

How and Why to Make a 754 Election

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Generally, a person receiving a partnership interest upon the death of a partner receives that interest with a basis equal to the fair market value of the interest immediately before the partner's death plus any assumed partnership liabilities. (§ 1014(a)(1).) This stepped up basis is then decreased by the amount of partnership income that is "in respect of a decedent." (§ 691(a).)

Income in respect of a decedent has been defined as any rights to income which have not been included in gross income under the method of accounting employed by the partnership. (*Woodhall v. C. I. R.* (9th Cir. 1972) 454 F.2d 226, 228.)

This stepped up basis creates a disparity between the incoming partner's inside basis and her outside basis. A partnership has the option of correcting this disparity by electing § 754. This statute evokes both § 743(b) and § 734(b). Section 743(b) adjusts the inside basis (subject to certain allocation rules) of the person receiving the partnership interest by the difference between her outside basis and her inside basis. (§ 743(b).) This would be beneficial to a partner who had an outside basis that exceeded the current inside basis immediately before the transfer. The new partner would enjoy a greater amount of depreciation and possibly recognize less gain on the sale of partnership assets. Obviously, if the situation was reversed and the incoming partner's outside basis were lower than the existing inside basis, it could be detrimental to the new partner. Additionally, the election may cause additional administrative costs as the different basis requires that the partnership to keep a separate record for the person receiving the partnership interest.

Section 734(b) works to adjust the basis of the remaining partnership property when there is: (1) a distribution causing recognition of gain or loss under § 731. This recognition is required to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution (§ 731(a)(1).); or (2) a distribution in which the tax basis of an asset is changed under § 732(a)(2) for non-liquidating distributions or § 732(b) for liquidating distributions.

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For the taxable year in which the distribution occurs, the partnership must include a written statement with its return. (26 C.F.R. § 1.754-1.) This written statement must include: (1) the name and address of the partnership; (2) the signature of any one of the partners; and (3) a declaration that the partnership is electing to use § 754 to apply to the provisions of § 743(b) and § 734(b). If the partnership has elected § 754 and has not properly revoked that election there is no reason to elect again. (§ 1.754-1.)

In order to make a valid election the return must be timely filed. (§ 1.754-1(b).) For partnerships this is on or before the fifteenth day of the fourth month following the close of the partnership's taxable year. (§ 1.6031(a)-1(e).) Courts have been stringent in this requirement. (*Gindes v. U. S.* (Ct. Cl. 1981) 661 F.2d 194, 200.) However, the taxpayer may file for an automatic 12-month extension in order to make the election. (§301.9100-2.)

Once a § 754 election is made it may not be revoked unless you obtain permission from the district director for the internal revenue district in which the partnership return is

required to be filed. (§ 1-754-1(c).) Sufficient reasons for revocation include: a change in the nature of the business of the partnership; a substantial increase in the assets of the partnership; a change in the character of partnership assets; or an increased frequency of retirements or shifts of partnership interests that would cause an increased administrative burden to the partnership. (*ibid.*)

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