What you need to know

Section 754 Election

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What you need to know:
Section 754
"Inside" vs. "Outside" Basis Problems

Section 754 of the IRS code deals with complex and often misunderstood tax concepts that often arise in partnerships. This article will outline these concepts, how they can lead to mismatch basis problems, and the curative aspects of the 754 election.

Before diving into the details of 754, it is important to understand consequences of certain partnership actions without a 754 election. Then we will see what happens to these (undesired) consequences when 754 is elected.

FAST FACTS

- "Inside" basis is the total equity the partnership has in its assets
- "Outside" basis is each partner's (tax) basis in their ownership
- Making the 754 election can benefit the owner greatly by allowing current deductions.

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Inside and Outside Basis

"Inside" basis is the total equity the partnership has in its assets, whereas "Outside" basis is each partner's (tax) basis in their share of the ownership. At the formation of a partnership inside and outside basis are usually equal.

FYI

With things always changing, be sure to talk with Reilly, Penner & Benton LLP to understand the most current rules that apply when working with section 754 elections.

As a general rule, the basis of partnership property shall not be adjusted as a result of a sale, exchange, death of a partner (IRS 743(a)) or redemption (IRS 734(a)).

Why is the no adjustment rule a problem?

When a sale, exchange, death of a partner, or redemption occurs, a mismatch of inside basis and outside basis will likely be the result as these values often differ from the partner's capital *account*. An example may help to illustrate.

Partnership ABC, three partners originally contributed $100,000 each, and the partnership bought land for $300,000. The land now has a fair market value of $375,000. All the gain is unrealized; the balance sheet has not changed. Inside and outside basis are still equal. Inside is total of $300,000 ($100,000 each), outside is $100,000 each.

Partner A now wants to cash out. Agrees to sell shares to new partner, X, for $125,000 cash. A is taxed on the $25,000 of gain. However, per the general rule, inside basis is transferred to the new partner with NO adjustment. X now has an inside basis of $100,000, but has an outside basis of $125,000 (what he paid for it). This becomes an issue when the partnership decides to sell the land. Total inside basis is $300,000, with a sale price of $375,000, resulting in a taxable gain of $25,000 for each partner. For partner X this is a problem; X has not gained anything, but has a tax liability.

Making the 754 Election

Making the 754 election will bring the inside and the outside basis into balance, therefore preventing underserved gains when appreciated property is sold. The critical thing to understand about the 754 election **is it is a tax concept only**. It does not appear on the balance sheet, no money is changing hands. Likely the only place to find it is on the partnership's tax schedule or the partner's K-1. When the election is in place, the partnership steps-up the total inside basis, **but it only affects the new partner.**

Partner	Orig. Inside Basis	Step Up	New Inside Basis	Sale $ (Portion)	Gain
B	$100,000	-	$100,000	$125,000	$25,000
C	$100,000	-	$100,000	$125,000	$25,000
X	$100,000	$25,000	$125,000	$125,000	Zero
Total	$300,000	$25,000	$325,000	$375,000	$50,000

Under the election the $125,000 for X is a return of capital, no gain. The election prevents that gain from showing up as taxable again.

HOW TO ELECT?

If the partnership decides they want the step-up they must make the 754 election. It must be made before the due date of the income tax return, including extensions, for the year that the transfer occurs. The partnership needs to attach the corresponding (signed) forms to the income tax return.

WHY NOT TAKE IT?

As a general rule, if a partnership has assets that are appreciating and routinely experiences changes in partnership owners, a Section 754 election should be given strong consideration.
But there are **drawbacks to consider:**
The primary drawback is that it cannot be revoked without IRS approval due to: a change in the nature of the partnership's business; a substantial increase in partnership assets; a change in the character of partnership assets; or an increased frequency of retirements and shifts in partnership interests that increase the administrative burden placed on the partnership by the election).
If the partnership sees a decline in the value of their assets, the Section 754 election has undesirable results. A loss in value would require the partnership to reduce a partner's inside basis to match their outside basis. If the asset is depreciable, it would result in negative depreciation adjustments.
The administrative burden when the partnership or transaction is complex. Requirements in code sections 743, 734, and 755 all contain additional complexity and exceptions, especially for depreciable property.

The challenges of the 754 election add consideration to the overall benefits of making this potentially advantageous election.