Season 1 – Episode 12 - Demystifying Section 754: Navigating Partnership Tax Elections

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Welcome to Tax Blueprints, a Rohr CPAs podcast. I'm Daniel Rohr, the managing shareholder of Rohr and Associates, a premier CPA firm based in California. I'm a CPA, personal financial specialist and enrolled agent. I have extensive experience advising individuals and business owners with tax minimization and personal financial planning strategies. On each episode of Tax Blueprints, I delve into the intricacies of tax laws, explain the subtleties of business tax planning, and guide individuals towards a path of financial stability. Whether you're a business owner navigating the murky waters of taxation or an individual planning for a worry-free retirement, Tax Blueprints will provide you with the tools and knowledge you need. I hope you enjoy this episode.

Today we'll be exploring a powerful partnership tax election under Code Section 754. This is a complex provision in the Eternal Revenue Code, and I hope to break it down into more digestible pieces. The Section 754 election is a tax provision that allows a partnership to adjust the basis of partnership property when a partner sells their interest or when a partnership interest is transferred due to a partner's death. In essence, it's a mechanism that provides a step up or step down in basis to reflect the fair market value at the time of transfer. To better understand this, let's take a look at a couple of examples. Let's say we have a partnership ABC with three equal partners Alice, Bob and Charlie. They each contributed $100,000. So the partnership has a basis of 300,000 in its assets. Now, let's say the market value of the partnership has grown to 600,000, and Charlie decides to sell his interest to David for 200,000, reflecting the current market value.

Without a section 754 election, David's outside basis, which is his tax basis in the partnership interest, would be 200,000, mirroring his investment. However, his share of the inside basis, which is the partnership's tax basis in its assets, would remain at Charlie's original 100,000. This creates discrepancy, and David paid 200,000. But his share of the inside base in the partnership's assets is only 100,000, potentially leading to unfair tax consequences down the line. This is where the section 754 election comes into play. If the partnership decides to make a section 754 election, david's share of the inside basis can be stepped up to match his purchase price of $200,000. This adjustment, made under Section 743 B, doesn't impact Alice or Bob's basis. The extra 100,000 will increase the depreciation or amortization deductions David can take in future years. If the underlying asset is a building with a remaining useful life of 20 years.

This step up in basis could give David an additional $5,000 of depreciation deductions each year, reducing his taxable income. The 5000 is 100,000 divided by 20 years. Without the section 754 election, David wouldn't benefit from these additional depreciation deductions. He would still have an outside basis of 200,000, but without the corresponding step up in the inside basis, his potential depreciation deductions would be lower resulting in higher taxable income. Let's consider a different scenario. Suppose Bob passes away and his interest in the partnership is inherited by his daughter Emily. The partnership interest is valued at 200,000. At the time of Bob's death, Emily’s outside base in the partnership interest will be stepped up to $200,000 due to the inheritance rules under code section 1014. Without a section 754 election, Emily’s share of the inside basis, the partnership's tax basis and its assets remains at Bob's original 100,000.

We see the familiar discrepancy here between Emily's outside basis and her share of the inside basis. However, if the partnership makes a 754 election, Emily’s inside basis can be stepped up to 200,000. Aligning it with her outside basis under section 743 B. This adjustment is specifically tied to Emily and doesn't affect the remaining partners. Like David in our earlier example, Emily also benefits from depreciating or amortizing the additional 100,000, which reduces her taxable income in future years. Now, these basis adjustments under section 743 B are not simple, straight-line adjustments. They must be allocated among the partnership's assets. That's where section 755 comes in. Let's dive into the weeds on this to see how this is accomplished in practice. Imagine a partnership that has a bunch of assets. It has $50,000 in cash, $100,000 in money it's expecting to get from customers. We call that accounts receivable.

$200,000 inventory and a building. The building originally cost 600,000. And over time, we've accounted for 150,000 of depreciation on the building. And the current market value of the building is now a million dollars. So now someone comes along. Let's call them new partner. New partner decides to buy out one of the existing partners who owns half the partnership. New partner pays 675,000 for his half share. Before new partner came in, the total value of half the assets, which is the inside basis of the partnership, was 400,000. Half the cash, half the accounts receivable, the inventory, and half the depreciated value of the building. But new partner paid 675,000 for this, which reflects the one half value of the million dollar building plus the other assets. So this means there's an extra 275,000 that we need to account for. This is the step up in basis under 743 B and is only available if a 754 election is made.

In this case, under section 755, we first assigned this 275,000 to the building. Why? Because its real market value is more than what we show on our books after considering depreciation. So for the new partner, the building's inside basis is 500,000, which is half of the market value. New partner will be allocated additional depreciation on the building based on the $500,000 basis, reducing their annual taxable income. The section 754 election can be a powerful tool when partnership interests change hands. It's important to know that once the 754 election is made, it applies to all transfers of interest in that year and all future years until it is revoked with the IRS, and the only way you can revoke it with the IRS is by way of filing a private letter ruling, which requires a user fee of $12,600. As you might suspect, Navigating sections 754, 743, B and 755 can be complex and requires a thorough understanding of the partnership's assets and the partner's circumstances.

Please make sure to use a qualified tax professional with experience in partnership transactions when dealing with these complicated issues.
That's all for this episode of Tax Blueprints of Rohr CPAs podcast. You can find us online at Rohrcpas.com/podcast and don't forget to subscribe on Apple podcasts or Spotify. If you enjoy the show, please consider rating or reviewing us wherever you listen. I'm your host, Daniel Rohr. Thanks for listening.

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