

## **Optional Basis Adjustment under IRC Section 734/743 in Tiered Partnership Structures**

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Through the provisions of Subchapter K of the Code<sup>1</sup>, tax practitioners are afforded a significant degree of flexibility in the structuring of partnership transactions and the income tax planning for partnerships and their partners. Two provisions in particular, § 734 and § 743<sup>2</sup>, provide for basis adjustments in certain situations or when the partnership has made an election under § 754. Both provisions can provide advantages to partners by blending the “aggregate” and “entity” approaches to partnership taxation. The calculation of these optional basis adjustments and the corresponding allocation of such adjustments among the assets of the partnership are governed by the Code and Treasury Regulations, and while these provisions are intended to alleviate differences in “inside” and “outside” basis, they are often quite daunting to follow. This is especially true given some of the recent changes made to the provisions. In addition, while the statutory authority provides its guidance in the terms of a single partnership, there is little guidance offered in the context of multiple tiers of partnerships and as a result, the calculations and allocations become much more challenging and complex.

### **Summary of Basis Partnership Concepts:**

Partnership taxation utilizes a strange mix of entity and aggregate principals. In many situations, there is no theoretical justification for when partnerships will be treated as entities, when they will be treated as aggregates of their partners, or when they will be treated as a combination of both. The lack of a clear theoretical structure in partnership taxation often results in an interpretation of the statutory guidance with respect to a particular transaction and much confusion as to the intended results of the guidance.

Under the entity concept, a partnership is treated as separate and independent from its partners. This concept provides that a partnership exists separately from its partners and owns its partnership property and conducts its partnership business in a separate capacity. This concept is illustrated in Subchapter K by providing that the basis of a partner in his partnership interest (outside basis) is separate and independent from the partnership’s basis in its assets (inside basis). Compare this to the approach taken in § 701 which provides that a partnership is not a taxable entity and incurs no federal income tax liability. Rather, each partner in a partnership is required to take into account his allocable share of partnership income and loss in computing his own federal income tax liability. This approach reflects the aggregate concept of partnership taxation, which views each partner as owning an undivided percentage interest in each partnership asset and realizing his share of partnership income or loss directly as a co-owner of the underlying partnership property. Subchapter K incorporates this concept and attempts to

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<sup>1</sup> All references to Code refer to the Internal Revenue Code

<sup>2</sup> All section references refer to section of the Internal Revenue Code unless otherwise indicated.

maintain the equality of the partnership's inside basis in its assets and the partner's aggregate outside basis. This concept can be illustrated by the rule that a contributing partner's basis in contributed assets is initially used for both the partner's basis in his partnership interest and the partnership's basis in the contributed assets.<sup>3</sup>

One of the challenges of partnership taxation is dealing with inside/outside basis disparities. A partner's outside basis in his partnership interest may be different from his share of the partnership's inside basis in its assets. Such disparities can occur upon a transfer of a partnership interest (including a transfer upon the death of a partner) and a partnership distribution of property to a partner. The basis adjustments under §§ 743(b) and 734(b) are intended to restore equality between inside and outside basis and operate to blend the aggregate and entity principals.

In general, the sale of a partnership interest or the death of a partner affects outside basis but does not directly affect the inside basis. However, the partnership is permitted to adjust the inside basis of its assets upon the transfer of an interest if the partnership properly makes a special basis election (the § 754 election). In addition, recent changes to the provisions require a basis adjustment in certain situations. Section 743 establishes the adjustment and § 755 provides the process and mechanics of adjusting the basis of the property.

Similar to disparities created upon the transfer of an interest, inside/outside basis disparities can occur as the result of certain distributions of property to a partner. Under the provisions of § 734(b), the partnership can elect to adjust the basis of retained property. Once again, § 755 provides the mechanics of allocation such adjustments to the partnership property.

### **Tiered Partnerships and Revenue Rulings 92-15 and 87-115**

Taxpayers and their tax advisors often utilize tiered partnership structures in the income tax planning of partnerships and partners, this is especially true in real estate partnerships. These structures are used to accomplish a great number of business objectives, including the segregation of business assets and liabilities and to set up economic and managerial rights with respect to specific assets and businesses and can be an important tax planning tool. However, while applying the provisions of Subchapter K is often complex and confusing when dealing with a single entity, it can be even more cumbersome and challenging in tiered partnership structures. Furthermore, while many of the provisions of Subchapter K have undergone significant changes in recent years and while there is sometimes mention of tiered partnership rules, many of the older provisions are silent with respect to tiered partnerships. Some of the difficulties in understanding the application of Subchapter K provisions to tiered structures stems from complexity in the provisions and the inherent tension between the aggregate and entity principals of partnership taxation. As a result, tax practitioners are often left to interpret how the provisions should apply to tiered partnerships based on guidance from secondary authority.

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<sup>3</sup> 1992-1 CB 215

The Internal Revenue Service (“Service”) has addressed the basic rules and concepts of §§ 734 and 743 in tiered partnership structures in two Revenue Rulings. Revenue Ruling 92-15<sup>4</sup> provides the IRS’s position on the application of § 734(b) to tiered partnerships. This Ruling analyzes the basis consequences of distributions by upper-tier partnerships of interests in lower-tier partnerships or other assets. Revenue Ruling 87-115<sup>5</sup> (FOONOTE 3) provides guidance on the application of § 743(b) in tiered partnership structures. This Ruling addresses the transfer of a partnership interest in an upper tier partnership and which assets of the upper tier partnership and the lower tier partnership are adjusted. In general, the approach taken by the IRS in both rulings treats the upper tier partnership and the lower tier partnership as independent entities in applying the adjustments under §§ 734(b) and 743(b).

### **Section 743 Provisions**

Following the aggregate theory of partnership taxation, upon the sale of a partnership interest, the purchaser would be entitled to a cost basis for his undivided interest in the partnership assets. In contrast, under the entity concept, the purchaser’s cost basis would represent the basis of the interest in the partnership only and would not affect the basis of the partnership assets. Prior to 1954, the Code did not provide clear guidance on what effect the purchase of a partnership interest had on the basis of the partnership assets. At this time, there was a significant amount of case law that approached purchases of partnership interest under the entity concept and rejected the efforts of partners to adjust the basis of partnership assets upon the transfer of a partnership interest.<sup>6</sup> In general, these cases denied transferee-partners relief upon the transfer of a partnership interest under the theory that the purchaser had acquired an interest in the partnership versus a direct interest in the partnership assets. This approach was consistent with that taken under the Code of 1939, which generally adopted the entity theory in addressing the treatment of the sales of partnership interests. In essence, § 734(a) codifies the general approach the courts followed in the pre-1954 cases.

Section 743(a) provides the general rule that the basis of partnership property is not adjusted as the result of a transfer of an interest in a partnership by sale or exchange or on the death of a partner. As a result of this general rule, the transfer of partnership interest has no effect on the basis of partnership property and the transferee partner’s share of the adjusted basis of the partnership assets is the same as that of the transferor partner immediately prior to the transfer. However, § 742 provides that the transferee partner’s adjusted basis in the partnership interest is equal to the cost basis of the partnership interest and is usually not equal to the sum of the partner’s share of the partnership’s adjusted bases in its assets. The operation of § 742 and the general rule of § 743(a) will generally result in an inside/outside basis disparity.

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<sup>4</sup> 1987-2 CB 163

<sup>5</sup> §§ 722 and 723

<sup>6</sup> *Wasson v. United States*, 56-2 USTC 9886

If the partnership has a valid § 754 election in place, the general rule of § 743(a) is replaced by the aggregate approach under § 743(b), which is intended to eliminate the disparity between inside/outside basis. Section 743(b) permits, and, in some cases, requires adjustments to a new partner's share of the partnership's adjusted bases in its assets. If an interest in a partnership is transferred by sale or exchange or on the death of a partner, § 743(b) requires a partnership that has a "substantial built-in loss"<sup>7</sup> or that has a valid § 754 election in effect to adjust the common basis of the partnership's assets with respect to the transferee-partner only upon the transfer of a partnership interest. The amount of the §743(b) adjustment is equal to the difference between the transferee's initial basis for his partnership interest and his proportionate share of the adjusted basis of the partnership assets. To the extent that the transferee-partner's basis in his partnership interest is greater than his share of the basis of the partnership assets, the §743(b) adjustment increases the basis of the partnership assets with respect to the transferee-partner. In contrast, if the basis of the partnership interest is less than the transferee-partner's share of the basis in the partnership assets, the adjustment results in a decrease to the basis of the partnership assets with respect to the transferee-partner.

Subsequent to the application of the provisions of § 743(b), a transferee-partner's share of the basis of all the partnership assets theoretically should equal the initial basis of the partnership interest. Under this theory, the operation of § 743(b) reflects the aggregate approach to partnership taxation in that the transferee-partner's basis in the partnership assets would be the same as if the partner had acquired a direct interest in the partnership assets. However, the allocation of the §743(b) adjustment is controlled by § 755, which does not utilize a pure aggregate approach in allocating the adjustment (see discussion below). As a result of the allocation provisions, a transferee-partner's adjusted basis for the partnership assets may not completely equal the basis of the assets that the transferee-partner would have if he acquired a direct interest in the assets. Notwithstanding the operation of § 755, it is effective in understanding how the §743(b) adjustment operates to think of the overall basis adjustment as the basis that would arise if there was a direct acquisition of partnership assets.

In order to calculate the §743(b) adjustment, a partnership must make a determination of the transferee-partner's "proportionate share" of partnership's basis in its common assets. This term is defined in regulations under § 743 as the sum of the transferee-partner's interest as a partner in the partnership's previously taxed capital, plus the transferee-partner's share of partnership liabilities.<sup>8</sup> According to the Regulations, the transferee-partners share of the partnership's previously taxed capital is determined by reference to a hypothetical transaction in which (immediately after the transfer of the interest) the partnership is assumed to have sold all of its assets in a fully taxable transaction for cash

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<sup>7</sup> A partnership has a substantial built in loss if the partnership's adjusted basis in partnership property exceeds the property's fair market value by more than \$250,000 – IRC Section 743(d) effective for transfers after October 22, 2004

<sup>8</sup> Regs. § 1.743-1(d)(1)

equal to the fair market value of the assets.<sup>9</sup> The transferee-partner's share of the previously taxed capital is equal to (1) the amount of cash that the partner would receive upon liquidation of the partnership immediately following the hypothetical transaction, increased by (2) the amount of the tax loss that would be allocated to the partner in the hypothetical transaction, and decreased by (3) the amount of the tax gain that would be allocated to the partner in the hypothetical transaction. Previous regulations under § 743(b) provided that a transferee-partner's proportionate share of a partnership's basis in its assets was equal to the sum of the transferee partner's interest as a partner in partnership capital and surplus, plus his share of partnership liabilities.<sup>10</sup>

**Example:** A is a member of partnership ABC. A has a 33.33% interest in the partnership. The partnership has a § 754 election in effect. A sells his interest in ABC to D for \$33,000. ABC's balance sheet immediately before the sale as follows:

<u>Assets</u>	<u>Adjusted Basis</u>	<u>FMV</u>
Cash	7,500	7,500
Inventory	45,000	46,500
Depreciable Assets	<u>30,000</u>	<u>60,000</u>
 Total	 82,500	 114,000
 <u>Liabilities and Capital</u>		
 Liabilities	 15,000	 15,000
 A's Capital	 22,500	 33,000
B's Capital	22,500	33,000
C's Capital	<u>22,500</u>	<u>33,000</u>
	 82,500	 114,000

Absent an adjustment, D will have disparity between his outside basis of \$33,000 and his inside basis of \$22,500. However, ABC has a § 754 election in effect. D's adjustment in ABC will equal the difference between D's basis in his partnership interest and D's share of the inside basis. D's outside basis is the sum of the amount paid for the interest and his share of partnership liabilities. Assuming that D has a pro rate 33.33% share in partnership liabilities D's basis in his partnership interest is \$38,000.

<sup>9</sup> Regs. § 1.743-1(d)(1), (2)

<sup>10</sup> Former Regs. § 1.743-1(b) effective for transfers occurring before December 15, 1999.

D's share of the inside basis equals his interest in previously taxed capital increased by his share of partnership liabilities. D's interest in previously taxed capital equals the cash that D would receive in the hypothetical sale, \$33,000, decreased by the gain that would be allocated to D on the hypothetical sale, \$10,500 (assuming a pro rata sharing of gain),<sup>11</sup> or \$22,500. Thus D's interest in the inside basis of ABC is \$27,500.

Accordingly, D's basis adjustment will be \$10,500 or the difference between D's outside basis and his share of the partnership's inside basis.

### **Section 734 Provisions**

In general, distributions of partnership property to partners do not affect the basis of undistributed partnership property. This general rule is set forth in § 734(a), which provides that the adjusted basis of partnership property is not adjusted as a result of a distribution by the partnership to a partner. This general rule once again reflects an entity approach to the taxation of partnership distributions and is similar to the approach taken by § 743(a), whereby the basis of partnership property is not affected by partner level transfers of partnership interests.

However, this general rule can result in a discrepancy, in certain instances, between the partnership's adjusted basis in its assets and the partners' adjusted basis in their partnership interests. Such discrepancy may arise following a distribution in which the distributee partner recognizes gain or loss under § 731 or in which the partner's adjusted basis in the distributed property is greater or less than the partnership's adjusted basis in the property immediately preceding the distribution. These differences can cause distortions in the amount and timing of income. For example, if a partner's interest is liquidated for cash, the partner will recognize gain equal to the excess of the cash received over the partner's adjusted basis in his partnership interest. The gain represents the partner's share of the appreciation in the partnership's assets. To the extent that there is no basis adjustment, a subsequent sale of the partnership assets by the partnership will result in the remaining partners being subject to tax on the same gain.

Like the provisions of § 743(b), § 734(b) is intended to eliminate discrepancies that may arise as the result of the distribution of partnership property. If the partnership has a valid § 754 election in effect or if there is a substantial basis reduction, § 734(b) provides that the partnership's basis in its assets is adjusted upon certain distributions by the partnership to a partner. The § 734(b) adjustment applies in the following circumstances:

1. the distributee partner recognizes gain under § 731(a)(1),<sup>12</sup>;
2. the distributee partner recognizes loss under § 731(a)(2),<sup>13</sup>

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<sup>11</sup> Note that any special allocations including those required under § 704(c) would directly effect the calculation of previously taxed capital and the amount of the adjustment under § 743.

<sup>12</sup> § 734(b)(1)(A).

<sup>13</sup> § 734(b)(2)(A).

3. the distributee partner's adjusted basis in the distributed property is less than the partnership's adjusted basis in the property immediately prior to the distribution ("disappearing basis"),<sup>14</sup> or
4. the distributee partner's adjusted basis in the distributed property is greater than the partnership's adjusted basis in the property immediately prior to the distribution ("created basis").<sup>15</sup>

With respect to scenarios (1) and (3), the 734(b) adjustment is an increase equal to the amount of gain recognized (1) or to the difference in the basis of the distributed asset (3). With respect to scenarios (2) and (4), the §734(b) adjustment is a decrease equal to the amount of loss recognized (2) or to the difference in the basis of the distributed asset (4). As with the §743(b) adjustment, the §734(b) adjustment is allocated according to the provisions of § 755 (see discussion below). However, unlike the §743(b) adjustment, the §734(b) adjustment affects all remaining partners.

**Example 2:** Facts are basically the same as in Example 1. Instead of selling his interest, A's interest is redeemed by partnership ABC for \$33,000 of cash. See the balance sheet immediately before the redemption below:

<u>Assets</u>	<u>Adjusted Basis</u>	<u>FMV</u>
Cash	40,500	40,500
Inventory	45,000	46,500
Depreciable Assets	<u>30,000</u>	<u>60,000</u>
 Total	 115,500	 147,000
 <u>Liabilities and Capital</u>		
 Liabilities	 48,000	 48,000
 A's Capital	 22,500	 33,000
B's Capital	22,500	33,000
C's Capital	<u>22,500</u>	<u>33,000</u>
	115,500	147,000

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<sup>14</sup> § 734(b)(1)(B).

<sup>15</sup> § 734(b)(2)(B).

A will recognize a gain under § 731 of \$10,500. Therefore, the § 734(b) adjustment to the common basis of the assets retained by the partnership will be \$10,500 equal to the gain recognized by A.

### **Recent Changes in Provisions**

In December 1999, final regulations<sup>16</sup> substantially changed the manner in which §743(b) basis adjustments are calculated and allocated. The new regulations were an attempt by Congress to modernize older provisions. While the provisions do make significant improvement over former regulations, there is still a great deal of uncertainty regarding their application in certain situations, especially in tiered structures and the calculation of “previously taxed capital.”

In addition, the American Jobs Creation Act of 2004<sup>17</sup> significantly modified the basis adjustments under §§ 743(b) and 734(b). In general, the AJCA changes require partnerships that do not have a § 754 election in effect to make mandatory downward basis adjustments under §§ 743(b) and 734(b). Under § 743(b), the mandatory adjustment applies if the partnership has a substantial built-in loss, which is defined as a difference in the adjusted basis in partnership property over the property’s fair market value in excess of \$250,000. This mandatory adjustment is effective for transfers occurring after October 22, 2004. Under § 734(b), the mandatory adjustment applies where there is a substantial basis reduction. Substantial basis reduction is defined with respect to a distribution if the sum of the downward basis adjustments exceeds \$250,000. Once again this provision is effective for distributions occurring after October 22, 2004.

### **Allocation of Adjustments – Section 755**

The determination of the amount of the §§ 743 and 734 basis adjustments is complicated enough in its own rite; however, it only constitutes the first half of the basis adjustment process. The second half of the arduous process involves the allocation of the adjustment among the assets of the partnership. The rules governing the allocation mechanics are found in § 755 and the Treasury Regulations promulgated under § 755.<sup>18</sup> Section 755 does not follow a pure aggregate approach and therefore, the allocation of the basis adjustments may not completely alleviate the inside/outside basis differences. In addition, while § 755 ostensibly governs only the allocation of the adjustment determined under §§ 743 and 734, the provisions of § 755 can, under certain facts and circumstances, actually prevent or defer a current basis adjustment.<sup>19</sup>

#### **Allocation of Section 743 Adjustments**

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<sup>16</sup> TD 8847 (12/14/1999).

<sup>17</sup> P.L. 108-357.

<sup>18</sup> Reg. § 1.755-1.

<sup>19</sup> See discussion below.

Soon after the issuance of new provisions governing the manner in which § 743(b) adjustments are calculated were issued, new provisions governing the allocation provisions of § 755 were also issued. Generally, the regulations, as finalized in 2003,<sup>20</sup> require that the adjustment be allocated based upon the amount of income or loss that would be allocated to the transferee partner upon a hypothetical taxable sale of the partnership assets at fair market value on the date of the transfer.

Regulation § 1.755-1(a) subdivides the allocation process into three distinct steps. The first step, and arguably the most crucial step, is the valuation of the partnership assets. The second step is the allocation of the adjustment between the two classes of property described in § 755(b). The third and final step is the allocation of the adjustment among the properties within each class.

### **Valuation of Partnership Property**

Each item of partnership property is assigned a fair market value based upon all the facts and circumstances taking into account § 7701(g).<sup>21</sup> Section 7701(g) provides that in no case will property be assigned a fair market value which is less than any non-recourse debt to which the property is subject.

If the partnership conducts a trade or business and the partnership holds § 197 intangibles the valuation procedure becomes measurably more complicated. Under these circumstances Regs. § 1.755-1(a)(2) requires that the valuation for purposes of § 755 be completed in a manner similar to the residual method required by § 1060. The residual method, as its name implies, requires the taxpayer to assign specific values to each tangible asset and then the residual, which is the positive difference between the gross value of the partnership and the total value assigned to the tangible assets, is allocated to § 197 intangibles.

The residual valuation method is applied as follows. First, the partnership must determine the value of the assets based upon all of the facts and circumstances including the application of § 7701(g). Second, the partnership must calculate “partnership gross value”, the value of the partnership as a going concern. Typically, in the case of a sale of a partnership interest the gross partnership value can be imputed from the sales price of the interest. In the case of an adjustment resulting from the death of a partner, Regs. § 1.755-1(a)(4)(i)(C) provide that the gross partnership value is tied to the post death stepped-up value under § 1014. On the other hand, if the adjustment flows from a “substituted basis” transaction such as a distribution by a partnership of an interest in a lower tier partnership under § 731 the partnership has no “independent” valuation to use as a benchmark. Consequently, the regulations fall back to the more general rule which provides that the partnership gross value equals the value of the partnership as a going concern increased by the amount of liabilities at the time of the exchange.<sup>22</sup>

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<sup>20</sup> See TD 9059 (6/9/2003).

<sup>21</sup> Regs. § 1.755-1(a)(3).

<sup>22</sup> Regs. § 1.755-1(a)(4)(ii)

Next, the partnership gross value calculated in step two is compared to the value of all non § 197 assets as calculated in step one and the excess, if any, equals the residual value of the partnership which is allocated to § 197 intangibles.<sup>23</sup> Finally, the residual value must be allocated among the intangible assets. This final allocation again uses the residual methodology. First, the value is allocated to “unrealized receivables” and then to other § 197 intangibles other than goodwill pro rata based on their relative fair market values. Last but not least any residual value left after allocating value to the non goodwill § 197 assets is then allocated to partnership goodwill.<sup>24</sup>

### **Allocation Between Classes**

The § 743(b) adjustment must be allocated between ordinary income and capital property. Again, to some extent, the regulations make use of a residual type of methodology this time integrated with the hypothetical sale methodology. Accordingly, the partnership first allocates the §743(b) adjustment to ordinary property. The amount allocated to ordinary property is equal to the total income or loss that would be allocated to the transferee partner of the partnership interest upon the hypothetical sale of the partnership’s ordinary income property. Not surprisingly, the amount allocated to capital gain property is equal to the total §743(b) adjustment less the amount already allocated to ordinary income property. If the residual allocable to capital gain property is actually negative, capital gain property is only reduced to the extent of the partnership’s basis in the capital gain property; any adjustment in excess of such basis is used to reduce the basis of ordinary income property.

### **Allocation Within Each Class**

The hypothetical sale method reigns with respect to the allocation of the adjustment among the property in the ordinary income class. The basis of each property within the ordinary income class is adjusted by the amount of income or loss that would be allocated to the transferee partner upon a hypothetical sale of the property.<sup>25</sup>

The capital gain property is similarly adjusted by the amount of gain that would be allocated to the transferee upon a hypothetical sale of the capital gain property.<sup>26</sup> To the extent the total gain thus far allocated to each property is greater than the § 743(b) adjustment the partnership then reduces the adjustment allocated to each capital gain property in proportion to the relative fair market values of each item within the capital gain property class.

In the case of substituted basis transactions, the allocation of the adjustment between classes and among the items of each class differ from the general rule in an attempt to

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<sup>23</sup> Where the partnership gross value is less than the value of the non-section 197 assets as calculated in the first step no allocation of value is assigned to § 197 intangibles.

<sup>24</sup> Regs. § 1.755-1(a)(5).

<sup>25</sup> Regs. § 1.755-1(b)(3)(i).

<sup>26</sup> Regs. § 1.755-1(b)(3)(ii).

avoid abusive basis shifting transactions. In the case of the substituted basis transactions the allocations of the adjustment are more similar to the adjustment allocations under § 734(b).<sup>27</sup>

### **Allocations of Section 734(b) Adjustments**

Just as with §743(b) the gross §734(b) adjustment is allocated among the assets of the partnership under the rules of § 755. The same three step process described above for allocating the § 743(b) adjustment is applicable to the allocation of the § 734(b) adjustment. Step one – valuation of partnership property – is identical whether the adjustment is pursuant to § 743(b) or § 734(b). However, Steps 2 and 3 – allocation of the adjustment to each class of partnership property and the allocation of the adjustment among the assets of each class - differs significantly depending on which section of the Code allows the adjustment.

#### **Allocation Between Classes**

The method of allocation of the adjustment among the classes of partnership property under Regs. § 1.755-1(c)(1) is driven by the nature of the partnership distribution. If the adjustment is the result of a partnership distribution of property (as apposed to cash) and the related increase or decrease in the basis of such distributed property of a certain class then the basis of property of the same class retained by the partnership will be adjusted. If, however, the adjustment is a result of a partnership distribution which causes the distributee partner to recognize gain or loss then the adjustment is allocated solely to the capital gain class of retained partnership assets.

#### **Allocation Within Each Class**

A § 734(b) positive adjustment allocated, pursuant to Regs. § 1.755-1(c)(2)(i) to a class of partnership property is allocated first to those assets within the class that are appreciated in value in proportion to the relative unrealized appreciation. Once all assets have been adjusted such that each property within the class has a basis equal to its fair market value any remaining adjustment is allocated to each asset within the class in proportion to the fair market value of each asset.

A § 734(b) negative adjustment allocated pursuant to Regs. § 1.755-1(c)(2)(ii) to a class of partnership property is allocated first to those assets within the class that are depreciated in value in proportion to the relative unrealized depreciation. Once all assets have been adjusted such that each property within the class has a basis equal to its fair market value any remaining adjustment is allocated to each asset within the class in proportion to the adjusted basis of each asset. Such adjustments must not reduce the basis of any asset below zero.<sup>28</sup>

### **Application of the Adjustments in the Tiered Partnership Context**

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<sup>27</sup> Regs. § 1.755-1(b)(5).

<sup>28</sup> Regs. §1.755-1(c)(3).

As if the calculation and allocation of the adjustments under §§ 743(b) and 754(b) were not complicated enough in the context of a single partnership, when a tiered partnership structure is added to the mix the application of these rules become even more complex and at times uncertain. The IRS has basically taken an entity approach with respect to adjustments in tiered partnerships. The service will look to see if each entity has a § 754 election in effect and will require or allow an adjustment for each tier only if that entity has made a separate election.

### **Section 743(b) – Revenue Ruling 87-115**

Imagine for a moment an upper tier partnership which holds an interest in a lower tier partnership. Often, especially in the world of real estate, this structure is the rule rather than the exception. Assume both the upper tier and lower tier partnership hold appreciated assets, in other words, assets with a fair market value which differs from their adjusted basis. If one of the partners in the upper tier partnership were to sell his or her interest in the partnership, potentially, there could be adjustments under § 743(b) at both the upper tier and lower tier partnerships.

The IRS in Revenue Ruling 87-115 provided guidance on the application of § 743(b) in the tiered partnership context. The facts in Revenue Ruling 87-115 were as follow. The upper tier partnership was held by four partners who each had a \$30 basis in their partnership interest as well as a \$30 share in the adjusted basis of partnership assets. The upper tier partnership purchased its interest in the lower tier partnership for \$80 and thus had an \$80 basis in its interest in the lower tier partnership. However, the upper tier's share of the adjusted basis of the lower tier partnership's assets was \$110. The lower tier partnership's only asset was a capital asset. The upper tier partnership also held inventory in which it had a basis of \$30. One of the partners of the upper tier partnership sold her interest in the upper tier partnership for \$50.

The Service ruled that if both the upper and lower tier partnerships both had § 754 elections in effect than both the upper and lower tier partnership would be required to make an adjustment to partnership property with respect to the purchaser's interest in the partnerships. The § 743(b) adjustment at the upper tier partnership level was \$20 which was equal to the difference between the purchaser's basis in its interest in the partnership (i.e. the purchase price) and the purchaser's interest in the inside basis of the partnership assets. Under the allocation rules in effect at the time of the ruling the adjustment was allocated equally to each asset - \$10 to the inventory and \$10 to the interest in the lower tier partnership (treated as a capital asset for purposes of the § 755 allocation).

With respect to the lower tier partnership the service stated that it was appropriate to treat the sale of the upper tier partnership as a deemed sale of an interest in the lower tier partnership which also had a § 754 election in place. Thus, rather than simply push down the \$10 adjustment with respect to the upper tier partnership's interest in the lower tier partnership's interest the service treated the deemed sale of the interest in the lower tier partnership as an almost independent transaction. Accordingly, the total § 743(b)

adjustment at the lower tier level was \$2.50, equal to the excess of the purchaser's share of the upper tier partnership's basis in the lower tier partnership over the purchaser's share of the adjusted basis in the lower tier partnership's assets. The adjustment at the lower tier partnership was allocable only to the upper tier partnership and to the purchaser of the interest in the upper tier partnership.

On the other hand, the Service ruled that if the upper tier partnership did not have a § 754 election in effect then no adjustment was available and similarly if the lower tier partnership did not have a § 754 election in effect then the § 743(b) adjustment would only be applicable to the upper tier partnership.

### **Section 734(b) – Revenue Ruling 92-115**

The IRS in Revenue Ruling 92-15 provided guidance on the application of § 734(b) in the tiered partnership context. The facts in Revenue Ruling 92-15 were as follows. Upper tier partnership is owned by A and B who each hold a 50% interest. A has no basis in her partnership interest but the interest has a fair market value of \$160,000. The upper tier partnership holds two assets; a capital asset with a basis of \$140,000 and a market value of \$240,000 and a 10% interest in the lower tier partnership with a basis of \$30,000 and a fair market value of \$80,000. The lower tier partnership also holds two assets – a capital asset with a basis of \$200,000 and a fair market value of \$700,000 and a non capital asset with no basis and a fair market value of 20,000. The upper tier partnership's proportionate share of the adjusted basis of the assets of the lower tier partnership was \$20,000.

The Service ruled on two different scenarios. In the first scenario the upper tier partnership distributed half of its capital asset (adjusted basis of \$70,000) to A in partial liquidation of A's interest in the upper tier partnership. A would normally take a basis in the distributed asset equal to the basis in the hands of the partnership, however, the basis in the hands of A is limited to A's basis in her partnership interest.<sup>29</sup> Thus A would have a zero basis in the distributed asset. The upper tier partnership had a § 754 election in effect and therefore, it would make a § 734(b) adjustment of \$70,000 and allocate the adjustment evenly among the two upper tier partnership assets. The lower tier partnership also had a § 754 election in effect. The Service explained that it would therefore be appropriate to push down the 35,000 adjustment allocable to the upper tier partnership's interest in the lower tier partnership to the lower tier partnership's assets. Accordingly, the Service ruled that the lower tier partnership should adjust its capital asset in the amount of \$35,000, but only with respect to the upper tier partnership's interest in the lower tier partnership.

In the second scenario the upper tier partnership distributed its interest in the lower tier partnership to A in partial liquidation of its interest in the upper tier partnership. Again, because the upper tier partnership had a § 754 election in effect the upper tier partnership should increase its basis in the remaining capital asset by \$30,000. The lower tier

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<sup>29</sup> § 732(a)(2).

partnership also had a § 754 election in effect. The Service ruled that the distribution of the interest in the lower tier partnership is treated as a sale or exchange of an interest in the lower tier partnership and thus an adjustment under § 743(b) would be applicable to the lower tier partnership.

### **Entity vs. Aggregate Theory – A Cornucopia of Issues**

The two revenue rulings provide some guidance and perhaps a partial framework for the application of §§ 743(b), 734(b) and 755 to tiered partnerships. On the other hand the application of §§ 743, 734 and 755 seems to be a tangled thistle of the aggregate and entity theories. When moved into the tiered partnership structure the thistle becomes that much denser. Any attempt to determine which theory dominates at any given moment will surely lead to vexation; nevertheless it is probably a necessary exercise. At times the guidance appears to lean toward the entity theory, at times it appears to lean toward the aggregate theory and at others it appears to be an impossible mix of the two with no readily apparent underlying principles.

The tiered partnership structure can give rise to a multitude of issues which are not necessarily directly addressed by the revenue rulings. In fact the revenue rulings themselves may give rise to certain questions. Finally, as noted above, there have been significant changes to §§ 743(b), 734(b) and 755 as well as to the regulation there under since the publication of the two revenue rulings. Despite the statutory and regulatory changes, and despite having ample time, the Service has neither rescinded nor superseded the Revenue Rulings. Therefore, while the rulings certainly still provide relevant authority, the changes to the Code and Regulations present additional challenges when trying to apply the guidance in the revenue rulings.

### **Calculation of Previously Taxed Capital**

In order to provide more certainty in the calculation of a partner's share of inside basis of partnership assets, the regulations promulgated in 2000 instituted a more concrete and mathematical methodology based upon the concept of previously taxed capital. Application of the concept to a single partnership may be mathematical, yet application of the concept in the tiered partnership structure can become more murky than mathematical. The uncertainty lies in whether to apply the concept at the entity level or to look through the lower tier entity and apply the previously taxed capital concept with respect to the assets of the lower tier partnership. The better and seemingly more consistent approach would be to calculate previously taxed capital at each tier independently in a manner consistent with the entity theory and with the general approach taken in the relevant revenue rulings.

### **It's Not Always Optional - Mandatory Negative Adjustments**

The adjustments under §§ 743 and 734 are frequently referred to as optional basis adjustments. However, in 2004, Congress decided that taxpayers had a few too many

options and accordingly, to the creative tax planner's dismay, curtailed a few of those loss duplication and loss shifting options through statutory changes to §§ 743 and 734.

Congress modified both §§ 743 and 734 to provide that if with respect to a transfer or distribution which would trigger a negative adjustment under those sections but for the lack of an election under § 754, then an adjustment may be required regardless of whether there is a § 754 election in effect. If there is a substantial basis reduction (under § 734(b) and (d)) or a substantial built in loss (under § 743(b) and (d)) then a downward basis adjustment will be required. These new mandatory adjustment rules engender two potential uncertainties in a tiered partnership context.

### **The Section 754 Election**

As modified, under certain circumstances, a downward adjustment is required upon a transfer of an interest or a distribution even where the partnership has not made a § 754 election. However, it is not clear whether or not the downward adjustment must necessarily filter down to the lower tier partnership absent a § 754 election. The guidance provided by the IRS in the revenue rulings discussed above invariably requires that the lower tier have a § 754 election in effect before any adjustment triggered at the upper tier partnership will work its way down to the lower tier partnership. This § 754 election requirement arguably reflects the predominance of the entity theory and perhaps the need for such an election even in the context of the mandatory negative adjustment. However, given the nature and structure of the relevant Code sections a more likely interpretation would be to treat the modified provisions as creating a deemed § 754 election. Thus, in the context of the tiered partnership structure the mandatory negative adjustment should be made at the lower tier, as long as there is a substantial basis reduction or built-in loss at the lower tier partnership. In other words, similar to the regular adjustment, the mandatory negative adjustment should be taken at the lower tier partnership; however, the adjustment should be independently calculated and allocated at each level.

### **The Investment Partnership Exception and the No Trade or Business Requirement**

Not surprisingly where there is a new rule there is also a new exception to the rule. Congress legislated an exception to the mandatory negative adjustment for §§ 743 and 734 for investment partnerships as defined in new §§ 743(f) and 734(e). A partnership will not qualify to use the exception if it operates or has in the past operated a trade or business. This begs the question whether a trade or business of a lower tier partnership will be attributed to the upper tier partnership with respect to the application of the investment partnership exception. Once again we jump back into the tangle of entity versus aggregate theory. Based upon preliminary guidance from the Service, the aggregate theory gains the upper hand. The Service requires the partnership to look through its interest and determine if the lower tier partnership conducts a trade or business. If it does, and the adjusted basis of the lower tier partnership comprises 25% or more of the capital of the upper tier partnership the trade or business of the lower tier

partnership will be attributed to the upper tier partnership for purposes of applying the investment partnership exception.<sup>30</sup>

### **Terminations of Upper Tier**

The regulations issued in 2000 clarify, through the provision of special rules with respect to § 743, that a substituted basis transaction may trigger a § 743 adjustment despite the fact that there is no gain or loss recognized on the transfer. Where there is no gain on a transfer it is conceivable that the § 743 rules could be more easily overlooked. However, the statutory trail clearly mandates the application of § 743 in the case of a liquidation of an upper tier partnership. Upon a liquidation of the upper tier partnership the interests in the of the upper tier partnership in the lower tier partnership are distributed to the partners of the upper tier partnership. Section 761(e) provides that a distribution of an interest in a partnership should be deemed a sale or exchange for purposes of § 743. Accordingly, prior to the dismantling and liquidation an upper tier partnership for non-tax reasons, it is important to encourage partnerships to closely examine the potential tax consequences under § 743 even where the liquidation would otherwise have no significant tax impact.

### **Avoid the Residual Valuation Urge**

Valuation is a critical step in the adjustment process. Occasionally, due to time and budgetary constraints, a partnership may be tempted to take what might appear to be a reasonable shortcut. Take for example an upper tier holding partnership which owns an interest in a lower tier partnership. The upper tier's only other asset is cash. The lower tier partnership owns and operates several retail properties. One of the partners in the upper tier holding partnership sells his interest in the upper tier partnership. The upper tier partnership evaluates the situation and makes an assumption that its adjusted basis in its interest in the lower tier is equal to the fair market value of the lower tier and thus the excess of the price paid for the interest must represent goodwill under the residual method. In this manner only the upper tier partnership requires a § 754 election and the positive adjustment will be amortizable over 15 years.

While this use of the residual method may initially appear appealing, a closer analysis would probably reveal that the excess value of the upper tier partnership interest more likely reflects an increase in the value of the lower tier partnership's assets. Thus, at the upper tier partnership level the excess value is more appropriately assigned to the interest in the lower tier partnership rather than to goodwill of the upper tier partnership. Under these circumstances, if only the upper tier partnership makes a section 754 election the adjustment would be allocated to the interest in the lower tier partnership. The transferee partner would obtain no benefit from the adjustment unless and until the upper tier partnership disposes of its interest in the lower tier partnership. A current benefit will only accrue to the transferee partner if the lower tier partnership also makes a section 754 election and then allocates the basis to appreciated depreciable assets.

### **Suspended Negative Adjustments**

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<sup>30</sup> Notice 2005-32, 2005-16 IRB 895.

Negative adjustments pursuant to section 734(b) may not decrease the basis in depreciated partnership assets below zero. Once the adjusted basis of assets in a particular class is decreased to zero any remaining adjustment cannot be used to decrease basis of assets in the other class. Any unused negative adjustment is suspended. The suspended adjustment lies in wait and will attach itself to any asset of a like class acquired by the partnership and consume its basis.<sup>31</sup>

In the context of tiered partnership structure, where the negative adjustment at the upper tier as it relates to the interest in the lower tier is partially suspended, the question arises as to the effect of the adjustment at the lower tier assuming a section 754 election is in effect. In Revenue Ruling 92-15 the Service explained that it was appropriate to push down the adjustment applicable to the lower tier to the assets of the lower tier. Under this rationale, it would appear that the adjustment at the lower tier should not exceed the adjustment at the upper tier even if there is sufficient basis in the lower tier assets to absorb the full adjustment.

### **Character of Interest in Lower Tier for Purposes of 755**

The allocation provisions of § 755 require the partnership to bifurcate its assets into two classes; ordinary income property and capital gain property. It is far from certain as to which class an interest in a lower tier partnership belongs. Entity theory would dictate treating the interest in the lower tier partnership as a capital asset. And, in fact, a sale or exchange of a partnership interest is generally treated as a sale or exchange of a capital asset.<sup>32</sup> Aggregate theory on the other hand would suggest that looking through the partnership interest to the assets of the lower tier interest would be more appropriate with respect to the classification determination. And, in fact, if a partnership holds ordinary income assets (unrealized receivables and inventory items) and an interest in the partnership is sold, a portion of the gain on the sale may be treated as ordinary under the rules of § 751.<sup>33</sup>

Further support for the aggregate approach can be found in the fact that the regulations under § 755 specifically provide that unrealized receivables under § 751 should be treated as ordinary income assets.<sup>34</sup> Moreover, under § 741(f), the determination of which partnership property should be treated as unrealized receivables or inventory requires the partnership to look through its interests in lower tier partnerships and treat its proportionate share of lower tier assets as assets of the upper tier partnership.

Thus, there appears to be more logical support for the aggregate approach. Accordingly, a partnership may need to bifurcate its interest into both classes of property for purposes of the § 755 allocation provisions. If the lower tier partnership holds both capital gain property and ordinary income property, a portion of the upper tier partnership's interest in

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<sup>31</sup> Regs § 1.755-1(b)(5)(iii)(D).

<sup>32</sup> See § 741.

<sup>33</sup> See section 741.

<sup>34</sup> Regs. § 1.755-1(a)(1).

the lower tier may be treated as capital gain property and a portion may be treated as ordinary income property.

As is often the case in the practice of tax law, one answer may lead to other, possibly arcane but interesting, questions. For instance, assuming that a bifurcation of the interest in the lower tier partnership is the correct answer, how will a subsequent shift the proportion of ordinary assets and capital gain assets effect past or future adjustments. Application of the bifurcation approach may prove challenging in the case of a suspended negative adjustment. The analysis of these and other issues are beyond the scope of this article, however, these difficult issues reflect the uncertain nature involved in application of these rules and the need for further exploration and guidance.

### **Contributions of Adjusted Property**

Historically, there has been some uncertainty as to the retained character of § 743 adjusted assets which have been contributed to a lower tier partnership. In other words, did the adjustment retain its character as a § 743 basis adjustment allocable only to the transferee or did the adjusted basis become part of the common basis of the lower tier partnership. However, the regulations under § 743 have to some extent clarified the appropriate treatment. Regulations § 1.743-1(h) provide that upper tier partnership's basis in the lower tier as well as the lower tier's basis in contributed property is determined with reference to the § 743 adjustment. Thus, the upper tier's basis in the lower tier includes the § 743 adjustment and the lower tier's basis in the contributed property includes the § 743 adjustment. The adjustment (at the lower and upper tier) however, must be segregated and allocated solely to the contributing upper tier partnership and then solely to the original transferee partner. This rule applies regardless of whether there is a § 754 election in effect at the lower tier. Certainly, the intentions of these rules are clear, however, the practical application of somehow tracking and allocating basis adjustments through two or more tiers of partnerships under various factual circumstances may prove to be challenging.

### **Practical Matters**

#### **Communication**

Partnerships cannot make adjustment under either § 743 or § 734 unless they are made aware of the transaction causing the adjustment. Logically, the regulations under § 743 require a transferee of an interest for which a § 754 election is in effect to provide written notice to the partnership within 30 days of the sale or exchange. The regulations do not specify whether the notice requirements apply to then require the partnership to give notice to any lower tier partnerships with § 754 elections in effect. However, as a practical matter it would seem advisable to have the upper tier partnership give notice to the lower tier partnerships. In the case of investment partnerships it is entirely possible that the upper tier partnership will have no knowledge of whether a lower tier partnership has a § 754 election in effect and therefore, notice may not be practical.

There are no penalties or other similar enforcement mechanisms with respect to the notice provisions. However, the potential for a disgruntled partner suing over a lost basis adjustment is probably sufficient motivation to provide notice when necessary.

In the context of § 734 there is no similar notice requirement – presumably because a partnership will be well aware of its own distributions. However, to the extent an adjustment may be pushed down to a lower tier it often will be beneficial to give timely notice to the lower tier.

### ***The Election***

One other item to keep in mind is that the §§ 743 and 734 adjustments are generally optional and require an affirmative and timely election. An upper tier partnership with a non controlling interest in a lower tier partnership may not have the leverage to compel the lower tier partnership to make the § 754 election. As a practical matter, however, since the institution of the mandatory negative adjustment, the potential adverse effect of making the election had been mitigated and typically the lower tier would have no tax motivations for refusing to make the election.

### **The Entity v. Aggregate Scorecard**

As demonstrated above the application of §§ 734 and 743 in the tiered partnership structure reflects an intense contest between the entity and aggregate theories. Below is a scorecard:

	Entity	Aggregate
(1)	General Rule of §§ 734(a) and 743(a) – no adjustment on distribution or transfer	Section 734(b) and 743(b) – allows adjustment to ameliorate inside/outside basis inequality
(2)	Section 754 election –the need to make an election seems to indicate a preference for the entity theory	Look through Lower Tier to determine trade or business for Investment partnership exception to mandatory negative adjustment
(3)	Section 755 allocations represent a mix of the two theories	Section 755 allocations represent a mix of the two theories
(4)	The Revenue Rulings requirement of a § 754 election reflects the entity theory.	On the other hand, the Revenue Rulings’ provision for an adjustment of the basis of the lower tier assets reflects the aggregate theory.
(5)		The bifurcation methodology with respect to §755 as supported by § 751(f) reflects the aggregate theory.

While there is no obvious pattern, perhaps, generalization can be made with respect to the application of the two theories within the realm of §§ 734 and 743. It would appear that to some extent, when it comes to the determination of the nature or character of the interest in the lower tier partnership the aggregate theory is slightly more dominant. And on the other hand, to some extent, when it comes to the calculation at each level the entity theory tends to dominate.

### **Conclusion**

The tension between the entity and aggregate theories in Subchapter K is probably most apparent in the application of §§ 743 and 734 in the tiered partnership context. Obviously, the concept of adjusting the basis of assets of a partnership is one engendered by the aggregate theory. However, the actual application of the rules under §§ 734 and 743 are replete with the influences of both the aggregate and the entity theory. With respect to certain issues the entity theory dominates and with respect to other issues the aggregate theory prevails and at times they meet halfway. Revenue rulings 87-115 and 92-15 provide some basic guidance on the application of §§ 743 and 734 to tiered partnership structures. The regulations provide a few glimpses of guidance with respect to very specific issues. However, under probably the majority of circumstances the partnership practitioner is left to her own devices and must carefully analyze each particular set of facts and circumstances in light of the minimal regulatory and administrative guidance and the application of the entity and aggregate theories.