



Business Transformations

Section 754 Elections for Transactions with Partners and Partnerships

By William G. Ruffner, CPA

A buyer of a business quite often will pay a purchase price that represents a premium that exceeds the tax basis of the assets held by the target entity. Often the buyer's desire for a tax basis step-up is in conflict with the seller's desire to mitigate double taxation and to optimize the portion of the gain that is taxed at a lower capital gains tax rate.

This conflict between buyer and seller is often present with C corporation targets (with some exceptions) and for S corporation targets if the sales price allocation among the assets would produce any ordinary gain. The conflict is not present, however, in a partnership scenario when a Section 754 election is available and made. In this case, a buyer can purchase a partnership interest (or a membership interest in an LLC or another eligible entity that is treated as a partnership for tax purposes) and obtain a tax basis step-up for any premium paid without causing adverse tax consequences to the selling partner.

In other words, the departing partner's tax consequences of selling his or her partnership interest is completely unaffected by the choice of making or not making the Section 754 election. In addition, the availability of the Section 754 election is not restricted by the percentage of ownership acquired in the partnership. In this light, the election appears to be very flexible.

The Section 754 election applies to the purchase of a partnership interest from a partner (a Section 743 adjustment) and to certain distributions from the partnership to the partners (a Section 734 adjustment). When a Section 754 election applies to the purchase of a partnership interest, the step-up in the tax basis of

the assets held by the partnership is only applicable to the purchasing partner. The election is available for a purchase of a partnership interest from a selling partner, but is not available for a partnership interest acquired from the partnership via a capital contribution (a Section 721 transaction).

Essentially the adjustment under Section 743 resulting from the Section 754 election is intended to equalize the inside and outside tax basis. The inside tax basis is the tax basis that the partnership has in the assets held by the partnership. The outside tax basis is the tax basis that the partners have in their partnership interests. When the purchasing partner pays more than the selling partner's tax basis in the partnership interest (a premium), the Section 743 adjustment steps up the inside tax basis to reflect the outside basis increase. Likewise, the Section 743 adjustment can eliminate the tax basis disparity in a discount purchase transaction by virtue of an inside basis step-down. Because there is no tax basis disparity in a Section 721 exchange, there is no Section 743 adjustment available via a Section 754 election.

A Section 754 election is made by the partnership, not the partner, and once made cannot be revoked without the consent of the IRS. It may therefore come into play when it is not desired. For example, a purchase may occur that is a premium (a tax basis step-up), and thereafter a purchase may occur that is a discount (a tax basis step-down). If the election is made for the first transaction, then it will also apply to the second transaction. In addition, once a Section 754 election has been made, it may also apply to distributions from the partnership to the partners. In that case, a Section

734 adjustment will eliminate disparity between the inside and outside tax basis caused by the partnership distribution. In this regard, the election appears to be inflexible.

The Section 734 adjustment, however, only applies when the partnership distribution causes a tax basis disparity. For example, a distribution exceeding a partner's tax basis could result in gain to the recipient partner, and absent a Section 754 election and a Section 734 adjustment the inside tax basis would be less than the outside tax basis. If the Section 754 election is in effect, the Section 734 adjustment would increase the partnership's tax basis in its assets (inside tax basis step-up equal the gain recognized by the partner). Whereas a Section 743 adjustment solely impacts the purchasing partner, the Section 734 adjustment prospectively affects all of the partners.

It should be noted that the Section 743 and Section 734 adjustments are not optional via a Section 754 election in the case of a "substantial built-in loss" as defined in Section 743 and a "substantial basis reduction" as defined in Section 734. While Congress has chosen to require a Section 754 election to make substantial tax basis step-ups, the same is not true of substantial tax basis step-downs. The threshold for "substantial" is \$250,000. Interestingly, this has eliminated a great deal of the risk of the partnership making a Section 754 election. 

William G. Ruffner, CPA, is director of taxation with Global Tax Management Inc.'s Pittsburgh office and a member of the Pennsylvania CPA Journal Editorial Board. He can be reached at bruffner@gtmgrp.com.