INSIDE OUT – REVALUATION OF PARTNERSHIP CAPITAL ACCOUNTS

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Foremost, a capital interest is a share of the value of partnership assets. Each partner has a separate capital account that generally tracks that partner's investment in the partnership. The value of the capital account represents the partners' distributive share of partnership equity (partnership assets minus partnership liabilities—the capital account does not include a partner's share of partnership liabilities). The interest in the partnership assets is distributable to the holder when either the partner withdraws from the partnership or the partnership liquidates.

Additionally, any partnership interest other than a capital interest is deemed a profits interest. A profits interest is merely a right to share in future earnings and profits. Unlike a capital interest, there is no current interest in partnership assets. The designation of an interest as a profits interest or a capital interest generally is made at the time of receipt of the partnership interest. Notwithstanding the lack of a capital contribution, partnerships are able to revalue capital accounts upon granting a profits interest to a service provider. Recent Treasury Regulations permit adjustments to capital accounts irrespective of whether a new or existing partner contributes services or money & property to the partnership in exchange for a partnership interest.

Rather than the fair market value, capital accounts are initially maintained at a historical cost of the partnership's assets. Consequently, any subsequent appreciation or depreciation of contributed assets is not reflected in the capital accounts. The distorted value of capital accounts is of significance because a fair representation of the actual economic deal among the partnership might be absent. Any disparity between historical costs and fair market values also propagates adverse tax consequences. In particular, such a scenario arises when an individual purchases a partnership interest based on the fair market value of the partnership assets. Nevertheless, the presence of such a hypothetical (and other specified events), allows the partners to increase or decrease their capital accounts.

Upon the purchase of a partnership interest for its fair market value, the amount paid becomes the basis for the purchaser's partnership interest (outside basis). The partner's outside basis is determined without considering any amount reflected in the partnership books as capital account. Still yet, the new partner is allocated the seller's pro rata share of the adjusted basis in property held by the partnership (inside basis). The inside basis is used by the partnership in computing depreciation, gain or loss on sale of assets, etc. The disparity between the inside basis and outside basis may result in foregoing depreciation deductions and inflating gains from subsequent property dispositions. Consequently, it might be wise for a buyer to negotiate a discounted purchase price to minimize the negative tax result. However, another option is for the partnership to trigger the Section 754 election to equalize the partner's outside and inside basis. Revaluations permit gains or losses inherent in the property to be taxed to the partner to whom it is properly allocable. Section 755 specifies the rules for allocating the incoming partner's basis adjustment to particular assets.

Let's explore a straightforward example. In anticipation of high demand for premium rental property during the upcoming Super World Games, the ABC Partnership purchased a condominium at Trunk Tower. Alas, a volatile political election for a seat on the town council undermined C's capitalist beliefs. Rather than indulging in her reverie of a free enterprise system, C has decided to take up painting seashells and offers Ronald her partnership interest in the condominium. A summary of the partnership balance sheet reflects a fair market value of $1,765,000 and an adjusted basis of $1,405,0000.

ABC BALANCE SHEET

Assets	Adjusted Basis	FMV
Condominium	$1,425,0000	$1,935,000
Liabilities	$150,0000	$150,000
Partner A	$425,000	$595,000
Partner B	$425,000	$595,000
Partner C	$425,000	$595,000
TOTAL	$1,425,0000	$1,935,000

Partner C offers to sell Ronald her one-third interest for $645,00 (one-third of the partnership's FMV). In return, C expects a cash payment of $595,000 and an assumption of her share of partnership liabilities. After the sale, Ronald would have outside basis for his partnership interest of $645,000 ($595,000 + $50,000). However, Ronald's share of the partnership's basis for its assets (his inside basis) would be $475,000 (one-third of $1,425,000). The $170,000 basis disparity would distort depreciation deductions if there were no step-up in basis. Also, if the partnership sells the condominium, Ronald's share of the taxable gain would be artificially inflated. A sale at the FMV of $1,1935,000, Ronald's recognizable one-third share of partnership gain would equal $170,000 (($1,1935,000 - $1,425,000) / 3)—despite a lack of economic gain because of an outside basis of $645,000 reflects Donald's one-third share of the condominium's fair market value ($1,935,000).

Upon a partner's transfer of a partnership interest, the partnership may elect under Section 754 to adjust the basis of partnership property. More specifically, a Section 754 election allows a step-up or step-down in basis in the manner provided in Section 743(b) to reflect the FMV at the time of the transfer. (Section 743(b) allows a basis adjustment that directly only affects an incoming partner.) Consequently, the election has the advantage of not taxing the incoming partner on gains or losses already reflected in the purchase price of the partnership interest. If the partnership proceeds with the Section 754 election, Ronald's inside basis will equal his outside basis of $645,000. The $170,000 basis disparity would be allocated to Ronald's share of the condominium.

It should be noted that revaluations are voluntary. A revaluation does not affect a partner's "tax basis" but does result in an increase or decrease in the economic investment in the partnership for any subsequent profit or loss allocations under Section 704(b). Furthermore, a Section 754 election may also result in adverse consequences. If the incoming partner's inside basis exceeds the outside basis, an election would create a negative

basis adjustment. Subsequently, additional depreciation deductions are forfeited; gains are increased and losses decreased upon disposition of property.

If the optional basis adjustment is desired, the election must be filed by the due date of the return for the year the election is effective and normally is filed with the return. Nevertheless, there are provisions for relief upon a partnership's inadvertent failure to file the election.