Section 743(b): A Second Basis Adjustment Following The Death of a Partner

By NANCY A. CHILLAG*

According to the author, while an adjustment to the basis of partnership assets under Section 743(b) may be made upon the death of a partner when the deceased partner's interest passes to the estate if a Section 754 election is in effect, it appears that a second Section 743(b) adjustment is available when the interest passes from the estate to the beneficiary because of sale or exchange treatment.

Nancy A. Chillag is associated with the San Francisco office of Arthur Andersen & Co.

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Under Section 743(b), if a Section 754 election is in effect, an upward or downward adjustment to the basis of partnership assets is required upon the death of a partner. If the partnership property has appreciated in value since the decedent partner acquired his interest, this adjustment can reduce future gain recognition on a sale of partnership assets and increase depreciation allocated to the successor partner. Practitioners who are aware of the availability of Section 754 and Section 743(b) make the adjustment upon death when the interest passes from the deceased partner to the estate. A Section 743(b) adjustment is also available, however, upon the sale or exchange of a partnership interest. While there is little or no authority on this issue, it appears that, through proper administration of the estate, a second Section 743(b) adjustment is available when the interest passes from the estate to the beneficiary because of sale or exchange treatment. This article will review the Section 754 election in conjunction with the Section 743(b) adjustment and suggest ways in which the estate planner can obtain a second adjustment.

Background

Partnership assets acquired by contribution from the partners usually take on the contribu-

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tor's adjusted basis under Section 723. If the partnership assets are acquired through purchase or by some other means, the basis is determined under the general rules of Sections 1011-1023. The basis of these assets (referred to as the inside basis) is generally not affected by transfers of a partnership interest unless the transfer causes a termination of the partnership or the partnership has a Section 754 election in effect.

A partner's adjusted basis of his partnership interest (referred to as the outside basis) is usually determined by the basis of the property contributed under Section 722. The basis of a partnership interest acquired other than by contribution depends upon the means of acquisition. If acquired by gift or transfer in trust, the transferee has a carryover basis under Section 1012. If the interest is acquired from a decedent, the basis under Section 1014 is equal to the fair market value of the interest at date of death.

The relationship between the basis of a partner's interest in the partnership and the basis of the partnership's assets is that the aggregate outside basis generally equals the aggregate inside basis. This calculation, however, is not consistent when a partner acquires his interest by purchase or on account of death unless a Section 754 election is in effect, because the new interest is at fair market value and the partnership assets maintain their old basis.

Under Section 754, if the partnership so elects, the basis of the partnership property shall be adjusted, as provided in Section 743(b) in the case of a transfer of a partnership interest by sale or exchange or upon the death of a partner.[1] The adjustment under Section 743(b) is either (1) to increase the adjusted basis of the partnership property by the excess of the transferee partner's basis (cost or fair market value) in his partnership interest over his proportional share of the adjusted basis of the partnership property, or (2) to decrease the adjusted basis of the partnership property by the excess of the proportional share of the adjusted basis of the partnership assets over the transferee's basis in his partnership interest. The purpose of allowing the adjustment is twofold. First, the adjustment provides an equalization of the inside basis and the outside basis. Second, this equalization prevents double taxation on a partnership's disposition of its assets. It also allows the transferee to depreciate his share of the assets using his cost basis (not his predecessor's) and to recognize gain or loss on the sale of partnership assets only on the spread between the sales price and the fair market value (as adjusted) of the assets on the date he received his partnership interest.

Making the Section 754 Election

The decision to make a Section 754 election is very important. It can have negative as well as positive effects. If the partnership assets increase in value, there is an upward adjustment; however, if they decrease in value, the partnership is required to make a downward adjustment. While it is common to assume that prices will increase in times of high inflation, this is not necessarily true. A perfect example involves computers: as technology increases, the price of computers decreases.

Another important aspect of a Section 754 election is that, once made, it is permanent: revocation can occur only with permission of the Internal Revenue Service.[2] The regulations specifically provide that no revocation will be permitted simply to avoid stepping down the basis of partnership assets.

When a partner dies and his interest passes to his estate, the executor must analyze the situation carefully. If the assets of the partnership have significantly increased in value and the partnership does not have a Section 754 election in effect, the executor may wish to request that the partnership make such an election. The two main concerns of the partnership will be the possibility of future decreases in asset values[3] and the administrative burden of maintaining separate records for each incoming partner.

The executor must also act quickly because of the deadline requirements for making the election. The election must be made in a written statement filed with the partnership return for the taxable year during which the distribution or transfer occurred. A very short decision making time may exist if the partner dies near the end of the partnership taxable year. The election may be made, however, within the time prescribed for extensions; the IRS is relatively lenient when an election deadline has been missed because of insufficient time to make a decision after the death of a partner or because of a mistake by the attorney/accountant.

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[1] Adjustments may also occur under Section 734 when property is distributed to a partner. Section 734, however, will not be discussed in this article.

[2] Reg. § 1.754-1(c).

[3] A decrease in value would be detrimental to all partners under Section 734(b) upon a liquidating distribution.

If a Section 754 election is in effect, the Section 743(b) adjustment is automatic upon the passing of the interest from the decedent to the estate. The estate planner, however, should be aware of the election and notify the partnership of the need to make the adjustment.

The starting point of a Section 743(b) adjustment is the determination of the transferee's basis in the interest. There will be a step-up in basis (assuming appreciation) to the fair market value on the date of death under Section 1014(a). Section 1014 contemplates the elective alternate valuation date of Section 2032. Thus, the alternate valuation date may be an appropriate starting point for a Section 743(b) basis adjustment. The same basis rules will apply if the interest was placed in a grantor trust prior to death because the grantor is treated as owning the interest until death, thus making the Section 743(b) adjustment available.[4]

Once the basis to the transferee is determined, the basis of the partnership assets will be adjusted under Section 743(b) to account for the increase or decrease.[5]

Carryover v. Additional Adjustment upon Distribution to a Beneficiary

The Section 743(b) adjustment is personal to each transferee. All items of gain, loss, deduction, etc., with respect to the previously existing partners are calculated using the basis of the property without a Section 743(b) adjustment.[6] When more than one transfer of a partnership interest occurs, the Section 743(b) adjustment of each transferee is determined by comparing the basis of the transferee's partnership interest with the partnership's common basis for its property without regard to any prior transferee's special basis adjustment. In other words, the new partner is not allowed to take the previous partner's adjustment, but rather a new adjustment must be computed. The Section 743(b) adjustment, however, is made only upon a transfer by sale, exchange or death. The distribution from the estate (the partner succeeding the decedent) to the beneficiary (the partner succeeding the estate) is obviously not a transfer on account of death. Therefore, the question is whether the distribution is sufficiently similar to a sale or exchange to warrant a second Section 743(b) adjustment.

Section 1014 does not treat the distribution from the estate to the beneficiary as a transfer. The regulations refer to the law governing wills and property distribution whereby all titles to property acquired by bequest, devise or inheritance relate back to the death of the decedent, regardless of the length of time the estate held the property. Accordingly, a common acquisition date exists for all titles to property acquired from a decedent within the meaning of Section 1014 and, thus, a common basis for all such interests exists. It is as though the estate never held the interest; therefore, the distribution is not treated as a transfer,[7] and without a transfer there can be no new Section 743(b) adjustment. The beneficiary will maintain the special basis adjustment that the estate received when the partnership interest originally passed from the decedent.

The disadvantage of the common basis rule is that estates often hold the partnership interest for a considerable amount of time during which the partnership property appreciates in value. The beneficiary cannot obtain a benefit from this appreciation without a Section 743(b) adjustment.

There is, however, an exception to the general rule of Section 1014: the common basis rule does not apply to property distributed by an executor or administrator under circumstances such that the distribution constitutes a sale or exchange.[8]

There are two situations requiring sale or exchange treatment: (1) the use of appreciated property to satisfy distribution of pecuniary bequests, and (2) the distribution of property subject to liabilities in excess of basis. While there are no court cases or IRS rulings on the issue, it would seem only logical that when a partnership interest passing from an estate to the beneficiary is required to be treated as a sale or exchange for tax purposes, a Section 743(b) adjustment should be allowed. A third situation that may also trigger Section 743(b) is a distribution of distributable net income (DNI). As discussed below, a DNI distribution has several characteristics similar to a sale or exchange. The

[4] CCH IRS Letter Rulings Reports No. 259, February 17, 1982, Ltr. Rul. 8206108; CCH IRS Letter Rulings Reports No. 262, March 11, 1982, Ltr. Rul. 8208127; CCH IRS Letter Rulings Reports No. 265, March 31, 1982, Ltr. Rul. 8212064, CCH IRS Letter Rulings Reports No. 266, April 8, 1982, Ltr. Rul. 8213071.

[5] Rev. Rul. 79-84, 1979-1 CB 223.

[6] Note that a Section 743(b) adjustment may not be available if the unrealized receivables of the partnership are, in essence, income in respect of a decedent. *Quick Trust*, CCH Dec. 30,187, 54 TC 1336 (1970).

[7] Reg. § 1.743-1(c)(iv).

[8] Reg. § 1.1014-4(a)(3).

remainder of this article will discuss these three situations.

Pecuniary Bequests

A pecuniary bequest requires the estate to distribute to the heir an amount specified in the will either in cash or in property.[9] The distribution of appreciated property in satisfaction of a pecuniary bequest results in taxable gain to the estate.[10] This will usually occur when the estate remains open for a considerable amount of time.[11]

For example, if the decedent's will provides that the estate distribute $20,000 to a beneficiary and the executor distributes $20,000 cash, no gain is realized. If, on the other hand, the executor distributes property which has a basis to the estate of $18,000, but at date of distribution has a fair market value of $20,000, the estate would realize a $2,000 gain.[12] The distributee's basis will be equal to the fair market value of the property at the date of distribution—$20,000.[13] This scenario resembles a sale or exchange due to the recognition of gain and the fact that the basis equals the fair market value of the property on the transaction date. If the property distributed is a partnership interest, the sale or exchange treatment should trigger Section 743(b).

Liabilities in Excess of Basis

If the estate makes a distribution of a partnership interest in satisfaction of a bequest and its share of partnership liabilities are in excess of the interest basis, sale or exchange treatment will result.[14] *Crane v. Commissioner*[15] established that liabilities assumed by the purchaser are included in the purchaser's basis and the seller must treat the liability as part of the amount realized. In that case a man devised to his wife a building with a mortgage of $262,000 and valued at date of death at exactly that amount. The taxpayer did not pay off the mortgage but did depreciate the building, thus reducing her basis. When the mortgagee threatened to foreclose, she sold the building subject to the mortgage for $2,500. The court held that her taxable gain on the sale was not limited to the money received but also included the amount by which the mortgage exceeded the adjusted basis of the building. The sale of the property subject to the mortgage was seen as a discharge of indebtedness to the extent of the excess, regardless of the lack of personal liability.[16]

The *Crane* decision has been extended to apply to other transactions such as charitable contributions and intrafamily gifts. *Crane* has not, however, been extended to include taxation of transfers by reason of death whenever liabilities exceed the decedent's basis. This exclusion involves only the original transfer from the decedent to the estate, not the distribution from the estate to the beneficiary.

If the estate holds a partnership interest for a considerable amount of time during which the partnership incurs liabilities in excess of basis, the distribution of the interest to the beneficiary is considered a discharge of indebtedness to the estate to the extent of those excess liabilities. According to *Crane*, the estate must recognize gain under Section 61 as though there were a sale or exchange of the interest.[17] The estate is taxed on the gain recognized and the beneficiary increases his basis in the partnership interest by the amount of gain recognized. In other words, he includes the encumbrance as part of his basis of the interest received.[18] This sequence of events should require a Section 743(b) adjustment.

Distributable Net Income

"Distributable net income" (DNI) is a term unique to trusts and estates. It is the taxable income of the estate computed with use of special modifications.[19] DNI limits the deduction allowable to estates for amounts paid, credited or required to be distributed to the beneficiaries. It also determines how much of an amount paid, credited or required to be distributed to a beneficiary will be includible in the beneficiary's gross income.[20]

If a beneficiary receives property which represents DNI, the basis of the property in the

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[9] Id.

[10] For a definition of "specified amount," see Rev. Rul. 67-74, 1967-1 CB 194.

[11] Reg. § 1.661(a)-2(f)(1); *Kenan v. Commissioner*, 40-2 USTC ¶ 9635, 114 F. 2d 217 (CA-2). See also *Suisman v. Eaton*, 36-2 USTC ¶ 9443, 15 F. Supp. 113 (D. Conn. 1935), aff'd per curiam, 83 F. 2d 1019 (CA-2 1936), cert. denied, 299 U. S. 573; Rev. Rul. 66-207, 1966-2 CB 243.

[12] For the rules regarding special valuation property, see Section 1040.

[13] Reg. § 1.1014-4(a)(3).

[14] Reg. § 1.661(a)-2(f)(2).

[15] 47-1 USTC ¶ 9217, 331 U. S. 1 (1947).

[16] *Crane* was recently expanded by the Supreme Court in *Commissioner v. Tufts*, 83-1 USTC ¶ 9328, 103 S. Ct. 1826 (1983). There the court held that the amount realized on the sale of property encumbered by a nonrecourse obligation includes the full amount of the unpaid indebtedness, regardless of the fair market value of the property.

[17] See also Reg. § 1.752-1(d).

[18] *Crane v. Commissioner*, 331 U. S. at 15.

[19] Reg. §§ 1.643(a)-1—1.643(a)-7.

[20] Reg. § 1.661(a)-2(f)(2).

hands of the beneficiary is its fair market value at the time it was paid, credited or required to be distributed to the extent such value is included in the gross income of the beneficiary.[21] To the extent the value of the property is not included in the beneficiary's gross income, its basis is determined under Section 1014(a)(1)—i. e., the fair market value at date of death. Note that the increase in basis is available only if property is distributed in a year that the estate has DNI.

The estate recognizes no gain or loss on a distribution of DNI.[22] Thus, the distribution does not resemble a sale or exchange with respect to the estate. An argument can be made, however, that the distribution resembles a sale or exchange with respect to the beneficiary, because he takes the property at the equivalent of a cost basis. Obtaining a cost basis is characteristic of a sale or exchange.

It is necessary to determine the type of property distribution that will be treated as DNI. Only property which is includible in the beneficiary's gross income can represent DNI. Under Section 102(a) gross income does not include the value of property acquired by gift, bequest, devise or inheritance. Therefore, if the decedent's will provides a specific bequest of the partnership interest, the distribution of the interest cannot be included in gross income and thus cannot represent DNI.[23] The same is true with a pecuniary bequest which is satisfied through the distribution of a partnership interest.

If the distribution, on the other hand, represents income from property held by the estate, it may be treated as a distribution of DNI.[24] For example, if the estate is required to distribute all of the generated income and the estate distributes the partnership interest instead of cash in satisfaction of the requirement, the beneficiary would include the fair market value of the distributed interest in his gross income. As a result, the basis of the interest to him would be its fair market value at date of distribution. If the property increased in value from date of death, the beneficiary would have a stepped-up basis. It is this step-up in basis which leads to the sale or exchange treatment and ultimately the Section 743(b) adjustment.

The weakness in the argument is that in a sale or exchange no party includes the full value of the property in gross income. Rather, it is usually the seller that recognizes the excess sales price over basis as gain. As stated above, if the estate is treated as the seller of the property, no gain is recognized on a distribution of DNI. This dilemma is best seen when comparing a DNI distribution to a distribution in satisfaction of a pecuniary bequest or a distribution where liabilities exceed basis. In the latter two situations, the estate recognizes gain on the distribution and the beneficiary takes the property at fair market value without recognition of income. These situations are far more characteristic of a sale or exchange.

Examination of the rationale for the Section 743(b) adjustment, however, indicates that the increase or decrease in the assets equalize the inside and outside basis of the partnership. It eliminates double taxation upon sale of the assets. In the DNI scenario, the beneficiary includes the full value of the interest in gross income and is taxed on that amount. Without the Section 743(b) adjustment he will be taxed again when the partnership sells its assets. To avoid this unfair result, the DNI distribution should be treated as a sale or exchange for purposes of Section 743(b). This argument, however, is debatable.

Conclusion

A Section 743(b) adjustment can be very advantageous to a beneficiary receiving a partnership interest through an estate. The estate planner should inquire as to the existence of a Section 754 election within the partnership and determine whether the value of the partnership interest is likely to increase during the time the estate holds the interest.

If it appears that the interest has appreciation potential, it is advisable to hold it in the estate as long as possible, with the income taxed to the estate, which may be in a lower tax bracket than the beneficiary. It should then be distributed in a way that will require sale or exchange treatment, thus triggering Section 743(b).

If the interest decreases in value while held by the estate, the property should be distributed so as not to trigger sale or exchange treatment. This can be accomplished by passing the interest through the residue of the estate.[25] This procedure,

[21] Reg. § 1.661(a)-2(f)(3).

[22] Reg. § 1.661(a)-2(f)(1).

[23] Furthermore, if appreciated property is distributed in satisfaction of a specific bequest, the resulting capital gain is usually not included in DNI. Rev. Rul. 68-392, 1968-2 CB 284.

[24] Section 102(b)(2).

[25] Reg. § 1.1014-4(a)(3).

however, may be treated as a DNI distribution, which would cause a downward adjustment to the property. The better solution would be to sell a high-basis, low fair market value partnership interest while it is in the estate. The estate thereby can recognize the loss, decrease DNI,[26] and then distribute the proceeds to the beneficiary. It may even be possible for the beneficiary to deduct the loss.[27]

It should be noted that if the partnership does not have a Section 754 election in effect or will not make the election at the request of the executor, the beneficiary may still be able to obtain a basis adjustment. If the partnership distributes property to him within two years of his acquisition of the partnership interest, he may elect to treat the partnership basis of the distributed assets as the basis they would have had if the Section 754 election had been in effect and the Section 743(b) basis adjustment had been made.[28] ●

[26] Rev. Rul. 56-270, 1956-1 CB 325.
[27] *Sam S. Brown,* CCH Dec. 19,581, 20 TC 73 (1953); Reg. § 1.642(h)-3.
[28] Section 732(d).

Tax-Free Treatment Allowed for Rollover from Plan Retroactively Disqualified

An employee who received a lump-sum distribution from a profit-sharing trust that had lost its exempt status was entitled to make a tax-free rollover of the total amount into an IRA. (*Baetens v. Commissioner,* United States Tax Court, CCH Dec. 40,957, 82 TC —, No. 14.) The entire distribution was entitled to tax-free rollover treatment because all of it was attributable solely to employer contributions in years when the trust was exempt from tax.

A company made contributions to a qualified profit-sharing plan from 1966 through its tax year ending March 31, 1973, but made no contributions to the plan after that date. After the plan was terminated in 1976, an employee received a lump-sum distribution of his entire account and rolled the amount over to an IRA. In 1979, the IRS issued a final adverse determination letter that retroactively disqualified the plan effective for tax years ending March 31, 1974, and thereafter.

For tax year 1977, the employee did not report the lump-sum distribution or the interest earned on his IRA as income. The IRS, however, determined that the distribution could not be rolled over tax free into an IRA because the trust was not exempt at the time of the distribution.

The Tax Court ruled that the status of the profit-sharing trust at the time of the contribution, rather than at the time of distribution, determined whether the amount could be rolled over tax free to the IRA. It held that the "part of the net distribution attributable to contributions to the trust made prior to its disqualification should be treated as a distribution from a qualified trust exempt from tax." Moreover, the court declared Reg. § 1.402(a)-1(a)(1)(ii) invalid to the extent that it refers solely to the exempt or nonexempt status of a trust at the time of distribution for determining whether the distribution can be rolled over into an IRA.—CCH COMPLIANCE GUIDE FOR PLAN ADMINISTRATORS, Issue No. 210, February 10, 1984.