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OPTIONAL BASIS ADJUSTMENTS UNDER SUBCHAPTER K: TRAP FOR THE UNWARY, TAX PLANNING TOOL, OR BOTH? SHOULD THEY BE MANDATORY?

by

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I. INTRODUCTION

The optional basis adjustments of Subchapter K have occupied a prominent position in tax planning and partnership operations for the past 60 years. In the dispositional context, the general approach of the Code to the taxation of partnerships and their partners treats the partnership as an entity, separate and distinct from its partners. Thus, if a partner disposes of his partnership interest by sale to a third party, no adjustment or modification of the bases of the assets of the partnership occurs. Such is the case even though ownership of the partnership has been altered and the purchase price for the interest reflects the fair market value of the partner's underlying share of the partnership assets. Similarly, if a partner's interest is liquidated by the partnership, although the value of the distributed assets equals that of the relinquished partnership interest, the bases of the partnership's remaining assets are unaffected. Thus, in the case of a disposition by sale or liquidation for cash of an appreciated partnership interest, although the seller/distributee is taxed on the gain, without a basis adjustment, the purchaser or the remaining partners will be taxed on the same gain when realized by the partnership. In a similar fashion, for a depreciated partnership interest, a "duplication of loss" will arise, *i.e.*, at both the partner *and* the partnership level.

By affording the purchaser and/or the remaining partners an elective basis adjustment in such settings, Congress has permitted the impacted parties to switch to an aggregate treatment of the enterprise and generate basis adjustments for the assets of the partnership. Through the adjustment, the aggregate inside basis of the partnership's assets generally will equal the aggregate outside basis for the partnership interests. As a consequence, the duplication of gains and losses from a tax policy standpoint is minimized, if not eliminated.

As with all elective provisions, the basis adjustment option, to some extent, permits taxpayers with full information to effectuate win-win situations. If the adjustment produces beneficial results, *i.e.*, elimination of additional income recognition and possible increased depreciation and amortization deductions, the election will be made and "double taxation" avoided. Should an election prove disadvantageous, *i.e.*, the elimination of additional loss availability and possible decreased depreciation and amortization deductions, the parties will refrain from doing so and loss duplication will ensue.

After 60 years, the rationale for the continuation of the election should be scrutinized and assessed from a tax policy standpoint. Whatever the wisdom behind such elective provisions when enacted in 1954, their existence should be revisited in the modern context and a determination made as to whether that rationale continues today. In light of the recent regulatory and legislative tinkering with the election, the question presented is whether the basis adjustment provisions should be mandatory in all cases involving the disposition of a partnership interest by sale or exchange as well as by partial or complete liquidation.

This Article is divided into ten parts. In Part II, the purpose and application of the section 743(b) basis adjustment is examined. The adjustment, if elected, generally applies to the transfer of a partnership interest by sale or exchange or by death. Part III discusses the rules governing the allocation of the overall section 743(b) adjustment to the transferee's share of the assets of the partnership.

In Part IV, the purpose and application of the section 734(b) basis adjustment is considered. Such adjustments generally arise on the distribution of partnership assets to a partner in the process of reducing his or her interest in the enterprise. Part V explores the rules governing the allocation of such an adjustment to the retained assets of the partnership.

Part VI examines the elective basis adjustment of section 732(d). That provision attempts, under specified circumstances, to afford a distributee partner the same results which the section 743(b) basis adjustment would have provided had the partnership elected under section 754.

Part VII assesses the tax planning possibilities as well as the traps for the unwary in making or failing to make the election for basis adjustments. In certain settings, "double taxation" may ensue if the partnership does not elect. In others, duplicate losses may arise.

Parts VIII and IX consider the case for and the case against continuing the elective aspects of these basis adjustments. The Article concludes that the elective aspect of basis adjustments conflicts with sound tax policy principles and calls for legislative amendments eliminating the election and mandating such adjustments in all cases.[1]

II. OPTIONAL ADJUSTMENT TO BASIS OF PARTNERSHIP PROPERTY ON TRANSFER OF A PARTNERSHIP INTEREST – SECTION 743(b)

A. *Outlining the Problem – Section 743*

The equivalence of inside basis (the overall basis of the partnership's assets) and outside basis (the overall basis for the partners' partnership interests) in Subchapter K is fundamental to its structure. It ensures that income earned through a partnership is taxed once, and only once. For

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1. The scope of the proposal is focused exclusively on a statutory amendment to mandate the sections 734(b) and 743(b) basis adjustments in all cases (accompanied by the repeal of section 732(d)). A similar proposal was advanced almost 30 years ago as part of a comprehensive response to the ALI Subchapter K Study. *See* Philip F. Postlewaite, Thomas E. Dutton, & Kurt R. Magette, *A Critique of the ALI's Federal Income Tax Project – Subchapter K: Proposals on the Taxation of Partners*, 75 GEO. L.J. 423 (1986). Given the snail's pace of tax reform, that call for the mandatory application of sections 734(b) and 743(b) is renewed.

There has been commentary about section 734(b) adjustments and their imperfections. *See* Howard E. Abrams, *The Section 734(b) Basis Adjustment Needs Repair*, 57 TAX LAW. 343 (2004); Karen C. Burke, *Repairing Inside Basis Adjustments*, 58 TAX LAW. 639 (2005). However, many of those problems stem from another defect in the current regime of partnership taxation, *i.e.*, the allowance of non-recognition for property distributions by a partnership (another topic which was addressed previously and which would not arise if that proposal were adopted and the non-recognition rules for property distributions modified). *See* Postlewaite et al., *supra* at 470. The non-recognition issue on property distributions and the imperfections of the allocation rules for section 734(b) basis adjustments is left for another day.

example, assume that A, B, and C are equal partners and in Year 1 each contributes $6,000 to Partnership ABC, which purchases Inventory and Capital Asset for $9,000 and $6,000 respectively. The tax balance sheet documents the equivalence of inside and outside basis:

Assets:	**Basis**	**Capital:**	**Basis**
Cash	$ 3,000	A	$ 6,000
Inventory	9,000	B	6,000
Capital Asset	6,000	C	6,000
Total	$18,000	**Total**	$18,000

This equivalence continues even with an appreciation or depreciation in value of the assets over time. For example, assume in Year 2 that the assets increase in value to $18,000 for Inventory and $12,000 for Capital Asset. The tax balance sheet appears as follows:

Assets:	**Adjusted Basis**	**Fair Market Value**	**Capital:**	**Adjusted Basis**	**Fair Market Value**
Cash	$ 3,000	$ 3,000	A	$ 6,000	$11,000
Inventory	9,000	18,000	B	6,000	11,000
Capital Asset	6,000	12,000	C	6,000	11,000
Total	$18,000	$33,000	**Total**	$18,000	$33,000

Additionally, the equivalence continues even though the partnership's activity generates income or loss. Assume in Year 3 that the assets are sold, yielding income to the partnership of $9,000 attributable to Inventory and $6,000 attributable to Capital Asset, which is allocated to the partners equally, *i.e.*, $5,000 per partner. Under Subchapter K, each partner is taxed on his share of the income, and the basis for each partner in his partnership interest increases accordingly. At the end of Year 3, the tax balance sheet reveals the equivalence of inside and outside basis:

Assets:	**Adjusted Basis**	**Fair Market Value**	**Capital:**	**Adjusted Basis**	**Fair Market Value**
Cash	$33,000	$33,000	A	$11,000	$11,000
Total	$33,000	$33,000	B	11,000	11,000
			C	11,000	11,000
			Total	$33,000	$33,000

In contrast to much of Subchapter K, which maintains basis equivalence, the general rule for sales or exchanges of partnership interests results in an imbalance. Under section 743(a), the basis for the partnership's assets is unaffected by the sale or exchange of a partnership interest. Thus, if at the end of Year 2 C sells her interest to D for $11,000, a gain of $5,000 will be recognized by C, *i.e.*, the increased value of her partnership interest attributable to her share of the assets' appreciation. However, due to the failure of section 743(a) to adjust the basis of the partnership's assets (as shown in the balance sheet for the close of Year 2 above), inside and outside basis will differ.

Assets:	**Adjusted Basis**	**Fair Market Value**	**Capital:**	**Adjusted Basis**	**Fair Market Value**
Cash	$ 3,000	$ 3,000	A	$ 6,000	$11,000
Inventory	9,000	18,000	B	6,000	11,000
Capital Asset	6,000	12,000	D	11,000	11,000
Total	$18,000	$33,000	**Total**	$23,000	$33,000

As a result of the failure to adjust, not only does C recognize $5,000 of income on the sale of her partnership interest, but D will have similar treatment upon the sale of the assets due to his reporting of his share of the partnership's income as earned, resulting in what appears to be "double taxation." When sold in Year 3, the assets generate $15,000 of gain, allocable equally, *i.e.*, $5,000, to each partner, A, B, and D. Thereafter, the partnership's tax balance sheet will reflect a disparity between inside and outside basis.

Assets:	**Adjusted Basis**	**Fair Market Value**	**Capital:**	**Adjusted Basis**	**Fair Market Value**
Cash	$33,000	$33,000	A	$11,000	$11,000
Total	$33,000	$33,000	B	11,000	11,000
			D	16,000	11,000
			Total	$38,000	$33,000

Thus, the imbalance remains even after the sale of the assets, and D will be made "whole" at best upon the sale or liquidation of her interest, which would generate an offsetting $5,000 loss.

Fortunately, the Code provides for adjustments to the basis of partnership property as the result of a sale or exchange of such an interest or the transfer of a partnership interest on the death of a partner if an election is in effect.[2] Without such an election, the purchaser typically has a basis for that interest which differs from the purchasing partner's share of the bases of the partnership's assets. As illustrated above, such disparities can lead to income tax consequences for the acquiring partner with respect to the pre-

2. I.R.C. §§ 754 and 743(b); Reg. § 1.743-1(a). *See generally* 1 ARTHUR B. WILLIS & PHILIP F. POSTLEWAITE, PARTNERSHIP TAXATION, ¶ 12 (7th ed. 2011) [hereinafter WILLIS & POSTLEWAITE, PARTNERSHIP TAXATION].

acquisition appreciation or depreciation of the partnership's assets. With an election in effect, the basis adjustment is intended to eliminate most, if not all, of these consequences.[3]

Consider again the sale to D of C's interest in Partnership ABC for $11,000. On the date of the sale, the balance sheet of the partnership is as follows:

Assets:	**Adjusted Basis**	**Fair Market Value**	**Capital:**	**Adjusted Basis**	**Fair Market Value**
Cash	$ 3,000	$ 3,000	A	$ 6,000	$11,000
Inventory	9,000	18,000	B	6,000	11,000
Capital Asset	6,000	12,000	C	6,000	11,000
Total	$18,000	$33,000	**Total**	$18,000	$33,000

C's one-third interest in the partnership's assets at the date of sale is:

Assets:	**Adjusted Basis**	**Fair Market Value**
Cash	$1,000	$ 1,000
Inventory	3,000	6,000
Capital Asset	2,000	4,000
Total	$6,000	$11,000

If the basis of the partnership property is not adjusted to reflect the sale to D, Partnership BCD will have $9,000 of income if it sells Inventory and a $6,000 gain if it sells Capital Asset. D's distributive share of the income from the sale of the Inventory will be $3,000, and her distributive share of the gain from Capital Asset will be $2,000. This treatment will be unfair to D, because she purchased a partnership interest based on one-third of the market values of Inventory and Capital Asset. She should not recognize taxable gain on the partnership's sale of those items at the values upon which she determined the purchase price for her interest. Furthermore, C already paid tax on the gain attributable to those assets when she sold her interest to D, *i.e.*, amount realized ($11,000) decreased by adjusted basis ($6,000) for a resulting gain of $5,000. To tax the gain again suggests that the fisc has extracted two pounds of flesh rather than one.[4]

3. I.R.C. § 743(b).

4. Importantly, the absence of the section 743(b) adjustment will not lead to actual "double taxation." In the example, assuming no subsequent appreciation or depreciation in value, D ultimately would offset her distributive share of the partnership's income attributable to pre-acquisition appreciation with the tax loss she would have on the subsequent sale or liquidation of the partnership interest. Under section 705(a)(1)(A), the basis for D's interest increases to $16,000 ($11,000 purchase price plus $5,000 of income) as Partnership BCD recognizes income on the

Similarly, an adjustment to basis would be required to avoid unfairness if C died and her partnership interest passed to D. The basis of the partnership interest in D's hands would be its fair market value at the date of C's death (or at the optional valuation date), *i.e.*, $11,000. If D's basis of $11,000 for the interest acquired from the decedent were not reflected in the basis of the partnership's assets, an unfair result similar to that in the purchase context would ensue, again invoking the specter of double taxation.

The basis adjustment seeks to avoid unfairness to D in either situation by permitting an adjustment to the basis of the partnership property to reflect the purchase price of the interest if acquired by sale or exchange or the estate tax basis if acquired by inheritance.[5] While unfairness to the transferee partner results in the case of a transfer of an appreciated partnership interest, a tax planning opportunity arises in the case of a transfer of a depreciated partnership interest. The transferor partner recognizes a loss on the transfer and the transferee will duplicate that loss when the assets are sold by the partnership.

Given the unsound tax consequences of a failure to elect the optional basis adjustments, *i.e.*, double taxation, loss duplication, and a disparity between inside and outside basis, the question arises as to why they are elective. As illustrated, tax policy concerns warrant such ameliorative treatment. As discussed in the next section, Congress recognized the soundness of such an approach. Nevertheless, it refrained from mandating basis adjustments even though its failure to do so permits a disparity between inside and outside basis and imposes collateral damage on the sound tax policy operation of Subchapter K.

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disposition of the assets. On the sale or liquidation of her interest for cash, D would recognize a $ 5,000 capital loss, her $16,000 basis less the sales proceeds of $11,000. While the dollar amount of income and loss will offset, time value considerations and characterization issues (possible ordinary income on some of the partnership's dispositions of assets and capital loss on sale) may prove disadvantageous.

5. The adjustment to the basis of partnership property affects only the acquiring partner and is available only if the partnership has made an election. Reg. § 1.743-1(j)(1). In certain settings, the adjustment is mandatory. *See* discussion *infra* at Part II, J. The other partners are unaffected by the adjustment; however, subsequent distributions may precipitate consequences under section 734(b) and subsequent transfers will be subject to section 743(b). *See* discussion *infra* at Part IV. The other partners' subsequent transferees or successors may be affected, because the election is ongoing and may be revoked only with the consent of the Commissioner.

B. Legislative History of the Bases Adjustments

Section 754, which authorizes basis adjustments under section 743 and section 734, was enacted as part of the 1954 codification of Subchapter K, the first comprehensive statutory treatment of partnerships and partners.[6] Prior to 1954, the tax treatment of such enterprises and their members was regarded as "perhaps the most complicated and confused area of the tax law."[7] The necessity for fundamental reform proved evident as partnership transactions became increasingly important from a revenue perspective while the judicial and statutory authority addressing them remained chaotic and inconsistent.[8] The principal objectives of the codification were comprehensive simplification and reformulation[9] to achieve consistent and predictable tax results.

Section 754 owes its origin to the Proposal drafted by the American Bar Association (ABA) and American Law Institute (ALI), which was the result of a collaborative study spanning several years.[10] Among the major problem areas identified by the Proposal were current distributions, liquidations, and transfers of partnership interests by sale or by death of a partner.[11] Such events could lead to discrepancies between the basis of partnership property and the basis of partners in their partnership interests. The 1939 Code did not provide for basis adjustments upon the transfer of a partnership interest or distributions of partnership assets.[12]

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6. S. REP. NO. 83-1622, at 89 (1954).

7. Comm. on Taxation of Partnerships, ABA Tax Sec., *Program and Comm. Rep.* 55 (1952) [hereinafter 1952 ABA Report].

8. H.R. REP. NO. 83-1337, at 65 (1954) ("The present statutory provisions are wholly inadequate. The published regulations, rulings, and court decisions are incomplete and frequently contradictory."). For a survey of the partnership tax rules of the 1939 Code, *see* Jacob Rabkin & Mark H. Johnson, *The Partnership Under the Federal Tax Laws*, 55 HARV. L. REV. 909 (1942).

9. *Forty Topics Pertaining to the General Revision of the Internal Revenue Code – Topic 29 – Partnerships:* Hearing Before the H. Comm. on Ways & Means, 83d Cong. 1369 (1953) (statement of Mark H. Johnson, American Bar Association) [hereinafter Hearing, 83d Cong.] ("[I]t is more important to have some set of clearly-defined rules than to have any one particular set of rules, because this is one area where clarity and certainty are more important than the end result."). *See also* S. REP. NO. 83-1622, *supra* note 6.

10. The ABA's 1949 recommendations initiated the ALI's subsequent study on partnership taxation, which was an integral part of the massive ALI project advocating the complete revision of the Federal tax code. In 1952, the ABA Tax Section adopted the ALI's recommendations which were approved "in principle" at the ALI's 1952 annual meeting. *See* 1952 ABA Report, *supra* note 7, at 55–56.

11. *See* 1952 ABA Report, *supra* note 7, at 56.

12. *See* H.R. REP. NO. 83-1337, *supra* note 8, at 70.

The ABA/ALI Proposal generally adopted an aggregate approach by recognizing the desirability of basis adjustments in the context of distributions of partnership assets and transfers of partnership interests and recommended basis adjustments as a general rule.[13] Such adjustments would minimize the amount and timing of distortions of income and loss. However, in the interest of simplicity and flexibility and the acknowledgement that basis adjustments could lead to burdensome administrative costs, especially for large partnerships, the Proposal allowed partnerships the option of electing out.[14] Accordingly, upon a distribution of partnership assets or a transfer of a partnership interest, a partnership could elect to refrain from making basis adjustments.

Under the House bill, this approach to basis adjustments was reversed. Basis for the partnership assets remained unchanged; however, if the partnership desired, it could elect to the contrary.[15] The election for basis adjustments addressed transfers of partnership interests only, not distributions of partnership assets.[16]

The House bill was highly criticized by the tax bar. The Senate Finance Committee redrafted the partnership provisions almost in their entirety,[17] adopting the concept of elective basis adjustments both in the case of distributions of partnership property as well as in the case of transfers of partnership interests.[18] In the end, Congress adopted basis adjustments, but

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13. *See* 1952 ABA Report, *supra* note 7, at 56.

14. *See* Hearing, 83d Cong., *supra* note 9, at 1370 (statement of Mark H. Johnson on behalf of the ABA: "[W]e provide a series of elections based upon an 'entity' approach, which we assume would be exercised generally by the larger and more complex partnerships.").

15. *See* H. R. REP. NO. 83-1337, *supra* note 8, at 70. The Committee on Ways and Means stated in its Report that "[i]t is anticipated that many partnerships will prefer not to make an election which entails the adjustment to the basis of partnership assets each time a transfer of an interest in a partnership takes place. The possible tax advantages of such an adjustment may be outweighed by the bookkeeping expenses and inconvenience." *Id.*

16. *See* H. REP. NO. 83-1337 *supra* note 8, at 68–69.

17. *See* Paul Jackson et al., *The Internal Revenue Code of 1954: Partnerships*, 54 COLUM. L. REV. 1183 (1954).

18. *See* S. REP. NO. 83-1622, *supra* note 6, at 406. The Committee stated that, in the context of transfers of partnership interests, "assigning this special basis largely to the transferee partner is desirable because it is more accurate than the House bill in reflecting the increase (or decrease) in basis to the partner to whom it is attributable. *Id.* at 97. In addition, unlike the House bill which made the election irrevocable until the termination of the partnership, the Senate bill "permitted the partnership to revoke the election, subject to the Regulations to be prescribed by the Secretary." Such a case would arise where a partnership could demonstrate that the benefits of the election were outweighed by increased administrative burdens.

concluded that basis should not be adjusted unless the partnership elects affirmatively to do so.[19]

The basis adjustment provisions remained virtually unchanged for 50 years. However, dramatic changes to the section 734 and section 743 basis adjustments that impacted their electivity were enacted by Congress in 2004. Prior to that time, a partnership had an unconstrained right to elect, or not to elect, under section 754. A section 754 election was not required, even in cases where the resulting adjustment under section 734(b) and section 743(b) would cause a decrease to the basis of the partnership property. Concerned about the potential for loss duplication, Congress significantly modified section 734 and section 743 by making certain basis adjustments mandatory.[20]

Those changes reduce the elective scope of section 754 and call into question the efficacy of continuing its electivity in all other cases. As the basis adjustments are mandatory in some cases, regardless of size or administrative burden, why not make them mandatory in all cases?

C. *Election under Section 754*

The basis adjustment is specifically conditioned on the filing of an election by the partnership. The election is a prerequisite to a basis adjustment. Although only the acquiring partner is affected by a section 743(b) basis adjustment, the election must be made by the partnership, not by the acquiring partner. The Regulations provide that the election is "filed with the partnership return for the taxable year during which the distribution or transfer occurs."[21] Once made, it requires the application of the adjustment to all current and future transfers of partnership interests by sale, exchange, or death as well as distributions of assets in certain settings. Only upon a revocation of the election, which is conditioned upon the approval of the Service, can these consequences be avoided.[22]

However, the revocation would not be permitted when designed to avoid stepping down the basis of the partnership assets upon a transfer or a distribution.

19. H. R. REP. NO. 83-1337, *supra* note 8, at 70.

20. As amended in 2004, section 734(b) requires a partnership without a section 754 election in effect to adjust the basis of partnership property for distributions to partners with respect to which there is a substantial basis reduction. Also, section 743(b) requires a partnership without a section 754 election to adjust basis to partnership property in the event of a transfer of a partnership interest with respect to which there is a substantial built-in-loss. Congress carved out an exception to mandatory basis adjustments under section 743(b) for electing investment partnerships.

21. Reg. § 1.754-1(b)(1).

22. The Regulations list examples of situations where a sufficient reason for revocation may exist: a change in the nature of the partnership business; a substantial

D. Operation of Adjustment to Basis of Partnership Properties — In General

Returning to the balance sheet of equal Partnership ABC, assume in Year 3 that C sells his partnership interest to D for $11,000 and recognizes gain of $5,000.[23]

Assets:	Adjusted Basis	Fair Market Value	Capital:	Adjusted Basis	Fair Market Value
Cash	$ 3,000	$ 3,000	A	$ 6,000	$11,000
Inventory	9,000	18,000	B	6,000	11,000
Capital Asset	6,000	12,000	C	6,000	11,000
Total	$18,000	$33,000	**Total**	$18,000	$33,000

The Code permits an elective adjustment to the bases of the partnership's properties. This adjustment in essence reflects the difference between the purchasing partner's basis in the transferred partnership interest and his share of the partnership's adjusted bases for those properties. Such a comparison may result in an overall increase in basis or an overall decrease in basis.[24]

In the example, C sells a one-third interest in the partnership to D for $11,000. Accordingly, D's basis in the transferred partnership interest is $11,000.[25] Under the Regulations, her section 743(b) basis adjustment equals the difference between her basis for the partnership interest and her interest in previously taxed capital increased by her share of partnership liabilities.[26] Previously taxed capital equals her share of the liquidation proceeds if all of the partnership assets were sold at fair market value ($11,000) decreased by her share of gain arising from the sale ($5,000) and increased by her share of loss ($0).[27] There are no liabilities in the example. Thus, D is entitled to a positive adjustment of $5,000 ($11,000 - $6,000).[28]

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increase in the assets of the partnership; a change in the character of partnership assets; and an increased frequency of retirements or shifts of partnership interests so that an increased administrative burden would result to the partnership from continuing under the election. An application for revocation will not be approved if the purpose is to avoid reducing the basis of partnership assets. *See* Reg. § 1.754-1(c)(1).

23. I.R.C. §§ 741, 751(a).
24. Reg. § 1.743-1(b).
25. Reg. § 1.743-1(c).
26. Reg. § 1.743-1(d)(1).
27. Reg. § 1.743-1(d)(2).
28. Reg. § 1.743-1(d)(1)(i)-(iii). *See also* Reg. § 1.743-1(d)(3), Exs. (1), (2).

The further allocation of the overall positive adjustment to the assets of the partnership is dependent upon another provision.[29] However, without more, the remedial effect of the adjustment is obvious. Upon a subsequent sale of the partnership's assets generating $5,000 of gain attributable to D, the $5,000 positive adjustment would offset her share of the gain.[30]

E. *Effect of Partnership Liabilities*

A factor in determining the total basis adjustment under section 743(b) is the role of partnership liabilities. The Regulations provide that the adjustment is determined by comparing the purchaser's basis for his partnership interest with his share of previously taxed capital increased by his share of the partnership's liabilities.[31]

Liabilities play a double role in the determination: (1) in the calculation of the basis for the transferee partner's partnership interest and (2) as an addition to the transferee partner's share of previously taxed capital in arriving at the transferee partner's share of inside basis.[32] The differential between amount (1) and amount (2) constitutes the amount of the basis adjustment. While the section 752 Regulations govern liability allocations, the determination of a transferee's share of previously taxed capital utilizes a fictional sale of all of the partnership's assets for cash.[33] The formula thereunder backs out the gain or loss from such a sale and the amount remaining is the partner's share of previously taxed capital. Previously taxed capital is increased by the transferee's share of the partnership's liabilities to determine the transferee's share of inside basis.[34] The resulting amount is compared with the transferee's basis for his acquired partnership interest. The difference is the overall section 743(b) adjustment, which may be positive or negative.

For example, assume the following balance sheet for Partnership ABC with $3,000 of recourse liabilities:[35]

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29. I.R.C. § 755; Reg. §§ 1.743-1(e), 1.755-1.

30. Gain or loss is determined under section 702 for all partners. Thereafter, the effects for the transferee partner are offset by the section 743(b) adjustment. *See* Reg. § 1.743-1(j).

31. Reg. § 1.743-1(d)(1).

32. *See* Reg. § 1.743-1(d)(3), Ex. (1). A partner's share of liabilities is determined under section 752 and its attendant Regulations.

33. Reg. § 1.743-1(d)(2).

34. As the focus is on the transferee's share of income or loss, allocable amounts under section 704(b) special allocations and section 704(c) allocations of pre-contribution gain or loss are taken into account.

35. Reg. §§ 1.743-1(d)(3), Ex. (1), 1.743-1(d)(1)(i)-(iii).

Assets:	Adjusted Basis	Fair Market Value	Capital:	Adjusted Basis	Fair Market Value
Cash	$ 3,000	$ 3,000	A	$ 6,000	$11,000
Inventory	9,000	18,000	B	6,000	11,000
Other Assets	6,000	12,000	C	6,000	11,000
Total	$18,000	$33,000	**Total**	$18,000	$33,000

Assume that A sells her interest to D for $11,000, *i.e.*, $10,000 plus of her share of partnership liabilities, $1,000.[36] D's basis for the acquired partnership interest is his $11,000 purchase price ($10,000 cash and $1,000 share of liabilities). D's share of previously taxed capital is cash on liquidation after taking liabilities into account ($10,000) decreased by his share of gain ($5,000) which totals $5,000, further increased by his share of the partnership's liabilities ($1,000), *i.e*, $6,000. The comparison yields a positive section 743(b) basis adjustment of $5,000.

F. Section 704(c) Allocation for Contributed Property

Income, gain, loss, and deduction with respect to contributed property must be allocated in such a manner as to attribute to the contributing partner the tax consequences of any pre-contribution appreciation or depreciation in the property.[37] The Regulations provide that section 704(c), including remedial allocations, is to be taken into account in determining a transferee partner's share of previously taxed capital.[38]

In determining the section 743(b) basis adjustment, if an election is in effect, the focus is on a determination of the transferee partner's interest in previously taxed capital, which equals the liquidation value of the interest increased by the taxable loss and decreased by the taxable gain attributable to that interest upon a hypothetical sale of the partnership's assets. The gain attributable to an interest is determined by taking section 704(c) into account.[39] Once determined, assuming the absence of partnership liabilities,

36. *See* I.R.C. § 752(d).

37. I.R.C. § 704(c).

38. Reg. §§ 1.743-1(d)(1)(ii), 1.743-1(d)(1)(iii). *See also* Reg. §§ 1.704-3(a)(6)(ii), 1.704-3(a)(7).

39. The example assumes that the traditional method for taking section 704(c) into account is employed. If curative or remedial section 704(c) allocations are in effect, they must be taken into account. Loss attributable to section 704(c) property is not taken into account because section 704(c)(1)(C) treats the property with regard to any partner other than the contributor as having a basis equal to fair market value. Thus, upon the purchase, with regard to the transferee partner and the partnership, there is no section 704(c) allocation because basis and value on the date of the property's original contribution are deemed to be the same.

the adjustment can be computed by comparing that figure with the adjusted basis for the acquired partnership interest.

For example, assume that Partnership KLM has a balance sheet as follows and that an election is in effect:

Assets:	**Adjusted Basis**	**Book**	**Fair Market Value**	**Capital:**	**Adjusted Basis**	**Book**	**Fair Market Value**
Cash	$ 5,000	$ 5,000	$ 5,000	K	$13,000	$13,000	$16,000
Inventory	21,000	21,000	24,000	L	13,000	13,000	16,000
Land	7,000	13,000	19,000	M	7,000	13,000	16,000
Total	$33,000	$39,000	$48,000	**Total**	$33,000	$39,000	$48,000

M has a lower adjusted basis for her partnership interest than either K or L, because M contributed unimproved land to the partnership at an agreed valuation of $13,000, for which she had an adjusted basis of $7,000. If the land contributed by M is sold by the partnership for $13,000 or more, the first $6,000 of gain is allocated to M. The balance of the gain is allocated equally among the three partners.

M has a capital account balance of $13,000, as do K and L. Since all three partners have the same economic interest in the partnership, a purchaser would pay the same price for the interest of any of the three partners provided that a section 754 election were in effect. The only differences between M on the one hand and K and L on the other are their adjusted bases for their partnership interests and their respective shares of previously taxed capital.

The amount of the adjustment varies, depending on whether the purchaser transacts with K or L (their situations are identical) or with M. Where the purchase is from a partner who is subject to section 704(c), the determination of taxable gain from the hypothetical sale transaction will be affected. The following chart illustrates the calculations which must be made in such a situation.

	The Selling Partner Is:	
	K or L	**M**
Purchaser's adjustment basis of the partnership interest acquired:		
Amount paid	$16,000	$16,000
Purchaser's share of previous taxed capital:		
Cash on liquidation	$16,000	$16,000
Decreased by taxable gain	3,000	9,000
	$13,000	$ 7,000
Amount of the § 743(b) adjustment	$ 3,000	$ 9,000

If either K or L sells his partnership interest, the section 704(c) allocation remains a problem to be solved in the future when the property is sold.[40] If M sells her partnership interest, the effect of the section 704(c) allocation on the purchase of M's interest disappears through the adjustment. The allocation is subsumed by the basis adjustment.[41] On selling her partnership interest, M recognizes taxable gain from the pre-contribution appreciation of the contributed property as well as her share of any post-contribution appreciation in value of the partnership property. As a result of the adjustment, the purchaser of M's interest, while technically allocated the gain resulting from the pre-contribution appreciation attributable to M, will offset that amount with the section 743(b) basis adjustment.

G. *Operation of Adjustment to Basis of Partnership Properties*

1. Calculation in Determining Items of Income, Gain, or Loss

The Regulations provide that the adjustment is personal to the transferee.[42] It is generally irrelevant and disregarded in the partnership's determination of its financial results.[43] Instead, after making these determinations, the adjustment is integrated into the transferee's distributive share; however, it has no impact on the transferee's capital account.[44]

For example, the sale of an asset by equal Partnership ABD for a gain of $9,000 would generate $3,000 of income for each partner. However, if D had a positive adjustment of $3,000 attributable to that asset, he would not be taxable on any of that gain.[45]

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40. Reg. § 1.743-1(d)(3), Ex.(1).
41. Reg. § 1.743-1(d)(3), Ex.(2).
42. Reg. § 1.743-1(j)(1).
43. Reg. § 1.743-1(j)(2).
44. *Id.*
45. Reg. § 1-743-1(j)(3). As discussed above, of particular concern is the integration of section 704(c) with the adjustment. Importantly, the adjustment takes section 704(c) into account. For operational purposes, a basis adjustment does not merely reduce or eliminate a partner's share of gain recognized on the subsequent disposition of the property by the partnership. In some cases, the adjustment may produce the opposite effect. In other words, a positive adjustment may produce a loss or vice versa. While the likelihood of this effect may be greater regarding section 704(c) property, it is not limited to that category. Assume that equal Partnership ABC purchased its sole asset for $3,000 which appreciated in value to $12,000. A sells her partnership interest to D for $4,000 and the partnership elects. D has a positive adjustment of $3,000. The partnership subsequently sells the property in an arm's-length transaction for $6,000, allocable $2,000 to each partner. D's $2,000 share of gain is reduced by the $3,000 positive adjustment producing a $1,000 loss.

2. Depreciation

The Regulations address the effect of a section 743(b) basis adjustment on the determination of depreciation deductions.[46] Additional deductions may arise through positive basis adjustments to depreciable property, which are added to the transferee's distributive share of such item.[47] Regarding the recovery period for the allocation, the increased basis is treated as arising from newly purchased recovery property.[48]

For example, assume that A sells her one-third interest in Partnership ABC to D for $5,000. The partnership has depreciable property with an adjusted basis of $9,000 and a fair market value of $15,000. Partner D has an adjustment to the depreciable property in the amount of $2,000 ($5,000 purchase price less his previously taxed capital of $3,000). If the property were depreciable under a straight-line method with a cost recovery period of five years and A's one-third share of the partnership's depreciation were $1,000, the depreciation for the year on the $2,000 adjustment would be $400, and he would have a $400 offset against his distributive share of partnership income for the year.[49]

Regarding negative adjustments which result in a decrease of the determined depreciation deduction, the Regulations provide similarly.[50] Reduced deductions are required. However, if the decreased basis adjustment exceeds the amount of the transferee's depreciation, other allocable items of depreciation of the transferee are reduced by the differential.[51] If a portion of the basis adjustment remains after applying the specified order of offset, ordinary income is recognized to the extent of the excess. The recovery period for the negative adjustment is the remaining cost recovery period of the underlying property.[52]

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46. Reg. § 1.743-1(j)(4).

47. Reg. § 1.743-1(j)(4)(i)(A).

48. Reg. § 1.743-1(j)(4)(i)(B)(1).

49. Reg. § 1.743-1(j)(4)(i)(C), Ex. (1). If the partnership is utilizing the remedial allocation method for previously contributed property, the portion of the adjustment allocable to the section 704(c) built-in gain is recovered over the partnership's recovery period. Any excess amount may be recovered pursuant to the method and period of the transferee's choice. *See* Reg. § 1.743-1(j)(4)(i)(C), Ex. (2).

50. Reg. § 1.743-1(j)(4)(ii).

51. Reg. § 1.743-1(j)(4)(ii)(A).

52. Reg. § 1.743-1(j)(4)(ii)(B). Examples are provided in the Regulations illustrating the application of these principles. The first example is a straightforward reduction of the transferee's share of depreciation by his negative adjustment. The second example illustrates that the recovery period for the negative adjustment is identical to the remaining recovery period of the partnership for the property. The third example generates ordinary income since the negative adjustment exceeds the transferee's depreciation from the asset for the year.

3. *Amortization*

The use of an election may result in amortization benefits as well. A taxpayer acquires an interest in an intangible asset held by a partnership "only if, and to the extent that, the acquiring taxpayer obtains, as a result of the transaction, an increased basis for such intangible."[53] Thus, amortization is available for transactions producing basis adjustments to certain intangible assets.

A qualifying intangible asset may be amortized over a 15-year period.[54] The Regulations specifically address the issue of the amortization consequences attributable to partnership basis adjustments. Any increased portion of the basis thereunder "is treated as a separate section 197 intangible and the intangible is treated as having been acquired at the time of the transaction that causes the basis increase. . ."[55]

For example, assume that Partnership ABC, to which each partner contributed $9,000 for his interest, purchases an intangible asset for $18,000.[56] After three years of amortization, the asset has a basis of $14,400 and each partner has a basis for his partnership interest of $7,800. The asset has increased in value to $54,000, the value of the partnership's total assets is $90,000, and C sells his partnership interest to D for $30,000.

Without an election, D receives only his share, $400 per year, of the amortization even though he paid full value for his partnership interest. However, with the election, his interest in the asset is bifurcated, *i.e.*, he continues to have a one-third interest ($4,800) in the partnership's common basis ($14,400) that generates $400 of amortization per partner per year over its remaining life of 12 years. In addition, he is considered to have a basis in the intangible asset equal to the basis adjustment of $23,333, which is amortizable over a new 15-year period, thereby generating a deductible expense of approximately $1,620 per year.[57]

H. *Other Transfers of a Partnership Interest*

In light of the legislative purpose of keeping inside and outside basis in sync, not every transfer of a partnership interest is a sale or exchange for

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53. STAFF OF THE JOINT COMM. ON TAX'N; TECHNICAL EXPLANATION OF THE TAX SIMPLIFICATION ACT OF 1993, 103d CONG., 161 (Comm. Print. 1993).

54. I.R.C. § 197. *See generally* PHILIP F. POSTLEWAITE, DAVID L. CAMERON, AND TOM KITTLE-KAMP, TAXATION OF INTELLECTUAL PROPERTY AND INTANGIBLE ASSETS (Warren, Gorham, & Lamont 1997) [hereinafter POSTLEWAITE ET AL., INTELLECTUAL PROPERTY].

55. Reg. § 1.197-2(g)(3).

56. *See also* Reg. § 1.197-2(k), Ex. (13) – (16).

57. Reg. § 1.197-2(k), Ex. (14).

purposes of the basis adjustment. Thus, not all transfers or dispositions give rise to a section 743(b) adjustment.

The controlling issue is whether a particular mode of transferring the partnership interest falls within the purview of the statute. For example, if a partner makes a gift of an interest in a partnership that has no liabilities, the gift is not a sale or exchange. The subsection is not applicable to that transfer. On the other hand, the transfer of a partnership interest as a gift constitutes a sale or exchange to the extent that the transferor's share of partnership liabilities exceeds the adjusted basis of the partnership interest. Accordingly, section 743(b) is applicable to the extent of any gain in that circumstance, because a basis adjustment in such a case would comport with the policy rationale of maintaining harmony between inside and outside bases.[58]

Other types of transfers of a partnership interest raise similar issues. For example, a contribution of a partnership interest to a corporation in a non-recognition transaction is an exchange. However, except where gain is recognized to the transferor,[59] the transferor's basis for the partnership interest carries over to the transferee. Thus, there is no adjustment to the basis of partnership property, even if an election were in effect. A similar issue arises with respect to the transfer of a partnership interest to another partnership.

A companion issue is whether such transfers, although not generating basis adjustments themselves, carry over pre-existing adjustments of the transferor. The Regulations address the treatment of special basis adjustments in such cases.[60] Following a gift of a partnership interest in which the donor has a basis adjustment, the donee is entitled to continue the treatment available to the donor regarding his basis adjustment.[61] Thus, if A is entitled to a $4,000 basis adjustment and gives his partnership interest to D, his child, D is entitled to similar treatment.[62]

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58. If there is no gain to the transferor partner, the transferee's adjusted basis for the partnership interest acquired generally will be the same as the transferor's adjusted basis under section 1015. However, if the transferor paid a gift tax on the transfer, section 1015(d) provides that the donee's basis for the property is adjusted by a portion of the federal gift tax paid, which increases the basis of the partnership interest in the hands of the donee. Nevertheless, as there has not been a sale or exchange of a partnership interest, this increase cannot constitute an adjustment under section 743(b).

59. I.R.C. §§ 351, 357.

60. *See* Reg. § 1.743-1(h).

61. Reg. § 1.743-1(f).

62. Reg. § 1.743-1(f), Ex. (iii). Apparently this treatment is available even if the donee takes a dual basis for the partnership interest because its fair market value on the date of the gift was less than its adjusted basis. *See* Reg. § 1.1015-1(a)(1).

While the basis adjustment continues with the transferred property in the partnership context, the contributor partnership, as it receives the benefits of the adjustment, must segregate the items and ensure that they are allocated to the partner to whom the adjustment is attributable.

Assume that A possesses an adjustment of $1,000 in Partnership ABC regarding Capital Asset X which has a common partnership basis of $6,000. If Partnership ABC transfers Capital Asset X to Partnership ABCDE for a one-third interest therein, Capital Asset X will have a $7,000 basis and Partnership ABC will have a $7,000 basis for its interest in the Partnership ABCDE. However, any tax consequences flowing from the $1,000 adjustment to Partnership ABCDE must be allocated exclusively to the partner, *i.e.*, Partnership ABC, responsible for it. Furthermore, consequences from the adjustment allocable to Partnership ABC must be allocated exclusively to A.[63]

I. On Death of Partner

The basis adjustment of section 743(b) is not restricted to a sale or exchange of a partnership interest where valuable consideration is received for the transferred interest. The adjustment also is available in the case of a transfer of a partnership interest upon the death of a partner.[64]

For example, assume that the balance sheet of equal Partnership ABC at the date of C's death is as follows:

Assets:	**Adjusted Basis**	**Fair Market Value**	**Capital:**	**Adjusted Basis**	**Fair Market Value**
Cash	$ 5,000	$ 5,000	A	$11,000	$16,000
Inventory	16,000	19,000	B	11,000	16,000
Capital Asset	12,000	24,000	C	11,000	16,000
Total	$33,000	$48,000	**Total**	$33,000	$48,000

C's partnership interest is valued at $16,000 for estate tax purposes. If the partnership files the election, the adjustment is $5,000 determined as follows:

63. Reg. § 1.743-1(h)(1).
64. I.R.C. § 743(b).

Adjusted basis for partnership interest acquired:		
Estate Tax value		$16,000
Proportionate share of adjusted basis of partnership:		
Previously taxed capital		
Cash on liquidation pursuant to hypothetical	$16,000	
Decreased by share of gain on sale	(5,000)	
		11,000
Section 743(b) adjustment to basis of partnership property:		$ 5,000

This treatment is consistent with the rationale for the adjustment, since the property owned by a decedent receives a basis equal to its fair market value at the date of death or at the optional valuation date.[65] Thus, the same adjustments are made to the basis of partnership property when a partner dies as when a partnership interest is sold or exchanged.

J. Mandatory Adjustment to Basis Under Section 743(b)

While the section 743(b) adjustment prevents unfair results to the purchaser of a partnership interest where the assets are appreciated, a failure to adjust arguably may produce a double benefit to the transferor and the transferee if the assets are depreciated. In 2004, Congress evidenced its concern with loss duplication in the partnership context. Previously, the partnership had the unfettered ability to determine whether it desired a basis adjustment for a transferee partner. Thus, without an election, it was possible for the seller and the purchaser to take a similar loss into account once the partnership assets were sold. While the loss would ultimately be offset by a corresponding amount of gain on the transferee's liquidation or sale of the interest, tax benefits, *i.e.*, loss duplication, arose through the failure to elect. Notwithstanding the general anti-abuse Regulation, which asserted its applicability in such settings,[66] Congress felt compelled to legislate, possibly due to serious doubt that the failure to elect under an optional statutory provision could constitute abuse.

Since 2004, an adjustment to the basis of the partnership's assets with regard to the transferee is mandatory, regardless of election, if a "substantial built-in loss" exists. Section 743(d) defines substantial built-in loss as existing when the bases of the partnership assets exceed the fair market values of those assets by more than $250,000 in the aggregate.[67] In such cases, the adjustment is required. Regulations address the need for aggregating related partnerships and the need for disregarding property

65. I.R.C. § 1014(a).

66. Reg. § 1.701-2(d), Ex. (8).

67. I.R.C. § 743 (b), (d) as amended by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 833(b), 118 Stat. 1418.

acquired with the purpose of eliminating a substantial built-in loss. The adjustment appears to be mandatory regardless of the absence of any tax saving motivation, *e.g.*, in the case of death.[68]

For example, assume that M, N, and P form Partnership MNP with equal contributions of $500,000. The Partnership purchases Capital Asset X for $700,000 and Capital Asset Y for $800,000. In Year 3, when the value of Capital Asset X remains $700,000 but the value of Capital Asset Y declines to $200,000, M transfers his partnership interest to Q for $300,000. On the date of the transfer, the balance sheet of Partnership MNP is as follows:

Assets:	**Adjusted Basis**	**Fair Market Value**	**Capital:**	**Adjusted Basis**	**Fair Market Value**
Capital Asset X	$ 700,000	$700,000	M	$ 500,000	$300,000
Capital Asset Y	800,000	200,000	N	500,000	300,000
			P	500,000	300,000
Total	$1,500,000	$900,000	**Total**	$1,500,000	$900,000

M recognizes a loss on the transfer of $200,000.

Prior to 2004, if the partnership did not make the election, a subsequent sale of Capital Asset Y for $200,000 would have resulted in a $600,000 loss, allocated equally to N, P, and Q. Thus, the partnership's failure to elect would have resulted in a duplication of the $200,000 loss M recognized on the transfer of his interest.

Under amended section 743(b), however, because the difference between the fair market value of the partnership's property ($900,000) and the partnership's adjusted basis for its property ($1,500,000) is more than the statutory threshold of $250,000, a substantial built-in-loss in the partnership's property exists. Consequently, a negative basis adjustment of $200,000 with respect to Q is required for the adjusted basis of the partnership property.

III. Allocating Optional Basis Adjustment Under Section 743(b) to Specific Partnership Properties

A. *Allocating the Optional Adjustment Amount — Section 755*

Section 743(b) addresses only the determination of the total amount of the aggregate optional adjustment to basis for all partnership property. It does not provide for its allocation to specific partnership properties. Instead, the allocation of the adjustment is governed by section 755.

68. Section 743(e) provides that specifically described enterprises, *i.e.*, investment partnerships and securities partnerships, are exempt from the mandatory application of section 743(b).

That provision establishes two rules for allocating the total amount of the optional adjustment to basis. The general rule allocates the adjustment "(1) in a manner which has the effect of reducing the difference between the fair market value and the adjusted basis of partnership properties, or (2) in any other manner permitted by regulations prescribed by the Secretary."[69]

In applying the general allocation rule, the provision adds a special rule which specifies that the increase or decrease to the basis of partnership property arising from a transfer of an interest is allocable to "(1) capital assets and property described in section 1231(b) or (2) any other property of the partnership," depending on which of the two specified classes of property generated the adjustment to basis under the Regulations.[70]

The Regulations expand upon this approach by noting that the allocation is made first between the two classes and thereafter among the assets within each class.[71] Thus, in allocating an adjustment, the amount of the adjustment is allocated first between the two classes of property, capital assets and other property.[72] Thereafter, the amount allocated to each class is allocated to specific properties within that class.[73]

B. *The Regulations*

The Regulations employ a hypothetical sale approach for allocating the adjustment by focusing on the tax consequences to the distributee in a fully taxable transaction at fair market value.[74] Through use of this approach, the income or loss that would be incurred by the transferee, including allocations under section 704(c), is offset. The focus applies both for allocations between classes as well as those within a class. Thus, whether the overall adjustment or class adjustment is positive or negative is generally irrelevant since the process ties the adjustment for each individual asset to the transferee's share of its inherent gain or loss.[75]

The Regulations authorize two-way adjustments, *i.e.*, positive or negative, both between the classes of capital assets and other property as well as permitting them within a class. By so doing, in the case of a partnership holding both appreciated and depreciated assets, the Regulations permit

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69. I.R.C. § 755(a); Reg. § 1.755-1.

70. I.R.C. § 755(b). For ease of reference, the two classes are referred to simply as "capital assets" and "other property."

71. Reg. § 1.755-1(a). The § 743(b) adjustment is addressed separately from the § 734(b) adjustment. *See* Reg. § 1.755-1(b); Donnell M. Rini-Swyers, *Allocating Basis Adjustments After the Section 755 Final Regulations*, 99 J. TAX'N 211 (2003).

72. I.R.C. § 755(b); Reg. § 1.755-1(b)(2).

73. I.R.C. § 755(a); Reg. § 1.755-1(b)(3).

74. Reg. § 1.755-1(b)(1)(ii).

75. Reg. § 1.755-1(b)(1).

adjustments increasing the basis of some assets while reducing the basis of others.

1. *Allocation Between Two Classes of Property*

Regarding the allocation of the basis adjustment between classes, the Regulations prioritize allocations by mandating the allocation to other property first.[76] Thereafter, the amount of the adjustment allocable to capital assets is determined and equals the difference between the total basis adjustment and that attributable to other property. However, a decrease in basis to capital assets cannot exceed the partnership's basis for that property. Once exhausted, the excess is applied to reduce the basis for other property.[77] The rule attempts to ensure that there is no disappearing or suspended basis adjustment.

Assume equal Partnership ABC with the following tax balance sheet:

Assets:	**Adjusted Basis**	**Fair Market Value**	**Excess of Fair Market Value Over Basis**	**D's Share of Income/Loss on Hypothetical Transaction**
Capital Assets				
Land Investment	$30,000	$ 60,000	$ 30,000	$10,000
Securities	15,000	90,000	75,000	25,000
Total	$45,000	$150,000	$105,000	$35,000
Other Property				
Inventory	$21,000	$ 66,000	$ 45,000	$15,000
Accounts Receivable	0	15,000	15,000	5,000
Total	$21,000	$ 81,000	$ 60,000	$20,000
Total	$66,000	$231,000	$165,000	$55,000
Capital:				
A	$22,000	$ 77,000	$ 55,000	
B	22,000	77,000	55,000	
C	22,000	77,000	55,000	
Total	$66,000	$231,000	$165,000	

If C sells her partnership interest to D for $77,000, the total adjustment available to D is $55,000, the excess of the basis for D's partnership interest ($77,000) over his share of previously taxed capital ($22,000).

76. Reg. § 1.755-1(b)(2)(i).

77. Reg. §§ 1.755-1(b)(2)(i)(A), 1.755-1(b)(2)(i)(B). Many of the complex allocation rules appearing in these Regulations are not generally necessary. As they deal with deep discount purchase price situations, their applicability is limited. Even in such cases, there are theoretical concerns with such an approach, *i.e.*, how can the value of the assets not equate with the purchase price in an arm's length transaction.

As the starting point, the Regulations ensure that the $55,000 adjustment is allocated between the classes based upon the hypothetical sale of assets, with priority given to other property. Thus, the portion of the $55,000 adjustment attributable to other property is the $20,000 of income that would arise upon a sale of such assets. The calculation for the capital assets involves a comparison between the overall adjustment ($55,000) and the amount allocated to the class of other property ($20,000), which results in a $35,000 adjustment to D's share of those assets.

2. *Allocation to Property Within a Class*

The Regulations address allocations of the adjustment to assets within a class, in essence, following a procedure similar to the overall adjustment.[78] Furthermore, the Regulations prioritize the adjustment to ordinary income property and focus on the income or loss that would be generated by each asset through the hypothetical sale. As a consequence, both positive and negative adjustments can arise simultaneously within a single class.[79]

If the value of the land were instead $123,000, *i.e.*, an increase in prior value by $63,000, and the inventory value were $3,000, *i.e.*, a decrease in prior value by $63,000, the altered tax balance sheet would appear as follows:

Assets:	**Adjusted Basis**	**Fair Market Value**	**Excess of Fair Market Value Over Basis**	**D's Share of Income/Loss Hypothetical Transaction**
Capital Assets				
Land	$30,000	$123,000	$ 93,000	$31,000
Investment Securities	15,000	90,000	75,000	25,000
Total	$45,000	$213,000	$168,000	$56,000
Other Property				
Inventory	$21,000	$ 3,000	($ 18,000)	($ 6,000)
Accounts Receivable	0	15,000	15,000	5,000
Total	$21,000	$ 18,000	($ 3,000)	($ 1,000)
Total	$66,000	$231,000	$165,000	$55,000
Capital:				
A	$22,000	$ 77,000	$ 55,000	
B	22,000	77,000	55,000	
C	22,000	77,000	55,000	
Total	$66,000	$231,000	$165,000	

78. Reg. § 1.755-1(b)(3).
79. Reg. §§ 1.755-1(b)(3)(i), 1.755-1(b)(3)(ii).

If C sells her partnership interest to D for $77,000, the total adjustment available to D is $55,000, the excess of the basis for D's partnership interest ($77,000) over his share of previously taxed capital ($22,000).

As its starting point, the Regulations ensure that the $55,000 adjustment is allocated between the classes with priority given to other property. Furthermore, the adjustment to both classes is not capped at $55,000. Thus, the portion of the adjustment attributable to the class of other property is a decrease of $1,000, *i.e.*, a $6,000 decrease attributable to the inventory offset by a $5,000 increase attributable to the accounts receivable. The adjustment attributable to D's share of the capital assets equals the overall adjustment of $55,000 increased by the $1,000 negative adjustment to other property. Thus, the adjustment to D's share of the capital assets is a positive adjustment of $56,000.[80]

IV. Optional Adjustment to Basis of Undistributed Partnership Property — Section 734(b)

A. *Reason for Optional Adjustment to Basis of Partnership Property Following Certain Distributions*

With property distributions in complete or partial liquidation of a partner's interest in the partnership, disparities between the inside basis of the partnership's assets and the outside basis of the partners' interests will frequently arise. Similar to the basis adjustments available on the transfer of a partnership interest, Congress adopted an elective approach to basis adjustments for partnership distributions of cash and/or property.

Section 734(a) provides that a distribution of partnership property to a partner has no effect on the basis of property retained by the partnership. This is so notwithstanding the appreciation or depreciation in the value of the asset(s) distributed and the partial or complete liquidation of the distributee. As with the section 743(b) adjustment, the primary purpose of the section 734(b) adjustment is to keep inside and outside basis in sync to prevent distortions of income or loss that can occur under the general rule.

For example, assume that the balance sheet of Partnership ABC is as follows:

Assets:	**Adjusted Basis**	**Fair Market Value**	**Capital:**	**Adjusted Basis**	**Fair Market Value**
Cash	$12,000	$12,000	A	$ 8,000	$11,000
Capital Asset X	3,000	11,000	B	8,000	11,000
Capital Asset Y	9,000	10,000	C	8,000	11,000
Total	$24,000	$33,000	**Total**	$24,000	$33,000

80. Reg. § 1.755-1(b)(2)(ii), Exs. (1), (2).

If C receives $11,000 in cash in liquidation of her interest, she realizes taxable gain of $3,000, *i.e.*, $11,000 received minus her $8,000 basis. This gain is one-third of the total potential gain of $9,000 on Capital Asset X and Capital Asset Y. Under the general rule, which provides no adjustment to the basis of the partnership property, the partnership will realize the full $9,000 of gain when Capital Asset X and Capital Asset Y are sold. Since $3,000 of gain has been recognized by and taxed to C, a portion of the gain will be double taxed. The situation is similar to a purchase of C's partnership interest by A and B without an adjustment to basis. As in a section 743 situation, this inequity will be corrected when A and B dispose of their partnership interests, but, because of timing and the character of the gain and loss, they may not be made whole.

If a full aggregate theory were used, C would be treated as if she had sold her pro rata share of each partnership asset to A and B for its fair market value and that portion of those assets would have a basis equal to the purchase price. Similar to the section 743(b) basis adjustment, the section 734(b) adjustment is intended to accomplish such a result following a distribution to a partner resulting in gain or loss recognition. The distributee partner has recognized a portion of the partnership gain or loss, and the adjustment is intended to prevent the remaining partners from recognizing it again.

A similar rationale exists for the application of section 734(b) to the distribution of property other than money in reduction of a partner's interest or withdrawal of a partner from the partnership. Where such property is appreciated or depreciated, its distribution carries out of the partnership gain or loss, which, if the property had been sold by the partnership, generally would have been attributable to all of the partners, not merely the distributee.

In the above example, instead of distributing cash for the partnership interest upon C's withdrawal, the partnership might distribute Capital Asset X, with an adjusted basis to the partnership of $3,000 and a fair market value of $11,000. Partners A and B have, in effect, acquired C's interest in the partnership in exchange for their two-thirds interest in Capital Asset X. In essence, A and B have acquired C's one-third interest in other partnership assets. C's one-third share of the partnership's adjusted bases for the assets in which she relinquished an interest in exchange for the two-thirds interest of A and B in Capital Asset X is as follows:

Cash	$4,000
Capital Asset Y	3,000
Total	$7,000

No gain or loss is recognized by the partnership on the distribution of Capital Asset X to C. The general rule in a non-taxable exchange of properties is that the property acquired takes the adjusted basis of the property exchanged. A distribution of property in reduction of a partner's interest or withdrawal of the partner from the partnership technically is not an exchange, and the properties exchanged are not necessarily like-kind properties, but the rationale of section 734(b) generally applies that principle. The transaction is summarized as follows:

> 1. The partnership, as constituted after C's retirement, acquired an interest in the undistributed partnership property. C's proportionate share of the partnership's basis for that undistributed partnership property (cash and Capital Asset Y) was $7,000.
> 2. The partnership distributed to C Capital Asset X having an adjusted basis to the partnership of $3,000. Partners A and B exchanged their two-thirds share of Capital Asset X, which had an adjusted basis to the partnership of $2,000.
> 3. The property acquired from C should take the same basis as the adjusted basis of the property exchanged. Consequently, there should be a decrease in the partnership's basis of its undistributed property generally in the amount of $5,000.

The mechanics of section 734(b) are intended to approximate an aggregate approach, to equalize inside basis and outside basis, and to prevent an increase or decrease in the aggregate basis for the partnership's assets (both those distributed and those retained). If the assets distributed to the distributee partner lose basis, the assets retained by the partnership generally gain basis, and vice versa.

B. *Analysis of Section 734(b)*

The basis adjustment, if elected by the partnership, is available in the case of a distribution of property by the partnership to a partner. Although the above example involved a distribution in liquidation of a partner's interest, a complete liquidation is not necessary to make the provision applicable. A distribution of property, including money, which merely reduces a partner's proportionate interest can precipitate adjustments. Current distributions of property, including money, to all partners in proportion to their interests, leaving their proportionate interests unchanged, also may invoke adjustments.

Section 734(b) generally is an elective provision which applies if the partnership has a section 754 election in effect for the year of the distribution.[81] The adjusted basis of undistributed partnership property is increased by the taxable gain recognized to the distributee and the excess of

81. *But see* sections 732(d) and 734(a) for settings in which the adjustment is mandatory.

the partnership's adjusted basis of the distributed property over the basis of the distributed property in the hands of the distributee. The adjusted basis of undistributed property is decreased by the loss recognized to the distributee and the excess of the basis of the distributed property in the hands of the distributee over the partnership's adjusted basis of the distributed property. Another, and perhaps easier, way to state the adjustment rules is that the partnership's adjusted basis for its undistributed property is increased by the amount of taxable gain recognized to the distributee, decreased by the amount of deductible loss recognized to the distributee, increased by the amount of the basis decrease for the distributed property when it passes from the partnership to the partner (the lost basis), and decreased by the amount of the basis increase for the distributed property when it passes from the partnership to the partner (the gained basis).

1. *Recognition of Gain or Loss*

Gain is recognized in either a current or a liquidating distribution only to the extent that cash distributed (or deemed to have been distributed under section 752(b)) exceeds the basis for the distributee partner's partnership interest. If property other than cash is distributed in either a current distribution or a liquidating distribution, gain still is limited to the excess of cash over the distributee's partnership basis, even though some of the other property distributed is unrealized receivables or inventory. Loss is recognized only in a liquidating distribution and only if the property distributed is cash, unrealized receivables, inventory, or a combination of the three.

2. *Basis of Distributed Property*

If property, other than or in addition to cash, unrealized receivables, or inventory, is distributed, the rules of section 732 determine whether its basis to the distributee partner after the distribution is more or less than its basis to the partnership before the distribution. If the distribution is a current distribution, the general rule is that the property has the same basis to the distributee that it had to the partnership immediately before the distribution. In that event, the distribution will not create a section 734(b) adjustment. However, the transferred basis of the distributed property in the aggregate cannot exceed the basis for the distributee partner's partnership interest, reduced by any money distributed in the same transaction. If that limitation applies, the aggregate basis of the distributed property to the distributee will be less than the aggregate basis of that property to the partnership. In that event, and assuming that an election is in effect, the decrease in basis of the property will cause an increase in basis for the remaining partnership property.

If the distribution is a liquidating distribution, there is no transferred basis with respect to the distributed property. There is an exchanged basis because the distributed property always takes a basis, in the aggregate, equal to the basis for the distributee's partnership interest, reduced by any money distributed.[82] The basis of the distributed property can either increase or decrease by reason of the distribution. Therefore, it can create either a downward or an upward adjustment to the basis of the remaining partnership property.[83]

3. *Illustration*

The Regulations[84] illustrate an adjustment when the liquidation of a partner's interest results in a decrease in the basis of an asset distributed and an increase in the basis of the remaining partnership property. In that example, D has a $10,000 basis for his one-third interest in Partnership DEF, which has the following tax balance sheet:

Assets:	**Adjusted Basis**	**Fair Market Value**	**Capital:**	**Adjusted Basis**	**Fair Market Value**
Cash	$ 4,000	$ 4,000	D	$10,000	$11,000
Capital Asset X	11,000	11,000	E	10,000	11,000
Capital Asset Y	15,000	18,000	F	10,000	11,000
Total	$30,000	$33,000	**Total**	$30,000	$33,000

If D receives Capital Asset X in complete liquidation of his interest, it will have a basis to him of $10,000, which is the basis of D's partnership interest. There has been a decrease of $1,000 in the basis of that asset, which will result in a $1,000 increase in the basis of the remaining partnership assets if the election is in effect. This increase is applied to the basis of Capital Asset Y, the only remaining partnership property other than money.[85] The new balance sheet of Partnership EF is as follows:

82. This is so on an aggregate basis. However, the distributee's basis in unrealized receivables and inventory items cannot exceed the basis of such property to the partnership prior to the distribution under section 732(c)(1).

83. The only circumstance in which a distribution of property in liquidation will not result in an increase or decrease of its basis is when the basis of the distributee's partnership interest equals the basis of the distributed property.

84. Reg. § 1.734-1(b)(1).

85. The allocation is made under the rules of section 755, discussed below.

Assets:	**Adjusted Basis**	**Fair Market Value**	**Capital:**	**Adjusted Basis**	**Fair Market Value**
Cash	$ 4,000	$ 4,000	E	$10,000	$11,000
Capital Asset Y	16,000	18,000	F	10,000	11,000
Total	$20,000	$22,000	**Total**	$20,000	$22,000

The effect of the adjustment is to prevent an overall increase or decrease in the basis of the total partnership assets, including those distributed, solely by reason of the distribution. The adjustment also preserves the equality of the total of the inside and outside basis of the partnership and the partners.

4. Depreciation and Amortization

As in the previous discussion of the impact of the section 743(b) adjustment on the depreciation or amortization amounts available to the transferee partner if an election is in effect, unsurprisingly, similar additional calculations are required in the case of a section 734(b) adjustment. The adjustments produce increases or decreases in the basis of the assets for the partnership. Accordingly, if the adjusted assets are depreciable or amortizable, additional tax consequences will arise for the continuing partners.[86]

C. Some Difficulties in the Operation of Section 734(b)

In contrast to the section 743(b) basis adjustment, the section 734(b) adjustment does not operate as well in certain situations. This is particularly so where there is a disparity between inside and outside basis existing at the time of a distribution.[87]

For example, assume that the tax balance sheet of Partnership BCD is as follows:

86. *See* David L. Cameron & Philip F. Postlewaite, *Amortization of Intangible Assets Under the Improved Final Regulations*, 93 J. TAX'N 150 (2000). *See generally* POSTLEWAITE ET AL., INTELLECTUAL PROPERTY, *supra* note 54.

87. Although the Treasury in 2004 markedly improved the operation of the section 743(b) basis adjustment through the issuance of new Regulations, its efforts in section 734(b) context were not as impressive.

Assets:	Adjusted Basis	Fair Market Value	Capital:	Adjusted Basis	Fair Market Value
Cash	$45,000	$ 45,000	B	$24,000	$ 40,000
Capital Asset X	15,000	40,000	C	24,000	40,000
Capital Asset Y	12,000	35,000	D	24,000	40,000
Total	$72,000	$120,000	**Total**	$72,000	$120,000

B sells her partnership interest to E for $40,000. The election is not in effect so there is no section 743(b) adjustment to the basis of partnership property. Thus, an imbalance is created between the inside basis of the partnership property and the outside basis of the partnership interests. The total inside basis of partnership property remains at $72,000. However, by virtue of the sale, the total of the outside basis of the partnership interests is increased to $88,000 ($24,000 for C, $24,000 for D, and $40,000 for E). The tax balance sheet would appear as follows:

Assets:	Adjusted Basis	Fair Market Value	Capital:	Adjusted Basis	Fair Market Value
Cash	$45,000	$ 45,000	B	$24,000	$ 40,000
Capital Asset X	15,000	40,000	C	24,000	40,000
Capital Asset Y	12,000	35,000	E	40,000	40,000
Total	$72,000	$120,000	**Total**	$88,000	$120,000

The intended result of section 734(b) is reached, if at all, only in situations where the inside basis and the outside basis are the same when the partner's withdrawal occurs. For example, in the above example, when E acquired his interest, if a $16,000 adjustment had been made to Capital Asset X and Capital Asset Y (for E's benefit), section 734(b) would work properly.[88]

However, section 734(b) cannot remedy the matter when there is a disparity between the inside basis and the outside basis due to a failure to elect. If E's interest is liquidated for $40,000 of cash and a section 754

88. Even if on the liquidation of E's interest none of the four events required for a section 734(b) adjustment occurred, *e.g.*, because only cash was received by E and no gain or loss was recognized by him, order is restored to the partnership under Regulation section 1.734-2(b)(1). The Regulation provides that if a transferee partner (E) in a complete liquidation of his interest receives property (cash in the example) to which no basis adjustment previously has been made, his "unused special basis adjustment" attributable to his interest in other property which he has relinquished ($16,000) is applied to the retained partnership property. After the adjustment, inside basis of $48,000 ($72,000 minus $40,000 distributed plus $16,000) would equal the outside basis of the total basis of the interests of C and D ($24,000 each).

election is made by the partnership, section 734(b) will not work properly. There will be no recognized gain or loss on the distribution, which is one of the prerequisites to its application.

After the distribution to E, the tax balance sheet of Partnership CD would be unbalanced and would reflect this disparity:

Assets:	**Adjusted Basis**	**Capital:**	**Adjusted Basis**
Cash	$ 5,000	C	$24,000
Capital Asset X	15,000	D	24,000
Capital Asset Y	12,000		
Total	$32,000	**Total**	$48,000

If the provision functioned perfectly, the basis of the remaining partnership property would be adjusted upward so that the partnership's basis of its assets equaled $48,000, the adjusted basis of the interests of C and D in the partnership.[89]

Other difficulties arise in the section 734(b) context which preclude it from functioning as well as the section 743(b) adjustment. The Regulations require that when a distribution of property results in an adjustment to the basis of undistributed property, the adjustment is allocated to remaining property of a similar character. Thus, adjustments attributable to cash and capital assets (including section 1231 property, but not section 1245 recapture) must be allocated to capital assets. Adjustments attributable to other property must be allocated to other property. The difficulty is that the allocation is based on the character of the distributed asset instead of the character of the asset responsible for the appreciation or depreciation of the partnership assets.

For example, assume that equal Partnership ABC, with the following tax balance sheet, distributes $60,000 to A in a liquidating distribution.

Assets:	**Adjusted Basis**	**Fair Market Value**	**Capital:**	**Adjusted Basis**	**Fair Market Value**
Cash	$ 70,000	$ 70,000	A	$ 50,000	$ 60,000
Inventory	60,000	65,000	B	50,000	60,000
Capital Asset X	20,000	45,000	C	50,000	60,000
Total	$150,000	$ 180,000	**Total**	$150,000	$180,000

89. Regulation section 1.734-2(b) may appear to redress this problem, but without success. It addresses a circumstance where a partner receives in liquidation of his interest property (including money) in which he has no special adjustment in exchange for his interest in property in which he has a special adjustment, whereas the problem exists when the property relinquished is property in which he should have a special adjustment but does not.

A will recognize a gain of $10,000, and the basis adjustment will be allocable to the class of capital assets only.[90] Thus, while inside and outside basis will be equal, the adjustment does not function properly. The tax balance sheet after the transaction would appear as follows:

Assets:	**Adjusted Basis**	**Fair Market Value**	**Capital:**	**Adjusted Basis**	**Fair Market Value**
Cash	$ 10,000	$ 10,000	B	$ 50,000	$ 60,000
Inventory	60,000	65,000	C	50,000	60,000
Capital Asset X	30,000	45,000			
Total	$100,000	$120,000	**Total**	$100,000	$120,000

Proper functioning of the adjustment would have allocated the overall basis adjustment between Inventory and Capital Asset X, *i.e.*, $1,666 to Inventory and $8,333 to Capital Asset X.

Finally, section 734(b) does not allow for positive and negative adjustments from a single transaction. Allocations between classes and within classes are only one-directional. Assume in the following case that A's partnership interest is liquidated for cash of $9,000.

Assets:	**Adjusted Basis**	**Fair Market Value**	**Capital:**	**Adjusted Basis**	**Fair Market Value**
Cash	$10,000	$10,000	A	$ 7,000	$ 9,000
Capital Asset X	5,000	14,000	B	7,000	9,000
Capital Asset Y	6,000	3,000	C	7,000	9,000
Total	$21,000	$27,000	**Total**	$21,000	$27,000

While this generates a basis increase of $2,000, the Regulations dictate that the adjustment is made solely to Capital Asset X ($5,000 + $2,000 = $7,000). Upon its sale, the remaining Partnership BC will recognize $7,000 of gain ($14,000 - $7,000 = $7,000), $3,500 each. From a tax policy standpoint, the basis adjustment should have been a $3,000 increase to Capital Asset X and a $1,000 decrease to Capital Asset Y, as is the case with the revised Regulations under section 755, which deal with the allocation of basis adjustments under section 743(b).

D. Mandatory Application of Section 734(b)

In 2004, Congress evidenced its concern with loss duplication in the partnership context. Given the ability of a partnership to determine whether

90. Had the inventory been substantially appreciated, section 751(b) would have come into play and resulted in a basis adjustment for the inventory.

to elect the adjustment for the partnership, it is possible to duplicate losses through a failure to elect, *i.e.*, the distributee partner recognizes loss on the distribution of cash and the partnership takes a similar loss into account if the remaining assets are sold subsequently. While the loss would ultimately be offset by a corresponding amount of income on the liquidation or sale of the remaining partnership interests, tax benefits through such efforts are possible.

Section 734(b) was amended to provide that an adjustment to the basis of the partnership's assets is mandatory, regardless of election, if a substantial basis reduction to the basis of the partnership's assets would occur. A substantial basis reduction is defined as a basis decrease in excess of $250,000. Regulations to effectuate the legislation are specially authorized.[91]

For example, assume that equal Partnership DEF does not have an election in effect. Its tax balance sheet is as follows:

Assets:	**Adjusted Basis**	**Fair Market Value**	**Capital:**	**Adjusted Basis**	**Fair Market Value**
Cash	$ 800,000	$ 800,000	D	$1,000,000	$ 700,000
Capital Asset X	1,000,000	600,000	E	1,000,000	700,000
Capital Asset Y	1,200,000	700,000	F	1,000,000	700,000
Total	$3,000,000	$2,100,000	**Total**	$3,000,000	$2,100,000

If F receives $700,000 cash in complete liquidation of his interest, he will recognize a $300,000 loss.

Prior to 2004, absent an election, this distribution would have created a disparity between the inside and outside bases of Partnership DE, which would allow D and E to duplicate the $300,000 loss that F recognized on his liquidating distribution. Under amended section 734, however, Partnership DE is required to make a basis adjustment because the distribution would create a basis reduction greater than $250,000 if an election had been in effect. Accordingly, the partnership is required to decrease the basis of the remaining partnership assets. The decrease is applied to both Capital Asset X and Capital Asset Y proportionally according to their decrease in value. The basis of Capital Asset X is reduced by $133,333 ($400,000/$900,000 × $300,000) and the basis of Capital Asset Y is reduced by $166,667 ($500,000/$900,000 × $300,000).[92] The new tax balance sheet is as follows:

91. I.R.C. §§ 734(d)(2), 743(d)(2).

92. *See* discussion *supra* at Part IV, regarding the allocation of section 734(b) adjustments among the remaining assets of the partnership. *See also* section 704(c)(1)(C), discussed at Part II, F., which is similarly intended to prevent loss duplication.

Assets:	**Adjusted Basis**	**Fair Market Value**	**Capital:**	**Adjusted Basis**	**Fair Market Value**
Cash	$ 100,000	$ 100,000	D	$1,000,000	$ 700,000
Capital Asset X	866,667	600,000	E	1,000,000	700,000
Capital Asset Y	1,033,333	700,000			
Total	$2,000,000	$1,400,000	**Total**	$2,000,000	$1,400,000

V. ALLOCATION OF SECTION 734(b) BASIS ADJUSTMENT AMONG UNDISTRIBUTED PARTNERSHIP PROPERTIES

The adjustment determined under section 743(b) is a total adjustment to the basis of all partnership property. The allocation of that total adjustment among the various undistributed properties is determined according to section 755,[93] which, as in the case of the allocation of a section 743(b) adjustment, requires a segregation of the total basis adjustment between two classes of property—capital assets and other property.

The allocation of a section 755(b) adjustment raises a question of grammatical interpretation. The statute provides that: "increases or decreases in the adjusted basis of partnership property arising from a distribution of, or a transfer of an interest attributable to, property consisting of—(1) capital assets and property described in section 1231(b), or (2) any other property of the partnership, shall be allocated to partnership property of a like character...." Whether the adjustment is allocated to the same class of property as the property distributed or to the class of property to which the increase or decrease is attributable is unclear from the peculiar sentence construction of the provision. Allocation to the same class as the property distributed produces distortions. Allocation to the class of property to which the adjustment is attributable produces an apparently logical result. This latter interpretation, however, is contrary to the grammatical construction of the sentence by the Treasury.

The Treasury has issued brief Regulations setting forth rules for the allocation of section 734(b) basis adjustments.[94] The rules provide that the basis adjustment is first allocated between the two classes of property—capital assets and other property. Where there is a distribution of partnership property resulting in an adjustment to the basis of undistributed partnership property, the adjustment must be allocated to remaining partnership property of a character similar to that of the distributed property with respect to which the adjustment arose. Thus, when the partnership's adjusted basis of distributed capital gain property immediately prior to distribution exceeds the basis for the property to the distributee partner (as determined under section

93. *See* Rini-Swyers, *supra* note 71; Abrams, *supra* note 1; and Burke, *supra* note 1.

94. Reg. § 1.755-1(c).

732), the basis for the remaining capital assets is increased by an amount equal to the excess. Conversely, when the basis to the distributee partner (as determined under section 732) of distributed capital gain property exceeds the partnership's adjusted basis for such property immediately prior to the distribution, the basis of the remaining capital assets in the partnership is decreased by an amount equal to such excess. Similar adjustments would be made with respect to any distribution of other property, i.e., the adjustment would be made only to property of the same class.

However, where there is a distribution resulting in an adjustment to the basis of undistributed partnership property (due to gain or loss recognized by the distributee partner), the adjustment is allocated only to capital gain property. The practical effect of this rule is to treat distributions that result in capital gain as giving rise to an increase in the basis of assets the income from which would be capital in nature.[95] Nevertheless, focusing upon the nature of the property distributed rather than the property responsible for the appreciation or deprecation may cause basis distortion.

If there is an increase in basis to be allocated within a class of property, the section 755 Regulations provide that it must be allocated first to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation before such increase (but only to the extent of each property's unrealized appreciation). Any remaining increase must be allocated among the properties within the class in proportion to their fair market values.

If there is a decrease in basis to be allocated within a class, it must be allocated first to properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation before such decrease (but only to the extent of each property's unrealized depreciation). Any remaining decrease must be allocated among the properties within the class in proportion to their adjusted bases. However, the basis of partnership property of the required character cannot be reduced below zero.

The Regulations contain a helpful example.[96] Assume that A, B, and C form equal Partnership ABC to which A contributes $50,000 of cash and Asset 1, capital gain property with a fair market value of $50,000 and an adjusted tax basis of $25,000. B and C each contribute $100,000 of cash to the partnership, which uses the cash to purchase Assets 2, 3, 4, 5, and 6. The latter three assets are ordinary income property. After seven years, the

95. Presumably, the Treasury was concerned that taxpayers would be able to arbitrage tax rates by obtaining capital gains for the distributee partner and a decrease in ordinary income for the remaining partners in the partnership. This concern should have been reduced by the existence of section 751(b) which would apply in many of such settings, forcing a basis increase or decrease because it treats some or all of the transaction as a sale.

96. Reg. § 1.755-1(c)(6), Ex.

adjusted basis and fair market value of the partnership's assets are as follows:

Capital Assets:	**Adjusted Basis**	**Fair Market Value**
Asset 1	$ 25,000	$ 75,000
Asset 2	100,000	117,500
Asset 3	50,000	60,000
Other Property		
Asset 4	40,000	45,000
Asset 5	50,000	60,000
Asset 6	10,000	2,500
Total	$275,000	$360,000

Assume that the partnership distributes Assets 3 and 5 (worth $120,000) to A in complete liquidation of his interest in the partnership. A's basis in the partnership interest was $75,000, whereas the partnership's basis in the distributed assets was $50,000 each. A will have a basis of $25,000 in Asset 3 (capital gain property) and a basis of $50,000 in Asset 5 (ordinary income property) because, under section 732(c), basis must first be allocated to the ordinary income property in an amount equal to the partnership's adjusted basis for such property.

In other words, A's basis of $75,000 in the distributed assets is first allocated to ordinary income property, which results in a reduction of $25,000 in the basis of the capital gain property distributed to him. This results in a basis increase to the partnership of a like amount. The basis increase must be allocated to the remaining partnership assets of a similar character (capital gain assets) in proportion to their relative appreciation. The fair market value of Asset 1 exceeds its tax basis by $50,000, whereas the fair market value of Asset 2 exceeds its tax basis by $17,500. Therefore, the basis of Asset 1 will be increased by $18,519 ($50,000/$67,500 × $25,000), whereas the basis of Asset 2 will be increased by $6,481 ($17,500/ $67,500 × $25,000).[97]

A partnership may not have sufficient basis in its remaining property of the requisite character. This could arise if the partnership does not have sufficient basis in its property (in the case of a basis decrease) or if the partnership lacks property of the character whose basis could be increased. In that event, the adjustment is made when the partnership subsequently acquires property of a like character to which an adjustment can be made. Such situations, of course, result in a disparity between inside and outside basis, thereby failing to achieve the overall legislative purpose for the adjustment.

97. *See generally* Monte A. Jackel & Shari R. Fessler, *The Mysterious Case of Partnership Inside Basis Adjustments*, 89 TAX NOTES 529 (October 23, 2000).

VI. SECTION 732(d) — SAFETY VALVE FOR TRANSFEREE PARTNER IF NO SECTION 754 ELECTION TO ADJUST BASIS

In certain cases, the Code permits a basis adjustment for certain partnership assets as a result of a transfer of a partnership interest even if the partnership has not made a section 754 election. The use of the provision is typically elective with the transferee partner, although in some circumstances the adjustment is mandatory.

The purpose of the statute is to afford, to the degree possible, a distributee partner who acquired his interest by transfer the same result that he would have had if an election had been in effect at the time of the transfer generating a section 743(b) adjustment. However, the basis of the distributed property under such an adjustment will not necessarily be the same as if there had been such a section 743(b) adjustment.

A. *The Conditions and Method of Section 732(d)*

The provision is available on an elective basis to a partner who (1) acquires his partnership interest by purchase or inheritance from another partner when the partnership did not have an election in effect and (2) receives a distribution of property other than money within two years thereafter. In that circumstance, the partner may elect to treat the basis that the property would have had if the adjustment were made when the partner acquired his interest as the basis for the distributed property.

The election is made by the distributee partner, and the consent of the partnership is not needed.[98] Although the election adjusts the basis as though a section 743(b) had been made at the time of the transfer, the adjustment is effective only at the time of the distribution. The amount of the adjustment, therefore, is not affected by any potential depreciation, depletion, or amortization on the portion of the basis resulting from the adjustment because such depreciation, depletion, or amortization has not in fact been taken.[99]

Generally such a distribution becomes important only if the partnership is about to sell the property (frequently ordinary income property) and the distributee wants to reduce the gain he will recognize if the

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98. One advantage of a section 732(d) election is that its use by the transferee/distributee partner imposes no obligation on the partnership to make adjustments for future transactions. It appears that the distributee need not be uniform in his election pattern, *e.g.*, the election might be made in one year and not another. With respect to multiple distributions in the same year, the issue is even more clouded since some authority suggests that all such non-liquidating distributions are treated as occurring on the last day of the year. *See* Reg. § 1.731-1(a)(1)(ii).

99. Reg. § 1.732-1(d)(1)(iv).

partnership makes the sale. In that case, the coordination between the partnership and the partner may be so close in consummating the sale that the Service takes the position that, in substance, the sale was made by the partnership followed by a distribution of the proceeds.[100] Because the provision is intended to be a relief provision and its election does not give the distributee an unwarranted tax advantage, such a position may not be justified.

The primary importance of the elective method of allocating basis to specific partnership properties is where the partnership has a significant amount of unrealized receivables and inventory items. If the allocation of basis to distributed properties is made under the general rule, no amount can be allocated to the distributed unrealized receivables and inventory items in excess of the adjusted basis of such items to the partnership.

For example, assume that Partnership ABC's balance sheet is as follows:

Assets:	**Adjusted Basis**	**Fair Market Value**	**Capital:**	**Adjusted Basis**	**Fair Market Value**
Cash	$ 3,000	$ 3,000	A	$ 4,000	$ 6,000
Inventory	6,000	12,000	B	4,000	6,000
Capital Asset X	3,000	3,000	C	4,000	6,000
Total	$12,000	$18,000	**Total**	$12,000	$18,000

Partner C dies, and the partnership shortly thereafter distributes his pro rata share of cash of $1,000, inventory valued at $4,000, and Capital Asset X valued at $1,000 in liquidation of his partnership interest.[101] If the general rule for allocation of the adjusted basis of C's interest (increased to $6,000 by reason of his death) were in effect, C's one-third share of the partnership's $6,000 adjusted basis for Inventory would transfer to the distributee. Thus, C's successor in interest would have a $2,000 basis for Inventory. That amount plus the cash of $1,000 distributed to C's successor in interest would be deducted from the basis of $6,000 for C's partnership interest on his death, leaving $3,000 as the adjusted basis of Capital Asset X with a fair market value of $1,000. If C's successor in interest sold Inventory, there would be $2,000 of ordinary income. If he sold Capital Asset X, there would be a $2,000 capital loss.

However, if because the partnership had not made a section 754 election C's successor in interest made an election under section 732(d), the adjusted basis of the distributed assets would be the same as though the

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100. *See* Commissioner v. Court Holding, Co., 324 U.S. 331 (1945).

101. Given the pro rata distribution, the rigors of section 751(b) are avoided.

adjustment to basis of partnership property under section 743(b) had been made on C's death. The assets would have bases of cash at $1,000, Inventory at $4,000, and Capital Asset X at $1,000. No gain or loss would be realized on the sale of the assets. Clearly, under the facts given, it would be beneficial for C's successor to elect such treatment.

The amount of the adjustment is determined as though the election was in effect and an adjustment made upon the transfer of the partnership interest. After the amount of the adjustment is determined, it is allocated to specific properties pursuant to section 755 in an identical manner to that of a normal section 743(b) adjustment. The purpose of the adjustment is to determine the basis of property distributed to the transferee partner. Therefore, the adjustment has no effect on property not so distributed. The section 732(d) adjustment is taken into account, however, as part of the partnership's basis for the property in determining the basis of distributed property.[102]

B. Basis of the Distributed Property

The basis of distributed property is determined under the general rules. Under these provisions, basis is derived from the partnership's basis for the distributed property immediately prior to the distribution. The section 732(d) adjustment affects the pre-distribution basis, which in turn affects the basis after the distribution by virtue of its effect on the pre-distribution basis.

If the distribution is a current distribution and the basis to the partnership of the distributed property is less than the basis of the distributee's partnership interest, the basis of the distributed property after the distribution is the same as the basis the property had to the partnership.[103] Because the section 732(d) adjustment is part of the partnership's basis, it has a direct effect on the basis of the property to the distributee.

However, the adjustment does not directly affect the basis of distributed property in all cases. If the basis of the distributed property is limited to the basis of the distributee partner's partnership interest, under section 732(a)(2) in a current distribution or under section 732(b) in a liquidating distribution, the adjustment only indirectly affects the basis to the distributee of the property through the allocation of the distributee's basis for his partnership interest under section 732(c).[104]

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102. Reg. § 1.732-1(e).
103. I.R.C. § 732(a)(1).
104. *See id.* §§ 732(c)(1)(B)(ii), 732(c)(2)(A), 732(c)(2)(B).

C. *Distribution of Unadjusted Property*

The property distributed to a partner making the election may not be the property to which the adjustment applies. In that case, the special basis adjustment will apply instead to any like-kind property received by the distributee, provided he has relinquished his interest in the property with respect to which the special basis adjustment applies.[105] The property distributed need not have been on hand when the distributee acquired his partnership interest as long as it is similar property to which the section 743(b) adjustment would have applied.[106] Such shifting may be very detailed and complicated.[107]

D. *Application of Section 732(d) by Requirement of Commissioner*

Section 732(d) requires a mandatory adjustment to distributed property in certain circumstances. A partner who acquired his interest by a transfer to which the section 754 election was not in effect is required to apply the adjustment to a distribution made to him at any time (not only within two years) if at the time the interest was acquired the following conditions are met:

> 1. The fair market value of all partnership property (other than money) exceeds 110 percent of its adjusted basis to the partnership;
> 2. An allocation of basis under section 732(c) (if the interest had been liquidated immediately after the transfer) would have shifted basis from property not subject to an allowance for depreciation, depletion, or amortization to property subject to such allowance; and
> 3. A special basis adjustment under section 743(b) would change the basis to the distributee of the property actually distributed.[108]

The purpose of the requirement is to prevent distortions beneficial to the taxpayer resulting from shifting increases in the value of non-depreciable property to the basis of depreciable property.

The impact of section 732(d) was narrowed by the amendments to section 732(c) affecting basis determinations for distributed property as well as by the enactment of section 197, which allows for the amortization of intangible assets. Section 732(d) applies on a mandatory basis only if an

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105. Reg. § 1.732-1(d)(1)(v).
106. *Id.* § 1.732-1(d)(1)(vi), Ex.
107. *Id.* § 1.743-1(g)(2)(ii).
108. *Id.* § 1.732-1(d)(4).

allocation of basis under section 732(c) would have resulted in a shift of basis from property not subject to an allowance for depreciation, depletion, or amortization to property subject to such an allowance. Prior to its amendment, section 732(c) focused on the distributed property's basis in allocating unused basis of the partnership interest to the distributed assets. It now focuses on relative appreciation, thereby minimizing such shifts.

Prior to the enactment of section 197, a partnership frequently would own both depreciable and non-depreciable property. The enactment of section 197 means, however, that some intangible assets owned by a partnership are now subject to an allowance for amortization. Thus, although basis shifting may occur (and basis may be shifted from assets with longer lives to those with shorter lives), section 732(d) would not be applicable because the assets still would be depreciable or amortizable. Section 732(d) can apply with respect to a partnership that owns land or other non-depreciable property; however, the impact of this provision has been narrowed.

VII. TRAPS FOR THE UNWARY AND TAX PLANNING OPPORTUNITIES

As illustrated in the prior discussion, the basis adjustments of Subchapter K afford planning opportunities for those with a working knowledge of their application and the results that they can generate. On the tax planning side for section 743(b), the transferee with a willing partnership should elect the adjustment where the partnership holds appreciated assets and thereby avoid double taxation provided the parties are "comfortable" about future events, *i.e.*, the foreseeable future will continue to involve an appreciation of the partnership's assets. Furthermore, the transferee will be entitled to additional amortization and depreciation deductions if the partnership holds such property.

The difficulty with the election, even where it is certain that it will avoid double taxation by the transferee or afford additional deductions, is that the election is binding into the future, not only with respect to future transferees under section 743(b), but also to future distributions of property subject to section 734(b) adjustments. Thus, if the partnership subsequently experiences economic reversals, the benefits of failing to elect, *i.e.*, "duplication of loss," are foreclosed.

In the depreciated assets setting, the parties should not elect where there is a loss in the partnership's assets that is not a substantial built-in loss, *i.e.*, less than $250,000 for the partnership as a whole. The failure to elect will generate beneficial results, as it will produce duplicate losses.[109]

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109. Given the imprecision in sections 734(b) and 755 adjustment allocations, not all loss duplication will be eliminated depending upon the mix of the partnership's assets, bases, and fair market values. *See generally* Jeffrey I.

With respect to tax traps involving the section 743(b) adjustment, failure to elect a basis adjustment, whether due to ignorance of the provision's existence or the failure to understand its operation, in an appreciated assets setting will result in double taxation and the loss of additional amortization and depreciation deductions for the transferee partner. Thus, the purchasing partner is at the mercy of the partnership unless he or she conditions the purchase on a section 754 election by the partnership. Even if the initial setting suggests utilizing the election, it is easy to forget that the election has consequences for the future. It will impact future transferees as well as the partnership on future distributions of assets. Thus, the election requires foresight and an ability to accurately forecast the future. Finally, the tax savings for the parties must be weighed against the administrative costs and record keeping involved in tracking the effect of the election, particularly as it is for the benefit of the transferee, not the partnership.

The section 732(d) election, while made exclusively by the partner, provides similar opportunities and traps. While it requires a distribution of property by the partnership, the basis adjustment permits favorable results. For example, in the case of distribution of inventory, the adjustment, if positive, would reduce the amount of ordinary income. If the property were depreciable or amortizable by the distributee, additional deductions would arise. On the trap for the unwary side, few practitioners, if any, consider the potential mandatory application of section 732(d) on a partnership distribution.

On the tax planning side for section 734(b), a willing partnership should elect the basis adjustment where the partnership holds appreciated assets in order to avoid "double taxation" provided the parties are "comfortable" about future events, *i.e.*, the foreseeable future will continue to involve an appreciation of the partnership's assets. In the depreciated assets setting, the parties should not elect where there is a loss in the partnership's assets that is not a "substantial built-in basis reduction," *i.e.*, less than $250,000, which generates beneficial results as it will produce duplicate losses.

With respect to tax traps involving the section 734(b) adjustment, failure to elect a basis adjustment, whether due to ignorance of the provision's existence or the failure to understand its operation, in an appreciated assets setting will result in double taxation and the loss of additional amortization and depreciation deductions for the partnership. Even if the initial setting suggests utilizing the election, it is easy to forget that the election has consequences for the future. It will impact future transferees as

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Rosenberg, *AJCA Imposes New Burdens for Partnership Basis Adjustments Under Sections 734 and 743*, 101 J. TAX'N 334 (2004). Thus, tax planning opportunities through the failure to elect remain.

well as the partnership on future distributions of assets. Thus, the election requires foresight and an ability to accurately forecast the future. Finally, the tax savings for the parties must be weighed against the administrative costs and record keeping involved in tracking the effect of the election.

A further difficulty with the section 734(b) adjustment is its failure to operate properly in all cases. As previously discussed, if there is a pre-existing disparity between inside and outside basis, the section 734(b) adjustment will not restore equilibrium. Additionally, the adjustment is typically one dimensional in contrast to the two dimensional approach of section 743(b). Given its operational dictates, it is far from certain that the assets responsible for the appreciation or depreciation in the value of the partnership will receive the appropriate amount of the adjustment.

VIII. ANALYSIS OF ARGUMENTS SUPPORTING THE ELECTIVE ASPECT OF THE BASIS ADJUSTMENTS OF SECTIONS 734(b) AND 743(b)

The founding values for the enactment of Subchapter K in 1954—simplicity and flexibility—have been the strongest arguments in favor of maintaining the electivity of the basis adjustment provisions of section 743(b) and section 734(b). Those values influenced the Congressional decision to minimize the administrative burdens and costs incurred by the operation of a partnership.[110]

While the crafting of Subchapter K was intended to bring order out of the chaos surrounding the taxation of partners and partnership, the electivity of the basis adjustments was but one of the numerous issues being considered. However, with the passage of 60 years, accompanied by the entry into the computer and electronic world, such an argument loses much of its persuasive force when basis adjustments are considered as a single tax policy issue. In the age of computers, the administrative burdens and costs of such determination are not what they once were.

In fact, the present complexity of the Code defies these arguments. Even before the 1999 amendments to the Regulations, partnerships, especially large ones, were faced with complex recording and computational problems in numerous areas. The pervasive use of special allocations

110. *See* H.R. REP. NO. 83-1337, *supra* note 8. *See also* Hearing, 83d Cong., *supra* note 9, at 1370 ("In the interest of simplicity and flexibility, however, we provide a series of elections based upon the 'entity' approach, which we assume would be exercised generally by larger and more complex partnerships."). Interestingly, the ALI/ABA Proposal embraced the concept that basis adjustments would occur *unless* the partnership elected out. In the final statutory version adopted by Congress, basis adjustments do not occur *unless* the partnership elects to do so.

evidences the fact that sophisticated tax counsel and accountants are invariably confronted with complex calculations.[111]

Furthermore, the amendments to section 743(b) and section 734(b) making the adjustments mandatory in certain loss settings not only added more complexity to the Code but also ensured that numerous partnerships will be required to make such calculations in order to determine whether the provision applies. These required calculations and determinations are contrary to tax simplicity.[112] While having theoretical merit, these amended rules require sophisticated accounting practices and thus confront partnerships with tremendous record-keeping burdens. Furthermore, the amendments signaled a new attitude by Congress, the Service, and Treasury favoring accuracy and efficiency as opposed to simplicity and flexibility.[113] In those few cases where the administrative and record keeping burden is genuine, Congress has provided exceptions from the calculations and determinations.[114]

The 2004 amendments to section 734(b) and section 743(b) underscore the increasing ambivalence regarding the elevation of flexibility and simplicity over consistency, efficiency, and overall sound tax policy.[115] The mandatory application of the provisions in such settings marks a partial victory against partnerships' ability to manipulate basis disparities.

The changes to the basis adjustment provisions are sweeping in scope because they apply to most partnerships, regardless of size. Administrative burdens and costs imposed are irrelevant. Thus, the transfer of a one percent interest or less in a partnership could trigger the mandatory application of the basis adjustment rule as long as the built-in-loss threshold is met. The mandatory basis adjustment rules also apply even in the case of a transfer due to the death of a partner, a situation in which an intention to duplicate losses should be lacking.

The mandatory application of the provisions would not only simplify partnership taxation by rendering obsolete section 732(d) and section 754, but it would also greatly facilitate the accuracy, uniformity, and efficiency of

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111. *See* WILLIS & POSTLEWAITE, PARTNERSHIP TAXATION, *supra* note 2, at 619.

112. *See* Reg. §§ 1.734-1, 1.755-1.

113. *See* WILLIS & POSTLEWAITE, PARTNERSHIP TAXATION, *supra* note 2, at ¶¶ 12.03[1] and 13.05[1].

114. *See* sections 743(e) and 743(f) regarding the inapplicability of the mandatory adjustment for electing investment partnerships and securitization partnerships. Interestingly, only securitization partnerships are exempt from section 734(b). *See* I.R.C. § 734(e).

115. The mandatory application of section 732(d) in certain settings was an earlier indication of this concern. Given that most practitioners are not aware of its existence, it has not received much attention in the literature.

partnership transactions.[116] Most importantly, it would rebalance equity considerations not only horizontally, between similarly situated partners, but also vertically, between partners with greatly varied tax characteristics, thereby curtailing or preventing abusive tax sheltering. Notwithstanding the 2004 amendments requiring mandatory application, transactions under section 734(b) and section 743(b) falling short of the $250,000 threshold remain untouched. Mandatory application of the basis adjustments in all cases would ensure vertical and horizontal equity in all cases.[117]

IX. REASONS FOR MAKING THE SECTIONS 734(b) AND 743(b) BASIS ADJUSTMENTS MANDATORY

The legislative history of Subchapter K links its origin to the excessive use of tax- motivated family partnerships of the 1940s.[118] The legal and historic context surrounding its enactment, in which both the United States Supreme Court and Congress sanctioned the use of tax-motivated entities,[119] stressed the "vital need" for "clarification," "simplicity," and "flexibility."[120] The accurate reflection of the economic aspect of partnership transactions was not a high priority for the drafters of Subchapter K; rather, their overriding objectives were certainty and the elimination of confusion.[121] Those principles led to the enactment of rules designed to facilitate

116. However, the mandatory application of the basis adjustment provisions would not cure the inherent problems with section 734(b) or the flawed allocation rules under sections 734(b) and 755, and the Regulations. While the 1999 amendments relating to optional basis adjustments greatly clarified the methodology of the allocation rules under sections 743(b) and 755, they failed to provide similar improvement to the corresponding rules under section 734(b).

117. An interesting aspect of the threshold is that Congress did not do similarly in section 704(c)(1)(C), where a mere loss potential of but a single dollar will trigger its application.

118. *See* discussion *supra* at Part II, B.

119. The economic and historic activity throughout the late 1940s and 1950s, where the top marginal tax rate was typically above 90 percent and the necessity for economic growth following World War II was stringent, offers a contextual basis for the prevailing policies embraced by the legislature and judiciary. *See* Superior Oil Co. v. Mississippi, 280 U.S. 390, 395–396 (1930), where Justice Holmes stated that "[t]he only purpose of the [taxpayer] was to escape taxation. . . . The fact that it desired to evade the law, as it is called, is immaterial, because the very meaning of a line in the law is that you intentionally may go as close to it as you can if you do not pass it."

120. *See* S. REP. NO. 83-1622, *supra* note 6, at 89 (1954). Equity among partners was another important concern for the drafters of the 1954 Code.

121. H.R. REP. NO. 83-1337, *supra* note 8, at 66 (1954). "This general treatment was adopted because of its extreme simplicity as contrasted with any other alternative and because it conforms to the usual expectations of partners."

partnership transactions expected to comply with the economics of the transaction.

Basis manipulation through the exploitative tax planning of the discrepancies between outside and inside partnership basis has emerged as a central concern of the Treasury and Internal Revenue Service. This indicates that the policies of simplicity and flexibility have largely failed and should give way to more significant concerns such as equity, accuracy, and efficiency. The recent major legislative changes to the adjustment of basis provisions, specifically the 2004 amendments to section 734(b) and section 743(b), partially addressed the problem of their electivity. Partnerships play a major and ever-increasing role in the field of federal taxation from a revenue perspective; therefore, policies promoting the tax policy goals of Subchapter K are required.

The drafters of Subchapter K in 1954 recognized the potential for shifting tax attributes through the manipulation of basis discrepancies.[122] Nevertheless, starting from the premise that the cost of complexity through the harmonization of inside and outside basis outweighed the benefits of accuracy, the drafters opted for a laissez faire approach, an optional election, for resolving the problem.

It is apparent that the elective nature of the provisions springs from a preference for simplicity and compromise and demonstrates a general commitment to avoid complex or burdensome solutions for both taxpayers and agents in the field.[123] Such preference could be explained, at least partially, by the fact that the drafters (1) were not as appreciative as Congress is currently of the timing issue and (2) were not confronted regularly with situations where partners had different tax profiles and were ready to exploit their differences to the detriment of the Treasury. As the tax sheltering activity of the 1990s and 2000s demonstrated, the attitudes and behavior of taxpayers shift and policies do not have immutable properties, regardless of their scope and desirability.[124] Consequently, as the application of competing policies compromises the functionality of partnership taxation, they must be challenged and re-evaluated.

The Treasury launched a subjective attack on abusive partnership transactions and published the final anti-abuse Regulation under section 701 in 1995.[125] Examples (10) and (11) of Regulation section 1.701-2(d) recognize the potential abusive exploitation of the basis adjustment

122. *See generally* Jackson et al., *A Proposed Revision of the Federal Income Tax Treatment of Partnership and Partners—American Law Institute Draft*, 9 TAX L. REV. 109 (1953); *See also* Jackson et al., *supra* note 17.

123. *See generally*, William S. McKee, *Partnership Allocations in Real Estate Ventures:* Crane, Kresser *and* Orrisch, 30 TAX L. REV. 1 (1974).

124. *See* Notices 2002-50, 2008-34.

125. Reg. § 1.701-2, T.D. 8588, 60 Fed. Reg. 23 (Jan. 3, 1995).

provisions along with the Treasury's determination to curtail them. In addition to the concern that the anti-abuse Regulations were erroneous with regard to the failure to elect under section 754, the legislative change imposing mandatory basis adjustment provisions demonstrates that Congress has grown increasingly dissatisfied with the operation of the basis adjustment provisions and sought sound tax policy results.

The Senate's version of the 2004 amendments regarded the electivity of the basis adjustments rules as "anachronistic" and rejected them almost in their entirety. It proposed mandatory basis adjustments in both "gain or loss situations," except for transfers of a partnership interest by reason of death, "which may involve unsophisticated taxpayers."[126]

Although the Senate's 2004 proposal for mandatory basis adjustments was regarded by its opponents as "misguided" and "overbroad"[127] and received only partial recognition, it highlighted the awareness of a conceptual truth of partnership taxation—namely that the aggregate basis of a partnership's assets should equal the aggregate basis of its partners' interests in the partnership. This congruence of bases ensures that each partner recognizes income or loss attributable to his partnership interest only once.

Ample scholarly arguments have been raised to support the necessity of inside and outside basis equality in the face of taxpayers' astute exploitation of the difference. Some propose the mandatory application of section 734(b).[128] Almost 30 years ago, a commentator, in a critical assessment of the 1984 American Law Institute six-year study of the taxation

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126. S. REP. NO. 108-192, at 190 (2004). The Senate also proposed the repeal of section 732(d).

127. *See* Monte A. Jackel & Robert G. Honigman, *The Proposed Abusive Tax Shelter Shutdown Act of 2001: The Mandatory Code Secs. 743 and 734 Adjustment Provisions Are Misguided, Overbroad and Just Plain Poor Tax Policy*, 4 J. PASSTHROUGH ENTITIES 5, 9 (2001) (arguing that the section 701 anti-abuse Regulations offered a satisfactory method in dealing with partnership transactions inconsistent with the intent of Subchapter K, including the shifting of loss or gain through inside-outside basis manipulation).

128. *See generally* William D. Andrews, *Colloquium on Partnership Taxation: Inside Basis Adjustments and Hot Asset Exchanges in Partnership* Distributions, 47 TAX L. REV. 3, 8 (1991). Professor Andrews stressed the "urgent need to make [§ 734(b)] mandatory [at least for in-kind distributions] because the failure to adjust is much more subject to systematic exploitation than in the cases of transfers and cash distributions." *See also* Noel B. Cunningham, "Needed Reform: Tending the Sick Rose," 47 TAX L. REV. 77 (1991). Professor Cunningham endorsed the proposal emphasizing that "many of the rules of Subchapter K are designed to preserve [the] equality" between the partnership's aggregate inside basis and the partners' aggregate outside basis.

of partners and partnerships,[129] advocated the mandatory application of both section 734(b) and section 743(b).[130] Responding to the ALI Study, the commentator proposed that (1) following "the transfer of a partnership interest by sale or death, the transferee's share of the partnership basis for its assets [should] equal the adjusted basis of his partnership interest, with resulting adjustments made in accordance with the assets' fair market values" and that (2) following distributions in complete or partial liquidation, the "partnership [should be required] to adjust its basis for assets relinquished by the distributee to reflect their 'cost' to the partnership."[131]

The major arguments supporting mandatory basis adjustments are that these rules: (1) would protect the purchaser from recognizing gains attributable to pre-entry appreciation and prevent the recognition of pre-entry losses, (2) would prevent the partnership from exploiting the electivity of basis adjustment provisions for the sole purpose of achieving favorable tax results, (3) would assure horizontal and vertical equity through the uniform treatment of all partners, regardless of their interest in the partnership, (4) would enhance the taxpayer's understanding by basing the adjustments on the assets' fair market value, which should provide "a coherent and consistent system" for determining tax consequences upon transfers, and (5) would prevent the provisions from being a trap for the unwary or a tax planning tool.[132]

X. CONCLUSION

For the past 60 years, the basis adjustment provisions have been shaped by, and representative of, the temporal context in which they were employed. Upon codification in 1954, the provisions highlighted broad Congressional goals such as economic stimulation through various forms of enterprises, many of which constituted partnerships for tax purposes. They also reflected the modest Congressional appraisal of the revenue to be generated under Subchapter K. At that time, flexible and simple rules, unburdened by stringent equity considerations, were viewed not only as desirable but necessary. Logic and accuracy were often sacrificed for the sake of simplicity. Consequently, it was not surprising that the complex rules

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129. AMERICAN LAW INST., FEDERAL INCOME TAX PROJECT, SUBCHAPTER K: PROPOSALS ON THE TAXATION OF PARTNERS 2-5 (1984).

130. *See* Postlewaite et al., *supra* note 1, at 621.

131. *Id.* at 622.

132. Some may criticize the proposal by asserting that it will be burdensome on small partnerships, non-compliance and erroneous results will ensue, and faith in the system will be undermined. However, in such settings, transfers of interests occur infrequently. Furthermore, while some additional record keeping will be required in such settings, that burden will be more than offset by the benefits noted in the text.

required to correct basis discrepancies following distributions and transfers of partnership interests were avoided. Instead, their use was left to taxpayers by the adoption of elective treatment. The conflict with the sound tax policy goals of vertical and horizontal equity as well as the inequality imposed on the fisc or taxpayers were ignored.

Confronted with the exploitation of basis discrepancies by ever-increasing partnership structures intended to generate significant revenue loss, Congress, Treasury, and the Service adopted several synthetic solutions against tax arbitrage, marking a radical shift in the war against abusive partnership transactions. Equity, accuracy, and efficiency became integral elements in the design of partnership taxation. The road for major reform remains open and widening.[133]

Basis discrepancies following distributions or transfers of partnership interests are conceptually incoherent and unjustifiable. Mandatory adjustments are not simple but necessary. Those who favor accuracy, equity, and efficiency should embrace them; those who do not have the freedom to choose a different or simpler modality of taxation for their business enterprises. There is no reason that section 734(b) and section 743(b) should not have uniform mandatory application to prevent basis manipulation in partnership transactions. It is time for Congress to act!

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133. On March 12, 2013, House Ways and Means Committee Chair, Dave Camp, released a discussion draft of his small business tax reform comprised of two Option plans. Dave Camp, *Ways and Means Discussion Draft*, COMMITTEE ON WAYS AND MEANS (March 12, 2013), http://waysandmeans.house.gov/uploadedfiles/final_sm_bus_passthrough_legislative_text_03.12.13.pdf. In Option 1, he proposed mandatory basis adjustments under sections 734(b) and 743(b) as well as the striking of sections 754 and 755. *Id.* Option 2 would repeal Subchapter K in its entirety and replace it with a new subchapter devoted to passthrough entities. *Id.*