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## Section 754 Elections: How and When to Make Them

-by Neil E. Harl\*

One of the uniquenesses of the partnership form of business organization is the opportunity to make an election for a new partner (as to the purchase price if above the income tax basis), or the successor to a deceased partner (as to the excess of the new income tax basis at death over the pro rata share of the basis of partnership property) and to distributions of property by the partnership, to adjust the basis of partnership property to apply to property distributions by the partnership and to transfers of interests in the partnership.<sup>1</sup> A corporation, by contrast, provides no opportunity to adjust the “internal” basis of assets as the external basis changes as a result of sale or exchange<sup>2</sup> or death.<sup>3</sup> That continues to pose a significant disadvantage for farm and ranch corporations.

The various pass-through entities, including limited liability companies (LLCs) and limited liability partnerships (LLPs), although they possess some characteristics of corporations, are treated as partnerships for income tax purposes which permits the entities to make Section 754 elections.<sup>4</sup>

### Who can make the elections?

The statute<sup>5</sup> refers to a “transfer” of a partnership interest under I.R.C. § 743 or a “distribution” of property as specified in I.R.C. § 734.<sup>6</sup> Section 743 refers to a “sale or exchange” or upon “death of a partner,” all of which support a basis adjustment, and also a basis adjustment is authorized in the presence of a “substantial built-in loss” after the transfer.<sup>7</sup> Section 734 refers to adjustment of basis only if there is a distribution of property or a substantial basis reduction (more than \$250,000).<sup>8</sup>

What about other situations where a basis adjustment could be helpful? For example, would a “deemed sale” be sufficient for eligibility for a section 754 election? This is not completely clear but several courts have wrestled with the issue over the past several decades.<sup>9</sup> For example, in what has been viewed as a leading case on the issue of indebtedness in excess of basis in a gift situation,<sup>10</sup> the Tax Court in *Johnson v. Commissioner*,<sup>11</sup> referred to such a situation as involving a “sale” and “part gift/part sale” but the situation fell well short of being a “sale” in the usual meaning of the term and the Court of Appeals referred to that passage as “suggestive but artificial language” and stated that the language used should not obscure the essence of the transaction.<sup>12</sup> There is

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nothing, moreover, that ties that authority to Section 754 elections. The statutory language in Section 743 is fairly clear in referring to the “. . . transfer of an interest in a partnership by sale or exchange. . . .”<sup>13</sup> Thus, it does not appear that a triggering of gain from debt in excess of basis<sup>14</sup> provides authority to use that as an occasion to invoke basis adjustment in a partnership. As the Seventh Circuit Court of Appeals stated in a 1980 decision,<sup>15</sup> the “. . . proper inquiry is whether a given transaction is properly characterized as a gift or a taxable disposition.” It is doubtful that the use of the term “sale” by the Tax Court has broadened the meaning of adjustments to basis triggered by debt in excess of basis as a “deemed” sale.

### Results of the election

If the election is made, it applies to give the partner involved a “special basis” for each property for purposes of figuring gain or loss on sale and for purposes of depreciation or both.<sup>16</sup> A partnership with a Section 754 election in effect -- (1) increases the adjusted basis of partnership property by the excess of the transferor’s basis for the transferred partnership interest over the transferee’s share of the adjusted basis to the partnership of the partnership’s property, or (2) decreases the adjusted basis of partnership property by the excess of the transferee’s share of the adjusted basis to the partnership of the partnership’s property over the transferee’s basis for the transferred partnership interest.<sup>17</sup>

The allocations of basis adjustments among partnership assets are made on the basis of the amounts of income, gain or loss that the transferee would be allocated if, immediately after the transfer, all of the partnership assets were disposed of in a fully taxable, hypothetical sale for fair market value.<sup>18</sup>

If a later installment sale of assets is implemented, and a loss results to the electing partner because of the basis increase, the partnership can report a gain and the electing partner can report a loss.<sup>19</sup>

The opportunity to make the election for a partnership in which one of the partners has died expires when the next tax return of the partnership is filed.<sup>20</sup> However, extensions may be granted for good cause for partnerships, LLCs and other entities that are characterized as partnerships for federal income tax purposes.<sup>21</sup> Extension requests may be denied if the request was not made promptly.<sup>22</sup>

### ENDNOTES

<sup>1</sup> I.R.C. § 754. See 8 Harl, *Agricultural Law* § 60.04[4][b][i] (2013); Harl, *Agricultural Law Manual* § 7.03[2][b][iii] (2013); 2 Harl, *Farm Income Tax Manual* § 6.07[3], [4] (2013 ed.).

<sup>2</sup> I.R.C. § 1001(a).

<sup>3</sup> I.R.C. § 1014(a).

<sup>4</sup> See, e.g., Ltr. Rul. 201135021, May 17, 2011 (LLC granted extension to make § 754 election); Ltr. Rul. 200626003, February 28, 2006 (LLC denied request for extension to make Sec 754 election).

<sup>5</sup> I.R.C. § 754.

<sup>6</sup> I.R.C. § 754.

<sup>7</sup> I.R.C. § 743(a).

<sup>8</sup> I.R.C. § 734(d)(1).

<sup>9</sup> See, e.g., *Johnson v. Comm’r*, 59 T.C. 791 (1973), *aff’d*, 495 F.2d 1079 (6th Cir. 1974), *cert. denied*, 419 U.S. 1040 (1974) (indebtedness in excess of basis).

<sup>10</sup> See Treas. Reg. § 1.1001-2(a), (b), Ex. 6.

<sup>11</sup> 59 T.C. 791 (1973).

<sup>12</sup> 495 F.2d 1079 (6th Cir. 1974), *cert. denied*, 419 U.S. 1040 (1974). See also *Levine v. Comm’r*, 72 T.C. 780 (1979), *aff’d*, 634 F.2d 12 (2d Cir. 1980); *Evangelista v. Comm’r*, 71 T.C. 1057 (1979), *aff’d*, 629 F.2d 1218 (7th Cir. 1980).

<sup>13</sup> I.R.C. § 743(a).

<sup>14</sup> See Treas. Reg. § 1.1001-2(a).

<sup>15</sup> *Evangelista v. Comm’r*, 629 F.2d 1218 (7th Cir. 1980).

<sup>16</sup> See Treas. Reg. § 1.743-1(a).

<sup>17</sup> Treas. Reg. § 1.743-1(b).

<sup>18</sup> I.R.C. § 743(b).

<sup>19</sup> Rev. Rul. 79-72, 1979-1 C.B. 278.

<sup>20</sup> Treas. Reg. § 1.754-1(b).

<sup>21</sup> E.g., Ltr. Rul. 201251004, Sept. 14, 2012 (extension granted).

<sup>22</sup> E.g., Ltr. Rul. 201102025, Sept. 8, 2010 (election denied; requirements not satisfied).

## CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

### FEDERAL ESTATE AND GIFT TAXATION

**ALLOCATION OF BASIS FOR DEATHS IN 2010.** The decedent died in 2010 and the trustee for the decedent’s estate

retained tax professionals for advice on estate tax matters including the necessity to file a Form 8939, *Allocation of Increase in Basis for Property Acquired from a Decedent*. The trustee of the decedent’s estate requested an extension of time pursuant to Treas. Reg. § 301.9100-3 to file the Form 8939 to make the I.R.C. § 1022 election and to allocate basis provided by section 1022 to eligible property transferred as a result of the decedent’s death. The IRS granted the extension. **Ltr. Rul. 201306011, Sept. 24, 2012.**