

STATEMENT OF AUDIT PROCEDURE

Basis Adjustments under Sections 734 and 743 of the Internal Revenue Code

Introduction

The Unincorporated Business Tax (the “UBT”) is a business level tax that applies to the net income of unincorporated businesses wholly or partly carried on within New York City (the “City”). Ad. Code § 11-503. Limited partnerships, partnerships, limited liability companies, sole proprietorships, and other unincorporated businesses are subject to the UBT. The UBT is a business tax that is separate from the City’s Personal Income Tax.

For purposes of this memo, the term “partnership” refers to any entity that constitutes a partnership for federal income tax purposes. New York City follows federal “check the box” entity classification rules to determine whether an entity is a partnership. See, Ad. Code §§ 11-126, 11-602.1, 11-652(1) and (13), and Finance Memorandum 99-1, *Federal Check-the-Box Rules New York City Tax Implications* (October 21, 1999).

This memo explains when adjustments to the basis of partnership assets pursuant to sections 734 and 743 of the Internal Revenue Code of 1986, as amended (the “IRC”), will affect the calculation of unincorporated business taxable income in New York City. It concludes that distributions of partnership assets and transfers of partnership interests have different potential effects on unincorporated business taxable income because they trigger different federal income tax consequences under sections 734 and 743 of the IRC, respectively.

Summary of Law and Analysis

The taxable income of an unincorporated business is the excess of its “unincorporated business gross income” over its “unincorporated business deductions”, minus certain deductions not subject to allocation and statutory exemptions. Ad. Code § 11-505. Federal gross income and deductions are the starting points for unincorporated business gross income and unincorporated business deductions. Ad. Code §§ 11-506, 11-507.

For federal income tax purposes, gross income is defined as “all income from whatever source derived,” including gains from dealings in property. IRC § 61. The U.S. Treasury Regulations define gain as “the

excess of the amount realized over the ... basis for the property sold or exchanged.” Treas. Reg. § 1.61-6(a). Basis in property is, in turn, generally equivalent to the cost of acquiring the property, subject to adjustments for depreciation and amortization and certain other events provided for within Subchapter K and elsewhere in the IRC. IRC §§ 723, 734, 742, 743, 1011, 1012, 1016.

The UBT does not include any specific statutory modification to the federal calculation of basis for purposes of determining unincorporated business gross income. Hence, a change in basis at the federal level will generally result in a corresponding change in basis at the City level and will flow through to unincorporated business gross income. Partnerships generally compute their gains in the same manner as individuals. IRC § 703. A partnership’s gain from the sale or exchange of property is the excess of its amount realized over its basis in the property. When a partner contributes property to partnership capital, the partner’s basis generally carries over to the partnership. IRC § 723.

Basis is relevant to unincorporated business deductions, not just unincorporated business gross income, because it determines the total amount of depreciation and amortization deductions taxpayers may claim. While the City Unincorporated Business Tax statute provides alternative methods for the calculation of depreciation or amortization for select periods of time and certain assets, the federal income tax rules for determining cost recovery deductions and the basis of partnership assets generally control. Ad. Code §§ 11-507, 11-509. Because depreciation and amortization deductions are derived from, and reflected in, the basis of partnership assets, adjustments to the basis of a partnership’s assets affect the size of the corresponding amortization and depreciation deductions for both federal and UBT purposes. IRC §§ 167, 168, 197.

Rules for allocating income and deductions among partners are provided under Section 704(c) of the IRC and the corresponding Treasury Regulations. Partners must report their distributive shares of partnership income, gain, loss, deduction, and credit, as well as certain other items that the partner must separately report. IRC §§ 701, 702, 703, 704. The UBT statute does not include modifications to these rules that are relevant to the effect of basis adjustments under Sections 734 and 743 of the IRC.

If a UBT taxpayer incorrectly reports its federal gross income or deductions, and thus incorrectly reports its unincorporated business gross income or deductions, the Department of Finance will correct the unincorporated business gross income or deductions for the error. Ad. Code §11-537.

IRC §734(b) Basis Adjustments

Section 734 of the IRC provides the conditions for an adjustment to the basis of undistributed partnership property after a partnership distributes property to a partner. Generally, a partnership may not adjust the basis of its assets following a distribution of property to a partner, but this general rule does not apply if the partnership has an election in effect under Section 754 of the Internal Revenue Code, or the transaction would result in a substantial basis reduction under Section 734(d). In such instances, the partnership adjusts its common basis in its undistributed property, and does not make adjustments that apply separately to any particular partner. Treas. Reg. § 1.734-1. Section 734 basis adjustments affect the partnership’s subsequent calculations of income, gain, loss and deduction, which then flow through to its City unincorporated business taxable income. The UBT thus incorporates Section 734 basis adjustments into the computation of unincorporated business taxable income.

IRC § 743(b) Basis Adjustments

Section 743 of the IRC provides conditions for an adjustment to the basis of partnership property following the transfer of an interest in a partnership. Generally, a partnership may not adjust the basis of its assets when a partner transfers its interest in the partnership, but this general rule does not apply if the partnership has an election in effect under Section 754 of IRC, or the partnership has a substantial built-in loss immediately after the transfer. In such instances, the partnership makes an adjustment to basis with respect to the transferee partner only, and does not adjust the common basis of its property. Treas. Reg. § 1.743-1(j). A separate distributive share calculation must be made to reflect the effects of the Section 743(b) adjustment that applies to the transferee's distributive share of income, gain, loss and deduction. Section 743 basis adjustments do not affect the partnership's subsequent calculations of income, gain, loss, or deduction. Treas. Reg. § 1.743-1(j)(3). Under this framework, the partnership's unincorporated business taxable income does not change in connection with a Section 743(b) adjustment because that adjustment only affects the transferee's income, gain, loss and deduction and thus does not flow through to the partnership's unincorporated business taxable income. See, *Dolly Co. v. Tully*, 65 A.D.2d 99 (N.Y. App. Div. 3d Dep't 1978), app. denied, 46 N.Y.2d 710 (N.Y. 1979).

Other Issues

In analyzing transfers of partnership interests and assets, DOF will follow sections 707(a)(2)(B) and 755 of the IRC, the Treasury Regulations promulgated thereunder, and applicable legislative history and case law. DOF will also follow Revenue Ruling 99-5 (1999-1 C.B. 434) and Revenue Ruling 99-6 (1999-1 C.B. 432) to determine the consequences of transfers of partnership interests that result in the formation and dissolution of partnerships for tax purposes.

Examples

Example 1: Sale of interest

Prior to sale of interest

A, B, C, D and E each invested \$24,000, for a total of \$120,000, to form a new partnership ABCDE that does business in the City; the partners share equal interests in profits, losses, distributions and capital. ABCDE purchased non-depreciable property for \$30,000 that is now worth \$45,000, and has engaged in no additional transactions. ABCDE did not incur any debt. ABCDE elected under section 754 of the IRC, to make optional adjustments to the basis of partnership property.

Sale of interest

A sells its interest in the partnership to T for \$27,000. Under sections 742 and 1011 of the IRC, T's basis in its partnership interest is \$27,000, which is equal to the amount it paid for the partnership interest.

Federal Tax Consequences

Due to its section 754 election, ABCDE will make a unique increase to the basis of its property that only applies to T and reflects T's purchase price. See, IRC § 743(b). The amount of the adjustment is equal to the excess of T's basis in its partnership interest over T's proportionate share of the partnership's basis in its property; in this case, the difference is \$3,000.

ABCDE's common basis in its property continues to be \$30,000 because the common basis of partnership property does not incur an adjustment under section 743(b) in connection with a section 754 election and sale of a partnership interest. ABCDE must determine its income, gain, loss and deduction without any basis adjustment, and then prepare a separate calculation for the adjustment specific to T.

UBT Consequences for ABCDE

The section 743(b) basis adjustment that occurs with respect to T's partnership interest does not factor into ABCDE's computation of its unincorporated business gross income or deductions, which are limited to the amounts allowable for federal income tax purposes. Only T's distributive share of income, deduction, gain, or loss reflects any additional depreciation or amortization deductions, or modified calculations of gain, arising from the property that obtained as section 743(b) basis adjustment. ABCDE's unincorporated business gross income and unincorporated business deductions, and therefore unincorporated business taxable income, do not reflect those section 743(b) adjustments.

Example 2: Liquidating distribution

Prior to liquidating distribution

Assume the same facts as Example 1, prior to the sale of A's partnership interest.

Liquidating distribution

A receives \$27,000 in cash in liquidation of her entire interest in the partnership. She has a gain of \$3,000 under section 731(a)(1) of the IRC.

Federal Tax Consequences

Due to its section 754 election, the partnership increases its basis in the property by \$3,000, to account for the gain A recognized, and its new basis is \$33,000 (\$30,000 plus \$3,000). See, Treas. Reg. § 1.734-1 (b)(1) Example 1.

B, C, D and E each have an equal interest in the partnership subsequent to the distribution of cash in liquidation of A's interest in the partnership. Because an adjustment pursuant to section 734(b) affects the common basis of partnership property, the partnership's calculation of income, gain, loss and deduction reflect the adjustment.

UBT Consequences for ABCDE

The section 734(b) basis adjustment to the common basis of ABCDE property factors into ABCDE's computation of its unincorporated business gross income and unincorporated business deductions. Since ABCDE uses its adjusted basis to calculate its partnership items of income, loss, gain, deduction and credit, for federal income tax purposes, these items flow through to its UBT computations unless a specific statutory modification applies. Therefore, ABCDE's unincorporated business taxable income will reflect any additional depreciation or amortization deductions, or modified calculations of gain, arising from the property that obtained the basis adjustment.

Example 3: partial sale of interest in a disregarded entity (single member LLC)

Prior to sale of interest

A, an individual, is the sole member of L, a limited liability company, which is a disregarded entity for federal, state and City tax purposes. L does business in the City. For tax purposes, A has a \$20,000 basis in L's assets, which have an aggregate \$100,000 fair market value.

Sale of interest

B, who is not related to A, purchases 50% of A's ownership interest in L for \$50,000. A does not contribute any portion of the \$50,000 to L; A and B thereafter operate the business as co-owners.

Federal Tax Consequences

When B purchases a membership interest from A, L becomes a partnership for federal income tax purposes because it has more than one owner and does not elect to be taxed as a corporation. L determines its basis in its assets as if B purchased a 50% interest in each of L's assets from A, and, immediately thereafter, A and B contributed their respective interests in those assets to L in exchange for membership interests.

A's basis in its remaining share of the assets is \$10,000 and B's basis in its newly acquired share of the assets is \$50,000. See, IRC § 722 and Rev. Rul. 99-5. Therefore, upon its conversion to a partnership, L obtains a transferred basis in the assets of \$60,000. See, IRC § 723.

UBT Consequences for L

L becomes a separate unincorporated entity subject to the UBT and must commence filing UBT tax returns. A was subject to the UBT as a sole proprietor and individually filed UBT returns that reported the income and activities conducted by L. L's transferred basis in the assets factors into its computation of its unincorporated business gross income and unincorporated business deductions. Since L uses its transferred basis to calculate its partnership items of income, loss, gain, deduction and credit, for federal income tax purposes, these items flow through to its UBT computations unless a specific statutory modification applies. Therefore, L's unincorporated business taxable income will reflect the additional depreciation or amortization deductions, or modified calculations of gain, arising from the additional basis attributable to B's newly acquired share of the assets.

Example 4: Contribution to a disregarded entity (single member LLC)

Prior to contribution

Assume the same facts as Example 3, prior to A selling its membership interest.

Contribution of assets (cash)

B contributes \$50,000 to L in exchange for a 50% ownership interest. L uses all of the contributed cash in its business; A and B continue to operate the business of L as co-owners.

Federal Tax Consequences

When B contributes cash to L in exchange for a membership interest, L becomes a partnership for income tax purposes because it has more than one owner and does not elect to be taxed as a corporation. L determines its basis in its assets as if B contributed cash and A contributed assets in exchange for partnership interests in a newly formed partnership.

A's basis in the partnership interest is \$20,000 (A's basis in the contributed assets), while B's basis in the partnership interest is \$50,000 (the amount of cash contributed to the partnership). See, IRC § 722 and Rev. Rul. 99-5. L obtains a \$20,000 transferred basis in the assets. See, IRC § 723.

UBT Consequences for L

L becomes a separate unincorporated entity subject to the UBT and must commence filing UBT tax returns. A was subject to the UBT as a sole proprietor and individually filed UBT returns that reported the income and activities conducted by L. L's transferred basis in the assets factors into its computation of its unincorporated business gross income and unincorporated business deductions. Since L uses its transferred basis to calculate its partnership items of income, loss, gain, deduction and credit, for federal income tax purposes, these items flow through to its UBT computations unless a specific statutory modification applies. Therefore, L's unincorporated business taxable income will reflect A's pre-existing basis in the assets, while B's contribution of cash does not result in any additional depreciation or amortization deductions, or modified calculations of gain with respect to the contributed assets.

Example 5: Sale of interest resulting in a disregarded entity (single member LLC)

Prior to sale of interest

A and B are equal partners in AB, an LLC that is classified as a partnership for federal tax purposes and does business in the City. B's basis in its membership interest is \$5,000. The assets of AB do not include any cash.

Sale of interest

A and B sell their interests in AB to C for \$20,000. After the sale, AB continues its business as a disregarded entity for tax purposes, but C is the sole member.

Federal Tax Consequences

The transaction is a sale of partnership interests for A and B, and a purchase of partnership assets for C. C determines its basis in AB's assets as if AB made a liquidating distribution of all its assets to A and B, and C then purchased the assets for \$20,000, thus obtaining a purchase price basis in the assets. See, IRC § 1012, Rev. Rul. 99-6.

UBT Consequences for AB

AB liquidates and ceases to exist for tax purposes, and must file a final UBT tax return. The sale of membership interests from A and B to C does not cause AB to recognize gain or loss.