TCJA – Modification to Substantial Built-in Loss Rules under IRC § 743(d)

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Objectives

- Understand the purpose of a IRC § 754 election.
- Determine what the substantial built in loss rules were intended to prevent.
- Review the changes to the substantial built in loss rules in the Tax Cuts and Jobs Act of 2017.

Purpose of Substantial Built-in Loss Rules

- The purpose of the substantial built-in loss (SBIL) rules of IRC § 743(d) is to prevent the double benefit of built-in losses that may result from the transfer of a partnership interest.
- The transferor partner has already recognized the built-in loss relating to partnership property upon sale or exchange of his interest.
- Partnership property basis needs to be adjusted with respect to transferee partner.
  - This eliminates the double counting of built-in loss partnership property.

Prior SBIL Loss Rules (thru 12/31/2017)

- General rule:
  - Partnership does not adjust the basis of partnership property following the transfer of a partnership interest.
- Exceptions IRC § 743(a):
  - The partnership has made a one-time election under IRC § 754 to make basis adjustments, or
  - The partnership has a SBIL immediately after the transfer.

Prior SBIL Loss Rules (thru 12/31/2017) (cont'd)

- Partnership adjustments are made with respect to the transferee.
- IRC § 743 adjustments approximate the difference between the inside basis of partnership property and transferee outside basis in his interest.
- The adjustments approximate the result of a direct purchase of partnership property by the transferee.

Prior Law SBIL Computation

- Used an aggregate approach to determine whether the partnership had a SBIL.
- The total FMV of partnership assets was compared to the total adjusted tax basis of partnership assets.
- A SBIL existed if the partnership’s adjusted basis in its property exceeded the FMV of the partnership's property by more than $250,000. IRC § 743(d).

Example 1 - Prior Law Computation

Example 1

- On 1/1/2017 Partnership ABC has assets with a FMV of $3 M / adjusted basis of $3.3 M.
- Partners A, B and C are equal partners and share all items of income and loss equally.
- Partner C sells his interest to D on 1/1/2017.
- ABC has a SBIL in the amount of $300,000 ($3.3 M adjusted basis – $3 M FMV of property).
- ABC must adjust the basis of its depreciated property downward by $100,000 for incoming Partner D.

Polling question 1

Have you audited a Sec. 743(b) adjustment?

- ❑ Yes
- ❑ No

TCJA Modifications to SBIL Rules

- **<u>In addition to the present-law definition</u>**, a SBIL also exists if the transferee would be allocated a net loss more than $250,000.

- Under the TCJA the partnership has a SBIL when
  - the partnership's adjusted basis in the partnership property exceeds by more than $250,000 the fair market value of such property, **<u>or</u>**
  - the transferee would be allocated a loss of more than $250,000 if the partnership assets were sold for cash equal to their fair market value immediately after such transfer.

Example 2 – Prior Law

Asset with Built in Loss in Excess of $250,000

No Substantial Built in Loss

- On January 1, 2015, individuals W, X, and Y formed WXY partnership.
- W contributed a non-depreciable asset G with a FMV of $3 million and a tax basis of $1 million.
- In addition, W, X, and Y each contributed equal 1/3 interests in asset L, whose tax basis and FMV equaled $3.6 million.
- The partnership broke even every year through December 31, 2016.

Example 2 – Prior Law (continued)

Initial Balance Sheet

Assets	FMV	Tax Basis
G	3,000,000	1,000,000
L	3,600,000	3,600,000
TOTAL	6,600,000	4,600,000

Liabilities	None	FMV	Tax
Capital	**W**	4,200,000	2,200,000
Capital	**X**	1,200,000	1,200,000
Capital	**Y**	1,200,000	1,200,000
TOTAL		6,600,000	4,600,000

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Example 2 – Prior Law (continued)

- The partnership agreement provides that any gain or loss on the sale or exchange of Asset G is to be specially allocated to partner W.

- W, X and Y share equally in all other partnership items, including any gain or loss on the sale or exchange of Asset L. The partnership did not make a section IRC § 754 election.

- The partnership's balance sheet at 12/31/2016 was as follows (expanded to show value of assets):

Example 2 – Prior Law (continued)

12/31/2016

Assets	FMV	Tax Basis	Liabilities	None	FMV	Tax
G	3,000,000	1,000,000	**Capital**	**W**	3,600,000	2,200,000
L	1,800,000	3,600,000	**Capital**	**X**	600,000	1,200,000
TOTAL	4,800,000	4,600,000	**Capital**	**Y**	600,000	1,200,000
			TOTAL		4,800,000	4,600,000

Note: that asset L declined in value by $1.8 million.

Example 2 – Prior Law (continued)

On January 1, 2017, Partner Y sold his partnership interest to Z for $600,000 and recognized a loss of $600,000 ($600,000 FMV less adjusted tax basis of interest of $1,200,000). Under prior law, because the partnership did not, **in the aggregate**, have a SBIL in its assets, it was not required to make an IRC § 743(b) adjustment with respect to Asset L. If the partnership were to sell Asset L, W, X, and Z would each recognize a loss of $600,000, even though Partner Y recognized his share of the loss in asset L when he sold his partnership interest to Z.

Polling question 2

The prior law used an aggregate approach to determine whether the partnership had a SBIL.

- ❑ True
- ❑ False

Example 3 – SBIL after TCJA

- The facts are the same as in Example 2, except that Y sold his interest to Z on or after January 1, 2018. While the partnership does not, in the aggregate, have a SBIL in its assets, if the partnership were to sell Asset L, immediately after the sale, transferee Z, would be allocated a loss of $600,000 (1/3 of the $1,800,000 loss).

- Accordingly, a substantial built-in loss exists and Asset L's basis must be reduced with respect to transferee Z by $600,000. IRC § 743(d).

Example 3 – SBIL after TCJA (cont'd)

- Without the IRC § 743(b) adjustment, transferee partner Z's share of inside basis in asset L would be $1,200,000 and Z's outside basis would be $600,000 (or the amount paid to Y for Y's interest). If the asset were sold, Z could recognize the same loss Y recognized when he sold his interest.

- The TCJA change to IRC § 743(d) adjustment will reduce Z's share of the partnership's basis in L by $600,000 and prevent the double counting of the loss.

Polling question 3

<u>In addition to the present-law definition</u>, a SBIL also exists if the transferee would be allocated a net loss more than $250,000.

- ❑ True
- ❑ False

Summary

- The purpose of the substantial built-in loss (SBIL) rules of IRC § 743(d) is to prevent the double benefit of built-in losses that may result from the transfer of a partnership interest.
- Under prior law, a SBIL existed if the partnership's adjusted basis in its property exceeded the FMV of partnership property by more than $250,000. IRC § 743(d).
- In addition to the prior law definition, the new law provides that a SBIL also exists if the transferee would be allocated a net loss more than $250,000.