

Now You See It - Now You Don't. Like Magic, the City of Portland Disallows Depreciation Deductions Otherwise Allowable as a Result of Code Section 754

07.11.19 01.07.26

Earlier this week, a local tax practitioner asked us whether it was true that the City of Portland no longer allows depreciation deductions resulting from an election under Section 754 of the Internal Revenue Code of 1986, as amended (the "Code"), for purposes of computing tax under the City of Portland Business License Tax ("BLT") and the Multnomah County Business Income Tax ("BIT"). The answer we gave was "yes." Of course, the response we received from the practitioner was "why." That question is more difficult to answer than the original question. Nevertheless, we present this blog post to remind tax practitioners of the City's position on this issue and to discuss the implications of the City's new position.

Background on Code Section 754

When a partner in a partnership sells his or her partnership interest to a new partner, this can create a mismatch between the partnership's basis in its assets (inside basis) and the new partner's outside basis in his or her partnership interest. To give the new partner a share of the inside basis equal to his or her outside basis, the partnership can make an election under Code Section 754 (a "754 Election") to adjust the basis of its assets under Code Section 743(b) upon the sale of the interest based on the new partner's cost basis. The adjustment affects only the new partner's share of inside basis. The purpose of the 754 Election is to place the new partner in the same position as he or she would have been in had he or she directly purchased a share of the partnership's assets.

Consider the following example:

Example 1.

(i) **Facts.** Partners A, B, and C (all individuals) form Partnership Z as equal partners, with each

partner contributing \$200,000 in cash. Partnership Z purchases a building for \$600,000. Five years later, Partnership Z has depreciated the building by \$60,000 and Partnership Z's inside basis is \$540,000. All net income of Z has been distributed to the partners. Each of the three partners now has an outside basis of \$180,000. The fair market value of the building is \$1,500,000. A sells her entire one-third interest in Partnership Z to D (an individual) for \$500,000. D's outside basis is \$500,000. Partnership Z subsequently sells the building for \$1,500,000 in the same year that D acquires his partnership interest.

(ii) **No 754 Election.** If no 754 Election is made when D purchases A's one-third interest in Partnership Z, Partnership Z's inside basis is unaffected, and D's one-third share of the inside basis is \$180,000. On the sale of the building, each partner (including D) recognizes one third of the \$960,000 gain, or \$320,000 each. D's share of inside basis increases to \$500,000 and his outside basis increases by his share of the gain, to \$820,000. If D subsequently sells or liquidates his interest in the partnership for \$500,000, D recognizes a \$320,000 loss.

(iii) **754 Election.** If Partnership Z makes a 754 Election when D purchases A's one-third interest in Partnership Z, Partnership Z's inside basis is increased by \$320,000 to \$860,000, with \$180,000 allocable to each of B and C, and \$500,000 allocable to D. When the building is sold, D recognizes no gain or loss. This is the same result as if D had directly purchased a one-third interest in the building from Partnership Z.

(iv) **Death of Partner.** If in Examples 1(ii) and 1(iii) above, D acquires his interest by bequest from A upon A's death rather than by purchase, the same results would occur. D's outside basis would be stepped up to fair market value on A's death, but D's share of Partnership Z's inside basis would not be stepped up absent a 754 Election.

Depreciation

As discussed above, a 754 Election is meant to put a new partner in a partnership with appreciated property in the same position as he or she would be if the partner invested in the property itself. One impact of a 754 Election is that, for purposes of depreciation, the new partner has a special basis in the partnership property that is adjusted by the election. Thus, in Example 1(iii) above, D would be entitled to depreciation deductions on the full \$500,000 of inside basis allocable to him (as compared with depreciation deductions on only the \$180,000 of inside basis in the absence of a 754 Election, as illustrated in Example 1(ii)).

City of Portland Disallowance of Depreciation Deductions

On October 11, 2017, the Director of the Revenue Division of the City of Portland adopted a Business Tax Policy with respect to partnership basis adjustments (the "BTP"). The result of

the BTP, in a nutshell, is that the additional depreciation deductions attributable to a partner's stepped-up inside basis resulting from a 754 Election are disallowed for purposes of the BLT and BIT.

The BTP outlines 754 Elections generally and provides an example with facts upon which Example 1 discussed above is based. The BTP provides that, while a 754 Election is a partnership transaction in form, it is a partner-level transaction in substance. As such, the BTP provides that the deduction for the step up in basis for partnership assets related to a 754 Election is not allowed for BLT and BIT purposes.

Local tax practitioners expressed concern to the City about its new position. Additionally, the tax community informed the City that its disallowance of depreciation deductions related to 754 Elections also means that the City is effectively disallowing the stepped-up tax basis for purposes of computing gain upon disposition of the underlying assets of a partnership. The Revenue Division representatives respectfully listened to these concerns. They offered, however, virtually no relief.

In May 2018, the City adopted Business Tax Administrative Rule 600.18-1 (the "Rule"). The Rule incorporates the guidance set forth in the BTP. Additionally, the City added a second example, which is set forth immediately below.

Example 2.

Corporation A and B each own 50% of Partnership Z. Corporation C buys Corporation A's entire interest in the partnership. Corporation C does business in the City of Portland in addition to owning half of Partnership Z. Corporation C ultimately sells its interest in Partnership Z three years later. Corporation C can include its stepped-up basis in determining the reportable gain from the sale of the interest in Partnership Z when determining its taxable income for purposes of the BLT and BIT because Partnership Z did not get to claim any of the additional depreciation from Corporation C's stepped-up outside basis.

In the Rule, the City notes that Code Section 743 adjustments are reported on Schedule K-1 to IRS Form 1065. It also expressly provides that any entity taxed as a partnership is subject to the Rule.

Conclusion

The Rule increases the net income of partnerships (and LLCs taxed as partnerships) for purposes of the BLT and BIT by the amount of depreciation deductions otherwise allowable pursuant to a 754 Election. Thus, depreciation deductions allowable against income for

federal and state income tax purposes are disallowed for local tax purposes.

Example 2 in the Rule illustrates the effect of the disallowance of depreciation deductions attributable to a 754 Election in the case of corporate partners. Such partners will not lose the ultimate benefit of a 754 Election for BIT and BLT purposes because no depreciation deductions attributable to a 754 Election will reduce their outside basis. Thus, when they sell their partnership interests, their outside basis (increased by the amount of depreciation deductions disallowed under the Rule) is available to offset gain.

However, the Rule subjects new partners in partnerships with appreciated property to higher tax than similarly situated partners in partnerships without appreciated property (as discussed above, something the 754 Election is meant to address). Consider partner D in Example 1(ii) above. Only depreciation deductions with respect to D's remaining \$180,000 share of inside basis will reduce D's share of income for purposes of the BIT and BLT. By comparison, if partner D was a partner in a partnership with a building worth \$1,500,000 and with respect to which the partnership had an inside basis of \$1,500,000, depreciation deductions with respect to D's \$500,000 share of basis would reduce D's share of income for purposes of the BIT and BLT.

It is also important to note that, in most cases, partners who are individuals with no trade or business income will generally never realize the benefit of a 754 Election for BIT and BLT purposes, because the sale of his or her partnership interest (under current law) will likely not be subject to BIT and BLT.

Query: What happens if a partnership made a 754 Election prior to the City's issuance of the BTP and the Rule? If the partnership had reported and paid BIT and BLT on net income after depreciation deductions attributable to a 754 Election, presumably the partnership would need to amend any open returns, increase its net income by such amount, and pay BIT and BLT (and possibly interest) on the recomputed amount. Going forward, of course, the partnership would have to compute net income for purposes of the BIT and BLT without any depreciation deductions attributable to a 754 Election.

While it may not seem fair or reasonable, the Rule contains the City's current position on the impact of 754 Elections on the BIT and BLT. It will be interesting to see if the City withdraws the BTP and the Rule, or if any taxpayer challenges them as going above and beyond the specific language and purview of the BIT and BLT Ordinances.

Posted in [State and Local Tax](#), [Tax Laws](#)

Tagged as [754 Election](#), [Business Tax Administrative Rule 600.18-1](#), [City of Portland](#), [City of Portland Business License Tax \("BLT"\)](#), [Code Section 754](#), [Depreciation](#), [fair market value](#), [inside basis](#), [Internal Revenue Code](#), [Multnomah County Business Income Tax \("BIT"\)](#), [outside basis](#), [partnership assets](#), [Portland](#)

Authored by

Larry J. Brant

Principal|Portland

503.553.3114 larry.brant@foster.com

Peter A. Evalds

Staff Attorney|Portland

503.553.3104 peter.evalds@foster.com

Steven D. Nofziger

Principal|Portland

503.553.3126 steven.nofziger@foster.com