

Purchasing a Partnership/LLC Interest: Tax Tip #2 – Code Section 754 Election

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When clients purchase from existing partners an interest in a partnership/LLC that holds “appreciated” real estate², there is a valuable partnership tax election under §754 of the Internal Revenue Code (“Code”) that should be obtained.³ For the purchaser, the §754 election allows the partnership to increase the tax basis of its assets allocable to the buyer, which creates (i) greater annual depreciation deductions and (ii) less taxable gain or even a loss when the partnership sells assets; this election, however, has no effect on the existing partners. Buyer’s counsel should determine if the partnership already has this election in effect, and if not, request that it be made. Set forth below is some relevant background followed by an example to highlight the benefits of the election.

Inside v. Outside Basis: A partnership maintains records of the tax basis of its assets, which is referred to as the “inside” basis of the assets. A partnership is a “pass-through” entity and all its taxable income, gain, loss and deductions are allocated among its partners on Schedule K-1s. As a result, inside basis is important to a partner since it is used to determine (i) taxable gain or loss on sale of property and (ii) depreciation deductions. Residential real estate can generally be depreciated on a straight line basis over 27.5 years while commercial real estate can be depreciated over 39 years; land, however, is not depreciable. Personal property (such as kitchen appliances in an apartment building) can be depreciated over much shorter lives and on an accelerated basis.

Partners in a partnership have to maintain records of their tax basis for their partnership interest, which is referred to as the “outside” basis for their partnership interest. This outside basis is used to determine (i) the taxable gain or loss on sale of the partnership interest, (ii) the treatment of cash distributions from the partnership to partners, which are only taxed if they exceed the outside basis, and (iii) whether a partner can use a tax loss allocated to them, which is only allowed up to the amount of the outside basis.

The buyer’s outside basis starts with the purchase price, but then adjustments are made:

First, partners increase their outside basis for any cash contributions made to the partnership. Code §752 provides that each partner is treated as making a deemed cash contribution to the partnership in an amount equal to their share of partnership liabilities, which is determined differently for recourse and non-recourse loans. As a result, the buyer can increase their outside basis by their share of partnership liabilities, which is very helpful.

Second, each year, the partnership allocates taxable income, gain, loss and deductions among its partners and may make distributions to its partners. The outside basis is increased for income and gain allocations, and decreased for loss or deduction allocations and cash distributions. For example, if a partner is allocated \$100 of taxable income and receives a \$60 cash distribution then the outside basis first goes up by the

\$100 income allocation and then goes down by the \$60 cash distribution. Other adjustments are required when liabilities increase or decrease during each year.

Inside Basis-Outside Basis Differential & Benefits of Election: If a person buys appreciated real estate, the tax basis of the property will be increased to the price paid, which can generate added depreciation deductions and lower gain (or even a loss) on sale of the property. However, when a person buys a partnership interest in a partnership holding appreciated property, there is no automatic adjustment of the inside basis of the partnership property that is allocable to the buyer's interest. As a result, the buyer's outside basis for their partnership interest would generally exceed that partner's share of the inside basis of partnership assets allocated to their interest in the partnership.

The making of the §754 election activates a special adjustment under §743 to the inside basis of the partnership's assets, but only for the portion of the partnership's assets allocated to the buying partner. Existing partners are not affected. For example, AB Partnership has ten equal partners with each having a 10% interest in the partnership. Each partner's outside basis is \$100 and the partnership's inside basis for its only asset, an office building, is \$1,000; the building now has a fair market value ("FMV") of \$5,000 and there is no debt. A buyer purchases a 10% interest from Partner A for \$500 (10% of the \$5,000 FMV). If the election is made then the partnership can increase its inside basis for 10% of the property, which is the buyer's share of that asset, from \$100 to the \$500 purchase price, solely for the buyer's benefit. As a result, the partnership can greatly increase the depreciation deductions allocated to the buyer while not reducing any deductions allocated to the other partners.

The §754 election is not made at closing, but only needs to be made on the partnership's tax return for the year in which the purchase is made. Once made, the election cannot easily be revoked.

Downsides of §754 Election: The §754 election complicates tax return preparation. This task may not be difficult if only one property is owned by the partnership, but it gets more complex if the partnership owns many properties. Sometimes, the partnership will only agree to the §754 election if the buyer pays the added tax preparation costs.

A §754 election is not generally desirable if the partnership holds "depreciated" real estate whose FMV is less than their tax basis since the election would force a decrease in the inside basis of partnership assets allocable to the buyer. A few years ago, Congress amended §754 to require a mandatory §754 election if there is a built-in loss (that is, excess of basis over F.M.V.) of more than \$250,000 in partnership property. This change has lessened concern that the election will cause harm if property values start to fall.

Conclusion: The Code §754 election can reduce a client's tax burden for many years with little adverse effect to other partners. It should be added to a request list for any client buying into a partnership holding appreciated property.

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¹ The May 2015 edition of eReport contained the preceding article by the author entitled “Purchasing a Partnership/LLC Interest: Tax Tip #1-Requiring Tax Distributions.”

² The election is even beneficial if the property’s fair market value has not gone up, but is greater than the adjusted tax basis of the property in the hands of the partnership. The adjusted basis of the property starts with the purchase price for the property, but is decreased each year by depreciation deductions claimed for the property.

³ The §754 election is valuable if the partnership owns any appreciated asset, not just real estate, and it also can apply to a transfer made on the death of a partner. However, the election is not available if the investor buys the partnership interest directly from the partnership, which can occur when the partnership wants to raise more capital and sells partnership interests directly to new investors for cash. In this case, there are certain tax planning tools that need to be considered by both the buyer and the existing partners, which will be discussed in a later installment.