Basis and Buildings

Tax Considerations in Real Property Planning and Administration

BeachFleischman
collaborate forward

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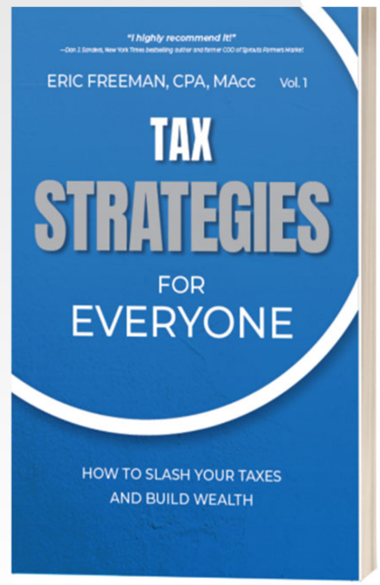
- **Tax Principal at BeachFleischman, PLLC**
- **Real Estate Practice Leader**
- **Areas of specialty include:**
  - Pass-through entities (partnerships and s-corporations)
  - Real estate consulting and planning
  - International taxation
  - Opportunity Funds
- **Industry experience:**
  - Real Estate
  - Hospitality
  - Construction
  - Financial Services
- **Professional Associations**
  - Urban Land Institute, Member
  - Real Estate & Allied Professionals, Member
  - Certified Commercial Investment Member, Affiliate Member
  - Pima County Real Estate Research Council, Treasurer
  - Metropolitan Pima Alliance, Member
  - AICPA, Member
  - ASCPA, Member



About BeachFleischman

- Arizona's largest locally owned firm
- A Top 200 largest public accounting firm (out of 44,000 US firms)
- Locations in Tucson, Phoenix, Nogales, Las Vegas and Hermosillo (MX)
- Over 7,000 clients
- Approximately 250 employees, including subsidiaries
- Subsidiaries include Contempo (payroll), Pinnacle Plan Designs (retirement)
- Wide range of industry experience with in-depth knowledge

Why Basis Matters

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Step-Up in Basis at Death

- Assets included in a decedent's estate take a fair market value basis under IRC Section 1014
- Measured at the date of death value, or the alternate valuation date six months later
- Depreciation restarts: inherited real property begins a new 27.5 or 39 year life
- Arizona community property advantage: BOTH halves step up, not just the decedent's half
  - Separate property states step up only the decedent's one-half interest
- But the step-up is not automatic at every level, and that is where planning is won or lost

- **WHY THIS MATTERS**
  - The step-up is the single largest tax benefit most families will ever receive
  - It is routinely lost simply because no one identified it in the year of death
  - With the exemption at $15M per individual, far fewer estates are taxable
  - Basis planning, not estate tax avoidance, is now the main event for most families

Inside vs. Outside Basis

- **OUTSIDE BASIS: the heir's basis in the partnership INTEREST. This steps up automatically.**
- **INSIDE BASIS: the partnership's basis in its ASSETS. This does NOT step up automatically.**
- **A FAMILIAR FACT PATTERN**
  - Dad contributed $400,000 cash for a 50% interest in an LLC taxed as a partnership
  - The partnership bought a Tucson apartment for $800,000 in 1998, now fully depreciated
  - At his death the apartment is worth $6,000,000, so his 50% interest is $3,000,000
  - On sale, almost $3,000,000 of gain flows to the heirs, but their higher outside basis offsets it at liquidation; a wind-up straddling year-end can mean gain one year and a capital loss the next
  - A 754 election keeps depreciation on the $3,000,000 step-up (less land) until sale and makes the asset gain/loss correct despite the inside/outside basis gap

OUTSIDE BASIS

$3,000,000

The heir's basis in the LLC interest. Steps up automatically.

THE GAP

$2,850,000

What a 754 election recovers

INSIDE BASIS

$150,000

The LLC's basis in the building. Unchanged without an election.

Section 754 Elections

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What Is a 754 Election?

- A partnership-level election allowing the entity to adjust the basis of its assets
- Available to LLCs and partnerships only. NOT to S-corporations or C-corporations.
- Two code sections do the work:
  - Section 743(b): transfer of a partnership interest, including by death, sale, or exchange
  - Section 734(b): certain distributions of money or property to a partner
- The adjustment is personal to the transferee partner. Other partners are unaffected.
- Once made, the election applies to all future transfers and distributions

- **THE KEY POINTS FOR NON-TAX ADVISORS**
  - The election changes nothing about who owns what or how the deal economics work
  - It changes only the tax depreciation and the mechanics of how the gain is reported at disposition
  - S-corporation shareholders have no equivalent, which is a major structuring consideration

Section 743(b): Transfers

- Applies when a partnership interest is transferred by sale, exchange, or death of a partner
- Adjusts inside basis of partnership assets to match what the transferee paid or inherited
- Positive adjustment when fair market value exceeds inside basis, the common estate scenario
- Negative adjustment when inside basis exceeds fair market value, possible in a down market
- Allocated among assets under Section 755, generally following relative appreciation
- The new basis is depreciated over a NEW recovery period, as if newly placed in service

- **PLANNING STRATEGIES**
  - Confirm the election before the partnership return for the year of death is filed
  - Obtain a qualified appraisal at date of death. The adjustment is only as good as the valuation.
  - Get the executor and the partnership's CPA talking early. They are often different firms.
  - Read the operating agreement. Many require the election, and a few prohibit it.
  - The adjustment belongs to the heir alone, so it does not dilute the other partners

Section 734(b): Distributions

- Applies when the partnership distributes cash or property to a partner
- Adjusts the basis of the partnership's REMAINING assets, benefiting the continuing partners
- Positive adjustment when a partner recognizes gain on cash distributed in excess of basis
- Positive adjustment when distributed property takes a lower basis in the partner's hands
- Negative adjustment when a partner recognizes loss, or property takes a higher basis
- Arises constantly in redemptions of a deceased partner's interest

- **PLANNING STRATEGIES**
  - Redemption versus cross-purchase changes which section applies. Model both before closing.
  - A redemption funded with life insurance is a very common estate planning trigger
    - Consider Connelly v. United States and whether a cross-purchase agreement is better
  - Watch Section 751 hot assets. Recapture and inventory convert capital gain to ordinary.
  - In a family LLC, a redemption can shift benefit to the children who remain as partners

Case Study: Not Electing

- Mom owns a 50% interest in an LLC taxed as a partnership holding a Tucson apartment complex
- She dies in 2026. Her interest is appraised at $3,000,000 at the date of death.
- The building was placed in service in 1998 and is nearly fully depreciated
- The LLC's inside basis attributable to her interest is $100,000

	No 754 Election	With 754 Election
Heir's basis in the LLC interest (outside)	$3,000,000	$3,000,000
LLC's inside basis for her share	$100,000	$100,000
Section 743(b) adjustment	None	$2,900,000
Allocated to building (27.5-year)	—	$2,600,000
Allocated to land (not depreciable)	—	$300,000
Added annual depreciation to the heirs	$0	$94,545
Deduction over the first 10 years	$0	$945,450

Mandatory Adjustments

- **A basis adjustment is REQUIRED, with or without a 754 election, in two situations**

- Substantial built-in loss on a transfer of an interest, under Section 743(d)
  - Inside basis exceeds fair market value by more than $250,000
- Substantial basis reduction on a distribution, under Section 734(d)
  - The downward adjustment would exceed $250,000

- The purpose is anti-abuse: to stop the duplication of losses
- Note the direction. These mandatory adjustments are downward. They cost the taxpayer.

- **A TRAP FOR THE UNWARY**
  - Partnerships miss these constantly, because no election was ever filed to prompt the analysis
  - A partnership with a substantial built-in loss must adjust whether it wants to or not
  - Test at every transfer, not only when a 754 election is already on the table

When to Elect and When Not To

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When It Makes Sense

- Death of a partner where the real property has appreciated significantly
- Death of a partner where the building is substantially or fully depreciated
- Purchase of a partnership interest at a premium to inside basis
- The partnership will HOLD the real estate rather than sell it immediately
- Enough remaining useful life for the heir to actually use the new depreciation
- Few partners and reliable records, so the tracking burden stays manageable
- Paired with a cost segregation study on the stepped-up basis, covered in the next section

- **THE STRONGEST CASE**
  - Long-held real estate in a family LLC with a fully depreciated building
  - Heirs who intend to keep operating the property for years to come
  - The first year depreciation pickup alone often exceeds the lifetime cost of the election

When to Think Twice

- The property is about to be sold. The outside basis step-up alone may cover the gain.
  - Consider timing of asset sale and liquidation of partnership interest
- Assets are worth less than inside basis, which produces an unwanted negative adjustment
- Many partners and frequent transfers, where tracking cost compounds every year
- Large syndicated or fund structures where recordkeeping is already strained
- Assets are non-depreciable, such as raw land, so the benefit only arrives on sale
- The partnership is winding down within a year or two

- **THE COST AND BENEFIT REALITY**
  - The election creates a permanent obligation to track a separate basis schedule per partner
  - Accounting fees rise every year the election remains in effect. Quantify this before electing.
  - Small partnerships sometimes elect, then cannot afford the ongoing compliance
  - Remember it is effectively irrevocable, so a negative year cannot simply be turned off

Making the Election

- A written statement attached to a timely filed partnership return, including extensions
- Filed for the tax year in which the transfer or distribution occurs
- The statement identifies the partnership and declares the election under Section 754
- Applies to that year AND all subsequent years. Treat it as irrevocable.
- Revocation requires IRS consent under Reg. Section 1.754-1(c) and is rarely granted
- A missed election may qualify for automatic 12-month relief under Reg. 301.9100-2
- Past 12 months it takes a private letter ruling, which is expensive and slow

- **PLANNING STRATEGIES**
  - Calendar the filing deadline the moment a partner dies. Relief only gets harder.
  - Add a Section 754 provision to every family LLC operating agreement now, before it is needed
  - Give the manager authority to elect without a full member vote
  - Where heirs disagree, resolve the question in the estate plan rather than after death

Cost Segregation

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Cost Segregation Basics

- Reclassification of depreciable lives to shorter recovery periods
- Requires an engineer to break out the separate components of real property
- Default lives: residential 27.5 years, commercial 39 years

- Commonly reclassified to 5 years:
  - Cabinets, appliances, blinds, counters, carpet, and equipment hookups
- Commonly reclassified to 15 years:
  - Landscaping, irrigation, paving, sidewalks, signs, and swimming pools

- The additional benefit: 5 year and 15 year property is eligible for bonus depreciation
- 100% bonus depreciation was made permanent by the OBBBA for property acquired after 1/19/2025

Cost Seg After a Step-Up

- The stepped-up basis is a NEW basis, and it can be cost segregated as if newly acquired
- This applies to the basis adjustment created by a Section 743(b) election
- The decedent’s prior depreciation history is wiped clean at death. No recapture carries over.
- A study can be done in a later year, using Form 3115 to catch up missed depreciation
- The study is built on the date-of-death value and the heir’s new holding period

- **PLANNING STRATEGIES**
  - Only worthwhile if the heirs have taxable income to absorb the deduction
  - Consider electing out of bonus depreciation to avoid stranding losses under the NOL limits
  - Passive loss rules still apply. Confirm the heir’s participation before promising a benefit.
  - This is the rare case where two large benefits stack cleanly on the same property

Case Study: Stacking Both

- Same facts. The Section 743(b) adjustment allocated to the building is $2,500,000.
- The heirs order a cost segregation study on that newly stepped-up basis
- Component percentages follow a typical multifamily study

Component of the stepped-up building basis	Amount	% of Basis
5-year personal property	$625,000	25%
15-year land improvements	$125,000	5%
27.5-year real property	$1,750,000	70%
Total Section 743(b) adjustment	$2,500,000	100%

$813,636

first-year depreciation with a study and 100% bonus

versus $90,909 without one

Additional first-year deduction: $722,727

Source: BeachFleischman analysis. Component percentages reflect a typical multifamily cost segregation study; actual results vary by property.

Cautions in Administration

- The decedent's depreciation recapture does not survive death, but the heir's will
- Once the heir claims accelerated depreciation, Section 1245 recapture applies on a later sale
- Bonus depreciation can create losses the heir cannot use if participation is passive
- The election is made at the partnership level. A fiduciary cannot force it without authority.
- Conflicts arise when some heirs want the deduction and others want simplicity
- The benefit depends entirely on a defensible date-of-death valuation

- **COORDINATION POINTS FOR ATTORNEYS**
  - Confirm who holds authority to make the election under the operating agreement
  - Address the 754 election directly in the estate plan rather than leaving it to default
  - Document the date-of-death valuation contemporaneously. Reconstructing it later is costly.
  - Identify the partnership's CPA early. The election is theirs to file, not the estate's.

Entity Structure

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Structures That Work

- LLC taxed as a partnership: full access to Section 754, the preferred real estate structure
- Tenancy in common: each owner's undivided interest steps up directly, with no election needed
- Revocable living trust: assets remain in the estate and receive a full step-up
- Arizona community property: both halves step up, so confirm the property is titled correctly
- Community property with right of survivorship: the step-up plus probate avoidance
- Irrevocable grantor trust: consider swap powers to pull appreciated assets back into the estate

- **PLANNING STRATEGIES**
  - For Arizona couples, verify titling now. A separate property characterization is expensive.
  - Swap powers let a grantor exchange cash for appreciated property to restore estate inclusion
  - With a $15M exemption, estate inclusion is usually worth more than exclusion

Common Structural Failures

- **S-CORPORATION HOLDING REAL ESTATE**
  - No 754 equivalent exists, so there is no inside basis step-up at a shareholder's death
  - The single most common and most expensive structural mistake we see
  - Converting out of an S-corp triggers gain. There is rarely a clean fix after the fact.

- Other recurring failures:
  - Gifting appreciated real property during life: carryover basis, and the step-up is lost
  - Joint tenancy with a non-spouse: only the decedent's share steps up
  - A family LLC with no 754 provision and a manager who declines to elect
  - Assets in an irrevocable trust outside the estate: no step-up at the grantor's death

- **PLANNING STRATEGIES**
  - Review entity choice BEFORE appreciation accumulates. Retrofitting is expensive.
  - For an existing S-corp, hold new acquisitions in a separate LLC going forward
  - Weigh estate inclusion against the step-up. Under current exemptions, inclusion usually wins.

Planning Checklist

- **AT THE PLANNING STAGE**
  - Confirm entity type, and flag every S-corporation holding appreciated real property
  - Add a Section 754 provision to operating agreements, with authority to the manager
  - Verify community property titling for Arizona married couples
- **AT DEATH**
  - Obtain a date-of-death appraisal immediately for every real property interest
  - Calendar the partnership return deadline for the year of death
  - Get the estate attorney, the executor, and the partnership's CPA in one conversation
- **IN ADMINISTRATION**
  - Model the election benefit against ongoing compliance cost before electing
  - Evaluate a cost segregation study on the stepped-up basis
  - Confirm the heirs' participation level before projecting any tax benefit

Thank you!

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