be filed. A request for revocation must be filed within 30 days of the partnership year end for which the election is intended to be effective, usually the partnership year within which the partner died. The IRS will only approve a request for reasons such as a change in the nature of the partnership business, a change in the character of the partnership assets, or an increased frequency of shifts of partnership interests such that an increased administrative burden would befall the partnership from the election. The regulations also flatly state that no application for revocation will be approved if its primary purpose is to avoid stepping down the basis of partnership assets.

If the partnership is beyond the 30 day revocation window under Reg. § 1.754-1(c), the partnership can seek nonautomatic relief for a late filed revocation under Reg. § 301.9100-1, which defines the standards for relief under Reg. § 301.9100-2. The partnership will need to send the IRS an $11,500 user fee along with a detailed explanation of why a revocation should be granted under Reg. § 301.9100-1, and hope for the best. Alternatively, the partners can constructively terminate the partnership under IRC § 708 by effecting a sale or exchange of more than 50 percent in partnership profits and capital with a twelve month period. This "constructive termination" automatically terminates all elections.

3. Revocation by Termination

If 50 percent or more of the total interest in partnership profits and capital are sold or

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109 Ltr. Ruls. 200906026, 200835007, 200827031, 200815008, 200808022, 200738009, 200530018, 200507007.
110 Ltr. Rul. 200802001.
111 Ltr. Rul. 200929003, 200908018, 200903069, 200838019, 200837001, 200834018, 200832014, 200827020, 200826027, 200606004, 200546002, 200537016, 200537008.
112 Ltr. Rul. 9452025.
113 Ltr. Rul. 200626003 (7/28/2006) (IRS denied relief under Reg. § 301.9100-3 for a partnership to make a late § 754 election after the decedent’s Form 706 was audited and the IRS included assets contributed to the partnership in the decedent’s estate under § 2036. The partnership did not make the § 754 election on the original return because at the time it did not seem that the benefits outweighed the complexity.); see also discussion at III.K. of this outline.
114 Reg. § 1.754-1(c).
115 Reg. § 1.754-1(c)(1).
116 Ltr. Ruls. 9234022, 9228018.
exchanged within a 12 month period, a partnership terminates for federal income tax purposes.\(^{118}\)

This is called a technical or “constructive” termination because in most cases the partnership continues to operate its business after the termination occurs. A constructive termination ends any partnership elections that were in effect prior to the termination, including a Section 754 election, except with respect to the incoming partner who acquired his interest by purchase.\(^{119}\)

Such termination is effective on the date of sale or exchange, which by itself or together with sales or exchanges occurring in the previous 12 months transfers an interest of 50 percent or more in partnership profits and capital.\(^{120}\)

However, the following transfers are not treated as sales or exchanges of a partnership interest causing a constructive termination:

- A transfer by gift, bequest, or inheritance.\(^{121}\)
- A liquidation of a partnership interest.\(^{122}\)
- Contributions of property by new or existing partners causing a shift in partnership interests of more than 50 percent.\(^{123}\)

a. Bequests Greater than a 50 Percent Partnership Interest

Whether pecuniary bequests and residuary bequests of a partnership interest are sales or exchanges for purposes of § 708 is less certain. Assume a partner dies owning a 51 percent interest in a partnership that has a § 754 election in effect from an earlier year. The transfer from the partner to his estate is clearly excluded from treatment as a constructive termination.\(^{124}\) But, because the partnership has a § 754 election in place, the estate adjusts the inside basis of its share of the partnership assets. Assume also that the estate distributes the 51 percent partnership interest in satisfaction of a pecuniary bequest. Does the distribution constitute a constructive termination that terminates the § 754 election and frees the partnership from the basis adjustments that would be required if the election were in place?\(^{125}\) The same question arises with respect to a residuary bequest of more than 50 percent.

Section 761(e) provides broadly that any distribution of a partnership interest constitutes an exchange for § 708 termination. Although the legislative history of § 761(e) indicates that Congress considered excluding partnership distributions by an estate or testamentary trust from sale or exchange treatment, the final statute does not do so.\(^{126}\) Nor do the regulations.\(^{127}\)

Satisfying a pecuniary bequest with a partnership interest is considered a sale by the estate for purposes of § 661 causing the estate to recognize gain or loss.\(^{128}\) The IRS has also held that it

\(^{118}\) Reg. § 1.708-1(b)(2).

\(^{119}\) Reg. § 1.708-1(b)(5).

\(^{120}\) Reg. § 1.708-1(b)(1)(iii)(b).

\(^{121}\) Reg. § 1.708-1(b)(1)(ii).

\(^{122}\) Reg. § 1.708-1(b)(2).

\(^{123}\) Id.

\(^{124}\) Reg. § 1.708-1(b)(1)(ii).

\(^{125}\) See discussion at Section III.G. infra.


\(^{127}\) Reg. § 1.761-1(e).

\(^{128}\) Reg. § 1.661(a)-2(f)(1).
closes the partnership's tax year. On the other hand, the distribution of a partnership interest by an estate that does not constitute a sale or exchange or close the partnership's tax year. Therefore, a specific bequest or residuary distribution of more than a 50 percent interest in a partnership would probably not terminate the partnership under § 708.

In sum, if the distribution of a greater than 50 percent interest in a partnership in satisfaction of a pecuniary or residuary bequest is considered a sale or exchange for purposes if Section 708, then the partnership automatically terminates its § 754 election. This could be invaluable where it would give the decedent partner’s interest the benefit of a § 754 election step-up in basis without the future basis adjustments normally required for the partnership’s other property.

b. Dividing the Partnership

A partnership also terminates, along with any elections, when it divides into two or more partnerships, and none of the resulting partnerships are owned by partners who had an interest in more than 50 percent of the capital and profits of the prior partnership. In this case, any resulting partnership of 50 percent or less of the prior partnership is treated as a liquidation of the partners’ interests and a contribution to a new partnership. Any resulting partnership that consists of partners owning more than 50 percent of the prior partnership’s capital and profits is considered a continuation of the prior partnership, with its elections intact.

EXAMPLE

A, B, C, and D are each 25 percent partners in ABCD Partnership that has a § 754 election in effect. The partnership divides its assets equally into AB Partnership and CD Partnership. A and B each own a 50 percent interest in AB. C and D each own a 50 percent interest in CD. ABCD Partnership has terminated because 50 percent or more of its capital and profits has been exchanged within a 12 month period. Neither AB nor CD is owned by partners who owned more than 50 percent of ABCD Partnership. Therefore, neither AB nor CD has a valid § 754 election in effect.

A partnership wishing to terminate a § 754 election by dividing a partnership must do so before the death of the key partner. The assets for which the § 754 election is undesirable should be transferred to a new partnership that is not considered a continuation of the prior partnership under § 708. This is major surgery, but may be warranted in the right circumstances.

On the other hand, if the partnership has not already made a § 754 election and has both highly appreciated and depreciated assets, it should consider dividing into two partnerships owned by the same partners. One partnership would own the appreciated assets and make a § 754 election. The other would own the depreciated assets and would not make the election. The post-division election by one partnership does not affect the other partnership. One must be

130 Prop. Reg. § 1.706-1(c)(2)(i), (ii); Reg. § 1.706-1(c)(3)(iv), (vi), Example 3.
131 See discussion at Section III.G. infra.
132 IRC § 708(b)(2)(B).
133 Reg. § 1.708-1(d).
134 Id.
135 Reg. § 1.708-1(d)(2)(ii).
careful that the cost basis of the depreciated assets does not exceed their fair market value by more than $250,000, or else the mandatory basis adjustment rules require the cost basis to be stepped down regardless. In addition, it is important to complete the division and have the new partnership make the § 754 election by the time it files its return that includes the year of the partner's death. The partnership with assets having the greatest fair market value (net of liabilities) will continue to use the federal ID number of the old partnership and the other partnership must obtain a new ID number.

I. The Duty of Consistency

Regardless of whether the partnership makes the § 754 election or not, the IRS and the Tax Court maintain that taxpayers have a "duty of consistency" to use the same basis for federal income tax purposes as the estate tax values finally determined. The taxpayer's duty of consistency is a judicial doctrine invoked where (1) the taxpayer made a representation of fact or reported an item for tax purposes in one tax year; (2) the Commissioner acquiesced in or relied on that fact for that year; and (3) the taxpayer desires to change the representation previously made in a later tax year after the earlier year has been closed by the statute of limitations.

The IRS Appeals Settlement Guidelines for Family Limited Partnerships discusses the duty of consistency in connection with partners using the undiscounted basis for federal income tax purposes, while benefiting from discounted values for estate tax purposes. It refers to Janis v. Commissioner in which the trustee used the undiscounted basis for determining cost of goods sold in an art inventory, even though a heavily discounted basis was used when valuing the art inventory for estate tax purposes. The Tax Court held that the trustee had a duty of consistency to use the same basis for estate and income tax reporting purposes. Although Janis did not involve a partnership § 754 election, the duty of consistency would apply whether or not a partnership makes a § 754 election. Thus, the partnership may not use a different basis for partnership assets than that finally determined for federal estate tax purposes.

J. Impact on Valuation of the Partnership

Because special basis adjustments have clear negative consequences, a purchaser would surely take them into consideration in valuing a partnership interest. For instance, higher discounts should apply during any seven year period in which the mixing bowl rules might apply. Additional discounts should also apply where the partnership agreement requires the partnership to make the § 754 election, or where the purchaser insists on it, because of the necessary extra recordkeeping requirements associated with it. And finally, discounts should apply to any partnership that may be subject to the new built-in loss limitation rules for property contributed on or after October 22, 2004 or the mandatory basis adjustment rules enacted by the American Jobs Creation Act of 2004. Even though it may be difficult to quantify the exact

136 IRC § 743(d); see also discussion at Section III.E. infra.
137 Reg. § 1.708-1(d)(2)(i); Reg. § 1.708-1(d)(4)(i).
138 APPEALS SETTLEMENT GUIDELINES, FAMILY LIMITED PARTNERSHIPS AND FAMILY LIMITED LIABILITY CORPORATIONS, Uniform Issue List (UIL) 2031.01-00 (Jan. 29, 2007).
139 Janis v. Comm'r, TC Memo 2004-117, aff'd 461 F.3d 1080 (9th Cir. 2006), aff'd on different ground 469 F.3d 256 (2nd Cir. 2006).
140 See discussion at Sections II.B.3. and IV.B. infra.
discount attributable to these basis adjustments, the accounting costs are real and staggering, despite that they only relate to timing differences. If Congress thought these timing differences were insignificant, they would not have enacted tough new laws to curb their abuses.

K. Impact on Partnerships Included under § 2044

When a surviving spouse dies with appreciated assets in a partnership interest owned by a QTIP trust that is included in his or her gross estate under § 2044(a), can the QTIP trust make a § 754 election to step up its share of the inside basis of the partnership assets? Some suggest that the answer is “no” because the partner (the QTIP trust) has neither sold, transferred, distributed its interest or died, which are prerequisites for the QTIP trust to adjust its share of the inside basis of partnership property under a § 754. However, § 2044(c) treats property included under IRC § 2044(a) as property “passing from the decedent.” Further § 1014(b)(10) treats property includible in the gross estate of the decedent under § 2044 as having “passed from the decedent” for purposes of acquiring a basis equal to the market value on the decedent’s date of death.

Therefore, if the partnership interest is included in the surviving spouse’s gross estate under § 2044 and is treated as “passing from the decedent” to the QTIP trust, the partnership should be eligible to make a § 754 election and adjust the QTIP trust’s share of the inside basis of the partnership assets, assuming it makes a timely election. The election must be filed by the extended due date of the partnership return for the year in which the surviving spouse died, or 12 months later under the automatic relief provision of Reg. § 301.9901-2. Failing that, the partnership may request permission to make a late election pursuant to Reg. § 301.9901-3 if the partnership has acted reasonably and not on the basis of hindsight.

L. Impact on Partnerships Included under § 2036

In Ltr. Rul. 200626003 the IRS denied an LLC permission to make a late § 754 after a partner died and the IRS included the LLC assets in the decedent’s gross estate under § 2036(a)(1). Section 2036(a)(1) requires the decedent’s estate to include “the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer [] by trust or otherwise, under which he has retained for his life...the possession or enjoyment of, or the right to the income, from the property.” The amount included is “the value of the entire property...at the time of the decedent’s death.” Letter Ruling 200626003 involved a decedent who had transferred an interest in real estate before he died to his three children, while retaining the right to all of the income from it. Later, he and his three children transferred their interests in the property to an LLC in exchange for a 25 percent interest each. The father continued to retain all of the income from the property.

After he died, the estate distributed the father’s LLC interest to the children and the LLC timely filed its partnership return, but did not make a § 754 election. The partners decided that the benefit “did not outweigh the complexity of creating multiple bases.” But after the IRS...

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142 Reg. § 1.754-1(b).
143 Reg. § 301.9901-2(a)(2)(vi).
144 Ltr. Rul. 200626003 (July 28, 2006).
audited the estate tax return and included the full value of the real estate in the father's gross estate under § 2036(a)(1), the partners changed their mind and asked for permission to make a late § 754 election. The IRS denied their request because they not meet the requirements for a late election under §§ 301.9100-1 and 301.9100-3, which require them to have acted reasonably and in good faith and not on the basis of hindsight.

Nonetheless, the IRS allowed a stepped up basis for the real estate under § 1014(b)(9) on the basis that it was property “acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment).” Thus, the Service allowed the LLC to adjust the basis of the real estate, without a § 754 election. The Tax Court also reached this same conclusion in Jorgensen v. Commissioner for partnership assets included in the decedent’s estate under IRC § 2036. This is particularly significant because the assets included in the Jorgensen’s estate included partnership interests owned by other family members who had received their interests by gift many years prior to Jorgensen’s death. Nonetheless, the Tax Court relied on the doctrine of equitable recoupment in IRC § 6214(b) to allow the other family members to step up the inside basis of partnership assets and reduce gains previously reported even though the statute of limitations had long since passed.

IV. AVOIDING TAXABLE DISTRIBUTIONS

A. General Rules

The general rule is that neither the partner nor the partnership recognizes gain or loss on a distribution to a partner, except to the extent that money is distributed in excess of a partner’s basis in his partnership interest. However, the exceptions to this rule nearly swallow up the rule. For example, the IRS can treat distributions of property as money based on substance over form if they have no legitimate business purpose. Alternatively, property can be treated like money pursuant to statute, as in the case of marketable securities under § 731(c). In addition, the transfer of partnership property to a partner in satisfaction of a guaranteed payment under § 707(c) is a taxable sale or exchange between the partner and the partnership. Distributions of ordinary income property under § 751 can be taxable, as can distributions treated as “disguised sales” under § 707(a) and distributions within seven years of a contribution of property under §§ 704(c)(1)(B) and 737. Therefore, it is almost more correct to say that taxable distributions are the norm and tax-free distributions the exception.

146 IRC § 1014(b)(9).
148 IRC §§ 731(a), (b).
149 CCA 200650014 (Sept. 7, 2006) (where the property was selected by the distributee, acquired by the partnership immediately before the distribution solely for the purpose of the distribution, and was unrelated to the partnership’s business activity); see also Countrywide Limited Partnership et al v. Comm’r, T.C. Memo 2008-3 (Jan. 2, 2008) (The IRS alleged that note distributed in liquidation of a partner’s interest had no legitimate business purpose and should therefore be treated as cash distributions resulting in a gain to the partners. However, the tax Court held in favor of the taxpayer finding a legitimate business purpose because the economic interest of the partners had changed.)
Section 754 Decision Tree
Decedent’s Estate with a Discounted Family Limited Partnership

EXHIBIT B

Is the fair market value of the partnership assets on the date of death greater than their cost basis?

Yes → Is the discounted value of the partnership assets greater than cost basis?

Yes → Will the estate or successor’s partnership interest be redeemed?

No → Is the estate’s interest significant?

Yes → Will the partnership sell assets shortly after death?

No → Make the § 754 election on an extended return.

No → If the IRS reduces the discount and the property has been sold, file amended return(s) within 3 years from the original filing date to adjust the gain or loss previously reported.

Yes → No → Do not make the election. Mandatory basis rules require the partnership to adjust (up or down) the decedent’s share of basis in the partnership assets to the discounted value of his partnership interest on the date of death. § 743(b)(2).

No → Is the cost basis of the partnership assets greater than the market value by more than $250,000? § 743(d).

No → Do not make the § 754 election.

Yes → Will a planned distribution of marketable securities cause a large gain? § 731(c)

No → Extend the partnership return for the year of death. Do not make the § 754 election.

Yes → Make a § 754 or 732(d) election.

If the IRS adjusts the discount so that the discounted value exceeds cost basis of assets, file a late § 754 election (on an original or amended return), but only if the estate’s interest is significant, the partnership will (or did) sell assets within a short time after death, and the estate’s interest has or will not be redeemed.

File amended partnership return(s) to reduce the previously reported gain or increase the loss.

No → Make the § 754 election on an extended return.

If the IRS reduces the discount and the property has been sold, file amended return(s) within 3 years from the original filing date to adjust the gain or loss previously reported.