NORTHERN TRUST

PLANNING FOR THE "NON-TAXABLE" ESTATE

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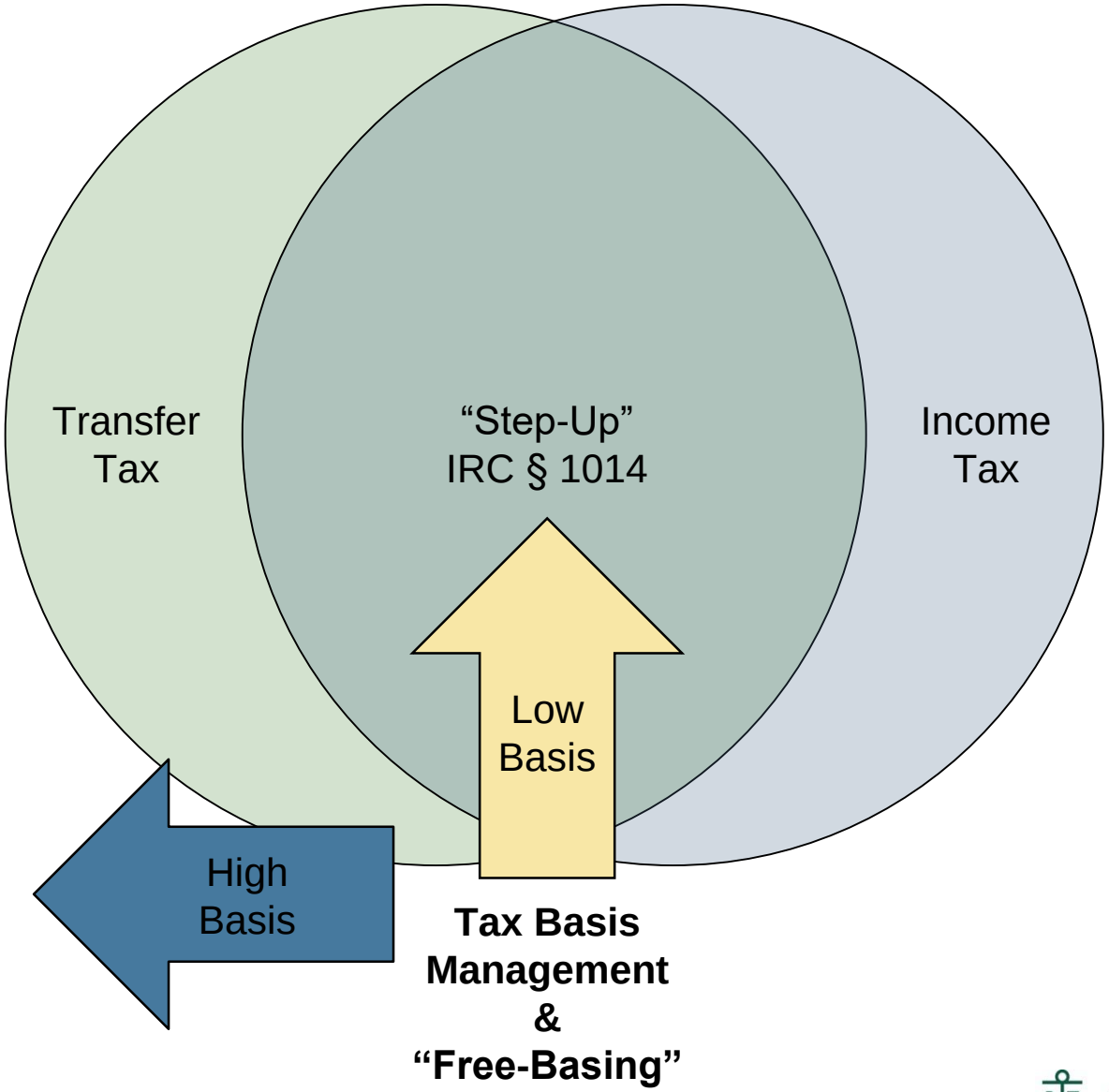
TPFRPTT II & V OTCROTBFFY 2018 Act ("Tax Cuts & Jobs Act")

The Tax COVFEFE and Jibberish Act

The ATRA Transfer Tax Landscape: Venn Diagram

Assets to be Transferred Out of the Gross Estate

(Wealth Transfer)



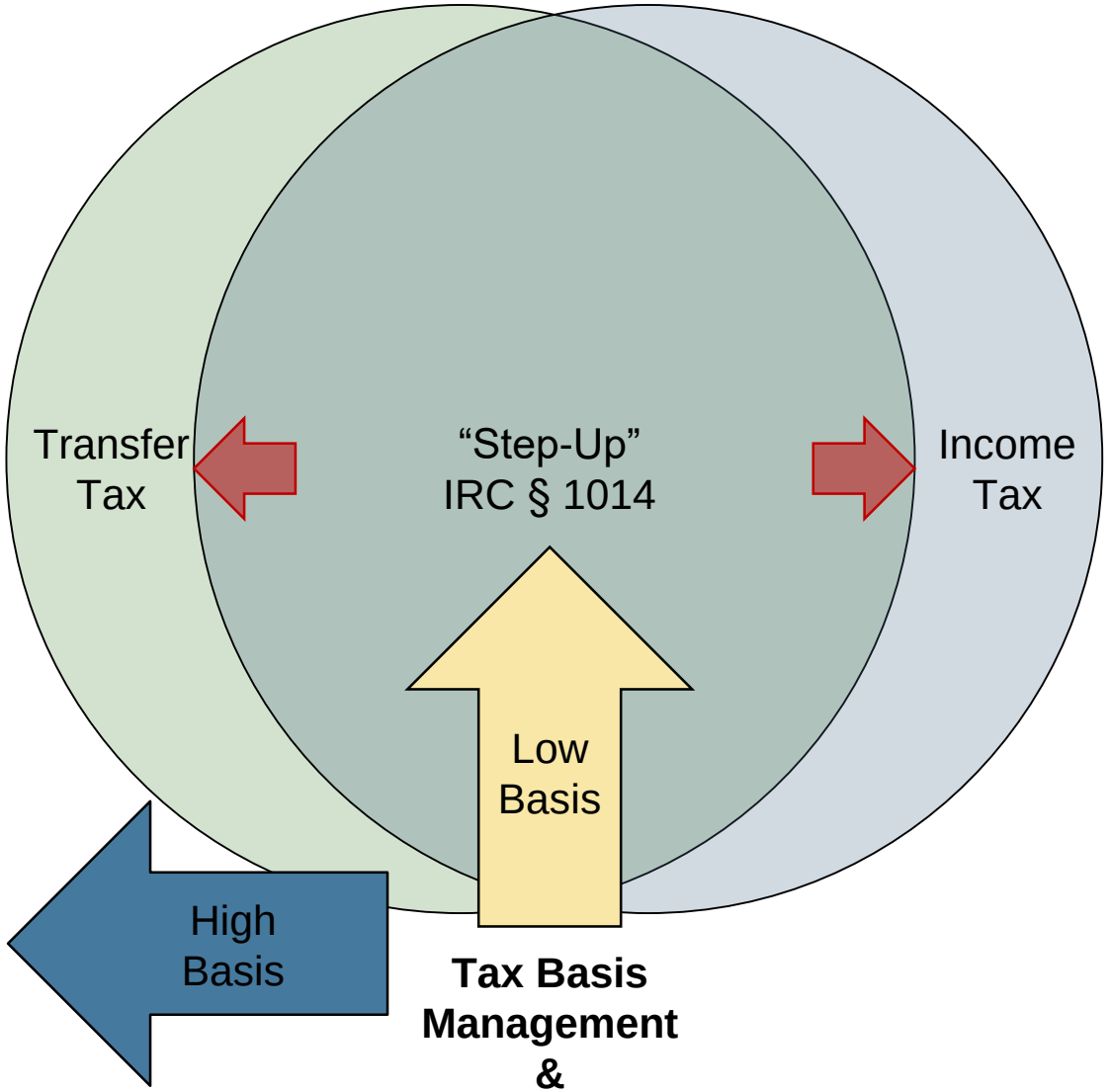
Assets Recognized During Lifetime

(Tax Avoidance & Deferral)

The Temporary TCJA Transfer Tax Landscape: Venn Diagram

Assets to be Transferred Out of the Gross Estate

(Wealth Transfer)

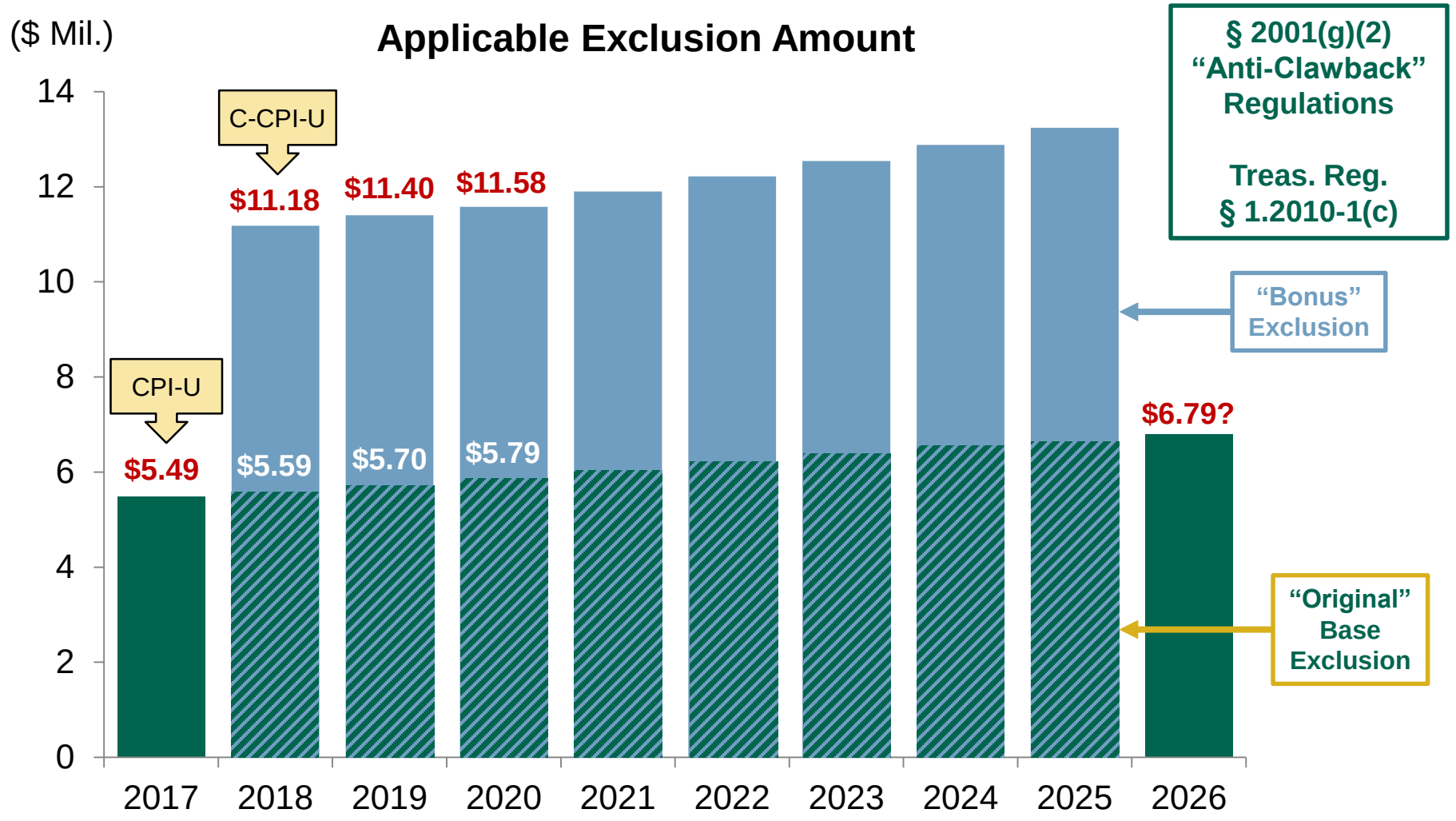


Tax Basis Management & "Free-Basing"

Assets Recognized During Lifetime

(Tax Avoidance & Deferral)

2012 All Over Again?



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To Gift or Not to Gift: That's the Question…

Up to Wealthy	*"Middle Class" Wealthy*	*Ultra-Wealthy*
$0 to ~$11.58 Mil.	~$11.58 Mil. to ~$40.0 Mil.	Above ~$40.0 Mil.
❑ Limit taxable gifts ❑ Preserve Applicable Exclusion ❑ Take advantage of free "step-up" in basis ❑ Limit valuation discounts ❑ Transfers of wealth in excess of the Applicable Exclusion via "zeroed-out" techniques ❑ Transfer high basis assets to IDGTs with "swap" power	❑ Taxable gifts in excess of the "Original" Applicable Exclusion depend on whether taxpayer can afford to make such gift ❑ Careful consideration of "split-gift" election (or NOT) in certain years ❑ Spousal Lifetime Access Trusts ❑ Retained cash flow techniques (i.e., preferred partnership freezes) ❑ Trusts that provide maximum "flexibility"	❑ Large taxable gifts to use "Original" and "Bonus" Applicable Exclusion ❑ Transfer to IDGTs (with "swap" power") ❑ Valuation discount planning ❑ "Zeroed-out" techniques, leveraging taxable gifts (i.e., installment sale) ❑ "Free-basing" with marital deduction and estate reduction planning with surviving spouse

Consider:

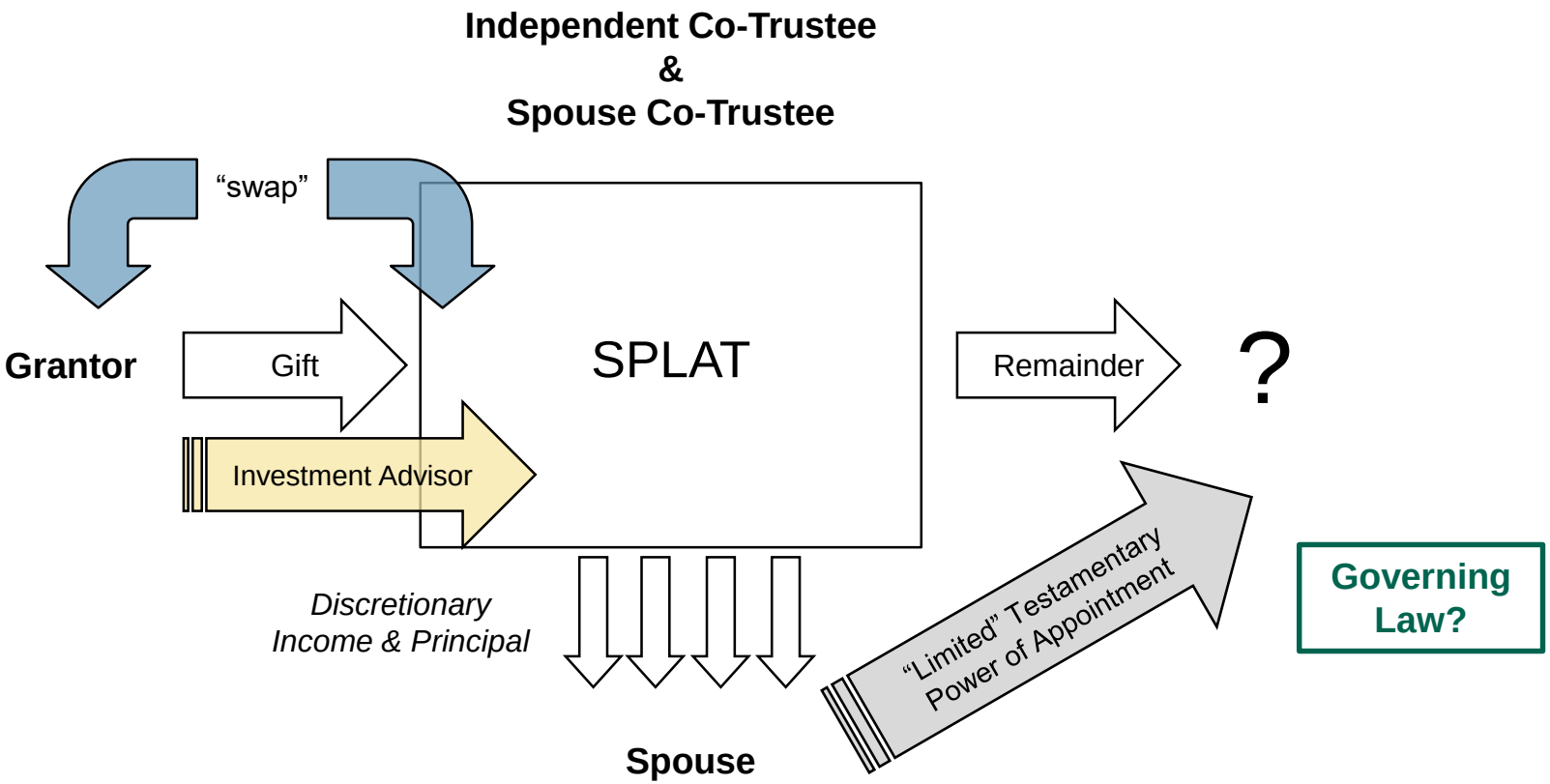
Applicable Exclusion gifts of cash (or marketable securities), and

Exercise of "swap" power in the future.

Applicable Exclusion Gifts

Spousal Lifetime Access Trusts
Grantor Trusts &
Flexibility

Spousal Lifetime Access Trust

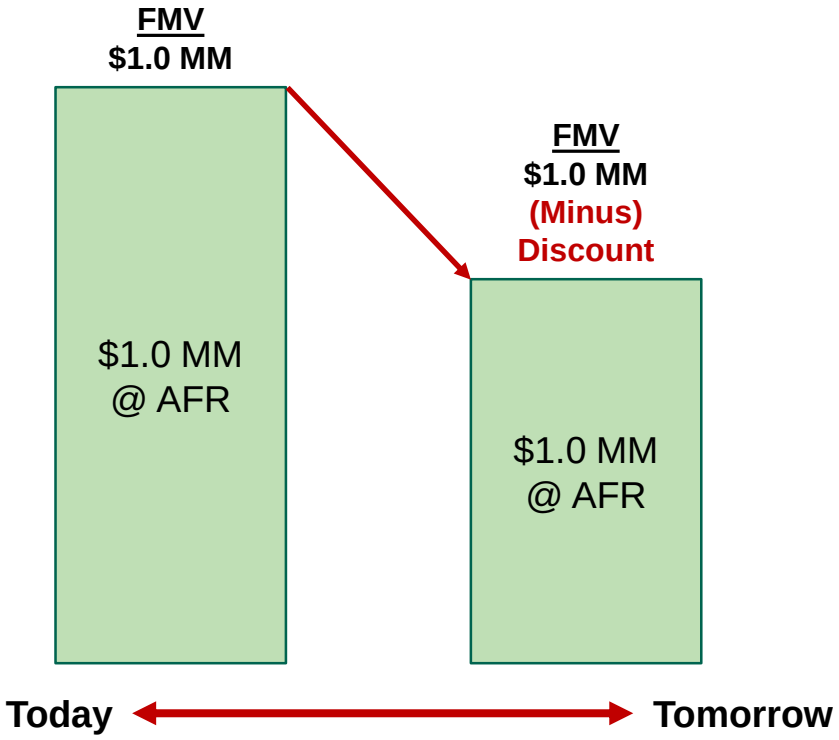


Valuation of Promissory Notes

The Valuation of Promissory Notes in the Future?

"In the case of an entity engaged in an active trade or business, at least 60 percent of whose value consists of the nonpassive assets of that trade or business, and to the extent that the liquidation proceeds are not attributable to passive assets within the meaning of section 6166(b)(9)(B), such proceeds may include such a note or other obligation if such note or other obligation is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds." Prop. Treas. Reg. 25.2704-3(b)(iv).

- Loans and Installment Sales Today
  - Applicable federal rate (long-term, not short or mid-term);
  - 10% (or less) equity;
  - No prepayment penalty; and
  - Adequate security not required.
- Promissory Notes Will Need to Be:
  - Adequately secured;
  - Requires periodic payments on a non-deferred basis;
  - Issued at market interest rates; and
  - Has a fair market value equal to the liability.



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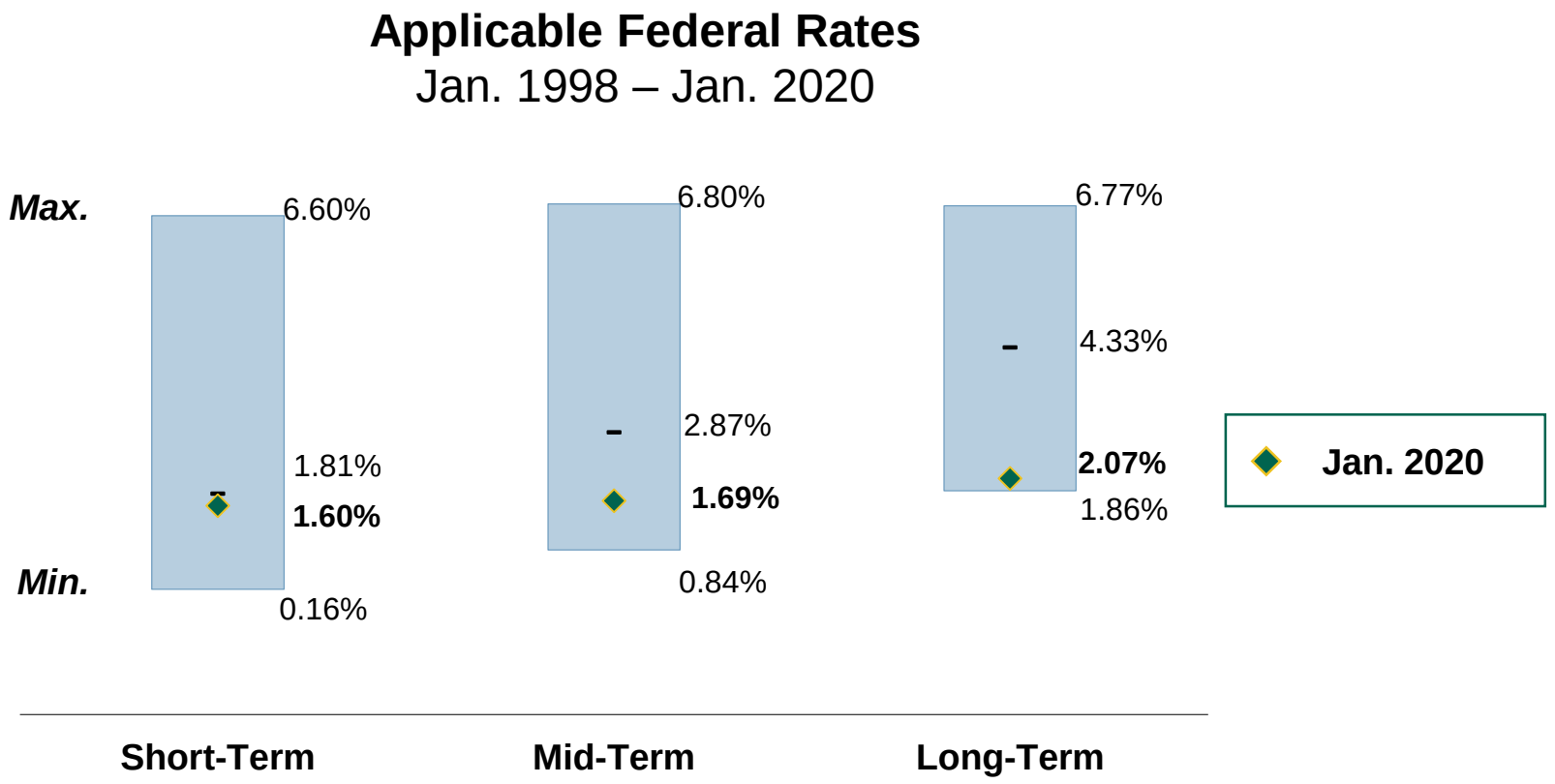
The Long-Term AFR Is Near Historical Low



Long-Term GRATs

50-, 70-, 100-, 360-Year GRATs???

What About Very Long Term GRATs?

50 Year GRAT

Annuity	$	318,232.10
Interest Rate		2.0%
Years		50
PV of Grantor's Retained Interest	$	10,000,000
Annuity Factor		31.42360589
Life Factor		0.628472118
Remainder Factor		0.371527882

7520 Rate at Death	§ 20.2036-1(c)(2): Amt. Incl.	
1.0%	$	31,823,209.70
2.0%	$	15,911,604.85
3.0%	$	10,607,736.57
4.0%	$	7,955,802.43
5.0%	$	6,364,641.94
6.0%	$	5,303,868.28
7.0%	$	4,546,172.81

60 Year GRAT

Annuity	$	287,679.66
Interest Rate		2.0%
Years		60
PV of Grantor's Retained Interest	$	10,000,000
Annuity Factor		34.76088668
Life Factor		0.695217734
Remainder Factor		0.304782266

7520 Rate at Death	§ 20.2036-1(c)(2): Amt. Incl.	
1.0%	$	28,767,965.83
2.0%	$	14,383,982.91
3.0%	$	9,589,321.94
4.0%	$	7,191,991.46
5.0%	$	5,753,593.17
6.0%	$	4,794,660.97
7.0%	$	4,109,709.40

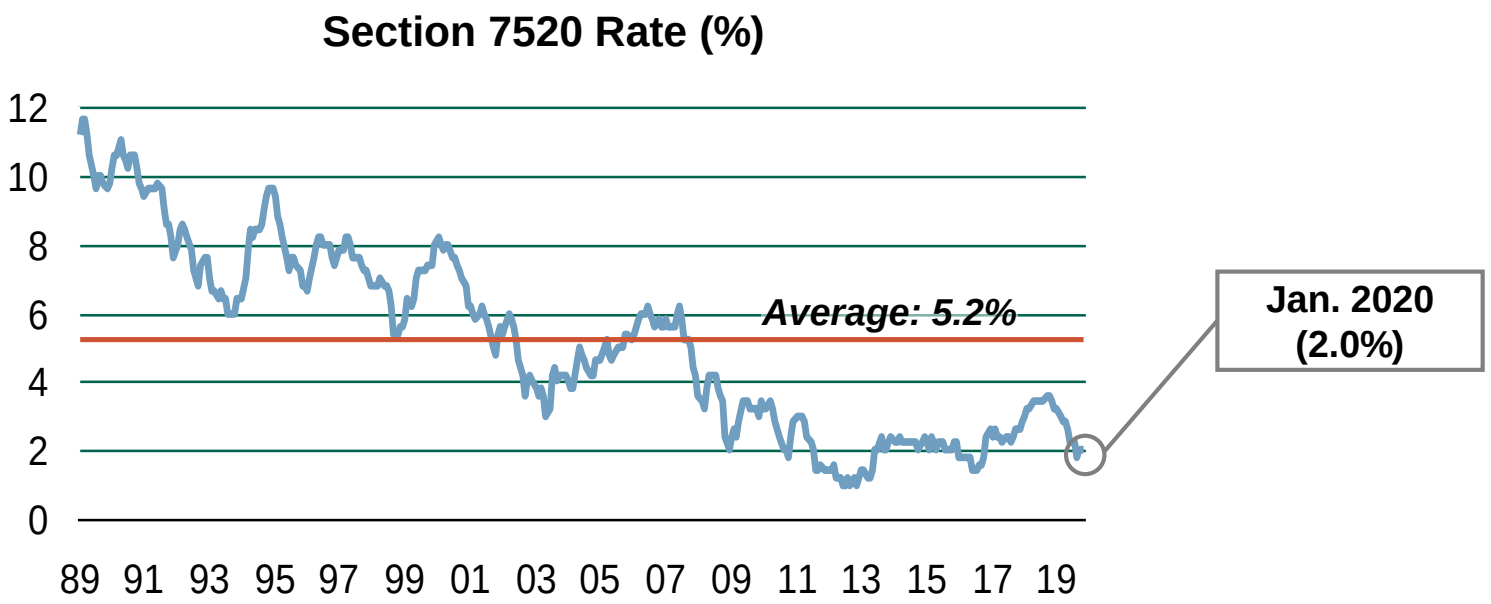
70 Year GRAT

Annuity	$	266,676.49
Interest Rate		2.0%
Years		70
PV of Grantor's Retained Interest	$	10,000,000
Annuity Factor		37.49861929
Life Factor		0.749972386
Remainder Factor		0.250027614

7520 Rate at Death	§ 20.2036-1(c)(2): Amt. Incl.	
1.0%	$	26,667,648.54
2.0%	$	13,333,824.27
3.0%	$	8,889,216.18
4.0%	$	6,666,912.13
5.0%	$	5,333,529.71
6.0%	$	4,444,608.09
7.0%	$	3,809,664.08

100 Years? 360 Years?

§ 20.2036-1(c)(2): Maximum Amount Includible		
7520 Rate	100 Year GRAT ($232,027 Annuity)	360 Year GRAT ($200,160 Annuity)
1.0%	$ 23,202,744	$ 20,016,044
2.0%	$ 11,601,372	$ 10,008,022
3.0%	$ 7,734,248	$ 6,672,015
4.0%	$ 5,800,686	$ 5,004,011
5.0%	$ 4,640,549	$ 4,003,209
6.0%	$ 3,867,124	$ 3,336,007
7.0%	$ 3,314,678	$ 2,859,435



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Tax Basis Management Basics

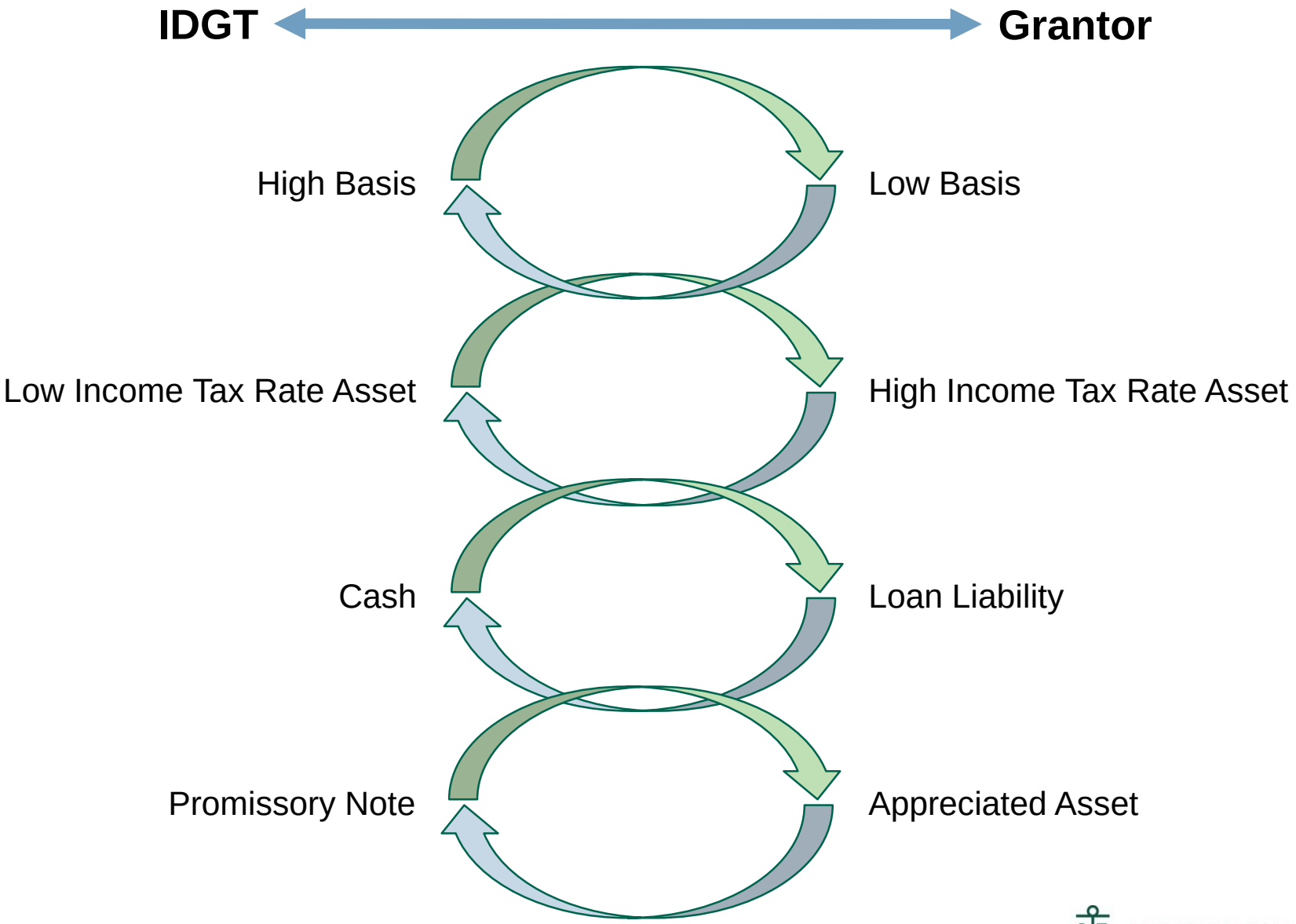
Some Assets Benefit from “Step-Up”—Some Do Not

“Step-Up” Important
[Higher Valuation]

“Step-Up” not Important
[Lower Valuation]

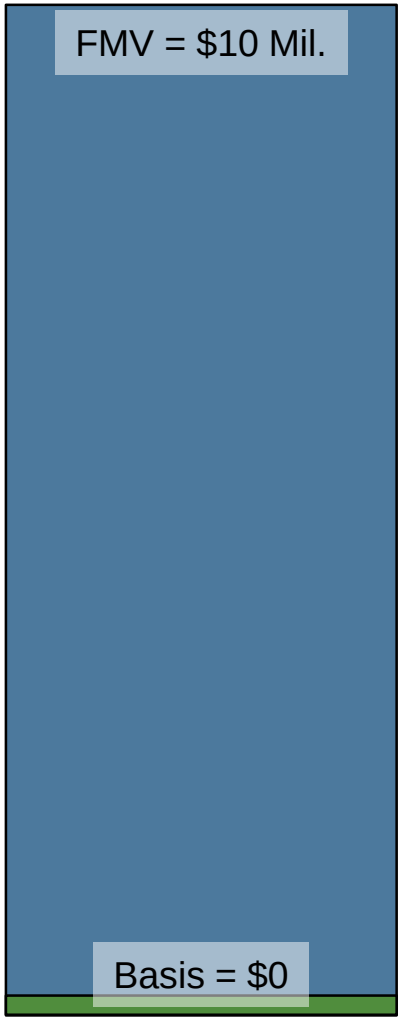
Asset Type	Tax Characteristic
Creator-Owned Copyrights, Trademarks, Patents & Artwork	Ordinary Transforms to Long-Term
“Negative Basis” Commercial Real Property LPs	Recapture & >100% Long-Term
“Bonus Depreciation” Qualified Property under § 168(k)	§ 1245 Recapture
Oil & Gas Investments	§ 1245 Recapture
Artwork, Gold & Other “Collectibles”	28% Long-Term
Low Basis Stock	20% Long-Term
Roth IRA Assets	Tax Free & No Surcharge
Qualified Small Business Stock (QSBS)	§ 1202 Gain [50, 60, 75 or 100%] Exclusion
High Basis Stock	Minimal Gain
Fixed Income	Typically Minimal Gain
Cash	Basis = Face Value
Passive Foreign Investment Company (PFIC) Shares	No “Step-Up”
Stock at a Loss	Capital Loss Erased
Variable Annuities	Partially IRD
Traditional IRA & Qualified Plan Assets	100% IRD

Tax Basis Management Basics: Grantor Trust Swapping?



Using Debt to "Multiply"
The "Step-Up" In Basis

Maximizing the "Step-Up" & Minimizing Estate Tax: Debt



Gross Estate
§ 2031 = $10 Mil.

Taxable Estate
§ 2051 = $10 Mil.

"Step-Up" in Basis
§ 1014(a) = $10 Mil.

Debt = $9 Mil.
(Cash)

Gross Estate
§ 2031 = $10 Mil.

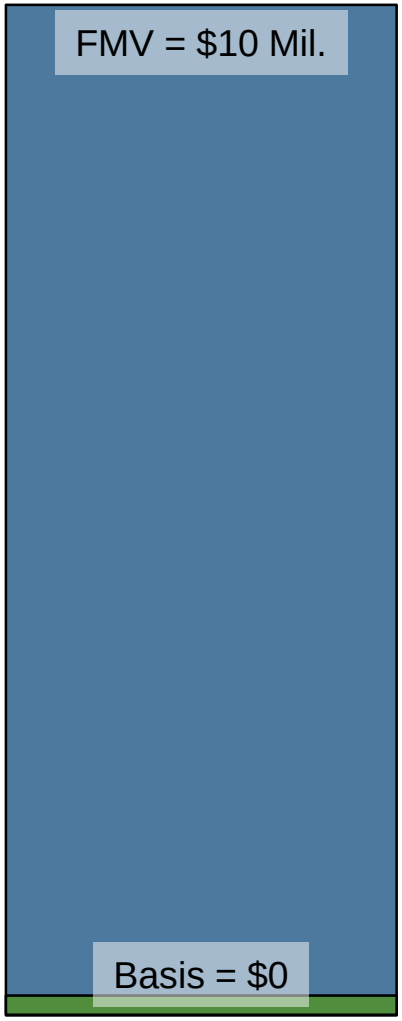
Indebtedness
§ 2053(a)(4) = ($9 Mil.)

Taxable Estate
§ 2051 = $1 Mil.

"Step-Up" in Basis
§ 1014(a) = $10 Mil.

"Zeroed-Out" Transfers
"Swap" for Appreciated Pty.
Private Split-Dollar Loan

Debt with QTIP Trusts?



Amount Includible
§ 2044(a) = $10 Mil.

Taxable Estate
§ 2051 = $10 Mil.

"Step-Up" in Basis
§ 1014(b)(10)→(b)(9)
= $10 Mil.

Amount Includible
§ 2044 = $10 Mil.

Indebtedness
§ 2053(a)(4) = ($9 Mil.)

Taxable Estate
§ 2051 = $1 Mil.

"Step-Up" in Basis
§ 1014(b)(10) = $10 Mil. or $ 1 Mil. (?)

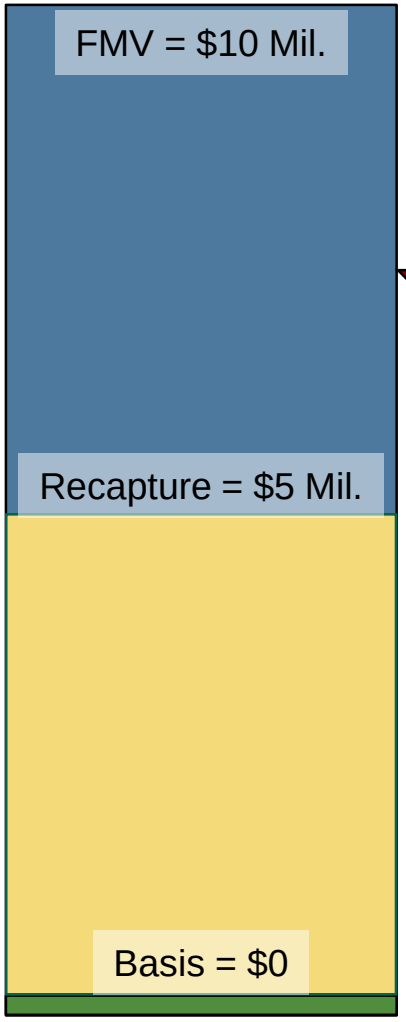
Amount Includible
§ 2044 = 1 Mil.

Taxable Estate
§ 2051 = $1 Mil.

Tax Basis Management

Using A Contract Derivative To "Transfer" But Still Own The Asset For The "Step-Up."

Sell The Appreciation Via Contract, Own The Asset



Depreciated Real Property

Debt = $4 Mil.

9-YEAR CONTRACT

Grantor "Sells"
Personal Obligation to Pay

Total Return =

FMV of Property
LESS Debt
PLUS Net Rental Income

9-YEAR PROMISSORY NOTE

$6 Mil.
LESS Discount
"Personal Obligation Risk"

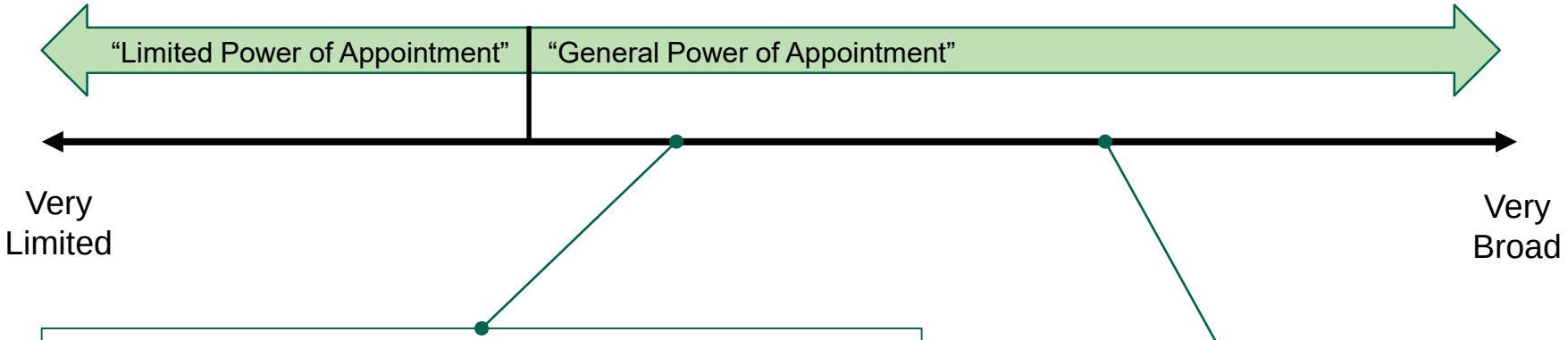
BUSINESS REASONS
Real Property Tax
Creditor Consent
Real Estate Transfer Tax
NIIT/Material Participation
Expenses of Transfer

IDGT

ISSUES
Valuation?
Settled Before Date of Death?
Estate Tax Deduction?
Ordinary Income/Deduction?
Satisfied with What Asset?

Powers of Appointment & "Upstream" Planning

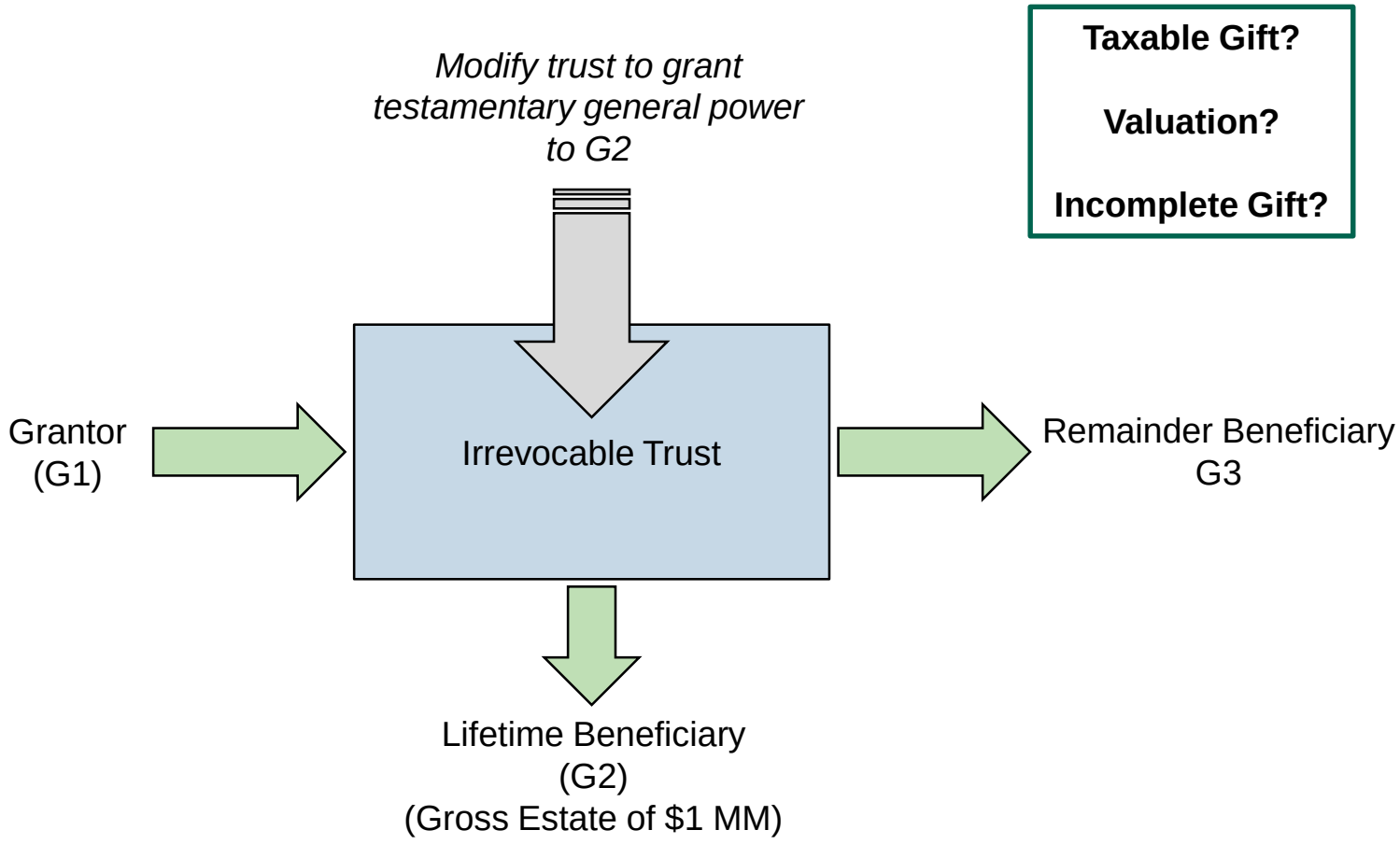
Powers of Appointment: How Restrictive?



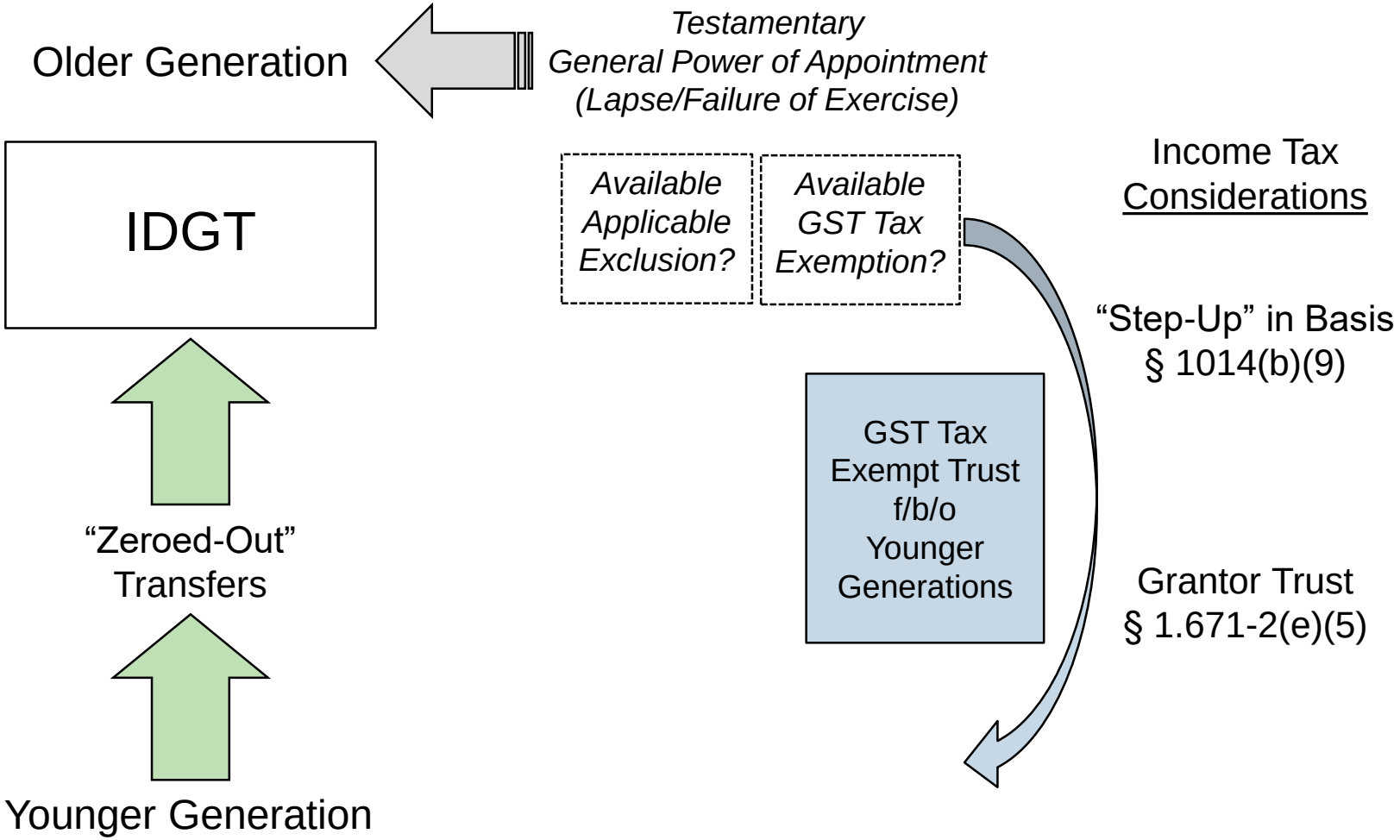
- Testamentary power;
- Exercisable in favor of creditors of the estate of the powerholder;
- With the consent of a non-adverse party;
- To the extent of available exclusion amount; and
- Only over assets that benefit the most from a "step-up"

- Inter-vivos or testamentary
- Exercisable in favor of:
  - Powerholder,
  - Estate of powerholder, and
  - Creditors of the estate of the powerholder
- Over all assets.

Granting Powers of Appointment



Upstream Planning: "Accidentally Perfect" Grantor Trust

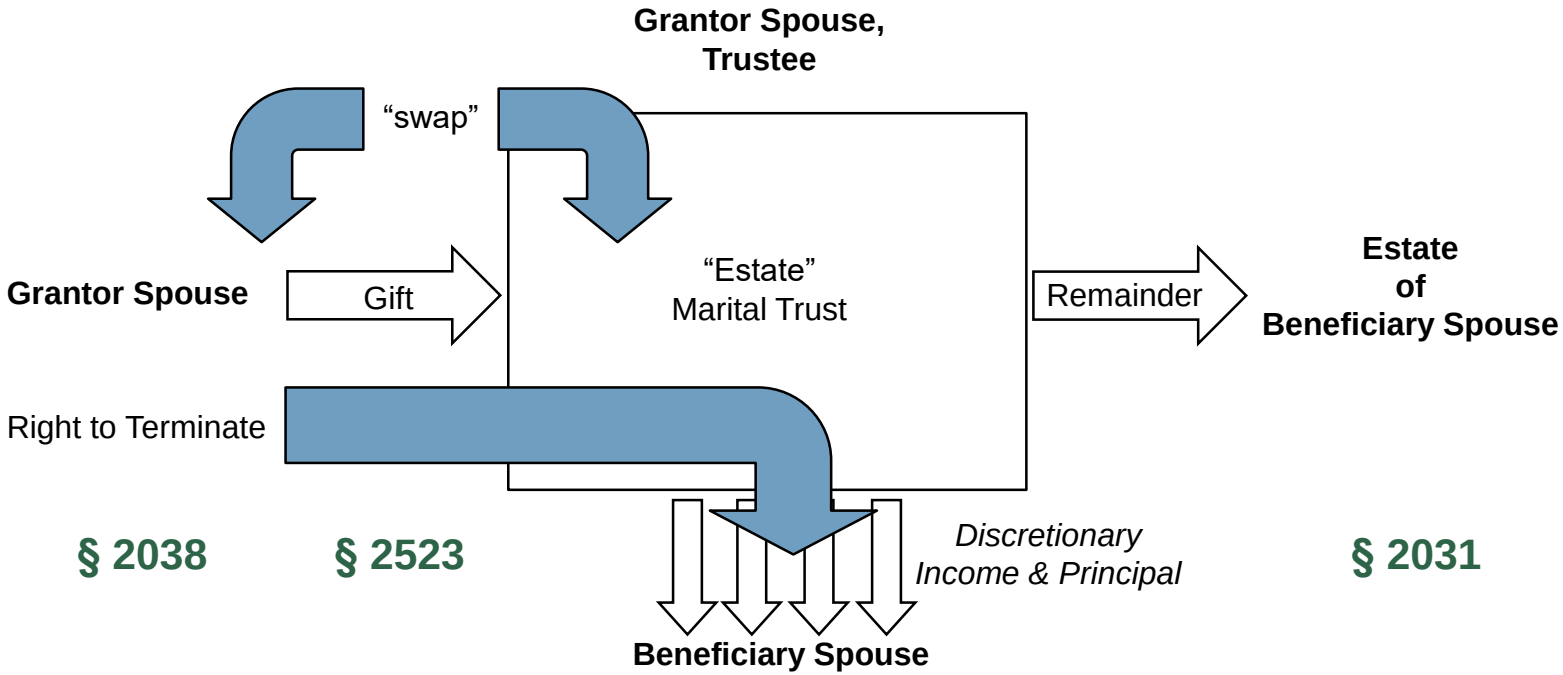


Tax Basis Management

“Double Step-Up” In Basis

“Double Step-Up” in Basis

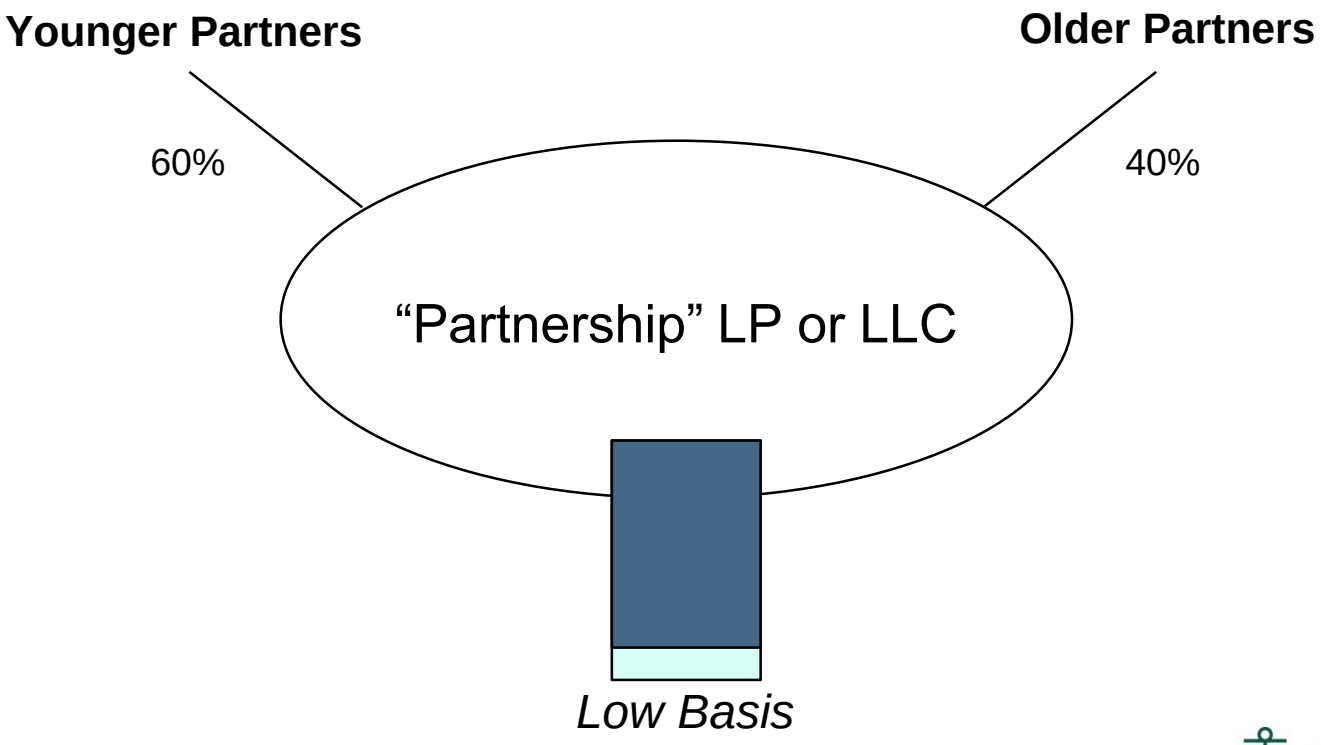
- Community Property
- Elective or Consensual Community Property Trusts (AK, TN & SD)
- Joint Exempt Step-Up Trust (JEST)
- Section 2038 Estate Marital Trust



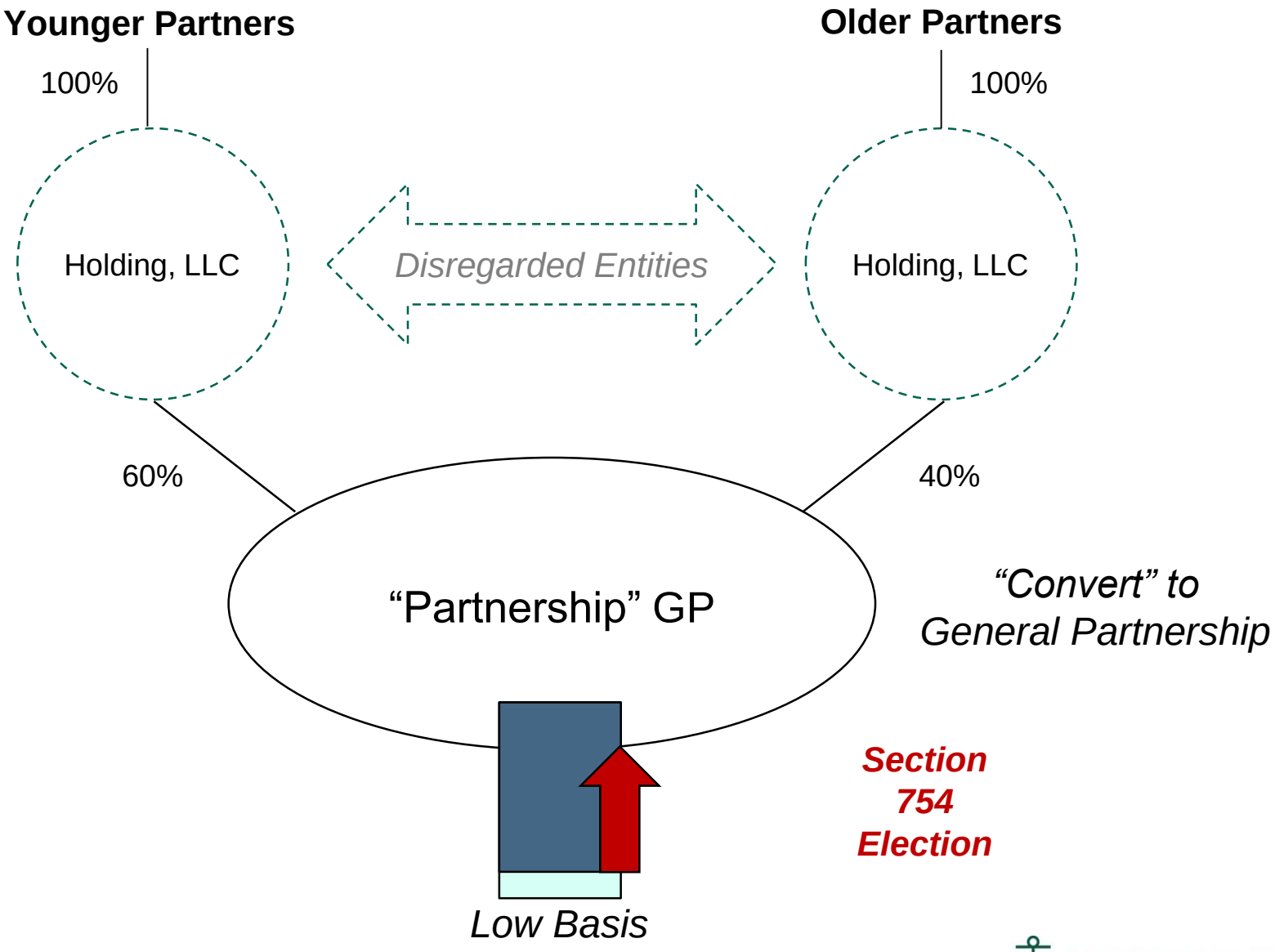
Maximizing the Step-Up in Basis

Eliminating Valuation Discounts On Pre-Existing FLP Interests Included in the Gross Estate

Eliminating Valuation Discounts on Pre-Existing FLPs

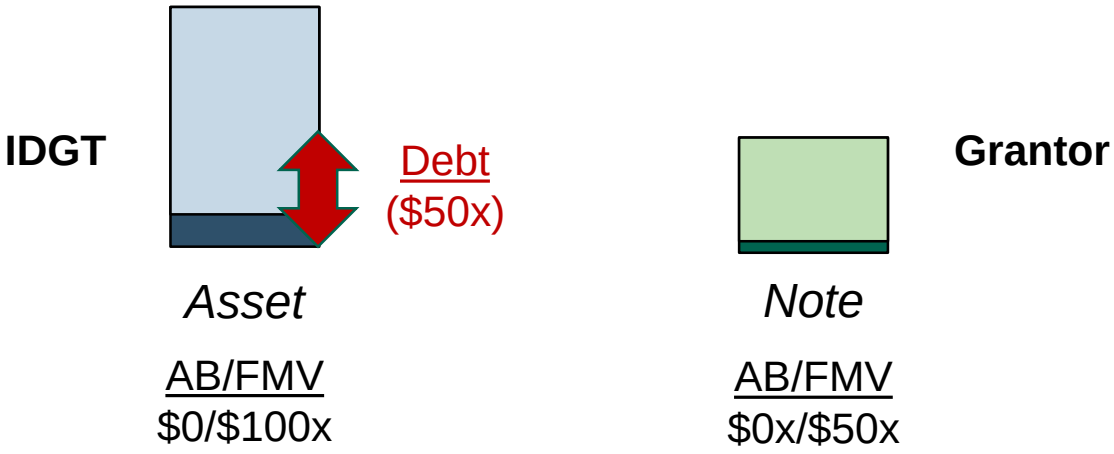


Eliminating Valuation Discounts on Pre-Existing FLPs



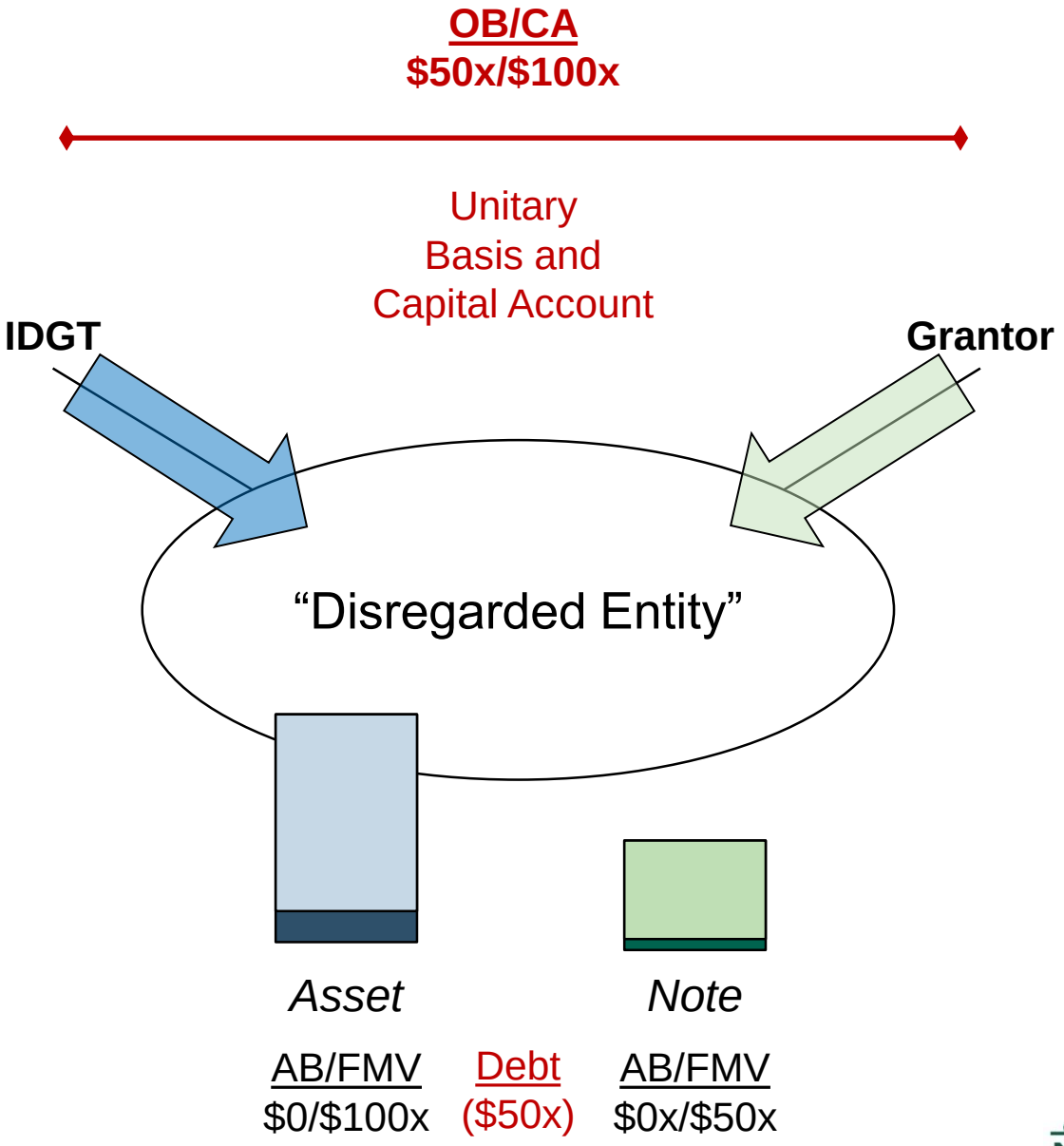
Eliminating Outstanding Installment Notes, Avoiding Gain At Death, And Getting A "Step-Up" On The IDGT Property

Installment Sale to IDGT and Outstanding Note

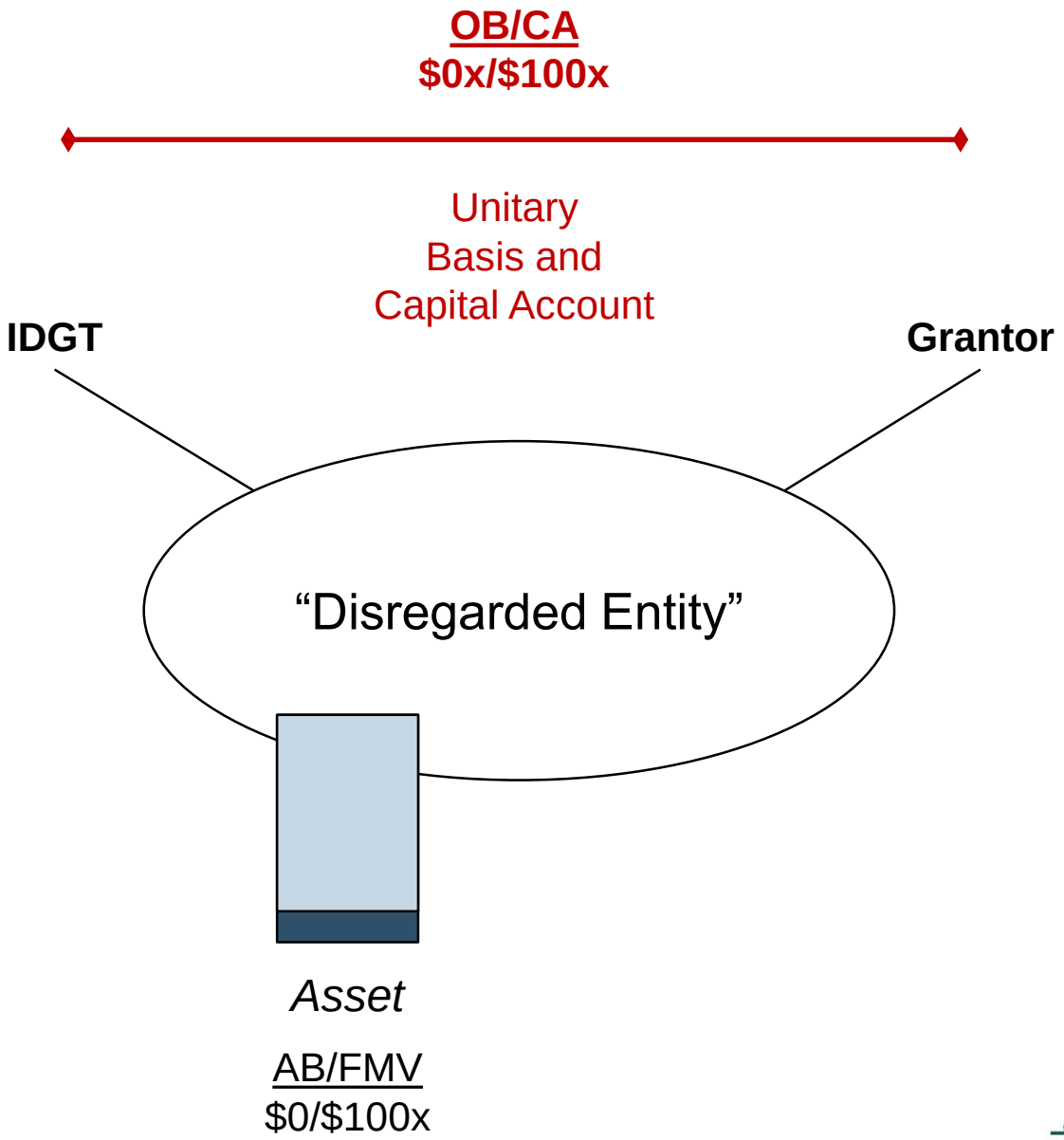


Potential $50x Taxable Gain Upon Conversion of Grantor Trust to Non-Grantor Trust

Contribution to Disregarded Entity



Debt Merges and Disappears



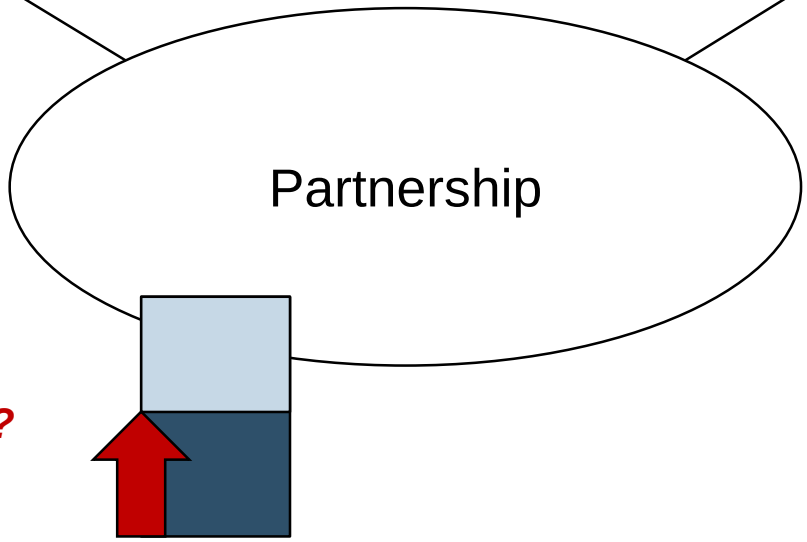
Conversion to Non-Grantor Trust & Partnership at Death

Rev. Rul. 99-5:
Conversion of disregarded entity to partnership created by transfer of an interest treated as purchase of assets and contribution to a new partnership.

OB/CA
$0x/$50x

OB/CA
$50x/$50x

Non-Grantor Trust ← **Estate of Grantor**



§ 754 Election? & § 743(b) Adjustment?

Asset

AB/FMV
$50x/$100x

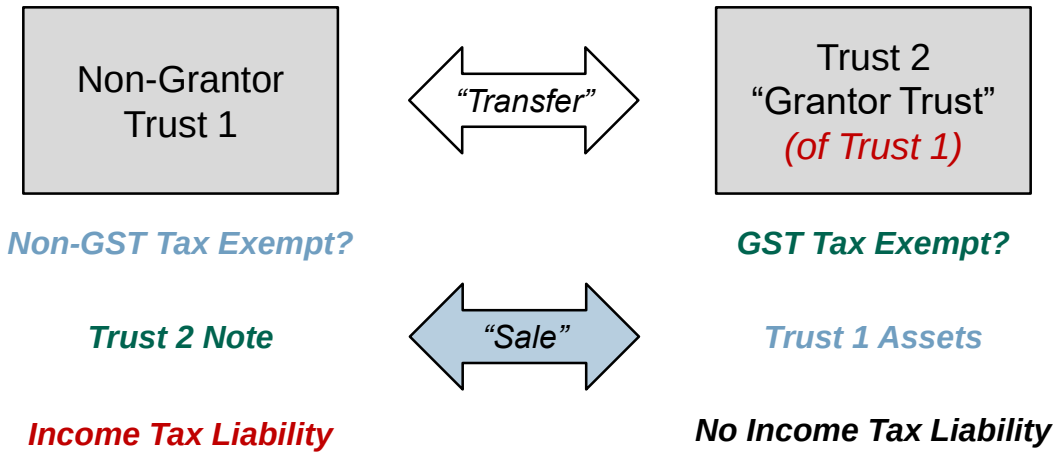
Managing Basis With Grantors And Grantor Trusts

Making a Trust a "Grantor Trust" as to Another Trust?

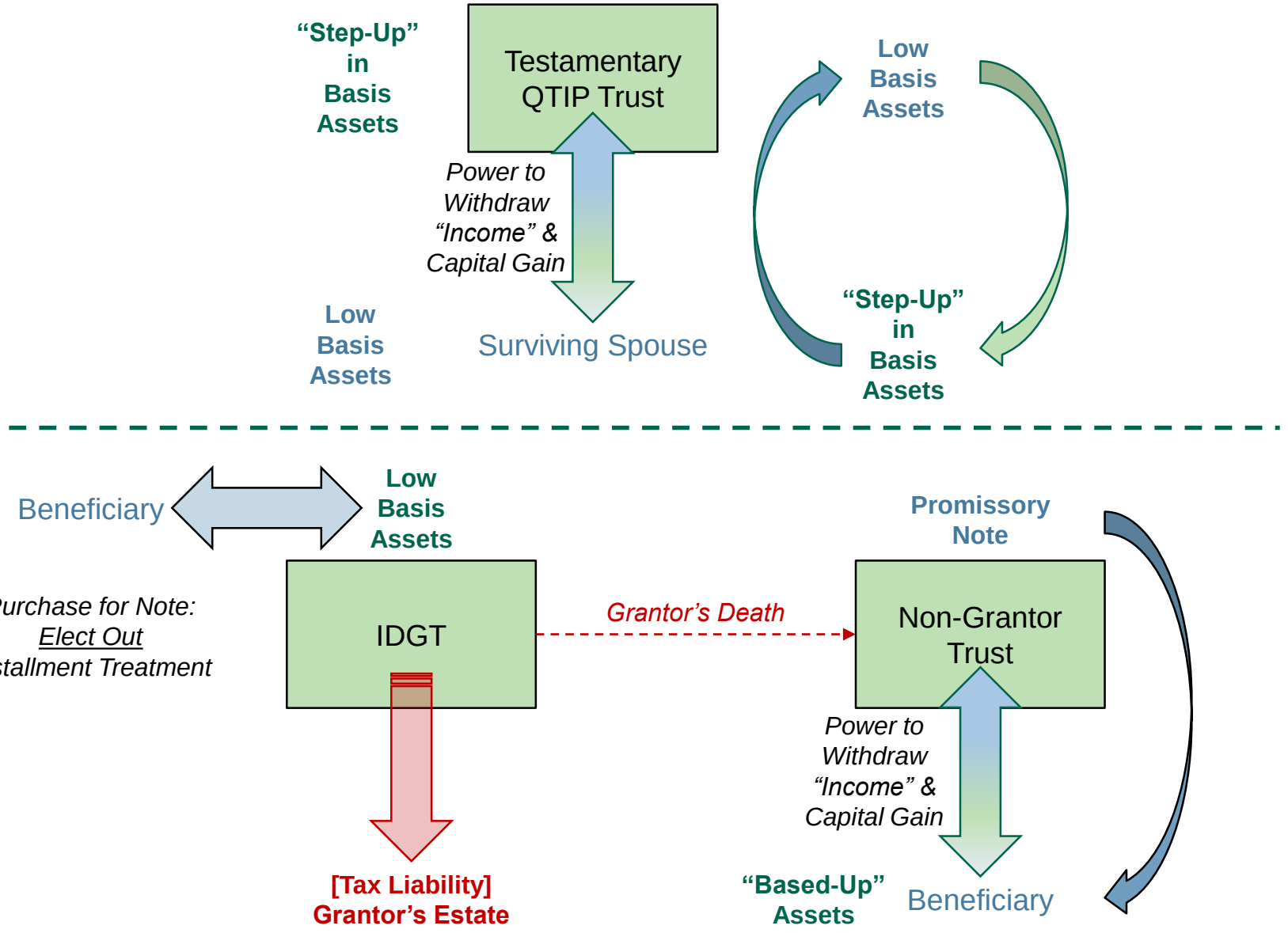
- PLR 201633021
  - Trust 1
    - Grantor deceased.
    - F/B/O children, spouse, and issue.
    - Trustee proposes to transfer assets to Trust 2.
  - Trust 2
    - F/B/O children, spouse, and issue.
    - Trust 1 retains sole power to revest net income of Trust 2.
    - Lapses on the last day of the calendar year.
    - "Net income" includes income under § 643(b) and capital gain.

RULING:

Trust 1 will be treated as the owner of the portion of Trust 2 over which they have the power to withdraw under § 678(a).



Basis Opportunities with Grantor Trusts of a Beneficiary?



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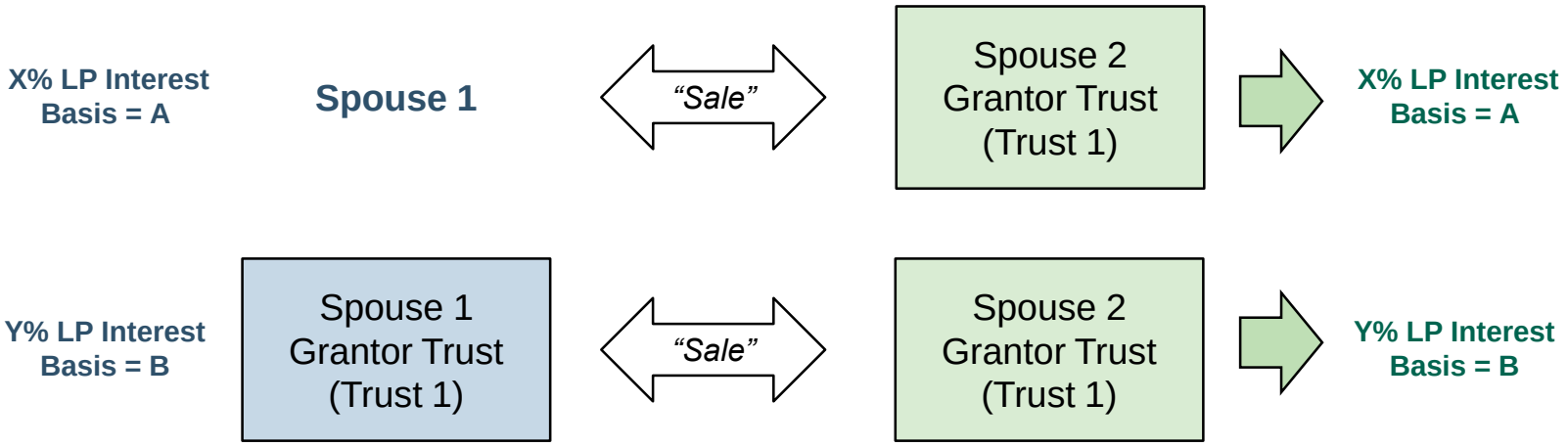
Spouse 1 Grantor Trust and Spouse 2 Grantor Trust

- PLR 201927003
  - Trust 1
    - Created and funded by Spouse 1
    - Grantor trust of Spouse 1 under § 675(4) [swap power]
    - Trustee proposes to transfer assets to Trust 2.
  - Trust 2
    - Created and funded by Spouse 2
    - Grantor trust of Spouse 2 under § 675(4) [swap power]
  - Transaction
    - Spouse 1 will sell LP interest in Partnership to Trust 2
    - Trust 1 will sell LP interest in Partnership to Trust 2

RULING:

Spouse 1 will recognize no gain or loss on the sales by Spouse 1 and Trust 1.

Basis of property acquired by Trust 2 from Spouse 1 and Trust 1 will be the same as the basis in the property of Spouse 1 and Trust 1 under § 1041(b)(2)



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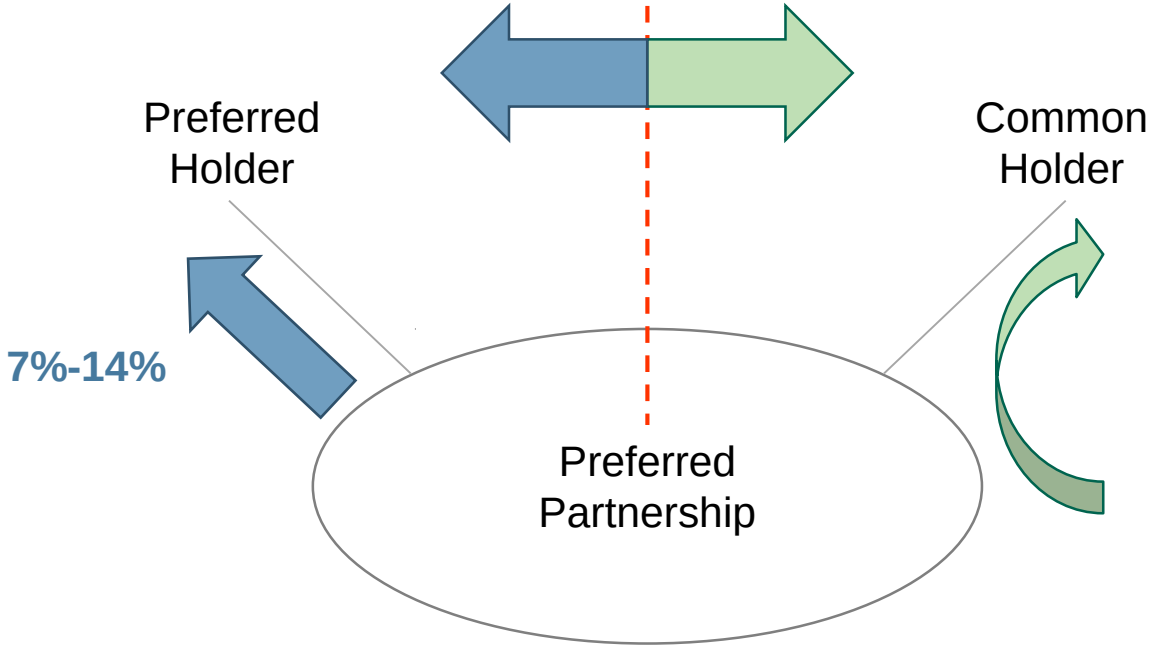
Preferred Partnership Structures: Forward, Reverse, and "Busted"

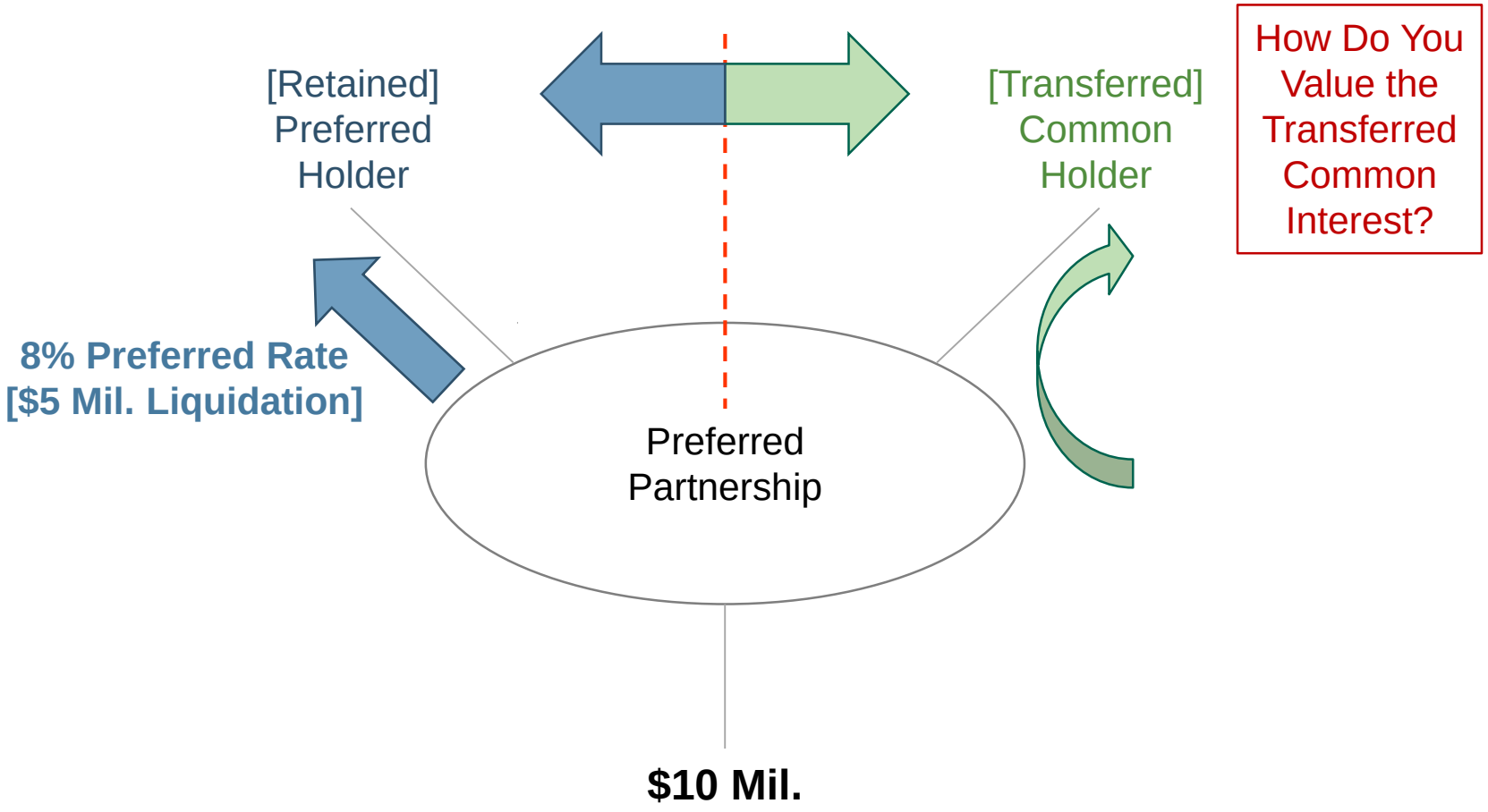
Preferred & Common: Retain or Transfer?



- Fixed Liquidation Value
- Annual Distribution at Fixed Rate/Amount
- Tax Items Preferentially Allocated
- Retain (Traditional), § 2701 Applies
- Transfer (Reverse), Normal Gift Tax Rules

- All Value in Excess of Preferred
- No Fixed Annual Distribution
- Residual Tax Items
- If Retain, Normal Gift Tax Rules
- If Transfer, § 2701 Applies

"Forward Freeze" Preferred Partnership Transaction



Forward Freeze: Subtraction Method (Valuing Common Interest)

- **Step 1: Determine**
  - Value of all family-held interests
- **Step 2: Subtract**
  - Value of senior equity interests
- **Step 3: Allocate**
  - Among the transferred interests
- **Step 4: Determine**
  - Value of the gift

Section 2701

Not liquidation value

No minority interest discount

Zero OR

Value of

"Qualified Payment" Interest

Minority interest discount

Lack of marketability discount

Subordination discount

Qualified Payment
Annual
Cumulative
Fixed Rate

Rev. Rul. 83-120

No ability to inflate value above liquidation

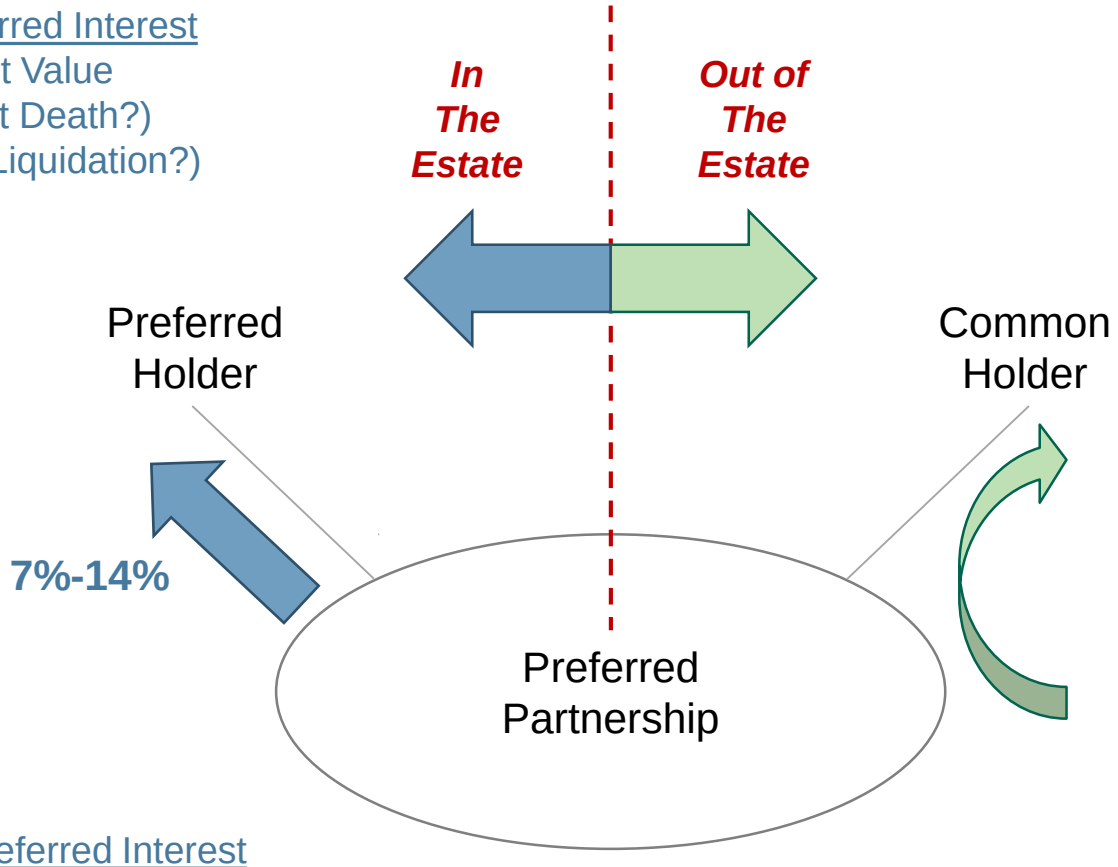
Retain Preferred/Transfer Common: Qualified or Non-Qualified

Estate Tax

Qualified Preferred Interest
Fair Market Value
(Liquidated at Death?)
(Cost-of-Living Liquidation?)

Gift Tax

Common Interest
Family Interests
less
Qualified Interest
less
Discounts



Non-Qualified Preferred Interest
Fair Market Value (Liquidated?)
less
Reg. § 25.2701-5(a)(3) Adjustment

Separate from § 2001(g) "Clawback" Regulations

Common Interest
Family Interests
less
Zero

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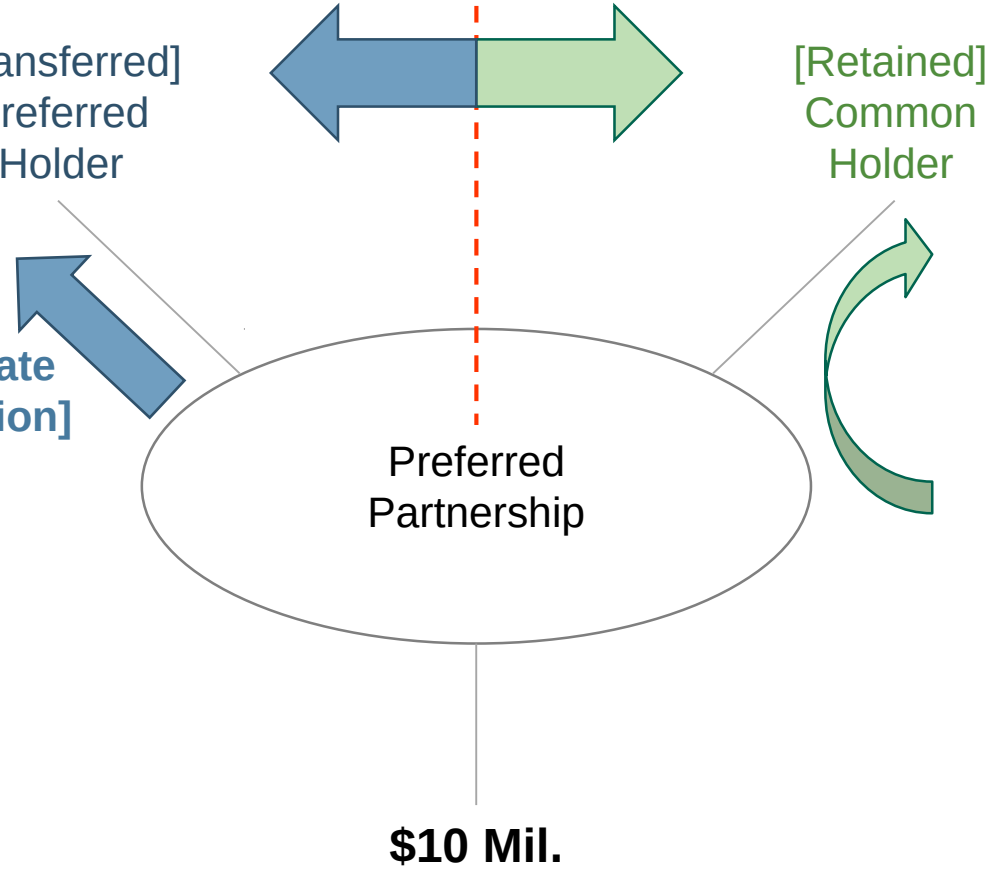
"Reverse Freeze" Preferred Partnership Transaction

How Do You Value the Transferred Preferred Interest?



Reverse Freeze: Junior Equity Exception & Rev. Rul. 83-120

"Junior Equity Exception" to Section 2701
- Normal gift tax valuation rules apply
- Lack of marketability and minority interest discounts applicable

Rev. Rul. 83-120

- Major Factors
  - Yield
  - Dividend Coverage
  - Dissolution Protection
- Minor Factors
  - Voting Rights
  - Lack of Marketability

Based on structure of the partnership

"high-grade, publicly-traded preferred stocks"

Preferred Stock Sectors

Financial Services

Oil & Gas

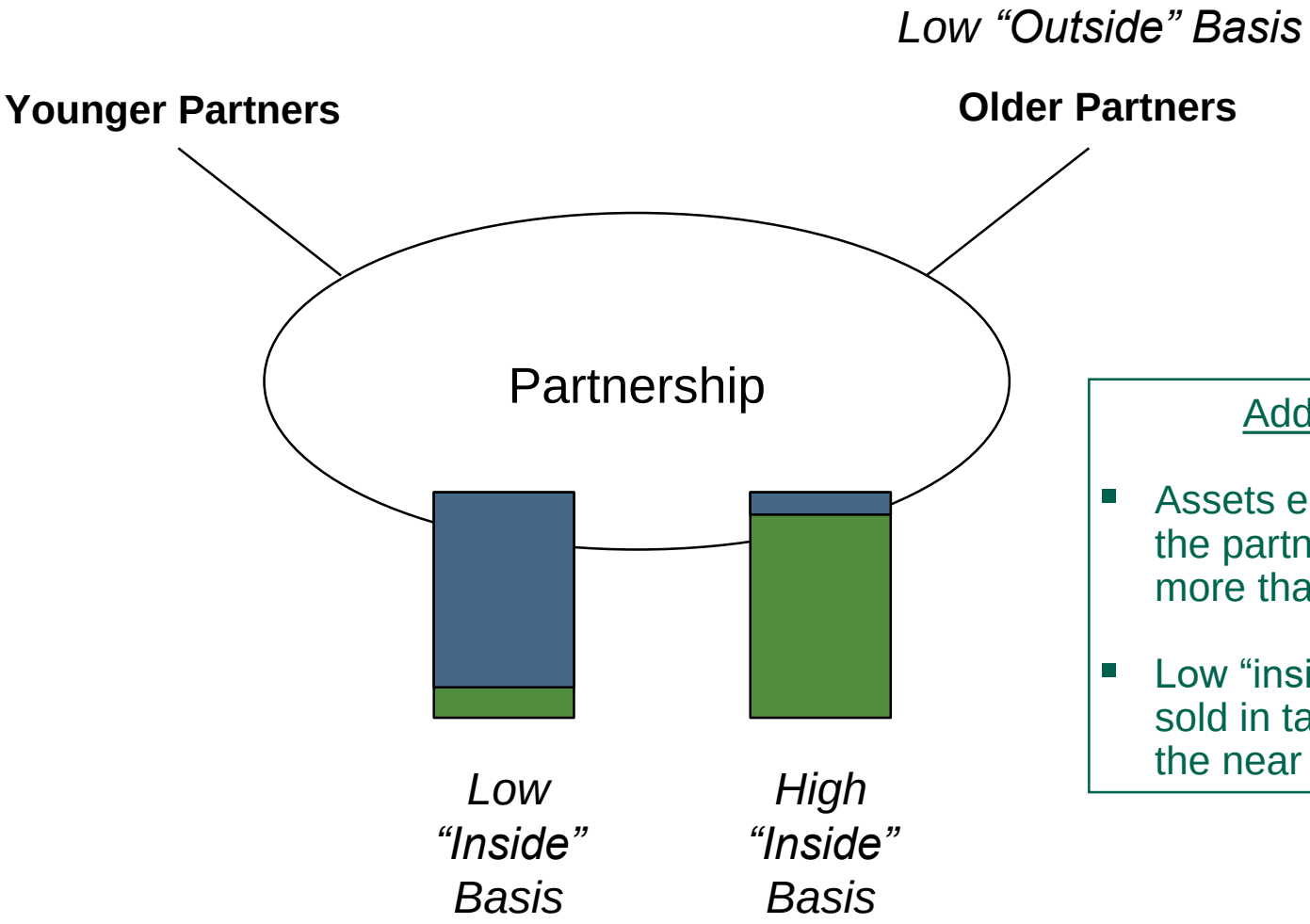
Real Estate

Preferred Stock Yields

7% to 14%

The Basics of Basis Stripping, Shifting, and Swapping

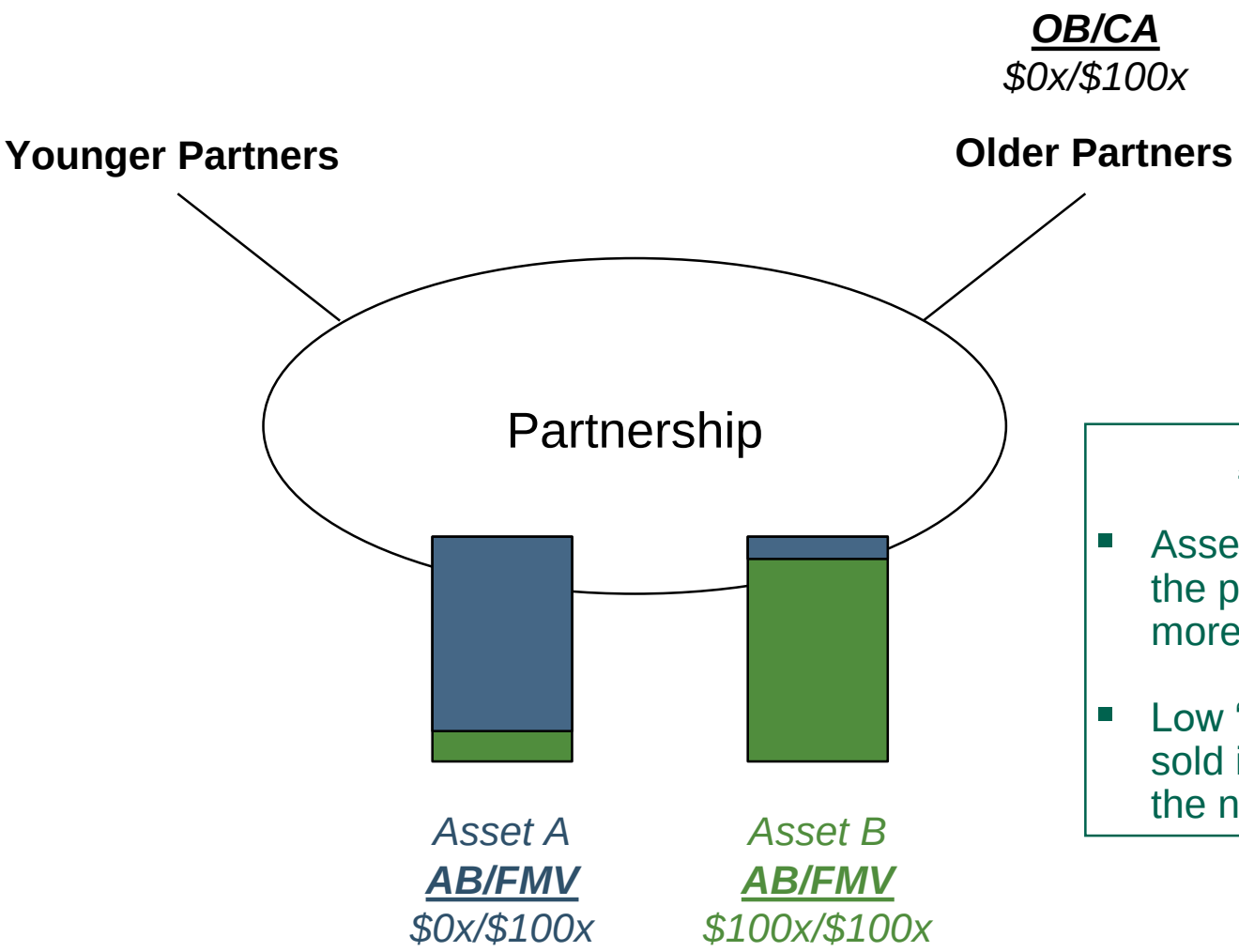
Importance of Partnerships in Tax Basis Management



Additional Facts:

- Assets either purchased by the partnership or contributed more than 7 years ago.
- Low "inside" basis asset to be sold in taxable exchange in the near future.

Importance of Partnerships in Tax Basis Management



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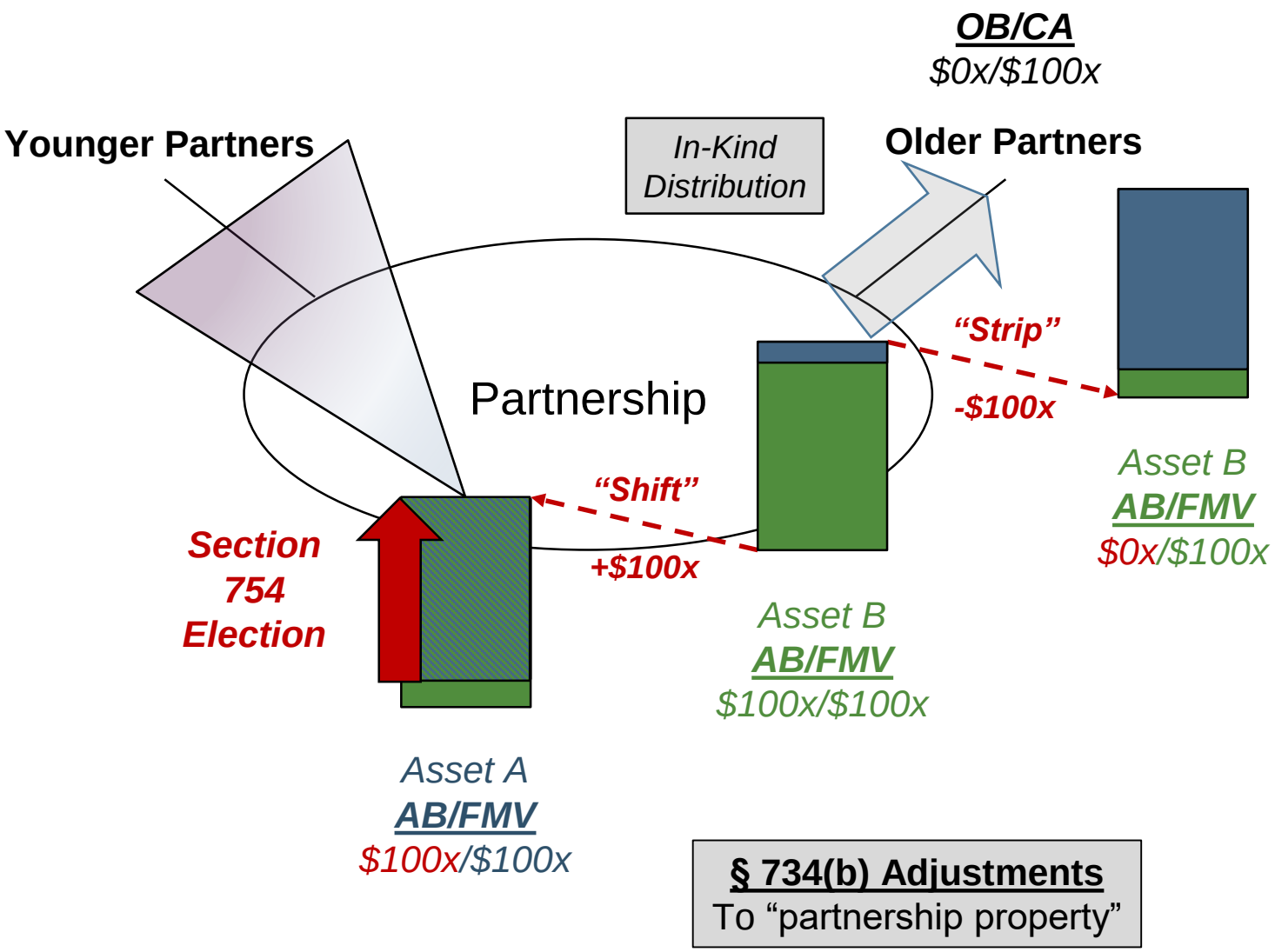
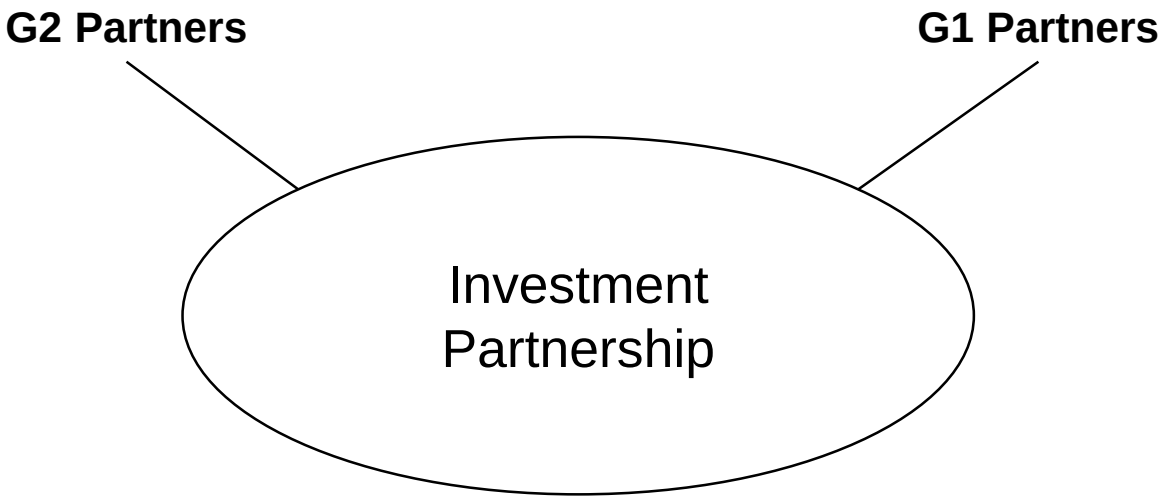
Importance of Partnerships in Tax Basis Management



Creating, Stripping, and Shifting Basis (Even with Marketable Securities)

"Old and Cold" Investment Partnership



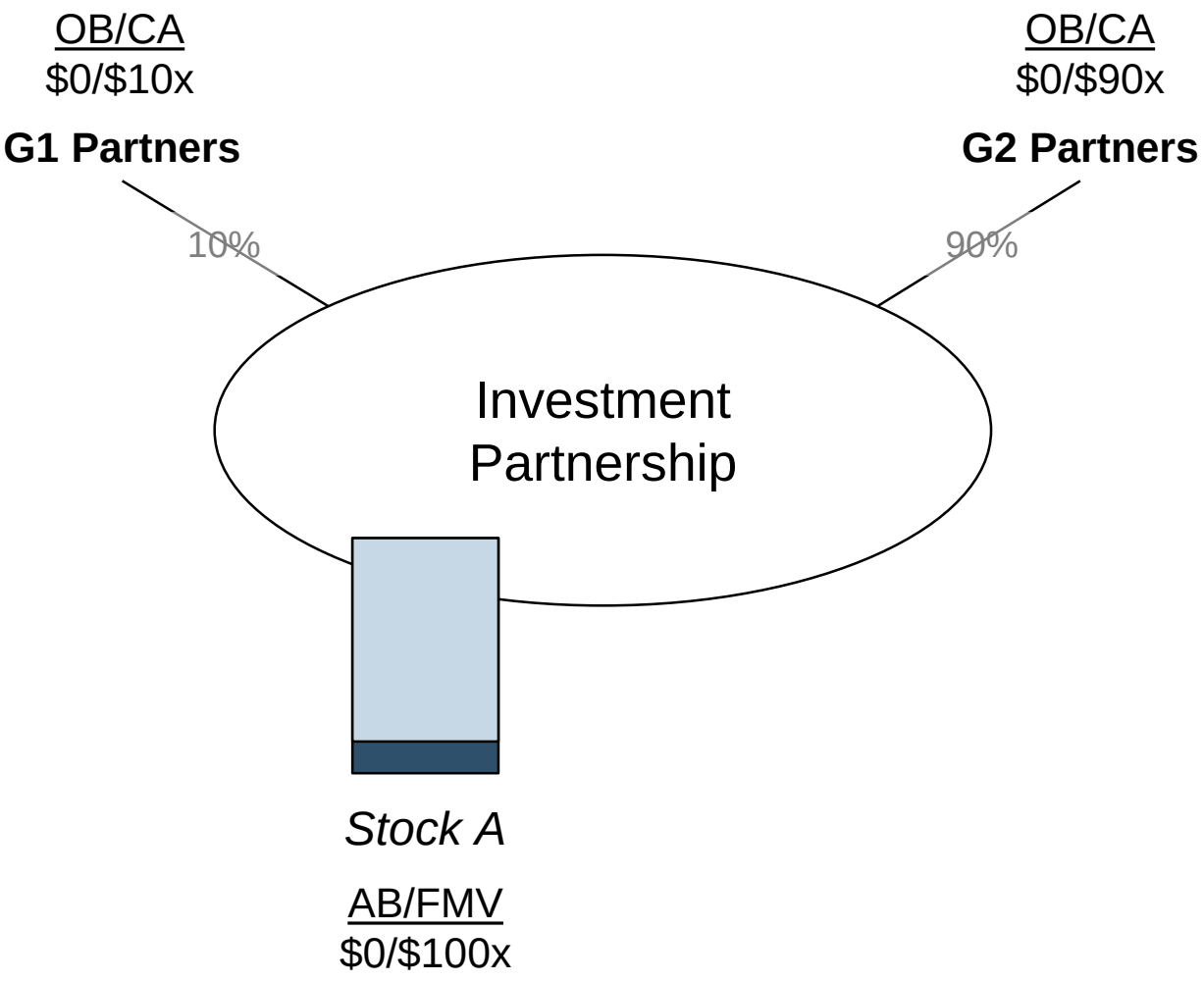
Investment Partnership under § 731(c)(3)(C) of the Code:

- Never engaged in a trade business.
- "Substantially all" (e.g., 90%) assets are (have been):
  - Money
  - Stock in a corporation (including pre-IPO shares)
  - Notes, bonds, debentures, or other debt
  - Derivative financial instruments (e.g., options, futures, short positions)
- All distributions to "eligible partners."

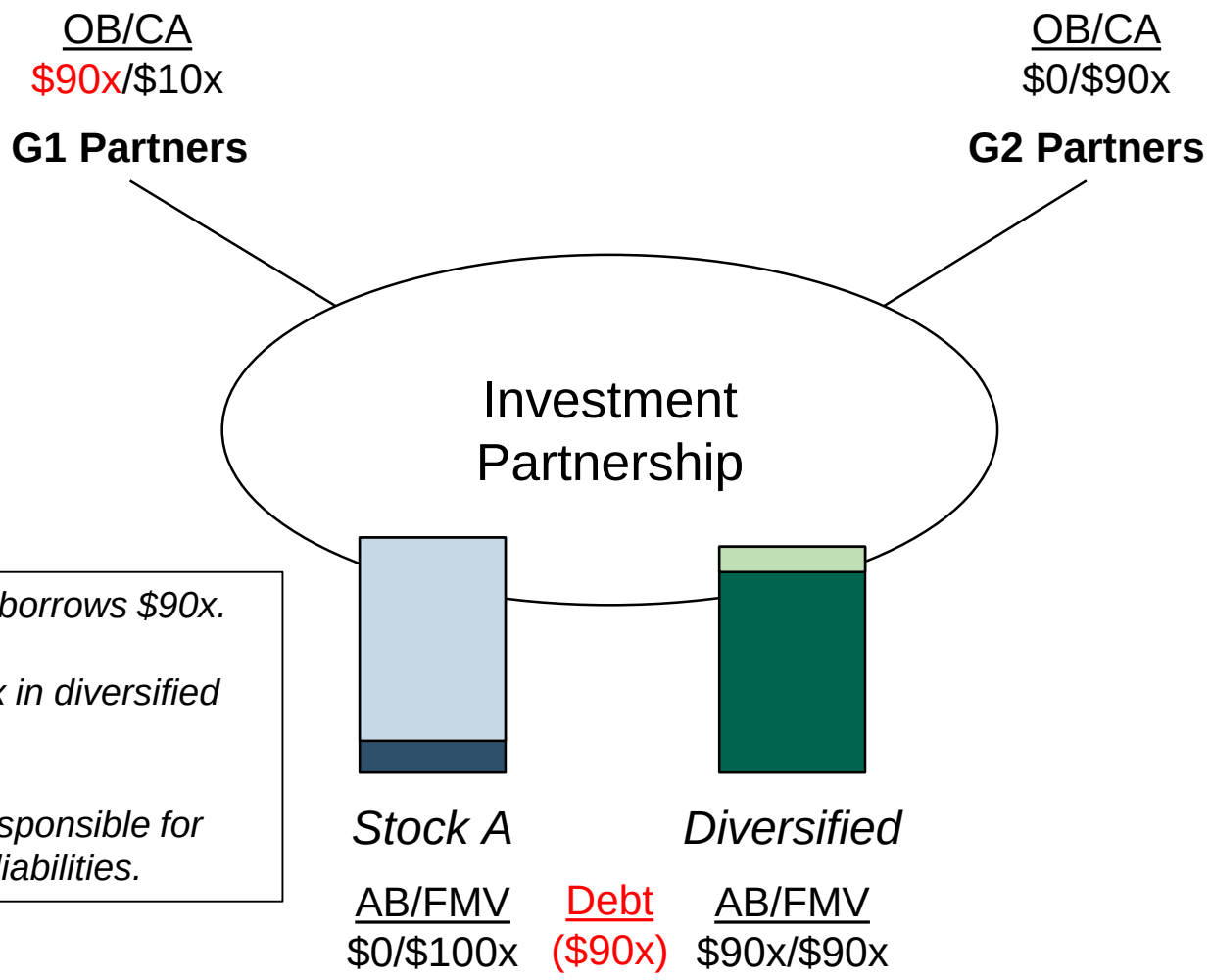
"Mixing Bowl" and "Disguised Sale" Rules Do Not Apply

- All assets purchased by partnership or contributed more than 7-years ago

Debt to Exchange Concentrated for Diversified Position

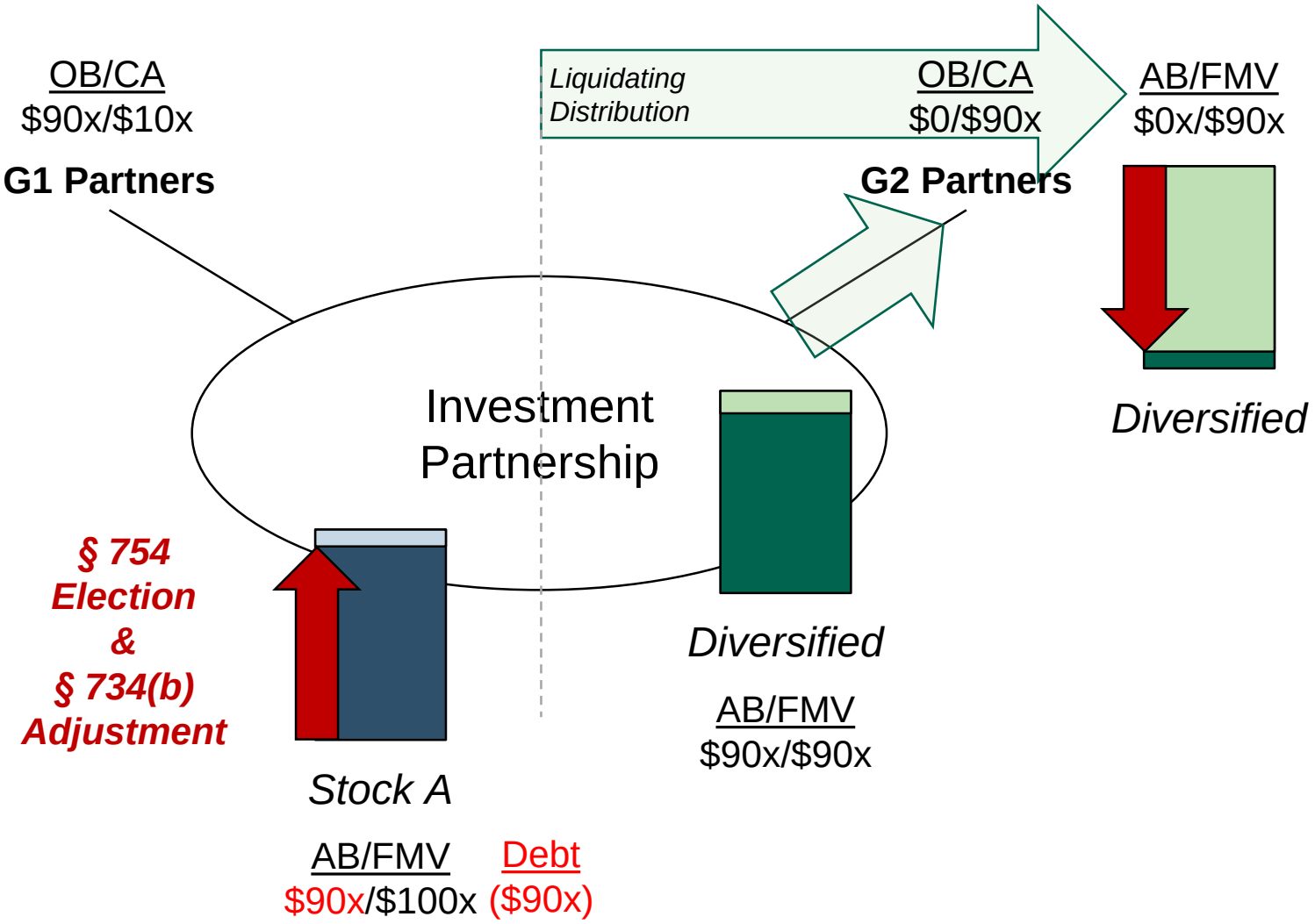


Debt to Exchange Concentrated for Diversified Position



1. *Partnership borrows $90x.*
2. *Invests $90x in diversified portfolio.*
3. *G1 solely responsible for partnership liabilities.*

Debt to Exchange Concentrated for Diversified Position



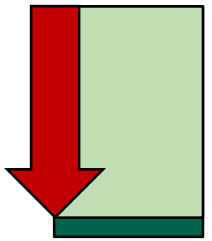
Debt to Exchange Concentrated for Diversified Position

OB/CA
$9x/$10x

G1 Partners

AB/FMV
$0x/$90x

Former G2 Partners



Diversified

Investment Partnership

Stock A

AB/FMV
$9x/$10x

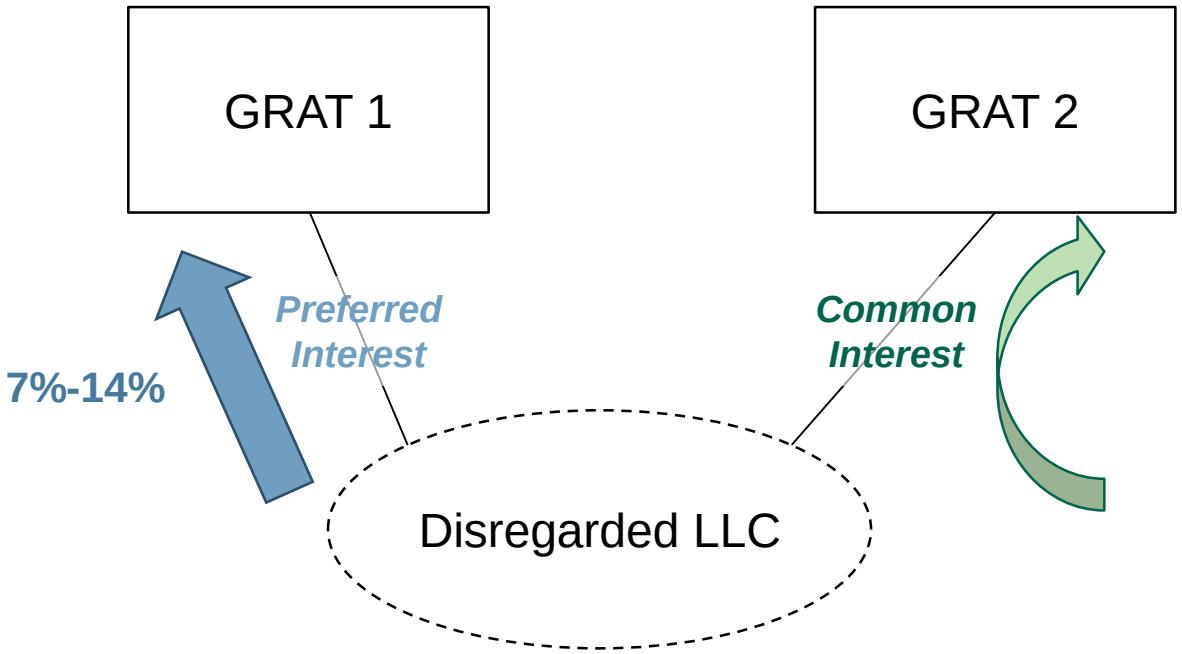
1. *Sells 90x of Stock A ($81x of AB).*
2. *Recognizes $9x of gain (+9x OB of G1=$99x).*
3. *Repays $90x to lender (-$90x OB of G1=$9x).*

Isn't this just an exchange fund?

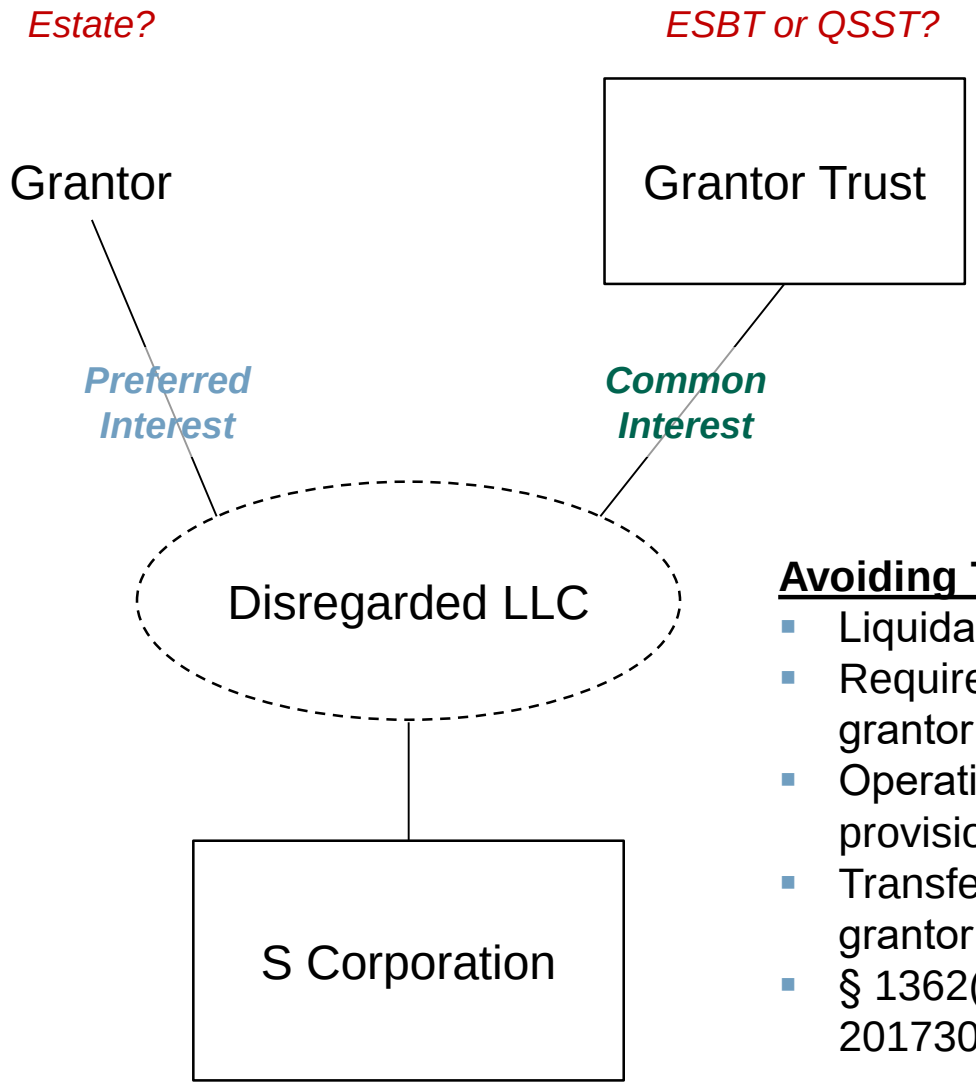
Can this be used with tangible personal property in lieu of a "like-kind" exchange?

Disregarded Entities

Disregarded Entities: GRATs



Preferred Freeze with S Corporation: Disregarded Entities



Avoiding Termination of S Election

- Liquidation of LLC before grantor's death
- Required liquidation/termination of LLC at grantor's death
- Operating agreement "Transfer On Death" provision to trust
- Transfer provision in revocable trust of grantor's interest to trust
- § 1362(f) relief (PLRs 200841007 & 201730002)

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PLANNING FOR THE "NON-TAXABLE" ESTATE

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PLANNING FOR THE "NON-TAXABLE" ESTATE[1]

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I. INTRODUCTION

A. Tax Reform

1. Generally

a. On December 22, 2017, the "To provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018"[2] act, more commonly known as the "Tax Cuts and Jobs Act" ("TCJA") became law. TCJA makes significant changes to the U.S. income tax system including reducing the top income tax rate but eliminating most itemized deductions of individual taxpayers, limiting the deductibility of business interest expense, reducing the corporate tax rate to 21%, adding a special deduction for business income of "pass-thru" entities, and changing the taxation of foreign earnings.

b. A complete discussion of the TCJA is beyond the scope of this outline, but a number of significant changes were made to the income and transfer taxation of individuals and partnerships, disregarded entities, and other non-corporate entities. These are discussed in detail in these materials.

c. Unless otherwise indicated, all changes are effective for tax years beginning after December 31, 2017, and most of the provisions will expire after December 31, 2025, due to the "Byrd rule,"[3] as adopted by the U.S. Senate, which require the affirmative vote of three-fifths of the members (60 Senators if no seats are vacant), which did not occur with TCJA. Thus, most of the provisions of TCJA will "sunset," reverting back to the law that was in place when the provisions were enacted (as discussed later in these materials).

2. Pertinent Changes to the Income Taxation of Individuals and Trusts

a. TCJA adds subsection 1(j) to the Internal Revenue Code of 1986, as amended (the "Code"), that temporarily decreases the highest Federal ordinary income tax rate from 39.6% to 37% (for individual taxpayers with taxable income over $518,400, married

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[1] Portions of these materials were initially prepared for the 52nd Annual Heckerling Institute on Estate Planning (2018), published by LexisNexis Matthew Bender, and are reprinted with the permission of the Heckerling Institute and the University of Miami. Portions of this material have been previously presented by Turney P. Berry & Paul S. Lee. *See also* Turney P. Berry and Paul S. Lee, *Retaining, Obtaining, and Sustaining Basis*, 7 Est. Plan. & Community Prop. L. J. 1 (Fall 2014).

[2] P.L. 115-97. The Senate parliamentarian removed the short title "Tax Cuts and Jobs Act" as extraneous. Hereinafter, P.L. 115-97 will nonetheless be referred to as the "Tax Cuts and Jobs Act" or "TCJA."

[3] Section 313 of the Congressional Budget Act of 1974, as amended (2 U.S.C. § 644).

individuals filing joint returns with taxable income over $622,050, and trusts with taxable income over $12,950).[4]

b. TCJA temporarily increases the standard deduction in 2020 to $12,400 for single filers and $24,800 for joint return filers,[5] but also temporarily limits the deduction for state and local sales, income, or property tax to $10,000.[6]

c. TCJA adds new subsection 67(g) of the Code that temporarily suspends all miscellaneous itemized deductions that are subject to the 2 percent of adjusted gross income floor (for example, unreimbursed employee expenses, tax preparation fees, and other expenses to produce or collect income or expenses to manage, conserve, or maintain property held to produce income).[7]

d. Effective for 2018, TCJA permanently amends the measure of inflation used for indexing of both income and transfer tax purposes, relying on "chained CPI" (Chained Consumer Price Index for All Urban Consumers or C-CPU-I) rather than CPI (CPI-U) used prior to the enactment of TCJA.

3. Pertinent Changes to Transfer Taxation

a. Temporary Doubling of Transfer Tax Exclusions/Exemptions

(1) Effective for estates of decedents dying and gifts made after December 31, 2017, TCJA adds new subparagraph section 2010(c)(3) to the Code that temporarily doubles the basic exclusion amount from $5 million to $10 million, which means, as adjusted for inflation, the basic Applicable Exclusion Amount for 2020 is $11.58 million per person.[8]

(2) As a result, the GST exemption amount for 2020 will also be approximately $11.58 million per person.[9]

b. Clawback and Anti-Clawback Regulations

(1) In order to address the issue of "clawback" (the risk that prior gifts covered by a gift tax exclusion that is greater than the estate tax exclusion available at the time of death, thereby giving rise to the risk of an additional estate tax liability), TCJA adds section 2001(g)(2) of the Code, which provides, "The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out this section with respect to any difference between—(A) the basic exclusion amount under section 2010(c)(3) applicable at the time of the

[4] § 1(j) of the Internal Revenue Code of 1986, as amended (the "Code"). Hereinafter, all section references denoted by the symbol § shall refer to the Code, unless otherwise noted. *See* Rev. Proc. 2019-44, 2019-47 I.R.B. 1023.

[5] § 63(c)(7)(A) and Rev. Proc. 2019-44, 2019-47 I.R.B. 1023.

[6] § 164(b)(6).

[7] § 67(g).

[8] Rev. Proc. 2019-44, 2019-47 I.R.B. 1023

[9] *See* § 2631(c).

decedent's death, and (B) the basic exclusion amount under such section applicable with respect to any gifts made by the decedent."[10]

(2) The estate tax calculation under section 2001(b) of the Code starts with a tentative tax on the combined amount of the taxable estate and adjusted taxable gifts (i.e., gifts after 1976 that are not brought back into the gross estate) without any reduction due to credits.[11] From that amount, the section 2001(b)(2) of the Code says to subtract the amount of gift tax that would have been payable if the rate schedule in effect at the decedent's death had been applicable at the time of the gifts.[12] The Code does not make clear whether, in this part of the calculation, whether to use the unified credit amount that was applied at the time of the gift or apply the credit amount available at death. This is where the risk of clawback theoretically occurs.[13] The final step in the in estate tax calculation applies the estate tax applicable credit amount.

(3) On November 26, 2019, the IRS issued final Treasury Regulations[14] (the "Anti-Clawback Regulations") to "solve" the risk of clawback. The Anti-Clawback Regulations adopt the rule initially proposed in 2018[15] and provides:[16]

> Changes in the basic exclusion amount that occur between the date of a donor's gift and the date of the donor's death may cause the basic exclusion amount allowable on the date of a gift to exceed that allowable on the date of death. If the total of the amounts allowable as a credit in computing the gift tax payable on the decedent's post-1976 gifts, within the meaning of section 2001(b)(2), to the extent such credits are based solely on the basic exclusion amount as defined and adjusted in section 2010(c)(3), exceeds the credit allowable within the meaning of section 2010(a) in computing the estate tax, again only to the extent such credit is based solely on such basic exclusion amount, in each case by applying the tax rates in effect at the decedent's death, then the portion of the credit allowable in computing the estate tax on the decedent's taxable estate that is attributable to the basic exclusion amount is the sum of the amounts attributable to the basic exclusion amount allowable as a credit in computing the gift tax payable on the decedent's post-1976 gifts.

(4) The "solution" in the Anti-Clawback Regulations is to revise the unified credit against the estate tax under section 2010 of the Code, rather than the hypothetical

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[10] § 2001(g)(2).

[11] § 2001(b)(1).

[12] § 2001(b)(2).

[13] The Form 706 instruction for "Line 7 Worksheet" provides that the basic exclusion amount available in each year using a Table of Basic Exclusion Amounts for each year in which gifts were made, from 1977 to date, (plus any applicable deceased spousal unused exclusion amount) is used in calculating the gift tax that would have been payable in that year (but using date of death tax rates). The effect is that the tentative tax on the taxable estate plus adjusted taxable gifts would NOT be reduced by any gift tax payable on those gifts if the gifts were covered by the Applicable Exclusion Amount at such time. Thus, the tentative estate tax would include a tax on the prior gifts that were sheltered by the Applicable Exclusion Amount.

[14] T.D. 9884, 84 Fed. Reg. 64,995 (11/26/19) (the "Anti-Clawback Regulations").

[15] REG-106706-18 (the "Proposed Anti-Clawback Regulations")

[16] Treas. Reg. § 20.2010-1(c).

gift tax under section 2001 of the Code. The preamble to the proposed Treasury Regulations published in 2018 asserts this approach was the "most administrable solution."[17] The preamble to the proposed Treasury Regulations describes a 5-step process for calculating the Federal estate tax. The first three steps determine the net tentative tax due (tax on the gross estate reduced by gift tax on taxable gifts after 1976, reduced by all credits available on such gifts). Step 4 requires a determination of the allowable estate tax credit equal to the Applicable Exclusion Amount in effect at the date of death. To address clawback, the preamble explains that the Anti-Clawback Regulations modify the amount in Step 4 such that "As modified, Step 4 of the estate tax determination therefore would require the determination of a credit equal to the tentative tax on the AEA[18] as in effect on the date of the decedent's death, where the BEA[19] included in that AEA is the larger of (i) the BEA as in effect on the date of the decedent's death under section 2010(c)(3), or (ii) the total amount of the BEA allowable in determining Step 2 of the estate tax computation (that is, the gift tax payable)."[20] As explained by a 2018 release, "the proposed regulations provide a special rule that allows the estate to compute its estate tax credit using the higher of the BEA applicable to gifts made during life or the BEA applicable on the date of death."[21]

(5) The practical effect of the foregoing "solution" is that in order for taxpayers to take advantage of the temporary increase in the Applicable Exclusion Amount under TCJA, taxpayers must first make a taxable gift that exhausts the original Applicable Exclusion Amount. In other words, there is no opportunity for taxpayers to make a taxable gift of $5.79 million (the temporary increase amount for 2019) "off the top" and still preserve the original $5.79 million of exclusion that existed prior to the enactment of TCJA. The preamble to the Anti-Clawback Regulations provides:[22]

> Specifically, the increased BEA[23] as adjusted for inflation is a "use or lose" benefit and is available to a decedent who survives the increased BEA period only to the extent the decedent "used" it by making gifts during the increased BEA period. The final regulations include Example 2 in § 20.2010-1(c)(2)(ii) to demonstrate that the application of the special rule is based on gifts actually made, and thus is inapplicable to a decedent who did not make gifts in excess of the date of death BEA as adjusted for inflation.

---

[17] The adjustment would be made to Step 4 in the calculation described in the preamble. Preamble to the Proposed Anti-Clawback Regulations.

[18] Applicable Exclusion Amount.

[19] Basic Exclusion Amount.

[20] The preamble also explains, "Some commenters suggested a BEA ordering rule, similar to that for DSUE, under which the increase in the BEA during the increased BEA period over the BEA in effect in 2017 (base BEA) is deemed to be allowable against gifts before the base BEA. They posited that this would allow donors to utilize the increase in the BEA without being deemed to have utilized the base BEA, so that the base BEA would remain available for transfers made after 2025. Specifically, a $5 million gift made during the increased BEA period would use the temporary increase in the BEA and preserve or "bank" the base BEA of $5 million so as to be available after 2025 for either gift or estate tax purposes. This suggestion was not adopted for several reasons." Preamble to the Proposed Anti-Clawback Regulations.

[21] IR-2018-229 (Nov. 11, 2018).

[22] Preamble to the Anti-Clawback Regulations.

[23] Basic Exclusion Amount, which includes the temporary increase under TCJA.

Example 2 provides a fact situation where A makes taxable gifts of $4 million at a time when the basic exclusion amount (BEA, which includes the temporary increase under TCJA) is $11.4 million (a gift in 2019). At the time of A's death, the BEA is $6.8 million (after 2025). In this situation, the example concludes, "Because the total of the amounts allowable as a credit in computing the gift tax payable on A's post-1976 gifts is less than the credit based on the $6.8 million basic exclusion amount allowable on A's date of death, this paragraph (c) does not apply. The credit to be applied for purposes of computing A's estate tax is based on the $6.8 million basic exclusion amount as of A's date of death, subject to the limitation of section 2010(d).

(6) For clients with taxable estates equal to or less than the original Applicable Exclusion Amount, there is no need to make any taxable gifts (other than, perhaps, annual exclusion gifts). As discussed later in these materials, preserving the Applicable Exclusion Amount for estate tax purposes in order to get a "free" step-up in basis on assets is recommended for these clients. For the ultra-wealthy with taxable estates far in excess of the temporarily doubled Applicable Exclusion Amount, large taxable gifts that exhaust the original Applicable Exclusion Amount and the temporary increase are likely to be the best advice. For the "middle class" wealthy, roughly defined as individuals with taxable estates of $5.79 million to $20 million (married couples with $11.58 to $40 million), the advice is much more complicated, highly dependent on a number of factors including whether the client can afford to make a gift in excess of the original Applicable Exclusion Amount in order to get the transfer tax benefit of the temporary increase under TCJA. To that end, practitioners should consider spousal lifetime access trusts, preferred partnership freezes (i.e., retention of the preferred interest and transfer of the common interest), or other similar planning techniques that might allow the taxpayer indirect (or direct) access to gifted assets if needed. In addition, for married clients, careful consideration should be given to whether to make a "split-gift" election under section 2513 of the Code in one or more taxable years since when the election is in effect, all taxable gifts for the year (whether made by one spouse or the other) are deemed to be made one-half by each spouse.[24] For example, consider a married couple that makes an $11.58 million taxable gift in 2025 from the assets owned by one of the spouses, intending to use a portion of the increased (bonus) exclusion before expiration in 2026. If split-gift election is in place, each spouse will be deemed to have made a $5.79 million gift, exhausting each of their original Applicable Exclusion Amounts, leaving each with no remaining exclusion in 2026 (other than any inflation-adjustment for that year). If, on the other hand, there is no split-gift election, then the gifting spouse will have utilized $11.58 million of his or her exclusion, and the non-gifting spouse would still retain the original Applicable Exclusion.

[24] Treas. Reg. 25.2513-1(b).

4. Qualified Business Income of "Pass-Thru" Entities

a. TCJA adds new section 199A of the Code (Qualified Business Income) for the benefit of any "taxpayer other than a corporation."[25] As such, this provision applies to sole proprietors, independent contractors, disregarded entities, partnership, and S corporations. In short and in great simplification, section 199A of the Code provides a 20% deduction for the "qualified business income" from a "qualified trade or business," which generally means any trade or business other than a "specified service trade or business" or the trade or business of "performing services as an employee" (other than a certain threshold amount). The section 199A deduction expires January 1, 2026.[26]

b. Generally, for taxpayers whose taxable income exceeds the threshold amounts (defined below) the section 199A deduction will be limited based, in whole or in part, on: (i) the type of trade or business engaged in by the taxpayer; (ii) the amount of W-2 wages paid with respect to the trade or businesses; and (iii) the unadjusted basis immediately after acquisition of qualified property held for use in the trade or business. The latter two limitations are often referred to as the "wages and basis" limitations, and these limitations can significantly limit the deduction under section 199A.

c. Qualified Business Income

(1) "Qualified business income"[27] is the net amount of "qualified items" with respect to any "qualified trade or business" of the taxpayer but does not include any qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income (such items of income are separately afforded a deduction under section 199A of the Code). In addition, qualified business income does not include:[28] (i) any reasonable compensation paid to the taxpayer for services rendered with respect to the trade or business; (ii) any guaranteed payment[29] for services rendered with respect to the trade or business; and (iii) to the extent provided in regulations, any amount paid or incurred by a partnership to a partner who is acting other than in his or her capacity as a partner for services.[30]

(2) "Qualified items" are only included in the definition of qualified business income to the extent such items of income that are effectively connected with the conduct of a U.S. trade or business within the meaning of section 864(c) of the Code.[31] Specific "investment items" are excluded, including:[32]

(a) Any item of short-term and long-term capital gain or loss;

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[25] § 199A(a).

[26] § 199A(i).

[27] § 199A(c)(3)(A).

[28] § 199A(c)(4).

[29] As described in section 707(c).

[30] As described in section 707(a).

[31] § 199A(c)(3)(A)(i).

[32] § 199A(c)(3)(B).

(b) Any dividend, income equivalent to a dividend, or payment in lieu of dividends;

(c) Any interest income, other than interest income which is properly allocable to a trade or business;

(d) Any gain or loss from commodities transactions, other than those entered into in the normal course of the trade or business or with respect to stock in trade or property held primarily for sale to customers in the ordinary course of the trade or business, property used in the trade or business, or supplies regularly used or consumed in the trade or business;

(e) Any foreign currency gains from section 988 transactions, other than transactions directly related to the business needs of the business activity;

(f) Net income from notional principal contracts, other than those clearly identified hedging transactions that are treated as ordinary income; and

(g) Any amount received from an annuity that is not used in the trade or business of the business activity.

(3) "Qualified trade or business" means any trade or business other than a "specified service trade or business," or the "trade or business of performing services as an employee."[33]

(4) "Specified service trade or business" includes:

(a) Services that are excluded from the definition of "qualified trade or business" under section 1202(e)(3)(A) of the Code (qualified small business stock, as discussed in more detail later in these materials) but carves out engineering and architecture services for these purposes,[34] leaving services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees or owners; or

(b) Services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.[35]

(5) The foregoing exclusion from the definition of a qualified business for specified service trades or businesses phases in for a taxpayer with taxable income in excess of a "threshold amount" and becomes fully effective once taxable income exceeds the threshold amount by $50,000 ($100,000 in the case of a joint return).[36] The initial "threshold amount" was $157,500 for each taxpayer (twice the amount in the case of a joint return).[37] This

[33] § 199A(d)(1).

[34] § 199A(d)(2)(A).

[35] § 199A(d)(2)(B).

[36] § 199A(d)(3).

[37] § 199A(e)(2)(A).

amount has been adjusted for inflation after 2018,[38] and in 2020 the threshold amount is $163,300.[39]

d. The amount of the deduction for each taxable year of the taxpayer under section 199A of the Code is equal to the ***SUM*** of:

(1) The *lesser* of:

(a) The "combined qualified business income amount of the taxpayer,"[40] or

(b) 20 percent of "the excess (if any) of—(i) the taxable income of the taxpayer for the taxable year, over (ii) the sum of any net capital gain (as defined in section 1(h)) plus the aggregate amount of the qualified cooperative dividends, of the taxpayer for the taxable year," [41] **PLUS**

(2) The *lesser* of:

(a) 20 percent of the "aggregate amount of the qualified cooperative dividends of the taxpayer for the taxable year,"[42] or

(b) The "taxable income (reduced by the net capital gain (as so defined)) of the taxpayer for the taxable year."[43]

e. The foregoing resulting amount may not exceed the taxable income of the taxpayer for the taxable year (reduced by net capital gain).[44]

f. "Combined qualified business income" is the **SUM** of:

(1) The sum of "deductible amount for each trade or business,"[45] **PLUS**

(2) 20 percent of the "aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year."[46]

g. The "deductible amount for each trade or business" is the *lesser* of:

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[38] § 199A(e)(2)(B).

[39] Rev. Proc. 2019-44, 2019-47 I.R.B. 1093.

[40] § 199A(a)(1)(A).

[41] § 199A(a)(1)(B).

[42] § 199A(a)(2)(A).

[43] § 199A(a)(2)(B).

[44] § 199A(a) [flush language].

[45] §§ 199A(b) [title to the subsection] and 199A(b)(1)(A).

[46] § 199A(b)(1)(B).

(1) 20 percent of the taxpayer's "qualified business income with respect to the qualified trade or business,"[47] or

(2) The "greater of—(i) 50 percent of the W–2 wages with respect to the qualified trade or business, or (ii) the sum of 25 percent of the W–2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property."[48]

h. "Qualified property" means tangible property of a character subject to depreciation that is held by, and available for use in, the qualified trade or business at the close of the taxable year, and which is used in the production of qualified business income, and for which the depreciable period has not ended before the close of the taxable year. [49] The depreciable period with respect to qualified property of a taxpayer means the period beginning on the date the property is first placed in service by the taxpayer and ending on the later of (i) the date 10 years after that date, or (ii) the last day of the last full year in the applicable recovery period that would apply to the property under section 168 of the Code (without regard to section 168(g) of the Code—alternative depreciation for certain types of property).[50]

i. The foregoing alternative calculation with W-2 wage will allow real estate businesses with large capital investments (regardless of whether financed) but very few employees to qualify for the section 199A deduction. It should be noted that there does not seem to be distinction between qualified property acquired before or after the effective date of the TCJA.

j. In the case of partnerships (and S corporations), the Code provides that section 199A of the Code will be applied at the partner (shareholder) level, each partner (shareholder) will take into account such person's allocable share of each qualified item, and each partner (shareholder) will be treated as having W-2 wages and unadjusted basis "immediately after acquisition of qualified property for the taxable year in an amount equal to such person's allocable share of the W–2 wages and the unadjusted basis immediately after acquisition of qualified property of the partnership or S corporation for the taxable year (as determined under regulations prescribed by the Secretary)."[51] For these purposes: (i) W-2 wages are determined in the same manner as the partner's (shareholder's) allocable share of wage expense; (ii) a partner's (shareholder's) allocable share of the unadjusted basis shall be determined in the same manner as the partner's (shareholder's) allocable share of depreciation; and (iii) for purposes of an S corporation, an allocable share shall be the shareholder's pro rata share of an item (wage expense or depreciation).[52]

k. Trusts and estates are eligible for the deduction under section 199A of the Code. To that end, the Code provides that rules similar to those under section 199(d)(1)(B)(i)

[47] § 199A(b)(2)(A).

[48] § 199A(b)(2)(B).

[49] § 199A(b)(6)(A).

[50] § 199A(b)(6)(B).

[51] § 199A(f)(1)(A).

[52] *Id.* [flush language].

(as in effect on December 1, 2017) for the apportionment of W-2 wages and unadjusted basis immediately after acquisition of qualified property.[53]

5. Pertinent Provisions of the 199A & 643(f) Final Regulations

a. Generally

(1) On February 8, 2019, the Treasury Department issued final Treasury Regulations under section 199A (the "199A Final Regulations"), along with anti-avoidance rules under section 643(f) of the Code (the "643(f) Final Regulations"). [54] A complete discussion of all of the provisions of the final regulations is beyond the scope of these materials, but certain provisions are important to note.

(2) The 199A Final Regulations provides needed guidance on the particulars of how the deduction is calculated and limited. However, it does not provide an expansive aggregation option to maximize the deduction, leaving entities with the question about whether a tax free merger or combination would be a better option.

b. Trade or Business Defined

(1) Trade or business is not defined in section 199A of the Code. The 199A Final Regulations adopts a definition of "trade or business" as used in section 162(a) of the Code, dealing with the deductibility of ordinary and necessary business expenses. Thus, "trade or business" means "a trade or business that is a trade or business under section 162 (a section 162 trade or business) other than the trade or business of performing services as an employee."[55]

(2) Solely for purposes of 199A, "trade or business" is extended to include the rental or licensing of tangible or intangible property to a related trade or business is treated as a trade or business if the rental or licensing and the other trade or business are commonly controlled, as defined in the aggregation rule discussed below but regardless of whether such rental or licensing trade or business can be aggregated under the entire rule.[56]

[53] § 199A(f)(1)(B),

[54] T.D. 9847, 84 Fed. Reg. 2952 (2-8-19) (collectively referred to as the "199A Final Regulations").

[55] Treas. Reg. § 1.199A-1(b)(14).

[56] *Id.*

c. Aggregation

(1) As written, the section 199A deduction is limited and calculated based separately for each trade or business. However, a taxpayer can have a trade or business that is operated across multiple legal entities. Thus, with the wages and basis limitations applied at each trade or business, there could potentially be very little allowable deduction under section 199A. A question arose as to whether, in order to maximize the section 199A deduction, taxpayers would need to legally restructure (e.g., merge entities) some or all of their trades or businesses. In response, the 199A Final Regulations permits (but does not require) aggregation of separate trades or businesses.[57]

(2) Under the 199A Proposed Regulations, aggregation is permitted but only if the individual (which includes a non-grantor trust and an estate[58]) can satisfy the following requirements:

(a) The same person or group of persons, directly or indirectly, by attribution under sections 267(b) or 707(b) of the Code, owns 50 percent or more of each trade or business to be aggregated, meaning in the case of such trades or businesses owned by an S corporation, 50 percent or more of the issued and outstanding shares of the corporation, or, in the case of such trades or businesses owned by a partnership, 50 percent or more of the capital or profits in the partnership;[59]

(b) The ownership requirement described above exists for a majority of the taxable year, including the last day of the taxable year, in which the items attributable to each trade or business to be aggregated are included in income;[60]

(c) All of the items attributable to each trade or business to be aggregated are reported on returns with the same taxable year, not taking into account short taxable years;[61]

(d) None of the trades or businesses to be aggregated is a specified service trade or business;[62] and

(e) The trades or business to be aggregated satisfy at least two of the following (based on facts and circumstances): (i) the trades or businesses provide products and services that are the same or customarily offered together; (ii) the trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources; and (iii) the trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group.[63]

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[57] Each trade or business must itself be a trade or business as defined in section 1.199A-1(b)(14) of the Treasury Regulations.

[58] *See* Treas. Reg. § 1.199A-1(a)(2).

[59] Treas. Reg. § 1.199A-4(b)(1)(i).

[60] Treas. Reg. § 1.199A-4(b)(1)(ii).

[61] Treas. Reg. § 1.199A-4(b)(1)(iii).

[62] Treas. Reg. §§ 1.199A-4(b)(1)(iv) and 1.199A-5 (for definition of a specified service trade or business).

[63] Treas. Reg. § 1.199A-4(b)(1)(v).

(3) Once an individual chooses to aggregate businesses, the individual must consistently report the aggregated trades or business in all subsequent taxable years.[64] An individual may add a newly created or nearly acquired (whether through a non-recognition transaction or not) trade or business.[65] Furthermore, if there is a "significant change in facts and circumstances" and a previously aggregated business no longer qualifies under the rules, then the trade or business will no longer be aggregate, but the individual can reapply for aggregation if allowable under the rules set above.[66]

(4) On the other end of the spectrum, the 199A Final Regulations have rules where an individual or "relevant passthrough entity"[67] (RPE) conducts multiple trades or businesses and has items of qualified business income that are properly attributable to more than one trade or business, the taxpayer or entity must allocate those items among the several trades or businesses to which they are attributable using a "reasonable method based on all the facts and circumstances."[68] The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect the income of each trade or business. It remains to be seen whether pass-thru entities that would not qualify under the aggregation option will choose to legally merge or otherwise combine and rely upon this rule instead.

d. Multiple Trust Provisions

(1) The 199A Final Regulations provide, "A trust formed or funded with a principal purpose of avoiding, or of using more than one, threshold amount for purposes of calculating the deduction under section 199A will not be respected as a separate trust entity for purposes of determining the threshold amount for purposes of section 199A."[69] This provision applies for taxable years ending after December 22, 2017.[70] The 199A Final Regulations then cite the 643(f) Final Regulations.

(2) Section 643(f) of the Code authorizes the Treasury Department to issue Treasury Regulations pursuant to which 2 or more trusts would be treated as 1 trust if: (i) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries; and (ii) a principal purpose of such trust is the avoidance of a tax.[71] For this purpose, spouses (the Code section actually reads, husband and wife) are treated as one person.[72] Until now, Treasury Regulations had not been issued.

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[64] Treas. Reg. § 1.199A-4(c)(1).

[65] *Id.*

[66] *Id.*

[67] A partnership (other than a publicly traded partnership) or an S-corporation that is owned, directly or indirectly by at least one individual, estate, or trust. *See* Treas. Reg. § 1.199A-1(b)(10).

[68] Treas. Reg. § 1.199A-3(b)(5).

[69] Treas. Reg. § 1.199A-6(d)(3)(vii).

[70] Treas. Reg. § 1.199A-6(e)(2)(i).

[71] § 643(f).

[72] *Id.* (flush language).

(3) The new 643(f) Final Regulations provide:[73]

> For purposes of subchapter J of chapter 1 of Title 26 of the United States Code, two or more trusts will be aggregated and treated as a single trust if such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and if a principal purpose for establishing such trusts or for contributing additional cash or other property to such trusts is the avoidance of Federal income tax. For purposes of applying this rule, spouses will be treated as one person.

(4) The proposed Treasury Regulations issued in 2018[74] provided a "principal purpose" provision which read, "A principal purpose for establishing or funding a trust will be presumed if it results in a significant income tax benefit unless there is a significant non-tax (or non-income tax) purpose that could not have been achieved without the creation of these separate trusts."[75] This provision and the examples noted below were stricken from the 643(f) Final Regulations. The preamble to the 643(f) Final Regulations, in response to comments to the proposed regulations, explained:

> [T]he Treasury Department and the IRS have removed the definition of "principal purpose" and the examples illustrating this rule that had been included in the proposed regulations, and are taking under advisement whether and how these questions should be addressed in future guidance. This includes questions of whether certain terms such as "principal purpose" and "substantially identical grantors and beneficiaries" should be defined or their meaning clarified in regulations or other guidance, along with providing illustrating examples for each of these terms. Nevertheless, the position of the Treasury Department and the IRS remains that the determination of whether an arrangement involving multiple trusts is subject to treatment under section 643(f) may be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 643(f), in the case of any arrangement involving multiple trusts entered into or modified before the effective date of these final regulations.

(5) The proposed regulations provided two examples. The first was a straightforward example where multiple and nearly identical trusts were created to solely maximize the section 199A deduction, and the trusts were aggregated into a single trust.[76] The second read, as follows:[77]

> *Example 2*. (i) X establishes two irrevocable trusts: one for the benefit of X's son, G, and the other for X's daughter, H. G is the income beneficiary of the first trust and the trustee is required to apply all income currently to G for G's life. H is the remainder beneficiary of the first trust. H is an income beneficiary of the second trust and the trust instrument permits the trustee to accumulate or to pay income, in its discretion, to H for H's education, support, and maintenance. The trustee

[73] Treas. Reg. § 1.643(f)-1(a).

[74] REG-107892-18 (the "643(f) Proposed Regulations").

[75] Prop. Treas. Reg. § 1.643(f)-1(b).

[76] Prop. Treas. Reg. § 1.643(f)-(1)(c), *Ex. 1*.

[77] Prop. Treas. Reg. § 1.643(f)-(1)(c), *Ex. 2*.

also may pay income or corpus for G's medical expenses. H is the remainder beneficiary of the second trust and will receive the trust corpus upon G's death.

(ii) Under these facts, there are significant non-tax differences between the substantive terms of the two trusts, so tax avoidance will not be presumed to be a principal purpose for the establishment or funding of the separate trusts. Accordingly, in the absence of other facts or circumstances that would indicate that a principal purpose for creating the two separate trusts was income tax avoidance, the two trusts will not be aggregated and treated as a single trust for Federal income tax purposes under this section.

(6) Even though the foregoing example was removed, it seems to imply that the aggregation of multiple trusts into one trust would not be applicable if, for example, a grantor created separate trusts for each of his or her children (and their descendants as remainder beneficiaries) even if each of the trust provisions were otherwise identical. Moreover, if significant differences existed between different trusts for the same group of beneficiaries, it would seem that aggregation would not be applicable either. The issue is how significant must such non-tax differences be to avoid the application of aggregation of the trusts.

(7) The effective date for the 643(f) Final Regulations apply to taxable years ending after August 16, 2018.[78] Although the preamble to the proposed regulation explains that it could apply to arrangements and trusts created prior to that point, "In the case of any arrangement involving multiple trusts entered into or modified before August 16, 2018, the determination of whether an arrangement involving multiple trusts is subject to treatment under section 643(f) will be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 643(f)."[79]

(8) The preamble to the proposed regulation points out, "The application of proposed §1.643(f)-1, however, is not limited to avoidance of the limitations under section 199A and proposed §§1.199A-1 through 1.199A-6."[80] Thus, for example, this rule might apply to one of the limitations on the sale of section 1202 (qualified small business stock) gain, as discussed in more detail below, which are limited to the definition a particular taxpayer.

6. Carried Partnership Interests and Transfers to Related Parties

a. Effective for tax years beginning after December 31, 2017, TCJA inserts a permanent "replacement" section 1061 of the Code[81] for certain partnership interest held in connection the performance of services, addressing the tax treatment of a profits interest in a partnership in exchange for the performance of services (often referred to as a carried interest). The provision treats as short-term capital gain taxed at ordinary income rates the amount of the taxpayer's net long-term capital gain "with respect to"[82] one or more "applicable

[78] Prop. Treas. Reg. § 1.643(f)-(1)(b).

[79] Preamble to 643(f) Proposed Regulations (Explanation of Provisions, VII. Proposed §1.643(f)-1: Anti-avoidance Rules for Multiple Trusts).

[80] *Id.*

[81] Redesignating the current section 1061 to section 1062 of the Code.

[82] § 1061(a)(1) and (2).

partnership interests"[83] that are held by a taxpayer at any time during the taxable year that exceeds the amount of such gain calculated as if a three-year holding period applies.

b. While the Code section as written is not the paragon of clarity, it seems as though section 1061 of the Code imposes a three-year holding period on an applicable partnership interest for purposes of determining the compensation of the partner (if granted the interest for the performance of services) or determining the character of any gain if the partnership interest is sold or otherwise transferred. In addition, section 1061 of the Code seems to (but not entirely clear) change the distributive share of gain to the holder of an applicable partnership interest by requiring a three-year holding period. What is not clear at all is whether the three-year holding period applies to the holding period of partnership property sold or exchanged for a taxable gain (as allocated to a partner as distributive share) or whether all net long-term capital gain (one-year holding period) is treated as short-term capital gain but only for the first three years held by the partner. Technical corrections or guidance from the Treasury Department or Congress would be greatly appreciated.

c. An "applicable partnership interest" is any interest in a partnership which, "directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person,"[84] in an "applicable trade or business." An applicable partnership interest does not include any "capital interest" in the partnership, which provides the taxpayer with a "right to share in the partnership capital commensurate with—(i) the amount of capital contributed…, or (ii) the value of such interest subject to tax under section 83 upon the receipt or vesting of such interest."[85] In addition, an applicable partnership interest does not include an interest held by a person who is employed by another entity that is conducting a trade or business (which is not an applicable trade or business) and who provides services only to the other entity.[86] There is also an exception for a partnership interest held by a "corporation."[87] The Conference report gives an example of two corporations that form a partnership to conduct a joint venture for developing and marketing a pharmaceutical product. The partnership interests held by the two corporations are not applicable partnership interests. Some practitioners had suggested that to avoid section 1061 that taxpayers could contribute their carried interest to an S corporation. In response, the IRS issued Notice 2018-18 which provides that the IRS intends to issue regulations that will provide that the term "corporation" in section 1061(c)(4)(A) does not include an S corporation and that will provide the regulations will have the same effective date as section 1061 (taxable years beginning after December 31, 2017).

d. An "applicable trade or business" is defined as "any activity conducted on a regular, continuous, and substantial basis which … consists"[88] of:

(1) "[R]aising or returning capital,"[89] and

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[83] § 1061(a).

[84] § 1061(c)(1).

[85] § 1061(c)(4)(B).

[86] § 1061(c)(1).

[87] § 1061(c)(4)(A).

[88] § 1061(c)(2).

[89] § 1061(c)(2)(A).

(2) Either: "(i) investing of in (or disposing of) specified assets (or identifying specified assets for such investing or disposition), or (ii) developing specified assets."[90]

e. "Specified assets" means:[91]

(1) Securities (as defined under rules for mark-to-market accounting for securities dealers);

(2) Commodities (as defined as defined under rules for mark-to-market accounting for commodities dealers);

(3) Real estate held for rental or investment;

(4) Cash or cash equivalents;

(5) Options or derivative contracts with respect to such securities, commodities, real estate, cash or cash equivalents, as well as an interest in a partnership to the extent of the partnership's proportionate interest in the foregoing.

f. A security for this purpose means any (1) share of corporate stock, (2) partnership interest or beneficial ownership interest in a widely held or publicly traded partnership or trust, (3) note, bond, debenture, or other evidence of indebtedness, (4) interest rate, currency, or equity notional principal contract, (5) interest in, or derivative financial instrument in, any such security or any currency (regardless of whether section 1256 of the Code applies to the contract), and (6) position that is not such a security and is a hedge with respect to such a security and is clearly identified.[92]

g. If a taxpayer "transfers any applicable partnership interest, directly or indirectly, to a person related to the taxpayer,"[93] then the taxpayer includes in gross income as short-term capital gain "so much of the taxpayer's net long-term capital gain with respect to such interest for such taxable year attributable to the sale or exchange of any asset held for not more than 3 years as is allocable to the interest."[94] To avoid double counting, the amount included as short-term capital gain on the transfer is reduced by the amount treated as short-term capital gain on the transfer for the taxable year under the general rule of section 1061(a) of the Code.[95]

h. It is unclear whether "transfer" would include a grantor's assignment of a partnership interest to a grantor trust, whether pursuant to a gratuitous transfer or a sale to an intentionally defective grantor trust.

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[90] § 1061(c)(2)(B).

[91] § 1061(c)(3).

[92] *See* § 475(c)(2).

[93] § 1061(d)(1).

[94] § 1061(d)(1)(A).

[95] § 1061(d)(1)(B).

i. A "related person" for this purpose is:

(1) A member of the taxpayer's family within the meaning of the attribution rules under section 318(a)(1) of the Code (spouse, children, grandchildren, and parents),[96] or

(2) A colleague of the taxpayer, defined as a "person who performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service."[97]

7. Temporary TCJA Estate Planning Landscape

a. The temporary doubling of the exemption equivalent amount (and GST exemption) will likely spur ultra-high net worth families to make taxable gifts to consume the additional exemptions before their scheduled expiration in 2026, similar to the period before 2013 when a reduction of the exemptions was also on the horizon.

b. What is more relevant is that TCJA made no changes to the transfer tax rate and to the "step-up" in basis under section 1014 of the Code. As such, it is clear that planning around the management of tax basis will continue to be a central and evergreen issue for wealthy individuals and families. The "step-up" in basis is a powerful feature of the Internal Revenue Code because it creates basis, often at very little or no estate tax cost (particularly with the large exemptions equivalent amounts [temporarily doubled] and the unlimited estate tax marital deduction).

B. The Old Paradigm: When In Doubt, Transfer Out

1. Notwithstanding the enactment of TCJA, the year 2013, with the enactment of the American Taxpayer Relief Act of 2012[98] ("ATRA") and the imposition of the 3.8% Medicare contribution tax on unearned passive income or net investment income[99] (hereinafter, the "3.8% Medicare Tax") that was enacted as part of the Health Care and Education Reconciliation Act of 2010 ("HCERA"),[100] which amended the Patient Protection and Affordable Care Act ("PPACA"),[101] marked the beginning of a significant change in perspective for estate planners.

2. For many years, estate planning entailed aggressively transferring assets out of the estate of high-net-worth individuals during their lifetimes to avoid the imposition of estate taxes at their deaths and consequently giving up a "step-up" in basis adjustment under section 1014 of the Internal Revenue Code of 1986, as amended (the "Code"). Because the estate tax rates were significantly greater than the income tax rates, the avoidance of estate taxes (typically to the exclusion of any potential income tax savings from the "step-up" in basis) was the primary focus of tax-based estate planning for wealthy individuals.

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[96] § 1061(d)(2)(A).

[97] § 1061(d)(2)(B).

[98] P.L. 112-240, 126 Stat. 2313, enacted January 2, 2013.

[99] § 1411.

[100] P.L. 111–152, 124 Stat. 1029, enacted March 30, 2010.

[101] P.L. 111-148, 124 Stat. 119, enacted on March 23, 2010.

3. By way of example, consider the planning landscape in 2001. The Federal estate and gift tax exemption equivalent was $675,000. The maximum Federal transfer tax (collectively, the estate, gift, and generation-skipping transfer tax) rate was 55%, and the law still provided for a state estate tax Federal credit. Because virtually all of the states had an estate or inheritance tax equal to the credit, the maximum combined Federal and state transfer tax rate was 55%. The combined Federal and state income tax rates were significantly lower than that. Consider the maximum long-term capital gain and ordinary income tax rates of a highly taxed individual, a New York City taxpayer. At that time, the combined maximum Federal, state, and local income tax rate for long-term capital gains was approximately 30% and for ordinary income, less than 50%.[102] As a result, the gap between the maximum transfer tax rate and the long-term capital gain tax rate for a New York City taxpayer was approximately 25%. In other words, for high income, high-net-worth individuals in NYC, there was a 25% tax rate savings by avoiding the transfer tax and foregoing a "step-up" in basis. Because this gap was so large (and larger in other states), estate planning recommendations often came down to the following steps, ideas and truths.

a. Typically, as the first step in the estate planning process, make an inter-vivos taxable gift using the $675,000 exemption equivalent, thereby removing all future appreciation out of the estate tax base.

b. Use the exemption equivalent gift as a foundation to transfer additional assets out of the estate during lifetime (for example, a "seed" gift to an intentionally defective grantor trust ("IDGT")—a trust that is a grantor trust[103] for income tax purposes but the assets of which would not be includible in the estate of the grantor—to support the promissory note issued as part of an installment sale to the IDGT).[104]

c. Draft the trusts and other estate planning structures to avoid estate tax inclusion for as many generations as possible (for example, leveraging the generation-skipping transfer ("GST") tax exemption by applying it to the seed gift to the IDGT and establishing the trust in a jurisdiction that has abolished the rule against perpetuities).

d. Forego the "step-up" in basis adjustment at death on the assets that have been transferred during lifetime, because the transfer tax savings were almost certainly much greater than any potential income tax savings that might result from the basis adjustment at death.

e. Know that the income tax consequences of the various estate planning techniques were appropriately secondary to avoiding the transfer tax.

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[102] Consisting of maximum Federal long-term capital gain tax rate of 28% and ordinary income tax rate of 39.1%, New York State income tax rate of 6.85%, and a New York City income tax rate of 3.59%. The effective combined tax rate depends, in part, on whether the taxpayer is in the alternative minimum tax, and the marginal tax bracket of the taxpayer.

[103] *See* §§ 671-679.

[104] *See, e.g.*, Stuart M. Horwitz & Jason S. Damicone, *Creative Uses of Intentionally Defective Irrevocable Trusts*, 35 Est. Plan. 35 (2008) and Michael D. Mulligan, *Sale to Defective Grantor Trusts: An Alternative to a GRAT*, 23 Est. Plan. 3 (1996).

f. Know that the state of residence of the decedent and the decedent's beneficiaries would not significantly affect the foregoing recommendations or ideas because of the large gap between the transfer tax and the income tax existing consistently across all of the states.

g. As a result, there was an enormous amount of consistency in the estate planning recommendations across the U.S., where the only differentiating factor was the size of the gross estate. In other words, putting aside local law distinctions like community vs. separate property, almost all $20 million dollar estates had essentially the same estate plan (using the same techniques in similar proportions).

4. The enactment of ATRA marked the beginning of a "permanent" change in perspective on estate planning for high-net-worth individuals. The large gap between the transfer and income tax rates, which was the mathematical reason for aggressively transferring assets during lifetime, has narrowed considerably, and in some states, there is virtually no difference in the rates. With ATRA's very generous applicable exclusion provisions, the focus of estate planning will become less about avoiding the transfer taxes and more about avoiding income taxes.

C. The "Permanent" Tax Landscape

1. Generally

a. As mentioned above, many of the income and transfer tax provisions of the TCJA affecting individuals will expire in 2026. As such, the "permanent" tax landscape for estate planners was transformed in 2013 due to increased income tax rates, and falling transfer tax liability, at both the Federal and state level. On the Federal side, the income and transfer tax provisions that became effective January 1, 2013, were enacted as part of ATRA, PPACA, and HCERA (the 3.8% Medicare tax). In the states, many states increased their income tax rates,[105] and a number of states continued the trend of repealing their state death tax (estate and inheritance tax).[106]

b. A complete discussion of all of the provisions of the Federal laws and the state laws is beyond the discussion of this outline. So, this outline will limit the discussion to the most relevant provisions.

[105] For example, the California enactment in 2012 of the Temporary Taxes to Fund Education, commonly known as Proposition 30 that raised the highest marginal income tax bracket to 13.3%.

[106] For example, (i) effective January 1, 2018, the New Jersey estate tax will be repealed; (ii) effective April 1, 2014, New York modified its state estate tax to immediately increase the state estate tax exemption from $1,000,000 to $2,062,500 per person and eventually have the exemption equal the Federal Applicable Exclusion amount by 2019; (iii) on July 23, 2013, North Carolina repealed its estate tax (effective date of January 1, 2013); and (iv) on May 8, 2013, Indiana repealed its inheritance tax (effective date of January 1, 2013).

2. Pertinent Provisions of ATRA

a. Federal Transfer Tax Landscape (Assuming No TCJA)

(1) Summary of the Pertinent Transfer Tax Provisions

(a) The top estate, gift, and GST tax rate is 40%.[107]

(b) The basic exclusion amount for each individual is $5 million,[108] indexed for inflation after 2011[109] ($5.79 million for 2020).[110]

(c) The applicable exclusion amount[111] (sometimes referred to as the "Applicable Exclusion Amount" or the "Applicable Exclusion") is the sum of base exclusion amount and in the case of a surviving spouse, the deceased spousal unused exclusion amount (the "DSUE Amount"). [112]

(d) Reunification of the estate, gift and GST tax system (providing a GST exemption amount equal to the basic exclusion amount under section 2010(c)).[113]

(e) Repeal of the "sunset" provision with respect to the foregoing transfer tax provisions.[114]

(2) Applicable Exclusion Amount

(a) ATRA "permanently" provides for a cost-of-living increase to the Applicable Exclusion Amount but does not provide for a decrease even in the event of deflation. [115] The Applicable Exclusion Amount can grow to a very large number.

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[107] § 2001(c) (for transfers above $1 million) and § 2641(a)(1).

[108] § 2010(c)(3)(A).

[109] § 2010(c)(3)(B).

[110] Rev. Proc. 2019-44, 2019-47 I.R.B. 1023.

[111] § 2010(c)(2).

[112] § 2010(c)(4). Enacted as part of the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010, Pub. L. 111-312, 124 Stat. 3296 ("TRA 2010"). Section 101(a)(2) of ATRA struck the "sunset" provisions of TRA 2010 by striking section 304 of TRA 2010.

[113] § 2631(c).

[114] § 101(a)(1) of ATRA provides for a repeal of the "sunset" provision in the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107-16, 115 Stat. 38, ("EGTRRA"). The "sunset" provision of EGTRRA is contained in § 901 ("All provisions of, and amendments made by, this Act [EGTRRA] shall not apply… to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010," and the "Internal Revenue Code of 1986 … shall be applied and administered to years, estates, gifts, and transfers … as if the provisions and amendments described [in EGTRRA] had never been enacted.").

[115] Temp. Treas. Reg. § 20.2010-1T(d)(3)(ii).

(b) By way of example, if the cost-of-living index increases at a compound rate of 2.7% over the next 10 and 20 years (the cost-of-living adjustment from 1983 to 2016 averaged 2.6% and the median has been 2.7%[116]), the Applicable Exclusion Amount will grow as follows:

FORECASTED APPLICABLE EXCLUSION AMOUNT ($ MILLION)			
	2020	2030	2040
2.7% COLI	$5.79	$7.56	$9.86

b. Pertinent Income Tax Provisions (Assuming No TCJA)

(1) Increase of the highest Federal ordinary income tax bracket to 39.6%.[117]

(2) Increase of the highest Federal long-term capital gain bracket to 20%.[118]

(3) Increase of the highest Federal "qualified dividend income" rate to 20%.[119]

3. 3.8% Medicare Tax on Net Investment Income

a. A full and complete discussion of the 3.8% Medicare Tax is beyond the scope of this outline but a general understanding is important. Fortunately, there are a number of better resources for that discussion.[120]

b. Section 1411 imposes a 3.8% excise on "net investment income"[121] ("NII") which includes:

(1) "Gross income from interest, dividends, annuities, royalties, and rents,"[122] (passive income), other than such passive income that is "derived in the ordinary course of a trade or business"[123] that is not a "Passive Activity or Trading Company" (as defined below);

(2) Gross income derived from a "Passive Activity or Trading Company," which is defined as:

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[116] Determined and published by the Bureau of Labor Statistics.

[117] § 1.

[118] § 1(h)(1)(D).

[119] § 1(h)(11) (allowing such income to be considered "net capital gain").

[120] *See* Richard L. Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax, Part 1 & Part 2*, Tax Notes, Aug. 12. 2013, p. 683 and Aug. 19, 2013, p. 785, and Blattmachr, Gans and Zeydel, *Imposition of the 3.8% Medicare Tax on Estates and Trusts*, 40 Est. Plan. 3 (Apr. 2013).

[121] § 1411(c).

[122] § 1411(c)(1)(A).

[123] *Id.*

(a) A trade or business that is "a passive activity (within the meaning of section 469) with respect to the taxpayer;"[124] or

(b) A trade or business that trades in "financial instruments or commodities (as defined in section 475(e)(2))."[125]

(3) Gain "attributable to the disposition of property other than property held in a trade or business not described"[126] as a Passive Activity or Trading Company; or

(4) Gross income from the investment of working capital.[127]

c. In arriving at NII, the Code provides for "deductions . . . which are properly allocable to such gross income or net gain."[128]

d. For individuals, the NIIT is imposed on the lesser of:[129]

(1) NII; or

(2) The excess of:

(a) "modified adjusted gross income for such taxable year"[130] ("MAGI"), over

(b) The "threshold amount"[131] ($200,000 for individual taxpayers, $250,000 for joint taxpayers, and $125,000 for married taxpayers filing separately).[132]

e. For estates and trusts, the NIIT is imposed on the lesser of:[133]

(1) The undistributed NII for the taxable year, over

(2) The excess of:

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[124] § 1411(c)(2)(A).

[125] § 1411(c)(2)(B).

[126] § 1411(c)(2)(C).

[127] § 1411(c)(3), referencing § 469(e)(1)(B), which provides "any income, gain, or loss which is attributable to an investment of working capital shall be treated as not derived in the ordinary course of a trade or business." *See* Prop. Reg. § 1.1411-6(a).

[128] § 1411(c)(1)(B).

[129] § 1411(a)(1)(A).

[130] § 1411(a)(1)(B)(i). Modified adjusted gross income is "adjusted gross income" as adjusted for certain foreign earned income. § 1411(d).

[131] § 1411(a)(1)(B)(i).

[132] § 1411(b).

[133] § 1411(a)(2).

(a) Adjusted gross income (as defined in §67(e)),[134] over

(b) "[T]he dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year"[135] ($12,950 of taxable income for 2020).[136]

f. The threshold amount for individuals does not increase with cost-of-living adjustments, but the taxable income amount threshold for trusts and estates does.

g. With respect to a disposition of a partnership interest or S corporation shares, the net gain will be subject to the NIIT but "only to the extent of the net gain which would be so taken into account by the transferor if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest."[137]

h. The following are excluded from the definition of NII:

(1) Distributions from "a plan or arrangement described in section 401(a), 403(a), 403(b), 408, 408A or 457(b),"[138] specifically referring to: [139]

(a) A qualified pension, stock bonus, or profit-sharing plan under section 401(a);

(b) A qualified annuity plan under section 403(a);

(c) A tax-sheltered annuity under section 403(b);

(d) An individual retirement account (IRA) under section 408;

(e) A Roth IRA under section 408A; and

(f) A deferred compensation plan of a State and local government or a tax-exempt organization under section 457(b).

(2) Gain or other types of income that generally would not be taxable under the Code, including: [140]

(a) Interest on state and local bonds (municipal bonds) under § 103.

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[134] § 1411(a)(2)(B)(i).

[135] § 1411(a)(2)(B)(ii).

[136] *See* Rev. Proc. 2019-44, 2019-47 I.R.B. 1023.

[137] § 1411(c)(4)(A).

[138] § 1411(c)(5).

[139] § 1411(c)(5) and Treas. Reg. §1.1411-8(a). *See also* REG-130507-11, Preamble and Proposed Regulations under Section 1411 (December 5, 2012), Fed. Reg. Vol. 77, No. 234, p. 72612-33 (hereinafter, "Preamble to § 1411 Proposed Regulations").

[140] *See* Preamble to § 1411 Proposed Regulations.

(b) Deferred gain under the installment method under § 453.

(c) Deferred gain pursuant to a like-kind exchange under § 1031 and an involuntary conversion under § 1033.

(d) Gain on the sale of a principal residence under § 121.

4. 3.8% Medicare Tax: Trusts and Interests in Pass-Through Entities

a. Generally

(1) If an individual, estate, or trust owns or engages in a trade or business, the determination of whether the income is derived in an active or passive trade or business is made at the owner's level.[141]

(2) If an individual, estate, or trust owns an interest in a trade or business through a partnership or S corporation, the determination of whether the income is derived in an active or passive trade or business is made at the interest-holder level.[142] Provided, however, the issue of whether the gross income is derived from trading in financial instruments or commodities is determined at the entity level.[143]

(3) A trust, or any portion of a trust, that is treated as a grantor trust is not subject to the 3.8% Medicare Tax.[144] The grantor will be deemed to have received all of the income from the trade or business. Hence, whether such trade or business is passive or active is determined at the grantor/owner level.

b. Non-Grantor Trusts

(1) The application of the 3.8% Medicare Tax to trusts that own closely-held business interests is controversial, and there is considerable uncertainty how a fiduciary that owns interests in a closely-held business can materially participate and thereby avoid the imposition of the tax.

(2) In *Mattie K. Carter Trust v. U.S.*,[145] the court held that in determining material participation for trusts the activities of the trust's fiduciaries, employees, and agents should be considered. The government argued that only the participation of the fiduciary ought to be considered but the court rejected that argument. In *Frank Aragona Trust v. Commissioner*,[146] the Tax Court held that the trust qualified for the real estate professional exception under section 469(c)(7) (deemed material participation) because three of the six co-trustees were full time employees of the trust-wholly owned LLC that managed the rental

[141] Treas. Reg. § 1.1411-4(b)(1).

[142] Treas. Reg. § 1.1411-4(b)(2)(i).

[143] Treas. Reg. § 1.1411-4(b)(2)(ii).

[144] Treas. Reg. § 1.1411-3(b)(1)(v).

[145] 256 F. Supp. 2d 536 (N.D. Tex. 2003)

[146] 142 T.C. 165 (2014).

properties. In addition, the Tax Court also considered the activities of co-trustees that had co-ownership interests in the entities held by the trust, reasoning that the interests of the co-trustees were not majority interests, were never greater than the trust's interests in the entities, and were compatible with the trust's goals.

(3) Notwithstanding the foregoing, the IRS ruling position is that only the fiduciary's activities are relevant. The IRS reaffirmed this ruling position in TAM 201317010. The ruling explains the IRS rationale as follows:

> The focus on a trustee's activities for purposes of § 469(h) is consistent with the general policy rationale underlying the passive loss regime. As a general matter, the owner of a business may not look to the activities of the owner's employee's to satisfy the material participation requirement. *See* S. Rep. No. 99-313, at 735 (1986) ("the activities of [employees] . . . are not attributed to the taxpayer."). Indeed, because an owner's trade or business will generally involve employees or agents, a contrary approach would result in an owner invariably being treated as materially participating in the trade or business activity. A trust should be treated no differently. A trustee performs its duties on behalf of the beneficial owners. Consistent with the treatment of business owners, therefore, it is appropriate in the trust context to look only to the activities of the trustee to determine whether the trust materially participated in the activity. An interpretation that renders part of a statute inoperative or superfluous should be avoided. *Mountain States Tel. & Tel. Co. v. Pueblo of Santa Ana,* 472 U.S. 237, 249 (1985).[147]

(4) At issue in the ruling were the activities of "special trustees" who did the day-to-day operations and management of the companies in question but lacked any authority over the trust itself. The ruling states:

> The work performed by A was as an employee of Company Y and not in A's role as a fiduciary of Trust A or Trust B and, therefore, does not count for purposes of determining whether Trust A and Trust B materially participated in the trade or business activities of Company X and Company Y under § 469(h). A's time spent serving as Special Trustee voting the stock of Company X or Company Y or considering sales of stock in either company would count for purposes of determining the Trusts' material participation. However, in this case, A's time spent performing those specific functions does not rise to the level of being "regular, continuous, and substantial" within the meaning of § 469(h)(1). Trust A and Trust B represent that B, acting as Trustee, did not participate in the day-to-day operations of the relevant activities of Company X or Company Y. Accordingly, we conclude that Trust A and Trust B did not materially participate in the relevant activities of Company X or Company Y within the meaning of § 469(h) for purposes of § 56(b)(2)(D) for the tax years at issue.[148]

(5) The need for a trustee to be active may affect the organization of business entities held in trust. For instance, a member-managed LLC may be more efficient than a manager-managed LLC unless a fiduciary is the manager.

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[147] TAM 201317010. *See also* TAM 200733023 and PLR 201029014.

[148] *Id.*

c. Pass-Through Entities

(1) The proposed Treasury Regulations issued in 2013[149] (the "2013 Proposed Regulations") provide that the exception for certain active interests in partnerships and S corporations will apply to a "Section 1411(c)(4) Disposition." A Section 1411(c)(4) Disposition is defined as the sale of an interest in any entity taxed as a partnership or an S corporation[150] (a "Pass-Through Entity") by an individual, estate, or trust if: (1) the Pass-Through Entity is engaged in one or more trades or businesses, or owns an interest (directly or indirectly) in another Pass-through Entity that is engaged in one or more trades or businesses, other than the business of trading in financial instruments or commodities; and (2) one or more of the trades or businesses of the Pass-Through Entity is not a passive activity (defined under section 469 of the Code) of the transferor.[151] Therefore, if the transferor (e.g., the trustee of a non-grantor trust) materially participates in one or more of the Pass-Through Entity's trades or businesses (other than trading in financial instruments or commodities), then some or all of the gain attributable to the sale of an interest in such entity would be exempt from the NIIT.

(2) The 2013 Proposed Regulations provide two possible methods of determining the amount of gain or loss from a Section 1411(c)(4) Disposition. The simplified method is available to a taxpayer if the gain of the transferor is $250,000 or less (including gains from multiple sales that were part of a plan).[152] If the gain exceeds $250,000, the transferor may use the simplified method if the sum of the transferor's share during the "Section 1411 Holding Period" (generally, the year of sale and the preceding two years) of separately stated items of income, gain, loss, and deduction of a type that the transferor would take into account in calculating NII is 5% or less than the sum of all separately stated items of income, gain, loss, and deduction allocated to the transferor over the same period of time, and the gain is $5 million or less.[153] Generally, the simplified method determines the amount gain or loss subject to NII by multiplying it by a fraction, the numerator of which is the sum of NII items over the Section 1411 Holding Period, and the denominator of which is the sum of all items of income, gain, loss, and deduction allocated to the transferor during the same period.[154]

(3) If the transferor does not qualify for the simplified method,[155] then the 2013 Proposed Regulations provides that the gain or loss that the transferor would have taken into account if the Pass-Through Entity had sold all of its "Section 1411 Property" for fair market value immediately before the disposition of the interest.[156] Section 1411 Property

[149] REG-130843-13. Generally, effective for taxable years beginning after December 31, 2013.

[150] Prop. Treas. Reg. § 1.1411-7(a)(2)(i)

[151] Prop. Treas. Reg. § 1.1411-7(a)(3).

[152] Prop. Treas. Reg. § 1.1411-7(c)(2)(ii) (all dispositions that occur during the taxable year are presumed to be part of a plan).

[153] Prop. Treas. Reg. § 1.1411-7(c)(2)(i).

[154] Prop. Treas. Reg. § 1.1411-7(c)(4).

[155] The 2013 Proposed Regulations provide certain exceptions for situations when a transferor will be ineligible to use the optional simplified reporting method, notwithstanding qualifying for such. Situations of exception would include if the transferor held the interest for less than 12 months or if the transferor transferred Section 1411 Property to the Passthrough Entity or received a distribution of property that is not Section 1411 property during the Section 1411 Holding Period. *See* Prop. Treas. Reg. § 1.1411-7(c)(3).

[156] Prop. Treas. Reg. § 1.1411-7(a)(1).

generally is the property owned by the Pass-Through Entity that if disposed by the entity would result in net gain or loss allocable to the transferor (partner or S corporation shareholder) that would be considered NII of the transferor (deemed sale of the activities, on an activity-by-activity basis, in which the transferor does not materially participate).[157]

(4) These rules apply in to all entities taxed as partnerships (limited liability companies, limited partnerships, general partnerships, etc.) and S corporations.

d. Qualified Subchapter S Trusts

(1) A qualified subchapter S trust (QSST)[158] is an eligible shareholder of an S corporation. Generally, a QSST may have only one beneficiary (who also must be a U.S. citizen or resident)[159] who may receive income or corpus during the beneficiary's lifetime, and all of its income[160] must be distributed (or required to be distributed) currently to that beneficiary while the trust holds S corporation stock.[161] A trust that has substantially separate and independent shares, each of which is for the sole benefit of one beneficiary, may qualify as a QSST as to each share.[162] If the trust holds other assets in addition to the S corporation stock, all of the fiduciary accounting income must be distributed, not just amounts attributable to the S corporation distributions.[163] The beneficiary of a QSST is taxed on all of the QSST's income and losses from the S corporation reported on the Schedule K-1 (as if the beneficiary was grantor of the trust for grantor trust purposes under section 678 of the Code).[164] In contrast, when the QSST sells the S corporation stock, the QSST is taxable on any resulting gain.[165]

(2) For 3.8% Medicare Tax purposes, the material participation (or lack thereof) of the beneficiary of a QSST determines to what extent the Schedule K-1 income from the S corporation will be subject to 3.8% Medicare Tax at the beneficiary level. On the other, for sales of interests in an S corporation by the QSST, material participation (and the applicability of a Section 1411(c)(4) Disposition, as discussed above) is determined at the trust (trustee) level. The preamble to the 2013 Proposed Regulations provide, in pertinent part:[166]

> In general, if an income beneficiary of a trust that meets the QSST requirements under section 1361(d)(3) makes a QSST election, the income beneficiary is treated as the section 678 owner with respect to the S corporation stock held by the trust. Section 1.1361–1(j)(8), however, provides that the trust, rather than the

[157] Prop. Treas. Reg. §§ 1.1411-7(a)(2)(iv), 1.1411-7(b), 1.469-2T.

[158] § 1361(d)(1)(A) treating such QSSTs as grantor trusts of U.S. citizens or residents under § 1361(c)(2)(A)(i).

[159] § 1361(d)(3)(A).

[160] Fiduciary accounting income, not taxable income. Treas. Reg. § 1.1361-1(j)(1)(i).

[161] § 1361(d)(3)(B).

[162] §§ 1361(d)(3) and 663(c).

[163] *See* PLR 9603007

[164] § 1361(d)(1)(B) and Treas. Reg. § 1.1361-1(j)(7)(i).

[165] Treas. Reg. § 1.1361-1(j)(8).

[166] Preamble to REG-130843-13.

> income beneficiary, is treated as the owner of the S corporation stock in determining the income tax consequences of the disposition of the stock by the QSST… For purposes of section 1411, the inclusion of the operating income or loss of an S corporation in the beneficiary's net investment income is determined in a manner consistent with the treatment of a QSST beneficiary in chapter 1 (as explained in the preceding paragraph), which includes the determination of whether the S corporation is a passive activity of the beneficiary under section 469… [T]hese proposed regulations provide that, in the case of a QSST, the application of section 1411(c)(4) is made at the trust level. This treatment is consistent with the chapter 1 treatment of the QSST by reason of §1.1361–1(j)(8). However, these proposed regulations do not provide any special computational rules for QSSTs within the context of section 1411(c)(4) for two reasons. First, the treatment of the stock sale as passive or nonpassive income is determined under section 469, which involves the issue of whether there is material participation by the trust.

e. Electing Small Business Trusts

(1) An electing small business trust (ESBT) [167] is another non-grantor trust that is an eligible S corporation shareholder. Unlike a QSST, an ESBT may have multiple beneficiaries[168] who can have discretionary interests in the income and principal of the trust.[169] For income tax purposes, an ESBT is treated as two separate trusts: (i) a portion that holds S corporation stock (the "S portion"); and (ii) a portion that holds all other assets (the "non-S portion").[170] Notwithstanding the foregoing, the grantor trust rules take precedence over the ESBT rules.[171] The S portion is treated as a separate taxpayer, and income reported to the trust on the Schedule K-1 is taxed at the highest individual income tax rates for each type of income.[172]

(2) For 3.8% Medicare Tax purposes, the S and non-S portions continue to be calculated separately for determining the amount of undistributed NII but are combined for purposes of determining if, and to what extent, the ESBT will be subject to the 3.8% Medicare Tax.[173] As discussed in more detail above, as with other non-grantor trusts, material participation (and the applicability of a Section 1411(c)(4) Disposition) is determined at the trustee level.

f. Charitable Remainder Trusts

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[167] § 1361(c)(2)(A)(v).

[168] Must be individuals, estates, or charitable organizations described in § 170(c)(2) through (c)(5). § 1361(e)(1)(A)(i) and Treas. Reg. § 1.1361-1(m)(1).

[169] *See* §§ 1361(e)(1) and 1361(c)(2).

[170] § 641(c) and Treas. Reg. § 1.1641(c)-1(a).

[171] Treas. Reg. § 1.641(c)-1(a).

[172] § 641(c)(1), (c)(2)(A), and Treas. Reg. § 1.641(c)-1(e).

[173] Treas. Reg. § 1.1411-3(c).

(1) It is unknown how the 3.8% Medicare Tax will be applied to charitable remainder trusts[174] (CRTs), particularly when dealing with commercial real property and how the income and gain therefrom will be taxed to the non-charitable beneficiary of the CRT.

(2) Because commercial real property is depreciable, planners should be aware of how the sale of such property in a CRT will affect the taxation of the distribution under the "tier" rules. Generally, the sale of most commercial real property will give rise to "unrecaptured § 1250 gain,"[175] which is taxed at a maximum Federal rate of 25%.[176] As a result, if commercial real property is sold in a CRT, the tier rules include gain taxed at 25%, as well as regular long-term gains at 20%. In addition, any gains and rental income from the property may or may not be considered NII, depending on the active (material participation) or passive participation of the parties involved (donor, recipient, or trustee) and the property in question.[177]

(3) It is unclear, at this point, how and whether the activities of the donor, recipient, and/or trustee will cause all or a portion of the income and gain attributable to the real property to be excluded or subject to the 3.8% Medicare Tax when distributed from the CRT.[178] Many questions remain unanswered. For example, if the trustee is an active participant on the rental property, does that immediately exclude all of the gain and income even if the donor/recipient is not materially participating? If the donor is an active participant on the property prior to contribution, does that mean all of the gain on a subsequent sale by the trustee of the CRT is excluded from the 3.8% Medicare Tax? Or does that mean only pre-contribution gain is excluded and post-contribution gain is NII? What if the active donor is also the sole trustee or co-trustee of the CRT?

5. Disparity among the States

a. The state estate and inheritance tax (collectively, "state death tax") landscape has changed significantly since 2001 when almost every state had an estate and/or inheritance tax that was tied to the then existing Federal state death tax credit.[179] As the law stands today, the Federal state death tax credit has been replaced by a Federal estate tax deduction under section 2058 of the Code, and only 16 states still retain a generally applicable

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[174] § 664.

[175] § 1(h)(6)(A) (Defined as the amount of long-term capital gain that would be treated as ordinary income if Section 1250(b)(1) included all depreciation and the applicable percentage under Section 1250(a) were 100%. This convoluted definition essentially provides that the aggregate straight-line depreciation taken on the property will be considered unrecaptured Section 1250 gain. Under the current depreciation system, straight-line depreciation is required for all residential rental and nonresidential real property. § 168(b)(3)(A), (B).

[176] § 1(h)(1)(E).

[177] The Treasury Department did not issue formal guidance on how the material participation will be determined in the final Treasury Regulations issued in 2013. It is unclear whether material participation will be determined at the trustee, donor, or recipient level.

[178] The Treasury Regulations provide the taxpayer's activities conducted through C corporations, partnerships, and S corporations can be grouped for passive activity (and 3.8% Medicare Tax purposes). Trusts are excluded. *See* Treas. Reg. § 1.496-4(a).

[179] §§ 531 and 532 of EGTRRA provided for a reduction of and eventual repeal of the Federal estate tax credit for state death taxes under § 2011, replacing the foregoing with a deduction under § 2058.

death tax.[180] In those states with a death tax, the rates and exemption can vary significantly. For example, Washington's estate tax provides for a top rate of 20% and an exemption of $2 million per person (indexed for inflation starting January 1, 2014 but only for the Seattle-Tacoma-Bremerton metropolitan area). Pennsylvania, on the other hand, provides for an inheritance tax rate of 4.5% for transfers to descendants, with almost no exemption. When taken in conjunction with the transfer tax provisions of ATRA (both the top Federal tax rate at 40% and the large Applicable Exclusion Amount), the combined Federal and state transfer tax cost to high-net-worth individuals has significantly fallen, when compared to 2001, by way of example.

b. State and local income tax laws and rates vary as well. A number of states have no state and local income tax (Florida, Texas, Nevada, New Hampshire, and Washington) and other states (California, Hawaii, Minnesota, New Jersey, New York, and Oregon) have relatively high income tax rates. When taken in conjunction with the income tax provisions of ATRA and the 3.8% Medicare Tax, the combined Federal and state income tax cost to most taxpayers has significantly risen since 2001.

c. Thus, the current estate planning landscape is characterized by significantly lower transfer tax costs, higher income tax rates, and significant disparity among the states when one compares the two taxes. As mentioned above, in 2001, for a New York City resident there was a 25% difference between the maximum transfer tax rate and the long-term capital gain tax rate. Today, that difference is approximately 13%.[181] In contrast, consider the tax rates in California. Because California does not have a state death tax, but currently has the highest combined income tax rate in the U.S., the difference between the transfer tax rate and the long-term capital gain tax rate is less than 3%.[182] Notably, the top combined ordinary and short-term capital gain tax rate in California is greater (approximately, 45% to 53%) than the transfer tax rate.

d. If one considers the "gap" (the difference between the transfer tax and the income tax rates) as a proxy for how aggressively estate planners will consider transferring assets out of the estate during lifetime, then one can see large differences among the states. On one side, there is California, where there is a very small or negative difference, compared to Washington where there is a very large gap (approximately 28% difference above the long-term capital gain tax rate).[183]

e. As a result, a reasonable prediction is that the consistency that has existed across the U.S. for similarly situated clients (distinguished only by the size of the potential gross estate) will exist no longer. Instead, estate plans will vary based on the state of residence of the client. For example, arguably California residents should be more passive in their estate plans, choosing more often than not, to simply die with their assets, than Washington

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[180] Connecticut, Delaware, District of Columbia, Hawaii, Illinois, Maine, Maryland, Massachusetts, Minnesota, New York, Oregon, Pennsylvania, Rhode Island, Tennessee, Vermont, and Washington. Iowa and Kentucky have an inheritance tax, but the exemption to lineal heirs is unlimited.

[181] New York has a maximum estate tax rate of 16%, when added to the maximum Federal tax rate of 40% and deducted pursuant to § 2058, the combined maximum transfer tax rate is 49.6%, compared to a maximum long-term capital gain tax rate of 36.5% for New York City taxpayers in the alternative minimum tax (20% Federal, 3.8% 3.8% Medicare Tax, 8.82% state, and 3.88% local).

[182] Combined long-term capital gain tax rate of 37.1% for California taxpayers in the alternative minimum tax (20% Federal, 3.8% Medicare Tax, and 13.3% state).

[183] Washington does not have a state income tax.

residents. This is because the income tax savings from the "step-up" in basis may, in fact, be greater than the transfer tax cost, if any.

D. Planning in the "Permanent" Landscape

1. Given how large the Applicable Exclusion Amount will be in the future, it is clear that increasingly the focus of estate planning will move away from avoiding the transfer tax, and become more focused on the income tax. Much of the estate planning analysis will be about measuring the transfer tax cost against the income tax savings of allowing the assets to be subject to Federal and state transfer taxes.

2. The new "paradigm" in estate planning might have these features:

a. Estate plans will vary significantly based upon many more variables:

(1) Time horizon or life expectancy of the client;

(2) Spending or lifestyle of the client, including charitable giving;

(3) Size of the gross estate;

(4) Future return of the assets;

(5) Tax nature of the types of assets (for example, to what extent will a "step-up" in basis benefit the client and the beneficiaries?);

(6) Expected income tax realization of the assets (for example, when is it likely that the asset will be subject to a taxable disposition?);

(7) State of residence of the client;

(8) State of residence and marginal income tax bracket of the likely beneficiaries; and

(9) Expectations about future inflation.

b. Estate planners will seek to use as little of a client's Applicable Exclusion Amount as possible during lifetime because it will represent an ever-growing amount that will provide a "step-up" in basis with little or no transfer tax cost at death. This conclusion assumes that "zeroed-out" estate planning techniques like installment sales to IDGTs and or "zeroed-out" grantor-retained annuity trusts[184] ("GRATs") can accomplish effectively the same amount of wealth transfer as a taxable gift but without using any or a significant portion of a client's Applicable Exclusion Amount. Wealth transfer is not accomplished when a taxpayer makes a gift and uses his or her Applicable Exclusion Amount toward that gift. There is wealth transfer only if and when the asset appreciates (including any appreciation effectively created by valuation discounts). That is essentially the same concept as an installment sale to an IDGT and

[184] Trust that provides the grantor with a "qualified annuity interest" under Treas. Reg. § 25.2702-3(b).

a GRAT, except that those techniques require appreciation above a certain rate, like the applicable federal rate[185] ("AFR") or the section 7520 rate.[186]

c. Because the "step-up" in basis may come at little or no transfer tax cost, estate planners will seek to force estate tax inclusion in the future.

d. The state of residence of the client and his or her beneficiaries will influence the estate plan. For instance, if a client is domiciled in California, and his or her beneficiaries living in California, then dying with the assets may be the extent of the tax planning. On the other hand, if the beneficiaries live in a state like Texas that has no state income tax, then transferring the assets out of the estate during the lifetime of the client may be warranted. As a result, estate planners will need to ask clients two questions that, in the past, did not significantly matter:

(1) Where are you likely to be domiciled at your death?

(2) When that occurs, where is it likely that your beneficiaries (children and grandchildren) will reside?

E. Portability Considerations

1. One of the newer features on the estate planning landscape is portability. A full discussion of the planning implications of portability is beyond the scope of this outline and there are resources publicly available that cover the subject in a comprehensive manner.[187] In the context of the "new paradigm" in estate planning discussed above, portability, at least in theory, can provide additional capacity for the surviving spouse's estate to benefit from a "step-up" in basis with little or no transfer tax costs.

2. In traditional by-pass trust planning, upon the death of an individual who has a surviving spouse, assets of the estate equal in value to the decedent's unused Applicable Exclusion Amount fund a trust (typically for the benefit of the surviving spouse). The trust is structured to avoid estate tax inclusion in the surviving spouse's estate. The marital deduction portion is funded with any assets in excess of the unused Applicable Exclusion Amount. The by-pass trust avoids estate tax inclusion in the surviving spouse's estate. From an income tax standpoint, however, the assets in the by-pass trust do not receive a "step-up" in basis upon the death of the surviving spouse. Furthermore, while the assets remain in the by-pass trust, any undistributed taxable income above $12,950 of taxable income (for 2020) will be subject to the highest income tax rates at the trust level.[188]

3. In portability planning, the decedent's estate would typically pass to the surviving spouse under the marital deduction, and the DSUE Amount would be added to the surviving spouse's Applicable Exclusion Amount. Because all of the assets passing from the

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[185] § 1274(d)(1).

[186] § 7520.

[187] *See* Franklin, Law and Karibjanian, *Portability – The Game Changer*, ABA-RPTE Section (January 2013) (http://meetings.abanet.org/webupload/commupload/RP512500/otherlinks_files/TheGameChanger-3-12-13v11.pdf).

[188] *See* Rev. Proc. 2017-58, 2017-45 I.R.B. 489.

decedent to the surviving spouse in addition to the spouse's own asset will be subject to estate taxes at his or her death, the assets will receive a "step-up" in basis. Additional income tax benefits might be achieved if the assets that would otherwise have funded the by-pass trust are taxed to the surviving spouse, possibly benefiting from being taxed at a lower marginal income tax bracket. In addition, if the by-pass trust would have been subject to a high state income tax burden (for example, California), having the assets taxed to a surviving spouse who moves to a low or no income tax state would provide additional income tax savings over traditional by-pass trust planning.

4. Of course, there are other considerations, including creditor protection and "next spouse" issues, which would favor by-pass trust planning. However, from a tax standpoint, the trade-off is the potential estate tax savings of traditional by-pass trust planning against the potential income tax savings of portability planning. Because the DSUE Amount does not grow with the cost-of-living index, very large estates ($20 million or above, for example) will benefit more with traditional by-pass trust planning because all of the assets, including any appreciation after the decedent's death, will pass free of transfer taxes. On the other hand, smaller but still significant estates (up to $7 million, for example) should consider portability as an option because the combined exclusions, the DSUE Amount frozen at $5.6 million and the surviving spouse's Applicable Exclusion Amount of $5.6 million but growing with the cost-of-living index, is likely to allow the assets to pass at the surviving spouse's death with a full step-up in basis with little or no transfer tax costs (unless the assets are subject to significant state death taxes at that time).

5. In evaluating the income tax savings of portability planning, planners will want to consider that even for very large estates, the surviving spouse has the option of using the DSUE Amount by making a taxable gift to an IDGT. The temporary Treasury Regulations make clear that the DSUE Amount is applied against a surviving spouse's taxable gift first before reducing the surviving spouse's Applicable Exclusion Amount (referred to as the basic exclusion amount).[189] The IDGT would provide the same estate tax benefits as the by-pass trust would have, but importantly the assets would be taxed to the surviving spouse as a grantor trust thus allowing the trust assets to appreciate out of the surviving spouse's estate without being burdened by income taxes.[190] If the assets appreciate, then this essentially solves the problem of the DSUE Amount being frozen in value. Moreover, if the IDGT provides for a power to exchange assets of equivalent value with the surviving spouse,[191] the surviving spouse can exchange high basis assets for low basis assets of the IDGT prior to death and essentially effectuate a "step-up" in basis for the assets in the IDGT.[192] The ability to swap or exchange assets with an IDGT is discussed in more detail below.

6. Portability planning is slightly less appealing to couples in community property states because, as discussed below, all community property gets a "step-up" in basis on the first spouse's death. Thus, the need for additional transfer tax exclusion in order to benefit from a subsequent "step-up" in basis is less crucial. This is not true, however, for assets that are depreciable (commercial real property) or depletable (mineral interests). As discussed below, these types of assets will receive a "step-up" in basis but over time, the basis of the asset will be

[189] Treas. Reg. § 25.2505-2T(d).

[190] *See* Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

[191] § 675(4)(C).

[192] Rev. Rul. 85-13, 1985-1 C.B. 184 and PLR 9535026.

reduced by the ongoing depreciation deductions. As such, even in community property states, if there are significant depreciable or depletable assets, portability should be considered.

F. Transfer Tax Cost vs. Income Tax Savings from the "Step-Up"

1. One of the first steps in analyzing a client's situation is trying to measure the potential transfer tax costs against the income tax savings that would arise from a "step-up" in basis. Under the current state of law, this is not an easy endeavor. First, the Applicable Exclusion Amount will continue to increase. Both the rate of inflation and the lifespan of the client are outside the planner's control. In addition, as mentioned in the previous section, if the client dies in a state that has a death tax, the calculation of the transfer tax cost will be complicated by that state's exemption and rate. Third, the income tax savings of the "step-up" in basis must be measured in relation to the beneficiaries who may live in a different state than the decedent.

2. Although a "step-up" in basis is great in theory, no tax will be saved if the asset is at a loss at the time of death resulting in a "step-down" in basis, the asset has significant basis in comparison to its fair market value at the time of death, or the asset will not benefit at all because it is considered income in respect of a decedent[193] (IRD). Furthermore, even if the assets will benefit from a significant "step-up" in basis, the only way to capture the income tax benefits of the basis adjustment is to sell the asset in a taxable disposition. Many assets, like family-owned businesses, may never be sold or may be sold so far in the future that the benefit of a "step-up" is attenuated. In addition, even if the asset will be sold, there may be a significant time between the date of death of the decedent when the basis adjustment occurs and the taxable disposition, so some consideration should be given to quantifying the cost of the deferral of the tax savings. Finally, the nature of the asset may be such that even if the asset will not be sold in a taxable disposition, it may confer economic benefit to the beneficiaries. For example, if the asset that receives a "step-up" in basis is either depreciable or depletable under the Code,[194] the deductions that arise do result in tax benefits to the owners of that asset. In addition, an increase in the tax basis of an interest in a partnership or in S corporation shares may not provide immediate tax benefits, but they do allow additional capacity of the partner or shareholder to receive tax free distributions from the entity.[195] These concepts and how certain assets benefit or don't benefit from the basis adjustment at death are discussed in more detail below.

3. Estate planning will focus increasingly on the income tax savings resulting from the "step-up" in basis. Estate planners will seek to maximizing the "step-up" in basis by ensuring that the assets that are includible in the estate of a decedent are the type of assets that will:

a. Benefit from a "step-up" (avoiding the inclusion cash or property that has a basis greater than fair market value)

b. Benefit the most from the "step-up" (for example, very low basis assets, collectibles, and "negative basis" assets); and

[193] § 691.

[194] *See e.g.*, § 1016(a)(2).

[195] *See e.g.*, §§ 731(a)(1) and 1368(b).

c. Provide significant income tax benefits to the beneficiaries (assets are likely to be sold in a taxable transaction after "step-up" or depreciable/depletable assets giving rise to ongoing income tax deductions).

4. In considering tax basis management in estate planning, estate planners will need to take a bifurcated approach based upon the tax nature of the assets. For clients who are likely to own primarily low-basis assets that would benefit the most from a step-up in basis (e.g., creators of intellectual property or real estate developers), the estate plan will be centered around dying with the assets and benefiting from the "step-up" in basis. To the extent the assets will be subject to Federal or state transfer taxes, then consideration must be given to ensuring that estate taxes can be paid on a timely or orderly manner. Thus, common features of the plan might include maintaining life insurance held by an irrevocable life insurance trust, qualifying for the payment of transfer taxes pursuant to the deferral provisions of section 6166, or securing a *Graegin*[196] loan.[197] For those clients who are likely to own assets that would not likely benefit from the "step-up" in basis (e.g., IRA assets, actively managed publicly-traded investment portfolios, or other high basis asset), then transferring the assets out of the estate would be paramount to the extent the assets would be subject to a significant Federal or state transfer tax liability. Finally, for those clients, who have both types of assets and whose assets would be subject to a significant transfer tax liability, the strategy would involve transferring the high basis assets out of the estate through a combination of zeroed-out transfer strategies and exercising the "swap" power proactively if the assets are held in a grantor trust, as discussed later in this article.

5. When clients are in a situation where no estate taxes will be due, referred to as a "free-base" situation, then estate planners should seek to maximize the value of certain assets because the "step-up" in basis is based on fair market value (rather than trying to reduce the value for transfer tax purposes). A "free-base" situation can arise when the assets includible in the estate are less than the decedent's remaining Applicable Exclusion Amount or a marital deduction transfer under section 2056 to the surviving spouse.[198] In these "free-basing" situations, practitioners will need to consider when valuations discounts are warranted and when the discounts should be removed.

6. In addition to the foregoing, estate planners will increasingly seek to:

a. Maximize the value of certain assets because the "step-up" in basis is based on fair market value (rather than trying to reduce the value for transfer tax purposes); and

b. Intentionally create estate tax inclusion, especially if the decedent lives in a state with no state death tax and if the decedent has significant unused Available Exclusion Amount above his or her assets.

G. Community Property Considerations

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[196] *Estate of Graegin v. Commissioner*, T.C. Memo. 1988-477, 56 T.C.M. (CCH) 387 (1988).

[197] *See* Stephanie Loomis-Price, Paul S. Lee, Charles E. Hodges, *Asset Rich, Cash Poor: Addressing Illiquidity with Graegin Loans, as Well as Sections 6166 and 6161*, 36 Tax Mgmt. Est. Gifts & Tr. J No. 4 (July 14, 2011).

[198] Another free-base situation could arise with a testamentary transfer to a zeroed-out charitable lead annuity trust. The creation of basis would significantly lower the on-going income tax liability of the non-grantor charitable lead trust. However, increasing the value would also increase the payments to charity that are required to zero-out the testamentary transfer to the trust.

1. Given the central role the "step-up" in basis has in estate planning now, community property states have a significant advantage over separate property states because both the decedent's and the surviving spouse's one-half interest in community property will receive a basis adjustment to fair market value under section 1014(b)(6). Because the unlimited marital deduction under section 2056 essentially gives couples the ability to have no transfer taxes on the first spouse's death, this "step-up" in basis provides an immediate income tax savings for the benefit of the surviving spouse (rather than the subsequent beneficiaries).

2. This theoretically provides a bifurcated approach to estate planning for spouses in community property:

a. During the lifetimes of both spouses, limit inter-vivos transfers and maximize value of the assets in order to benefit the most from the basis adjustment under section 1014(b)(6).

b. During the lifetime of the surviving spouse, with assets in excess of the Available Exclusion Amount (taking into account any amounts that might have been "ported" to the surviving spouse), transfer as much wealth as possible out of the estate through inter-vivos transfers and other estate planning techniques. Further, through the use of family limited partnerships ("FLPs") and other techniques, attempt to minimize the transfer tax value of the assets that would be includible in the estate of the surviving spouse.

3. Notably, with the U.S. Supreme Court's decisions in *U.S. v. Windsor*[199] and *Obergefell v. Hodges*[200]and the issuance of Revenue Ruling 2013-17,[201] and proposed regulations addressing definitions of terms related to marital status,[202] the tax ramifications are far reaching for same-sex couples residing in community property states or owning community property.

4. The basis adjustment at death for community property and other planning considerations, including electing into community property status, are discussed in more detail later in these materials.

II. SECTION 1014 AND THE TAX NATURE OF CERTAIN ASSETS

A. General Rule: The "Step-Up" in Basis to Fair Market Value

1. Generally, under section 1014(a)(1), the "basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent" is the "fair market value of the property at the date of the decedent's death."[203] The foregoing general rule is often referred to as the "step-up" in basis at death, under the assumption that assets generally appreciate in value. However, many assets depreciate in value, and this general rule will mean a loss of tax basis to fair market value at date of death (a "step-down" in basis). For

[199] 133 S. Ct. 2675 (2013).

[200] 135 S. Ct. 2584 (2015).

[201] Rev. Rul. 2013-17, 2013-38 I.R.B. 201.

[202] Definition of Terms Relating to Marital Status, 80 Fed. Reg. 64378 (proposed Oct. 23, 2015).

[203] § 1014(a)(1).

purposes of this outline, we refer to the general rule of section 1014(a)(1) as a "step-up" in basis, whether the asset is appreciated or at a loss at the time of the decedent's death.

2. The Code goes on to say that if the executor of the estate elects an alternate valuation date under section 2032 or special use valuation under section 2032A, then the basis is equal to the value prescribed under those Code sections.[204]

3. If land, or some portion thereof, that is subject to a qualified conservation easement is excluded from the estate tax under section 2031(c), then "to the extent of the applicability of the exclusion," the basis will be the "basis in the hands of the decedent"[205] ("carryover basis").[206]

4. In the context of partnerships, typically the "step-up" in basis is reflected in the partnership interest owned by a decedent partner at the time of his or her death. If a section 754 election is made, then the basis of the assets inside the partnership will be adjusted to reflect the "step-up" in the partnership interest. As discussed later in these materials, how those basis adjustments are reflected and allocated is complex and often results in less than ideal results for individual taxpayers.

B. Defining "Property Acquired From a Decedent"

1. Generally

a. The Treasury Regulations generally provide, "The purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent that is equal to the value placed upon such property for purposes of the federal estate tax."[207] In other words, the basis adjustment at death under Section 1014(a) of the Code is tied directly to the imposition of the estate tax.

b. However, there are a number of situations where the basis adjustment at death is available without inclusion of the property in a U.S. gross estate. As such, understanding some of the different ways in which property is "acquired from a decedent" is important, separate from the question of whether estate tax has or will be imposed on such property.

2. Section 1014(b)(1): Bequest, Devise, or Inheritance

a. Section 1014(b)(1) of the Code provides, "Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent"[208] is considered "to have been acquired from or to have passed from the decedent."[209]

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[204] §§ 1014(a)(2) and (a)(3).

[205] § 1014(a)(4).

[206] § 1015.

[207] Treas. Reg. § 1.1014-1(a).

[208] § 1014(b)(1). *See also*, Treas. Reg. § 1.1014-2(a)(1).

[209] § 1014(b) [introductory language].

b. Property acquiring a "step-up" in basis under this subsection does not necessarily need to be included in a decedent's gross estate, particularly when nonresident alien decedents are involved.[210]

3. Section 1014(b)(2): Revocable and Retained Income Trusts

a. Section 1014(b)(2) of the Code provides, "[p]roperty transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust"[211] is considered "to have been acquired from or to have passed from the decedent."

b. As discussed later in these materials, except for certain assets (non-U.S. situs) held by trusts created by or controlled by nonresident aliens, these assets would be includible in the decedent's gross estate under section 2036 of the Code (due to the retained income interest) or section 2038 of the Code (due to the right of revocation).

4. Section 1014(b)(3): Retained Control Trusts

a. Section 1014(b)(3) of the Code provides, "property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust"[212] is considered "to have been acquired from or to have passed from the decedent."

b. As discussed later in these materials, except for certain assets (non-U.S. situs) held by trusts created by or controlled by nonresident aliens, these assets would be includible in the decedent's gross estate under section 2038 of the Code (because of the retained powers over assets).

5. Section 1014(b)(4): Exercised Testamentary General Power of Appointment

a. Section 1014(b)(4) of the Code provides, "[p]roperty passing without full and adequate consideration under a general power of appointment exercised by the decedent by will"[213] is considered "to have been acquired from or to have passed from the decedent."

b. Assets passing pursuant to the exercise of a testamentary general power of appointment would also be includible in the power holder's estate under section 2041 of the Code, whether or not exercised, under section 2041 of the Code and entitled to a basis adjustment under section 1014(b)(9) of the Code.

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[210] Rev. Rul. 84-139, 1984-2 C.B. 168 (real property owned by a nonresident alien and not subject to U.S. estate tax will take a basis equal to its fair market value) and PLR 201245006 (assets held in a foreign revocable trust will receive a basis adjustment at death under section 1014(b)(1) of the Code even though the assets are not subject to U.S. estate tax). However, as discussed later in these materials, it is likely the IRS mistakenly cited (b)(1) in PLR 201245006 as the operative subsection for the basis adjustment at death.

[211] § 1014(b)(2). *See also*, Treas. Reg. § 1.1014-2(a)(1) and Rev. Rul. 57-287, 1957-1 C.B. 517, *modifying* Rev. Rul. 55-502, 1955-2 C.B. 560.

[212] § 1014(b)(9).

[213] § 1014(b)(4). *See also*, Treas. Reg. § 1.1014-2(a)(4).

c. If a nonresident alien is granted a testamentary power of appointment over appreciated non-U.S. situs property and the power is exercised in the will of the nonresident alien decedent, it is conceivable such property would receive a "step-up" in basis under section 1014(b)(4) of the Code.

6. Section 1014(b)(6): Community Property

a. Section 1014(b)(6) of the Code provides, "[p]roperty which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate under chapter 11 of subtitle B (section 2001 and following, relating to estate tax)"[214] is considered "to have been acquired from or to have passed from the decedent."

b. Community property considerations, and planning opportunities with such property, are discussed in more other parts of these materials.

7. Section 1014(b)(9): Assets Subject to U.S. Estate Tax

a. Section 1014(b)(9) of the Code provides, "property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate under chapter 11 of subtitle B"[215] is considered "to have been acquired from or to have passed from the decedent."

b. This provision is essentially the catch-all provision that provides a basis adjustment at death under section 1014(a) of the Code if any asset, or portion thereof, is included in a decedent's gross estate. Prior to its enactment, because a joint interest in property is deemed to have been acquired by lifetime transfer (not by "bequest, devise, or inheritance" as required by section 1014(b)(1) of the Code), the joint interest would have been included in the decedent's gross estate for estate tax purposes but would not have been entitled to a "step-up" in basis. In enacting this provision, the legislative history states there is "no justification for denying property included in a decedent's gross estate for estate tax purposes a new basis at date of death."[216]

8. Section 1014(b)(10): QTIP Marital Trusts

a. Section 1014(b)(10) of the Code provides, "[p]roperty includible in the gross estate of the decedent under section 2044 (relating to certain property for which marital deduction was previously allowed)"[217] is considered "to have been acquired from or to have passed from the decedent."

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[214] § 1014(b)(6). *See also*, Treas. Reg. § 1.1014-2(a)(5), Rev. Rul. 87-98, 1987-2 C.B. 206, Rev. Rul. 66-283, 1966-2 C.B. 297, Rev. Rul. 59-220, 1959-1 C.B. 210, and Rev. Rul. 55-605, 1955-2 C.B. 382.

[215] § 1014(b)(9). *See also,* Treas. Reg. § 1.1014-2(a)(4).

[216] S. Rep. No. 1622, 83d Cong., 2d Sess. 107 (1954).

[217] § 1014(b)(10).

b. This provision provides the basis adjustment for assets held in qualified electing QTIP trusts under sections 2056(b)(7) and 2523(f) of the Code for which an estate or gift tax marital deduction was granted when originally funded. There is some additional discussion regarding the basis adjustment at the death for assets subject to debt held in QTIP trusts later in these materials.

C. Basis Consistency and Reporting Rules for Property Acquired from a Decedent

1. Generally

a. On July 31, 2015, the President signed the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015[218] (commonly referred to as the "Highway Bill") into law. Among the non-expiring provisions in the Highway Bill are provisions that create new sections 1014(f) and 6035 of the Code.[219] Pursuant to these provisions, taxpayers acquiring property from a decedent whose estate was required to file a Federal estate tax return must report their adjusted tax basis consistently with the value of the property as finally determined for Federal estate tax purposes, or if not finally determined, the value as reported by the statement made under section 6035 of the Code. Specifically, beneficiaries cannot claim a higher basis than the estate tax value. Further, the executor is required to furnish the IRS and to each person acquiring any interest in property included in the gross estate a statement of value and any other information prescribed by the IRS.

b. Section 6035 imposes reporting requirements for individuals who are required to file a Form 706 under section 6018(a) (e.g., an executor) or under section 6018(b) (e.g., a recipient of the decedent). If a Form 706 must be filed, the reporting party is now also required to report valuation information to the IRS and to each person acquiring any interest in property included in the decedent's gross estate. The statement must be delivered within 30 days of the earlier of the date the return is filed or the date the estate tax return was due (with extensions). If the value is subsequently adjusted (e.g., by audit or amendment), a supplemental statement must be provided within 30 days. The penalty for each failure is $250, to a maximum of $3 million, and if the failure to report was intentional, the penalty is increased to $500, with exceptions for reasonable cause. [220]

c. If a taxpayer claims a tax basis on his or her income tax return in excess of the basis reported under section 1014(f) of the Code, a 20% penalty[221] is applied to the

[218] P.L. 114-41 (the "Highway Bill").

[219] § 2004 of the Highway Bill.

[220] §§ 6721, 6724(d)(1)(D), and 6724(d)(2)(II). The penalty under section 6721 if the Code for failing to file an information return was increased from $100 to $250 by the Trade Preferences Extension Act of 2015 (P.L. 114-27) on June 29, 2015. The penalty under section 6723 of the Code for failing to comply with a "specified information reporting requirement" does not apply, because "specified information reporting requirement" is a defined term limited under sections 6724(d)(3) of the Code, applying to circumstances which do not apply here.

[221] § 6662(a) (accuracy-related penalties on underpayments).

underpayment arising from the "inconsistent estate basis reporting."[222] The 6-year statute of limitations applies in the case of an overstatement of basis.[223]

d. Note that section 1014(f)(1) of the Code limits application of the section to situations where Federal estate tax values have been determined. Section 1014(f)(3) defines "determined" in such a way that ordinarily a return would need to be filed. Furthermore, section 1014(f) of the Code only applies to "property whose inclusion in the decedent's estate increased the liability for the tax imposed by chapter 11."[224]

e. These provisions apply to estate tax returns (and related income tax returns) filed after July 31, 2015.[225]

2. Temporary and Proposed Regulations[226]

a. Introduction

(1) On March 4, 2016, the Department of Treasury published temporary and proposed regulations providing guidance regarding the basis consistency and information reporting rules of IRC §§ 1014(f) and 6035. The proposed regulations apply to property acquired from a decedent or by reason of the death of a decedent whose federal estate tax return is filed after July 31, 2015.

(2) The proposed regulations clarify various definitions contained in IRC §§ 1014(f) and 6035. "Information Return" means Form 8971, "Information Regarding Beneficiaries Acquiring Property from a Decedent," and the "Statement" required to be furnished to each beneficiary. Prop. Reg. § 1.6035-1(g)(2). "Statement" means the payee statement described as Schedule A of the Information Return.[227]

(3) The proposed regulations also provide guidance on the following topics: (1) property subject to the basis consistency rules; (2) reporting requirements; (3) property subject to the reporting requirements; (4) reporting due dates; (5) the effect of post-death adjustments to basis; (6) identity of the beneficiaries who must receive a Statement; (7) supplemental information and treatment of subsequently-discovered property; (8) reporting subsequent transfers; and (9) beneficiaries' inability to contest estate tax value.

b. Property Subject to the Basis Consistency Rules

(1) Generally, all property included in the decedent's gross estate (including property the basis of which is determined in whole or in part with reference to property in the gross estate, such as like-kind exchange property or property subject to an

[222] § 6662(b)(8) and 6662(k).

[223] § 2005 of the Highway Bill and re-designated § 6502(e)(1)(B)(ii).

[224] § 1014(f)(2).

[225] §§ 2004(d) and 2005(b) of the Highway Bill.

[226] The following discussion comes from materials entitled, "Basis Bonanza: A Few Creative Ways to Generate Basis Step-Up," prepared by Charles A. Redd of Stinson Leonard Street LLP who graciously gave the authors consent to reproduce them as part of these materials.

[227] Prop. Treas. Reg. § 1.6035-1(g)(2).

involuntary conversion) that generates a federal estate tax in excess of allowable credits (other than a credit for a prepayment of tax) is subject to the basis consistency rules.[228] If the estate pays no federal estate tax, then none of the estate property is subject to the basis consistency rules.[229]

(2) Property that qualifies for an estate tax charitable or marital deduction under sections 2055, 2056 or 2056A of the Code are excluded from the property subject to the basis consistency rules because such property does not generate estate tax liability.[230]

(3) In addition, tangible personal property for which an appraisal is not required under section 20.2031-6(b) of the Treasury Regulations is not subject to the basis consistency rules. The proposed regulations are not clear whether this exception applies if the aggregate value of all tangible personal property is under the $3,000.00 threshold provided in the regulations or whether the exception applies to each item of tangible personal property the value of which is under the $3,000.00 threshold. However, an example in the proposed regulations indicates that this exception applies for any individual item the value of which is under $3,000.00.[231] A further indication that the exception applies to each item the value of which is under $3,000.00 is found in the Instructions to Form 706, which requires an appraisal only for those items valued at more than $3,000.00.

c. Reporting Requirements

(1) An "executor" who is required to file a federal estate tax return pursuant to IRC § 6018(a) is required to provide an Information Return (i.e., Form 8971 and Schedule A) to the IRS and a Statement (i.e., Schedule A) to all beneficiaries who will receive property that was included in the decedent's gross estate.[232]

(2) This reporting requirement does not apply if the executor is not required by IRC § 6018(a) to file a federal estate tax return, but files a federal estate tax return for other reasons (e.g., to make a portability election, a GST exemption allocation or a protective filing to avoid any penalty if an asset value is later determined to require the filing of a return).[233]

(3) The due date for providing an Information Return and Statement to the IRS and the Statements to the beneficiaries is the earlier of 30 days after the due date of the federal estate tax return or 30 days after the date the federal estate tax return is actually filed.[234]

d. Property Subject to the Reporting Requirements

(1) Generally, all property required to be reported on a federal estate tax return (including property the basis of which is determined in whole or in part with reference

[228] Prop. Treas. Reg. § 1.1014-10(b)(1).

[229] Prop. Treas. Reg. § 1.1014-10(b)(3).

[230] Prop. Treas. Reg. § 1.1014-10(b)(2).

[231] Prop. Treas. Reg. § 1.6035-1(b)(2), *Ex.1*.

[232] Prop. Treas. Reg. § 1.6035-1(a)(1).

[233] Prop. Treas. Reg. § 1.6035-1(a)(2).

[234] Prop. Treas. Reg. § 1.6035-1(d)(1).

to property in the gross estate, such as like-kind exchange property or property subject to an involuntary conversion) is subject to the reporting requirement.[235] This includes property included in the gross estate but not held by the estate, such as property held in a revocable trust established by the decedent. Regarding property owned by a deceased nonresident alien, only the property that is subject to the U.S. estate tax is reportable.[236] For a decedent holding community property, the reporting requirement only applies to the decedent's one-half of community property.[237]

(2) Four classes of property are exempt from the reporting requirement: (a) cash (other than a coin collection or other coins or bills with numismatic value); (b) income in respect of a decedent (as defined in section 691 of the Code); (c) tangible personal property for which an appraisal is not required under section 20.2031-6(b) of the Treasury Regulations; and (d) property sold, exchanged or otherwise disposed of (and therefore not distributed to a beneficiary) by the estate in a transaction in which capital gain or loss is recognized.[238]

e. Effect of Post Death Adjustments

(1) The proposed regulations recognize that post-death adjustments to a property's basis may still occur after the valuation date for estate tax purposes. A beneficiary's initial basis in property acquired from the decedent or as a result of the decedent's death will be the value of such property as reported on the federal estate tax return. However, the beneficiary's initial basis may be adjusted due to the operation of other provisions of the Code governing basis.[239]

(2) Such adjustments could include gain recognized by the decedent's estate upon distribution of the property, post-death capital improvements and depreciation and post-death adjustments to the basis of an interest in a partnership or S corporation.[240]

(3) The basis of property subject to debt (whether recourse or non-recourse) is the gross up value of the property and thus, post-death payments on such debt will not result in an adjustment to the property's basis.[241]

f. Identity of the Beneficiaries Who Must Receive a Statement

(1) Statements must be provided to any person receiving reportable property (referred to as a "beneficiary").[242] There is no exception to exclude reporting to a beneficiary who receives property which is not subject to the basis consistency rules (e.g.,

[235] Prop. Treas. Reg. § 1.6035-1(b)(1).

[236] *Id.*

[237] *Id.*

[238] Prop. Treas. Reg. § 1.6035-(b)(1)(i)-(iv).

[239] Prop. Treas. Reg. § 1.1014-10(a)(2).

[240] *Id.*

[241] *Id.*

[242] Prop. Treas. Reg. § 1.6035-1(c)(1).

bequests that qualify for the marital or charitable deduction). If a beneficiary is a trust or another estate, the statement is provided to the trustee or the executor not the beneficiaries of that trust or estate.[243]

(2) If the executor has not identified the property that will be distributed to each beneficiary by the due date for submitting the Information Return and Statements, the executor must report on the Statement for each such beneficiary all of the reportable property that could be used to satisfy that beneficiary's interest.[244] The proposed regulations further provide, "Once an exact distribution has been determined, the executor may, but is not required to, file and furnish a supplemental Information Return and Statement."[245]

(3) If a beneficiary cannot be located by the reporting due date, the executor must still file the Information Report and must explain the efforts made to locate the beneficiary. Prop. Reg. § 1.6035-1(c)(4). A supplemental report must be filed within 30 days of locating the beneficiary. Prop. Reg. § 1.6035-1(c)(4).

(4) For life estates, a beneficiary includes "the life tenant, the beneficiary of a remainder interest is remainderman(men) identified as if the life tenant were to die immediately after the decedent, and the beneficiary of a contingent interest is a beneficiary, unless the contingency has occurred prior to the filing of the Form 8971. If the contingency subsequently negates the inheritance of the beneficiary, the executor must do supplemental reporting…to report the change of beneficiary."[246] The inclusion of a contingent beneficiary as a beneficiary who must receive a Statement may be a drafting error, but until such time as the proposed regulations are finalized or amended, executors must report the basis of life estate property to contingent beneficiaries.

g. Supplemental Information and Subsequently-Discovered Property

(1) An executor must file supplemental Information Returns and Statements if any change occurs that causes the reported information to be incorrect.[247] No supplement is required to: (i) correct an inconsequential error or omission within the meaning of section 301.6772-1(b) of the Treasury Regulations; or (2) specify the actual distribution of property previously reported as being available to satisfy the interests of multiple beneficiaries.[248] The due date of the supplement is 30 days after: (1) the final value is determined, (2) incorrect or incomplete information is discovered or (3) a supplemental federal estate tax return is filed reporting additional assets.[249]

(2) If property is later discovered and reported on a supplemental federal estate tax return before the period of limitation on assessment of tax expires, such property's basis for basis consistency purposes will be the final value as shown on the

[243] Prop. Treas. Reg. § 1.6035-1(c)(2).

[244] Prop. Treas. Reg. §§ 1.6035-1(c)(3) and 1.6035-1(e)(3)(ii), *Ex. 2*.

[245] Prop. Treas. Reg. § 1.6035-1(c)(3).

[246] Prop. Treas. Reg. § 1.6035-1(c)(1).

[247] Prop. Treas. Reg. § 1.6035-1(e)(2).

[248] Prop. Treas. Reg. § 1.6035-1(e)(3).

[249] Prop. Treas. Reg. § 1.6035-1(e)(4)(i).

supplement to the federal estate tax return.[250] However, if the discovered property is not reported on a supplemental federal estate tax return before the limitation period expires, the basis of such property is zero.[251]

h. Reporting Subsequent Transfers

(1) If property that previously was reported or is required to be reported is distributed or transferred (by gift or otherwise) by the beneficiary to a related transferee in a transaction in which the related transferee determines its basis, in whole or in part, by reference to the beneficiary/transferor's basis, the beneficiary/transferor must, within 30 days of the transfer, file with the IRS a supplemental Statement and furnish a copy to the transferee.[252]

(2) If the subsequent transfer occurs before the final value is determined for estate tax purposes, then the transferor must also give the executor a copy of the Statement.[253] "A related transferee means any member of the transferor's family as defined in section 2704(c)(2), any controlled entity…and any trust of which the transferor is a deemed owner for income tax purposes.[254]

D. Section 1014(e): The One Year Conundrum

1. Section 1014(e) provides that if "appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent's death,"[255] and the property is "acquired from the decedent by (or passes from the decedent to) the donor of such property (or spouse of such donor),"[256] then the property will not receive a "step-up" in basis and it will have the basis in the hands of the decedent before the date of death.[257]

2. For purposes of the foregoing, the Code provides that carryover basis shall apply to any appreciated property "sold by the estate of the donor or by a trust of which the decedent was the grantor" but only "to the extent the donor of such property (or the spouse of such donor) is entitled to the proceeds from such sale."[258]

3. This rule does not apply if the property passes to the issue of the original donor, and it is unclear whether this rule applies if the property is placed in trust where the original donor or donor's spouse is a potential beneficiary.[259] In *Estate of Kite v. Commissioner*[260] prior to her husband's death, the surviving spouse funded an inter-vivos QTIP

[250] Prop. Treas. Reg. § 1.1014-10(c)(3)(i)(A).

[251] Prop. Treas. Reg. § 1.1014-10(c)(3)(i)(B).

[252] Prop. Treas. Reg. § 1.6035-1(f).

[253] *Id.*

[254] *Id.*

[255] § 1014(e)(1)(A).

[256] § 1014(e)(1)(B).

[257] § 1014(e)(1) (flush language).

[258] § 1014(e)(2)(B).

[259] *See* PLRs 200210051, 200101021, 9026036, and TAM 9302002.

[260] T.C. Memo 2013-43.

trust for the benefit of her husband with appreciated assets. Her husband died a week after the QTIP trust was created and funded. The surviving spouse reserved a secondary life estate for the benefit of the surviving spouse, and the inclusion in her husband's estate was offset with a QTIP election. As such, after her husband's death, the appreciated assets were held in a marital trust for the surviving spouse, the original donor of the assets. Two other marital trusts were created for the benefit of the surviving spouse. The three marital trusts engaged in a series of transactions that effectively terminated the marital trusts, with a subsequent sale of the assets by the surviving spouse to the children for a deferred annuity. These transactions were at issue in the case, and the tax court concluded that a taxable gift was deemed to occur upon the sale of the marital trust assets under section 2519. However, in a footnote, the Tax Court provided that all of the assets in the marital trusts, including the appreciated assets gifted to him shortly before death, received a step-up in basis under section 1014 of the Code.[261] The decision and the result of the case (in particular the with respect to section 1014(e)) have been criticized by a number of commentators.[262]

E. Community Property and Elective/Consensual Community Property

1. The Code provides a special rule for community property. Section 1014(b)(6) provides that "property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate"[263] shall be deemed to have been acquired from or to have passed from the decedent.

2. There are currently nine community property states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. There are two states that are separate property states but they allow couples to convert or elect to treat their property as community property: Alaska[264] and Tennessee.[265] Generally, these elective or "consensual community property" laws allow resident and nonresident couples to classify property as community property by transferring the property to a qualifying trust, and for nonresidents, a qualifying trust requires at least one trustee who is a resident of the state or a company authorized to act as a fiduciary of such state, and specific language declaring the trust asset as community property.

3. Clearly, for residents of separate property states, taking advantage of the "consensual community property" laws of another state has the potential for a basis adjustment under section 1014(b)(6). There has been no direct ruling on whether that would be the case under the laws of Alaska or Tennessee. However, a number of commentators have argued that assets in such "consensual community property" arrangements would, indeed, receive a full

[261] "All of the underlying trust assets, including the OG&E stock transferred to Mr. Kite in 1995, received a step-up in basis under sec. 1014." *Estate of Kite v. Commissioner*, T.C. Memo 2013-43, footnote 9.

[262] *See* Jeffrey N. Pennell, *Jeff Pennell on Estate of Kite: Will it Fly?*, LISI Estate Planning Newsletter #2062 (Feb. 11, 2013) and John J. Scroggin, *Understanding Section 1014(e)*, LISI Estate Planning Newsletter #2192 (Feb. 6, 2014).

[263] § 1014(b)(6).

[264] Alaska Stat. 34.77.010 et al. (Alaska Community Property Act).

[265] Tenn. Code Ann. § 35-17-101 et al. (Tennessee Community Property Trust Act of 2010).

"step-up" in basis under section 1014(b)(6).[266] A professional fiduciary must be designated in Alaska or Tennessee in order to invoke the respective statutes and the administrative expense ought to be weighed against the potential benefit, taking into consideration the uncertainty.

F. Establishing Community Property and Maintaining the Character

1. Given how valuable the full "step-up" in basis under section 1014(b)(6) can be for community property, practitioners should pay special attention to methods of transmuting separate property to community property and maintaining the community property even if the couple moves to a separate property state. Married couples who move from a separate property state and establish residence in a community property state can typically transmute their separate property to community property by way of agreement.[267] By way of example, California provides "married persons may by agreement or transfer, with or without consideration… transmute separate property of either spouse to community property."[268] As long as the couple has the intent to remain permanently in the community property state, the transmutation could occur immediately upon establishing residence in the state. In other words, there is no time requirement after establishing residency when transmutation would be considered valid.

2. Generally, if a couple moves from a community property state to a separate property state, the property will continue to maintain its community property status (but see below). However, maintaining that status to maximize the benefit of section 1014(b)(6) can be a challenge. For example, if community property is sold to purchase real property located in a separate property state, some courts have provided that the real property is held by the couple as tenants in common, notwithstanding the fact that the source of the funds is community property. Furthermore, if one spouse transfers assets to another spouse outright (as often happens in the estate planning process to "equalize" the estates of the spouses who are now living in a separate property state), the property is no longer considered community property. Generally income from community property and reinvestments of such income will retain its community property character. Money earned while domiciled in a separate property state will obviously be considered separate property. It is quite easy for commingling of funds to occur if, for example, an asset is bought with both community and separate property. Tracing of the funds and the income from such funds will be required from that point forward. As such, practitioners in separate property states should pay special attention to those clients who move from community property states and may want to consider ways to ensure and make clear how such property will continue to be held and reinvested.

3. Fourteen separate property states (Alaska, Arkansas, Colorado, Florida, Hawaii, Kentucky, Michigan, Montana, New York, North Carolina, Oregon, Utah, Virginia, and Wyoming) have enacted the Uniform Disposition of Community Property Rights at Death Act ("UDCPRDA"). UDCPRDA provides that property that was originally community property will

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[266] Jonathan G. Blattmachr, Howard M. Zaritsky and Mark L. Ascher. *Tax Planning with Consensual Community Property: Alaska's New Community Property Law*, 33 Real Prop. Probate and Tr. J. 615 (Winter 1999). *See also Commissioner v. Harmon*, 323 U. S. 44 (1944) (an Oklahoma income tax case involving elective community property), *McCollum v. U.S.*, 58-2 USTC § 9957, 2 A.F.T.R.2d 6170 (N. D. Okla. 1958) (explaining what *Harmon* meant, and distinguishing it in the context of basis), and Rev. Rul. 77-359, 1977-2 C.B. 24.

[267] Simply moving to a community property state will typically not automatically cause separate property to be considered community property.

[268] Cal. Fam. Code § 850.

retain its character as such for testamentary purposes. The UDCPRDA is limited in scope,[269] and is not a tax statute. It is not clear whether decedents with surviving spouses who live in a state that has enacted the UDCPRDA are in a better position to claim the "step-up" in basis under section 1014(b)(6), than those decedents who do not. Regardless, some practitioners worry that the UDCPRDA does not mandate community property treatment for section 1014 purposes at all, rather it merely means that the property will be treated "the same as" community property for state law purposes. Section 1014(b)(6) requires that property be treated as community property under the law of some state; if a state does not have the concept of community property, does the UDCPRDA treat non-community property as if it were community property, or does it transmute non-community property into community property? There appears to be no definitive Federal tax authority on the point.

G. Joint Revocable Trusts and the "JEST"

1. Following in the line of a number of rulings,[270] a planning technique referred to as the "Joint Exempt Step-Up Trust" ("JEST") has arisen that seeks to give married couples residing in non-community property states some of the same "step-up" in basis enjoyed by couples who pass away with community property under section 1014(b)(6). The attorneys who developed this technique have published the details of the JEST, including the numerous tax, creditor protection, and other legal issues surrounding the technique.[271]

2. The basic structure of the JEST is:

a. Married couple funds a jointly-established revocable trust, with each spouse owning a separate equal share in the trust. Either spouse may terminate the trust while both are living, in which case the trustee distributes 50% of the assets back to each spouse. If there is no termination, the joint trust becomes irrevocable when the first spouse dies. The first dying spouse has a general power of appointment over all trust assets.

b. Upon the first death, all assets are includible in the estate of the first to die.

c. Upon the first death, assets equal in value to the first dying spouse's unused Available Exemption Amount will be used to fund a bypass trust ("Credit Shelter Trust A") for the benefit of the surviving spouse and descendants. These assets will receive a stepped-up basis and will escape estate tax liability upon the surviving spouse's death. Any asset in excess of the funding of Credit Shelter Trust A will go into an electing qualified terminable interest property trust ("QTIP Trust A") under section 2056(b)(7). The assets in the QTIP Trust receive a step-up in basis upon the first spouse's death and on the surviving spouse's death.

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[269] It is limited to real property, located in the enacting state, and personal property of a person domiciled in the enacting state.

[270] PLRs 200102021, 200210051, 200604028, 200413011, 200403094 and TAM 9308002

[271] Alan S. Gassman, Christopher J. Denicolo, and Kacie Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses-Part 1*, 40 Est. Plan. 3 (Oct. 2013), Alan S. Gassman, Christopher J. Denicolo, and Kacie Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses-Part 2*, 40 Est. Plan. ___ (Nov. 2013), and Gassman, Ellwanger & Hohnadell, *It's Just a JEST, the Joint Exempt Step-Up Trust*, Steve Leimberg's Estate Planning Email Newsletter-Archive Message #2086 (4/3/13).

d. If the first dying spouse's share is less than his or her Available Exemption Amount, then the surviving spouse's share will be used to fund a "Credit Shelter Trust B" with assets equal to the excess exemption. According to the authors of this technique, the assets of the Credit Shelter Trust B will avoid estate taxation at the surviving spouse's death, notwithstanding that the surviving spouse originally contributed the assets to the JEST and had the power to terminate the trust and reclaim the assets. The authors provide that in order to further assure a step-up in basis on the assets in the Credit Shelter Trust B, it is best that the surviving spouse is not a beneficiary of Credit Shelter Trust B or perhaps to only be a beneficiary that may be added by an independent trust protector in the future.

e. Any assets remaining of the surviving spouse's share in excess of what is funded into Credit Shelter Trust B will be used to fund a QTIP Trust B.

f. The traditional concerns with this sort of planning have been whether there is one or more taxable gifts between the spouses in creating and funding the trust, and whether the desired "step-up" is available. Definitive guidance remains scarce.

H. Section 2038 Estate Marital Trusts

1. Another possible method of providing a "step-up" in basis for all marital assets on the death of the first spouse to die is using what is sometimes referred to as a "Section 2038 Estate Marital Trust." The basic features of a Section 2038 Estate Marital Trust are:

a. Grantor (the "Grantor Spouse") contributes assets to a trust for the benefit of his or her spouse (the "Beneficiary Spouse"). The Grantor Spouse can be the sole trustee or co-trustee of the trust. The trustee has the discretion to distribute income and principal only to the Beneficiary Spouse for such spouse's lifetime. Upon the Beneficiary Spouse's death, the trust assets pass to the Beneficiary Spouse's estate.

b. The Grantor Spouse retains a right to terminate the trust prior to the Beneficiary Spouse's death. Upon such termination, the trust assets must be distributed outright to the Beneficiary Spouse.

c. The Grantor Spouse retains the power, in a non-fiduciary capacity, to reacquire or "swap" the trust corpus by substituting other property of an equivalent value.

2. The trust does not provide for distribution of all income annually[272] or for the conversion of unproductive property[273] as would be required for a general power of appointment marital trust or QTIP Trust. However, the trust should qualify for the gift tax marital deduction because the trust funds are payable only to the Beneficiary Spouse's estate, and thus the spouse's interest is not a nondeductible terminable interest under section 2523(b).[274]

3. The contribution of assets to the trust should be a completed gift notwithstanding the Grantor Spouse's right to change the manner or time of enjoyment of the

[272] *See* §§ 2056(b)(5), 2056(b)(7)(B)(ii)(I), Treas. Reg. § 20.2056(b)-7(d)(2), Rev. Rul. 72-333, 1972-2 C.B. 530, and Rev. Rul. 68-554, 1968-2 C.B. 412.

[273] *See* Treas. Reg. §§ 20.2056(b)-5(f)(4) and 20.2056(b)-5(f)(5).

[274] *See* Treas. Reg. §§ 25.2523(a)-1(b)(3), 25.2523(b)-1 and 20.2056(c)-2(b)(1)(iii).

assets because the only beneficiary of the trust is the Beneficiary Spouse or the estate of the Beneficiary Spouse.[275]

4. During the lifetime of the Beneficiary Spouse, the trust will be treated as a grantor trust for income tax purposes with respect to the Grantor Spouse under section 677(a) which provides, in pertinent part, that the "grantor shall be treated as the owner of any portion of a trust… whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor … may be distributed to … the grantor's spouse"[276] or "held or accumulated for future distribution to … the grantor's spouse."[277] Because the Beneficiary Spouse and his or her estate is the sole beneficiary of the lifetime and the remainder interests, grantor trust treatment should be as to all of the assets in the trust and as to both income and principal.[278] Thus, no portion of the trust's income should be taxable as a non-grantor trust. However, in order to ensure grantor trust status as to all of the assets and tax items of the trust, practitioners might consider having the Grantor Spouse retain the power, in a non-fiduciary capacity, to reacquire the trust corpus by substituting other property of an equivalent value.[279]

5. If the Beneficiary Spouse dies first, the trust assets will be payable to his or her estate and thus are includible in the gross estate under section 2031 and entitled to a "step-up" in basis.

6. If the Grantor Spouse dies first, the trust assets will be includible in the gross estate under section 2038. It provides, the gross estate will include the value of all property "[t]o the extent of any interest therein of which the decedent has at any time made a transfer … by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3 year period ending on the date of the decedent's death."[280]

I. The Tax Nature of Particular Assets

1. Generally

a. Understanding how and to what extent assets will benefit from a "step-up" in basis is critical to the estate planning process. Obviously, certain assets like highly-appreciated assets will benefit more from the "step-up" in basis at death than cash (which has a basis equal to its face value which is equal to its fair market value) or property at a loss (a "step-down" in basis). Moreover, appreciated assets like gold that are considered "collectibles"[281] under the Code, benefit more from a step-up in basis than other appreciated capital assets because the Federal long-term capital gain tax rate for collectibles is 28%, rather than 20%.

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[275] *See* Treas. Reg. § 25.2511-2(d).

[276] § 677(a)(1).

[277] § 677(a)(2).

[278] See Treas. Reg. § 1.677(a)-1(g).

[279] § 675(4)(C) and Rev. Rul. 2008-22, 2008-16 I.R.B. 796.

[280] § 2038(a)(1).

[281] § 1(h)(4).

b. A list of asset categories or types starting with those that benefit the most from the "step-up" in basis and ending with those that benefit the least (or actually suffer a "step-down" in basis), might look like this:

(1) Creator-owned intellectual property (copyrights, patents, and trademarks), intangible assets, and artwork;

(2) "Negative basis" commercial real property limited partnership interests;

(3) Oil & gas investment assets (to be sold after date of death);

(4) Investor/collector-owned artwork, gold, and other collectibles;

(5) Low basis stock or other capital asset;

(6) Roth IRA assets;

(7) Oil & gas investment assets (to be held after date of death);

(8) Qualified Small Business Stock (QSBS);

(9) High basis stock;

(10) Cash;

(11) Passive Foreign Investment Company (PFIC) Shares;

(12) Stock or other capital asset that is at a loss;

(13) Variable annuities; and

(14) Traditional IRA and qualified plan assets.

c. A full discussion of every asset type listed above is beyond the scope of these materials, but a number of them deserve additional consideration and discussion.

2. Creator-Owned Intellectual Property, Intangible Assets and Artwork

a. Generally

(1) In the hands of the creator, intellectual property, intangible assets and artwork represent the type of asset that, from a tax standpoint, benefits greatly from the "step-up" in basis. For the most part, during the lifetime of the creator, these assets have little or no basis in the hands of the creator, and the sale, exchange, disposition, licensing or other exploitation of these types of assets are considered ordinary income to the creator. If the asset is transferred in a "carry-over" basis transaction like a gift, the tax attributes carry to the donee. On the other hand, if the creator of the asset dies with the asset, the asset is entitled to a "step-up" in basis and the asset becomes a long-term capital gain asset in the hands of the beneficiaries.

(2) Patents, copyrights, and trademarks are common assets, but intangible rights might also include the right of publicity, defined loosely as the right of an individual to have a monopoly on his or her own name, likeness, attributes, etc. In the case of well-known artists, actors, and celebrities, this right of publicity can be quite valuable. Some states, like New York, do not recognize a postmortem right to publicity,[282] while approximately 19 states have specifically codified the postmortem right to publicity. Notably, California[283] has codified the postmortem right to publicity, which lasts for a term of 70 years after the death of the personality. Further, the California statute specifically provides that such rights are freely transferable during lifetime or at death.

(3) As one can see, each of these intangible assets has its own peculiarities (for example, the duration of the intangible rights) that may affect its value at the date of transfer (whether during lifetime or at death) and that may affect whether the asset or particular rights can be transferred at all.

b. Copyrights

(1) Under U.S. law, copyright protection extends to "original words of authorship fixed in any tangible medium of expression," which includes: "(1) literary works; (2) musical works, including any accompanying words; (3) dramatic works, including any accompanying music; (4) pantomimes and choreographic works; (5) pictorial, graphic, and sculptural works; (6) motion pictures and other audiovisual works; (7) sound recordings; and (8) architectural works."[284] The courts have ruled that computer software constitutes protected literary works.[285]

(2) Knowing the duration of an existing copyright is critical to understanding what value a copyright may have today and what value a copyright may have in the future.

(a) For works copyrighted on or after January 1, 1978, a copyright's duration is based upon the life of the author plus 70 years.[286]

(b) For works copyrighted prior to January 1, 1978, a copyright's duration was 28 years, with the author (and his or her estate) having the right to renew and extend the term for another 67 years (for a total of 95 years).[287]

(3) For works copyrighted on or after January 1, 1978, the author (or the author's surviving spouse or descendants if the author is deceased) has a right to terminate

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[282] *See, Milton H. Greene Archives Inc. v. Marilyn Monroe LLC*, No. 08-056471 (9th Cir. 8/30/12), *aff'g* 568 F. Supp. 2d 1152 (C.D. Cal. 2008). *See* http://rightofpublicity.com for a good discussion of statues, cases, and current controversies, maintained by Jonathan Faber of the Indiana University McKinney School of Law.

[283] Ca. Civ. Code § 3344.

[284] 17 U.S.C. § 102(a)(1)-(8).

[285] *See, e.g., Apple Computer, Inc. v. Franklin Computer Corp.*, 714 F.2d 1243 (3rd Cir. 1983).

[286] 17 U.S.C. § 302(a).

[287] 17 U.S.C. § 304.

any transfer or assignment of copyright by the author 35 years after the transfer or assignment.[288] These termination rights apply "in the case of any work other than a work made for hire, the exclusive or nonexclusive grant of a transfer or license of copyright or of any right under a copyright, executed by the author on or after January 1, 1978, otherwise than by will."[289] Because only the author has the right of termination during his or her lifetime, even if a gift is made of the copyright, the author's continued right of termination calls into question how the copyright can be irrevocably transferred (especially since there seems no mechanism to waive the termination right) and appropriately valued for transfer tax purposes.

(4) Payments to the creator of a copyright on a non-exclusive license give rise to royalty income, taxable as ordinary income.[290] An exclusive license (use of substantially all of the seller's rights in a given medium) is treated as a sale or exchange. When the creator is the seller, it is deemed to be a sale of an asset that is not a capital asset,[291] so it is taxed at ordinary rates. By contrast, if the seller is not the creator, capital asset treatment under section 1221 is available if such seller is not a dealer.[292] Notwithstanding the foregoing, if the creator/author of the copyright, gifts the asset (carryover basis transaction), a sale or exchange by the donee is not afforded capital treatment either.[293] A gift for estate planning purposes, therefore, may have the unintended effect of prolonging ordinary income treatment after the death of the author/creator of the copyright.

(5) In contrast, upon the death of the author/creator who still owns the asset at death, the copyright is entitled to a "step-up" in basis to full fair market value under section 1014 and the asset is transformed into a long-term capital gain asset. Because the basis of the copyright included in the creator's estate is no longer tied to that of the creator, the asset no longer falls within the exclusion from capital asset treatment under section 1221(a)(3) and, thus, are capital assets in the hands of the creator's beneficiaries. The copyright is deemed to immediately have a long-term holding period even if it is sold within 1 year after the decedent's death.[294]

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[288] 17 U.S.C. § 203(a).

[289] *Id.*

[290] § 61(a)(6). *See also* Treas. Reg. § 1.61-8. Rev. Proc. 2004-34, 2004-22 I.R.B. 964, allows certain taxpayers to defer to the next taxable year, certain payments advance royalty payments.

[291] § 1221(a)(3). § 1221(b)(3) provides a limited exception for copyrights in musical works, pursuant to which the taxpayer may elect to have § 1221(a)(3) not apply to a sale or exchange.

[292] It could also be afforded § 1231 treatment (asset primarily held for sale to customers in the ordinary course of a trade or business).

[293] § 1221(a)(3)(C).

[294] § 1223(9).

c. Patents

(1) Individuals who patent qualifying inventions are granted the "right to exclude others from making, using, offering for sale, or selling"[295] such invention for a specified term. The term for a utility or plant patent is 20 years, beginning on the earlier of the date on which the application for the patent was filed.[296] The term for a design patent is 14 years from the date of grant.[297]

(2) Similar to the taxation of copyrights, payments received for a transaction that is not considered a sale or exchange or payments received for a license will be considered royalty income, taxable as ordinary income.[298]

(3) Prior to the enactment of TCJA, the sale or exchange of a patent could be afforded capital gain treatment if the transaction qualified under section 1235 of the Code or because the Treasury regulations specifically provide that a patent or invention are not considered "similar property"[299] to a copyright, which is excluded from capital gain treatment.[300] In addition, capital gain treatment under section 1231 of the Code would be possible but only if the patent is considered to have been "used in a trade or business."[301]

(4) Effective for dispositions after December 31, 2017, TCJA amended section 1221(a)(3) of the Code providing that "a patent, invention, model or design (whether or not patented), and a secret formula or process"[302] which is held either by the taxpayer who created the property or a taxpayer with a substituted or transferred basis from the taxpayer who created the property (or for whom the property was created) will be specifically excluded from the definition of a capital asset. In addition, TCJA makes a conforming amendment to section 1231(b)(1)(C) of the Code, specifically listing "a patent, invention, model or design (whether or not patented), and a secret formula or process" (just like a copyright) as an asset that is excepted from the term "property used in a trade or business." [303] As such the sale or exchange of such property will no longer qualify for capital gain tax treatment unless it fall under section 1235 of the Code.

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[295] 35 U.S.C. § 154(a)(1).

[296] 35 U.S.C. § 154(a)(2).

[297] 35 U.S.C. § 173.

[298] § 61(a)(6). *See also* Treas. Reg. § 1.61-8.

[299] "For purposes of this subparagraph, the phrase "similar property" includes for example, such property as a theatrical production, a radio program, a newspaper cartoon strip, or any other property eligible for copyright protection (whether under statute or common law), but does not include a patent or an invention, or a design which may be protected only under the patent law and not under the copyright law." Treas. Reg. § 1.1221-1(c)(1).

[300] Even with the exclusion from "similar property," the individual generally had to be considered a non-professional inventor (otherwise the patent would be considered stock in trade or inventory in the hands of a professional inventor).

[301] § 1231(a)(3)(A)(i). The holding period is deemed to start when the patent is reduced to practice. *Kuzmick v. Commissioner*, 11 T.C. 288 (1948).

[302] § 1221(a)(3).

[303] § 1231(b)(1)(C).

(5) Like the tax treatment of the creator of a copyright, if the creator dies with a patent, the asset is entitled to a "step-up" in basis to full fair market value under section 1014, and the asset is transformed into a long-term capital gain asset.

(6) Section 1235 Transactions

(a) The House bill of TCJA proposed a repeal of section 1235 of the Code, but the repeal did not make it the final version of TCJA.

(b) Section 1235 provides that a "transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 1 year."[304]

(c) Only an individual may qualify as a holder, regardless of whether he or she is in the business of making inventions or in the business of buying and selling patents.[305] Specifically, a qualified "holder" includes (i) the creator of the patent,[306] or (ii) "any other individual who has acquired his interest in such property in exchange for consideration in money or money's worth paid to such creator prior to actual reduction to practice of the invention covered by the patent,"[307] provided that in such instance, the individual is not an employer of the creator or related to the creator.[308] As such, a trust, estate, or corporation will not qualify as a holder under section 1235, although a transfer to a grantor trust would not likely disqualify a subsequent sale or exchange to capital gain treatment.[309] An entity taxable as a partnership does not qualify as a holder, but each individual in the partnership may qualify separately as such.[310]

(d) A sale or exchange by a qualified holder to a "related person" will not qualify for capital-gain treatment under section 1235.[311] A "related person" is generally defined by reference to section 267(b) and includes (i) the holder's spouse, ancestors, and lineal descendants (but not siblings);[312] (ii) a fiduciary of any trust of which the holder is the grantor; (iii) any corporation, partnership, or other entity in which the holder (and other related persons) own 25% or more of the ownership interests.[313]

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[304] § 1235(a).

[305] § 1235(a)(2) and Treas. Reg. § 1.1235-2(d)(3).

[306] § 1235(b)(1).

[307] § 1235(b)(2).

[308] § 1235(b)(2)(A)-(B).

[309] *See* Treas. Reg. § 1.671-2(c). If a holder sells his or her interest in a transfer qualifying under section 1235 and later dies before all payments are received, the estate and/or beneficiary of the deceased reports the payments as long-term capital gain as income in respect of a decedent.

[310] Treas. Reg. § 1.1235-2(d)(2). *See also*, PLRs 200135015, 200219017, 200219019, 200219020, 200219021, 200219026, 200506008, 200506009, and 200506019.

[311] § 1235(d).

[312] § 1235(d)(2)

[313] § 1235(d)(1).

(e) Because of the foregoing limitations of who can qualify as a holder and the related person limitations on who can be the transferee, many estate planning techniques involving patents are limited if capital gain treatment is to be retained.

(f) If a qualified holder sells his or her interest in a patent under section 1235 and later dies before all payments are received, the estate and/or beneficiary of the deceased reports the payments as long-term capital gain as IRD.[314]

d. Artwork

(1) The taxation of artwork in the hands of the artist is the same as it would be for the creator of a copyright, as discussed above. Generally, all payments pursuant to a license and a taxable sale or exchange of the artwork give rise to ordinary income.[315] A third-party collector or investor in the artwork might qualify for capital gain treatment or section 1231 treatment, as long as the property is not held out for sale in the ordinary course of a trade or business (inventory).[316] Similarly, capital gain treatment is not available to a donee of the artist because the donee's basis is determined by reference to the artist's basis.[317]

(2) Artwork in the hands of a collector or investor (third-party other than the creator or a donee of the creator) is considered a collectible under the Code and would be subject to the 28% long-term capital gain tax, rather than 20%.[318] Under the Code, a "collectible" is any work of art, rug, antique, metal, gem, stamp, coin, alcoholic beverage, or any other tangible personal property designated by the IRS as such.[319]

(3) As with copyrights and patents, the basis of property in the hands of a person acquiring property from a deceased artist is the fair market value of the property at the date of the artist's death or on the alternate valuation date, if so elected.[320] The artwork in the hands of the estate or the artist's beneficiaries becomes a capital asset, qualifying for long-term capital gain treatment.[321]

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[314] § 691 and Treas. Reg. § 1.691(a)(3).

[315] §§ 1221(a)(3) and 61(a)(6). Section 1221(b)(3) of the Code provides a limited exception for copyrights in musical works, pursuant to which the taxpayer may elect to have section 1221(a)(3) not apply to a sale or exchange.

[316] § 1221(a)(1).

[317] §§ 1221(a)(5)(B) and 1015.

[318] § 1(h)(4).

[319] §§ 1(h)(5)(A) and 408(m)(2).

[320] § 1014(a).

[321] *See* §§ 1221(a)(3) and 1223(9).

3. "Negative Basis" and "Negative Capital Account" Partnership Interests

a. "Negative basis" is the colloquial phrase used to describe a situation where the liabilities in a partnership (as also shared by the partners) are in excess of the tax basis of the partnership assets (and in the basis of the partners' interests in the partnership). When a partner has a negative capital account, so that the outside basis is less than the partner's share of partnership liabilities, a taxable sale of the partnership property (or of the partnership interest) will create "phantom gain." Note, the basis of an asset may not go below zero, so the phrase "negative basis" is technically incorrect. Even successful real property investment partnerships may have "negative basis" assets where the underlying developed real property has been fully depreciated and cash from refinancings has been distributed to the owners or partners.

b. The following example illustrates how this "negative basis" problem can arise and how costly a taxable event would be from an income tax standpoint:

(1) Taxpayer buys an office building in 1983 for $10,000,000 (assume for purposes of this example, the entire purchase price is properly allocated to the office building, which is depreciable). Over the next 30 years, the property appreciates in value, the taxpayer fully depreciates the original basis of $10 million in the building to zero,[322] borrows against the property, and takes the loaned funds tax free. As a result in 2014, the office building is worth $20 million, has zero adjusted tax basis, and has a mortgage on the building of $15 million ($5 million of net equity in the property).

(2) Note, because the property was placed in service in 1983, an accelerated method of depreciation was allowable on the property.[323] As such, a taxable sale of the property will be subject to recapture under the Code. Because the property was placed in service prior to 1986, recapture is under section 1245 (rather than section 1250, which generally

[322] §§ 1016(a)(2), 168(a), and Treas. Reg. § 1.1016-3(a)(1)(i).

[323] Accelerated Cost Recovery System ("ACRS") was enacted in 1981 under the Economic Recovery Tax Act of 1982 ("ERTA"), P.L. 97-34. ACRS was later modified by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), P.L. 97-248, and the Tax Reform Act of 1984, P.L. 98-369, when the recovery period for most real property was extended from 15 to 18 years. In 1985, the real property recover period was extended from 18 to 19 years, P.L. 99-121, § 103. ACRS generally applies to property placed in service after December 31, 1980, and before December 31, 1986. Prop. Treas. Reg. § 1.168-4(a). The Tax Reform Act of 1986, P.L. 99-514, ("TRA 1986") dramatically changed the applicability of ACRS to real property investments and instituted the modified ACRS ("MACRS"). Notably, the "applicable recovery period" for most real property assets like buildings are placed in 27.5 or 39-year recovery periods, while land improvements fall within 15 or 20-year recovery periods. § 168(c). In this example, because it was placed in service before 1984, the building would be considered 15-year real property, pursuant to which the applicable percentage of depreciation was 12% in the first year, reducing to 5% in from 11 to 15 years.

applies to real property).[324] As such, the total amount of the depreciation deductions is subject to recapture as ordinary income.[325]

(3) If the building is sold for $20 million in a taxable transaction, the gain would break down as follows:

Amount Recognized:	$20,000,000
Adjusted Basis:	$ ------
Recapture:	$10,000,000 ordinary income
Long-Term Capital Gain:	$10,000,000 long-term capital gain

Assuming the taxpayer is in the highest income tax bracket and in a relatively high income tax state, like a New York City taxpayer, the ordinary rate would be approximately 45% and the long-term capital gain rate would be approximately 37%. The total tax liability would be $8.2 million. After repayment of the $15 million of debt, the taxpayer (who would net $5 million in cash from the transaction before taxes) would actually be in deficit by approximately -$3.2 million after the payment of income taxes.

(4) Compare the result if the taxpayer died owning the building (assume for simplicity's sake, the building no longer has a mortgage). The building would get a "step-up" in basis under section 1014(a) to fair market value, the recapture and long-term capital gain tax problem would be eliminated. If the taxpayer has $5.34 million of Applicable Exclusion available, the maximum estate tax liability (assuming a top state death tax rate of 16% and state death tax exemption equal to the federal exclusion amount) is approximately $7.3 million (maximum blended rate of 49.6%). If the Applicable Exclusion Amount grows to $8 million for example, then the estate tax liability falls to a bit less than $6.0 million. If the foregoing building was in California, the income tax liability would be greater, and the estate tax cost would be even less because California does not have a death tax. With an Applicable Exclusion Amount of $5.34, the estate tax liability is less than $5.9 million.

(5) Property placed in service after 1986 will not have as egregious of an income tax problem because the gain would not have recapture calculated under section 1245. Rather, section 1250 would be the applicable recapture provision. "Section 1250 property" means any real property, with certain exceptions that are not applicable,[326] that is or has been property of a character subject to the allowance for depreciation.[327] Section 1250(a)(1)(A) provides that if section 1250 property is disposed of, the "applicable percentage" of the lower of the "additional depreciation" in respect of the property or the gain realized with respect to the disposition of the property shall be treated as ordinary income. In short, section 1250 provides

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[324] § 1245(a)(5) before being amended by TRA 1986, defines "§1245 recovery property" to include all recovery property under ACRS, real or personal, other than certain types of 19-year (18-year for property placed in service after March 15, 1984, and before May 9, 1985; and 15-year for property placed in service before March 16, 1984) real property and low-income housing: residential rental property, property used "predominantly" outside the United States, property as to which an election to use straight-line recovery is in effect, and certain low-income and Federally insured residential property. The foregoing types of property are subject to recapture under Section 1250. In this example, the office building does not fall within the listed categories, and as such is subject to recapture under Section 1245.

[325] *See* § 1245(a)(1).

[326] § 1245(a)(3).

[327] § 1250(c).

that all or part of any depreciation deduction in excess of straight-line depreciation is recaptured as ordinary income. [328] Under the current depreciation system, straight-line depreciation is required for all residential rental and nonresidential real property.[329] As such, section 1250 recapture is typically not a problem for property placed in service after 1986. The Code does, however, tax "unrecaptured section 1250 gain" at a 25% tax rate. Unrecaptured section 1250 gain is essentially the lesser of all depreciation on the property or the net gain realized (after certain losses) to the extent not treated as ordinary income under section 1250.[330]

(6) From an estate planning perspective, it is important to remember that even if recapture is inherent in an appreciated property, it does not apply to a disposition by gift or to a transfer at death, unless the recapture would be considered income in respect of a decedent.[331]

c. Today, most real property investments are not held individually, but are held typically in an entity taxable as a partnership (for example, a limited liability company or limited partnership). When real property investments are subject to refinancing followed by a distribution of the loan proceeds, the partnership debt rules under section 752 must be considered when determining the income tax cost of selling such property. Any increase in a partner's share of partnership liabilities (whether recourse or nonrecourse to such partner) is treated as a contribution of money by the partner to the partnership, resulting in an increase in the partner's basis in his or her partnership interest ("outside basis").[332] Any decrease in a partner's share of partnership liabilities is treated as a distribution of money by the partnership to the partner, resulting in a decrease in the partner's outside basis.[333] A partner's outside basis may not be reduced below zero, so a deemed distribution of money that arises from a decrease in a partner's share of liabilities will give rise to gain recognition.[334]

d. In the example described above, consider if a partnership owned a fully depreciated $20 million building. The partnership has $15 million of debt which is in excess of the basis in the building and in excess of the taxpayer's outside basis. Assume for this example that we can ignore other partners because they have relatively insubstantial interests in the partnership. When a partner has a negative capital account, so that the outside basis is less that the partner's share of partnership liabilities, it is also colloquially called "negative basis." As discussed, this is a misnomer because basis can never go below zero. [335] A transfer by the taxpayer, whether a taxable sale or a gift to a non-grantor trust, creates what is often referred to as "phantom gain" because the transferee takes over the transferor partner's negative capital account. It should also be noted that a partner who sells his or her partnership interest must include in income his or her allocable share of the partnership's recapture from depreciated

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[328] § 1250(b)(1), (3), (5).

[329] § 168(b)(3)(A)-(B).

[330] § 1(h)(6).

[331] § 1250(d)(1) and (2).

[332] §§ 752(a) and 722. Treas. Reg. § 1.752-1(b).

[333] §§ 752(b) and 733. Treas. Reg. § 1.752-1(c).

[334] § 731(a) or 751.

[335] Partnership borrowings and payments of liabilities do not affect the capital accounts, because the asset and liability changes offset each other. See Treas. Reg. § 1.704-1(b)(2)(iv)*(c)*.

partnership property.[336] The transfer results in a decrease in the transferor partner's share of liabilities, which in turn is treated as a distribution of money to the partner when the partner has an outside basis of zero, resulting in gain in a donative transfer or additional gain in the case of taxable sale.[337]

e. When dealing with highly appreciated, depreciable assets like real property and partnership debt, taxable sales of the property and inter-vivos transfers of partnership interests can be problematic. [338] In many cases, given reduced transfer tax rates and growing Applicable Exclusion Amounts, it will make more economic sense to die owning these assets, than to transfer them during the partner's lifetime. The transfer of a partner's interest on death is a disposition that does not result in gain or loss recognition, even if the liability share exceeds outside basis.[339] The outside basis of the decedent receives a "step-up" in basis to fair market value (net of liabilities) but is also increased by the estate's share of partnership liabilities.[340] Further, if the partnership makes an election under section 754, the underlying assets in the partnership will also receive a "step-up" in basis.[341]

f. Even if a section 754 election is not made, the estate or the successor beneficiaries of the partnership interest can get the benefit of a "step-up" in the underlying assets if the successor partner makes an election under section 732(d) and if the partnership distributes the assets for which there would have been a basis adjustment.[342] The election must be made in the year of the distribution if the distribution includes property that is depreciable, depletable, or amortizable. If it does not include such property, the election can wait until the first year basis has tax significance. [343]

4. Traditional IRA and Qualified Retirement Assets

a. At the end of 2017, the Investment Company Institute estimated that total retirement assets were over $27 trillion (including government plans, private defined benefit

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[336] §§ 751 and 453(i)(2). Under § 751, unrealized receivables are deemed to include recapture property, but only to the extent the unrealized gain is ordinary income. Treas. Reg. § 1.751-1(e) and (g).

[337] Rev. Rul. 84-53, 1984-1 C.B. 159, Situation 4.

[338] *See* Steve Breitstone and Jerome M. Hesch, *Income Tax Planning and Estate Planning for Negative Capital Accounts: The Entity Freeze Solution*, 53 Tax Mgmt. Memo. 311 (August 13, 2012).

[339] *See* Elliott Manning and Jerome M. Hesch, *Sale or Exchange of Business Assets: Economic Performance, Contingent Liabilities and Nonrecourse Liabilities (Part Four)*, 11 Tax Mgmt. Real Est. J. 263, 272 (1995), and Louis A. del Cotto and Kenneth A. Joyce, *Inherited Excess Mortgage Property: Death and the Inherited Tax Shelter*, 34 Tax L. Rev. 569 (1979).

[340] §§ 1014(a), 1014(b), 742; Treas. Reg. §§ 1.1014-1(a), (b), and 1.742-1. The election is made by the distributee partner's attaching a schedule to the income tax return setting out (i) the election to adjust the basis of distributed property under Section 732(d), and (ii) the computation of the basis adjustment to the distributed properties. Treas. Reg. § 1.732-1(d)(3).

[341] § 743(a).

[342] § 732(d) and Treas. Reg. §1.732-1(d)(1)(i)-(iii). The election is made by the distributee partner's attaching a schedule to the income tax return setting out (i) the election to adjust the basis of distributed property under Section 732(d), and (ii) the computation of the basis adjustment to the distributed properties. Treas. Reg. § 1.732-1(d)(3).

[343] Treas. Reg. § 1.732-1(d)(2).

plans, defined contribution plans and individual retirement accounts).[344] Assets in IRAs and defined contribution plans totaled more than ½ of the total at approximately $16.3 trillion. Although IRA and qualified retirement assets make up one of the largest asset types of assets owned by individuals, they are one of the most problematic from an estate planning perspective.

b. IRA and qualified retirement assets are not transferable during the lifetime of the owner,[345] so the assets are never candidates for lifetime gifts unless the owner is willing to incur a taxable distribution of the assets. As such, to the extent not drawn-down prior to death, the assets are includible in the estate for transfer tax purposes,[346] and by definition, the assets will use some or all of the decedent's Applicable Exclusion Amount, unless the assets are transferred to a surviving spouse under the marital deduction under section 2056 or to a charitable organization under section 2055.[347] To make things worse, IRA and qualified retirement assets are considered income in respect of a decedent (IRD) under section 691.[348] IRD assets are not entitled to a "step-up" in basis,[349] and all distributions (whether paid over time or not) to a beneficiary are taxable as ordinary income.[350] Even though the beneficiary is entitled to an income tax deduction[351] ("IRD deduction") for estate taxes payable by virtue of the inclusion of the assets, there is no Federal income tax deduction for state death taxes that might be payable, and given the reduced Federal transfer tax rate of 40% and the cost-of-living increase on the Applicable Exclusion Amount, many taxpayers will have very little or no IRD deduction to shelter the on-going ordinary income tax problem.

c. A distribution from a decedent's IRA to a surviving spouse may be "rolled over" to another qualified retirement plan or IRA, thereby deferring the recognition of income.[352] In addition, if the surviving spouse is the beneficiary of all or a portion of the decedent's IRA, the surviving spouse may also elect to treat the decedent's IRA as his or her own IRA.[353] In both of the foregoing cases, the IRD problem discussed above continues after the death of the surviving spouse (unless the surviving spouse remarries).

d. Because of the income tax liability built-in to retirement plans and IRAs, they should be among the first assets considered for clients who intend to benefit charity at

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[344] Investment Company Institute, *Release: Quarterly Retirement Market Data, Third Quarter 2017*, http://www.ici.org/research/stats/retirement/ret_17_q3, as of September 30, 2017 (12/20/17).

[345] *See* the anti-alienation provision in § 401(a)(13)(A).

[346] § 2039(a).

[347] The IRS has taken the position that qualified retirement assets used to fund a pecuniary bequest to a charitable organization will be considered an income recognition event, triggering ordinary income. CCA 200644020.

[348] *See e.g., Ballard v. Commissioner*, T.C. Memo 1992-217, *Hess v. Commissioner*, 271 F.2d 104 (3d Cir. 1959), Rev. Rul. 92-47, 1992-1 C.B. 198, Rev. Rul. 69-297, 1969-1 C.B. 131, PLR 9132021, and GCM 39858 (9/9/91).

[349] § 1014(c).

[350] §§ 61(a)(14), 72, 402(a) and 408(d)(1), assuming the decedent owner had no nondeductible contributions. *See* § 72(b)(1) and (e)(8).

[351] § 691(c)(1).

[352] § 402(c)(9).

[353] Treas. Reg. § 1.408-8, Q&A-5(a).

death. Many techniques are available beyond outright charitable gifts including, for example, testamentary funding of a charitable remainder trust.[354]

e. Contrast the foregoing treatment with Roth individual retirement plans ("Roth IRAs").[355] Roth IRA assets are treated similarly to assets in a traditional IRA in that: (i) the account itself is not subject to income tax;[356] (ii) distributions to designated beneficiaries are subject to essentially the same required minimum distribution rules after the death of the original Roth IRA owner;[357] and (iii) surviving spouses may treat a Roth IRA as his or her own and from that date forward the Roth IRA will be treated as if it were established for the benefit of the surviving spouse.[358] In contrast to a traditional IRA, distributions to a qualified beneficiary are not taxable to the beneficiary,[359] and as discussed above, are not subject to the 3.8% Medicare Tax.[360] The overall result for decedents with Roth IRA assets, the qualified beneficiaries of the Roth IRA effectively receive the benefit of a "step-up" in basis. Since 2010,[361] all taxpayers regardless of adjusted gross income[362] can convert traditional IRA assets into a Roth IRA. The conversion is considered a taxable event causing the converted amount to be includible in gross income and taxable at ordinary income tax rates.[363] Taxpayers can also make direct taxable rollovers from qualified company-based retirement accounts (section 401(k), profit sharing, section 403(b), and section 457 plans) into a Roth IRA.[364] Individuals who have excess qualified retirement assets, have sufficient funds to pay the resulting tax liability from outside of the retirement account, and who are not planning to donate the asset to a charitable organization are should consider a Roth IRA conversion. Notwithstanding the clear benefits of passing the Roth IRA assets to children and grandchildren outside of the scope of the IRD provisions, not many individuals are willing to pay the income tax cost of the conversion.

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[354] *See* Paul S. Lee and Stephen S. Schilling, *CRTs Are Back (in Four Delicious Flavors)*, Trusts & Estates (Oct. 2014), p. 40-43.

[355] § 408A.

[356] Treas. Reg. § 1.408A-1, Q&A-1(b).

[357] Treas. Reg. § 1.408A-6, Q&A-14. One specific exception is the "at-least-as-rapidly" rule under § 401(a)(9)(B)(i).

[358] Treas. Reg. § 1.408A-2, Q&A-4.

[359] § 408A(d)(1).

[360] § 1411(c)(5).

[361] Tax Increase Prevention and Reconciliation Act of 2005, P.L. 109-222, effective for tax years beginning after December 31, 2009.

[362] Prior to this change, only taxpayers having less than $100,000 in modified adjusted gross income could convert a Traditional IRA to a Roth IRA. Former § 408A(c)(3)(B).

[363] § 408A(d)(3)(A)(i).

[364] *See* Notice 2008-30, 2008-12 I.R.B. 638 (3/24/2008) and Notice 2009-75, 2009-39 I.R.B. 436 (9/28/2009). § 408A(d)(3)(A).

5. Passive Foreign Investment Company (PFIC) Shares

a. A PFIC is a foreign corporation, 75% or more of the gross of which is "passive,"[365] or the average percentage of assets that produce passive income of which is at least 50%.[366] The PFIC rules do not apply to any U.S. taxpayer who is a 10% shareholder of a controlled foreign corporation.[367]

b. The PFIC rules generally provide that when a U.S. shareholder receives a distribution from a PFIC, rather than treating them under the normal rules of U.S. taxation (e.g., dividend treatment), a special tax regime applies. Under the PFIC tax regime, distributions from a PFIC will be treated either as "excess" or "nonexcess" distributions.

(1) An excess distribution is any portion that exceeds 125% of the average distributions made to the shareholder with respect to the shareholder's shares within the 3 preceding years (or shorter if the shareholder has held the shares for less than 3 years).[368] All other distributions or portions thereof are treated as nonexcess distributions.

(2) With respect to nonexcess distributions, the normal rules of U.S. taxation apply, which generally results in dividend treatment.[369] However, the dividend will not be considered a qualified dividend taxable at 20% because a PFIC will never be a "qualified foreign corporation."[370]

c. The portion of any distribution that is considered an excess distribution will first be allocated to each day in the shareholder's holding period for the shares.[371] Any portion so allocated to the current year and the non-PFIC years will be included in the year of receipt as ordinary income (not qualified dividends).[372]

d. The portion of the excess distribution that is allocated to other years (the "PFIC years") is not included in the shareholders income, but is subject to a "deferred tax."[373] The deferred tax is added to the tax that is otherwise due. In computing the "deferred tax" the shareholder multiplies the distribution allocated to each PFIC year by the top marginal tax rate in effect for that year.[374] The shareholder then adds all of the "unpaid" tax amounts for all of the PFIC years, and then computes interest on those unpaid tax amounts as if the shareholder had not paid the tax for the PFIC years when due using the applicable federal

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[365] § 1297(a)(1). Generally, "passive income" is foreign personal holding company income, as provided in § 954(c). § 1297(b).

[366] § 1297(a)(2).

[367] § 1297(e).

[368] § 1291(b)(2)(A).

[369] Prop. Treas. Reg. § 1.1291-2(e)(1).

[370] *See* § 1(h)(11)(C)(iii).

[371] § 1291(a)(1)(A).

[372] § 1291(a)(1)(B).

[373] § 1291(c).

[374] § 1291(c)(1).

underpayment rate.[375] The deferred tax and interest are separate line items on the individual shareholder's income tax return.[376]

e. The sale of PFIC shares are considered excess distributions to the extent the consideration for the sale is in excess of the shareholder's tax basis in the PFIC shares.[377] Thus, effectively the gain is treated as ordinary income, which is treated as realized ratable over the seller's holding period for purposes of determining the deferred tax and interest for prior years.

f. U.S. shareholders of a PFIC may make a "qualified elective fund" (QEF) election to avoid the excess distribution regime. If the shareholder makes a QEF election, the shareholder must include in gross income a pro rata share of the PFIC's ordinary income and net capital gain each taxable year.[378] If a shareholder makes this election, he or she must have access to the PFIC's books and records so the allocable share of the PFIC's income and gain can be calculated.

g. The death of a U.S. shareholder is not a taxable disposition of the PFIC shares if the death results in a transfer to a domestic U.S. estate or directly to another U.S. taxpayer.[379] By contrast, a transfer upon the death of a U.S. shareholder to a testamentary trust or to a foreign person will be considered at taxable disposition.[380] The proposed Treasury Regulations treat a transfer upon death as a transfer by the shareholder immediately prior to death and thus reportable in the decedent's last tax return.[381]

h. If the PFIC shares are held in a grantor trust, the grantor's death is a taxable disposition unless one of the exceptions applies.[382]

i. PFIC shares are nominally eligible for a "step-up" in basis. However, section 1291(e)(1) provides that a succeeding shareholder's basis in PFIC shares is the fair market value of the shares on date of death but then reduced by the difference between the new basis under section 1014 and the decedent's adjusted basis immediately before date of death.[383] Thus, a succeeding shareholder's basis in PFIC shares received from a decedent is limited to the adjusted basis of the decedent prior to death.

j. The foregoing basis reduction rule does not apply to PFIC shares received by a succeeding U.S. shareholder upon the death of a nonresident alien decedent if the decedent was a nonresident alien during his or her entire holding period.[384]

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[375] § 1291(c)(1) through (c)(3).

[376] § 1291(a)(1)(C).

[377] § 1291(a)(2).

[378] § 1293(a).

[379] Prop. Treas. Reg. § 1.1291-6(c)(2)(iii)(A).

[380] Prop. Treas. Reg. § 1.1291-6(c)(2)(iii)(B).

[381] Prop. Treas. Reg. § 1.1291-6(d)(2).

[382] Prop. Treas. Reg. § 1.1291-6(c)(3)(iv).

[383] § 1291(e)(1).

[384] § 1291(e)(2).

6. Qualified Small Business Stock (QSBS)[385]

a. Section 1202 of the Code excludes a percentage of gain (50%, 75%, or 100%, depending on the original acquisition date) on the sale or exchange of "Qualified Small Business Stock" (QSBS) held for more than five years, and the percentage of exclusion (hereinafter referred to as the "Exclusion Percentage") depends on the date on which the QSBS was acquired. Although a certain percentage of gain is excluded, the non-excluded gain, defined in the Code as "section 1202 gain," is taxed at a maximum 28% rate,[386] not the 20% preferential long-term capital gain rate. Section 1202 gain is defined as the excess of "the gain which would be excluded from gross income under section 1202 but for the percentage limitation in section 1202(a)," over "the gain excluded from gross income under section 1202"[387] (hereinafter referred to as, "Section 1202 Gain"). With the addition of the 3.8% excise tax on net investment income, the following chart sets out the maximum effective tax rates and exclusions, depending on whether the taxpayer is in AMT or not:[388]

[385] For a more complete discussion of QSBS, *see* Paul S. Lee, L. Joseph Comeau, Syida C. Long, and Julie Miraglia Kwon, *Qualified Small Business Stock (The Next Big Bang)—The Quest for Quantum Exclusions: (Queries, Qualms, and Qualifications)*, 53rd Annual Heckerling Institute on Estate Planning (2019), published by LexisNexis Matthew Bender.

[386] *See* §§ 1(h)(1)(F) and 1(h)(4)(A)(ii).

[387] § 1(h)(7).

[388] The chart excludes the 60% exclusion with respect to QSBS of certain empowerment zone businesses acquired after December 21, 2000 since the enactment of the 75% and 100% exclusions have made the 60% exclusion of no value to taxpayers. *See* §§ 1202(a)(2) and 1397C(b).

Acquisition Date	Exclusion Percentage	Maximum QSBS Rate	Maximum QSBS AMT Rate[389]	Maximum Rate (No QSBS)
Aug. 11, 1993 to Feb. 17, 2009	50%[390]	15.90%	16.88%	23.80%
Feb. 18, 2009 to Sep. 27, 2010	75%[391]	7.95%	9.42%	23.80%
After Sep. 27, 2010	**100%[392]**	**0.00%**	**0.00%**	**23.80%**

b. As one can see, the maximum tax savings from QSBS comes from stock acquired after September 27, 2010. One might also note that under some circumstances, the sale of QSBS stock might be subject to a higher rate than if section 1202 did not apply (e.g., stock entitled to a 50% exclusion under section 1202 sold during a time when the taxpayer's highest tax bracket is 15%). It's important to note that section 1202 is not elective. Under such circumstances, the taxpayer would have been better off intentionally losing QSBS status by, for example, failing the 5-year holding requirement or making a disqualifying transfer, as discussed in more detail below.

c. In calculating any tax liability associated with the sale of QSBS, it is important to make a distinction between Section 1202 Gain (as defined above), gain that is excluded under section 1202(a) of the Code (the "Excluded Section 1202 Gain"), and the taxable gain that is not subject to section 1202 (the "Non-Section 1202 Gain"). As noted above, Section 1202 Gain is taxed at a maximum rate of 28% (31.8%) and is carefully defined in terms of gain that would be excluded but for the percentage limitations noted above. By consequence, Section 1202 Gain is also limited by the "Per-Issuer Limitation," discussed below, which limits the total amount of gain that is subject to the percentage exclusions. Any other gain, namely Non-Section 1202 Gain is taxed at the preferential 20% (23.8%) long-term capital gain tax rate. Non-Section 1202 Gain can include the unrecognized gain inherent in appreciated assets contributed to the corporation in exchange for stock in the corporation under section 351 of the Code. Under section 358 of the Code, the stock received in the corporation will receive a carryover basis, but

[389] For taxpayers who acquired their stock on or before September 27, 2010, 7% of the excluded gain is a preference item. *See* §§ 57(a)(7) and 1202(a)(4)(C), which is only applicable to QSBS acquired after September 27, 2010. The taxable portion of the gain is subject to the maximum AMT rate of 28% plus the 3.8% excise tax on net investment income, but the 7% preference item is subject only to the AMT tax, not the excise tax. As a result, the 50% exclusion results in a maximum AMT rate of 16.88%, as follows: {[50% taxable gain + (7% x 50% of excluded gain)] x 28% AMT rate} + (50% taxable gain x 3.8% excise tax). The 75% exclusion results in a maximum AMT rate of 9.42%, as follows: {[25% taxable gain + (7% x 75% of excluded gain)] x 28% AMT rate} + (25% taxable gain x 3.8% excise tax).

[390] § 1202(a)(1).

[391] § 1202(a)(3).

[392] § 1202(a)(4).

for purposes of the Per-Issuer Limitation, discussed below, the fair market value of the contributed property is used in calculating the tenfold multiplier of the "Per-Issuer Limitation."

d. The Code provides a "Per-Issuer Limitation," which prescribes the maximum gain that can be excluded under section 1202(a) of the Code. Section 1202(b)(1) of the Code provides, "If the taxpayer has eligible gain for the taxable year from 1 or more dispositions of stock issued by any corporation, the aggregate amount of such gain from dispositions of stock issued by such corporation which may be taken into account … for the taxable year shall not exceed the greater of—"[393]

(1) "$10,000,000 reduced by the aggregate amount of eligible gain taken into account by the taxpayer . . . for prior taxable years and attributable to dispositions of stock issued by such corporation" (the "$10 Million Per Taxpayer Limitation"),[394] or

(2) "10 times the aggregate adjusted bases of qualified small business stock issued by such corporation and disposed of by the taxpayer during the taxable year" (the "10 Times Basis Limitation").[395]

e. The foregoing provision is not a model of clarity, but it does provide some interesting opportunities to possibly multiply and maximize the amount of gain exclusion by taking advantage of multiple taxpayers and engaging in careful tax basis management prior to the time of QSBS share issuance. In determining the applicability of the Per-Issuer Limitation, it's important to note that it is based on a per-issuer (per corporation), per taxpayer basis. Further, the $10 Million Per Taxpayer Limitation is reduced by recognized gains in previous taxable years, whereas the 10 Times Basis Limitation is not. The 10 Times Basis Limitation, in contrast, is taken into account only for the taxable year in question. At an initial glance it may seem that taxpayers are limited to one or the other, but a careful reading of the section makes it clear that taxpayers are entitled to both of the limitations, not just the greater of the two of them. Section 1202(b)(1) provides that the QSBS exclusion benefit "for the taxable year" may not exceed the greater of the two limitations. Thus, each taxable year in which the taxpayer has eligible gain on QSBS, either the $10 Million Per Taxpayer Limitation or the 10 Times Basis Limitation will be applied (the greater of the two of them).

f. In addition to the QSBS gain exclusion, section 1045 of the Code allows a taxpayer to sell QSBS and defer the recognition of gain by rolling the proceeds of the first sale into a new acquisition of QSBS within sixty days of the sale. To qualify for the rollover, the taxpayer must have held the original QSBS for more than six months at the time of the sale, and the taxpayer must elect the application of section 1045 of the Code to the original sale.[396] If these conditions are met, then the taxpayer has a 60-day period beginning on the date of the original sale to purchase the replacement QSBS.[397] Section 1045 of the Code was enacted in 1997,[398] and originally this rollover provision only applied to individual taxpayers, which did

[393] § 1202(b)(1).

[394] § 1202(b)(1)(A).

[395] § 1202(b)(1)(B).

[396] § 1045(a).

[397] *See* § 1045(a)(1).

[398] *See* Taxpayer Relief Act of 1997, P.L. 105-34, § 313(a).

not match the eligible qualified taxpayers under section 1202. In 1998, section 1045 was amended so that it applies to any "taxpayer other than a corporation,"[399] and such amendment became effective as though it had been included when the section was originally enacted.[400]

g. In order for stock to be considered QSBS, it must be:

(1) Stock in a C corporation;[401]

(2) Originally issued after August 10, 1993 (date of enactment of the Revenue Reconciliation Act of 1993);[402]

(3) On the date of issuance, issued by a corporation that is a "qualified small business," as defined below;[403] and

(4) Except for certain exceptions noted below, "acquired by the taxpayer at its original issue,"[404] in exchange for money or other property (not including stock),[405] or as compensation for services provided to such corporation.[406]

h. The foregoing is often referred to as the "Original Issue" or "Original Issuance" requirement. The term "Original Issue" refers to an issuance of stock directly from the corporation to a Qualified QSBS Shareholder, as opposed to, for example, an acquisition of such stock on a secondary market or acquisition from another person. It does not refer to the timing of the issuance of stock. In other words, it should not be interpreted to mean that only the first issuance of stock from a corporation will be considered QSBS. The Original Issuance requirement is not violated if a taxpayer receives the stock "by gift"[407] or "at death."[408] Thus, if the transferred stock satisfied the Original Issuance requirement in the previous owner's hands, it continues to satisfy that requirement. However, it is unclear the breadth of transfers that would be considered "by gift" and "at death." Because section 1202 is an income tax section, it is reasonable to conclude that transfers "by gift" and "at death" are defined as they would be under Chapter 1 of Title 26 of the United States Code (e.g., transferee basis would be determined under sections 1015 and 1014 of the Code), rather than as these transfers would be defined under Chapters 11 and 12 (estate and gift tax). In addition, the Original Issuance requirement is not violated if a taxpayer receives the stock in a transfer "from a partnership to a partner,"[409] provided the stock received from the partnership otherwise meet the requirements of section

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[399] § 1045(a).

[400] *See* IRS Reform Act of 1998, P.L. 105-206, § 6005(f)(1).

[401] § 1202(c)(1).

[402] *Id.*

[403] § 1202(c)(1)(A).

[404] § 1202(c)(1)(B).

[405] § 1202(c)(1)(B)(i).

[406] § 1202(c)(1)(B)(ii).

[407] § 1202(h)(2)(A).

[408] § 1202(h)(2)(B).

[409] § 1202(h)(2)(C).

1202(g) (e.g., limited to such shareholder's interest at the time the QSBS was acquired by the partnership) other than the 5-year holding requirement. This exception only applies to partnerships and apparently does not apply to distributions from other types of pass-thru entities (as defined in section 1202(g)(4) of the Code), like S corporations, although they are eligible holders of QSBS.

i. Under section 1202(d) of the Code, a "qualified small business" (hereinafter, referred to as "QSB") is a domestic C corporation[410] that meets the following requirements (hereinafter, collectively referred to as the "Aggregate Gross Asset Requirement"):

(1) The "aggregate gross assets" of such corporation (or any predecessor thereof) "at all times" on or after August 10, 1993, and before the issuance did not exceed $50 million;[411] and

(2) The "aggregate gross assets" of such corporation "immediately after the issuance (determined by taking into account amounts received in the issuance)" do not exceed $50 million.[412]

"Aggregate gross assets" means the "amount of cash and the aggregate adjusted bases of other property held by the corporation."[413] However, for this purpose, "the adjusted basis of any property contributed to the corporation (or other property with a basis determined in whole or in part by reference to the adjusted basis of property so contributed) shall be determined as if the basis of the property contributed to the corporation (immediately after such contribution) were equal to its fair market value as of the time of such contribution."[414]

j. Stock in a corporation will not be considered QSBS unless "during substantially all of the taxpayer's holding period for such stock, such corporation meets the active business requirements" (hereinafter referred to as the "Active Business Requirement") … "and such corporation is a C corporation." [415] "Substantially all" refers to the taxpayer's holding period, and there is no guidance or safe harbor that describes what period of time will be considered sufficient for these purposes. Although two court cases have held that the taxpayers failed to meet the Active Business Requirement, the court failed to give guidance on how "substantially all" is to be determined.[416]

k. Under section 1202(e)(1) of the Code, a corporation is deemed to meet the Active Business Requirement for any period if during that time:

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[410] § 1202(d)(1).

[411] § 1202(d)(1)(A).

[412] § 1202(d)(1)(B).

[413] § 1202(d)(2)(A).

[414] § 1202(d)(2)(B).

[415] § 1202(c)(2)(A).

[416] *See Owen v. Commissioner*, T.C. Memo. 2012-21, and *Holmes v. Commissioner*, T.C. Memo 2012-251, *aff'd*, No. 13-71034 (9th Cir. 2015)

(1) At least 80 percent (by value) of the assets of the corporation are used "in the active conduct of 1 or more qualified trades or businesses,"[417] and

(2) The corporation is an "eligible corporation"[418] (any domestic corporation other than a (i) DISC or former DISC, (ii) regulated investment company, real estate investment trust, or REMIC, and (iii) cooperative). [419]

l. A "qualified trade or business" is defined by negation. It is any trade or business, other than any:

(1) "Banking, insurance, financing, leasing, investing, or similar business;"[420]

(2) "Farming business (including the business of raising or harvesting trees);"[421]

(3) "Business involving the production or extraction of products that would provide depletion deductions under sections 613 and 613A"[422] of the Code (e.g., oil, natural gas, minerals, etc.); and

(4) "Business operating a hotel, motel, restaurant, or other similar businesses."[423]

m. Notwithstanding the exclusion of certain companies performing "services" in certain fields like health, the IRS has ruled that companies that deploy technology, manufacturing assets, or other intellectual property to provide services exclusively to clients in the health care industry would nonetheless qualify for QSBS status.[424]

(1) PLR 201436001 involved a company that worked exclusively with clients in the pharmaceutical industry to commercialize experimental drugs. Specifically, the company's activities included research on drug formation effectiveness, per-commercial testing procedures, and manufacturing of drugs. The IRS explained, "the thrust of § 1202(e)(3) is that businesses are not qualified trades or businesses if they offer value to customers primarily in the form of services, whether those services are the providing of hotel rooms, for example, or in the form of individual expertise (law firm partners)."[425] The IRS ruled, "Company is not in the business of offering service in the form of individual expertise. Instead, Company's activities involve the deployment of specific manufacturing assets and intellectual property assets to create

[417] § 1202(e)(1)(A).

[418] § 1202(e)(1)(B).

[419] § 1202(e)(4).

[420] § 1202(e)(3)(B).

[421] § 1202(e)(3)(C).

[422] § 1202(e)(3)(D).

[423] § 1202(e)(3)(E).

[424] *See* PLRs 201436001 and 201717010.

[425] PLR 201436001.

value for customers. Essentially, Company is a pharmaceutical industry analogue of a parts manufacturer om the automobile industry. Thus, although Company works primarily in the pharmaceutical industry, … Company does not perform services in the health industry within the meaning of § 1202(e)(3)."[426]

(2) PLR 201717010 involved a company that was formed to provide more complete and timely information to health care providers. In particular, company owned and deployed patents and other technology for the detection of "B," pursuant to which it performed "X" testing, analyzed the results of X testing, and prepared laboratory reports for healthcare providers. In ruling that the company qualified for QSBS status, it noted that the company simply provides lab results to health care professionals, does not discuss diagnoses or treatment, does not discuss lab tests to patients, and only has contact with patients for billing purposes. Further, the skills of the company's employees are not useful in preforming the tests, and they are not subject to state licensing requirements as healthcare professionals. Finally, none of the company's revenue is earned in connection with patients' medical care.

(3) It is not clear whether all of the foregoing factors must exist in order for a company that works in excluded service fields to have QSBS status, but it seems important that there must exist a physical asset, process, proprietary methodology, technology, patent, or other intellectual property such that it is not a company where "the principal asset of the trade or business is the reputation or skill of one or more of its employees."[427]

7. Original issuance is also met if a pre-existing business that is a sole proprietorship, disregarded entity, or partnership for Federal income tax purposes converts to a C corporation and as part of that conversion issues shares to the owners of the business. While section 1202 contains an aggregate gross asset limitation, there is no time frame by which a preexisting trade or business must convert to a C corporation, so even businesses that have been in existence for a long period of time could become QSBS companies. In the wake of the enactment of TCJA, the ability to convert preexisting businesses to C corporations and qualify them for QSBS is an important planning option to consider. The reason is that many pass-through business owner will not get a significant benefit from the 199A deduction due many of the limitations of the deduction including the "wages and basis" limitations, the 199A deduction will expire in 2026, but the C corporation rate is permanently reduced to 21%. Therefore the path to consider QSBS for pass-through businesses has never been smoother. Given the aggregate gross asset limitation, it remains to be seen if a preexisting business can divide its business to meet the gross asset test at the time of original issuance. To that end, the Code provides, "The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this section, including regulations to prevent the avoidance of the purposes of this section through split-ups, shell corporations, partnerships, or otherwise."[428] Given that section 199A specifically excludes certain service businesses by citing section 1202(e)(3)(A) of the Code,[429] it might be instructive to look to the 199A Final Regulations, particularly the aggregation rules, to determine whether a trade or business held by a pass through entity can nonetheless be divided in order to meet the QSBS requirements prior to conversion to a C corporation.

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[426] *Id.*

[427] PLR 201717010.

[428] § 1202(k).

[429] *See* § 199A(d)(2)(A).

8. As mentioned above, a taxpayer that receives QSBS "by gift" or "at death" retains its character as QSBS, and the taxpayer is treated as having acquired the stock in the same manner as the transferor with a tacking of the transferor's holding period.[430] If the transfer is "at death," the QSBS receives a "step-up" in basis under section 1014, but appreciation after date of death would continue to be eligible for gain exclusion under section 1202. Because of the gain exclusion and gain rollover aspects of QSBS, most taxpayers should seek to make inter-vivos transfers of these assets out of their gross estates to the extent they exceed their transfer tax exclusions (both state and Federal). Simply put, heirs will not benefit as much from a "step-up" in basis because of the gain exclusion features of QSBS, and as discussed below, QSBS status can be retained and transferred through donative transfers to donees. One possible planning technique to multiply the benefit of the QSBS exclusion which is subject to the $10 Million Per Taxpayer Limitation (for QSBS shares that have less than $1 million of adjusted basis) is to make gifts to family members (e.g., children, but not spouses[431]) and non-grantor trusts (treated as separate taxpayers and might include inter-vivos marital deduction trusts for the benefit of a spouse).

9. There is potential for shareholders of a QSBS corporation to exclude as much as $500 million of gain (assuming the $50 million gross asset limitation mentioned above is met but not exceeded, and depending on how certain provisions are interpreted, perhaps even more) if tax basis management is carefully considered prior to the (and maybe even after) original issuance of the QSBS.

a. For purposes of the 10 Times Basis Limitation, the Code provides that "the adjusted basis of any stock shall be determined without regard to any addition to basis after the date on which such stock was originally issued."[432] For that reason, a "step-up" in basis at death or a partnership basis shift (discussed later in these materials) during lifetime are unhelpful in increasing the exclusion tenfold.

b. As mentioned above, in order for a company to qualify for QSBS status, the "aggregate gross assets" of the corporation before and after the original issuance must not exceed $50 million. For purposes of this calculation, the term "aggregate gross assets" means the "amount of cash and the aggregated adjusted bases of other property held by the corporation."[433] As such, a corporation can qualify for QSBS status even if the fair market value at the time of issuance is greater than $50 million. However, Code further provides that for these purposes, "the adjusted basis of any property contributed to the corporation (or other property with a basis determined in whole or in part by reference to the adjusted basis of property so contributed) shall be determined as if the basis of the property contributed to the corporation (immediately after such contribution) were equal to its fair market value as of the time of such contribution."[434] This latter provision presumably added to prevent shareholders (or partners in predecessor entities) from "stuffing" the corporation with low basis, high value assets.

c. It is common for companies that eventually become corporations that are eligible for QSBS status to start as entities taxed as a partnership (e.g., limited liability

[430] §§ 1202(h)(1), (2)(A) and (B).

[431] § 1202(b)(3).

[432] § 1202(b)(1) [flush language].

[433] § 1202(d)(2)(A).

[434] § 1202(d)(2)(B).

company). The conversion from partnership to C corporation can be accomplished a number of different ways, including making an election under a state law statute. Most conversions are non-taxable events for income tax purposes, often involving contribution of assets under section 351 of the Code, liquidations of the partnership, or distribution of assets from the partnership in some combination. Under most circumstances, the end result is the original partners receive shares in the new C corporation equal to the inside basis of the assets of the partnership or to the outside basis in their partnership interests (but without credit for partnership liabilities reflected in in the outside basis).[435] Notwithstanding that treatment on conversion, section 1202 of the Code provides two special rules with respect to basis for QSBS purposes:

(1) "In the case where the taxpayer transfers property (other than money or stock) to a corporation in exchange for stock in such corporation—such stock shall be treated as having been acquired by the taxpayer on the date of such exchange, and the basis of such stock in the hands of the taxpayer shall in no event be less than the fair market value of the property exchanged."[436]

(2) "If the adjusted basis of any qualified small business stock is adjusted by reason of any contribution to capital after the date on which such stock was originally issued, in determining the amount of the adjustment by reason of such contribution, the basis of the contributed property shall in no event be treated as less than its fair market value on the date of the contribution."[437]

d. These special provision ostensibly allow taxpayers to calculate basis for purposes of section 1202 purposes (and possibly multiplying that basis benefit tenfold):

(1) Based on the fair market value of contributed assets at the time of contribution (e.g., assets held by the LLC when the conversion to C corporation occurred), and

(2) Based on the fair market value of property contributed even after the original issuance.

e. Owners of companies seeking QSBS status have an opportunity prior to conversion to C corporation status to leverage the "10 times" exclusion by increasing basis in the company (and the resulting stock) without violating the Aggregate Gross Asset Requirement. Strategies that should be considered including:

(1) Valuing appreciated assets (e.g., technology or other intellectual property) to full fair market value;

(2) Contributions of appreciated assets, but the fair market value reduces the potential amount of "aggregate gross asset" that can be held by the company at the time conversion;

(3) A contribution of cash to the company by one or more of the owners. Each dollar has the potential of excluding $10 dollars of gain;

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[435] *See* Rev. Rul. 84-111, 1984 C.B. 88.

[436] § 1202(i)(1).

[437] § 1202(i)(2).

(4) Having the owners borrow funds, so they can contribute cash to the company prior to conversion. Borrowing at the company level when the company is a partnership in order to increase the cash within the company is likely not to work because while the partnership liability increases outside basis for the partners, the conversion to C corporation results in a reduction of each partner's share of liabilities (lowering outside basis and possibly triggering gain);[438] and

(5) Selling assets for a taxable gain or otherwise triggering gain at the company or owner level (consideration should be given to qualifying for installment sale treatment to provide an immediate basis boost but defer the taxable income).

III. MAXIMIZING AND MULTIPLYING THE "STEP-UP" IN BASIS

A. Generally

1. As discussed above, estate planning will focus increasingly on the income tax savings resulting from the "step-up" in basis. Estate planners will seek to maximizing the "step-up" in basis by ensuring that the assets that are includible in the estate of a decedent are the type of assets that will:

a. Benefit from a "step-up" (avoiding the inclusion cash or property that has a basis greater than fair market value)

b. Benefit the most from the "step-up" (for example, very low basis assets, collectibles, and "negative basis" assets); and

c. Provide significant income tax benefits to the beneficiaries (assets are likely to be sold in a taxable transaction after "step-up" or depreciable/depletable assets giving rise to ongoing income tax deductions).

2. In considering tax basis management in estate planning, estate planners will need to take a bifurcated approach based upon the tax nature of the assets. For clients who are likely to own primarily low-basis assets that would benefit the most from a step-up in basis (e.g., creators of intellectual property or real estate developers), the estate plan will be centered around dying with the assets and benefiting from the "step-up" in basis. To the extent the assets will be subject to Federal or state transfer taxes, then consideration must be given to ensuring that estate taxes can be paid on a timely or orderly manner. Thus, common features of the plan might include maintaining life insurance held by an irrevocable life insurance trust, qualifying for the payment of transfer taxes pursuant to the deferral provisions of section 6166, or securing a *Graegin*[439] loan.[440] For those clients who are likely to own assets that would not likely benefit from the "step-up" in basis (e.g., IRA assets, actively managed publicly-traded investment portfolios, or other high basis asset), then transferring the assets out of the estate would be paramount to the extent the assets would be subject to a significant Federal or state transfer tax

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[438] *Id.*

[439] *Estate of Graegin v. Commissioner*, 56 T.C.M. (CCH) 387 (1988).

[440] *See* Stephanie Loomis-Price, Paul S. Lee, Charles E. Hodges, *Asset Rich, Cash Poor: Addressing Illiquidity with Graegin Loans, as Well as Sections 6166 and 6161*, 36 Tax Mgmt. Est. Gifts & Tr. J No. 4 (July 14, 2011).

liability. Finally, for those clients, who have both types of assets and whose assets would be subject to a significant transfer tax liability, the strategy would involve transferring the high basis assets out of the estate through a combination of zeroed-out transfer strategies and exercising the "swap" power proactively if the assets are held in a grantor trust, as discussed later in this article.

3. When clients are in a situation where no estate taxes will be due, referred to as a "free-base" situation, then estate planners should seek to maximize the value of certain assets because the "step-up" in basis is based on fair market value (rather than trying to reduce the value for transfer tax purposes). A "free-base" situation can arise when the assets includible in the estate are less than the decedent's remaining Applicable Exclusion Amount or a marital deduction transfer under section 2056 to the surviving spouse.[441] In these "free-basing" situations, practitioners will need to consider when valuations discounts are warranted and when the discounts should be removed.

4. In addition to the foregoing, estate planners will increasingly seek to:

a. Maximize the value of certain assets because the "step-up" in basis is based on fair market value (rather than trying to reduce the value for transfer tax purposes); and

b. Intentionally create estate tax inclusion, especially if the decedent lives in a state with no state death tax and if the decedent has significant unused Available Exclusion Amount above his or her assets.

B. Swapping Assets with Existing IDGTs

1. Generally

a. In 2011 and 2012, many wealthy individuals made significant taxable gifts, using all or a significant portion of their Available Exclusion Amounts because of the risk of that the exemptions would "sunset" back to 2001 levels. Many of those gifts were made to IDGTs.

b. A common power used to achieve grantor trust status for the IDGT is one described under section 675(4)(C) of the Code, namely giving the grantor, the power, in a non-fiduciary capacity, to reacquire the trust corpus by substituting other property of an equivalent value.[442] For income tax purposes, transactions between the grantor and the IDGT will be disregarded.[443] As such, grantors may exercise the power to swap high basis assets for low basis assets without jeopardizing the estate tax includibility of the assets and without having a taxable transaction for income tax purposes.

c. To maximize the benefits of the swap power, it must be exercised as assets appreciate or are sold over time. When exercised properly, this can ensure that only those assets that benefit the most from the step-up will be subject to estate inclusion.

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[441] Another free-base situation could arise with a testamentary transfer to a zeroed-out charitable lead annuity trust. The creation of basis would significantly lower the on-going income tax liability of the non-grantor charitable lead trust. However, increasing the value would also increase the payments to charity that are required to zero-out the testamentary transfer to the trust.

[442] § 675(4)(C) and Rev. Rul. 2008-22, 2008-16 I.R.B. 796.

[443] *See* Rev. Rul. 85-13, 1985-1 C.B. 184 and PLR 9535026.

(1) If grantor does not have sufficient other assets, repurchase will be difficult - although the donor could borrow cash from a third party.

(2) The grantor could use a promissory note in exchange for the property in the IDGT, but as discussed below, it is unclear what the tax basis of the promissory note will be to the IDGT after the death of the grantor, if any portion of the note remains outstanding at such time.

(3) Because the sudden or unexpected death of the grantor may make a repurchase difficult or impossible, estate planners may want to consider drafting "standby" purchase instruments to facilitate fast implementation of repurchase.

d. While the Federal income tax consequences of a swap for equivalent value seem clear, practitioners should consult whether the transaction will also be ignored for other local law purposes.

(1) Some states do not recognize grantor trust status or only recognize it under certain circumstances. By way of example, Pennsylvania does not recognize grantor trust status if the trust is irrevocable. Thus, in Pennsylvania, an IDGT will be subject to state income taxation, and all transactions between the IDGT and the grantor would be taxable events for state tax purposes. [444]

(2) While New York recognizes grantor trust status for income tax purposes, the New York Department of Taxation and Finance has ruled that an exchange of assets between a grantor and his IDGT was a sale for sales tax purposes if the assets transferred would be subject to sales tax for any unrelated taxpayers.[445]

2. Swapping with a Promissory Note of Grantor

a. If, under the swap power, a grantor exchanges his or her own promissory note (rather than assets individually owned by the grantor) for assets in an IDGT, the exchange and all payments on the promissory note will be ignored for Federal income tax purposes, as long as grantor trust status remains. However, it is unclear what tax basis the IDGT has in the promissory note if the grantor dies, thereby terminating grantor trust status. As discussed later in this outline, the death of the grantor is likely not a recognition event, and it is likely that the assets in the IDGT (the promissory note) will not get a step-up in basis. Rather, the promissory note will have the same basis that the grantor had in the note at the time of the exchange.

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[444] Arkansas, the District of Columbia, Louisiana, and Montana tax the grantor only in a limited set of circumstances. *See* Ark. Inc. Tax Reg. § 4.26-51-102, D.C. Code §§ 47-1809.08 to 47-1809.09, La. Rev. Stat. Ann. § 47:187, and Mont. Code Ann. § 15-30-2151(5). Tennessee recently clarified an issue regarding grantor trusts, so effective for tax returns filed on or after May 20, 2013, a grantor, instead of a the trustee, of a grantor trust may file the Hall income tax (on interest and dividends) return and pay the tax if the grantor reports the trust income on his or her own individual Federal tax return. *See* Public Chapter 480 and T.C.A. § 67-2-102.

[445] New York State Department of Taxation and Finance Advisory Opinion (TSB-A-14(6)S) (Jan. 29, 2014).

b. The issue at hand is whether a grantor has basis in his or her own promissory note. If not, then the basis is likely to be zero. If the grantor does have basis, then the basis is likely to be the amount of the indebtedness. If the basis in the promissory note is zero, then when grantor trust is terminated, the IDGT will have a zero basis in the note, such that when the note is ultimately satisfied by the debtor (the estate or beneficiaries of the estate), capital gain will be recognized by the trust, which will be a non-grantor taxable trust at such time.

c. The IRS position is that a debtor has no basis in his or her own promissory note.[446] The Tax Court has consistently held when partners have contributed promissory notes to the entity, the contributing partner does not get increased adjusted basis in his or her partnership interest because the partner has no basis in the note.[447] In *Gemini Twin Fund III v. Commissioner*, the Tax Court wrote, "Even assuming, as petitioner argues, that a note is property under State law and for other purposes, a taxpayer has no adjusted basis in his or her own note. Until the note is paid, it is only a contractual obligation to the partnership. The existence of collateral does not change this result."[448]

d. However, in other contexts, the courts have held that an unsecured promissory note does, in fact, create basis, as long as the note represents a genuine indebtedness. In *Peracchi v. Commissioner*,[449] the taxpayer contributed real property to a corporation. The real property was encumbered by debt in excess of basis. Under section 357(c) of the Code, any liabilities in excess of basis will be considered gain upon contribution to a corporation (NAC) controlled by the taxpayer under section 351 of the Code. To avoid this gain, the taxpayer also contributed a promissory note in an amount equal to the excess liabilities, claiming the note has a basis equal to its face amount. The IRS argued that the note has a zero basis. The Ninth Circuit agreed with the taxpayer. The opinion provides:

> We are aware of the mischief that can result when taxpayers are permitted to calculate basis in excess of their true economic investment. *See* Commissioner v. Tufts, 461 U.S. 300 (1983). For two reasons, however, we do not believe our holding will have such pernicious effects. First, and most significantly, by increasing the taxpayer's personal exposure, the contribution of a valid, unconditional promissory note has substantial economic effects which reflect his true economic investment in the enterprise. The main problem with attributing basis to nonrecourse debt financing is that the tax benefits enjoyed as a result of increased basis do not reflect the true economic risk. Here Peracchi will have to pay the full amount of the note with after-tax dollars if NAC's economic situation heads south. Second, the tax treatment of nonrecourse debt primarily creates problems in the partnership context, where the entity's loss deductions (resulting

[446] *See, e.g.,* Rev. Rul. 80-235, 1980-2 C.B. 229 (liability created by the written obligation of a limited partner does not create basis in the limited partnership interest), and Rev, Rul. 68-629, 1968-2 C.B. 154 (contribution of promissory notes to a corporation did not create tax basis, resulting in gain under section 357(c) of the Code because the taxpayer contributed other assets with liabilities in excess of tax basis).

[447] *VisionMonitor Software, LLC v. Commissioner*, T.C. Memo. 2014-182, *Dakotah Hills Offices Ltd. Part. v. Commissioner*, T.C. Memo. 1998-134, *Gemini Twin Fund III v. Commissioner*, T.C. Memo 1991-315, aff'd without published opinion, 8 F.3d 26 (9th Cir. 1993), *Bussing v. Commissioner*, 88 T.C. 449 (1987), *Oden v. Commissioner*, T.C. 1981-184, aff'd without published opinion, 678 F.2d 885 (4th Cir. 1982).

[448] *Gemini Twin Fund III v. Commissioner*, T.C. Memo 1991-315.

[449] 143 F.3d 487 (9th Cir. 1997). *But see Seggerman Farms Inc. v. Commissioner*, 308 F.3d 803 (7th Cir. 2002) and *Alderman v. Commissioner*, 55 T.C. 662 (1971).

> from depreciation based on basis inflated above and beyond the taxpayer's true economic investment) can be passed through to the taxpayer. It is the pass-through of losses that makes artificial increases in equity interests of particular concern. *See, e.g.*, Levy v. Commissioner, 732 F.2d 1435, 1437 (9th Cir. 1984). We don't have to tread quite so lightly in the C Corp context, since a C Corp doesn't funnel losses to the shareholder.

The court then goes on to point out that if the note has a zero basis, then the corporation also will have a zero basis in the note,[450] which would create a subsequent gain if the note then was sold to a third party:

> We find further support for Peracchi's view by looking at the alternative: What would happen if the note had a zero basis? The IRS points out that the basis of the note in the hands of the corporation is the same as it was in the hands of the taxpayer. Accordingly, if the note has a zero basis for Peracchi, so too for NAC. *See* I.R.C. section 362(a). But what happens if NAC--perhaps facing the threat of an involuntary petition for bankruptcy--turns around and sells Peracchi's note to a third party for its fair market value? According to the IRS's theory, NAC would take a carryover basis of zero in the note and would have to recognize $1,060,000 in phantom gain on the subsequent exchange, even though the note did not appreciate in value one bit. That can't be the right result. [Footnote omitted]

The dissenting judge in the *Perrachi* opinion remarked, "The taxpayer has created something -- basis -- out of nothing."

e. It is unclear what this means for swap transactions with an IDGT and the tax ramifications upon repayment of the debt when the IDGT becomes a non-grantor trust. What is clear is that the IRS will claim that the grantor's note has no tax basis. There are sound arguments on both sides of the debate.[451] It can validly be argued that none of the authorities mentioned above are on point. For example, if creditor loans $1 million to debtor and creditor is deemed to have zero basis in the promissory note, then why is there no income or gain when the creditor is paid back in full or why is the creditor entitled to realize a loss if the debt is not paid back in full? Further, in the installment sale to IDGT context, if the death of the grantor is treated as a sale immediately after the date of death, then a zero basis in the note would be a taxable gain event. Yet, very few practitioners believe that should be the case. As such, there is a clear argument for giving the IDGT a basis in the note equal to the basis in the assets sold.

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[450] *See Lessinger v. Commissioner*, 872 F.2d 519 (2d Cir. 189). The court agreed with the IRS's argument that the note had a zero basis, but then concluded the note had a basis in the corporation's hands equal to its face value.

[451] *See* Stuart Lazar, Lessinger, Peracchi, *and the Emperor's New Clothes: Covering a Section 357(c) Deficit with Invisible (or Nonexistent) Property*, 58 Tax Lawyer No. 1, 41 (Fall 2004); Elliott Manning, *The Issuer's Paper: Property or What? Zero Basis and Other Income Tax Mysteries*, 39 Tax L. Rev. 159 (1984); and Jerred G. Blanchard Jr., *Zero Basis in the Taxpayer's Own Stock or Debt Obligations: Do Those Instruments Constitute 'Property'?*, 2005 Tax Notes 1431 (March 21, 2005).

C. Valuation Discounts On or Off?

1. Generally

a. A common "free-base" situation occurs when the first spouse passes away, and assets are transferred to or for the benefit of the spouse in a transfer that qualifies for the marital deduction under section 2056. In community property states, as mentioned above, the "step-up" in basis will also apply to the assets held by the surviving spouse. Clearly, for income tax purposes, a higher valuation is preferable to a lower valuation. As such, consideration should be given to when valuation discounts should be created and when they should be removed. For example, when both spouses are alive, it is sensible to avoid valuation discounts, and if the assets that would be includible in the surviving spouse's estate are significantly above the Applicable Exclusion Amount (including any ported amount), then valuation discounts will likely save more in estate taxes than the income tax savings from the subsequent "step-up" at the surviving spouse's estate. If a quick succession of deaths is a worry, practitioners should be prepared to layer valuation discounts immediately after the first death, so post-mortem estate planning might include the estate creating family limited partnerships prior to the complete settlement of the estate.

b. Where assets have been divided among generations to create discounts, consideration should be given to undoing those arrangements if the effect is to depress the value of an estate below the amount of Available Exemption Amount in order to increase the income tax basis of the assets.

c. Family limited partnerships or other entities that create valuation discounts could be dissolved or restated to allow the parties to the entity to withdraw for fair value or to remove restrictions on transferability.

(1) An option could be given to a parent allowing the sale of the parent's interest to a child or children for undiscounted fair market value at death. Giving such an option to a parent would be a gift unless accompanied by adequate and full consideration.

(2) If undivided interests in property are owned, family control agreements could be entered into that require all generations to consent to the sale of the property as one tract, and join in paying the expenses of a sale, if any one owner wanted to sell. Quite obviously such agreements may be contrary to other estate planning or ownership goals of the family.

d. The ability of the IRS to ignore provisions of an agreement that increase the value of assets in the hands of a parent, but not in the hands of a child, is uncertain. By its literal terms section 2703 applies only to provisions that reduce value and to restrictions on the right to sell or use property. To illustrate, in *Estate of James A. Elkins, Jr., et al. v. Commissioner*,[452] the Tax Court applied section 2703 to ignore a family co-tenancy agreement requiring all owners of fractional interests in art to agree before the art could be sold. The purpose of that agreement was to limit the marketability of each fractional interest. But what might the effect on value be of an agreement which provided, instead, that any fractional owner could compel the sale of the entire asset? Similarly, a provision that allows a shareholder in business to put stock to the business at death for fair market value would seem to be outside the

[452] 140 T.C. 86 (2013), *rev'd*, *Estate of James A. Elkins, Jr. v. Commissioner*, 767 F.3d 443 (5th Cir. 2014).

scope of the section. In many instances amending old agreements to include such provisions will be more likely to create gifts from the younger owners to the older owners than would terminating an old agreement and creating a new one.

2. Conversion to General Partnership

a. One option for eliminating valuation discounts with family limited partnership interests is to "convert" the limited partnership (or limited liability company) to a general partnership.

(1) Section 2704(b) of the Code will disregard certain "applicable restrictions" on the ability of the partnership to liquidate. However, an exception exists for "any restriction imposed . . . by any Federal or State law."[453] Since the effective date of section 2704 of the Code, many states have amended their limited partnership and limited liability company statutes to provide for significant restrictions on an owner's ability to liquidate his or her ownership interest in those entities, thereby rendering section 2704(b) inapplicable.[454] Proposed Treasury Regulations issued in August 2016 would have enabled the IRS to disregard certain features of applicable state law that limited the application of section 2704. Those proposed regulations were roundly criticized and were ordered to be withdrawn in their entirety.[455] The proposed regulations were officially withdrawn as of October 20, 2017.[456]

(2) General partnership statutes, on the other hand, provide much more liberal provisions for liquidation and dissolution of a partnership and for the withdrawal of a partner. For example:

(a) Section 801 of the Uniform Partnership Act (UPA)[457] provides in a partnership at will, dissolution occurs upon a person's express will to withdraw.

(b) Under section 601(1) of the UPA, a person is dissociated as a partner when the partnership has notice of the person's express will to withdraw as a partner.

(c) Section 602(a) of the UPA points out that a person has the power to dissociate as a partner at any time, rightfully or wrongfully.

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[453] § 2704(b)(3)(B).

[454] *See*, *e.g.*, *Kerr v. Commissioner*, 113 T.C. 449 (1999) (The Tax Court held section 2704(b) of the Code was not applicable because the partnership agreement was no more restrictive than § 8.01 of the Texas Revised Limited Partnership Act, which generally provides for the dissolution and liquidation of a limited partnership pursuant to the occurrence of events specified in the agreement or upon the written consent of the partners.), *aff'd* 292 F.3d 490 (5th Cir. 2002) (The Fifth Circuit affirmed the decision that section 2704(b) of the Code is inapplicable under section 2704(b)(2)(B)(i) of the Code. Section 2704(b)(2)(B)(i) provides that "the transferor or any member of the transferor's family, either alone or collectively, must have the right to remove the restriction" immediately after the transfer for the restriction to be one that would be disregarded. In the case, the University of Texas was a partner in the partnership.).

[455] Steven T. Mnuchin, Secretary of Treasury, *Second Report to the President on Identifying and Reducing Tax Regulatory Burdens, Executive Order 13789*, 2018-03004 (Rev. 1), (October 2, 2017) [https://www.treasury.gov/press-center/press-releases/Documents/2018-03004_Tax_EO_report.pdf].

[456] FR Doc. 2017-22776, 82 Fed. Reg. 48779.

[457] Uniform Partnership Act, as adopted in 2007 and last amended in 2013, by the National Conference of Commissioners on Uniform State Laws (hereinafter, UPA).

(d) Sections 701(a) and (b) of the UPA provide, upon dissociation, the partnership is required to purchase the person's interest in the partnership for a buyout price that is the *greater* of liquidation value or the value based on a sale of the entire business as a going concern without the person.[458]

(3) Furthermore, nothing under section 2704(b) of the Code prohibits being less restrictive in the partnership agreement.

(4) Where retaining limited liability of a partner is important, the partner should consider utilizing a wholly-owned limited liability company that is treated as a disregarded entity for Federal tax purposes.[459] The use of disregarded entities is discussed in more detail later in these materials. In this instance, the partner would first contribute his or her limited partnership or limited liability company interest into the disregarded entity and then the limited partnership or limited liability company would "convert" to a general partnership. The conversion can be accomplished under a conversion power,[460] interest exchange[461] and dissolution, or other merger transaction.

(5) Because all of the limited partners and limited liability company members retain the same proportionate interest in the resulting entity, there is no gift for transfer tax purposes because of the "vertical slice" exception to section 2701 of the Code.[462]

3. The *Powell* "Solution"

a. Another planning option that could cause inclusion of FLP assets without valuation discounts is to argue that section 2036(a) of the Code applies, relying on the argument set forth in *Estate of Powell v. Commissioner*.[463]

(1) Pursuant to the facts, the decedent's son, acting under a power of attorney for the benefit of the decedent, contributed $10 million of cash and securities to a FLP in return for 99% limited partnership interest. The decedent's two sons contributed unsecured promissory notes to the FLP in exchange for a 1% general partnership interest. The son, acting under the power of attorney, contributed the 99% limited partnership interest to a lifetime charitable lead annuity trust (CLAT) that would pay an annuity amount to charity for the lifetime of the decedent with the remainder passing to the decedent's sons at the death of the decedent.

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[458] The comment to section 701(b) of the UPA provides, "Liquidation value is not intended to mean distress sale value. Under general principles of valuation, the hypothetical selling price in either case should be the price that a willing and informed buyer would pay a willing and informed seller, with neither being under any compulsion to deal. The notion of a minority discount in determining the buyout price is negated by valuing the business as a going concern. Other discounts, such as for a lack of marketability or the loss of a key partner, maybe appropriate, however. For a case applying the concept, see *Fotouhi v. Mansdorf*, 427 B.R. 798, 803–05 (Bankr. N.D. Cal. 2010)."

[459] A single owner entity that has not elected to be classified as an association (corporation). See § 7701 and Treas. Reg. §§ 301.7701-1(a), -2(c)(2), -3(b)(1)(ii).

[460] *See* § 1141(a)(1) of the UPA

[461] *See* § 1131(a) of the UPA.

[462] *See* Treas. Reg. § 25.2701-1(c)(4).

[463] *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017).

The son may not have had the authority to make the transfer to the CLAT because the power of attorney only allowed gifts to the principal's issue up to the federal gift tax annual exclusion. The value of the taxable gift of the remainder interest to the sons was calculated with a 25% valuation discount on the limited partnership interest due to lack of control and marketability. The decedent died 7 days after the contribution to the CLAT.

(2) The IRS argued that the $10 million of contributed assets were includible in the decedent's estate under the following Code sections: (i) section 2036(a)(1) (retained enjoyment of income); (ii) section 2036(a)(2) (retained right in conjunction with any person to designate who could enjoy the property or its income; (iii) section 2038 (power to alter, amend, revoke, or terminate the transfer at the decedent's death; and (iv) section 2035(a) (transfer of property within three years of death that otherwise would have been includible sections 2036-2038 of the Code or section 2042 (inclusion of life insurance proceeds). Interestingly, the taxpayer did not contest the application of section 2036(a)(2) or argue that the bona fide transfer for full and adequate consideration exception to section 2036 applied. Rather, the taxpayer contended that section 2036 and 2038 could not apply because the decedent did not own any interest in the FLP at death.

(3) The Tax Court agreed that section 2036(a)(2) applied. In the majority opinion, the Tax Court held that (i) the decedent, in conjunction with all other partners, could dissolve the partnership, and (ii) the decedent, through her son acting under the power of attorney and as a general partner of the FLP, could control the amount and timing of distributions. In previous cases, the courts had applied section 2036(a)(2) to certain FLP cases,[464] but this was the first application of section 2036(a)(2) where the decedent exclusively owned a limited partnership interest.

(4) The majority opinion goes on to explain that the inclusion amount under section 2036 must be adjusted under section 2043(a) of the Code. Although the majority opinion admits that "read in isolation" section 2036(a)(2) would require that the amount includible in the estate would be the full date of death value of the cash and securities transferred to the FLP, it asserts that section 2036(a)(2) must be read in conjunction with section 2043(a) of the Code.

(a) Section 2043(a) of the Code provides, in pertinent part, if there is a transfer of an interest includible under section 2036 "for a consideration in money or money's worth, but is not a bona fide sale for adequate and full consideration in money or money's worth,"[465] then the amount includible in the gross estate is "only the excess of the fair market value at the time of death of the property otherwise to be included on account of such transaction, over the value of the consideration received therefor by the decedent."[466]

(b) As such, the amount includible under sections 2036 and 2043 of the Code is the valuation discount due to lack of control and marketability—the value of the contributed assets ($10 million) less the value of the limited partnership interest received

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[464] *See Estate of Strangi v. Commissioner*, T.C. Memo. 2003-15, *aff'd*, 417 F.3d 468 (5th Cir. 2005) and *Estate of Turner v. Commissioner*, T.C. Memo. 2011-209 (both cases involved a decedent owning a general partnership interest). *But see Kimball v. U.S.*, 371F.3d 257 (5th Cir. 2004), *rev'g*, 244 F. Supp 2d 700 (N.D. Tx. 2003) and *Estate of Mirowski v. Commissioner*, T.C. Memo. 2008-74.

[465] § 2043(a).

[466] *Id.*

($7.5 million due to valuation discount of 25%), assuming no change in the value of the transferred assets. The majority opinion refers to this amount as the "hole" in the doughnut. The court refers to the limited partnership interest as the "doughnut," which would be included in the gross estate if the transfer was deemed void or included in the gift amount if the gift is recognized. The court concluded, in this instance, that the transfer was void or revocable, and as such, the limited partnership was includible in the estate of the decedent.

(c) If there had been a change in the value of the transferred assets between the transfer and the date of death, the net inclusion amount would be increased by any appreciation or reduced by any depreciation. According to the majority opinion:

> Changes in the value of the transferred assets would affect the required inclusion because sec. 2036(a) includes in the value of decedent's gross estate the date-of-death value of those assets while sec. 2043(a) reduces the required inclusion by the value of the partnership interest on the date of the transfer. To the extent that any post-transfer increase in the value of the transferred assets is reflected in the value of the partnership interest the decedent received in return, the appreciation in the assets would generally be subject to a duplicative transfer tax. (Conversely, a post-transfer decrease in value would generally result in a duplicative reduction in transfer tax.)[467]

(d) In other words, the date of death value of the limited partnership interest would also be included under section 2033 of the Code, so all of the post-contribution appreciation would also be subject to estate tax. Thus, more value may be included in the gross estate than if the decedent had never contributed assets to the FLP.

(5) The concurring opinion, which was joined by seven judges, asserts that the planning involved in this case is "best described in aggressive deathbed tax planning." It then agrees that section 2036(a)(2) of the Code applies because the decedent make a transfer of the $10 million in cash and securities (to the partnership), but the decedent "retained the proverbial 'string' that pulls these assets back into her estate." However, as the concurring opinion provides:

> This is where I part company with the Court, because I do not see any "double inclusion" problem. The decedent's supposed partnership interest obviously had no value apart from the cash and securities that she allegedly contributed to the partnership. The partnership was an empty box into which the $10 million was notionally placed. Once that $10 million is included in her gross estate under section 2036(a)(2), it seems perfectly reasonable to regard the partnership interest as having no distinct value because it was an alter ego for the $10 million of cash and securities.
>
> This is the approach that we have previously taken to this problem. *See Estate of Thompson*, 84 T.C.M. (CCH) at 391 (concluding that the decedent's interest in the partnership had no value apart from the assets he contributed to the partnership); *Estate of Harper v. Commissioner*, T.C. Memo. 2002-121, 83 T.C.M. (CCH) 1641, 1654; cf. *Estate of Gregory v. Commissioner*, 39 T.C. 1012, 1020 (1963) (holding that a decedent's retained interest in her own property

[467] *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017), footnote 7.

> cannot constitute consideration under section 2043(a)). And this is the approach that I would take here. There is no double-counting problem if we read section 2036(a)(2), as it always has been read, to disregard a "transfer with a string" and include in the decedent's estate what she held before the purported transfer—the $10 million in cash and securities.
>
> Rather than take this straightforward path to the correct result, the Court adopts as the linchpin of its analysis section 2043(a). Neither party in this case advanced any argument based on section 2043(a); indeed, that section is not cited in either party's briefs. And as the Court recognizes, *see* op. Ct. p. 28, we have not previously applied section 2043(a), as the Court does here, to limit the amount includible in a decedent's gross estate under section 2036(a). *See, e.g.*, *Estate of Harper*, 83 T.C.M. (CCH) at 1654 (ruling that section 2043(a) "is inapplicable where, as here, there has been only a recycling of value and not a transfer for consideration"). [468]

(6) While asserting that section 2043(a) is inapplicable in this case, the concurring opinion goes on to opine that even if section 2043(a) did apply, it is not clear that the decedent's partnership interest (the result of a now disregarded transfer) can constitute consideration in money or money's wort within the meaning of section 2043(a).

(7) It is unclear how future cases will resolve the double inclusion issue. The Powell majority opinion was not joined by a majority of the Tax Court judges. Eight judges represented the majority opinion, seven judges agreed with the result but rejected the double inclusion issue, and two judges concurred with the result only.

b. If assets are deemed includible for estate tax purposes under section 2036, it's been held that the assets in a partnership should receive a basis adjustment under section 1014 of the Code without the need for a section 754 election providing an inside basis adjustment under section 743.[469] Under the majority opinion's theory, a portion of the partnership assets would be included under section 2036, reduced by section 2043(a) (the valuation discount), and a portion would be included under section 2033 (the partnership interest). As such, in order to "step-up" the basis of the underlying assets, a section 754 election may in fact be needed. Of course, as discussed later in these materials, a liquidating distribution of partnership assets would accomplish the same thing.

c. From a planning standpoint, intentionally claiming applicability of section 2036 of the Code to partnership interests held by a decedent should accomplish the desired result of a "step-up" in basis on the assets in the partnership. However, if the majority opinion's view of the double inclusion problem is correct, claiming section 2036 should be done with caution. If the partnership assets have not appreciated or have depreciated in value since the contribution, then claiming section 2036 should provide a full step-up in basis. Further, if there is a double inclusion problem because assets have appreciated, then if there is sufficient Applicable Exclusion Amount available to cover the additional inclusion, then there is effectively no cost and the estate would still be in a "free-base" situation.

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[468] *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017), concurring opinion.

[469] *See* Order, *Hurford Investments No. 2, Ltd. v. Commissioner*, No. 23017-11, 2017 BL 138848 (T.C. Apr. 27, 2017) and PLR 200626003.

D. General Powers of Appointment

1. Generally

a. A general power of appointment, as defined in the Code,[470] is a power exercisable in favor of: (i) the power holder, (ii) his or her estate, (iii) his or her creditors, or (iv) creditors of his or her estate. From a transfer tax standpoint, the mere existence of an exercisable general power of appointment at the death (a testamentary general power) of the power holder will cause assets subject to the power to be includible in the power holder's estate.[471] Moreover, the lack of knowledge of the existence of a general power of appointment will not exclude the property subject to the power form being included in the estate of the deceased power holder.[472]

b. From an income tax standpoint, if the holder of the power exercises a testamentary general power, the property passing under the power is deemed to have passed from the deceased power holder without full and adequate consideration, and the property will get a "step-up" in basis.[473] If the holder of the power dies without exercising the testamentary general power of appointment, the property that was subject to the power is also deemed to have been acquired from the deceased power holder and such property will receive a "step-up" in basis.[474]

c. Given the potential income tax savings from the "step-up" in basis and growing Applicable Exclusion Amounts in the future, estate planners will need to consider how, under what circumstances and to what extent a testamentary general power of appointment should be granted to future trust beneficiaries, even if the assets have been correctly transferred into a vehicle (like a dynasty trust) that is structured to avoid estate tax inclusion at every generation. So-called "limited general powers" may be helpful in this respect. For example, a power to appoint only to the creditors of the power holder's estate may be less susceptible to undesirable appointment than a power to appoint more broadly. Further, the exercise of a power may be subject to the consent of another person so long as the person does not have a substantial interest adverse to the exercise of the power in favor of the decedent, his or her estate, his or her creditors, or the creditors of his or her estate.[475]

2. Rights of Creditors

a. The rights of creditors to property over which a powerholder has a testamentary general power is worth considering. The majority view at common law is that the powerholder of a power, conferred on the powerholder by another, is treated as the beneficial owner of the appointive property for purposes of creditors' rights only if (1) the power is general *and* (2) the powerholder exercises the power. No distinction is made between a testamentary and a presently exercisable power. Creditors of a powerholder of a *non*-general power, on the other hand, cannot reach the appointive assets even if the power was effectively exercised. The theory is that the donor who creates a non-general power did not intend to benefit the powerholder.

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[470] §§ 2041(b)(1) and 2514(c).

[471] § 2041(a)(2) and Treas. Reg. § 20.2041-3(b).

[472] *Freeman Estate v. Commissioner*, 67 T.C. 202 (1976).

[473] Treas. Reg. § 1.1014-2(a)(4).

[474] Treas. Reg. § 1.1014-2(b)(2).

[475] Treas. Reg. § 20.2041-3(c)(2).

b. Explaining the distinction between the exercise and non-exercise of a general power for purposes of creditor access, one court noted:

> When a donor gives to another the power of appointment over property, the [powerholder]... does not thereby become the owner of the property. Rather, the appointee of the power [meaning, the powerholder], in its exercise, acts as a "mere conduit or agent for the donor." The [powerholder], having received from the owner of the property instructions as to how the power may be utilized, possesses nothing but the authority to do an act which the owner might lawfully perform.[476]

c. When the powerholder of a general power exercises the power by will, the view that the appointed property is treated as if it were owned by the powerholder means that the creditors of the powerholder's estate can reach the appointed property for the payment of their claims.[477] The rule prevails even if this is contrary to the expressed wishes of the donor of the power.[478]

d. The exercise of the power by will does not confer actual beneficial ownership of the appointive assets on the powerholder for all purposes. The assets do not ordinarily become part of the powerholder's probate estate. Thus, in terms of priority, the powerholder's own estate assets are ordinarily used first to pay estate debts, so that the appointive assets are used only to the extent the powerholder's probate estate is insufficient.

e. Under the majority view at common law, the powerholder's creditors can reach the appointive assets only to the extent the powerholder's exercise was an *effective* exercise. A few states, however, follow the view that even an ineffective exercise entitles the powerholder's creditors to reach the appointive assets.[479] Moreover, even in states adhering to the majority view, an ineffective exercise can sometimes "capture" the appointive assets for the powerholder's estate, in which case the appointive assets become part of the powerholder's probate estate for all purposes, including creditors' rights.

f. When the powerholder of a general power makes an inter vivos appointment, treating the appointed assets as if they were owned by the powerholder does not automatically mean that the powerholder's creditors can subject the appointed assets to the payment of their claims. If the appointment is in favor of a *creditor*, the powerholder's other, unsatisfied creditors can reach the appointed assets only by having the appointment avoided as a "preference" in bankruptcy proceedings. Apart from bankruptcy, the powerholder can choose to pay one creditor rather than another with his or her owned assets, and the same is true with respect to appointive assets. If the appointment is in favor of a *volunteer* (i.e., the appointment is gratuitous), the powerholder's creditors can reach the appointed assets only if the transfer is the equivalent of a fraudulent transfer under applicable state law.

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[476] *Univ. Nat'l Bank v. Rhoadarmer*, 877 P.2d 561 (Colo. App. 1991).

[477] *See, e.g., Clapp v. Ingraham*, 126 Mass. 200 (1879).

[478] *See, e.g., State Street Trust Co. v. Kissel*, 19 N.E.2d 25 (Mass. 1939).

[479] *See, e.g., Estate of Breault*, 211 N.E.2d 424 (Ill. App. Ct. 1965).

g. In a minority of jurisdictions, the powerholder of a general power, conferred on him or her by another, is *not* treated as the owner of the appointive property even if the power is exercised.[480] Of course, if the powerholder exercises the power in favor of himself or herself or his or her estate, the appointed property becomes owned in the technical sense, and creditors even in states adhering to the minority view would be able to subject the assets to the payment of their claims to the same extent as other property owned beneficially by the powerholder. A minority of states has enacted legislation that affects the rights of the powerholder's creditors. The legislation is not uniform. Some of the legislation expands the rights of the powerholder's creditors and some contracts them. The following is a sampling of the legislation:

(1) Michigan legislation expands the rights of the creditors of the powerholder of an unexercised general power. During the powerholder's lifetime, the powerholder's creditors can subject the appointive property to the payment of their claims if the power is presently exercisable. If the powerholder has actually made an *inter vivos* exercise of the power, the rules explained above with respect to inter vivos exercises presumably would be applied. At the powerholder's death, the powerholder's creditors can subject the appointive property to the payment of their claims. In both instances, however, the appointive property is available only to the extent that the powerholder 's owned property is insufficient to meet the debts.[481]

(2) New York legislation expands the rights of the powerholder's creditors in some particulars but restricts them in others. The legislation adopts the same rules as the Michigan legislation, but limits their application to general powers presently exercisable. As to general testamentary powers, the powerholder's estate creditors can subject the appointive property to the payment of their claims only if the powerholder, as donor, reserved the power in himself or herself; as to general testamentary powers conferred on the powerholder by another, the powerholder's estate creditors cannot reach the appointive property even when the powerholder's will exercises the power.[482]

h. The Uniform Powers of Appointment Act takes the following position. If the power is conferred by another, the rights of the powerholder's creditors depend on whether the power is general or non-general. If the power is general, the appointive property is subject to a claim of (1) a creditor of the powerholder, to the extent the powerholder's property is insufficient, if the power is presently exercisable (whether or not actually exercised), and (2) a creditor of the powerholder's estate, to the extent the estate is insufficient, subject to the right of a decedent to direct the source from which liabilities are paid.[483] If the power is non-general, the general rule is that creditors have no rights in the appointive property.[484]

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[480] *See, e.g., St. Matthews Bank v. DeCharette*, 83 S.W.2d 471 (Ky. 1935).

[481] *See* Mich. Comp. Laws § 556.123.

[482] *See* N.Y. Est. Powers & Trusts Law §§ 10-7.1, *et seq.*

[483] *See* Uniform of Powers of Appointment Act § 502.

[484] *See* Uniform of Powers of Appointment Act § 504(a).

3. Formula

a. One option is to draft a testamentary general power of appointment that by formula absorbs any unused portion of a beneficiary's unused Applicable Exclusion Amount (including any DSUE Amount). This would provide a "step-up" in basis to those assets subject to the power without causing any Federal estate tax liability. In theory, this formula can be drafted with great precision. However, in practice, it is quite difficult to draft, particularly if the drafting occurs many years from the anticipated and likely exercise (or death of the power holder). Further, as discussed below, the formula may be subject challenge by the IRS.[485]

b. A testamentary general power of appointment that attempted to achieve the maximum favorable tax results would seem to require the following features:

(1) A formula that determines the size or amount of the general power of appointment. As mentioned above, in theory, the starting amount of the formula is the Applicable Exclusion Amount as defined in section 2010(c)(2), which would include the Basic Exclusion Amount under section 2010(c)(3)(A), including any increases due to the cost-of-living increase, and any DSUE Amount.

(2) The starting amount would then need to be reduced by any reductions due to taxable gifts that reduced the Applicable Exclusion Amount prior to death and any testamentary transfers that would not otherwise be deductible for Federal estate tax purposes (marital transfers under section 2056 and charitable transfers under section 2055).

(3) Once the size of the power of appointment has been so determined, the formula would need to provide that the power is not simply exercisable against all of the assets in trust, but that it is only exercisable against those assets in the trust that would benefit the most from a "step-up" in basis, given the tax nature of the asset (as discussed above). For example, if the trust only held publicly-traded assets, the formula would need to ensure that the power is exercisable against the lowest basis lots of securities, not against the securities that have unrealized losses or the cash. The formula would likely need to determine the total income tax cost (including state income taxes) to the trust in a constructive liquidation of the assets in a taxable transaction for fair market value and then segregate those assets or portion of assets (like a separate lot of stock) that have the highest relative income tax cost compared to fair market value (the highest "effective" income tax cost). Without this refinement, the basis adjustment under section 1014(a) will be applied across all of the assets whether they benefit from the "step-up" in basis or not, and if the total value of the assets exceed the size of the general power of appointment, no asset will get a full "step-up" in basis.[486]

(4) The formula would likely also distinguish between assets that are and are not likely to be sold or redeemed in a taxable transfer (for example, closely-held C corporation shares in a family-owned business) and those assets that are not likely to be sold but

[485] The IRS has ruled favorably on other formula general powers of appointment dealing with estate inclusion in lieu of a generation-skipping transfer. *See, e.g.*, PLRs 9527024 and 911054.

[486] Similar to the basis adjustment under section 743 upon the death of a partner when the partnership makes or has a section 754 election. *See also* Rev. Proc. 64-19, 1964-1 C.B. 682 , in the marital funding area, which requires that the assets selected for distribution be fairly representative of the appreciation and depreciation between the decedent's death and the funding.

provide some ongoing income tax benefits by virtue of the "step-up" in basis (for example, depreciable and depletable assets).

(5) In determining the "effective" income tax cost in a constructive liquidation of the trust assets, the formula may need to reduce the original size of the power of appointment to take into account any state death tax costs (if the beneficiary dies in a state with a state death tax) that would result from the existence of the general power of appointment. Most states with a death tax have an exemption that is smaller than the Federal Applicable Exclusion Amount, and no state provides for "portability" of a deceased spouse's unused state death tax exemption. As such, formula would need to take into account the "effective" state death tax cost (in comparison to the fair market value of the asset) and compare that to the income tax savings from the "step-up" in basis for the assets with the highest "effective" income tax cost on the date of death. The formula might then reduce the size of the general power of appointment to so that at the very least the "effective" state death tax cost equals (but likely is less than) the "effective" income tax cost of those assets that would be subject to the power of appointment. Note, some states provide that a general power of appointment is not subject to state death tax.[487] Because of the foregoing, drafters may choose to limit the size of the general power of appointment to the lesser of the Applicable Exemption Amount and any applicable state death tax exemption.

(6) To complicate things further, in determining the size of the general power of appointment, the formula will need to consider differences between the Applicable Exclusion Amount and the any remaining GST exemption the beneficiary may have at the time of death. If, for example, Applicable Exclusion Amount is greater than the beneficiary's GST exemption, should the general power of appointment be reduced to the lesser of the two amounts thereby foregoing some portion of the available "free" step-up in basis? Or should the general power of appointment be the greater of the two amounts but provide a different disposition of those assets depending on whether GST exemption is applied to such "transfer" (even in the failure to exercise the power of appointment)? In other words, assets receiving both a "step-up" in basis and application of the beneficiary's GST exemption would continue to stay in the dynasty trust, for example, and assets that only receive "step-up" in basis would be held in a separate "non-exempt" GST trust.

c. Even if the formula could be so written with such precision, there is a chance that the IRS would challenge the general power of appointment (especially if the beneficiary has a surviving spouse) as indeterminable at the time of death of beneficiary or subject to a contingency or condition precedent, and as such, the formula does not give rise to an exercisable general power of appointment.

(1) As noted above, the size of the general power of appointment should be reduced by any transfers that would not otherwise be deductible for Federal estate tax purposes (marital transfers under section 2056 and charitable transfers under section 2055). Whether a transfer will qualify for the marital deduction or a charitable deduction may be dependent on a QTIP election under section 2056(b)(7)(B)(v) or a qualified disclaimer under section 2518, both of which occur after the date of death. A QTIP election is made on a timely filed estate tax return,[488] and a qualified disclaimer is made 9 months after date of death.[489]

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[487] Pennsylvania provides that mere existence of a general power of appointment does not cause inclusion of the assets subject to the power for inheritance tax purposes. Under § 9111(k) of Title 72 of the Pennsylvania Consolidated Statutes, property subject to a power of appointment is exempt from Pennsylvania inheritance tax in the estate of the donee of the power of appointment.

[488] § 2056(b)(7)(B)(v).

(2) The IRS's argument might be that despite the crux of the Fifth Circuit's ruling in *Clayton v. Commissioner,*[490] a QTIP election relates back to the date of death and the same could be said about qualified disclaimers,[491] these actions do not relate to a general power of appointment under section 2041. The election and disclaimer do, however, affect the size of the general power of appointment. As such, they are similar to a contingency that has not yet occurred on the date of death.

(3) In Private Letter Ruling 8516011, the IRS ruled that a marital bequest that was conditioned upon the surviving spouse's survival of the decedent's admission to probate would not be included in the surviving spouse's estate because the spouse died prior to the will being admitted to probate. In the ruling, the IRS stated that even though the spouse had the power to admit the will to probate and thus had a power of appointment, this power of appointment was subject to the formal admission to probate, which in turn requires a substantive determination by the court regarding the validity of the will. As such, the general power of appointment was deemed not to exist for estate tax purposes.[492]

d. In addition, if the formula allows the grantor to alter the amount subject to the general power of appointment, then there is a potential issue under section 2036 of the Code. For example, if the amount subject to the power is reduced by subsequent taxable gifts or by the taxable bequests under the will, then by choices reserved to the grantor, the general power of appointment may cover more or less assets. On the other hand, if the general power of appointment is not modified by these subsequent factors, it will likely not function as intended. There is a risk that too much will be subject to the general power of appointment (e.g., if grantor leaves 100% of estate to charity or to a spouse) or too little (e.g., if the grantor makes large taxable gifts/bequests).

4. Trust Director

a. Because of the complexities of the formula and the risk of challenge by the IRS, estate planners may want to rely upon an independent person to grant or modify the terms of a limited power of appointment and expand it to a general power of appointment.[493] This has the obvious benefit of allowing the trust protector to determine the size of the

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[489] § 2518(b)(2).

[490] 976 F.2d 1486 (5th Cir. 1992), *rev'g* 97 T.C. 327 (1991).

[491] *See* § 2518(a) and Treas. Reg. § 25.2518-1(b).

[492] *See* TAM 8551001 and *Kurz Estate v. Commissioner*, 101 T.C. 44 (1993), aff'd, 68 F.3d 1027 (7th Cir. 1995).

[493] *See, e.g.*, Alaska Stat. § 13.36.370(b)(4) ("modify the terms of a power of appointment granted by the trust"); Idaho Code §15-7-501(6)(c) ("To modify the terms of any power of appointment granted by the trust. However, a modification or amendment may not grant a beneficial interest to any individual or class of individuals not specifically provided for under the trust instrument."); S.D. Codified Law § 55-1B-6(3) ("Modify the terms of any power of appointment granted by the trust. However, a modification or amendment may not grant a beneficial interest to any individual or class of individuals not specifically provided for under the trust instrument."); Wyo. Stat. § 4-10-710(a)(xi) ("to grant a power of appointment to one (1) or more trust beneficiaries or to terminate or amend any power of appointment granted by the trust; however… of a power of appointment may not grant a beneficial interest to any person or class of persons not specifically provided for under the trust instrument or to the trust protector, the trust protector's estate or for the benefit of the creditors of the trust protector.").

testamentary power of appointment and the assets that will be subject to the power as the situation and the tax laws change in the future. Such person is referred to in the Uniform Directed Trust Act as a "trust director" but other names include "trust protector" or "trust advisor."

b. The power would need to be granted prior to the death of the beneficiary and in writing, in all likelihood. Because of the problems with relying on a formula as discussed above, a trust director may choose to grant a general power of appointment to each beneficiary equal to a fixed pecuniary amount based upon the beneficiary's estate situation (value of assets, existence of a surviving spouse, structure of the beneficiary's estate plan, state of domicile, etc.) and the nature of the assets in the trust (making the general power of appointment exercisable only against certain assets or portions of assets). The trust director could provide that the power of appointment will be exercisable at the death of the beneficiary, but can be revoked or modified at any time by the trust director. The trust director might modify such power of appointment, for example, if the beneficiary's estate situation changed or if certain trust assets are sold.

E. Forcing Estate Tax Inclusion

1. Different Strategies for Causing Estate Tax Inclusion

a. Give someone—trustee, trust director, or person with a power of appointment—the discretion to grant a general power of appointment or to expand a special power of appointment so it becomes general. The power could be granted shortly before death if the step up in basis is desirable given the tax rates in effect at that time (considering, of course, that when a potential power holder is "shortly before" death may not always be easy to determine). Should the person with the power to grant or expand the power be a fiduciary? Should protection be given for a decision to grant or not to grant the power of appointment? Should the general power be able to be rescinded or modified by the person granting the power? Where the circumstances are clearly defined, a formula grant of a general power may be easier, and more successful, than a broadly applicable formula.

b. Terminate the trust and distribute the assets to one or more beneficiaries. If a beneficiary does not have a taxable estate, then there may be no transfer tax reason to maintain the trust and there may be a negative income tax consequence to such maintenance. Quite obviously, there may be non-tax detriments to a beneficiary having outright ownership of such assets. In such instances, transferring assets from a trust that is not includible in the beneficiary's estate into a new trust over which the beneficiary has a general power of appointment – perhaps one exercisable only with the consent of a non-adverse party to the creditors of the beneficiary's estate – may produce a step-up with minimal risk of asset diversion or dissipation.

c. Include a formula in the trust agreement which would cause estate tax inclusion if appreciation is not sufficient for estate tax benefits to outweigh income tax benefits of a step up

(1) Example: I make a gift of $5 million of stock with a basis of zero to a trust for my children. Trust agreement provides that on my death, if 40% of the excess of the date of death value of any asset over the date of gift value of the asset is less than 23.8% of the excess of the date of death value of the asset over the basis of the asset, the asset is distributable to my estate. The formula could be written as follows if (E)*(D-G) < (I)(D-B), asset

is distributable, where E=estate tax rate, I=income tax rate, D=date of death value, G=date of gift value, B=basis. If the value of the stock is $7.5 million at my death, the stock would be distributed to my estate so that I get the income tax benefit of the step up, which exceeds my transfer tax savings.

(2) Formula creates an "estate tax inclusion period"[494] ("ETIP") so GST exemption cannot be allocated to the trust.

d. Appoint the donor as trustee, although many trust agreements provide that the donor may never be named as trustee.

e. Move the trust from an asset protection jurisdiction to a jurisdiction where donor's creditors can reach the assets. This would also require that the donor have some beneficial interest in the trust that would cause it to be a self-settled trust.

f. Estate could take the position that there was an implied agreement of retained enjoyment under section 2036(a)(1). For example, donor begins living in a home gifted to the trust (perhaps pursuant to a qualified residence trust) without paying rent and takes the position that there was an implied agreement at the outset that the donor would be able to do so.

(1) A recent Federal district court case could help in this context. In the 1970's two cases dealing with the Goodwyn family established the principle that if a trust agreement prohibited the grantor from acting as de facto trustee, the mere fact that the grantor did in fact act as de facto trustee would not established a retained interest under section 2036 of the Code.[495] In the 1973 opinion the court stated:

> Under the terms of the deeds creating these trusts, the trustees were granted broad discretionary powers with respect to both the distribution of income to the beneficiaries and the investment and management of the corpus of the trusts. Notwithstanding the designation of Richards and Russell as trustees, it further appears that at all times from the establishment of the trusts until his last illness, the decedent exercised complete control with respect to the purchase and sale of trust assets, investment of any proceeds, and the determination of the amounts, if any, to be distributed to the respective beneficiaries.
>
> The assets of the various trusts, together with other trusts, as well as property owned by the decedent, were accounted for by a single set of records maintained in the offices of the decedent. Except for the Federal income tax returns prepared and filed by the decedent on behalf of the various trusts, no separate records were maintained showing the assets and income of any of these trusts.
>
> The respondent argues that the decedent should be treated as trustee, in fact, possessing such rights and powers as to cause the inclusion of the assets thereof in his gross estate, relying on sections 2033, 2036 (a)(2), and 2038. Section 2033 requires a finding that the decedent had an interest in the assets of the trusts at the time of his death. There is no basis for such a finding. Section 2038(a)(1) relates

[494] § 2642(f).

[495] *Estate of Goodwyn*, T. C. Memo. 1973-153, nor a power for the grantor trust provisions of sections 671, *et seq.*, of the Code, *Estate of Goodwyn v. Commissioner,* T.C. Memo. 1976-238.

to "a power" exercisable by the decedent "to alter, amend, revoke, or terminate," the trusts. No such power was reserved by the decedent. Accordingly, in the final analysis the respondent's position is predicated on the determination that by reason of the de facto control exercised by the decedent the trusts are includable in his estate pursuant to section 2036(a)(2). It is clear that the powers granted to the trustees would, if reserved by the decedent, be such as to require the inclusion of the assets of the trusts in the estate of the decedent. *United States v. O'Malley* [66-1 USTC ¶ 12,388], 383 U.S. 627 (1966). Does the fact that the decedent was able to exercise such powers through the cooperation of unrelated trustees require a different result? The question thus presented for decision is whether the value of such trusts is includable in the estate of the decedent by reason of the de facto control over the trusts exercised by the decedent, notwithstanding that no power to exercise such control was reserved to or by the decedent once he resigned his duties as trustee of certain of these trusts.

In the course of the trial of this case, and in his briefs, respondent made no secret of the fact that support for respondent's position was to come from the decision of the U.S. Supreme Court in the case of *United States v. Byrum* then pending on writ of certiorari from the U.S. Circuit Court of Appeals for the Sixth Circuit ([71-1 USTC ¶ 12,763] 440 F.2d 949). The Supreme Court has since rendered its decision in that case. [72-2 USTC ¶ 12,859] 408 U.S. 125 (1972). By that decision, the Supreme Court has rejected the position of the respondent in the instant case that the de facto exercise of control over the management and investment of the trust res is within the ambit of section 2036.

In distinguishing *United States v. O'Malley*, *supra*, the Supreme Court in the Byrum case said:

In our view, and for the purposes of this case, *O'Malley* adds nothing to the statute itself. The facts in that case were clearly within the ambit of what is now § 2036(a)(2). That section requires that the settlor must have "retained for his life * * * the right * * * to designate the persons who shall possess or enjoy the property or the income therefrom." *O'Malley* was covered precisely by the statute for two reasons: (1) there the settlor had reserved a legal right, set forth in the trust instrument; and (2) this right expressly authorized the settlor, "in conjunction" with others, to accumulate income and thereby "to designate" the persons to enjoy it.

It must be conceded that Byrum reserved no such "right" in the trust instrument or otherwise. The term "right," certainly when used in a tax statute, must be given its normal and customary meaning. It connotes an ascertainable and legally enforceable power, such as that involved in *O'Malley*. Here, the right ascribed to Byrum was the power to use his majority position and influence over the corporate directors to "regulate the flow of dividends" to the trust. That "right" was neither ascertainable nor legally enforceable and hence was not a right in any normal sense of that term.

The right or power upon which the tax is predicated must thus be a legal right reserved in the trust instrument, or at least by some form of agreement between the trustees and the settlor. Admittedly, such a right did not exist in the case of the Richards and Russell Trusts. To hold otherwise would not only be contrary

> to the reasoning of the Supreme Court in the *Byrum* case but would present the insuperable problem of determining to what degree compliance on the part of unrelated trustees with the wishes of the grantor would be sufficient to constitute requisite control over the trust res within the meaning of section 2036.
>
> It would indeed be an unusual situation for a grantor to appoint trustees, whether corporate or otherwise, in the expectation that such trustees would, where given a choice, act contrary to the wishes and intent of the grantor. Notwithstanding that Richards and Russell permitted the decedent full discretion in the management of these trusts, as a matter of law the trustees were responsible and answerable for the decedent's acts on their behalf. *See* 2 Scott, Trusts 1388 (3d ed., 1967); 3 Scott, Trusts 1794 (3d ed., 1967). Had they so elected, Richards and Russell could have taken control of the trust res at any time.

(2) The 1977 opinion renders an identical holding bolstered by certain legislative history:

> There is nothing in the record to show that the trustees could not have undertaken exclusive control of the trust res if they had elected to do so. Whatever power Goodwyn exercised over the trust assets, administration or distribution, he did so on the trustee's behalf and not in his own right.
>
> Because of Goodwyn's failure to have a legally enforceable right, we have already held, following *Byrum*, that the assets of these trusts were not includable in the decedent's estate under 2036(a)(2). Since a similar legal right or power is a prerequisite under section 674(a), consistency appears to require the same decision with respect to the applicability of this section. We see no other possible decision.
>
> Section 671 precludes attributing the income to Goodwyn on any other theory of dominion and control under the definition of gross income, including the Clifford doctrine. We interpret this limitation to mean that if Goodwyn cannot be considered as a trustee, in fact, under the statutory provisions of subpart E, he cannot be considered as such by virtue of the judicial doctrines arising from the Clifford case which Congress intended to limit through the enactment of subpart E. But the protection of section 671, as explained in the House Ways and Means Committee Report, cited *supra*, does not extend to situations involving the assignments of future income.

(3) With respect to the legislative history of the Internal Revenue Code of 1954, the 1977 opinion states:

> While the record indicates that the legal formalities have been complied with, it also indicates that the designated "independent" trustees, whether by agreement or otherwise, entrusted the management of the trusts' assets and the distribution of income therefrom to the sole discretion of the decedent. The decedent kept all the records, made all of the investments and decided the amount to be distributed to beneficiaries. The trustees merely acquiesced in these actions.
>
> On the basis of these facts, the judicial decisions following the Supreme Court's decision in *Helvering v. Clifford* [40-1 USTC ¶ 9265], 309 U.S. 331 (1940), and

> the later so-called *Clifford* regulations might well warrant the attribution of the income from these trusts to the decedent. However, to the extent these previous principles are not embodied in the present statutory provisions of the Code, they must be considered no longer applicable. Section 671 provides that subpart E represents the sole criterion of dominion and control under section 61 (relating to the definition of gross income) and thereby also under the *Clifford* doctrine.
>
> The Report of the Committee on Ways and Means on the Internal Revenue Code of 1954 explains clearly that this exclusivity was the intent of Congress:
>
> It is also provided in this section [671] that no items of a trust shall be included in computing the income or credits of the grantor (or another person) solely on the grounds of his dominion and control over the trust under the provisions of section 61 (corresponding to sec. 22(a) of existing law). The effect of this provision is to insure that taxability of *Clifford* type trusts shall be governed solely by this subpart. However, this provision does not affect the principles governing the taxability of income to a grantor or assignor other than by reason of his dominion and control over the trust. Thus, this subpart has no application in situations involving assignments of future income to the assignor, as in *Lucas v. Earl* [2 USTC ¶ 496] (281 U.S. 111), *Harrison v. Schaffner* [41-1 USTC ¶ 9355] (312 U.S. 579), and *Helvering v. Horst* [40-2 USTC ¶ 9787] (311 U.S. 112), whether or not the assignment is to a trust; nor are the rules as to family partnerships affected by this subpart.
>
> Consequently, in order for a grantor to be held taxable pursuant to subpart E on the income of a trust which he has established, he must have one of the powers or retained interests proscribed by subpart E.

(4) So, that's where the law has stood for many years. Along comes a bad facts makes bad law case, that of *Securities and Exchange Commission v. Wyly*.[496] The issue there was whether certain trusts should be considered grantor trusts for income tax purposes, thus causing the grantors to owe income tax, or whether the trusts were properly considered to be offshore, managed by an Isle of Man trustee. The opinion states:

> Section 674(a) provides that: "[t]he grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party." Quoting a prominent tax treatise, defendants concede that the "power of disposition" includes "powers to 'effect such major changes in the enjoyment of a trust's income and corpus as the addition and elimination of beneficiaries' as well as 'minor and customary power[s]' over income and corpus distribution." Because a non-beneficiary trustee is considered a non-adverse party under the statute, "[s]ection 674(a) captures virtually every trust, including the [IOM] trusts." Thus, defendants concede that "[u]ltimate liability under [s]ection 674[] … turns on whether any of the statutory exceptions apply." In his treatise, defendants' expert confirms that the Wylys' had a power of disposition under this statute. *See* Robert T. Danforth, Norman H. Lane, and Howard M.

[496] *Securities and Exchange Commission v. Wyly*, 2014 WL 4792229 (S.D.N.Y. Sept. 25, 2014).

Zaritsky, Federal Income Taxation of Estates and Trusts §9.04[1] ("A right to use trust funds without adequate compensation also affects beneficial enjoyment, because the holder can reduce the assets from which the named beneficiaries can benefit. Thus, a grantor's right to live rent-free in a house owned by the trust is a power of disposition under Section 674(a).").

According to defendants, the Bulldog Trusts are not grantor trusts because they fall under the section 674(c) exemption. Under that exemption, section 674(a) does not apply to "certain powers that are exercisable by independent trustees." According to the corresponding IRS regulation, which summarizes the statute, [t]he powers to which section 674(c) apply are powers (a) to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, or (b) to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries). In order for such a power to fall within the exception of section 674(c) it must be exercisable solely (without the approval or consent of any other person) by a trustee or trustees none of whom is the grantor and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor. To determine whether the Bulldog Trusts are covered by this exception, it is necessary to answer three questions: 1) Did the IOM trustees have the power to "distribute, apportion, or accumulate income" or "pay out corpus" to or for a beneficiary or beneficiaries?; 2) Were the IOM trustees a) the grantor, or b) a "related or subordinate" party as defined by the statute?; and 3) Were the trustees able to "exercis[e] [those powers] solely (without the approval or consent of any other person)"?

The first two questions are straightforward. First, the IOM trustees certainly had the power, as set out in the trust deeds, to "distribute, apportion, or accumulate income" or "pay out corpus" to or for a beneficiary. Second, the IOM trustees were neither the grantor, nor one of the individuals on the exclusive list of "related or subordinate" parties defined by the statute. The only remaining question is whether the IOM trustees were able to exercise those powers "solely" or "without the approval or consent of any other person."

Defendants argue, citing a 1976 Tax Court case, that a grantor may only be taxed on "a power reserved by instrument or contract creating an ascertainable and legally enforceable right, not merely the persuasive control which he might exercise over an independent trustee who is receptive to his wishes." As such, defendants contend that the Wylys did not share in the power to distribute, apportion, or allocate income, or to pay out corpus, because the trust deeds allocated those powers solely to the IOM trustees. Thus, the Bulldog Trusts fall within the shelter of 674(c)'s "independent trustees exception."

I disagree. "Such a rigid construction is unwarranted. It cannot be squared with the black-letter principle that 'tax law deals in economic realities, not legal abstractions.'" As Professor Robert Danforth, the defendants' own expert, writes in his treatise, "[i]t would certainly violate the purpose of the independent trustee rule to require an independent trustee to act with the consent of the grantor or a related or subordinate person." The Wylys, through the trust protectors who were all loyal Wyly agents, retained the ability to terminate and replace trustees.

> The Wylys expected that the trustees would execute their every order, and that is exactly what the trustees did.
>
> The evidence amply shows that the IOM trustees followed every Wyly recommendation, whether it pertained to transactions in the Issuer securities, making unsecured loans to Wyly enterprises, or purchases of real estate, artwork, collectibles, and other personal items for the Wylys and their children. The trustees made no meaningful decisions about the trust income or corpus other than at the behest of the Wylys. On certain occasions, such as the establishment of the Bessie Trusts, the IOM trustees actively participated in fraudulent activity along with the Wylys. The Wylys freely directed the distribution of trust assets for personal purchases and personal use. Because the Wylys and their family members were beneficiaries, the IOM trustees were thus "distributing" income for a beneficiary at the direction of the grantors—the Wylys. [497]

(5) *Wyly* presents potential problems for ordinary trusts if the advisors routinely follow a grantor or beneficiaries "advice." The *Goodwyn* rule was clear, but if you believe *Wyly* then in many trusts we would likely discover that the grantor or beneficiaries were "pulling the strings" although they had no legal right to do so. However, in the context of obtaining basis for grantors, *Wyly* could be helpful by enabling a grantor to argue for the application of section 2036 unexpectedly. Note particularly that the *Goodwyn* rationales appear to be based on a trustee having authority; if an advisor who is not a fiduciary can direct a trustee, and the trustee must follow the direction, then will *Goodwyn* protect the grantor whose advisor follows the grantor's advice regularly.

g. Use a freeze partnership so that grantor's retained preferred interest gets a basis adjustment at death.

(1) Transfers cash flow and appreciation in excess of the donor's preferred return and liquidation preference

(2) Section 754 election (discussed below) would allow a corresponding step up to partnership's inside basis.

(3) Requires payment of a preferred return to donor, which may be difficult if yield on underlying assets is not sufficient

(4) Preferred interest valued at zero unless an exception to section 2701 exists or if an exemption to the zero valuation rule exists (for example, a qualified payment interest)

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[497] Because I conclude that both the Bulldog and Bessie Trusts were grantor trusts under Section 674, I need not reach the issue of whether they were also grantor trusts under Section 679. Although the SEC contends that the trading profits on sales of Issuer securities should be taxed at the ordinary income rate, I decline to do so. Rather, I will approximate unpaid taxes by applying the rate the Wylys would have had to pay if they owned the shares personally, which requires applying the ordinary income or capital gains rate for the taxable year. Thus, the "reasonable approximation" of disgorgement is $111,988,622.76 for Sam Wyly and $58,896,281.97 for Charles Wyly when using the lower capital gains rate. *See* JX 9904A and JX 9904B ("Calculations Using the Ordinary and Capital Gains Tax Rates for All Transactions in Registered Securities Attributable to Sam and Charles Wyly ").

(5) Even if the section 2701 requirements are not met and preferred interest has a zero value (e.g. because non-cumulative) so that the value of the gift equals the donor's entire interest in the partnership, at donor's death the value of preferred is includible in gross estate (put right can ensure that the value at least equals liquidation preference) and there is no transfer tax on the income and appreciation to the extent it exceeds the donor's preferred return.

2. Tax consequences of estate tax inclusion

a. Value of property at death is includible in gross estate.

b. Section 2001(b) provides that adjusted taxable gifts do not include gifts that are includible in the gross estate. Thus, there is a distinction between including assets in the estate of a beneficiary and including gifted assets in the estate of the donor.

c. There is no reduction available for gifts treated as having been made by a spouse because of a split gift election, so estate tax inclusion generally should not be used for property for which a split gift election was made.

d. Question of how much is excluded from adjusted taxable gifts where less than all of the gifted property is includible in the estate (e.g. because of distributions of income or distributions of appreciation)?

(1) This does not seem to be addressed under sections 2001, 2701 and 2702 and the Treasury Regulations thereunder.

(2) Example: I make a completed gift of $5 million of stock with a zero basis to a trust for my children and the stock is included in my estate as a result of one of the methods described above. During my lifetime any income and appreciation in excess of $5 million is distributed to my children free from transfer tax. On my death, the remaining $5 million of stock is includible in my gross estate and is not included in my adjusted taxable gifts. The basis in the stock will be stepped up to the value on the date of death and the stock can be sold free from capital gains tax.

(3) Example: Same as the previous except that I retain the right to receive trust income during my lifetime. My income interest does not reduce the value of the gift because it does not meet the requirements of section 2702. All appreciation is distributed to my children during my lifetime. On my death, I receive a basis "step-up" and my adjusted taxable gifts are reduced. Under the Treasury Regulations,[498] however, my adjusted taxable gifts are only reduced by the value of my income interest and not by the full $5 million value of the stock.

[498] Treas. Reg. § 25.2702-6.

F. "Reverse" Estate Planning: Turning your Poorer Parent into an Asset

1. Generally

a. Many clients who have taxable estates also have a surviving parent or parents who lack a taxable estate. A child of a parent whose taxable estate is less than the parent's Applicable Exclusion Amount may make use of the excess to save income, estate, and generation-skipping taxes if the child can transfer assets upstream, from child to parent, in such a way that the assets are included in the parent's estate with little likelihood that the parent will divert the transferred assets away from the child or child's descendants.

b. Although the benefits of such planning have always existed, the permanent increase in the Applicable Exemption Amount recently has enhanced the benefits of such planning.

2. Estate and Generation-Skipping Tax Benefits.

a. To the extent a child transfers assets to an ancestor, the ancestor will include those assets in the ancestor's estate and may shelter those assets with the ancestor's estate and GST tax exemptions. Transfers can be made without using the child's Applicable Exclusion Amount:

(1) Annual exclusion gifts may be made to the ancestors. The gifts may be made outright or in trust depending on circumstances (e.g. ancestors may be given *Crummey*[499] withdrawal rights). Discounted gifts may be made although doing so will add benefits to the transaction only if the discount is unlocked prior to the ancestor's death. The benefits of annual exclusion gifts may be significant. To illustrate, $14,000 per year for 10 years at 5% equals $176,000. If child is married and there are even two living parents, then $56,000 for 10 years at 5% exceeds $700,000.

(2) Child could make adjusted taxable gifts to the ancestor. Although it may appear that such would be a wasted use of the child's gift tax exemption, if the ancestor is able to leave the given amount to child and child's descendants without estate or generation-skipping tax then the only waste would be opportunity cost to the extent that other methods could be found to transfer assets to a parent without making a gift.

(3) Child may create a GRAT that has a vested remainder in ancestor. That is, the GRAT assets, after the annuity term ends, will be paid to ancestor or to ancestor's estate. The value of the remainder will be included in the ancestor's estate and will pass in accordance with the ancestor's estate plan.

(a) The ancestor's executor may allocate generation-skipping tax exemption to the remainder interest without regard to any ETIP under section 2642(f) because the ancestor has not made an inter vivos transfer of property that would be included in the estate immediately after the transfer. The amount allocated would be equal to the fair market value of the remainder interest. Where the GRAT term is 10 years (or longer), and is back-weighted, the remainder value will remain a comparatively small percentage of the GRAT for the first several years of the term. Upstream GRATs will, in general, have longer terms that GRATs that are

[499] *See Crummey v. Commisioner*., 397 F.2d 82 (9th Cir. 1968).

designed to transfer assets immediately to children. Commentators have speculated that a GRAT may be created with a vested interest in a child, with that child immediately transferring the remainder interest to that child's children and allocating that child's GST exemption at the time of transfer. There is no authority on whether such a transaction achieves the intended result. Private Letter Ruling 200107015 ruled negatively on the assignment of a remainder interest in a charitable lead annuity trust primarily on the grounds that section 2642(e) is specifically designed to limit the ability to leverage generation-skipping tax exemption by using a charitable lead annuity trust. Here the GRAT remainder is not being transferred at the time of its creation, but rather at its fair market value at a later time (the death of the parent owner), which is arguably not abusive.

(b) Use of an Upstream GRAT presents several advantages compared with a child's assignment of a remainder interest to grandchildren. Because GST exemption that would otherwise be wasted is being used there is no, or certainly less, pressure to keep the remainder interest in parent's estate at zero or a de minimis value and the value changes depending on when parent dies (a date that in almost all instances will be uncertain). If a concern is that the value of the remainder interest could exceed the threshold beyond which parent's estate would be required to pay Federal estate tax (or file an estate tax return), then the amount vested in parent could be fixed by a formula tied to the remaining assets in parent's estate. Suppose a 10 year GRAT is funded with $1,000,000 with annual payments that increase at 20% per year is created in a month when the section 7520 rate is 2.0%. The annual payments required to zero-out the GRAT are $44,125. Further, suppose that parent dies at the end of year 5 when the section 7520 rate is 5.0% and the value of the trust assets have grown at 6% per year. The value of the GRAT will be $975,740 with five years of payments remaining and the value of the remainder will be about $403,000.

3. Income Tax Benefits

Assets included in a parent's estate for estate tax purposes obtain a new income tax basis under section 1014(b)(9) but not if assets acquired by the parent from a child by gift within one year of the parent's death pass back to the child or the child's spouse.[500] Suppose that the assets pay into a trust for descendants but a third party has a power of appointment to add beneficiaries to the trust?

4. Creditor Protection for Child

a. Assets that a parent transfers in trust to a child may be insulated from the child's creditors so long as the child's rights in the trust are properly limited. The sine qua non is that parent must make the transfer into the trust for state law purposes.

b. The lapse of a *Crummey* withdrawal right may be a state law transfer, although most practitioners and trustees do not treat it as such, except in those states which provide specifically to the contrary (such as under the Uniform Trust Code). A safer approach would be to have parent exercise parent's power of appointment in favor of a new trust for the benefit of child. If the power is general the parent should become the grantor of the trust for state law purposes.

[500] § 1014(e).

5. Limiting Parent's Ability to Divert Assets

a. The strategies called for require that parent have a testamentary general power of appointment. A power limited to the appointment of assets to the creditors of a parent's estate will be a general power under section 2041(b)(1). If it is desirable that a parent have additional discretion the parent could be given a power to appoint to descendants, with or without charities, and such additional powers could be conditioned on the consent of child or others because all that is required in order to capture the tax benefits is the limited testamentary general power.

b. If a child desires to receive an interest in the assets transferred to parent back from parent (e.g. parent transfers the assets into a trust for child and child's descendants that is not available to child's creditors), then giving parent a power that is broader than a power to appoint to the creditors of parent's estate may be desirable. For example, a parent could be given a power to appoint to parent's children and the creditors of parent's estate. Child could ensure that assets were not diverted to a sibling by purchasing from the siblings an assignment of any rights the siblings receive in assets appointed by parent that originated with child. The assignment would be independent of parent but would limit the ability of a creditor (or the government) to argue that the child transferred the assets to parent in a manner that did not give parent any true control. The ability to reach such an agreement with minors is limited.

6. Parent's Creditors.

a. A parent who has or is likely to have creditors will not be a good candidate for these sorts of transactions. Creditors could include health-care providers or Medicaid, tort victims (for example, if parent is still driving), and beneficiaries of legally binding charitable pledges.

b. In addition, by definition, a parent who is married to someone who is not also child's parent has a potential creditor at death although in limited instances marriage agreements coupled with state law limitations on the rights of a surviving spouse to take property over which a decedent has a testamentary general power of appointment may make these transactions feasible.

7. Upstream Sale to a Power of Appointment Trust (UPSPAT)

a. Suppose a child creates a grantor trust, sells assets to the trust for a note, gives the child's parent a testamentary general power of appointment over the trust assets so that the assets will be included in the parent's estate at the parent's death and receive new basis, and then the trust (which remains a grantor trust with respect to the child ever after the parent's death) uses the assets to pay off the note. The net effect is that the parent's net estate is increased by zero or a small amount yet the child receives new basis.

b. Because the contemplated transaction is not designed to remove assets from the child's estate for estate tax purposes, the issues under section 2036 that require that the grantor trust be appropriately "seeded" would not apply. However, a sale to an unseeded trust could result in a note having a value less than its stated face value, thus causing child to make a gift. Parent's guarantee of the note could reduce that risk.

c. Does the existence of the parent's general power cause the assets to be stepped-up to full fair market value, or will the value of the note reduce the amount of the step-

up? section 2053(a)(4) provides that the value of the taxable estate will be reduced by indebtedness in respect of property included in a decedent's estate. The Treasury Regulations provide, in relevant part:

> A deduction is allowed from a decedent's gross estate of the full unpaid amount of a mortgage upon, or of any other indebtedness in respect of, any property of the gross estate, including interest which had accrued thereon to the date of death, provided the value of the property, undiminished by the amount of the mortgage or indebtedness, is included in the value of the gross estate. If the decedent's estate is liable for the amount of the mortgage or indebtedness, the full value of the property subject to the mortgage or indebtedness must be included as part of the value of the gross estate; the amount of the mortgage or indebtedness being in such case allowed as a deduction. But if the decedent's estate is not so liable, only the value of the equity of redemption (or the value of the property, less the mortgage or indebtedness) need be retuned as part of the value of the gross estate. In no case may the deduction on account of the mortgage or indebtedness exceed the liability therefor contracted bona fide and for an adequate and full consideration in money or money's worth.[501]

d. Thus the net increase to parent's estate would seem to be zero. If parent guaranteed the obligation then this concern would be reduced. Arguably such a step is unnecessary because the regulations may be read as discretionary or optional. Further, outside the trust context, the Supreme Court decision in *Crane v. Commissioner*[502] suggests that the basis increase is based on the fair market value of the property regardless of the associated debt.

e. If the amount over which parent has a testamentary general power of appointment is limited by formula to an amount that would not increase parent's taxable estate to more than the federal estate tax exclusion taking into consideration parent's other assets, then a basis adjustment can be obtained for that amount because there is no need for the debt to offset the assets included in parent's estate. The trust should provide that it is for the benefit of the child's descendants, not the child, to avoid the one year prohibition of section 1014(e), as discussed in more detail above.

f. Might the IRS argue that payment on the note is an indirect return of assets to the child? To the extent the note is not for fair market value that would be a direct return of assets. Suppose the terms of the trust and the sale provided that no assets could be used to pay off the note beyond those required to satisfy the fair market value of the note as determined for federal gift tax purposes. The desired result would be that the amount of the child's gift would be trapped in the trust and pass other than to a child.

g. Supposed child "sells" cash to the grantor trust for a promissory note. Section 1014(e) applies, by its terms, only to "appreciated property" acquired by the decedent by gift within one year prior to the decedent's death. If the cash in the grantor trust is later swapped for child's appreciated property that would not be appreciated property acquired by gift. The cash might have acquired in part by gift – if the note were not valued at par – but not the appreciated property. Is this extra step valuable in minimizing a challenge?

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[501] Treas. Reg. § 20.2053-7.

[502] 331 U.S. 1 (1947) (holding that the proper tax basis of the property acquired by bequest subject to a mortgage "is the value of the property, undiminished by mortgages thereon.")

h. Does the death of a parent terminate the grantor trust status of the trust? If yes, that would cause the sale to be recognized by child as of that moment, thus undoing the benefits of the transaction. This is unlike a sale to a grantor trust where grantor trust status terminates because the grantor dies where, as discussed later in this outline, the consensus appears to be that death cannot, or ought not, trigger a taxable transaction. The Treasury Regulations provide that a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer – defined as any transfer other than one for fair market value – of property to a trust.[503] Section 678 by its terms confers grantor trust status (or status that is substantially similar to grantor trust status) only in situations involving inter-vivos general powers. The IRS ruling position is that an inter-vivos right to withdraw makes the power holder a grantor under section 678 but not replacing the true grantor if one still exists. What is the effect of parent's testamentary general power of appointment? The Treasury Regulations contain two examples that are close but not directly on point:[504]

> Example 4. A creates and funds a trust, T. A does not retain any power or interest in T that would cause A to be treated as an owner of any portion of the trust under sections 671 through 677. B holds an unrestricted power, exercisable solely by B, to withdraw certain amounts contributed to the trust before the end of the calendar year and to vest those amounts in B. B is treated as an owner of the portion of T that is subject to the withdrawal power under section 678(a)(1). However, B is not a grantor of T under paragraph (e)(1) of this section because B neither created T nor made a gratuitous transfer to T.
>
> Example 8. G creates and funds a trust, T1, for the benefit of B. G retains a power to revest the assets of T1 in G within the meaning of section 676. Under the trust agreement, B is given a general power of appointment over the assets of T1. B exercises the general power of appointment with respect to one-half of the corpus of T1 in favor of a trust, T2, that is for the benefit of C, B's child. Under paragraph (e)(1) of this section, G is the grantor of T1, and under paragraphs (e)(1) and (5) of this section, B is the grantor of T2.

i. Note that this is the same issue which exists with respect to creating a lifetime QTIP trust that is a grantor trust with respect to the creating spouse. After the beneficiary spouse dies, the property may remain in trust for the benefit of the creating spouse and the couple's descendants becoming, essentially, a credit-shelter trust. However, if the creator spouse remains the grantor of the trust for income tax purposes that will produce a substantial additional transfer tax benefit.[505]

j. An UPSPAT may be "ready to go" to minimize the risks of delay when a parent (or ancestor) becomes ill. The descendant may create the UPSPAT and transfer assets to it retaining lifetime and testamentary powers of appointment to ensure that the gift is incomplete. An instrument by which the descendant gives up those powers of appointment may be drafted as may the form of a note, leaving only the date and interest rate blank. Thus, on short notice, the descendant may contact the trustee, deliver the instrument surrendering the powers of

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[503] Treas. Reg. §1.671-2(e)(1).

[504] Treas. Reg. §1.671-2(e)(6).

[505] *See* Mitchell M. Gans, Jonathan G. Blattmachr & Diana S.C. Zeydel, *Supercharged Credit Shelter Trust*, 21 Prob. & Prop. 52 (July/Aug. 2007).

appointment and, in exchange for that gift, receiving the note. Obviously, a sale document could be completed at the same time if desirable. Prudence suggests that the note be transferred immediately to another party to minimize the risk that the IRS recharacterizes the sale-note-payoff as a return of assets to the descendant.

8. Accidentally Perfect Grantor Trust

a. Similar in many respects to the UPSPAT discussed above is a technique that has been called the "Accidentally Perfect Grantor Trust" (APGT). [506] The transferor uses a parent's unused Applicable Exemption Amount and GST exemption, benefits from a "step-up" in basis, but still retains grantor trust status after the parent's death. Pursuant to this technique, a younger generation establishes an IDGT and moves wealth into the IDGT (e.g., pursuant to an installment sale as with the UPSPAT) the terms of which provide that the parent is a beneficiary of the IDGT and is granted a testamentary general power of appointment over the IDGT's appreciated assets equal to the parent's unused Applicable Exemption Amount and GST exemption (e.g., pursuant to a formula provision, as discussed above). Upon the death of the parent, the assets may be held for the benefit of the younger generation grantor and his or her descendants.

b. In order to be successful, the APGT must avoid estate tax inclusion at the younger generation's level under sections 2036 through 2038, cause estate tax inclusion at the parent's passing, and provide for a "step-up" in basis for the estate tax includible assets.[507]

c. From an income tax standpoint, according to the proponents of the APGT, whether the ongoing trust will continue to be a grantor trust with respect to the younger generation or a non-grantor trust depends on whether the parent exercises the general power of appointment or allows it to lapse. The Treasury Regulations provide:

> If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, then such person will be treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code.[508]

d. Thus, if the ongoing trust arises because the parent exercises the general power of appointment, then the parent is the grantor for income tax purposes, and the ongoing trust will be a non-grantor trust for income tax purposes. More significantly, the argument goes, if the ongoing trust is created as a result of the failure to exercise or lapse of the general power of appointment, then the trust will continue to be a grantor trust with respect to the younger generation who is also a potential beneficiary of such trust ongoing trust.

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[506] For an excellent discussion of this technique, see Mickey R. Davis & Melissa J. Willms, *Trust and Estate Planning in a High-Exemption World and the 3.8% "Medicare" Tax: What Estate and Trust Professionals Need to Know*, The Univ. of Tex. School of Law 61st Ann. Tax Conf. – Est. Pl. Workshop (2013).

[507] *But see* PLR 200101021 on the applicability of Section 1014(e).

[508] Treas. Reg. § 1.671-2(e)(5).

e. In addition, it would be a challenge for the IRS to know that the grantor/beneficiary is claiming ongoing grantor trust status. From an income tax reporting standpoint, prior to the death of the holder of the testamentary general power of appointment, the Form 1041 (if one believes one should, in fact, be filed) simply states the trust is a grantor trust and all tax items are being reported on the grantor's personal income tax return. In the year of the power holder's death, the Form 1041 would be reported the same way with no change in taxes obviously and with, perhaps, a disclosure that grantor trust status will continue to be claimed. All of the changes to tax basis would occur on the grantor's personal income tax return.

G. Assets in IDGTs and the Installment Notes Included in the Estate

1. Generally

a. Notwithstanding the popularity of the estate planning technique that involves the sale of assets to an IDGT for an installment sale note, the tax ramifications of the death of the grantor when the note is still outstanding is still unclear. Most commentators and practitioners agree that nothing occurs for income tax purposes until grantor trust status terminates.[509]

b. Many would agree that if grantor trust status is terminated during the lifetime of the grantor, a transfer is deemed to occur and the grantor may recognize gain to the extent the amount owed to the grantor exceeds the grantor's basis in the assets. The IRS has ruled that when the grantor of a grantor trust that holds a partnership interest that is subject to liabilities renounces grant trust status, the grantor is treated as transferring the partnership interest to the trust. When the interest transferred is a partnership interest and the grantor's share of the partnership liabilities is reduced, the grantor is treated as having sold the partnership interest for an amount equal to the grantor's share of the reduced liabilities.[510] The Treasury Regulations also provide that if a taxpayer creates a grantor trust which purchases a partnership interest and the grantor later renounces grantor trust status, then the taxpayer is considered to have transferred the partnership interest to the trust. The taxpayer's share of liabilities that are eliminated as a result of the transfer are considered part of the amount realized for income tax purposes.[511] This is one of the most problematic features of selling "negative basis" real property partnership interests to IDGTs.

c. Of course, the foregoing can get quite complicated when one considers that the original assets sold to the trust may no longer be in the trust due to a swap power retained by the grantor, and the asset in the trust may have appreciated or depreciated in value, carrying both high and low tax basis at the time of the deemed transfer. What is the deemed amount realized calculated against? For this reason, practitioners advise against terminating grantor trust status while the debt is still outstanding and advise clients to pay off the debt prior to the death of the grantor if at all possible.

d. There is unfortunately no dispositive authority on the income tax consequences on the assets in the IDGT and on the outstanding installment note at the death of the grantor. It is beyond the scope of this outline to discuss the intricacies of the arguments that

[509] *See* Rev. Rul. 85-13, 1985-1 C.B. 184.

[510] Rev. Rul. 77-401, 1977-2 C.B. 215.

[511] Treas. Reg. § 1.1001-2(c), Ex. 5. *See also* TAM 200011005.

have been posed, but there are a number of resources that are publicly available that will serve as better resources.[512] However, given the nature of estate planning today (maximizing the "step-up" in basis), some discussion of the subject is warranted.

2. Assets in IDGTs

a. Generally

(1) Notwithstanding arguments to the contrary,[513] the conventional view is that if the assets in the IDGT are not included in the grantor's gross estate, the trust assets will not receive a "step-up" in basis under section 1014. [514] Most practitioners and commentators take the position that whatever assets happen to be in the IDGT at the time of the grantor's death carry their historical tax basis. Hence, the reason swapping high basis assets with low basis assets in existing IDGTs will continue to be so important prior to the death of the grantor.

(2) One possible alternative is to view the trustee of the IDGT as having purchased the assets for the outstanding amount of the installment note at the time of the grantor's death. The basis of the assets would thus be determined under section 1012 of the Code. However, this necessarily requires practitioners to take the position that an exchange occurs at the death of the grantor, which may give rise to adverse income tax consequences to the estate with respect to the note.

(3) In a ruling involving a sale from one grantor trust to another, the IRS provided, "[W]hen either Trust 1 or Trust 2 ceases to be treated as a trust owned by A under § 671 by reason of A's death or the waiver or release of any power under § 675, no opinion is expressed or implied concerning whether the termination of such grantor trust treatment results in a sale or disposition of any property within the meaning of § 1001(a), a change in the basis of any property under § 1012 or § 1014, or any deductible administration expense under § 2053."[515] Further, IRS has asserted (in a situation involving a conversion of a nongrantor trust to a grantor

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[512] *See, e.g.*, Elliott Manning and Jerome M. Hesch, *Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements*, 24 Tax Mgmt. Est., Gifts & Tr. J. 3 (1999), Jonathan G. Blattmachr, Mitchell M. Gans, and Hugh H. Jacobsen, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 96 J. Tax'n 149 (2002), Ron Aucutt, *Installment Sales to Grantor Trusts*, 2 Bus. Entities 28 (2002).

[513] *See* Jonathan G. Blattmachr, Mitchell M. Gans, and Hugh H. Jacobsen, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 96 J. Tax'n 149 (2002). This is not true for nonresident alien decedents; a basis adjustment is allowed regardless of whether assets are includable in the gross estate. Rev. Rul. 89-139, 1984-2 C.B. 168.

[514] *See* CCA 200937028, dealing with a case where the taxpayer transferred assets into a trust and reserved the power to substitute assets. In the ruling, the chief counsel quotes from Section 1.1014-1(a) Treasury Regulations: "The purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent which is equal to the value placed upon such property for purposes of the Federal estate tax. Accordingly, the general rule is that the basis of property acquired from a decedent is the fair market value of such property at the date of the decedent's death. . . . Property acquired from the decedent includes, principally . . . property required to be included in determining the value of the decedent's gross estate under any provision of the [Internal Revenue Code.]" From this the chief counsel concludes, "Based on my reading of the statute and the regulations, it would seem that the general rule is that property transferred prior to death, even to a grantor trust, would not be subject to section 1014, unless the property is included in the gross estate for federal estate tax purposes as per section 1014(b)(9)."

[515] PLR 200434012.

trust) that "the death of the owner…is generally not treated as an income tax event."[516] The same ruling also asserted that "the Service should not take the position that the mere conversion of a nongrantor trust to a grantor trust results in taxable income to the grantor."[517]

(4) In 2015, the IRS added "[w]hether the assets in a grantor trust receive a section 1014 basis adjustment at the death of the deemed owner of the trust for income tax purposes when those assets are not includible in the gross estate of that owner under chapter 11 of subtitle B of the Internal Revenue Code" to the list of "areas under study in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a revenue ruling, a revenue procedure, regulations, or otherwise."[518]

b. Foreign Trust Rulings

(1) PLR 201544002

(a) In PLR 201544002, husband and wife (both of whom are foreign citizens and non-residents of the United States) funded a joint foreign revocable trust with their community and separate property. Each spouse retained the right to revoke the trust with respect to his or her community property and separate property held in trust. Under the trust agreement, the surviving spouse has the power to appoint the trust assets to his or her estate by will.

(b) The IRS held that upon the first death of a spouse, the surviving spouse would receive a step-up (or step-down) in basis under section 1014(b)(2) of the Code with respect to the decedent's spouse's separate property and one-half share of the community property.

(c) The IRS further held that upon the death of the surviving spouse (who held a general power of appointment), to the extent the surviving spouse exercises the general power of appointment by will, the trust assets will receive a step-up (or step-down) in basis under section 1014(b)(4) of the Code.

(d) The ruling acknowledged the no-rule policy as mentioned above, but avoided it on the ground that the ruling request had been submitted before the no-rule policy was announced in 2015 and became effective.

(2) PLR 201245006

(a) In PLR 201245006, the taxpayer asked the IRS how to determine the basis of property upon the death of the grantor for property owned by an irrevocable non-U.S. situs (foreign) trust. The taxpayer ("Taxpayer") was a foreign citizen and non-resident of the United States. Taxpayer proposed to transfer assets to an irrevocable trust ("Trust") established under the laws of Taxpayer's country ("Country"). The assets of Trust were to include cash and stock in two companies that are publicly traded in Country and on the New York Stock Exchange. The trustees of Trust are Taxpayer and X, an unrelated party ("Trustees").

[516] CCA 200923024 (the IRS considered the facts an "abusive transaction.")

[517] *Id.*

[518] Rev. Proc. 2015-37, 2015-26 I.R.B. 1196 (effective for all requests received after June 15, 2015). Continued in section 5.01(12) of Rev. Proc. 2016-3, 2016-1 I.R.B. 126.

Trustees were to pay all Trust income to Taxpayer during his lifetime and could distribute principal to Taxpayer in their absolute discretion. Upon Taxpayer's death, Taxpayer had a special testamentary power of appointment over the income and principal of Trust in favor of his issue. If Taxpayer did not exercise his special power of appointment, Trust property would be held in further trust for the benefit of Taxpayer's issue.

(b) The IRS ruled that the foreign trust was a grantor trust for U.S. income tax purposes. The IRS then ruled that the basis of the property held in trust would be the fair market value of the assets as provided under section 1014(a) of the Code.

(c) Significantly, the IRS ruled that section 1014(b)(9) of the Code (requiring the property to be included in determining the value of the decedent's gross estate) was inapplicable. Rather, the assets received by the grantor's issue would fall under section 1014(b)(1) of the Code (property acquired by bequest, devise, or inheritance). The IRS reasoned:

> Taxpayer's issue will acquire, by bequest, devise, or inheritance, assets from Trust at Taxpayer's death. The assets acquired from Trust are within the description of property acquired from a decedent under § 1014(b)(1). Therefore, Trust will receive a step-up in basis in Trust assets under § 1014(a) determined by the fair market value of the property on the date of Taxpayer's death. See Rev. Rul. 84-139, 1984-2 C.B. 168 (holding that foreign real property that is inherited by a U.S. citizen from a nonresident alien will receive a step-up in basis under § 1014(a)(1) and 1014(b)(1)). This rule applies to property located outside the United States, as well as to property located inside the United States.

(d) In coming to the conclusion, the ruling points out that "Section 1014(b)(9)(C) provides that § 1014(b)(9) shall not apply to property described in any other paragraph of § 1014(b)." In other words, inclusion in the gross estate may not necessarily be the only avenue to receive a "step-up" in basis.

(e) While some practitioners may seek to interpret this ruling as allowing a "step-up" in basis for assets in an irrevocable grantor trust that are not otherwise included in the gross estate of the grantor, in actuality, it appears the drafters of the ruling at the Treasury Department may have mistakenly referred to section 1014(b)(1) of the Code ("Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent.") in the ruling. One of the authors of this outline was directly involved in the ruling. The ruling should have referred to section 1014(b)(3), which provides for a "step-up" in basis for "property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust."[519] While not clear in the ruling, the grantor retained the power to alter beneficial enjoyment from and after his death, not during his lifetime.[520] As such, this ruling may

[519] § 1014(b)(3).

[520] The drafters of the trust could not provide for a lifetime power to change beneficial enjoyment without losing foreign grantor trust status. The Code provides grantor trust status with respect to a foreign person for a portion of any trust if "the only amounts distributable from such portion (whether income or corpus) during the lifetime of the grantor are amounts distributable to the grantor or the spouse of the grantor." § 672(f)(2)(A)(ii).

not stand for the proposition that assets in an IDGT can receive a "step-up" in basis, notwithstanding the fact the assets are not includible in the estate of the grantor.

3. Installment Notes

a. Generally

(1) As noted above, while grantor trust exists, nothing is deemed to have occurred for income tax purposes. As such, the grantor-seller in an installment sale to an IDGT effectively has no tax basis at all.[521] The concept of tax basis is moot until grantor trust status terminates, on death or otherwise.

(2) Except for transactions between a grantor and a grantor trust, it is well-established that installment obligations[522] are a form of IRD if the grantor-seller dies with the note outstanding. Section 453B(c) provides that the general rule concerning immediate recognition of gain or loss on the subsequent transfer of an installment obligation at death is inapplicable, and the installments will be subject to the IRD rules under section 691.[523] Thus, the installment note will not be entitled to a "step-up" in basis.

(3) The issue of what happens with an installment obligation from an IDGT when a grantor dies has not been settled. Some have argued that the installment obligation is IRD. Others have argued that the installment note is not IRD, but the death of the grantor will be a taxable event (as it would be if grantor trust had been terminated during the lifetime of the grantor). As such, gain is recognized on the last income tax return of the decedent in an amount equal to the outstanding debt and the basis of the assets deemed to be transferred at such time.[524] Most practitioners and many commentators believe the installment obligation is not IRD and death is not a recognition event.[525] Thus, the installment obligation is entitled to a "step-up" in basis under section 1014.[526]

b. Valuation

(1) If the installment obligation is outstanding at the time of the grantor's death, the grantor's estate will be included in the estate at its fair market value. The Treasury Regulations provide:

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[521] *See* Rev. Rul. 85-13, 1985-1 C.B. 184.

[522] Generally, obligations reportable by the grantor-seller under the installment method under § 453.

[523] Treas. Reg. § 1.691(a)-5.

[524] *See Madorin v. Commissioner*, 84 T.C. 667 (1985), Rev. Rul. 77-402, 1977-2 C.B. 222, and Treas. Reg. § 1.1001-2(c), Ex. 5 and 6.

[525] *See* GCM 200923024 (After providing that a taxable event occurs when grantor trust is terminated during the lifetime of the grantor, the memorandum does on to say, "We would also note that the rule set forth in these authorities is narrow, in so far as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner which is generally not treated as an income tax event.").

[526] *See, e.g.*, Elliott Manning and Jerome M. Hesch, *Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements*, 24 Tax Mgmt. Est., Gifts & Tr. J. 3 (1999), and Jonathan G. Blattmachr, Mitchell M. Gans, and Hugh H. Jacobsen, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 96 J. Tax'n 149 (2002).

> The fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus interest accrued to the date of death, unless the executor establishes that the value is lower or that the notes are worthless. However, items of interest shall be separately stated on the estate tax return. If not returned at face value, plus accrued interest, satisfactory evidence must be submitted that the note is worth less than the unpaid amount (because of the interest rate, date of maturity, or other cause), or that the note is uncollectible, either in whole or in part (by reason of the insolvency of the party or parties liable, or for other cause), and that any property pledged or mortgaged as security is insufficient to satisfy the obligation.[527]

(2) The IRS has agreed that "all available data and all relevant factors affecting the fair market value must be considered"[528] in determining the value of a promissory note, and face value is not necessarily the value to be included in the gross estate.

(3) Many practitioners have, in the past, claimed valuation discounts on installment note obligations included in the estate due to a number of factors including a low interest rate, lack of security, and the obligor's inability to pay the note as it becomes due.[529] Practitioners may want to consider whether a valuation discount should be claimed today if the obligation will be entitled to a "step-up" in basis to fair market value at little or no transfer tax cost (assuming there is sufficient Applicable Exemption Amount available at the time of the grantor's death).

(4) Interestingly, in transfers to a related person[530] that trigger section 691(a)(2) (subsequent transfers of IRD assets, including a transfer to the obligor that would result in a cancellation of the indebtedness), the Code mandates that the fair market value of the obligation (and the amount that would be recognized at such time) may not be less than the face value of the obligation.[531]

c. SCINs and CCA 201330033

(1) Self-cancelling installment notes ("SCINs") have been used in conjunction with IDGTs to circumvent estate inclusion of the value of the note upon the death of the grantor. Generally, a SCIN is a promissory note where the remaining debt is cancelled upon the death of the note holder. With a SCIN, a risk premium must be added as additional consideration for the death on cancellation feature. The risk premium can be in the form of additional principal or additional interest. The calculation of the risk premium is based on mortality tables and a discount rate (i.e., an interest rate). However, there is no clear authority as to what interest rate and what mortality table must be used to compute the risk premium for SCINs.

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[527] *See* Treas. Reg. § 20.2031-4

[528] TAM 8229001.

[529] *See* M. Read Moore, *Valuation Discounts for Private Debt in Estate Administration*, 25 Est. Plan. 195 (1998) and Jerry M. Hesch, Alan S. Gassman, and Christopher J. Donicolo, *Interesting Interest Questions: Interest Rates ,for Intra-Family Transactions*, 36 Est. Gifts & Tr. J. 128 (2011).

[530] Referring to the definition under § 453(f)(1), which in turn refers, generally, to the definition under §§ 318(a) or 267(b).

[531] § 691(a)(5)(B).

(2) In CCA 201330033, the chief counsel of the IRS advised that a sale of stock in exchange for installment notes and SCINs resulted in a taxable gift.

(a) The situation described in the ruling involved a series of estate planning transactions including gifts to IDGTs, exchanges of assets with IDGTs, transfers to GRATs, and sales of assets to IDGTs in exchange for a series of promissory notes. All of the notes provided for annual interest payments during the terms of the notes and for principal to be paid at the end of the terms. Some of the notes were for a term of years based upon the decedent's life expectancy as determined under the mortality tables under section 7520. Some of the notes were SCINs that provided for a risk premium in the form of additional principal and some were SCINs that provided for a risk premium in the form of additional interest. In calculating the risk premiums, the additional principal and interest specifically were based upon the section 7520 tables, according to the ruling. The taxpayer was diagnosed with a health condition shortly after the transactions and died within six months of these transactions.

(b) The IRS ruled that a deemed gift occurred because the value of the term notes and SCINs were less than the value of the stock sold in the transactions. The ruling specifically asserts that the valuation tables under section 7520 do not apply to the promissory notes at question:

> We do not believe that the § 7520 tables apply to value the notes in this situation. By its terms, § 7520 applies only to value an annuity, any interest for life or term of years, or any remainder. In the case at hand, the items that must be valued are the notes that decedent received in exchange for the stock that he sold to the grantor trusts. These notes should be valued based on a method that takes into account the willing-buyer willing-seller standard in § 25.2512-8. In this regard, the decedent's life expectancy, taking into consideration decedent's medical history on the date of the gift, should be taken into account. I.R.S. Gen. Couns. Mem. 39503 (May 7, 1986).

(c) This ruling seems to be one of first impression, casting doubt on the general practice of using the section 7520 mortality tables and concepts in calculating the risk premium associated with SCINs.

(d) Because the last ruling requested was predicated upon no taxable gift, the Service did not need to rule on the estate tax implications of the transactions at hand. However, the ruling did note similarities to the situation described in *Musgrove vs. United States*,[532] where the court ruled that the decedent retained an interest in the amount transferred and thus estate tax inclusion was warranted.

H. The Upside of Debt

1. Generally

a. As mentioned above, the analysis around estate planning will be measuring the estate and inheritance tax cost (if any) of having an asset includible in the estate against the income tax savings from a "step-up" in basis on the asset. Because both the estate tax

[532] 33 Fed. Cl. 657 (1995).

liability and the adjusted tax basis at death are measured by the fair market value of the assets, the two taxes are typically in contradistinction to each other. The estate tax cost is offset, in whole or in part, by the "step-up" in basis. The judicious use of debt or other encumbrances may allow taxpayers to reduce estate tax cost but still maintain or increase the "step-up" in basis.

b. Consider the following examples:

(1) Taxpayer owns an asset worth $10 million and has a $0 adjusted tax basis (for example, fully depreciated commercial real property). At the taxpayer's death, the amount includible in the gross estate for estate tax purposes under section 2031 and the new adjusted tax basis of the asset under section 1014(a) will each be $10 million. Assuming no estate tax deductions, the taxable estate under section 2051 (taxable estate is determined by taking the gross estate and reducing it by the appropriate deductions) is also $10 million.

(2) Same as above, except the taxpayer has a plan to transfer $9 million of assets out of the taxpayer's estate prior to death (could be a gift or a GRAT or a discounted sale, or any other bit of cleverness). If the taxpayer transfers the zero basis asset, the taxpayer faces the income tax basis problem. Suppose, therefore, that the taxpayer borrows $9 million, using the asset as collateral for the debt. Ignoring for the moment the $9 million of borrowed cash (which would be includible in the estate), at the taxpayer's death, the amount includible in the gross estate due to the asset is $10 million, and the adjusted tax basis of the asset is also $10 million.[533] Next, the taxpayer disposes of the $9 million using the preferred technique (gift, GRAT, etc.). Now, the taxable estate is $1 million because the estate is entitled to a deduction under section 2053(a)(4), "for unpaid mortgages on, or any indebtedness in respect of, property where the value of the decedent's interest therein, undiminished by such mortgage or indebtedness, is included in the value of the gross estate."[534] Thus, the taxpayer's estate would receive a full "step-up" in basis of $10 million for a taxable estate of $1 million. Of course, if the debt proceeds remained in the estate in full, then gross estate is $19 million (asset + debt) reduced by $9 million of debt on the asset, resulting in a taxable estate of $10 million.

(3) Same as above, except after the loan but prior to death, the taxpayer engages in a series of "zeroed-out" transfers like GRATs or installment sales to IDGTs, with the result that only $4 million of the original $9 million of debt proceeds remain in the estate. The overall result, including the debt proceeds, is the asset would still receive a "step-up" in basis to $10 million but the taxable estate would only be $5 million. The gross estate would be $14 million (asset + debt proceeds) reduced by $9 million of debt on the asset.

(4) Same as above, except after the loan, instead of engaging in "zeroed-out" transfers, the taxpayer exchanges the $9 million of cash from the loan with a $9 million/$0 tax basis asset that is in an IDGT (assets not otherwise includible in the taxpayer's estate). The overall result is both the $10 and $9 million assets would receive a "step-up" in basis to fair market value (totaling $19 million of basis adjustment), but the taxable estate would be $10 million ($19 million gross estate, reduced by $9 million of debt).

c. As the foregoing examples show, the key to reducing estate tax exposure and maximizing the "step-up" in basis is (i) ensuring the deductibility of the debt, and (ii) engaging in an additional transaction that reduces estate tax exposure of the debt proceeds or

[533] *See Crane v. Commissioner*, 331 U.S. 1 (1947).

[534] § 2053(a)(4).

exchanges the debt proceeds (cash) for something that would benefit from a "step-up" in basis. Of course, one of the easiest ways to reduce the estate tax exposure on the loan proceeds is simply to spend it aggressively.

2. Qualified Unpaid Mortgages and Indebtedness

a. In order for an estate to obtain a full estate tax deduction for debt owed by the decedent, the Treasury Regulations states that the full value of the asset must be included in the gross estate and the indebtedness must be a liability of the estate:

> A deduction is allowed from a decedent's gross estate of the full unpaid amount of a mortgage upon, or of any other indebtedness in respect of, any property of the gross estate, including interest which had accrued thereon to the date of death, provided the value of the property, undiminished by the amount of the mortgage or indebtedness, is included in the value of the gross estate. If the decedent's estate is liable for the amount of the mortgage or indebtedness, the full value of the property subject to the mortgage or indebtedness must be included as part of the value of the gross estate; the amount of the mortgage or indebtedness being in such case allowed as a deduction. But if the decedent's estate is not so liable, only the value of the equity of redemption (or the value of the property, less the mortgage or indebtedness) need be returned as part of the value of the gross estate. In no case may the deduction on account of the mortgage or indebtedness exceed the liability therefor contracted bona fide and for an adequate and full consideration in money or money's worth.[535]

b. The full value of the unpaid mortgage may be deducted under section 2053(a)(4), even if the property is valued at less than fair market value pursuant to the special use provisions under section 2032A.[536]

c. The liability underlying the indebtedness must be bona fide and for adequate and full consideration.[537]

d. As mentioned, if the liability is a charge against the property but the property is not included in the gross estate, there is no estate tax deduction. As such, if a decedent only owned a one-half interest in property, the estate is not entitled to a deduction for the liability.[538] Furthermore, if the asset is real property located outside of the U.S. and is not includible in the gross estate, no deduction may be taken for any unpaid mortgage.[539]

e. The Treasury Regulations distinguish between a mortgage or indebtedness for which the estate is not liable but which only represents a charge against the

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[535] Treas. Reg. § 20.2053-7.

[536] Rev. Rul. 83-81, 1983-1 C.B. 230.

[537] *See Feiberg Estate v. Commissioner*, 35 T.C.M. 1794 (1976), *Bowers Estate v. Commissioner*, 23 T.C. 911 (1955), *acq.*, 1955-2 C.B. 4, and *Hartshorne v. Commissioner*, 48 T.C. 882 (1967), *acq.*, 1968-2 C.B. 2.

[538] *See Courtney Estate v. Commissioner*, 62, T.C. 317 (1974) and *Fawcett Estate v. Commissioner*, 64 T.C. 889 (1975).

[539] Treas. Reg. § 20.2053-7

property. Under those circumstances, the Treasury Regulations provide that only the "equity of redemption"[540] (value of the property less the debt) will be included in the gross estate.

3. Debt on Assets in Trust

(1) Given the foregoing, would the same full "step-up" in basis be available for assets in a trust that would be includible for estate tax purposes (or subject to a general power of appointment) if the assets were encumbered by debt? For example, consider a QTIP trust that holds a $5 million asset with an adjusted tax basis of $1 million (perhaps an inter-vivos QTIP trust funded with a highly appreciated asset or a testamentary QTIP funded with a $1 million asset that appreciated significantly). The trustee of the QTIP trust borrows $3 million, using the $5 million asset as collateral for the loan, and then distributes the $3 million of loan proceeds to the surviving spouse as a principal distribution. Upon the death of the surviving spouse, does the $5 million asset in the QTIP trust receive an adjusted tax basis of $5 million (fair market value) or $2 million (the net value and the net amount taxable in the surviving spouse's estate)?

(2) Assets held by a QTIP trust (for which a marital deduction was granted upon funding)[541] are includible under section 2044(a), which provides "[t]he value of the gross estate shall include the value of any property to which this section applies in which the decedent had a qualifying income interest for."[542] For these purposes, section 2044(c) provides that for purposes of calculating the amount includible in the gross estate of the decedent, the property "shall be treated as property passing from the decedent."[543] Does the foregoing provision mean that only the net value is includible, similar to the "equity of redemption"[544] concept of section 2053(a)(4) discussed above because the debt is not a legal obligation of the surviving spouse?

(3) The basis adjustment at death on the QTIP property is conferred by section 1014(b)(10). For these purposes, it provides that "the last 3 sentences of paragraph (9) shall apply as if such property were described in the first sentence of paragraph (9)."[545] The latter reference to section 1014(b)(9) is the basis adjustment at death for "property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate under chapter 11 of subtitle B or under the Internal Revenue Code."[546]

(4) Section 1014(b)(9) provides for a reduction of tax basis for property acquired before the death of the decedent. It provides the tax basis must be "reduced by the amount allowed to the taxpayer as deductions in computing taxable income … for exhaustion, wear and tear, obsolescence, amortization, and depletion on such property before the death of the

[540] *Id.*

[541] *See* § 2044(b).

[542] § 2044(a).

[543] § 2044(c).

[544] Treas. Reg. § 20.2053-7.

[545] § 1014(b)(10).

[546] § 1014(b)(9).

decedent."[547] This is in contrast to the basis adjustment under section 1014(b)(4),[548] which applies when a general power of appointment is exercised and which does not require a similar reduction in basis. That being said, section 1014(b)(9), which applies when no other paragraph of section 1014 applies, does not require any other basis reduction (for debt, by way of example). As such, the basis adjustment under section 1014(a) applies which provides the basis shall be the "fair market value of the property at the date of the decedent's death."[549]

(5) Does this mean, in the foregoing example, the basis on the asset in the QTIP trust should be $5 million because that is the fair market value of the property at the surviving spouse's death or can the fair market value of the asset be interpreted as the "net value" of $2 million?

I. NINGs/DINGs/WINGs and Other Things

1. Taxpayers in high income tax states often look for opportunities to defer or avoid their state income tax exposure. In light of this objective, the use of "incomplete gift, non-grantor trusts" has arisen in states that do not have an income tax. Most prevalently, practitioners have taken advantage of the laws of Delaware (Delaware incomplete non-grantor trust or "DING") and Nevada (Nevada incomplete non-grantor trust or "NING").[550] Pursuant to this technique, as long as the assets are retained in the DING or NING, the income from such assets will not be subject to state income tax.

2. The salient features of DING and NING planning are:

a. The taxpayer creates a non-grantor trust;

b. The taxpayer contributes assets to the trust that the taxpayer no longer wants to be subject to state income tax;

c. The trust provides that the taxpayer/grantor is a permissible beneficiary of the trust;

d. The contribution of assets to the non-grantor trust are not considered a taxable gift; and

e. The assets in the non-grantor trust will be includible in the taxpayer/grantor's estate for estate tax purposes.

3. Prior to 1997, a self-settled trust (a trust that provides for the benefit of the grantor) like the one described above would not have qualified as a non-grantor trust. The

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[547] *Id.*

[548] It applies to "Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will." § 1014(b)(4).

[549] § 1014(a)(1).

[550] S*ee* Peter Melcher and Steven J. Oshins, *New Private Letter Ruling Breathes Life into Nevada Incomplete Gift Non-Grantor Trusts*, Wealthmanagement.com, the digital resource of REP. and Trusts & Estates (Apr. 16, 2013), and Steven J. Oshins, *NING Trusts Provide Tax and Asset Protection Benefits*, CCH Estate Planning Review - The Journal, Page 150 (Aug. 20, 2013).

Treasury Regulations provide, "Under section 677 a grantor is, in general, treated as the owner of a portion of a trust whose income is, or in the discretion of the grantor or a nonadverse party, or both, may be applied in discharge of a legal obligation of the grantor." Thus, if under state law creditors of the grantor can reach the assets of the trust, then the trust will be considered a grantor trust for income tax purposes. Prior to 1997, all of the states provided that creditors of a grantor could reach the assets of any self-settled trust. Since 1997, a number of states like Alaska, Delaware and Nevada have enacted "domestic asset protection trusts" (DAPTs) that purportedly allow grantors to create self-settled trusts but prohibit creditors of the grantor from reaching the assets in the trust.

4. A number of rulings under Delaware law affirmed the non-grantor trust status of the DING.[551] All of the rulings relied upon an incomplete gift predicated upon the grantor retaining a special testamentary power of appointment to redirect the trust assets.[552] Notwithstanding that the grantor was a permissible beneficiary of the trust, the rulings avoided grantor trust status through the use of a distribution committee that had to approve any distribution to the grantor. The members of the distribution committee were deemed to be adverse parties (for example, trust beneficiaries) under section 672(a), and as a result, the trust was not a grantor trust.

5. In 2007, the IRS announced that it was re-examining the question of whether the distribution committee members have a general power of appointment.[553] In 2012, the IRS ruled that the retention of a testamentary power of appointment makes the original transfer incomplete but only with respect to the remainder interest but not the lead interest.[554]

6. Subsequent rulings have confirmed that practitioners have "settled on" typical approaches. State income tax may be avoided if assets may be transferred into a non-grantor trust in such a way as to avoid the transferor making a gift. The typical acronym for such trusts is a DING Trust, for Delaware Incomplete Non-Grantor Trusts, but there is nothing magical about Delaware as the state in which the trust should be created.

7. PLR 201426014 set forth these provisions of the trust:

> The information submitted states that Settlor proposes to create an irrevocable trust (Trust) for the benefit of himself, his daughters, his daughters' issue, and six individuals A through F. Corporate Trustee is a trust company located in State.
>
> Trust provides that during Settlor's lifetime, the Corporate Trustee shall distribute as much of the net income and/or principal as Distribution Committee may at any time and from time to time determine, to members of a class consisting of the Settlor and the Distribution Committee members, in such amounts or proportions as the Distribution Committee members may, acting by unanimity, select, for any purpose (Unanimous Member Power). The Corporate Trustee shall also distribute as much of the net income and/or principal as the majority of the Distribution

[551] PLRs 200148028, 200247013, 200502014, 200612002, 200637025, 200647001, 200715005, and 200731019.

[552] *See* Treas. Reg. §§ 25.2511-2(b) and 25.2511-2(c).

[553] IR-2007-127.

[554] CCA 201208026.

Committee members (excluding, however, any Distribution Committee Member who, if he or she were a trustee, would be considered an interested trustee or an insured trustee) may at any time and from time to time determine, to the Settlor and/or any one or more of the Settlor's lineal descendants, if such determination is consented to, in writing, by the Settlor (Settlor's Consent Power). Further, the Corporate Trustee shall distribute as much of the principal to any one or more of the lineal descendants of the Settlor, as the Settlor, in a non-fiduciary capacity, determines is for the health, education, maintenance, and support of any such lineal descendant (Settlor's Sole Power). The Settlor is not required to exercise the Settlor's Sole Power. Any net income not distributed by the Corporate Trustee will be accumulated and added to principal.

Trust further provides that upon Settlor's death, the Trust property will be distributed to such one or more persons (other than the Settlor, the Settlor's estate, the Settlor's creditors, and the creditors of the Settlor's estate) as the Settlor may appoint by a Will specifically referring to this power of appointment (Settlor's Testamentary Power). In default of appointment, the Trust property shall be set aside into per stirpital shares for the Settlor's then living descendants, and each share so set aside for a descendant will be distributed to the trustees of a Descendant's Separate Trust to be held as a separate trust and to be disposed of under the terms of such trust.

Trust further provides that Child 1, Child 2, and individuals A through F, are designated as the Distribution Committee members. If any Distribution Committee members are unable to serve for any reason, he or she shall not be replaced and the remaining Distribution Committee members shall continue to serve and act with full authority. Trust terminates at the death of Settlor, thus the Distribution Committee ceases to exist.

Finally, Trust provides that if both Child 1 and Child 2 are no longer serving as Distribution Committee members, or if there are fewer than two serving Distribution Committee members, the Trust property will be distributed to the Settlor and Trust shall terminate.

8. PLR 201510006 (part of a series) is illustrative of the current state of DING, NING and similar rulings. The IRS refused to provide a definitive ruling on grantor trust status because the circumstances of how the trust operates are a question of fact. All other rulings were favorable.

a. The facts were:

A Trust provides that, during Grantor's lifetime, Co-Trustees must distribute such amounts of net income and principal as directed by the Power of Appointment Committee ("Committee") and/or Grantor as follows:

> At any time, the Co-Trustees, pursuant to the direction of the majority of the Committee members, with the written consent of Grantor, shall distribute to Grantor or Beneficiaries such amounts of the net income or principal as directed by Committee (Grantor's Consent Power);

> At any time, Co-Trustees pursuant to the direction of all of the Committee members other than the Grantor, shall distribute to Grantor or Beneficiaries such amounts of the net income or principal as directed by the Committee (Unanimous Consent Power); and
>
> Grantor has the power in a nonfiduciary capacity, at any time, to appoint to any one or more of Beneficiaries such amounts of the principal (including the whole thereof) as Grantor deems advisable to provide for such Beneficiary's health maintenance, support and education (Grantor's Sole Power).

Further, upon Grantor's death, the remaining balance of Trust shall be distributed to such person or persons or entity or entities, other than Grantor, his estate, his creditors, or the creditors of his estate, as Grantor may appoint by will (Grantor's Testamentary Power of Appointment). In default of the exercise of this limited power of appointment, the balance of Trust will be divided into as many equal parts as are necessary to satisfy certain dispositions either outright or in trust for Grantor's then living issue, Individual 1, Individual 2, and Individual 3.

b. The rulings were:

1. So long as the Power of Appointment Committee is serving, no portion of the items of income, deductions, and credits against tax of Trust shall be included in computing under § 671 the taxable income, deductions, and credits of Grantor or any members of the Power of Appointment Committee;

2. The contribution of property to Trust by Grantor will not be a completed gift for federal gift tax purposes;

3. Any distribution of property by Committee from Trust to Grantor will not be a completed gift, subject to federal gift tax, by any member of Committee;

4. Any distribution, of property by Committee from Trust to any Beneficiary, other than Grantor, will not be a completed gift, subject to federal gift tax, by any member of Committee, other than Grantor; and

5. Committee members do not possess a general power of appointment within the meaning of § 2041 and, accordingly, Trust will not be includible in any Committee member's gross estate under § 2041.

c. With respect to the general power issue, the ruling states:

The powers held by the Committee members under the Grantor's Consent Power are powers that are exercisable only in conjunction with the creator, Grantor. Accordingly, under §§ 2514(b) and 2041(a)(2), the Committee members do not possess general powers of appointment by virtue of possessing this power. Further, the powers held by the Committee members under the Unanimous Member Powers are not general powers of appointment for purposes of §§ 2514(b) and 2041(a)(2). As in the examples in §§ 25.2514-3(b)(2) and 20.2041-3(c)(2), the Committee members have substantial adverse interests in the property subject to this power. Accordingly, any distribution made from Trust to

a beneficiary, other than Grantor, pursuant to the exercise of these powers, the Grantor's Consent Power and the Unanimous Member Powers, are not gifts by the Committee members. Instead, such distributions are gifts by Grantor.

9. In PLR 201507008 (part of a series) the IRS concluded that the trust was a grantor trust but that the gifts to the trust would be incomplete.

a. The grantor – referred to as the "Trustor" – could borrow trust assets, as such the ruling provides:

> During Trustor's lifetime, Trustor may at any time and from time to time borrow any part of the accumulated net income and principal of the Trust ("Borrowing Power"). If the Trustor does so, Trustee (who is also an Independent Trustee) shall determine the rate of interest to be charged, which rate shall not be less than a reasonable market rate of interest at the time the loan is made, and shall determine whether or not the loan should be secured. Trustor may release this Borrowing Power, in whole or in part. Trustee (who is also an Independent Trustee) may also make loans (with adequate collateral and interest) to any person.

b. With respect to the incomplete gift, the ruling states:

> In *Estate of Sanford v. Commissioner*, 308 U.S. 39 (1939), the taxpayer created a trust for the benefit of named beneficiaries and reserved the power to revoke the trust in whole or in part, and to designate new beneficiaries other than himself. Six years later, in 1919, the taxpayer relinquished the power to revoke the trust, but retained the right to change the beneficiaries. In 1924, the taxpayer relinquished the right to change the beneficiaries. The Court stated that the taxpayer's gift is not complete, for purposes of the gift tax, when the donor has reserved the power to determine those others who would ultimately receive the property. Accordingly, the Court held that the taxpayer's gift was complete in 1924, when he relinquished his right to change the beneficiaries of the trust. A grantor's retention of a power to change the beneficial interests in a trust causes the transfer to the trust to be incomplete for gift tax purposes, even though the power may be defeated by the actions of third parties. *Goldstein v. Commissioner*, 37 T.C. 897 (1962). *See also Estate of Goelet v. Commissioner*, 51 T.C. 352 (1968).
>
> In this case, Trustor retained the Trustor's Consent Power over the income and principal of Trust. Under § 25.2511-2(e), a donor is considered as himself having a power if it is exercisable by him in conjunction with any person not having a substantial adverse interest in the disposition of the transferred property or the income therefrom. The Distribution Adviser may not have any beneficial interest in Trust or in any trust created under Trust, and the Distribution Adviser is not a taker in default for purposes of § 25.2514-3(b)(2). Therefore, the Distribution Adviser has no substantial adverse interest in the disposition of the assets of Trust. The Distribution Adviser is merely a coholder of the Trustor's Consent Power. Trust provides that, in the event no Distribution Adviser is serving, Trustee (who is also an Independent Trustee) shall hold and exercise full power to make discretionary distributions of net income and principal of any trust (pursuant to the same standards as were applied to the Distribution Adviser).

Under § 25.2511-2(e), a trustee, as such, is not a person having an adverse interest in the disposition of the trust property or its income. Further, Trustee (who is also an Independent Trustee) has no beneficial interest in Trust and is not a taker in default for purposes of § 25.2514-3(b)(2). Accordingly, Trustee (who is also an Independent Trustee) has no substantial adverse interest in Trust. Therefore, Trustor is considered as possessing the power to distribute income and principal to his issue because he retained the Trustor's Consent Power. The retention of this power causes the transfer of property to Trust to be wholly incomplete for federal gift tax purposes.

Trustor also retained a Lifetime Limited Power of Appointment to appoint income and principal to the issue of Trustor's father or Foundation. Trustor's Lifetime Limited Power of Appointment can only be exercised in conjunction with the Trust Protector. Under §§ 25.2511-2(e) and 25.2514-3(b)(2), Trustor is considered to solely possess the power to exercise Trustor's Lifetime Limited Power of Appointment because the Trust Protector (who is merely a coholder of Trustor's Lifetime Limited Power of Appointment) has no substantial adverse interest in the disposition of the assets transferred by the Trustor to Trust because (i) the Trust Protector may not have any beneficial interest in any trust (whether before or after the Trustor's death), (ii) the Trust Protector is not a permissible appointee of the Trustor's Lifetime Limited Power of Appointment, and (iii) the Trust Protector is not a taker in default of the exercise of the Trustor's Lifetime Limited Power of Appointment.

Under § 25.2511-2(c), a gift is incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries. In this case, Trustor's Lifetime Limited Power of Appointment gives Trustor the power to change the interests of the beneficiaries. Accordingly, the retention of Trustor's Lifetime Limited Power of Appointment causes the transfer of property to Trust to be wholly incomplete for federal gift tax purposes. *See Sanford v. Commissioner*.

Finally, Trustor retained the Testamentary Limited Power of Appointment to appoint Trust property to issue of Trustor's father or Foundation, other than to Trustor's estate, Trustor's creditors, or the creditors of Trustor's estate. Under § 25.2511-2(b) the retention of a testamentary power to appoint the remainder of a trust is considered a retention of dominion and control over the remainder. Accordingly, the retention of this power causes the transfer of property to Trust to be incomplete with respect to Trust remainder for federal gift tax purposes.

Trustor retains dominion and control over the income and principal of Trust until the Distribution Advisor (or Trustee (who is also an Independent Trustee) if there is no Distribution Advisor) exercises his distribution power. Trustor's Powers over the income and principal are presently exercisable and not subject to a condition precedent. Therefore, consistent with *Goldstein v. Commissioner* and *Goelet v. Commissioner*, even if third party actions (i.e., distributions by the Distribution Adviser and/or the Trustee (who is also an Independent Trustee) to the Trustor) may defeat the Trustor's ability to change beneficial interests, the transfer of assets by the Trustor to Trust is wholly incomplete for gift tax purposes.

c. Rulings continue to be issued,[555] and in a recent ruling, PLR 201614006, distributions were made according to the following provisions:

> On Date, Grantor created Trust, an irrevocable trust, for the benefit of Grantor and the other Permissible Beneficiaries. Trustee, a corporate trustee, is the sole trustee of Trust. During Grantor's lifetime, Trustee must distribute such amounts of net income and principal to any of the Permissible Beneficiaries as directed by Distribution Committee and/or Grantor, as follows: (1) At any time, Trustee, pursuant to the direction of a majority of Distribution Committee, with the written consent of Grantor, shall distribute to any of the Permissible Beneficiaries such amounts of the net income or principal of Trust (Grantor's Consent Power); (2) At any time, Trustee, pursuant to the direction of all Distribution Committee members, shall distribute to Permissible Beneficiaries such amounts of the net income (Unanimous Member Power); and (3) At any time, Trustee, shall distribute to any of the Permissible Beneficiaries, other than Grantor, all or any portion of the principal of Trust directly for the health, education, maintenance, or support of the Permissible Beneficiaries as directed by Grantor (Grantor's Sole Power). Grantor's exercise of Grantor's Sole Power shall be exercisable in a nonfiduciary capacity. Distribution Committee may direct that distributions be made equally or unequally and to or for the benefit of any one or more of the Permissible Beneficiaries of Trust to the exclusion of others. Any net income not distributed by Trustee will be accumulated and added to principal.
>
> Trust provides that at all times there must be at least two members of the Distribution Committee. If at any time there are fewer than two individuals serving on the Distribution Committee, then the Distribution Committee shall be deemed not to exist. The Grantor shall not serve as a member of the Distribution Committee. The Distribution Committee shall consist of two adults other than Grantor who are also Permissible Beneficiaries. The Distribution Committee members act in a nonfiduciary capacity. A vacancy on the Distribution Committee must be filled in the following order: Grantor's Father, Grantor's Son, and Grantor's Daughter. Distribution Committee is initially composed of three of the Permissible Beneficiaries and will cease to exist upon Grantor's death.
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> Upon Grantor's death, Trust shall terminate and the remaining balance of Trust shall be distributed to or for the benefit of any person, other than Grantor's estate, Grantor's creditors, or the creditors of Grantor's estate, as Grantor may appoint by will. In default of the exercise of this limited power to appoint (Grantor's Testamentary Power) the balance of Trust property will be divided into equal shares and distributed either outright or in trust to or for Grantor's named individuals.

d. Pursuant to the foregoing provisions, the IRS ruled:

> 1. For so long as the Distribution Committee is serving, no portion of the income, deductions, and credits against tax of Trust shall be included in computing the taxable income, deductions, and credits of Grantor or any member of the Distribution Committee under § 671.

[555] *See*, *e.g.*, PLR 20155005 (part of a series) and 201613007 (part of a series).

2. The contribution of property to Trust by Grantor will not be a completed gift for federal gift tax purposes.

3. Any distribution of property by the Distribution Committee from Trust to Grantor will not be a completed gift, subject to federal gift tax, by any member of the Distribution Committee.

4. Any distribution of property by the Distribution Committee from Trust to any beneficiary of Trust, other than Grantor, will not be a completed gift subject to federal gift tax, by any member of the Distribution Committee.

5. The members of the Distribution Committee do not possess a general power of appointment within the meaning of § 2041, and accordingly, Trust will not be includible in any Distribution Committee member's gross estate under § 2041.

10. As discussed later in these materials, incomplete non-grantor trusts, given their particular tax characteristics (e.g., incomplete gift, taxpayer separate from the grantor, and estate tax includible) can be helpful in the allocation of outside basis when partnership interest are transferred.

11. In 2014, New York enacted a statute that provides "incomplete gift non-grantor trusts" will be treated as grantor trusts, for New York state income tax purposes.[556] An "incomplete gift non-grantor trust" is defined as a New York resident trust (generally, created by a New York resident or domiciliary) that meets the following conditions:

a. "the trust does not qualify as a grantor trust under section six hundred seventy-one through six hundred seventy-nine of the internal revenue code," and

b. "the grantor's transfer of assets to the trust is treated as an incomplete gift under section twenty-five hundred eleven of the internal revenue code, and the regulations thereunder."[557]

J. Private Derivative Contracts to "Transfer" but Still Own for the "Step-Up"

1. Financial derivatives are a staple in the capital markets. On the other hand, the use of financial derivatives for estate planning purposes is relatively new. The primary benefit of using a derivative (as opposed to the actual underlying asset form which its returns are "derived") is that the underlying asset does not need to be transferred or even owned.

2. In the estate planning context, derivatives or contractual rights have been used to "transfer" carried interests in private equity, leveraged buyout, and venture capital funds.[558]

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[556] N.Y. Tax Law § 612(b)(41). The provision does not apply to income of such trusts that were liquidated before June 1, 2014. 2014 N.Y. Laws 59, Part I, § 9 (Mar. 31, 2014).

[557] *Id.*

[558] In a different context, contractual rights tied to or deriving value to the return of endowment funds have been used with charitable remainder trusts to avoid unrelated business taxable income. *See*, *e.g.*, PLRs 200922061, 200703037, 200733032, 200733033, 201022022, 201016082, 201016085, 201016086,

The use of a derivative is usually required because the investors in the fund require that the transferor (holder of the carried interest) to retain the carried interest or because the carried interest of the grantor may be subject to a vesting schedule. Furthermore, the use of the derivative arguably avoids complications under section 2701 of the Code.

3. Generally, "carry derivative" planning involves the creation of an IDGT, and entering into a contractual arrangement with the IDGT. Under the contract, the grantor would be required to pay the IDGT, at a stated future date, an amount based on the total return of the carry (the sum of the distributions the grantor receives and the fair market value of the carried interest on that future date). The contract is typically settled on an expiration date (e.g., 5 years) or upon the death of the grantor, if earlier. The IDGT will typically be funded with a taxable gift, and then pay "fair market value" for the rights under the contract. A professional appraiser determines the fair market value of the contractual rights based upon the particulars of the carried interest (e.g., type of fund, experience of the general partner, strategy, hurdle parameters, etc.), current interest rates, and terms of the contract. Upon settlement, the grantor would pay the trust an amount of cash (or property) equal to the value of the carried interests, plus an amount equal to the distributions (net of any claw backs) less hurdle/strike price (if any).

4. Private derivatives may be used in estate planning with more common assets where for practical and tax reasons, the taxpayer ought to retain ownership of the property. Consider the following examples.

a. "Negative basis" commercial real property interests.

(1) If the property is transferred to an IDGT (either by installment sale or taxable gift), upon the death of the grantor the debt in excess of basis will trigger taxable gain. In addition, because the property is held in the IDGT, there will be no "step-up" in basis for the benefit of the grantor's heirs.

(2) The "step-up" in basis would have eliminated both the "negative basis" problem and recapture of the depreciation under section 1250, which is taxed at 25% (and sometimes under section 1245, which is taxed at ordinary income tax rates).[559]

(3) The transfer of legal title has certain transactional costs (e.g., legal fees and documentary stamp tax), may require consent from a lender, and might trigger a costly reassessment for real property tax purposes.[560]

b. Creator-owned copyrights.

(1) As mentioned above, it is unclear if the author's continued right of termination calls into question how the copyright can be irrevocably transferred (especially

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201011035, 201007063, 201003023, 201003024, 200952059, 200951037, 200913063, 200913065, and 200824021.

[559] *See* Elliott Manning and Jerome M. Hesch, *Sale or Exchange of Business Assets: Economic Performance, Contingent Liabilities and Nonrecourse Liabilities (Part Four)*, 11 Tax Mgmt. Real Est. J. 263, 272 (1995), and Louis A. del Cotto and Kenneth A. Joyce, *Inherited Excess Mortgage Property: Death and the Inherited Tax Shelter*, 34 Tax L. Rev. 569 (1979).

[560] For example, Proposition 13, California Constitution Article XIII(A).

since there seems no mechanism to waive the termination right) and appropriately valued for transfer tax purposes.

(2) A gift of a copyright may have the unintended effect of prolonging ordinary income treatment after the death of the author/creator of the copyright.

(3) In contrast, upon the death of the author/creator who still owns the asset at death, the copyright is entitled to a "step-up" in basis to full fair market value under section 1014 and the asset is transformed into a long-term capital gain asset.

c. If the foregoing can be the underlying property in a private derivative, can the contract be leveraged in a way that can double or triple the amount of the potential wealth transfer? For example, if the underlying property is worth $1 million, can a contractual right be structured so that grantor must pay to the IDGT 2 times or 3 times the return of the underlying property?

5. Potential Issues or Problems

a. Valuation of the "contractual right" vs. valuation of the underlying property?

b. Economic risk of loss, particularly to the party (e.g., IDGT) that was expected to benefit from appreciation.

c. If contract is not settled prior to death, is the decedent's obligation deductible for estate tax purposes under section 2053?

d. Income tax issues upon settlement after death?

e. Potential Chapter 14 implications, in particular section 2701 as an applicable retained interest and section 2703?

f. Financial risks that grantor (or IDGT) will be unable to meet the obligations under the contract (or installment note if purchased by the IDGT).

6. Given some of the foregoing issues, it is highly recommended that the obligor grantor settle the contract prior to death. For example, if the contract is not settled prior to death, it is likely the payments to the IDGT will be taxable as ordinary income.

7. Chapter 14 Issues

a. Section 2701

(1) The IRS might argue that the contract/derivative rights held by the IDGT (or the note held by the grantor if the transaction involves an installment sale) are an applicable retained interest.

(2) It is unlikely that the interests in the contract will be fall under the definition of an applicable retained interest, which requires a distribution right or a liquidation, put, call, or conversation right.[561]

(3) A number of private letter rulings have held that an option to acquire an equity interest is not an equity interest to which section 2701 would apply.[562]

b. Section 2703

(1) Section 2703 provides that for transfer tax purposes, the value of any property is determined without regard to any right or restriction relating to the property.[563] A right or restriction means any option, agreement, or other right to acquire or use the property at a price less than the fair market value (determined without regard to the option, agreement, or right) or any restriction on the right to sell or use such property.[564]

(2) A right or restriction will not be disregard if it satisfies three conditions:

(a) The right or restriction is a bona fide business arrangement;

(b) The right or restriction is not a device to transfer property to members of the decedent's family for less than full and adequate consideration; and

(c) The terms of the right or restriction are comparable to similar arrangements entered into by persons in an arm's length transaction.[565]

(3) Could the IRS argue that the property in the decedent's estate is being reduced in value by virtue of the existence of the contract?

(a) It is unlikely that this argument would prevail particularly because no property would be specifically required to settle the contract. There is a claim that will be satisfied with property (that would have received a "step-up" in basis), which is simply the fulfillment of the grantor's obligations under the contract. What if the contract provides that the claim may only be satisfied in cash? How can cash be "reduced" in value?

(b) In Revenue Ruling 80-162,[566] the IRS held that a gift is made upon the grant of an option (if not received for full and adequate consideration), and not

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[561] *But see* CCA 2014442053. *See also* Richard L. Dees, *Is Chief Counsel Resurrecting the Chapter 14 'Monster'?*, 145 Tax Notes 11, p. 1279 (Dec. 15, 2014).

[562] *See* PLRs 9350016, 9616035, 9722022, 199952012, 199927002 and 200913065.

[563] § 2703 and Treas. Reg. § 25.2703-1(a).

[564] Treas. Reg. § 25.2703-1(a)(2).

[565] § 2703(b).

[566] Rev. Rul. 80-162, 1980-2 C.B. 280. See also Rev. Rul. 84-25, 1984-1 C.B. 191. The IRS held that, "In the case of a legally enforceable promise for less than an adequate and full consideration in money or money's worth, the promisor makes a completed gift under section 2511 of the Code on the date when the promise is binding and determinable in value rather than when the promised payment is actually made."

when the option is exercised. Under these circumstances, a gift might have been made upon the signing of the contract/derivative but for which full and adequate consideration was received.

IV. TAX BASIS MANAGEMENT AND THE FLEXIBILITY OF PARTNERSHIPS

A. Generally

1. There are limited ways of changing the basis of an asset without having a recognition event for income tax purposes. The donee of a gift generally acquires "carryover" basis[567] increased by any Federal gift tax paid attributable to any appreciation in the property transferred.[568] Moreover, if the fair market value of the gift is less than the donor's basis, the donee's basis on a subsequent sale of the property will depend on whether the sale creates a gain or a loss. If the donee recognizes a loss, the donee's basis for purposes of determining the recognizable amount of such loss is the fair market value of the property at the time of the gift. If the donee recognizes a gain, the donee's basis for purposes of determining the recognizable amount of such gain is the donor's basis at the time of the gift. A sale at an amount somewhere in between the basis for determining loss and the basis for determining gain results in no gain or loss recognized. [569] As discussed above, the basis of most assets will get a "step-up" in basis if acquired from a decedent under section 1014(a).

2. Estate planners should consider using entities treated as partnerships for tax purposes to proactively manage the tax basis of the assets of families. The partnership rules provide sufficient planning flexibility to shift and change the basis of property through distributions (both non-liquidating and liquidating distributions) and the use of certain elections like the section 754 election. For example, a partnership could distribute a high basis asset into the hands of a partner with zero outside basis. The basis of the property in the hands of the partner generally would become a zero basis asset eligible for a "step-up" in basis on the subsequent death of the partner.[570] With a section 754 election, the "stripped" basis (i.e., the partnership's basis in the asset immediately prior to the distribution) would allow an upward basis adjustment to the other assets remaining inside the partnership.[571] Furthermore, because partnership debt can create tax basis to certain partners, the careful management of each partner's allocable share of that debt can increase or decrease basis.[572] Notwithstanding the general rules above, other provisions of subchapter K must be considered, including the "mixing bowl" transaction and disguised sale rules.[573]

3. Understanding and proactively using the subchapter K rules concerning the basis of assets inside a partnership and the outside basis that the partners have in their partnership interests thus can become a valuable tax-saving tool for the estate planner. In particular, estate planners should have a working knowledge of the following subjects pertaining to subchapter K and the income tax treatment of partnerships:

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[567] § 1015(a).

[568] § 1015(d).

[569] § 1015(a) and Treas. Reg. § 1.1015-1(a)(1) & (2).

[570] §§ 732(a)(2) and 1014(a).

[571] § 734(b).

[572] § 752.

[573] §§ 704(c)(1)(B), 707(a)(2)(B), 731(c), 737, and 751(b).

a. Unitary basis rules;

b. Calculating inside and outside basis;

c. Non-liquidating "current" distributions of partnership property;

d. Liquidating distributions of partnership property;

e. "Mixing Bowl" transactions;

f. Partnership liabilities and basis;

g. Section 754 election and inside basis adjustments;

h. Partnership divisions; and

i. Anti-abuse rules.

B. Entity Classification

1. These materials focus on planning opportunities with entities classified as partnerships (and to a certain extent, disregarded entities) for Federal tax purposes. An unincorporated entity with two or more owners may elect to be classified as an association (taxed as a corporation[574]) or as a partnership. An unincorporated entity with a single owner may elect to be treated as an association (taxed as a corporation) or disregarded as an entity separate from its owner (disregarded entity).[575] Unless the unincorporated entity elects otherwise, a domestic eligible entity is a partnership if it has two or more owners or is a disregarded entity if it has (or deemed to have) a single owner.[576]

2. A taxpayer whose default classification is a partnership or a disregarded entity may elect to be classified as an S corporation.[577] An eligible entity that makes a timely and valid election to be classified as an S corporation will be deemed to have elected to be classified as an association taxable as a corporation.[578]

C. Anti-Abuse Rules

1. In 1995, the IRS issued "anti-abuse" Treasury Regulations[579] that permit the IRS to recharacterize any transaction that involves a partnership if a principal purpose of the transaction is to reduce the present value of the partners' "aggregate Federal tax liability" in a

[574] *See* Treas. Reg. § 301.7701-2(b)(2).

[575] *See* Treas. Reg. § 301.7701-3(a).

[576] Treas. Reg. § 301.7701-3(b). Form 8832 and an election to be an S corporation under section 1362(a) of the Code (Form 2553, Election by a Small Business Corporation)

[577] Treas. Reg. § 301.7701-3(c)(1)(i).

[578] *Id.*

[579] Treas. Reg. § 1.701-2.

manner inconsistent with the intent of subchapter K.[580] The breadth of these provisions are potentially infinite, but generally apply to artificial arrangements. The discussion herein focuses on only those arrangements that result in changes in tax basis in light of attempting to maximize the "step-up" in basis.

2. The Treasury Regulations provide that the following requirements are implicit in the "intent" of subchapter K:

a. The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose;[581]

b. The form of each partnership transaction must be respected under substance over form principles;[582] and

c. The tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income (collectively, proper reflection of income) or "the application of such a provision [of subchapter K] to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision."[583]

3. The Treasury Regulations provide that certain of the factors that may be taken into account in determining whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate Federal tax liability in a manner inconsistent with the intent of subchapter K. Some of those factors are:

a. The fact that substantially all of the partners (measured by number or interests in the partnership) are related (directly or indirectly) to one another;

b. The present value of the partners' aggregate Federal tax liability is substantially less than it would have been had the partners owned the partnership's assets and conducted the partnership's activities directly;

c. The benefits and burdens of ownership of contributed property are retained by the contributing partner, or the benefits and burdens of ownership of partnership property are shifted to the distributee partner, before and after the property actually distributed;

d. The present value of the partners' aggregate Federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction; and

e. Partners who are necessary to claiming a certain tax position but who have a nominal interest in the partnership, are substantially protected from any risk of loss, or

[580] Treas. Reg. § 1.701-2(b).

[581] Treas. Reg. § 1.701-2(a)(1).

[582] Treas. Reg. § 1.701-2(a)(2).

[583] Treas. Reg. § 1.701-2(a)(3).

have little or no participation in profits other than a preferred return that is a payment for the use of capital.[584]

4. Pertinent to the concept of changing the tax basis of property, the Treasury Regulations provide 2 examples of situations that generally indicate that basis shifts resulting from property distributions are allowable under the anti-abuse provisions:

a. The first example involves a liquidating distribution of appreciated, nonmarketable securities from a partnership without a section 754 election in place. The distribution resulted in a stepped-up basis in the securities. Because no section 754 was in place, there was no downward basis adjustment by the amount of untaxed appreciation in the asset distributed. The example acknowledges that the remaining partners will enjoy a timing advantage because the adjusted bases of the remaining assets were not adjusted downward. Further, the example provides that the partnership and the liquidating partner had as a principal purpose to take advantage of the basis shift. Notwithstanding the foregoing, the Treasury Regulations conclude this does not violate the anti-abuse provisions.[585]

b. The second example involves a liquidating distribution of an appreciated, non-depreciable asset, and depreciable property with a basis equal to its fair market value. The distribution resulted in a shift of basis from the non-depreciable asset to the depreciable asset (adding basis in excess of fair market value). This resulted in additional depreciation deductions and tax benefits to the liquidated partner. The example provides that the partnership and the liquidating partner had as a principal purpose the foregoing tax advantage to the liquidating partner. Notwithstanding the foregoing, the Treasury Regulations conclude this does not violate the anti-abuse provisions.[586]

5. The Treasury Regulations do provide an example of an abusive situation. In that example, a partner contributes property with inherent loss to a partnership formed for the purpose by related parties, who contribute cash, used to purchase a nonmarketable security with a value and inside basis equal to the value of the contributed property. The contributor will have a section 704(c) allocation of the inherent loss and an outside basis equal to the value of the contributed loss property. The property is leased for three years to a prospective purchaser, who has an option to purchase at the value at the time of the contribution. Three years later, but before the sale under the option, the contributor receives a liquidating distribution of the other property with an inside basis equal to the value of the contributed property,[587] but that will have a distributed transferred basis equal to the basis of the contributed property, so that the contributor still has the original inherent loss. The sale by the partnership of the contributed loss property, recognizing the loss after the contributor has withdrawn from the partnership, results in a partnership loss that is allocated to the related partners since the loss that would have been

[584] Treas. Reg. § 1.701-2(c).

[585] Treas. Reg. § 1.701-2(d), Ex. 9.

[586] Treas. Reg. § 1.701-2(d), Ex. 10.

[587] This transaction might have a different result today. Section 704(c)(1)(C), enacted in the American Jobs Creation Act of 2004, P.L. 108-357, provides that contributed property has a "built-in loss," for purposes of allocating income to other partners, the inside basis will be treated as being equal to its fair market value at the time of contribution.

allocated under section 704(c) to the contributor is no longer a partner. The Treasury Regulations conclude that this situation is abusive.[588]

6. Notwithstanding the existence of these anti-abuse rules, the IRS may also rely on non-statutory principles like substance-over-form, step-transaction, and sham-transaction doctrines to recast certain partnership transactions.[589]

7. In addition to the anti-abuse rules, some mention should be made about the codification of the economic substance doctrine under section 7701(o) of the Code.[590] It provides, in pertinent part, "In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if— the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction."[591] However, the Code provides an exception for "personal transactions of individuals" and "shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income."[592] It is unclear to what extent this provision could apply to the planning techniques discussed in this outline, particularly since this new paradigm in estate planning combines both transfer tax and income tax planning.

D. Unitary Basis Rules

1. A partner has a "unitary basis" in his or her partnership interest, even if the partner has different classes of partnership interest (general and limited, preferred and common, etc.) and even if the partner acquired the partnership interests in different transactions.[593] This is in contrast to the "separate lot" rules applicable to shares of corporate stock when such separate lots can be "adequately identified."[594]

2. Under this unitary basis concept, basis is generally allocated in property to the relative fair market value of different interests when determining such basis allocation is relevant (for example, the sale of a partnership interest or a distribution of property in redemption of a partnership interest). When, however, partnership liabilities exist, changes in a partner's share of debt must be taken into account (deemed distributions and contributions of cash under section 752) in determining basis (corresponding additions or reductions of outside basis under sections 722 and 733).[595]

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[588] Treas. Reg. § 1.701-2(d), Ex. 8. *See also* FSA 200242004 (Transfer of loss property to tax partnership, a sale of the partnership interest to unrelated party with no section 754 election in effect, followed by sale of loss property by the partnership. The transaction was recharacterized under Treas. Reg. § 1.701-2 as sale of assets).

[589] Treas. Reg. § 1.701-2(i).

[590] Health Care and Education Reconciliation Act of 2010, P.L. 111-152, § 1409 (Mar. 30, 2010).

[591] § 7701(o)(1).

[592] § 7701(o)(5)(B).

[593] Rev. Rul. 84-53, 1984-1 C.B. 159. *Cf.* PLR 200909001 (the unitary basis rule does not apply to publicly-traded partnership interests).

[594] *See* Treas. Reg. § 1.1012-1(c). Even if lots cannot be identified, then a first-in, first-out accounting convention is used to determine gain or loss.

[595] *See* Treas. Reg. 1.752-1.

3. A partner will have a split holding period in his or her partnership interest if the partner acquires his or her partnership interest by contributing assets with different holding periods or by subsequent contributions. The split holding periods are allocated generally in proportion to the fair market value of the property in question.[596]

4. Unitary basis is determined on a partnership by partnership basis even, so it seems, if a partner has an interest in 2 or more partnerships that are identical in all respects (including the interests of other partners) except, perhaps the assets in the partnership, there does not seem to be a statutory rule that the unitary basis of the partner must be aggregated. This may have important planning implications in estate planning as it bears to reason that it might make sense for taxpayers to segregate low basis and high basis assets into different partnerships.

5. In estate planning, it is common for grantors to simultaneously own interests in FLPs individually and deem to own, for income tax purposes, FLP interests in an IDGT due to grantor trust status. This assumes that grantor trust status equates to the IDGT being disregarded or ignored for income tax purposes, and thus, the grantor will be treated for all income tax purposes as the owner of the trust assets. This apparently is the position of the government. Revenue Ruling 85-13[597] provides that a "defective grantor trust" will be "ignored" for income tax purposes. As discussed later in this outline regarding the use of disregarded entities in transfer tax planning, however, the cases, Code, and Treasury Regulations are not necessarily consistent with this interpretation.

6. In any case, assuming an IDGT may be "ignored" for income tax purposes, because of the unitary basis rule, subsequent contributions of high basis property by the grantor will result in proportional increases (in a pro rata FLP) to the outside basis of the IDGT partnership interests. Given that the FLP interests held by the IDGT will generally not benefit from a "step-up" in basis at the death of the grantor, this can have the advantage of increasing the basis of the FLP interests without requiring an additional transfer to the trust or estate tax inclusion. Of course, if the grantor has a power to swap assets of equivalent value, exchanging high basis assets for the FLP interests is likely to be more advantageous from a basis increase standpoint.

E. Contributions of Property

1. How a partner's outside basis in his or her partnership interest is initially determined starts with the partner's contribution of property in exchange for an ownership interest in the partnership. Generally, a contribution of property[598] to a partnership is a non-recognition event for tax purposes. As such, there is typically no gain or loss at the time of contribution.[599] Gain or loss may be recognized upon certain contributions of encumbered

[596] *See* Treas. Reg. § 1.1223-3.

[597] Rev. Rul. 85-13, 1985-1 C.B. 184.

[598] A partner may also contribute services to the partnership in exchange for an interest in the partnership, but a discussion of those rules is beyond the scope of this outline.

[599] § 721(a).

property,[600] contributions of property that are treated as disguised sales (discussed later in these materials),[601] and contributions to a partnership that is considered an "investment company." [602]

2. Under section 721(b) of the Code, gain is realized on the contribution of property to a partnership if the partnership would be treated as an "investment company" under section 351(e) of the Code. Section 351(e) of the Code and the Treasury Regulations provide that any contributions will be deemed to be a transfer to an investment company if the transfer results, directly or indirectly, in diversification of the transferor's interests, and the transferee is, in pertinent part, a corporation more than 80 percent of the value of whose assets are held for investment and are stocks or securities, or interests in regulated investment companies, or real estate investment trusts. Said another way, a contribution (e.g., stocks and securities) to partnership would not result in taxable gain if (i) the portfolio constitutes a "diversified portfolio" at the time of the transfer, and (ii) such contribution is not part of a plan whereby another person contributes an "undiversified" portfolio of stock and securities to the same investment partnership.[603] There is an exception for contributions of assets which, in the aggregate, are an insignificant part of the total value of assets transferred. There have been a number of rulings on the issue of whether the contribution is insignificant. The rulings have generally held that if the contribution makes less than 5% of the total value, then it will be considered insignificant and thus will not trigger a taxable event.[604]

3. Under section 723 of the Code, upon a contribution of property, the partnership has a transferred basis (inside basis) in the property received, increased by any gain recognized under section 721(b).[605] Accordingly, under section 722 of the Code, the contributing partner receives an exchanged basis (outside basis) in his or her partnership interest equal to the adjusted basis of the contributed property plus any contributed money.[606] Furthermore, under section 1223(2) of the Code, the partnership "tacks" or continues the contributing partner's holding period for any assets received in a nonrecognition contribution with a transferred

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[600] § 731(a) (gain is recognized when a partner receives actual or constructive cash distribution from the partnership in excess of the adjusted basis in the partnership interest) and § 752(b) (gain may be recognized upon contribution when there is a decrease in a partner's share of partnership liabilities, causing a deemed distribution of money and reducing the outside basis below zero). *See also* Treas. Reg. § 1.752-1(g), *Ex. 1*.

[601] *See* § 707(a)(2) and Treas. Reg. § 1.707-3.

[602] § 721(b).

[603] A contribution of stocks and securities will be considered diversified if, taken in the aggregate, (a) the stock or securities of any one issuer do not constitute more than 25% of the value of the contributed assets and (b) the stock and securities of 5 or fewer issuers do not constitute more than 50% of the value of the transferred assets. *See* Treas. Reg. 1.351-1(c)(6)(i).

[604] *See* Rev. Rul. 87-9, 1987-1 C.B. 133 (contribution of cash representing 11% the total contribution was held to be significant, resulting in diversification), PLR 9451035 (cash in excess of 5% of the aggregate assets are considered significant, resulting in diversification) and PLR 9504025 (cash equal to 1% of the value of assets contributed is insignificant) and PLR 200006008 (contributions of stock portfolios to an LLC are insignificant because the assets constitute less than 5% of the company's total value after the transfer).

[605] *See also* § 7701(a)(42) and (43) (definition of "substituted basis property" and "transferred basis property").

[606] *See also* § 7701(a)(44) (definition of "exchanged basis property").

basis.[607] A contributing partner tacks the holding period of the contributed property to the holding period of the partnership interest received in the exchange.[608] Under the unitary basis principle, the holding period of the interest will not be affected by subsequent adjustments for allocations of partnership tax items.[609]

4. Under section 704(c) of the Code, the contributing partner remains responsible for the tax consequences when the unrecognized gains or losses from the contributed property are realized by the partnership after contribution. As such, the contributing partner is taxed on any inherent gain (difference between the adjusted basis in the property and the fair market value of the property at the time of contribution) when the gain is realized, and the contributing partner is entitled to any deductions or losses inherent in any obligations transferred.[610] Section 704(c) of the Code is discussed in some detail later in these materials, but a complete discussion is beyond the scope of this outline.

5. When property encumbered by a liability is contributed to a partnership, generally, the liability is transferred to the partnership (to the extent of the fair market value of the property).[611] The contribution is treated as two separate transactions, a contribution of property and a liability. The contribution of the liability will decrease the contributing partner's outside basis in his or her partnership interest (due to a deemed distribution to the partner) by the share of liability shifted to other partners.[612] A contributing partner will recognize gain under these circumstances when the deemed distribution exceeds the adjusted basis of the property contributed (or the pre-existing outside basis of the partner).[613]

6. As discussed in more detail later in these materials, if the partnership has a section 754 election in place, the partner's gain upon contribution of encumbered property will provide an upward inside basis adjustment to the partnership property.[614] The inside basis adjustment, however, will not necessarily be allocated to the contributed property because of how section 755(b) allocates the basis adjustment (essentially to all partnership property). The gain should decrease the amount of built-in gain to be allocated under section 704(c).[615] If there is no section 754 election in place, the partnership's basis in the contributed asset is not increased, and

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[607] *See* Rev. Rul. 68-79, 1968-1 C.B. 310 (new partner contributing cash for an interest in a continuing partnership is entitled to long-term capital gain on allocable share of gain on partnership long-term capital asset sold one month after admission). *But see Citizens Nat'l Bank of Waco v. U.S.*, 417 F.2d 675 (5th Cir. 1969) (tacking permitted in part gift, part sale transfer to trust even though liability transferred exceeded transferor's basis, and transferee's basis was determined by amount of liability, not transferor's basis).

[608] *See Commissioner v. Lehman*, 165 F.2d 383 (2d Cir. 1948) (holding period of partnership interest is not determined by partnership's holding period of assets; partners do not split holding period for increase in percentage interest on withdrawal of a partner), *aff'g* 7 T.C. 1088 (1946).

[609] *See Commissioner v. Lehman*, 165 F.2d 383 (2d Cir. 1948)), *aff'g* 7 T.C. 1088 (1946).

[610] *See* § 704(c)(1)(A) and Treas. Reg. §§ 1.704-1(b)(4)(i) and 1.704-3(a)(4).

[611] § 752(c) and Treas. Reg. § 1.752-1(e).

[612] §§ 705(a)(2), 752(b), 733(1), and Treas. Reg. §§ 1.722-1, *Ex. 1*, 1.733-1, and 1.752-1(f).

[613] §§ 752(b), 731(a), 705(a)(2), and Treas. Reg. § 1.722-1, *Ex. 2*.

[614] § 734(b).

[615] § 704(c)(1)(A) and Treas. Reg. § 1.704-3(a).

the contributing partner may experience a temporary "doubling" of gain, the tax on the deemed distribution and an eventual tax on the allocation under section 704(c).[616]

7. If the amount of the liability exceeds the tax basis of the contributed property (but not its fair market value), the contributing partner will have a "negative tax capital account," even though the book value capital account is positive. This is sometimes referred to as "negative basis," although the contributing partner's outside basis is never less than zero. The term negative basis reflects the fact that the partner will have to report gain for the reduction in the remaining share of the partnership's liabilities, on the disposition of the partnership interest, or on the partnership's disposition of the encumbered property, without being entitled to any corresponding cash.[617]

8. If a partner contributes property encumbered by a nonrecourse liability, the partner will never receive a deemed distribution under section 752(b) that exceeds the basis of the partnership interest because the second tier allocation of nonrecourse liabilities to section 704(c) minimum gain significantly reduces the liability shift.[618] Under the second tier nonrecourse liabilities are allocated in accordance with section 704(c) minimum gain. Section 704(c) minimum gain represents a partner's share of gain allocated under section 704(c) to the partner contributing appreciated property computed based on the hypothetical sale of the property subject to the nonrecourse loan in satisfaction of the nonrecourse liability for no consideration other than relief from the nonrecourse liability. Thus, the section 704(c) minimum gain allocated to the contributing partner is the excess amount of the nonrecourse debt over the adjusted basis of the property. The result is that the excess of the nonrecourse debt over the basis is allocated to the contributing partner's outside basis.[619]

F. Current and Liquidating Distributions

1. Non-Liquidating "Current" Distributions

a. Cash Distributions

(1) Unless a distribution (or a series of distributions) results in a termination of a partner's interest in a partnership, it will be considered a non-liquidating or "current" distribution.[620] Since most FLPs are structured as "pro rata" partnerships,[621] it is

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[616] *See* §§ 723, 734, 754 and Rev. Rul. 84-15, 1984-1 C.B. 158.

[617] *See* § 752(d), Treas. Reg. § 1.752-1(h), and TAM 9619002 (discharge of partner's share of partnership recourse indebtedness in personal bankruptcy was deemed partnership distribution, not discharge of indebtedness, because partnership not discharged; the recourse debt converted to nonrecourse debt for bankrupt partner and was reallocated to other partners). *See also Commissioner v. Tufts*, 461 U.S. 300 (nonrecourse liability taken into account in determining basis is taken into account in determining amount realized, even when it exceeds fair market value of encumbered property).

[618] *See* Treas. Reg. § 1.752-3(a)(2). The lower the basis of the contributed property relative to encumbrance, the less the liability shift is because the section 704(c) minimum gain is more.

[619] *Id.*

[620] Treas. Reg. § 1.761-1(d).

[621] This is generally due to the "same class" exception under § 2701(a)(2)(B). With respect to this exception, the Treasury Regulations provides, "A class is the same class as is (or is proportional to the class of) the transferred interest if the rights are identical (or proportional) to the rights of the transferred

important to recognize that, generally, there is no gain or loss on pro rata current distributions regardless of the type of asset being distributed,[622] unless cash distributed exceeds the outside basis of the partnership interest of any of the partners.[623]

(2) Distributions of cash (including a reduction in a partner's share of liabilities and distributions of marketable securities[624]) to a partner reduces the partner's outside basis, with gain recognized to the extent the cash distributed exceeds outside basis.[625] No loss is ever recognized on a current distribution.[626] Any gain resulting from a current distribution of cash is considered capital gain that would result from a sale of the partner's interest.[627] The gain may be ordinary income if the distribution results in a disproportionate sharing of certain "unrealized receivables" and "inventory items" of the partnership (section 751 assets).[628] The definitions of these types of assets (sometimes referred to as "hot assets") include more things than might be obvious. Unrealized receivables include rights to payment for goods or services not previously included in income,[629] and recapture property, but only to the extent unrealized gain is ordinary income (as discussed above). "Inventory items" include any property described in section 1221(a)(1) (inventory or other property held for sale to customers in the ordinary course of business and any other property that would not result in capital gain or gain under section 1231 (accounts receivables).

(3) The holding period of any gain from the distribution of cash is determined by the partner's holding period in his or her partnership interest.[630] If the partner acquired his or her partnership interest by contributing property to the partnership (typically in a nonrecognition[631] transaction), the holding period of the property transferred is added to the partnership interest's holding period.[632] If the partner acquires the partnership interest at different times, the partnership interest will have different holding periods, allocated in proportion to the fair market value of the contributed property.[633]

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interest, except for non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to management and limitations on liability)." Treas. Reg. § 25.2701-1(c)(3).

[622] § 731(a)(1) and Treas. Reg. §§ 1.731-1 and 1.732-1(b).

[623] § 731(a)(1) and Treas. Reg. § 1.731-1(a).

[624] § 731(c) and Treas. Reg. § 1.731-2.

[625] § 733(a) and Treas. Reg. § 1.733-1.

[626] §§ 731(a)(2) and 731(b). A loss may only occur with a liquidating distribution. Treas. Reg. §1.731-1(a)(2).

[627] § 731(a).

[628] § 751.

[629] § 751(b) and Treas. Reg. § 1.751-1(b)(2), (d)(1).

[630] *See* GCM 36196 and *Commissioner v. Lehman*, 165 F.2d 383 (2d Cir. 1948), *aff'g* 7 T.C. 1088 (1946), *cert. denied*, 334 U.S. 819 (1948).

[631] § 721.

[632] §§ 1223(1), 1223(2), and 723; Treas. Reg. §§ 1.1223-1(b) and 1.723-1.

[633] Treas. Reg. § 1.1223-3(a), (b) and (f), Ex. 1; *See* T.D. 8902, *Capital Gains, Partnership, Subchapter S, and Trust Provisions*, 65 Fed. Reg. 57092-57101 (Sept. 21, 2000).

(4) It should be noted that if a partner transferred his or her partnership interest in exchange for cash (or other property), the tax rate on capital gain may be different than if the partner received cash from the partnership in liquidation/redemption of the partnership interest. The planning opportunities that might arise as a result of this anomaly is discussed in more detail later in this outline.

(a) Upon a sale or exchange, the transferor recognizes gain under rules similar to section 1001.[634] The transferee of the partnership interest takes a cost basis in the partnership interest equal to the consideration paid,[635] and carries over the transferor's capital account and share of forward and reverse section 704(c) gain in the partnership assets, if any.[636]

(b) The character of the gain is capital subject to recharacterization under section 751(a). The transferor partner recognizes ordinary income or loss in an amount equal the income or loss that would be allocated to the partner if the partnership sold all of the partnership assets at fair market value.[637] Capital gain or loss is recognized in an amount equal to the gain or loss that would be calculated under section 1001 minus the ordinary income (or plus the ordinary loss) computed under section 751(a).[638]

(c) All of the foregoing provides for similar results to a cash distribution to a partner. For determining the rate of tax on the capital gain, on the other hand, one looks through to the underlying partnership assets.[639] Thus, depending on the assets held by the partnership, the transferor partner may recognize capital gain at a 20%, 25%, and 28% federal rate.

b. Property Distributions

(1) Neither the partner nor the partnership will recognize any gain or loss upon a distribution of property,[640] unless the property is a marketable security (treated as cash)[641] or is a "hot asset" under section 751 (mentioned above). If the distributed property is subject to indebtedness, any net change (typically an increase) in the partner's share of liability is treated as a contribution (in most cases) or a distribution of cash by the partner, and the distributed property is distributed without recognizing any gain.[642]

(2) The basis of the distributed property in the hands of the partner is based on the tax basis that the partnership had in the property prior to the distribution (the "inside

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[634] *See* § 741.

[635] Treas. Reg. § 1.704-1(b)(2)(iv)(b).

[636] Treas. Reg. § 1.704-3(a)(7).

[637] Treas. Reg. § 1.751-1(a)(2).

[638] *Id.*

[639] *See* § 1(h)(5)(B), (h)(9), and (h)(10). Treas. Reg. § 1.1(h)-1(a).

[640] § 731(a)-(b) and Treas. Reg. § 1.731-1(a)-(b). Although the "mixing bowl" rules may apply to trigger gain to a partner who contributed the distributed property. §§ 704(c)(2)(B) and 737.

[641] § 731(c) and Treas. Reg. § 1.731-2.

[642] Treas. Reg. § 1.752-1(e) and (g).

basis").[643] The basis of the distributed property will, however, be limited to the outside basis of the partner's partnership interest, as adjusted for cash distributions (reduction) and changes in liabilities because the distributed property is encumbered with debt.[644] This limitation, effectively, transfers the inherent gain in the partnership interest (outside basis) to the distributed property. When multiple properties are distributed and the outside basis limitation is triggered, the outside basis is allocated first to section 752 property and any excess to other property.[645] All other distributed property once all outside basis has been exhausted will have a zero basis.

(3) Generally speaking, the character of the distributed property in the hands of the partner will be determined at the partner level, with the exception of unrealized receivables and inventory items, as defined in section 751.[646] This provision prevents a partner from converting an ordinary income item, like inventory in the partnership's hands, into a capital asset. The holding period of the distributed property includes the holding period of the partnership.[647]

c. Partnership Inside Basis

(1) When gain is recognized on a distribution (cash in excess of outside basis) or when the basis of the distributed property is reduced because outside basis is less than the basis of the property prior to the distribution, absent a section 754 election, there is no adjustment to the partnership's inside basis. This gives may give rise to a temporary duplication of gain or to a loss of basis to the partnership (and to the partners).

(2) If a section 754 election is made, an adjustment of basis under section 734(b) occurs when a partner recognizes gain due to a distribution (or deemed distribution) of cash in excess of outside basis, or property is distributed that results in a reduction of basis on the distributed property.[648] The adjustment results in an increase to the inside basis of the partnership assets. The basis increase is allocated among two different classes of assets: (i) capital and section 1231 assets, and (ii) ordinary income property.[649] Any basis adjustment due to gain from a distribution of cash must be allocated to capital assets.[650] As discussed in more detail in these materials, under section 755 of the Code, any increased basis adjustment is allocated first to appreciated property in proportion to the amount of unrealized appreciation, with any remaining increase allocated to all of the properties within the same class

[643] § 732(a)(1) and Treas. Reg. § 1.732-1(a). Note, that if a Section 754 election is in place or if the partnership had a substantial built-in loss under Section 743(d), the inside basis includes any basis adjustment allocable to the partner under Section 743(b) but only as they relate to the partner. If the distributed property is not the property that was the subject of the basis adjustment under Section 743(b), the adjustment is transferred to the distributed property in the same class (capital gain or ordinary property). Treas. Reg. § 1.755-1(a).

[644] *See* Treas. Reg. §§ 1.732-1, 1.736-1(b)(1), and 1.743-1(d)(1).

[645] § 732(c)(1)(A)(i) and Treas. Reg. §1.732-1(c)(1)(i).

[646] § 735(a).

[647] § 735(b). Note, the holding period of the partner's interest in the partnership is generally irrelevant when determining the holding period of distributed property.

[648] § 734(b)(1).

[649] Treas. Reg. §§ 1.755-1(a)(1) and 1.755-1(c)(1).

[650] Treas. Reg. § 1.755-1(c)(1)(ii).

in proportion to fair market values.[651] Thus, there is a possibility of allocating basis to an asset above its fair market value, creating the possibility of a recognizable loss to the partners. Adjustments under section 734(b) are discussed in more detail later in this outline.

2. Liquidating Distributions

a. Liquidating distributions (whether in one distribution or a series of distributions) terminate the liquidated partner's entire interest in a partnership.[652] Liquidating distributions are treated the same as current distributions except a loss may be recognized,[653] and the basis of property distributed to a partner may be increased (discussed below).[654] The only way to recognize a loss upon a liquidating transfer is if the distribution consists only of cash (but not including marketable securities[655]) and section 751 assets (hot assets).[656]

b. In the estate planning context, most partnerships are structured as "pro rata" or single class share partnerships because of the "same class" exception under section 2701(a)(2)(B). With respect to this exception, the Treasury Regulations provides, "[a] class is the same class as is (or is proportional to the class of) the transferred interest if the rights are identical (or proportional) to the rights of the transferred interest, except for non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to management and limitations on liability)."[657] In order to qualify for this exception, it generally requires that distributions must be made proportionately and at the same time (and perhaps with the same assets). In order to effectuate a disproportionate distribution of property to, for example, an older partner with limited outside basis (trying to maximize the benefit of the "step-up"), one would need to redeem a portion of the partner's interest (lower the percentage ownership), which would be considered a current distribution, or liquidate the partner.

c. When property is distributed in liquidation of a partner's interest, for purposes of determining the basis in the hands of the former partner, the Code provides the basis in section 751 assets cannot exceed the transferred basis.[658] However, basis of other property distributed can be increased if the liquidated partner's outside basis (reduced by cash distributed and adjusted for any change in the partner's share of liabilities as a result of the distribution) is greater than the inside basis of the assets distributed.[659] If the transferred basis is in excess of the fair market value of the distributed asset, then a loss can be recognized on a subsequent sale or, if the property is depreciable, depletable or amortizable, the added basis can provide tax benefits in the form of ongoing deductions.

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[651] Treas. Reg. § 1.755-1(c)(1)(i).

[652] § 761(d).

[653] § 731(a)(2) and Treas. Reg. § 1.731-1(a)(2).

[654] § 732(b), 732(c), and Treas. Reg. § 1.732-1(b).

[655] § 731(c)(1) refers to § 731(a)(1), the gain provision, not § 731(a)(2), the loss provision.

[656] § 731(a)(2). Treas. Reg. §§ 1.731-1(a)(2) and 1.732-1(c)(3).

[657] Treas. Reg. § 25.2701-1(c)(3).

[658] § 732(c)(1)(A) and Treas. Reg. § 1.732-1(c)(1)(i).

[659] § 732(b) and Treas. Reg. § 1.732-1(b).

d. The basis adjustments to the partnership are the same as discussed with current distributions, in particular, if there is a section 754 election in place. With respect to liquidating distributions, the inside basis adjustments may be increased or decreased (rather than only increased in a current distribution). This is because a liquidating distribution may result in a loss to the withdrawing partner,[660] and a property distribution may result an increased tax basis.[661] Another difference with liquidating distributions exists when there is a substantial basis reduction. Under section 734(a), an inside basis adjustment is not required upon a distribution of property to a partner, unless a section 754 election is in place or unless "there is a substantial basis reduction with respect to such distribution,"[662] which will exist if the amount exceeds $250,000.[663] There will be a substantial basis reduction when the sum of: (i) any loss recognized by the liquidating partner, and (ii) the excess of the basis of distributed property to the liquidated partner over the partnership's transferred inside basis, exceeds $250,000. For example, if a partner with an outside basis of $2 million is distributed an asset with an inside basis of $1 million in full liquidation of his or her interest, then under section 732(b) of the Code, the partner's basis in the distributed asset is now $2 million. Because the partner's basis in the asset now exceeds the partnership's basis in the asset by more than $250,000, there is a substantial basis reduction. Consequently, the partnership must reduce the basis of its remaining assets by $1 million as if a section 754 election were in effect. [664]

e. Adjustments for the gain or loss on the partnership interest, or for distributed capital or section 1231 assets may be made only to the inside basis of capital or section 1231 assets, while adjustments to reflect a limitation on the basis of ordinary income property are allocated only to partnership ordinary income property. There may be a positive adjustment for ordinary income assets, and a negative adjustment for capital assets, or the reverse, but no positive adjustment for one capital or ordinary income asset, and negative adjustment for another.[665] Like the adjustments for current distributions, positive adjustments for a class are allocated to appreciated properties, first, in proportion to unrealized gain, and then to all properties in proportion to fair market value.[666] Similarly, reductions in partnership assets are allocated first to property that has declined in value in proportion to the unrealized loss, then to all properties in proportion to their adjusted basis.[667]

3. Distributions and "Hot Assets"

a. Section 751 was enacted to prevent partners from converting ordinary income to capital gain through sales or exchanges of their partnership interests or through distributions of partnership property. Generally, the Code provides that any consideration received by a partnership in exchange for his or her partnership interest that is attributable to

[660] § 734(b)(2)(A) and Treas. Reg. §1.734-1(b).

[661] § 734(b)(2)(B) and Treas. Reg. §1.734-1(b).

[662] § 734(a).

[663] § 734(d). The subsection refers to § 734(b)(2)(A), which in turn refers to §731(a)(2) relating to liquidating distributions, and § 734(b)(2)(B), which refers to § 732(b) also relating to liquidating distribution.

[664] *See* IRS Notice 2005-32, 2005-1 C.B. 895.

[665] Treas. Reg. § 1.755-1(c)(2).

[666] Treas. Reg. § 1.755-1(c)(2)(i).

[667] Treas. Reg. § 1.755-1(c)(2)(ii).

unrealized receivables or inventory items ("hot assets") shall be treated as an amount realized in exchange for property other than a capital asset.[668] In other words, to the extent applicable, it converts what otherwise would be considered capital gain (sale of a partnership interest) to ordinary income.

b. Section 751(b) provides that if a partner receives a distribution of hot assets (sometimes referred to as "section 751(b) property") in exchange for all or part of his or her partnership interest,[669] or receives other partnership property (not hot assets) in exchange for all or part of his or her interest in such hot assets,[670] then the transaction will be considered a sale or exchange between the distributee partner and the partnership (as constituted after the distribution). Section 751(b) applies to both non-liquidating distributions as well as liquidating distributions.[671] In effect, section 751(b) only applies to distributions involving an exchange of interests in one class of property for another class of property (ordinary for capital/capital for ordinary). As such, section 751(b) does not apply to distributions of one partner's share of both section 751(b) property and other property.[672] Furthermore, if a partnership has only one class of property (e.g., no hot assets), then section 751(b) will never apply. Thus, any disproportionate distribution of partnership property that results in any partner receiving more or less than his or her proportionate share of the hot assets will trigger section 751(b).

c. If section 751(b) applies to a distribution, then income inclusion is required. If, by way of example, a partner receives a disproportionate distribution of section 751(b) (hot assets), then the partner will realize capital gain. If, on the other hand, the partner a disproportionate distribution of other property, then the partner will realize ordinary income.

d. In determining whether there has been a disproportionate shift of hot assets or other property, the Treasury Regulations provide for a hypothetical transaction involving:

(1) Current distribution of partnership property relinquished by the distributee partner (the partner's decreased interest in section 751(b) property or other property) in order to determine the partner's tax basis in the relinquished property;[673] and

(2) Partnership sale of the increased share in the other section 751(b) property in exchange for the property relinquished by the partner.[674]

e. The Code provides two specific exceptions to section 751(b). It does not apply to distributions of property to a partner who contributed the property to the

[668] § 751(a).

[669] § 751(b)(1)(A).

[670] § 751(b)(1)(B).

[671] *See* Treas. Reg. § 1.751-1(b)(1).

[672] *See* Rev. Rul. 57-68, 1957-1 C.B. 207.

[673] *See* Treas. Reg. §§ 1.751-1(b)(1)(iii), 2(iii), and 3(iii).

[674] *See* Treas. Reg. §§ 1.751-1(b)(1)(iii), 2(ii), and 3(ii).

partnership.[675] Section 751(b) also does not apply to section 736(a) payments made to a retiring partner or a successor in interest of a deceased partner.[676]

f. Originally, the definition of "unrealized receivables" under section 751(c) only included rights to payments for services and rights to payments for goods. Since its enactment, 751(c) property has been expanded to include many additional types of property, the sale of which would result in the realization of ordinary income.[677] In particular, the following types of assets have been added as "unrealized receivables" for purposes of section 751:

(1) Section 1245 property, but only to the extent that ordinary income would be recognized under section 1245(a) if a partnership were to sell the property at its fair market value.[678] The amount is treated as an unrealized receivable with a zero basis. Section 1245 property includes property which allows for depreciation other than buildings or their structural components.[679]

(2) Section 1250 property but only to the extent that ordinary income would be recognized under section 1240(a) if a partnership were to sell the property at its fair market value.[680] Section 1250 property is any depreciable property other than section 1245 property.[681] Generally, gain which is treated as ordinary income under section 1250(a) is the lower of: (a)" additional depreciation" taken after 1975, and (b) the gain realized on the disposition of the property.[682] "Additional depreciation" generally refers to section 1250 property held for one year or less, all depreciation taken (in that one year or less), and for section 1250 property held for more than one year, the excess of the depreciation taken over the amount of depreciation which would have been taken if the straight-line method of depreciation had been used. Since TRA 1986, the "applicable recovery period" for most commercial real property assets are placed in 27.5 or 39-year recovery periods, while land improvements fall within 15 or 20-year recovery periods.[683] Most importantly, the depreciation method for nonresidential and residential real property is straight line.[684] Thus, most commercial real property assets would fall out of the definition of "unrealized receivables" and would not be considered a "hot" section 751(b) asset.

(3) Amortizable section 197 intangibles (patents, copyrights, goodwill, going concern value, etc.), which by definition are held in connection with a trade or

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[675] § 751(b)(2)(A).

[676] § 751(b)(2)(B).

[677] One court ruled that section 751(c) "invites a liberal construction by stating that the phrase 'unrealized receivables' *includes* certain specified rights, thereby implying that the statutory definition of term is not necessarily self-limiting." *Logan v. Commissioner*, 51 T.C. 482, 486 (1968).

[678] § 704(c) and Treas. Reg. §§ 1.751-1(c)(4)(iii), -1(c)(5).

[679] § 1245(a)(3).

[680] Treas. Reg. §§ 1.751-1(c)(4)(v), -1(c)(5), -1(a)(1)(i) and -1(a)(2)(ii).

[681] § 1250(c).

[682] § 1250(a)(1)(A).

[683] § 168(c).

[684] § 168(b).

business or an activity described in section 212.[685] Amortizable section 197 intangibles are treated as property which is of the character subject to the allowance for depreciation,[686] and these assets are subject to section 1245 recapture.[687] Generally, this does not include self-created intangibles,[688] so intangible assets in the hands of the creator (or held by a donee of such intangible) would fall out of the definition of "unrealized receivables" and would not be considered a "hot" section 751(b) asset.

(4) Section 1248 stock of a controlled foreign corporation (CFC) to the extent that ordinary income would be recognized under section 1248(a) if a partnership were to sell the CFC stock at its fair market value.[689] The amount is treated as an unrealized receivable with a zero basis. The ordinary income under these circumstances is generally the "dividend," which is determined, in part, by the additional corporate income tax that would have been paid by the CFC if it had been taxed as a domestic corporation plus the tax which would have been paid by the taxpayer by including in gross income (as long-term capital gain).[690]

(5) Section 1254 property, which includes oil, gas, geothermal, or other mineral property, to the extent that ordinary income would be recognized under section 1254(a) if a partnership were to sell the property at its fair market value.[691] The amount is treated as an unrealized receivable with a zero basis. Section 1254 recaptures certain previously expensed amounts as ordinary income to the extent of gain realized on the disposition of section 1254 property. Amounts deducted under sections 263 (capital expenditures), 616 (development expenditures with respect to a mine or other natural deposit other than an oil or gas well), and 617 (mining exploration expenditures), which otherwise would have been included in the property's adjusted tax basis, must be recaptured as ordinary income.[692] In addition, any amount deducted under section 611 (deduction for depletion) must be recaptured to the extent it reduced the tax basis (e.g., cost depletion) of the section 1254 property.[693] The calculation for section 1254 property is determined at the partner level, not at the partnership.[694]

(6) Section 617(f)(2) mining property to the extent of the amount that would be treated as ordinary income under section 617(d)(1) if a partnership were to sell the mining property at its fair market value.[695] The amount is treated as an unrealized receivable with a zero basis. Pursuant to section 617(a), a taxpayer can elect to deduct, as ordinary and necessary business expenses, expenditures paid or incurred during the taxable year and prior to the beginning of the development stage of the mine, for the purpose of ascertaining the existence,

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[685] *See* §§ 197(c) and (d)(1).

[686] § 197(f)(7) and Treas. Reg. § 1.197-2(g)(8).

[687] *See* Treas. Reg. § 1.197-2(g)(8).

[688] § 197(c)(2).

[689] *See* § 751(c) and Treas. Reg. §§ 1.751-1(c)(4)(iv), -1(c)(5).

[690] § 1248(b) and Treas. Reg. § 1.1248-4.

[691] § 751(c) and Treas. Reg. §§ 1.751-1(c)(4)(ix), -1(c)(5).

[692] *See* § 1254(a)(1)(A)(i) and Treas. Reg. § 1.1254-1(b)(1)(i)(A).

[693] *See* § 1254(a)(1)(A)(ii) and Treas. Reg. § 1.1254-1(b)(1)(i)(B).

[694] *See* Treas. Reg. § 1.1254-5(b)(1).

[695] *See* Treas. Reg. §§ 1.751-1(c)(4)(i) and -1(c)(5).

location, extent, or quality of any deposit of ore or other mineral. In general, under section 617(d)(1), a portion of the gain recognized on the sale or other disposition of mining property is treated as ordinary income (the deducted exploration expenditures).

(7) Section 1252(a)(2) farm land to the extent that ordinary income would be recognized under section 1252(a)(1) if a partnership were to sell the property at its fair market value.[696] The amount is treated as an unrealized receivable with a zero basis. Section 1252 generally provides that, if a taxpayer has held farm land for less than 10 years and has elected to deduct soil and water conservation expenditures under section 175, then upon disposition of the land, the taxpayer is required to treat a portion of the gain as ordinary income.[697]

(8) Section 1253 property, to the extent that ordinary income would be recognized under section 1253(a) if the partnership were to sell the property at its fair market value. The amount is treated as an unrealized receivable with a zero basis. Under §1253(a), the transfer of a franchise, trademark, or trade name is not treated as a sale or exchange of a capital asset if the transferor retains any "significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark or trade name."[698]

(9) Partnership property subject to basis reduction under section 1017, relating to income from discharge of indebtedness that is excluded from income under section 108(a). These are reductions are treated as depreciation subject to section 1245 or section 1250 recapture.

(10) Market discount bonds to the extent that ordinary income would be recognized under section 1276(a) if a partnership were to sell the bonds at fair market value.[699] The amount is treated as an unrealized receivable with a zero basis. Section 1276(a) provides that gain recognized upon the disposition of any market discount bond[700] is treated as ordinary income to the extent of "accrued market discount" on the bond. The term "market discount bond" means any bond having "market discount."[701] The term "market discount" means the excess of the stated redemption price of the bond over the basis of the bond immediately after its acquisition by the taxpayer.[702]

4. Mixing Bowl Transactions

a. Generally

(1) Because both property contributions to and distributions from a partnership are generally nonrecognition events, partnerships could be used to exchange property without recognizing income despite the fact that the properties would not have qualified as a like-

[696] *See* Treas. Reg. §§ 1.1252-1(a), 1.751-1(c)(4)(vii), and -1(c)(5).

[697] § 1252(a).

[698] § 751(c) and Treas. Reg. §§ 1.751-1(c)(4)(viii), -1(c)(5).

[699] § 751(c) and Treas. Reg. § 1.751-1(c)(5).

[700] *See* § 1278(a)(1).

[701] § 1278(a)(1)(A).

[702] § 1278(a)(2).

kind exchange under section 1031. The partnership would be treated as a "mixing bowl" where assets are commingled and then the partnership is dissolved, each partner walking away with a different mixture of assets. As a result of this perceived abuse, Congress enacted the "mixing bowl transaction" provisions of sections 704(c)(1)(B) and 737. These provisions can be triggered when contributed property is distributed to another partner or if other property is distributed to a contributing partner.

(2) Some of the techniques discussed in these materials require a distribution of partnership property to one partner (or less than all of the partners). If such property had been contributed by a partner (rather than purchased by the partnership), then these "mixing bowl" rules could be implicated, possibly triggering gain to one or more of the partners. As discussed, if seven years have elapsed from contribution to distribution, then that gain can be avoided.

b. Contributed Property to Another Partner-Section 704(c)(1)(B)

(1) If contributed property is distributed within seven years of the date of contribution to any partner other than the partner who contributed such property, the contributing partner must generally recognize a taxable gain or loss in the year of distribution. [703]

(2) The amount of such gain or loss will generally equal the lesser of (a) the difference between the fair market value of the contributed at the time the property was contributed and the contributing partner's basis in the contributed property, or (b) the difference between the fair market value of the contributed property and the inside basis of the partnership at the time of the distribution.[704] The reason for the latter limitation is the gain or loss is meant to be limited to the amount that would have been allocated to the contributing partner under section 704(c) had the partnership sold the asset.

(3) The character of any such gain or loss is determined by the character of the contributed property in the hands of the partnership.[705]

(4) If the contributed property is exchanged for other property in a tax free exchange, the property received will be treated as the contributed property for the application of section 704(c)(1)(B).[706]

(5) The outside basis of the contributing partner and the inside basis of the contributed property and the "non-contributing" partner (distributee) are adjusted for any gain or loss without the need for a section 754 election.[707]

(6) With respect to transfers of partnership interests, the Treasury Regulations provide, for section 704(c) purposes, "If a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. If the contributing partner transfers a portion of the

[703] § 704(c)(1)(B).

[704] § 704(c)(2)(B)(i) and Treas. Reg. § 1.704-4(a).

[705] Treas. Reg. § 1.704-4(b).

[706] Treas. Reg. § 1.704-4(d)(1)(i).

[707] § 704(c)(1)(B)(iii) and Treas. Reg. § 1.704-4(e).

partnership interest, the share of built- in gain or loss proportionate to the interest transferred must be allocated to the transferee partner."[708] Specifically to contributed property distributions to another partner, the Treasury Regulations provide, "The transferee of all or a portion of the partnership interest of a contributing partner is treated as the contributing partner for purposes of section 704(c)(1)(B) and this section to the extent of the share of built-in gain or loss allocated to the transferee partner."[709]

(7) Similar to the general anti-abuse provisions mentioned above, the Treasury Regulations provides that "if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 704(c)(1)(B)," [710] based on all the facts and circumstances, the IRS can recast the transaction appropriately. One example given in the Treasury Regulations deals with a partnership having a nominal outside partner for a number of years, and then prior to the expiration of the (now seven years) section 704(c)(1)(B) period, adding a partner to whom it is intended the contributed property will be distributed. When the contributed property is distributed after the "mixing bowl" period has expired, the example provides that a taxable transfer is deemed to have occurred because the "mixing bowl" period is deemed to have been tolled until the admission of the intended recipient partner of the contributed property.[711]

c. Other Property Distributed to Contributing Partner- Section 737

(1) If a partner contributes appreciated property to the partnership and, within seven years of the date of contribution, that partner receives a distribution of any property other than the contributed property, such partner generally will be required to recognize gain upon the receipt of such other property.[712] The reason for this provision is to avoid deferral of the gain that would have been allocated to the contributing partner under section 704(c) because such gain would not be triggered unless the partnership actually sold the property in a taxable transaction. If section 737 is triggered, to avoid a doubling of the gain, the subsequent distribution of the property previously contributed by the same partner does not trigger gain.[713]

(2) Unlike section 704(c)(1)(B), this provision only applies to gain, not loss. As a result, in order to recognize any loss under section 704(c), the partnership would need to sell the asset in a taxable transaction.

(3) Under section 737(a), a partner who has contributed section 704(c) property and who receives a distribution of property within seven years thereafter is required to recognize gain in an amount equal to the *lesser* of:

(a) The excess (if any) of the fair market value (other than money) received in the distribution over the adjusted basis of such partner's outside basis

[708] Treas. Reg. § 1.704-3(a)(7).

[709] Treas. Reg. § 1.704-4(d)(2).

[710] Treas. Reg. § 1.704-4(f)(1).

[711] Treas. Reg. § 1.704-4(f)(2), Ex. 2.

[712] §§ 704(c)(1)(B) and 737.

[713] § 737(d)(1) and Treas. Reg. § 1.737-3(d).

immediately before the distribution reduced (but not below zero) by the amount of money received in the distribution (sometimes referred herein as the "excess distribution");[714] or

(b) The "net precontribution gain,"[715] which is the net gain (if any) which would have been recognized by the distributee partner under section 704(c)(1)(B) if, at the time of the distribution, all section 704(c) property contributed by the distributee partner within seven years of the distribution that is still held by the partnership were distributed to another partner.[716]

(4) For purposes of calculating the excess distribution, the fair market value of the distributed property is calculated according to the willing buyer, willing seller standard.[717] The value determined by the partnership will control, provided the value is reasonably agreed to by the partners in an arm's-length negotiation and the partners have sufficiently adverse interests.[718] If the distributed property is subject to a liability, it is the gross value of the property that is used in the calculation.[719]

(5) Any portion of the property that consists of property previously contributed by the distributee partner is not taken into account in determine the amount of the partner's "net precontribution gain" or the "excess distribution."[720] In such case, the basis of the previously contributed property is computed as if such property had been distributed in a "separate and independent distribution prior to the distribution that is subject to section 737."[721]

(6) The Treasury Regulations provide, "The transferee of all or a portion of a contributing partner's partnership interest succeeds to the transferor's net precontribution gain, if any, in an amount proportionate to the interest transferred."[722] The Treasury Regulation then provides, "See Section 1.704-3(a)(7) and Section 1.704-4(d)(2) for similar provisions in the context of section 704(c)(1)(A) and section 704(c)(1)(B)." As mentioned above, the Treasury Regulations provide for purposes of section 704(c)(1)(B) purposes, the transferee of a partnership interest is treated as a contributing partner. There is some debate as to whether a transferee under section 737 is treated as a contributing partner as specifically provided for section 704(c)(1)(B).[723] It seems, however, the consensus view is that a

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[714] § 737(a)(1).

[715] § 737(a)(2).

[716] § 737(b). Other than a partner who owns, directly or indirectly, more than 50 percent of the capital or profits interest in the partnership. *See* Treas. Reg. § 1.737-1(c)(1). Further, any losses inherent in section 704(c) property contributed by the distributee partner within the preceding 7-year period are netted against gains in determining net precontribution gain. *See* Treas. Reg. § 1.737-1(e), Ex. 4(iv).

[717] Treas. Reg. § 1.737-1(b)(2).

[718] *Id.*

[719] Treas. Reg. § 1.737-1(e), Ex. 2.

[720] § 737(d)(1) and Treas. Reg. § 1.737-2(d)(1).

[721] Treas. Reg. § 1.737-3(b)(2).

[722] Treas. Reg. § 1.737-1(c)(2)(iii).

[723] *See* Richard B. Robinson, *"Don't Nothing Last Forever"—Unwinding the FLP to the Haunting Melodies of Subchapter K*, 28 ACTEC J. 302 (2003), Ellen K. Harrison and Brian M. Blum, *Another View: A Response to Richard Robinson's "'Don't Nothing Last Forever'--Unwinding the FLP to the Haunting Melodies of Subchapter K,"* 28 ACTEC J. 313 (2003), and Richard B. Robinson, *Comments on Blum's and*

transferee steps in the shoes of the transferor as the contributing partner. One partnership treatise provides, "Any transferee of all or part of a contributing partner's partnership interest steps into the shoes of the contributing partner under § 737 to the extent of a proportionate part of the net precontribution gain."[724] The same authors go on to assert, "The step-in-the-shoes rule should apply for all aspects of § 737 (e.g., the exception for distributions of previously contributed property provided by Regulations § 1.737-2(d)), although the Regulation by its terms is more limited."[725] Another leading treatise provides, "… if the contributing partner transfers his interest in a transaction in which gain or loss is not recognized, the transferee should step into his shoes in order to preserve the taxation of the built-in gain."[726]

(7) The character of the gain is determined by reference to the "proportionate character of the net precontribution gain,"[727] which is to say, it is generally determined by its character in the hands of the partnership.

(8) The partner's outside basis and the partnership's inside basis in the contributed property are automatically adjusted without the need for a section 754 election.[728] Further, the basis of the distributed property is adjusted to reflect the recognized gain on the partner's outside basis.[729]

(9) Marketable securities are generally treated as money for purposes of section 737.[730] In determining "net precontribution gain" under section 737, however, marketable securities contributed to the partnership are treated as contributed property.[731]

(10) Similar to the anti-abuse guidelines under section 704(c)(1)(B), the Treasury Regulations provide that transactions can be recast if, based on all the facts and circumstances, they are "inconsistent with the purposes of section 737."[732] The deemed abusive example provided in the Treasury Regulations involves a transaction, in an intentional plan to avoid section 737, where there is a contribution of property to a partnership (under section 721) immediately before a distribution of other property to the contributing partner (who also made a

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Harrison's "Another View," 28 ACTEC J. 318 (2003). *See also* Paul Carman, *Unwinding the Family Limited Partnership: Income Tax Impact of Scratching the Pre-Seven Year Itch*, 96 J. Tax'n 163 (Mar. 2002) and *Shop Talk: When Is a Transferee Partner a Contributing Partner?*, 98 J. Tax'n 317 (May 2003).

[724] McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, Fourth Edition (Thompson Reuters, 2017), ¶ 19.08[2][e]. The treatise goes on to assert, "The step-in-the-shoes rule should apply for all aspects of § 737 (e.g., the exception for distribution

[725] Id. at ¶ 19.08[2][e], fn. 167.

[726] Willis, Pennell, Postlewaite & Lipton, *Partnership Taxation*, Sixth Edition (Thompson Reuters, 2017), ¶ 13.02[1][a][v].

[727] § 737(a) [flush language] and Treas. Reg. § 1.737-1(d).

[728] § 737(c) and Treas. Reg. § 1.737-3. The increase in inside basis is allocated to property with unrealized gain of the same character as the gain recognized. *See* Treas. Reg. §§ 1.737-3(c)(3) and 1.737-3(e), Ex. 3.

[729] § 737(c)(1) and Treas. Reg. § 1.737-3(b)(1).

[730] §§ 737(c)(1), 737(e), and Treas. Reg. § 1.731-2(a).

[731] Treas. Reg. § 1.731-2(g)(i)-(iii).

[732] Treas. Reg. § 1.731-4(a).

previous contribution of appreciated property). Gain under section 737 would be avoided because the contribution increased the outside basis of the contributing partner. Then the partnership liquidates the contributing partner's interest in a nontaxable distribution, returning the contributed property (temporarily parked in the partnership to avoid gain on the distribution of other property prior to the liquidation of the partner's interest).[733]

5. Disguised Sale Rules

a. If a partner who has contributed appreciated property to a partnership receives a distribution of any other property or cash generally within two years of the contribution, based on the applicable facts and circumstances, the distribution may cause the partner to recognize gain as of the original date of contribution with respect to his or her contributed property under the "disguised sale" rules. [734]

b. Specifically, section 707(a)(2)(B) of the Code provides for disguised sale treatment if:

(1) "there is a direct or indirect transfer of money or other property by a partner to a partnership,"[735]

(2) "there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner),"[736] and

(3) The two transfers, "when viewed together, are properly characterized as a sale or exchange of property."[737]

c. Distributions in a transaction determined to be a disguised sale are treated as payments by the partnership to the disguised seller-partner, acting in an independent capacity, and not as a partner.[738]

d. The Code and the Treasury Regulations take a facts-and-circumstances approach to determine whether a disguised sale has occurred. The Treasury Regulations provide that simultaneous distributions are disguised sales if "the transferor money or other consideration would have been made but for the transfer of property."[739] For non-simultaneous transfers and distributions, a disguised sale occurs if the "subsequent transfer is not dependent on the entrepreneurial risks of partnership operations."[740] The Treasury Regulations provide two rebuttable presumption in determining whether a disguised sale has occurred:

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[733] Treas. Reg. § 1.731-4(b), Ex. 1.

[734] § 707(a)(2)(B).

[735] § 707(a)(2)(B)(i).

[736] § 707(a)(2)(B)(ii).

[737] § 707(a)(2)(B)(iii).

[738] § 707(a)(2) and Treas. Reg. § 1.707-3.

[739] Treas. Reg. § 1.707-3(b)(1)(i).

[740] Treas. Reg. § 1.707-3(b)(1)(ii).

(1) If the contribution and distribution occur within a 2-year period (regardless of the order), a disguised sale is presumed to have occurred, unless the facts and circumstances "clearly establish that the transfers do not constitute a sale;"[741] and

(2) If the contribution and distribution occur more than two years apart (regardless of the order), a disguised sale is presumed not to have occurred, unless the facts and circumstances "clearly establish that the transfers constitute a sale." [742]

e. The Treasury Regulations provide a list of 10 factors that would tend to prove the existence of a disguised sale. Notably, the Treasury Regulations provide, "Generally, the facts and circumstances existing on the date of the earliest of such transfers are the ones considered in determining whether a sale exists."[743] The factors are:

(1) The timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;

(2) The transferor has a legally enforceable right to the subsequent transfer;

(3) The partner's right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured;

(4) Any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration

(5) Any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations

(6) The partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt);

(7) The partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer (taking into account the income that will be earned from those assets);

(8) Partnership distributions, allocations or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property;

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[741] Treas. Reg. § 1.707-3(c)(1).

[742] Treas. Reg. § 1.707-3(d).

[743] Treas. Reg. § 1.707-3(b)(2).

(9) The transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits; and

(10) The partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.

f. The definition of a disguised sale is written broadly enough to include transactions that would include a deemed sale of property by the partnership to one or more partners. To that end, the Treasury Regulations provide, "Rules similar to those provided in section 1.707-3 apply in determining whether a transfer of property by a partnership to a partner and one or more transfers of money or other consideration by that partner to the partnership are treated as a sale of property, in whole or in part, to the partner."[744] If a contribution and distribution is thus treated as a disguised sale, the partnership recognizes gain (or loss) on the property distributed that is shared by all partners, and the contribution is consideration for the property, not a contribution to the partnership. As a result, the disguised purchaser is entitled to a purchase price cost basis in the property, and a new holding period, instead of the transferred basis and tacked holding period of a partnership distribution. Furthermore, a disguised sale will not affect capital accounts, since it is not considered a partnership distribution. The Treasury Regulations also provide, "Rules similar to those provided in section 1.707-5 apply to determine the extent to which an assumption of or taking subject to a liability by a partner, in connection with a transfer of property by a partnership, is considered part of a sale."[745]

g. As mentioned, the two year presumption of a disguised sale is a facts and circumstances test based upon the factors listed above. These factors point toward circumstances where the distribution and contribution are related or tied in such a way that disguised sale treatment is warranted. However, if the contribution and distribution have independent significance in the context of the business purpose of the partnership, then the rebuttable presumption is likely to be overcome. That being said, if practitioners proceed with any of the planning ideas discussed in these materials and if they require a distribution of property to a partner (e.g., basis strip), then practitioners should inquire whether the distributee partner contributed any money or property to the partnership within two years of the distribution and if not the case, caution against such partner making any contributions within two years of the distribution (unless necessitated for business reasons).

h. The partnership is required to disclose transfers of property that are not treated as disguised sales to a partner if they are made within two years before or after transfers of consideration by the distributee or the partnership's incurring liabilities transferred to the distributee with property.[746]

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[744] Treas. Reg. § 1.707-6(a).

[745] Treas. Reg. § 1.707-6(b)(1).

[746] Treas. Reg. §§ 1.707-3(c) and 1.707-8 (requiring the filing of Form 8275).

6. Leveraged Distributions and Disguised Sales

a. The Treasury Regulations provide that if a partnership incurs a liability and distributes the loan proceeds to a partner, the distribution will be treated as part of a disguised sale only to the extent that the amount of the distribution exceeds the distributee partner's allocable share of the partnership liability.[747] This "leveraged partnership distribution" exception allows a partnership to borrow money and distribute the entire amount to a single partner, even if the partner just contributed property to the partnership, provided that the entire liability is properly allocated to the distributee partner under section 752 of the Code (as discussed later in these materials).

b. Generally, the assumption of liabilities encumbering transferred property is not alone considered indicative of a disguised sale unless the liabilities are incurred or in contemplation of the transfer. The Treasury Regulations generally presume liabilities incurred within two years of the contribution of the property are incurred in contemplation of the transfer.[748] Under section 1.707-5(a)(5) of the Treasury Regulations, a partnership's assumption of a "qualified liability," or a partnership's taking property subject to a "qualified liability," in connection with a transfer of property by a partner to the partnership is not treated as part of a disguised sale. Prior to 2014, the Treasury Regulations defined four types of qualified liabilities, which were liabilities that encumber the property[749] and those that are:

(1) Incurred more than two years prior to the transfer;[750]

(2) Not incurred in anticipation of the transfer;[751]

(3) Incurred to finance capital expenditures (allocable under the rules of section 1.163-8T of the Treasury Regulations) on the property;[752] or

(4) Incurred in the ordinary course of a trade or business transferred, but only if all of the assets that are material to that trade or business are transferred to the partnership.[753]

c. In 2016, the IRS issued proposed, temporary, and final Treasury Regulations[754] addressing the use of leverage to circumvent the disguised sale rules and the

[747] Treas. Reg. § 1.707-5(b)(1).

[748] *See* Treas. Reg. §§ 1.707-5(a)(7) (disguised sale to partnership) and 1.707-6(b)(1) (disguised sale by partnership).

[749] The disguised sale by partnership rules treat all partnership liabilities incurred by the partnership more than two years before the transfer as qualified, even if they do not encumber partnership property. Treas. Reg. § 1.707-6(b)(2)(iii)(B).

[750] Treas. Reg. § 1.707-5(a)(6)(i)(A).

[751] Treas. Reg. § 1.707-5(a)(6)(i)(B).

[752] Treas. Reg. § 1.707-5(a)(6)(i)(C).

[753] Treas. Reg. § 1.707-5(a)(6)(i)(D).

[754] T.D. 9787, T.D. 9788, and REG-122855-15 (Oct. 5, 2016).

allocation of liabilities. This multi-faceted issuance was in response to the public comments to proposed Treasury Regulations published in 2014 (the "2014 Proposed Regulations").[755]

d. The 2014 Proposed Regulations were, in part, issued to address certain leveraged (debt-financed) partnership distributions and bottom-end (bottom-dollar) guarantees. Whether liabilities have been properly allocated to a partner under these types of transactions has been the subject of a number of court and IRS rulings that are instructive to review.

(1) The disguised sale rules generally provide that a contribution of property by a partner to a partnership followed by a transfer of money or other consideration from the partnership to the partner will be treated as a sale of property by the partner to the partnership if, based on all the facts and circumstances, the transfer of money or other consideration would not have been made but for the transfer of the property (and, for non-simultaneous contributions, the subsequent transfer is not dependent on the entrepreneurial risks of the partnership).[756] Notwithstanding the foregoing rule, the Treasury Regulations provide an exception for distributions of money to a partner if the distribution is traceable to a partnership borrowing and if the amount of the distribution does not exceed the partner's allocable share of the liability incurred to fund the distribution.[757]

(2) A bottom-end guarantee is a type of arrangement pursuant to which debt is allocated to a partner, but the risk of loss to the partner is very remote and the liability represents the last dollars to be paid to the lender. For example, a developer holds real estate with a fair market value of $10 million, an adjusted basis of zero, and subject to a recourse debt of $3 million. If the developer contributes the property to a partnership (e.g., UPREIT), then there would be a $3 million deemed distribution under sections 731(a) and 752(b) of the Code, unless the partnership allocated $3 million of the partnership's liabilities. The partnership refinances the contributing partner's $3 million liability into the partnership's pre-existing $1 billion line-of-credit, and the contributing partner guarantees the "bottom" $3 million of the line-of-credit. At the time of the guarantee, the partnership owns $5 billion of assets. Under the Treasury Regulations under section 752 prior to the issuance of the 2014 Proposed Regulations, the contributing partner would have been allocated $3 million of liability. Thus, the contributing partner can contribute the real estate without recognizing gain and diversify the single real property holding with minimal economic exposure.

(3) The Tax Court in *Canal Corp v. Commissioner*[758] held that an indemnity provided by a contributing partner would not be respected under the anti-abuse rule of section 752 of the Code.[759] Thus, the court concluded that the contribution of property followed by a cash distribution triggered the disguised sale rules. The facts of the case are:

(a) WISCO (a subsidiary of Canal Corp) and GP formed an LLC, to which WISCO contributed a business valued at $775 million, and GP contributed a business valued at $376 million. On the same day as the contributions, the LLC borrowed $755 million from a bank. The loan was guaranteed by GP, but WISCO agreed to indemnify GP for

[755] REG-119305-11 (January 30, 2014).

[756] *See* Treas. Reg. § 1.707-3.

[757] Treas. Reg. § 1.707-5(b).

[758] *Canal Corp v. Commissioner*, 135 T.C. 199 (2010).

[759] Treas. Reg. § 1.752-2(j).

any principal payments (not interest) GP might have to pay under the guaranty. Under the indemnity agreement, the parties agreed that GP had to proceed first against the LLC assets before seeking indemnification from WISCO, and if WISCO made any payments under the indemnity, WISCO would receive a proportionately increased interest in the LLC. On the day the loan proceeds were received, the LLC distributed $755 million to WISCO.

(b) WISCO paid $604 million of the loan proceeds to Canal in the form of repayment of intercompany loans and a dividend. WISCO then loaned the remaining $151 million to Canal. After all of the foregoing transactions, WISCO's assets consisted of its interest in the LLC, the $151 million Canal note, and a corporate jet valued at $6 million.

(c) After the distribution of the loan proceeds, the LLC had net equity value of $400 million (contributed businesses minus the loan). GP had a 95% interest in the LLC with a capital account of $376 million, and WISCO had a 5% interest in the LLC with a capital account of $20 million.

(d) Within a month after closing, the LLC borrowed $491 million from GP Finance (a subsidiary of GP) to refinance a portion of the original loan. The following year, the LLC borrowed $264 million from GP Finance to repay the balance of the original loan. The terms of the GP Finance loans were similar to the original loan terms, and the parties executed similar guaranty and indemnity agreements with respect to the GP Finance loans.

(e) The LLC operated with this structure for a year. GP desired to acquire another corporation and, for antitrust purposes, had to sell its LLC interest before making the new acquisition. GP found a buyer for the LLC, but the buyer insisted only on buying 100% of the LLC interests. As a result, GP purchased WISCO's 5% interest for $41 million. GP also paid Canal $196 million to compensate Canal for the loss of the tax deferral Canal believed it had achieved under the leveraged partnership structure. WISCO then cancelled the $151 million note receivable from Canal.

(4) In ILM 201324013, the IRS relied on the anti-abuse provision to disregard a partner's indemnity of a partnership liability. The IRS concluded that the leveraged distribution exception did not apply to a distribution to the indemnifying partner because the liability was not properly allocable to het distribute partner. In the ruling, the IRS offered 3 arguments for disregarding the indemnity:

(a) The indemnity lacked important features that were typically used in a commercially-driven transaction. According to the IRS, a typical indemnity includes such features such as a net worth maintenance requirement, an arms-length fee, an obligation to provide annual financial statements, and evidence that the parties engaged in a genuine negotiation over the indemnity. In the ruling request, the IRS noted the indemnity allowed the partner to sell off assets, make distributions to shareholder, or shift assets to related entities to insulate its assets if the partner expected the indemnity to be enforced.

(b) The indemnity provided no practical or commercial risk of being enforced. The partnership liability was guaranteed by affiliates of the non-distributee partner. The distribute partner agreed to indemnify those guarantors, but only to the extent the guarantors actually made payments on the guarantees. The distribute partner had no direct or indirect obligation to the lender under the indemnity. If the guarantors defaulted on their

guarantees, the indemnifying partner had no obligation under the indemnity to pay the lender, even if the underlying partnership liability had not been paid.

(c) The non-distributee partner, in the opinion of the IRS, merely used the partnership as a conduit to borrow from the bank to accommodate the distributee partner's structure.

(5) In TAM 200436011,[760] a partner contributed assets to the partnership. The partnership borrowed against the contributed assets and made a simultaneous distribution to the contributing partner. The partnership had three classes of ownership interests: Senior Preferred Interests, Junior Preferred Interests, and Junior Common Interests. The contributing partner owned 100% of the Senior Preferred Interests. The contributing partner, along with other partners, owned the other two junior interests. The partnership allocated 100% of the gross income every quarter to the contributing partner up the amount of the preferred return on the Senior Preferred Interests. The partnership agreement also specified that the contributing partner's share of excess nonrecourse liabilities would be determined under the "significant item" method,[761] the result being that 100% of the nonrecourse liabilities would be allocated to the contributing partner in respect of the preferred return on the Senior Preferred Interests treated as the significant partnership item. The IRS ruled that a preferred return (gross income allocation) is not a "significant item" for purposes of allocating partnership liabilities. Therefore, all of the liability could not be allocated to the distributee partner, and the distribution did not qualify for the leveraged partnership exception. The IRS explained, a "significant item of partnership income or gain" does not refer to a tranche of bottom-line gross or net income, but instead refers to partnership income of a certain character or type, such as gain from the sale of property or tax-exempt income.

e. The 2014 Proposed Regulations sought to amend not only the disguised sale rules under section 707 but also made significant changes to the sharing of partnership recourse and nonrecourse liabilities under section 752. In response to commentary, in 2016, the IRS issued temporary regulations under section 707 (the "707 Temporary Regulations") for disguised sale rule purposes and under section 752 (the "752 Temporary Regulations") directly relating to bottom-dollar payment obligations.[762] In addition, the IRS issued final regulations Treasury Regulations under section 707 of the Code (the "707 Final Regulations") and section 752 of the Code, relating to allocations of excess nonrecourse liabilities for disguised sale rule purposes (the "752 Final Regulations").[763]

f. The 707 Temporary Regulations require a partner to apply the same percentage used to determine the partner's share of excess nonrecourse liabilities under section 1.752-3(a)(3) (with certain limits) in determining the partner's share of partnership liabilities for disguised sale rule purposes only.

(1) The rationale stated in the preamble to the 707 Temporary Regulations is that this more accurately reflects the economic arrangement of the partners. The preamble states, "In most cases, a partnership will satisfy its liabilities with partnership profits,

[760] *See also* ILM 200513022.

[761] Treas. Reg. § 1.752-3(a)(3).

[762] T.D. 9788 (including two correcting amendments, 81 Fed. Reg. 80993 and 81 Fed. Reg. 80994).

[763] T.D. 9787 (including a correction, 81 Fed. Reg. 80587).

the partnership's assets do not become worthless, and the payment obligations of partners or related persons are not called upon. This is true whether: (1) a partner's liability is assumed by a partnership in connection with a transfer of property to the partnership or by a partner in connection with a transfer of property by the partnership to the partner; (2) a partnership takes property subject to a liability in connection with a transfer of property to the partnership or a partner takes property subject to a liability in connection with a transfer of property by the partnership to the partner; or (3) a liability is incurred by the partnership to make a distribution to a partner under the debt-financed distribution exception in §1.707-5(b)."

(2) As such, the 707 Temporary Regulations provide, "For purposes of § 1.707- 5, a partner's share of a liability of a partnership, as defined in § 1.752-1(a) (whether a recourse liability or a nonrecourse liability) is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability under § 1.752-3(a)(3)… but shall not exceed the partner's share of the partnership liability under section 752 and applicable regulations."[764]

(3) Thus, the 707 Temporary Regulations treat all partnership liabilities, whether recourse or nonrecourse, as nonrecourse liabilities solely for disguised sale purposes under section 707 of the Code. The 707 Final Regulations, however, provide limitations on the available allocation methods under section 1.752-3(a)(3) of the Treasury Regulations, applicable solely for disguised sale purposes under section 707, for determining a partner's share of excess nonrecourse liabilities. Under section 1.752-3(a)(3) of the 2014 Proposed Regulations, the "significant item method" and the "alternative method" (as discussed later in these materials) were removed and were replaced by a new approach based on a partner's liquidation value percentage.[765] In response to commentary, the 752 Final Regulations retain the significant item method and alternative method, but do not adopt the liquidation value percentage approach for determining a partner's interest in profits. That being said, the IRS concluded that the allocation of excess nonrecourse liabilities in accordance with the significant item method and the alternative method has been abused by partnerships and their partners for disguised sale purposes. The pre-existing Treasury Regulations already provided that the "additional method" does not apply for disguised sale rule purposes. The 752 Final Regulations now provide, "The significant item method, alternative method, and additional method do not apply for purposes of § 1.707-5(a)(2)."[766]

(4) Therefore, under the 707 Temporary Regulations, a partner's share of any partnership liability for disguised sale purposes is determined using the same percentage used to determine the partner's share of the partnership's excess nonrecourse liabilities under section 1.752-3(a)(3) of the Regulations based on the partner's share of partnership profits.

g. The 752 Temporary Regulations provide generally that the extent to which a partner (or related party) has an obligation to make a payment is based on the facts and circumstances, taking into account obligations inside and outside the partnership agreement and imposed by law, and if the obligation is not recognized, then section 752 will be applied as if the obligation did not exist.[767] Then the 752 Temporary Regulations carved out a specific provision

[764] Treas. Reg. § 1.707-5T(a)(2).

[765] *See* § 1.752-3(a)(3) of the 2014 Proposed Regulations.

[766] Treas. Reg. § 1.752-3(a)(3).

[767] Treas. Reg. § 1.752-2T(a)(3)(i).

for "bottom-dollar" guarantees, which generally would not be recognized as payment obligations under section 1.752-2T(b)(3) of the Treasury Regulations. [768]

(1) The 752 Temporary Regulations broadly define a "bottom dollar payment obligation" as:[769]

(a) With respect to a guarantee (or similar arrangement), any obligation other than one in which the partner (or related person) is or would be liable up to the full amount of such partner's (or related person's) payment obligation if any amount of the partnership liability is not otherwise satisfied;

(b) With respect to an indemnity (or similar arrangement), any obligation other than one in which the partner (or related person) is or would be liable up to the full amount of such partner's (or related person's) payment obligation if any amount of the indemnitee's or benefited party's payment obligation is satisfied; and

(c) An arrangement with respect to a partnership liability that uses tiered partnerships, intermediaries, senior and subordinate liabilities, or similar arrangements to convert what would otherwise be a single liability into multiple liabilities if, based on the facts and circumstances, the liabilities were incurred pursuant to a common plan, and with a principal purpose of avoiding having at least one of such liabilities or payment obligations being treated as a bottom dollar payment obligation (as described above).

(2) The 752 Temporary Regulations provide that an obligation will not be considered a bottom dollar payment obligation merely because:

(a) A maximum amount is placed on the partner's (or related) person's payment obligation;

(b) A partner's (or related person's) payment obligation is stated as a fixed percentage of every dollar of the partnership liability to which such obligation relates (a vertical slice obligation); or

(c) There exists a right of proportionate contribution running between partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable.

(3) The 752 Temporary Regulations include an example where ABC limited liability company, which is treated as a partnership for tax purposes, borrows $1,000 from a bank. The LLC has 3 equal members. A guarantees up to $300 of the ABC liability if any amount of full liability is not recovered. B guarantees up to $200, but only if the bank recovers less than $200. A and B waive their rights of contribution from each other. Based on these facts, the 752 Temporary Regulations conclude:

(a) A's $300 guarantee obligation is not a bottom dollar payment obligation. As a result, A's payment obligation is recognized under section 1.752-

[768] Treas. Reg. § 1.752-2T(a)(3)(ii)(A).

[769] Treas. Reg. § 1.752-2T(a)(3)(ii)(C).

2T(b)(3) of the Treasury Regulations, and A's economic risk of loss under section 1.752-2(b)(1) of the Treasury Regulations is $300.

(b) B's guarantee is a bottom dollar payment obligation. As a result, B's payment obligation is not recognized under section 1.752-2T(b)(3) of the Treasury Regulations, and B bears no economic risk of loss under section 1.752-2(b)(1) of the Treasury Regulations.

(c) The result is that $300 of ABC's liability is allocated to A under section 1.752-2(a) of the Treasury Regulations (relating to a partner's share of recourse liabilities), and $700 is allocated to A, B, and C under section 1.752-3 of the Treasury Regulations (relating to a partner's share of nonrecourse liabilities).

(4) The 752 Temporary Regulations further provide if a partner (or related person) has a payment obligation that would be recognized section 1.752-2T(b)(3) of the Treasury Regulations (referred to as the "initial payment obligation") but for a right of indemnification or reimbursement, then such bottom dollar payment obligation will nevertheless be recognized provided the partner (or related person) is liable for at least 90% of the initial payment obligation.[770] The preamble provides the following example: "if one partner (Partner A) guarantees 100 percent of a partnership liability and another partner (Partner B) indemnifies Partner A for the first one percent of Partner A's obligation, Partner A's obligation would be characterized as a bottom dollar payment obligation under the general rule because Partner A would not be liable to the full extent of the guarantee if any amount of the partnership liability is not otherwise satisfied…. Such bottom dollar payment obligation is recognized under §1.752-2T(b)(3) if, taking into account the indemnity, … the partner … is liable for at least 90 percent of the initial payment obligation."

(5) The 752 Temporary Regulations imposes a requirement that a partnership must disclose a bottom dollar payment obligation (including those obligations that would be recognized under the 90% threshold exception described above) on Form 8275, Disclosure Statement, attached to the return of the partnership for the taxable year in which the bottom dollar payment obligation is undertaken or modified.[771]

h. The 707 Temporary Regulations were incorporated by cross reference in a notice of proposed rulemaking published on October 5, 2016 (the "707 Proposed Regulations").[772] That notice also incorporated by cross reference the 752 Temporary Regulations and included new proposed regulations under sections 704 and 752 (the "752 Proposed Regulations").

i. The 707 Final Regulations formally add a new type of "qualified liability" to the pre-existing four types. This new qualified liability is one that is not incurred in anticipation of a transfer of the property to a partnership but that was incurred in connection with a trade or business in which property transferred to the partnership was used or held, provided that all assets related to that trade or business are transferred other than assets not material to a continuation of the trade or business.[773] The 707 Final Regulations also provide guidance on the

[770]Treas. Reg. § 1.752-2T(a)(3)(ii)(B).

[771] Treas. Reg. § 1.752-2T(a)(3)(ii)(D).

[772] REG-12855-15.

[773] Treas. Reg. § 1.707-5(a)(6)(i)(E).

treatment of preformation capital expenditures,[774] tiered partnerships, and liabilities in assets-over mergers. These subjects are beyond the scope of these materials.

j. 2017 Treasury Action under Executive Order 13789

(1) In 2017, under Executive Order 13789, titled "Reducing Regulation and Controlling Regulatory Costs," the President ordered the Treasury to identify significant tax regulations issued on or after January 1, 2016, that (i) impose an undue financial burden on U.S. taxpayers, (ii) add undue complexity to the Federal tax laws, or (iii) exceed the statutory authority of the IRS. In an interim report, dated June 22, 2017, Treasury identified eight such regulations.

(2) On October 2, 2017, the Secretary of the Treasury published its second report providing specific recommendations with regard to those regulations.[775] Pursuant to this second report, it provided recommendations regarding the proposed and temporary regulations governing how liabilities are allocated for purposes of disguised sale treatment.[776] According to the second report, the temporary regulations "would, in general terms, have applied the rules relating to non-recourse liabilities to formations of partnerships involving recourse liabilities… While Treasury and the IRS believe that the temporary regulations' novel approach to addressing disguised sale treatment merits further study, Treasury and the IRS agree that such a far-reaching change should be studied systematically. Treasury and the IRS, therefore, are considering whether the proposed and temporary regulations relating to disguised sales should be revoked and the prior regulations reinstated."[777]

(3) The second report did, however, agree that the regulations relating to bottom-dollar guarantees should be retained. According to the second report, "Before the proposed and temporary regulations relating to bottom-dollar guarantees were issued, the liability allocation rules permitted sophisticated taxpayers to create basis artificially and thereby shelter or defer income tax liability. Bottom-dollar guarantees permitted taxpayers to achieve these results without meaningful economic risk, which is inconsistent with the economic-risk-of-loss principle underlying the debt allocation rules for recourse obligations."[778]

k. 2018 Proposed Withdrawal of Regulations and Reinstatement

(1) On June 18, 2018, the IRS issued a proposal to withdraw the 707 Proposed Regulations and also remove the 707 Temporary Regulations and reinstate section 1.707-5(a)(2) of the Treasury Regulations in effect, prior to the 707 Temporary Regulations, as of April 1, 2016 (the "Prior 707 Regulations").

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[774] *See* Treas. Reg. § 1.707-4(d).

[775] Secretary of Treasury, *Second Report to the President on Identifying and Reducing Tax Regulatory Burdens, Executive Order 13789*, 2018-03004 (Rev. 1), (October 2, 2017) [https://www.treasury.gov/press-center/press-releases/Documents/2018-03004_Tax_EO_report.pdf] (hereinafter, the Second Report under Executive Order 13789).

[776] T.D. 9788 and 81 F.R. 69282.

[777] Second Report under Executive Order 13789, p. 5.

[778] *Id.* at p. 5-6.

(2) Under section 1.707-5(a)(2) of the Prior 707 Regulations, a partner's share of a partnership's recourse liability equals the partner's share of the liability under section 752 and the Treasury Regulations thereunder. A partnership liability is a recourse liability to the extent that the obligation is a recourse liability.[779]

(3) Under section 1.707–5(a)(2)(ii) of the Prior 707 Regulations, a partner's share of a partnership's nonrecourse liability is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability.[780] A partnership liability is a nonrecourse liability of the partnership to the extent that the obligation is a nonrecourse liability.[781]

(4) As mentioned above, the 707 Final Regulations limited the available methods for determining a partner's share of an excess nonrecourse liability for disguised sale purposes. Under the 707 Final Regulations, a partner's share of excess nonrecourse liability for disguised sale purposes is determined only in accordance with the partner's share of partnership profits and by taking into account all facts and circumstances relating to the economic arrangement of the partners. Therefore, the significant item method, the alternative method, and the additional method[782] do not apply for purposes of determining a partner's share of a partnership's nonrecourse liability for disguised sale purposes.

(5) Section 1.707–5(a)(2)(i) and (ii) of the Prior 707 Regulations provided that a partnership liability is a recourse or nonrecourse liability if the liability was treated as a partnership liability for purposes of section 752, specifically dealing with contingent liabilities under section 1.752-7 of the Treasury Regulations. In the proposed reinstatement, the IRS requests additional guidance on this issue.

(6) Examples 2, 3, 7, and 8 under section 1.707–5(f) of the Prior 707 Regulations are reinstated with the exception of added language to Example 3 to reflect an amendment made by the 707 Final Regulations regarding an anticipated reduction in a partner's share of a liability that is not subject to the entrepreneurial risks of partnership operations.

(7) The 707 Temporary Regulations are proposed to be removed thirty days following the date these regulations are published as final regulations in the Federal Register. The amendments to section 1.707–5 are proposed to apply to any transaction with respect to which all transfers occur on or after thirty days following the date these regulations are published as final regulations in the Federal Register.

7. Distributions of Marketable Securities

a. A distribution consisting of marketable securities generally is treated as a distribution of cash (rather than property) but only for purposes of determining whether gain is recognized as a result of the distribution.[783] For these purposes, marketable securities includes financial instruments (stocks, equity interests, debt, options, forward or futures contracts,

[779] As determined under Treas. Reg. § 1.752–1(a)(1).

[780] As determined under Treas. Reg. § 1.752–3(a)(3).

[781] As determined under Treas. Reg. § 1.752–1(a)(2).

[782] *See* Treas. Reg. § 1.752–3(a)(3).

[783] § 731(c).

notional principal contracts and other derivatives) and foreign currencies which are actively traded.[784] In addition, the Code provides that a marketable security includes "any financial instrument which, pursuant to its terms or any other arrangement, is readily convertible into, or exchangeable for, money or marketable securities."[785] Further, the Code provides that a marketable security includes "any financial instrument the value of which is determined substantially by reference to marketable securities."[786]

b. There are a number of applicable exceptions to the foregoing treatment of distributions of marketable securities, including: (1) distributions of contributed securities to the partner who contributed them;[787] (2) distributions of securities that were not marketable when acquired by the partnership and are distributed within five years of becoming marketable;[788] and (3) distributions of securities from an "investment partnership" to an "eligible partner."[789]

c. An "investment partnership" is defined as a partnership substantially all of whose assets consist of specified investment-type assets and has never been engaged in a trade or business.[790] Specified investment-type assets include (1) money, (2) stock in a corporation, (3) notes, bonds, debentures, or other evidences of indebtedness, (4) interest rate, currency, or equity notional principal contracts, (5) foreign currencies, and (6) derivative financial instruments (including options, forward or futures contracts and short positions).[791] A partnership will not be considered engaged in a trade or business by reason of any activity undertaken as an investor, trader, or dealer in such specified investments.[792]

d. An "eligible partner" is one who, before the date of distribution, did not contribute to the partnership any property other than specified investment-type assets permitted to be held by an investment partnership.[793]

e. If one of these exceptions do not apply and a distribution of marketable securities results in gain to the distributee partner, the gain is the excess of the value of the marketable securities over the partner's outside basis.[794] The amount of marketable securities treated as cash is reduced (and the potential recognized gain is reduced) by:

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[784] § 731(c)(2)(A) and (C).

[785] § 731(c)(2)(B)(ii).

[786] § 731(c)(2)(B)(iii).

[787] § 731(c)(3)(A) and Treas. Reg. § 1.731-2(d)(1).

[788] § 731(c)(3)(A)(ii) and Treas. Reg. § 1.731-2(d)(1)(iii). To qualify for this exception, the security must not have been marketable on the date acquired and the entity to which the security relates must not have had any outstanding marketable securities on that date. Further, the partnership must have held the security for at least 6 months prior to the security becoming marketable, and the partnership must distribute the security within 5 years from the date the security became marketable.

[789] §§ 731(c)(3)(C)(i) and 731(c)(3)(A)(iii).

[790] § 731(c)(3)(C)(i).

[791] § 731(c)(3)(C)(i)(I) through (VIII).

[792] § 731(c)(3)(C)(ii)(I) and Treas. Reg. § 1.731-2(e)(3)(i).

[793] § 731(c)(3)(C)(iii)(I).

[794] § 731(c)(3)(B) and Treas. Reg. § 1.731-2(a) and (j), Ex. 1.

(1) "such partner's distributive share of the net gain which would be recognized if all of the marketable securities of the same class and issuer as the distributed securities held by the partnership were sold (immediately before the transaction to which the distribution relates) by the partnership for fair market value, over;"[795]

(2) "such partner's distributive share of the net gain which is attributable to the marketable securities of the same class and issuer as the distributed securities held by the partnership immediately after the transaction, determined by using the same fair market value."[796]

f. Any unrealized loss in the marketable securities is not recognized, either by the partnership or the partner.[797]

g. The basis of distributed marketable securities when gain is recognized under section 731(c) is the basis as determined under section 732 but increased by the amount of gain recognized as a result of the distribution.[798] The basis of distributed securities when no gain is recognized will be based on the general rule of section 732 for distributions.

h. The outside basis of the distributee partner is determined as if no gain is recognized and no adjustments to is made to the basis of the marketable security attributable to the distribution itself.[799] As a result, the distributee-partner's outside basis is reduced only by the basis of the distributed securities determined under section 732 without regard to any basis increase under section 731(c)(4) (which is reflected in the securities).

i. For inside basis purposes, section 734 (adjustment to inside basis when there is a section 754 election or substantial basis reduction) is applied as if no gain were recognized and no basis increase was made to the distributed securities.[800] Even if a section 754 election is in place, any gain triggered from a distribution of marketable securities will not be reflected in the inside basis of any other partnership property. However, if a section 754 election is in place, the inside basis of partnership can be adjusted for any lost basis resulting from the limitation of the basis of the marketable securities in the partner's hands to the partner's outside basis (because outside basis is not adjusted to reflect the gain, as mentioned above).[801] Therefore, for purposes of sections 733 and section 734 of the Code, a distribution of marketable securities is treated as a property distribution.

j. If the partner receives other property in addition to marketable securities in the same distribution, the reduction in outside basis due to the marketable securities (cash) is taken into account first, with any remaining basis applied against the other property distributed. [802]

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[795] § 731(c)(3)(B)(i).

[796] § 731(c)(3)(B)(ii),

[797] § 731(b).

[798] § 731(c)(4)(A) and Treas. Reg. § 1.731-2(f)(1)(i).

[799] § 731(c)(5) and Treas. Reg. § 1.731-2(f)(1)(ii).

[800] § 731(c)(5) and Treas. Reg. § 1.731-2(f)(2).

[801] Treas. Reg. § 1.731-2(j), Ex. 6(iv).

[802] § 731(a)(1) and Treas. Reg. § 1.731-2(f)(1)(ii), (j), Ex. 5.

G. Partnership Liabilities and Basis

1. Introduction

a. Generally, as discussed in more detail below, a partner's basis in his or her partnership interest (outside basis) includes the partner's share of the partnership's liabilities. As such, any increase in a partner's share of partnership liabilities will increase the partner's outside basis. Conversely, any decrease in a partner's share of partnership liabilities will decrease the partner's outside basis and could also cause the partner to recognize income.

b. Outside basis determines, among other things, the amount of money a partnership can distribute to a partner without triggering gain. Section 731(a) of the Code provides that a partnership does not recognize gain on a distribution of money expect to the extent that the amount of money distributed exceeds the partner's basis in his or her interest.

c. In addition, section 704(d) of the Code provides that a partner's distributive share of partnership losses is allowed only to the extent of the partner's outside basis at the end of the partnership taxable year in which the loss occurred. Any loss in excess of the partner's outside basis is disallowed. The excess loss is allowed as a deduction at the end of the first succeeding partnership taxable year (and any subsequent years) but only to the extent, if any, of the partner's outside basis at the end of that year.

d. Importantly, in the context of tax basis management, outside basis determines (in whole or in part) the adjusted basis of property distributed to a partner. As discussed in more detail above, the basis of distributed property to a partner in a current distribution is the *lesser* of the inside basis of the property and the outside basis of the distributee partner.[803] With respect to liquidating distributions of property, the basis of the distributed property is simply the outside basis of the distributee partner (as reduced by any money distributed in the same transaction).[804]

2. Current Treasury Regulations

a. The partnership rules make an important distinction between recourse and nonrecourse liabilities. In this context, generally, recourse liabilities increase basis only as to the partner who bears economic risk of loss, whereas nonrecourse liabilities increase basis proportionately among all of the partners. A partnership liability is considered recourse if any partner or "related person" bear the economic risk of loss for the liability.[805] Conversely, a liability is considered nonrecourse to the extent no person or "related person" bears such risk of loss.[806]

b. Under the current Treasury Regulations, a partner is deemed to have the economic risk of loss if the partner would be required to pay the liability in the event all of the

[803] § 732(a).

[804] § 732(b).

[805] Treas. Reg. § 1.752-1(a)(1).

[806] Treas. Reg. § 1.752-1(a)(2).

partnership assets are worthless,[807] even if the economic reality is that the chance the partner will be required to pay or have the ability to pay the liability is very small. Under section 1.752-2(b)(1) of the Treasury Regulations, a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated:

(1) The partner or related person would be obligated to make a payment to any person or a contribution to the partnership because that liability becomes due and payable; and

(2) The partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner.

c. Whether the partner's or related person's payment or contribution obligation exists (and the extent of such obligation) depends on all the facts and circumstances, like the existence of the following:

(1) Contractual obligations like "guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors or to other partners, or to the partnership;"[808]

(2) Partnership obligations including "obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership;"[809]

(3) Payment obligations "imposed by state law, including the governing state partnership statute;"[810] and

(4) Reimbursement rights a partner or related person may have from another partner or a person who is related to such other partner.[811]

d. In making a determination of whether a partner or related person has a payment obligation on a partnership liability and bears the economic risk of loss, it is assumed the partner or related person will be able to pay the obligations "irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation."[812] This presumption is sometimes referred to as the "deemed satisfaction rule." Notwithstanding the deemed satisfaction rule, a payment obligation is disregarded if, taking into account all of the facts and circumstances, the obligation is subject to contingencies that make it unlikely that the obligation will be discharged. If a payment would arise in the future after the occurrence of an event that is not determinable with reasonable certainty, the obligation is ignored, but only until the triggering event occurs.[813]

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[807] Treas. Reg. § 1.752-2(b).

[808] Treas. Reg. § 1.752-2(b)(3)(i).

[809] Treas. Reg. § 1.752-2(b)(3)(ii).

[810] Treas. Reg. § 1.752-2(b)(3)(iii).

[811] Treas. Reg. § 1.752-2(b)(5).

[812] Treas. Reg. § 1.752-2(b)(6).

[813] Treas. Reg. § 1.752-2(b)(4).

e. Any increase in a partner's share of liabilities (including any assumption by a partner of any partnership liabilities) is treated as contribution of cash by the partner in the partnership, thereby increasing basis.[814] Any decrease is treated as a distribution of cash to the partner, thereby reducing basis and possibly resulting in the recognition of gain if the amount of the deemed distribution exceeds available outside basis.[815] If property that is subject to a liability is contributed to or distributed from a partnership, the transferee is deemed to assume the liability but only to the extent the liability is not in excess of the fair market value.[816]

f. The Treasury Regulations state that a person will be a "related person" to a partner if they have a relationship that is specified in sections 267(b) and 707(b)(1) but with a few modifications.[817] Including those modifications, a person is related to a partner if they are (in part):

(1) Members of the same family (spouse, ancestors and lineal descendants);

(2) An individual and a corporation if more than 80% of the value of the outstanding stock of the corporation is owned, directly or indirectly, by or for such individual;

(3) A grantor and a fiduciary of any trust;

(4) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;

(5) A fiduciary of a trust and a beneficiary of such trust;

(6) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;

(7) A fiduciary of a trust and a corporation if more than 80% of the value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;

(8) A person and a charitable organization if the organization is controlled directly or indirectly by such person or, if the person is an individual, by members of the individual's family;

(9) A corporation and a partnership if the same persons own more than 80% in value of the outstanding stock of the corporation and more than 80% of the capital interest or the profits interest in the partnership;

(10) An S corporation and another S corporation (or C corporation) if the same persons own more than 80% in value of the outstanding stock of each corporation;

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[814] § 722 and Treas. Reg. § 1.752-1(b).

[815] §§ 733, 731(a), 751 and Treas. Reg. § 1.752-1(c).

[816] Treas. Reg. § 1.752-1(e).

[817] Treas. Reg. § 1.752-4(b)(1).

(11) Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of that estate;

(12) A partnership and a person owning, directly or indirectly, more than 80% of the capital interest, or the profits interest, in such partnership; or

(13) Two partnerships in which the same persons own, directly or indirectly, more than 80% of the capital interests or profits interests.

g. To avoid double counting, the Treasury Regulations provide that persons owning interests (directly or indirectly) in the same partnership are not treated as related persons for purposes of determining their share of partnership loss.[818]

h. The Treasury Regulations further provide that if (i) a partnership liability is held or guaranteed by another entity that is a partnership, S corporation, C corporation, or trust; (ii) a partner or related person (directly or indirectly) owns 20% or more in such other entity, and (iii) a principal purpose of having such other entity act as a lender or guarantor is to avoid having the partner bears the risk of loss for all or part of the liability, then the partner is treated as holding the other entity's interest as a creditor or guarantor to the extent of that partner's or related person's ownership interest in such other entity.[819] The ownership interest of the partner and related person are determined according to each entity in the following manner:

(1) Partnership: highest percentage interest in any partnership loss or deduction for any taxable year;[820]

(2) S corporation: percentage of outstanding stock owned by the shareholder;[821]

(3) C corporation: percentage of the issued and outstanding stock owned by the shareholder based upon fair market value;[822] and

(4) Trust: actuarial percentage interest owned beneficially.[823]

i. An otherwise nonrecourse partnership liability is treated as a recourse liability to the extent that a partner or a related person holds an interest in the liability, referred to as "partner nonrecourse debt" in the Treasury Regulations.[824] In such case, the economic risk of loss is allocated to such partner (or related person) to the extent not otherwise allocated to another partner. [825]

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[818] Treas. Reg. § 1.752-4(b)(2)(iii).

[819] Treas. Reg. § 1.752-4(b)(2)(iv)(A).

[820] Treas. Reg. § 1.752-4(b)(2)(iv)(B)(1)

[821] Treas. Reg. § 1.752-4(b)(2)(iv)(B)(2).

[822] Treas. Reg. § 1.752-4(b)(2)(iv)(B)(3).

[823] Treas. Reg. § 1.752-4(b)(2)(iv)(B)(4).

[824] *See* Treas. Reg. § 1.704-2(b)(4).

[825] Treas. Reg. § 1.752-2(c)(1).

j. If a partner (or related person) pledges property outside the partnership (a direct pledge) as security for a partnership liability, the partner is deemed to bear the risk of loss to the extent of the "net fair market value" of the pledged property.[826] If a partner contributes property to a partnership solely for the purpose of securing a partnership liability (an indirect pledge), the partner is deemed to bear the risk of loss to the extent of the "net fair market value" of the pledged property.[827] Contributed property will not be deemed indirectly pledged unless "substantially all of the items of income, gain, loss, and deduction attributable to the contributed property are allocated to the contributing partner, and this allocation is generally greater than the partner's share of other significant items of partnership income, gain, loss, or deduction."[828]

k. As with other partnership provisions, the Treasury Regulations contain anti-abuse rules that would disregard the form of the situation "if facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's economic risk of loss with respect to that obligation or create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise."[829] The Treasury Regulations discuss 2 situations:

(1) Arrangements tantamount to a guarantee:[830]

(a) Partner or related person undertakes one or more contractual obligations so the partnership may obtain a loan;

(b) Contractual obligations of the partner or related person eliminate substantially all the risk to the lender that the partnership will not satisfy its obligations under the loan; and

(c) One of the principal purposes is to attempt to permit partners (other than those who are directly or indirectly liable for the obligation) to include a portion of the loan in the basis of their partnership interests.

(2) A plan to circumvent or avoid the obligation, based on the facts and circumstances, of a partner (or related person).[831]

l. A complete discussion of how nonrecourse liabilities are shared by partners is beyond the scope of this outline, but the Treasury Regulations generally provide that a partner's share of such liabilities are the sum of:[832]

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[826] Treas. Reg. § 1.752-2(h)(1).

[827] Treas. Reg. § 1.752-2(h)(2).

[828] *Id.*

[829] Treas. Reg. § 1.752-2(j)(1).

[830] Treas. Reg. § 1.752-2(j)(2). *See* CCA 200246014 (a guarantee was disregarded due to a number of facts including sever undercapitalization and the provisions of the guarantee set forth many waivers and defenses for the benefit of the purported guarantor).

[831] Treas. Reg. § 1.752-2(j)(3). An example is provided that involved a general partnership, minimally capitalized corporation as a partner and a deficit capital account restoration obligation. The obligations of the corporate partner and the capital account restoration obligation are ignored for purposes of Section 752.

[832] Sometimes referred to as the sum of tier one, tier two, and tier three allocations.

(1) The partner's share of "partnership minimum gain"[833] (gain that would be realized if all property subject to nonrecourse liability is sold in full satisfaction of the liabilities and for no other consideration);[834]

(2) Amount of taxable gain that would be allocated to the partner under section 704(c) (arising because the partner contributed property to the partnership and the partnership still holds the property) if the partnership disposed of all partnership property subject to nonrecourse liabilities in a taxable transaction in full satisfaction of the liabilities and for no other consideration;[835] and

(3) The partner's share of "excess nonrecourse liabilities" (liabilities not allocated above).[836]

m. Section 1.752-3(a)(3) of the Treasury Regulations provides a number of methods to determine a partner's share of "excess nonrecourse liabilities." Under one method, a partner's share of "excess nonrecourse liabilities" is generally "determined in accordance with the partner's share of partnership profits" under all of the "facts and circumstances relating to the economic arrangement of the partners."[837] As a result, if an FLP has pro rata shares (as is common), and no partner has made a contribution of property to the partnership, then nonrecourse debt will also be shared pro rata. The partnership agreement may specify the partners' interests in partnership profits so long as the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain (often referred to as the "significant item" method). Alternatively, excess nonrecourse liabilities may be allocated among partners in a manner that deductions attributable to those liabilities are reasonably expected to be allocated (often referred to as the "alternative" method). Additionally, the partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on section 704(c) property[838] or property for which reverse section 704(c) allocations are applicable[839] where such property is subject to the nonrecourse liability, to the extent that such built-in gain exceeds the gain described in section 1.752-3(a)(2) of the Treasury Regulations with respect to such property (often referred to as the "additional" method).

n. As discussed earlier in these materials, for disguised sale rule purposes only, a partner's share of partnership liabilities, whether recourse as to that partner or

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[833] Treas. Reg. § 1.752-2(d)(1).

[834] Treas. Reg. § 1.752-3(a)(1).

[835] Treas. Reg. § 1.752-3(a)(2).

[836] Treas. Reg. § 1.752-3(a)(3).

[837] *Id.*

[838] As defined under section 1.704-3(a)(3)(ii) of the Treasury Regulations.

[839] As described in section 1.704-3(a)(6)(i) of the Treasury Regulations.

nonrecourse,[840] is determined solely under the profit share provision.[841] The significant item method, alternative method, and additional method are unavailable for this purpose.[842]

3. 2016 Proposed Regulations

a. As mentioned above, the 2014 Proposed Regulations sought to amend not only the disguised sale rules under section 707 but also made significant changes to the sharing of partnership recourse and nonrecourse liabilities under section 752. The 2014 Proposed Regulations took a much more fact-specific approach providing that a partner will be treated as having the economic risk of loss only if there is a significant possibility that the partner will have to a pay a partnership liability and that the partner will have enough net worth to pay the liability with his or her own assets. If both of those conditions do not exist, then the partnership liability will be allocated to all of the partners as a nonrecourse liability. As with the previous regulations, the determination of the extent to which a partner or related person has an obligation to make a payment is based on the facts and circumstances, except that under the proposed Treasury Regulations, the obligation will not be recognized if it fails any of "recognition requirements."[843]

b. The recognition requirements were:[844]

(1) The partner or related person is:

(a) Required to maintain a commercially reasonable net worth throughout the term of the payment obligation; or

(b) Subject to commercially reasonable contractual restrictions on transfers of assets for inadequate consideration.

(2) The partner or related person is required periodically to provide commercially reasonable documentation regarding the partner's or related person's financial condition.

(3) The term of the payment obligation does not end prior to the term of the partnership liability.

(4) The payment obligation does not require that the primary obligor or any other obligor with respect to the partnership liability directly or indirectly hold money or other liquid assets in an amount that exceeds the reasonable needs of such obligor.

(5) The partner or related person received arm's length consideration for assuming the payment obligation.

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[840] Treas. Reg. § 1.707-5T(a)(2)(i) and (f), *Ex. 2*, and T.D. 9788.

[841] Treas. Reg. § 1.707-5T(a)(2)(ii) and T.D. 9788.

[842] Treas. Reg. § 1.752-3(a)(3) and T.D. 9787.

[843] § 1.752-2(b)(3) of the 2014 Proposed Regulations.

[844] Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(A)-(G).

(6) In the case of a guarantee or similar arrangement, the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied.

(7) In the case of an indemnity, reimbursement agreement, or similar arrangement, the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the indemnitee's or other benefitted party's payment obligation is satisfied.

c. In addition to the recognition factors, the 2014 Proposed Regulations would have effectively eliminate the deemed satisfaction rule for partners (other than individuals and estates of decedents). While it is still assumed that all partners and related persons who have obligations to make payments actually preform those obligations, a payment obligation is recognized only to the extent of the net value of the partner or related person.[845] A partner or related person's net value is determined under section 1.752-2(k) of the Treasury Regulations that determine the net value of disregarded entities.

d. In response to comments to the 2014 Proposed Regulations, the IRS withdrew the proposed regulations under section 1.752-2 in 2016 and propose to move the recognition factors (other than those concerning bottom-end/bottom-dollar arrangements[846]) to an anti-abuse rule under section 1.752-2(j) (the "2016 Proposed Regulations). [847] Pursuant to the 2016 Proposed Regulations, an obligation of a partner (or related person) to make a payment will not be recognized if "the facts and circumstances evidence a plan to circumvent or avoid the obligation."[848] The list of non-exclusive list of factors[849] that may indicate a plan to circumvent or avoid the payment obligation (other than an obligation to restore a deficit capital account upon liquidation of a partnership) include:[850]

(1) The partner (or related person) is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment, including, restrictions on transfers for inadequate consideration or on distributions by the partner (or related person) to equity owners in the partner (or related person).

(2) The partner or related person is not required to provide (either at the time the payment obligation is made or periodically) commercially reasonable documentation regarding the partner's (or related person's) financial condition.

(3) The term of the payment obligation ends prior to the term of the partnership liability, or the partner (or related person) has a right to terminate its payment obligation, if the purpose of limiting the duration of the payment obligation is to terminate such

[845] § 1.752-2(b)(3)(iii) of the 2014 Proposed Regulations.

[846] As mentioned earlier in these materials, these are addressed in the temporary regulations under section 752 of the Code.

[847] REG-122855-15 (October 5, 2016).

[848] Prop. Treas. Reg. § 1.752-2(j)(3)(i).

[849] Determined at the time the partner or related person makes the obligation or the obligation is modified. *See* Prop. Treas. Reg. § 1.752-2(j)(3)(ii).

[850] Prop. Treas. Reg. § 1.752-2(j)(3)(ii).

payment obligation prior to the occurrence of an event or events that increase the risk of economic loss to the guarantor or benefited party.[851]

(4) There exists a plan or arrangement in which the primary obligor or any other obligor (or a person related to the obligor) with respect to the partnership liability directly or indirectly holds money or other liquid assets in an amount that exceeds the reasonable foreseeable needs of such obligor.

(5) The payment obligation does not permit the creditor to promptly pursue payment following a payment default on the partnership liability, or other arrangements with respect to the partnership liability or payment obligation otherwise indicate a plan to delay collection.

(6) In the case of a guarantee or similar arrangement, the terms of the partnership liability would be substantially the same had the partner or related person not agreed to provide the guarantee.

(7) The creditor or other party benefiting from the obligation did not receive executed documents with respect to the payment obligation from the partner or related person before, or within a commercially reasonable period of time after, the creation of the obligation.

e. The 2016 Proposed Regulations include an example of a gratuitous guarantee by a partner that would be disregarded, thereby causing the partnership liability to be nonrecourse debt (not recourse as to the guarantor partner):[852]

> In 2016, A, B, and C form a domestic limited liability company (LLC) that is classified as a partnership for federal tax purposes. Also in 2016, LLC receives a loan from a bank. A, B, and C do not bear the economic risk of loss with respect to that partnership liability, and, as a result, the liability is treated as nonrecourse under §1.752-1(a)(2) in 2016. In 2018, A guarantees the entire amount of the liability. The bank did not request the guarantee and the terms of the loan did not change as a result of the guarantee. A did not provide any executed documents with respect to A's guarantee to the bank. The bank also did not require any restrictions on asset transfers by A and no such restrictions exist.

The example concludes the facts and circumstances evidence a plan to circumvent or avoid the payment obligation pointing to the following factors: (i) the partner is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment; (ii) the partner is not required to provide (either at the time the payment obligation is made or periodically) commercially reasonable documentation regarding the partner's or related person's financial condition to the benefited party; (iii) in the case of the guarantee, the terms of the liability are the same as they would have been without the guarantee; and (iv) the creditor did not receive executed documents with respect to the payment obligation from the partner at the time the obligation was created.

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[851] For example, termination prior to the due date of a balloon payment or a right to terminate that can be exercised because the value of loan collateral decreases. Prop. Treas. Reg. § 1.752-2(j)(3)(ii)(C).

[852] Prop. Treas. Reg. § 1.752-2(j)(4), *Ex. 1*.

4. 2017 Treasury Action under Executive Order 13789

a. As mentioned above in the disguised sale rule section, the Secretary of the Treasury published its second report to the Executive Order 13789. It generally confirmed that the temporary regulations regarding bottom-dollar guarantees will be retained, but that certain proposed and temporary regulations regarding how liabilities are allocated for disguised sale treatment may be revoked.

b. The second report also states, "Treasury and the IRS are reviewing and considering ways to rationalize and lessen the burden of partnership tax regulations governing liabilities and allocations more generally. In their review, Treasury and the IRS will take into account the ways in which the rules under different sections of the Internal Revenue Code interact, and may propose further changes to the relevant liability or allocation regulations."[853]

H. Loss of Grantor Trust Status with Partnership Liabilities

1. Because grantor trust status will be terminated on the death of the grantor or "turned off" by the release of the power causing grantor trust status, [854] changing trustees,[855] or repayment of borrowed trust assets,[856] taxpayers must deal with having a trust that will ultimately be considered a separate taxable entity, a non-grantor trust. In the context of partnerships, this normally does not cause adverse tax consequences, but if there is partnership debt, it can, under certain circumstances, trigger gain.

2. As mentioned above, if grantor trust status is terminated during the lifetime of the grantor, a transfer is deemed to occur, and the grantor may recognize gain to the extent the amount the IDGT may owe to the grantor (installment obligation) exceeds the grantor's basis in the assets. For this reason, practitioners advise against terminating grantor trust status while the debt is still outstanding and advise clients to pay off the debt prior to the death of the grantor if at all possible.

3. Gain can also result if grantor trust status is renounced and, due to the creation of a new taxpayer (the trust), it results in a reduction of partnership liabilities of the grantor or the IDGT. Outside basis of the partnership would no longer be calculated across all of the partnership interests and would thus be determined separately. If all of the partnership liabilities are nonrecourse, then no net reduction should occur to either the grantor or the trust. However, if the grantor had guaranteed some partnership debt thereby making such debt recourse as to the grantor, then the loss of grantor trust status would result in a net reduction of partnership liabilities with respect to the trust partner and a deemed distribution on the partnership shares owned by the trust. If there is insufficient outside basis in the trust shares, capital gain would be recognized by the trust.

4. The IRS has ruled that when the grantor of a grantor trust that holds a partnership interest that is subject to liabilities renounces grantor trust status, the grantor is treated as transferring the partnership interest to the trust. When the interest transferred is a

[853] Second Report under Executive Order 13789, p. 6.

[854] *E.g.*, § 675(4)(C) power.

[855] *E.g.*, § 674(c) power.

[856] *See* § 675(c).

partnership interest and the grantor's share of the partnership liabilities is reduced, the grantor is treated as having sold the partnership interest for an amount equal to the grantor's share of the reduced liabilities.[857]

5. The Treasury Regulations also provide that if a taxpayer creates a grantor trust which purchases a partnership interest and the grantor later renounces grantor trust status, then the taxpayer is considered to have transferred the partnership interest to the trust. The taxpayer's share of liabilities that are eliminated as a result of the transfer are considered part of the amount realized for income tax purposes.[858]

6. The loss of grantor trust status due to the death of the grantor should not result in a reduction of partnership liabilities with respect to the IDGT. If anything, it may result in an increase of such liabilities and an increase in basis if the partnership had recourse debt as to the grantor.

I. Basis Issues with Transfers of Partnership Interests

1. Generally

a. When a donor makes a gratuitous transfer of a partnership interest to a donee, even if the donee is not a deemed to be the donor for income tax purposes (e.g., a grantor trust of the donee), generally no gain or loss is recognized on the transfer.[859] The donee has the donor's basis in the interest received, increased by any gift tax paid.[860] The transferred basis is, however, limited to fair market value of the partnership interest, for purposes of determining a loss.[861] Given the foregoing limitation with respect to losses, valuation discounts could, in fact, limit the ability of the donee to recognize a portion of a subsequent loss. In such cases, the partner might be better off having received distributions of partnership assets in-kind and selling such assets, rather than selling the partnership interest itself. The tax difference between selling a partnership interest and selling distributed assets is discussed in more detail later in this outline.

b. If the donor transfers only a portion of his or her partnership interest, only a portion of the donor's unitary outside basis is transferred. One would assume that a pro rata portion of the donor's outside basis would also be transferred to the donee. In other words, if a donor owns a partnership interest having an outside basis of $100 and the donor gifts 55% to a donee (who is not a grantor trust), then the donee will now own a partnership interest with an outside basis of $55. Surprisingly, that may not be the case.

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[857] Rev. Rul. 77-401, 1977-2 C.B. 215.

[858] Treas. Reg. § 1.1007-2(c), Ex. 5. *See also* TAM 200011005.

[859] This assumes that the transfer is not considered a part sale/part gift transfer. Gain, possibly ordinary income under section 751(a) of the Code, but not loss, may be recognized with a part sale/part gift, but only when the sale price exceeds the outside basis of the partnership interest. *See* § 751(a) and Rev. Rul. 60-351, 1960-2 C.B. 169 (gift accelerated gain on an installment obligation). The sale price would be deemed to include any partnership liabilities deemed to have been transferred. *See* § 752(d), Rev. Rul. 77-402, 1977-2 C.B. 222 (grantor trust converting to a taxable trust), and *Madorin v. Commissioner*, 84 T.C. 667 (1985).

[860] § 1015(d).

[861] § 1015(a).

c. In Revenue Ruling 84-53,[862] the IRS ruled in the context of calculating outside basis of a transferred partnership interest, "the basis of the transferred portion of the interest generally equals an amount which bears the same relation to the partner's basis in the partner's entire interest as the fair market value of the transferred portion of the interest bears to the fair market value of the entire interest."[863] Under this calculation, if the gift of the 55% partnership interest carries a valuation discount (which it should since that reflects fair market value), then the 55% interest would actually transfer less than $55 of basis.

d. For example, assume a donor has a partnership interest that has a fair market value of $200 (the value represents a controlling interest in the partnership but reflects some discounts for lack of marketability) and an outside basis of $100. The donor gifts 45% of his or her partnership interest to a donee. Assume further that 45% transfer carries a valuation discount of 30%. As a result the gift tax value (fair market value) of the transfer is $63 (reflecting a 30% discount on an interest which has a value before the discount of $90). Under the formula of Revenue Ruling 84-53, the transferred interest has a fair market value of $63, and the fair market value of the entire interest is $200, resulting in only 31.5% of the donor's original basis having been transferred ($63/$200). After the transfer, the donee owns 45% of the partnership interest with an outside basis of $31.50, and the donor retains 55% of the partnership interest but has an outside basis of $68.50.

$$\text{Transferor's Adjusted Basis } \$100 \times \frac{\text{Fair Market Value (Discounted) Transferred Portion } \$63}{\text{Fair Market Value Transferor's Entire Portion } \$200} = \text{Transferee's Adjusted Basis } \$31.50$$

It should be noted, that had the valuation of the donor's interests prior to the transfer included the same valuation discount (30%), then the foregoing formula would have resulted in $45 of basis apportioned to the transferred interests (a proportionate percentage). It's the fact that the value of the transferor's entire portion has no (or less) valuation discount that causes the "distortion."

e. Many practitioners are surprised by this result, and some have contended that Revenue Ruling 84-53 is not applicable to gratuitous transfers. [864] It is true that Revenue Ruling 84-53 dealt exclusively with the taxable sale of a partnership interests. The ruling also assumed that there was no discount in value of limited versus general partnership

[862] Rev. Rul. 84-53, 1984-1 C.B. 159.

[863] *Id.* The ruling relies on Treasury Regulation § 1.61-6(a) which provides that when a part of a larger property is sold, the basis of the entire property shall be equitably apportioned among the several parts for purposes of determining gain or loss on the part sold.

[864] *See* Ellen K. Harrison and Brian M. Blum, *Another View: A Response to Richard Robinson's "'Don't Nothing Last Forever'--Unwinding the FLP to the Haunting Melodies of Subchapter K,"* 28 ACTEC J. 313 (2003). In support of their assertion, the authors cite Treasury Regulation section 1.743-1(f) that states, "in the case of the gift of an interest in a partnership, the donor is treated as transferring and the donee is treated as receiving, that portion of the [section 743] basis adjustment attributable to the gifted partnership interest." *But see* Richard B. Robinson, *Comments on Blum's and Harrison's "Another View,"* 28 ACTEC J. 318 (2003).

interests.[865] This fact may have been the reason why an "equitable apportionment" of basis was done on the basis of the fair market value of the interest conveyed to the transferor's entire uniform basis. To the extent a discount is involved, transferring a lower amount of basis increases gain. In addition, in the case of gifts, allowing discounts to affect the amount of basis conveyed allows manipulation, as later described in this outline. There are some reasons why the basis apportionment rule may be different for gratuitous transfers, including sales to grantor trusts that can be interpreted as gifts for income tax purposes.

f. On the other hand, sales to grantor trusts are structured to be bona fide sale transactions that are nonetheless ignored for income tax purposes. The Code defines the amount of gain as "the excess of the amount realized therefrom over the adjusted basis."[866] The amount realized is "the sum of any money received plus the fair market value of the property (other than money) received."[867] Since the amount realized is based on fair market value, it makes perfect sense that the basis of the transferred property (the partnership interest) would also be apportioned based on the fair market value of the property. Similarly, estate, gift, and generation-skipping transfer taxes are based on the "value" of the property transferred, sometimes defining the same in terms of "money or money's worth."[868] Value, for these purposes, is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. Most would agree that this valuation standard for transfer tax purposes is the same as it would be in determining the amount realized for income tax purposes. Thus, there may be some basis for apportioning tax basis of gifted property by referencing the fair market value (including applicable valuation discounts) of the property.

g. Some commentators argue that Revenue Ruling 84-53 specifically refers to section 1.61-6(a) of the Treasury Regulations which provides, "When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts." They argue that "equitably apportioned" should be interpreted to mean that when a partner transfers 45% of his or her partnership interest, then 45% of the partner's outside basis should "equitably" pass to the transferee.[869] This produces the same result as in Rev. Rul. 84-53 where it was assumed that general and limited partnership interests had the same value regardless of any differences in right to vote and right to liquidate the partnership. A question arises as to the correct result if (i) all of the partnership interests do not have identical voting rights and economic rights to profits, distributions, and partnership capital, and (ii) if there are limitations or restrictions on a partner's ability to immediately receive his or her

[865] Situation 2 in the ruling involved a transfer by A of one half of A's general partnership interest and Situation 3 in the ruling involved a transfer by A of A's limited partner interest. Both transfers involved a sale of 1/3 of A's economic interest in the partnership and both were valued at $10x. Moreover, the ruling misquotes Treas. Reg. § 1.61-6(a) on which it relies. The regulation does not provide that "the basis of the transferred portion of the interest generally equals an amount which bears the same relation to the partner's basis in the partner's entire interest as the fair market value of the transferred portion of the interest bears to the fair market of the entire interest." The regulation says that "when a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts…"

[866] § 1001(a).

[867] § 1001(b).

[868] *See* §§ 2031, 2512 and 2642

[869] *See* Richard B. Robinson, *Comments on Blum's and Harrison's "Another View,"* 28 ACTEC J. 318 (2003) where he correctly points out that "The term 'equitably apportioned' has been consistently interpreted to mean 'divided according to the fair market value of the separate parts.'"

proportionate share of the fair market value of the partnership's business and assets. What apportionment is equitable where there are differences in partners' rights?

h. To illustrate why fair market value may be an appropriate way of apportioning outside basis, consider a partnership that holds assets and other underlying business interests having a value of $10 million.

(1) Scenario 1: The partnership agreement provides for 2 classes of interests: 50 units of Class A-Voting and 50 units of Class B-Non-Voting. The partnership agreement provides that each unit, whether voting or non-voting, is entitled to a pro rata allocation of all profits and partnership distributions, and the partnership will be liquidated according to capital accounts upon the unanimous vote of all of the Class A holders. Donor owns 50 units of Class A, and 50 units of Class B. Assume, Donor's spouse owns a small interest of Class B, but such interest and its share of partnership capital is ignored for purposes of simplicity (thus, the entity is a partnership for tax purposes, not a disregarded entity). Donor's unitary capital account is $10 million, and the outside basis of the of the Donor's units is $8.0 million. Assume that the Class B units are entitled to a 30% valuation discount. If Donor gifts 50 units of Class B (50% of Donor's units, having a fair market value of $3.5 million), then the transferee will receive $5 million of capital account.

(a) With regard to basis, if one follows Revenue Ruling 84-53, the transferee will succeed to $2.65 of basis (with donor retaining $5.35 million of basis), as follows:

$$\underset{\$8{,}000{,}000}{\text{Transferor's Adjusted Basis}} \times \frac{\text{Fair Market Value (30\% Discount) Transferred Portion } \$3{,}500{,}000}{\underset{\$10{,}000{,}000}{\text{Fair Market Value Transferor's Entire Portion}}} = \underset{\$2{,}650.000}{\text{Transferee's Adjusted Basis}}$$

(b) If one ignores the ruling and apportions basis proportionately (the same way capital account is apportioned), then the transferee would succeed to $4.0 million of basis (50% of the Donor's total basis):

$$\underset{\$8{,}000{,}000}{\text{Transferor's Adjusted Basis}} \times \underset{50\%}{\text{Percentage Transferred}} = \underset{\$4{,}000{,}000}{\text{Transferee's Adjusted Basis}}$$

(c) If an independent third party purchased the 50 Class B-Non-Voting units from the transferee for cash, the purchaser would not pay $5.0 million (because the units have no voting rights and are unmarketable). It would presumably pay $3.5 million for the Class B units. Under Revenue Ruling 84-53, the seller would recognize $850,000 of gain. On the other hand, if the proportionate rule for basis is used then the seller would actually recognize a $500,000 of loss, which does not seem reasonable since the transferor held appreciated partnership interest before the gift.[870] However, as shown in the example below

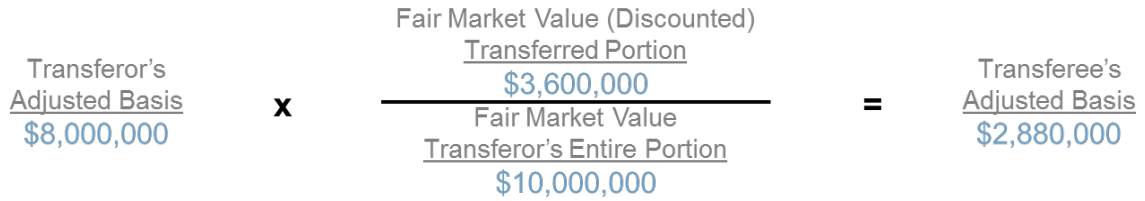
[870] While not applicable under these facts, if the purchaser had to make a purchase price allocation under section 1060 of the Code (to determine tax liability of the seller and to determine the new basis of the purchased business assets), the Code mandates that the price allocated to an asset may not be more than the fair market value (willing buyer/willing seller) of such asset.

discussing the possible use of incomplete gift non-grantor trusts, if the sequence of transfers is changed, the same artificial loss is possible. Similarly, there could be an "artificial" loss if basis was allocated based on relative fair market values and shortly thereafter the partnership was liquidated and distributions were made in accordance with capital accounts. The transferee who had a basis in her interest that was higher than her share of capital accounts might realize a loss, assuming that cash or assets treated as cash were distributed so that the substituted basis rules did not apply to the liquidation.

(2) Scenario 2: The partnership agreement provides for 2 classes of interests: 100 units of Class A Preferred-Voting and 100 units of Class B Common-Non-Voting. The partnership agreement provides the Class A Preferred units have a liquidation preference of $4.0 million and an annual cumulative preferred yield of 12%, and the Class B Common units are entitled to any excess profits or return on the partnership assets after taking into account the economic rights of Class A. Donor owns 100 units of Class A, and 100 units of Class B. Assume, Donor's spouse owns a small interest of Class B, but such interest and its share of partnership capital is ignored for purposes of simplicity (thus, the entity is a partnership for tax purposes, not a disregarded entity). Donor's unitary capital account is $10 million, and the outside basis of the of the Donor's units is $8.0 million. Assume that the Class B units are entitled to a 40% valuation discount. If Donor gifts 100 units of Class B (fair market value of $3.6 million), then the transferee will receive $6.0 million of capital account (because a liquidation of the partnership at the time of the transfer would limit the Class A units to $4.0 million of partnership property). How should the outside basis be "equitably" apportioned to the transferred Class B units? The Class A and Class B do not have identical economic rights to partnership property, profits, and distributions (not to mention Class A has voting rights and Class B does not).

(a) One option is to apportion the basis according to capital accounts, so $4.8 million (60% of the $8 million of outside basis) will pass to the transferee of the Class B units. However, that again presumes that Class A and Class B have identical economic rights under the partnership agreement. They do not. While the holders of Class B may have $6.0 million of capital account, they do not have the right to liquidate the partnership. Further, consider that the 12% cumulative preferential distribution might have been gifted when preferred rates are much lower. Said another way, given how high the Class A preferential rate is, there is a chance that all partnership profits (and perhaps partnership property) will be needed to satisfy the 10% preferred distribution. Based on these facts, apportioning according to capital account balances does not seem reasonable.

(b) The only methodology that takes into account the different economic rights of the Class A and Class B holders and the market conditions at the time of the transfer is to apportion according to fair market values. As mentioned above, the gifted Class B shares are valued at $3.6 million. Prior to the transfer, the Donor had the right to liquidate the partnership, so the Donor's Class A and Class B units are worth $10 million (all of the assets in the partnership) prior to the transfer. It should be noted that this doesn't necessarily mean that the Class A units are worth $6.4 million (a 60% premium over the $4.0 million liquidation preference) but $10 million is the value that a third-party purchaser would pay for all of Donor's units prior to the gift. Pursuant to Revenue Ruling 84-53, the transferred basis allocated to Class B is $2.88 million:



2. Estate Planning Implications

a. The income and estate planning implications are significant. In the example above, the result is the donor retains a disproportionate amount of the basis, and the donee receives less. If the donee is in a lower income tax bracket or resides in a state (or is a resident non-grantor trust of such state) that has no state income tax and if the donor is in a higher income tax situation, a taxable event like the sale of the partnership interests (or the sale of the assets of the partnership followed by a distribution of the assets) would generally result in less taxes to be paid when compared to having the donor be the sole taxpayer. In addition, if the donee is near death, then holding a lower basis asset provides more potential for a "step-up" in basis.

b. Often, however, the donor is in the senior generation and is wealthier than the donee. Under those circumstances, how can this distortion in basis be used, assuming it would be preferred that the donor retain less basis (for a potential "step-up" in basis) and the donee receive more basis. Consider the following:

(1) As in the first example in the previous section, donor owns a partnership interest that has a fair market value of $200 and an outside basis of $100. Transfers of minority interest in the partnership are entitled to a 30% valuation discount.

(2) The donor transfers a 45% interest to a DING, NING, or other incomplete gift non-grantor trust.[871] A properly structured incomplete gift non-grantor trust has the following features:

(a) The trust not a grantor trust (although the grantor is a permissible beneficiary of the trust);

(b) Contributions to the trust by the grantor are not completed gifts for Federal gif tax purposes; and

(c) The assets of the trust are includible in the grantor's gross estate upon the grantor's death, although the corpus is subject to a testamentary special power of appointment held by the grantor.

(3) After the initial transfer to the incomplete gift non-grantor trust, the donor gifts the remainder of his or her partnership interests (55% interest) to an IDGT.

(4) For basis purposes, based on Revenue Ruling 84-53, the non-grantor trust (the assets of which will be includible in the estate of the donor at death) has a

[871] The same result could be achieved if the donor transfers the interest to the donor's spouse although in that case the basis adjustment would occur, of course, on the spouse's death rather than the death of the grantor. *See* § 1041(b).

partnership interest with an outside basis of $31.50 (although representing 45% of the donor's interest). The IDGT (the assets of which are not includible in the donor's estate), on the other hand, has a partnership interest with an outside basis of $68.50 (representing 55% of the donor's interest). Thus, a disproportionate amount of basis ends up passing with the partnership interest that is out of the donor's estate, while the partnership interest that remains in the estate is poised to get a disproportionately large "step-up" in basis (particularly, if as discussed above, certain measures are taken to reduce or eliminate the valuation discounts attributable to the partnership interest in the non-grantor trust).

J. Capital Accounts and Estate Planning

1. Generally

a. One of the central concepts in partnership taxation is each partner's "capital account." The capital account maintenance rules are not based on generally accepted account principles but are based on the Treasury Regulations under section 704(b) of the Code.

b. By way of example, in order to ensure the validity of a partnership's allocation of tax items, many partnership agreements are written to satisfy the "substantial economic effect" test,[872] which requires (i) that the allocations must have economic effect, and (ii) the economic effect must be substantial. In order for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. According to the Treasury Regulations, this means "in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden."[873] The economic effect of an allocation will be deemed substantial if there is a reasonable probability that the allocation will affect substantially the dollar amount to be received by the partners from the partnership, independent of the tax consequences.[874]

c. The "safe harbor" Treasury Regulations provide that allocations will have economic effect if:[875]

(1) The partnership maintains capital accounts under section 1.704-1(b)(2)(iv) of the Treasury Regulations;

(2) Upon liquidation of the partnership (or any partner's interest in the partnership), liquidating distributions are required to be made in accordance with the positive capital account balances of the partners; and

(3) Either:

(a) Each partner is unconditionally obligated to restore any deficit in such partner's capital account on liquidation of the partnership; or

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[872] Treas. Reg. § 1.704-1(b)(2)(i).

[873] Treas. Reg. § 1.704-1(b)(2)(ii)(*a*).

[874] Treas. Reg. § 1.704-1(b)(2)(iii).

[875] Treas. Reg. § 1.704-1(b)(2)(ii)(*b*). In addition, allocations that are attributable to property secured by nonrecourse debt required to comply with additional requirements.

(b) The partnership agreement has a "qualified income offset" provision.[876]

d. If allocations do not fall under the foregoing safe harbor provisions, they will be deemed to have economic effect provided that as of the end of each partnership taxable year, a liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic results to the partners as would occur if the foregoing requirements above had been satisfied. This is referred to as the economic effect equivalence.[877] This would be similar to an approach that some partnerships employ called "targeted allocations." Targeted allocations assume a hypothetical liquidation at the end of each accounting period where it is determined what each partner would receive if all of the partnership assets are sold for cash as each asset is valued under section 704(b) of the Code. The hypothetical cash proceeds are distributed in liquidation of the partnership under the distribution provisions of the partnership agreement. Once that amount is determined, each partner is allocated section 704(b) profits and losses so that the partner's capital account balance at the end of the period is equal to the amount of cash the partner would have received in the hypothetical liquidation. The IRS has not formally blessed targeted capital account allocations as qualifying under the economic effect equivalence rule.[878]

e. If the partnership agreement does not address allocations or the allocation do not have substantial economic effect, allocations will be made according to each partner's economic interest in the item of income or deduction, based on the facts and circumstances (referred to as the "partner's interest in the partnership" or "PIP").[879] In determining the PIP, the Treasury Regulations point to the partner's capital contributions to the partnership and the partner's interest in the economic profits and losses (if different from his or her interest in the taxable income and losses), cash flow, non-liquidating distributions, and liquidating distributions of capital.[880] Generally, a PIP (and thus allocations hereunder) will be based on the amount the partner would receive if the partnership liquidated and distributed all of its assets.

f. In effect, the Treasury Regulations use a partner's capital account as a yardstick to measure the partner's economic interest in the partnership property at any given point and time. Stated simplistically, a partner's capital account reflects the amount of equity invested in the partners and is adjusted to reflect the ongoing profits and losses of the partnership.

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[876] *See* Treas. Reg. § 1.704-1(b)(2)(ii)(*d*). Generally, if a partner unexpectedly receives certain adjustments, allocations, or distributions (relating to depletion allowances, changes in the partner's interest in the partnership, a partnership loss related to section 751(b) property, or adjustments under the family partnership rules of section 704(e)(2) of the Code) and it causes a deficit capital account balance for the partnership, a qualified income offset provision will allocate as quickly as possible items of income and gain in an amount and manner sufficient to eliminate that deficit capital account balance.

[877] *See* Treas. Reg. § 1.704-1(b)(2)(ii)(*i*).

[878] *See* Treas. Reg. § 1.704-1(b)(2)(ii)(h)*(i)* and Proposed Treasury Regulations under section 707(a)(2)(A) of the Code, REG-11452-14, 80 Fed. Reg. 43,652 (July 23, 2015). The preamble requests comments on the impact of targeted allocations on certain allocations but then provides "[n]o inference is intended as to whether and when targeted capital account agreements could satisfy the economic effect equivalence rule."

[879] Treas. Reg. § 1.704-1(b)(3)(i).

[880] Treas. Reg. § 1.704-1(b)(3)(ii).

Thus, if the partnership is liquidated at some point, it reflects the amount the partner would receive upon liquidation of the partnership, assuming all partnership assets were disposed of at their book value.

g. A full discussion of the capital account maintenance rules is beyond the scope of this outline, but some discussion is warranted.

(1) Each partner's capital account is increased by:[881]

(a) The amount of money contributed to the partnership by the partner;

(b) The fair market value of property contributed to the partnership by the partner, net of any liabilities that the partnership assumes or takes subject to; and

(c) Allocations to the partner of items of partnership income and gain, including tax-exempt income.

(2) Each partner's capital account is decreased by:[882]

(a) the amount of money distributed by the partnership to the partner;

(b) the fair market value of property distributed by the partnership to the partner, net of any liabilities that the distributee partner assumes or takes the distributed property subject to; and

(c) allocations to the partner of items of partnership loss and deduction and partnership expenditures that are neither deductible by the partnership in computing its taxable income nor properly chargeable to capital account.

(3) Partnership agreements may provide that the partner's capital accounts will be adjusted to reflect a revaluation of partnership property, but such adjustments must be based on the fair market value of the partnership's properties (assuming for these purposes that the value of the property is not less than any indebtedness on the property) and must reflect the manner in which gain or loss (not previously reflected in capital account balances) would be allocated to the partnership if each partnership property were sold at its fair market value in a taxable transaction.[883] The adjustments are deemed to be made principally for a substantial non-tax business purpose under the following circumstances:[884]

(a) in connection with a contribution of money or property to the partnership by a new or existing partner in exchange for an interest in the partnership;

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[881] Treas. Reg. § 1.704-1(b)(2)(iv)(*b*).

[882] *Id.*

[883] Treas. Reg. § 1.704-1(b)(2)(iv)(*f*)(*1*) and (*2*).

[884] Treas. Reg. § 1.704-1(b)(2)(iv)(*f*)(*5*).

(b) in connection with the liquidation of the partnership or a distribution of money or other property by the partnership to a retiring or continuing partner as consideration for an interest in the partnership;

(c) in connection with the grant of an interest in the partnership, as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner;

(d) in connection with the issuance by the partnership of a non-compensatory option; or

(e) under generally accepted industry accounting practices, provided substantially all of the partnership's property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market.

h. The Treasury Regulations provide, "a partner who has more than one interest in a partnership shall have a single capital account that reflects all such interests, regardless of the class of interests owned by such partner (e.g., general or limited) and regardless of the time or manner in which such interests were acquired." [885] This one capital account rule presumably would apply if the partner held preferred and common interests in a partnership and would apply if the partner is deemed to own interests held by an IDGT pursuant to Revenue Ruling 85-13.[886]

2. Capital Accounts and Transfers of Partnership Interests

a. The Treasury Regulations provide that "upon the transfer of all or a part of an interest in the partnership, the capital account of the transferor that is attributable to the transferred interest carries over to the transferee partner."[887] The Treasury Regulations contain a simple example[888] pursuant to which a partner sells half of the partner's interest in a general partnership (representing a 25% interest in the partnership) for $10,000. At the time of the transfer, the general partnership held $40,000 in cash and securities, and the transferring partner's capital account prior to the transfer was $11,000. The example provides, in accordance with the Treasury Regulations "the partnership agreement provides" the transferee "inherits 50 percent of"[889] the transferor's capital account balance. Thus, the transferee inherits a capital account of $5,500. In other words, the Treasury Regulations seem to take the position that the portion of the transferor's capital account that carries over to the transferee equals the percentage of the transferor's total interest that is sold. In other words, when only a portion of a partner's interest is transferred and the partnership is a pro rata partnership, then the amount of capital account carried over to the transferee is in direct proportion to the amount transferred and retained. Thus, for example, if the transferor's capital account was $200 prior to the transfer and the transferor

[885] Treas. Reg. § 1.704-1(b)(2)(iv)(*b*).

[886] *See* Rev. Rul. 85-13, 1985-1 C.B. 184.

[887] Treas. Reg. §§ 1.704-1(b)(2)(iv)(*l*) and 1.704-1(b)(5), ex. 13.

[888] Treas. Reg. § 1.704-1(b)(5), Ex. 13.

[889] *Id.*

transferred (by gift or sale) 45% of his or her interest, then $90 of capital account carries over to the transferee:

Transferor's Capital Account	x	Percentage Transferred	=	Transferee's Capital Account
$200		45%		$90

b. As mentioned in the above, however, this is not how the calculation of transferred outside basis is calculated under Revenue Ruling 84-53.[890] In this example, assume the donor's partnership interest has a fair market value of $200 (for simplicity's sake, assume the fair market value is equal to the transferor's capital account) and an outside basis of $100. When the transferor transfers 45% of his or her partnership interest and if the transfer carries a valuation discount of 30% (discounted value of $63.00), then only $31.50 of outside basis is deemed to have been transferred (not $45.00), as follows:

Transferor's Adjusted Basis	x	Fair Market Value (Discounted) Transferred Portion / Fair Market Value Transferor's Entire Portion	=	Transferee's Adjusted Basis
$100		$63 / $200		$31.50

Clearly, this will have a direct impact on the gain recognized by the transferor if the transfer is a taxable sale and if the transfer is a gift, the amount of basis carried over to the donee.

c. The calculation of transferred capital account is straightforward when dealing with a partnership that has only one class of partnership interest (each partner holds a static percentage of the profits, losses, and capital of the partnership). However, it becomes more complicated when dealing with partnerships that have multiple classes of interests (e.g., preferred and common interests or profits and capital interests). For example, if a partner contributes $100 to a partnership, in exchange for 10% of the future profits of the partnership and 10% of the capital of the partnership, how much capital account would be transferred if the partner then made a gift of the profits interest but retained the right to receive a return of the capital upon liquidation of the partnership. It would seem in this situation that no capital account should pass to the donee and the donor would retain $100 of the capital account, notwithstanding the profits interest transferred might have significant value for gift tax purposes.[891] As the Treasury Regulations provide in the context of the family partnership provisions of section 704(e) of the Code, "a capital interest in a partnership means an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership. The mere right to participate in the earnings and profits of a partnership is not a capital interest in the partnership."[892] If no capital account is allocated to a transferred profits interest, should outside basis be allocated to it under Revenue Ruling 84-53 because it has some value?[893]

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[890] Rev. Rul. 84-53, 1984-1 C.B. 159.

[891] *See* CCA 201442053. *See also*, Richard Dees, *Is Chief Counsel Resurrecting the Chapter 14 "Monster,"* 145 Tax Notes 1279 (Dec. 15, 2014).

[892] Treas. Reg. § 1.704-1(e)(1)(v).

[893] For an excellent discussion of the complexities of identifying a partner's interest in profits and capital, *see* Sheldon I. Banoff, *Identifying Partners' Interests in Profits and Capital: Uncertainties, Opportunities and Traps*, 85 Taxes-The Tax Magazine 197 (March 2007).

3. Capital Accounts, Liquidations, and Redemptions

a. It's clear that capital accounts, when properly maintained, determine how much partnership property will be received by the partner upon liquidation of the partnership. However, it's not as clear how much property a partner should receive upon a complete or partial redemption of such partner's interest, particularly in the family and estate planning context.

b. If a partnership completely redeems a partner's interest, must the partner receive property equal in value to the partner's entire capital account balance or must the partnership distribute property equal in value to the fair market value of the interest, which might include significant discounts in value? What value should be distributed if it is a partial redemption, fair market value (including valuation discounts) or capital account balance (not including discounts)? The answer significantly affects the economics of many estate planning transfers. For example, assume a partnership owns property with a fair market value of $1,000,000. After a series of estate planning transfers, the partnership is owned 40% by the grantor and 60% by non-grantor trusts for the benefit of the grantor's children. If the partnership makes a full redemption of the grantor's interest at a discounted value (assume a 45% discount), then the grantor will receive $220,000, rather than $400,000. This redemption at discounted value creates a shift in value of $180,000 for the benefit of the non-grantor trusts.

c. Is this a taxable gift? How are the capital accounts of the remaining partners affected? If capital accounts are properly maintained, does a "capital shift" occur and what are the tax ramifications of that shift? As Sheldon Banoff writes, "a 'capital shift' occurs when one or more partners directly or indirectly give up their right to a portion of their capital interest to one or more other existing partners. As a result, the transferor partner's right to repayment of capital is reduced, while the transferee partner's right to capital increases. The meaning, relevance and impact of 'capital shifts in the analysis of partnership ownership realignments is far from clear."[894]

d. On the gift tax issue, the Treasury Regulations provide that a bona fide sale, exchange, or other transfer of property, in the ordinary course of business will not constitute a gift:

> Transfers reached by the gift tax are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefor. However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth.[895]

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[894] Sheldon I. Banoff, *Partnership Ownership Realignments via Partnership Reallocations, Legal Status Changes, Recapitalization and Conversions: What Are the Tax Consequences?*, 83 Taxes-The Tax Magazine 105 (March 2005).

[895] Treas. Reg. § 25.2512.8.

The courts have, however, held that if the transaction is between family members, special scrutiny is required, and the presumption is that the transfer is a gift.[896] The Treasury Regulations provide that if a corporation makes a transfer to shareholder B for less than full and adequate consideration, the other shareholders are deemed to have made a gift to B (but only to the extent it exceeds B's own interest in such amount as a shareholder). Further, a transfer by B to a corporation for less than full and adequate consideration will be treated as a gift by B to the other shareholders to the extent of their proportionate interests in the corporation.[897]

e. In this context, the courts have consistently held that fair market value is based on the willing buyer/willing seller standard, which necessarily requires consideration of valuation discounts and premiums when warranted by the facts and circumstances. For example, in *Estate of Mary D. Maggos v. Commissioner*,[898] the Tax Court held that a complete redemption of one of the shareholders of a closely held corporation for less than less than the fair market value of the stock was a gift by the redeemed shareholder to the sole remaining shareholder (the son of the redeemed shareholder). The Tax Court determined that the fair market value, after taking into account a control premium and a discount for lack of marketability (which were deemed to offset each other), of the redeemed stock was $4.9 million. Because the redeemed shareholder only received $3.0 million (in the form of a promissory note), the Tax Court held that the redeemed shareholder made a gift of $1.9 million to her son at the time of the redemption.

f. As noted above, the "safe harbor" rule for economic effect provides that all distributions must be made according to positive capital account balances upon a "liquidation of the partnership (or any partner's interest in the partnership)."[899] This would seem to imply that a complete redemption of a partner's interests requires a distribution of partnership property equal in value to the partner's capital account. However, the Treasury Regulations explain that the foregoing requirement is "not violated if all or part of the partnership interest of one or more partners is purchased (other than in connection with the liquidation of the partnership) by the partnership or by one or more partners … pursuant to an agreement negotiated at arm's length by persons who at the time such agreement is entered into have materially adverse interests and if a principal purpose of such purchase and sale is not to avoid the principles of"[900] the economic benefit principles (allocations must correspond with economic benefit or burden). The Treasury Regulations do not elaborate on what would be considered "materially adverse interests," though the phrase "sufficiently adverse interests" is used in the context of distributions of section 704(c) property, which requires valuation at "the price at which the property would change hands between a willing buyer and a willing seller at the time of the

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[896] *See Cavallaro v. Commissioner*, T.C. Memo 2014-189, *Harwood v. Commissioner*, 82 T.C. 238 (1984), *aff'd*, 786 F.2d 1174 (9th Cir. 1986) and *Estate of Reynolds v. Commissioner*, 55 T.C. 172 (1970).

[897] Treas. Reg. § 25.2511-1(h)(1). Also, if a shareholder makes a transfer to a corporation for less than full and adequate consideration, then the contributing shareholder is treated as having made a gift to the other shareholders.

[898] *Estate of Mary D. Maggos v. Commissioner*, T.C. Memo 2000-129. *See also, Kincaid v. U.S.*, 682 F.2d 1220 (1982) (deemed gift upon contribution of ranchland to a corporation for less valuable non-voting stock when there was no business reason for such contribution), *Senda v. Commissioner*, T.C. Memo 2004-160 (contribution of stock to family limited partnership and transfers of the interests were deemed gifts of the underlying stock), and *Trenchard v. Commissioner*, T.C. Memo 1995-121 (taxpayer's excess contributions to a corporation, not in the ordinary course of business, deemed a gift).

[899] Treas. Reg. § 1.704-1(b)(2)(ii)(*b*)(*2*).

[900] Treas. Reg. § 1.704-1(b)(2)(ii)(*b*) [last paragraph].

distribution" but which will be deemed correct if the "value is reasonably agreed to among the partners in an arm's-length negotiation and the partners have sufficiently adverse interests."[901]

g. Taken together, the foregoing would seem to imply that as long as the value distributed upon full (or partial) redemption is appropriately determined under the willing buyer/willing seller standard (which necessarily might include valuation discounts and premiums), then "arm's-length negotiation" and "materially adverse interests" can be deemed to exist. Thus, the value paid upon full redemption would necessarily be fair market value, not capital account value. If the value is greater or less than fair market value, the courts have consistently held that a taxable gift will result.

4. Example

a. The following example will provide an illustration of how tax basis and capital account would be calculated if a taxpayer gifted interests in a FLP and then later had his or her interest in the FLP fully redeemed (liquidated).

b. D formed Family, LLC by contributing $3 million of cash and an asset worth $7 million with zero basis. Assume for purpose of this example, Family, LLC is taxed as a partnership because a non-grantor trust contributed a nominal amount of property to the Family, LLC, but for purposes of this example the trust's ownership interest (and any interest it may have in any partnership property and any allocations relating to the same) is ignored. A qualified business appraiser has determined that D's interest has a fair market value of $10 million because it represents a controlling interest in the LLC and the resulting control premium negates any valuation discount due to lack of marketability. The adjusted tax bases and capital accounts are:

Partnership	**Inside Basis**	**§ 704(b) Book Value**
Cash	$3,000,000	$3,000,000
Appreciated Asset	$0	$7,000,000
TOTAL	***$3,000,000***	***$10,000,000***
Partners (Ownership %)	**Outside Basis**	**Book Capital Account**
D (100%)	$3,000,000	$10,000,000
TOTAL	***$3,000,000***	***$10,000,000***

c. D subsequently gifts 60% of the units to his two children, C1 and C2, in equal shares. At the time of the gift, the LLC owns the same $10 million in assets. A qualified business appraiser has determined that D's interest, after the transfer, has a fair market value of $2.2 million, and each child's interest is worth $1.65 million (45% valuation discount). The resulting tax bases and capital accounts are:

[901] "The fair market value of the distributed section 704(c) property is the price at which the property would change hands between a willing buyer and a willing seller at the time of the distribution, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. The fair market value that a partnership assigns to distributed section 704(c) property will be regarded as correct, provided that the value is reasonably agreed to among the partners in an arm's-length negotiation and the partners have sufficiently adverse interests." Treas. Reg. § 1.704-4(a)(3).

Partnership Assets	Inside Basis	§ 704(b) Book Value
Cash	$3,000,000	$3,000,000
Appreciated Asset	$0	$7,000,000
TOTAL	***$3,000,000***	***$10,000,000***
Partners (Ownership %)	**Outside Basis**	**Book Capital Account**
D (40%)	$2,010,000	$4,000,000
C1 (30%)	$495,000	$3,000,000
C2 (30%)	$495,000	$3,000,000
TOTAL	***$3,000,000***	***$10,000,000***

Note how, after the gift, capital accounts are in proportion to the ownership interests of the partners, but the outside bases are not. D's ownership interest retains 67% of the $3,000,000 of tax basis, and C1 and C2 each hold 16.5% of the original basis (33% in the aggregate). This is because the value of D's interest prior to the transfer was $10 million and the gift to the children was valued, in aggregate, at $3.3 million due to valuation discounts.

d. Assuming the same values, Family, LLC distributes $2.2 million (fair market value) to D in complete redemption of D's interest. Assuming this is the only transaction affecting basis and capital accounts since formation and gift, and also assuming the LLC has a section 754 election in place, the result of the redemption is as follows:

Partnership Assets	Inside Basis	§ 704(b) Book Value
Cash	$800,000	$800,000
Appreciated Asset	$190,000	$7,000,000
TOTAL	***$990,000***	***$7,800,000***
Partners (Ownership %)	**Outside Basis**	**Book Capital Account**
C1 (50%)	$495,000	$3,900,000
C2 (50%)	$495,000	$3,900,000
TOTAL	***$990,000***	***$7,800,000***

e. D recognizes $190,000 of gain on the redemption because the cash distributed is in excess of D's outside basis of $2,010,000 prior to the distribution.[902] As discussed later in these materials, the section 754 election provides an increase in the inside basis of partnership property in an amount equal to the amount of gain recognized to D under section 734(b)(1) of the Code. The basis increase is allocated under section 755 of the Code to the zero basis partnership asset (the only asset capable of receiving the basis increase since cash always has a basis equal to face value). Had there been no section 754 election in place, the basis of the appreciated asset would have remained at zero and the inside basis of all of the partnership property would be $800,000 but the outside bases of the partners would have been $990,000. The inside basis adjustment eliminates this discrepancy. Importantly, note how the capital account balances of C1 and C2 have been increased by $900,000 each. The cumulative effect of the redemption at fair market value creates an aggregate "capital shift" of $1.8 million in favor of the children.

[902] § 731(a)(1).

K. Section 754 Election and Inside Basis Adjustments

1. Generally

a. As discussed above, whether a partnership has a section 754 election in place has a direct bearing on the inside basis of the assets held by a partnership. Those adjustments to basis are made pursuant to section 743, when there is a sale or exchange of a partnership interest or a death of a partner occurs, and section 734, when there is a distribution to a partner.

b. Generally, the inside bases of partnership assets are not adjusted when a partnership interest is sold or exchanged, when a partner dies or when there is a distribution of property to a partners. These transactions can create discrepancies between inside and outside basis, which in turn can create distortions in the amount of income recognized and the timing of the income. For example, if a partner dies or a partner sells his or her partnership interest, the transferee partner will have a basis in the partnership interest equal to fair market value or the cost of the sale. If that basis is greater than the inside basis of the assets, when the partnership sells those assets, additional gain will be allocated to the transferee partner. Similarly, if a partnership makes a liquidating distribution to a partner for cash, and the partner recognizes gain as a result of that distribution because the partner's outside basis is less than the cash distributed, that gain essentially represents the liquidated partner's share of appreciation in the partnership. Absent an adjustment to inside basis, a subsequent sale of the partnership assets will result in that gain being allocated to the remaining partners. The adjustments under sections 743 and 734 attempt to adjust for those types of discrepancies. Adjustments can increase or decrease the inside basis of partnership property.

c. A section 754 election is generally made by the partnership in a written statement filed with the partnership return for the taxable year during which the transfer in question (sale, exchange, death or distribution) occurs.[903] Once the election is made, it applies to the year for which it is filed as well as all subsequent taxable years until and unless it is formally revoked.[904]

2. Basis Adjustments under Section 743(b)

a. Essentially, the inside basis adjustment under section 743(b) is the difference between the outside basis that the transferee partner receives against the transferee's share of inside basis. As such, adjustments under section 743(b) result in either:

(1) An increase in the transferee's share of partnership inside basis "by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property"[905] or

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[903] Treas. Reg. § 1.754-1(b)(1). Under certain circumstances, there is a 12-month extension past the original deadline. Treas. Reg. § 301.9100-2.

[904] § 754 and Treas. Reg. § 1.754-1(a). An election may be revoked if there exists: (i) a change in the nature of the partnership business; (ii) a substantial increase in or a change in the character of the partnership's assets; and (iii) an increase in the frequency of partner retirements or shifts in partnership interests (resulting in increased administrative costs attributable to the § 754 election). Treas. Reg. § 1.754-1(c)(1).

[905] § 734(b)(1).

(2) A decrease in the transferee's share of partnership inside basis "by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership."[906]

b. A transferee partner's proportionate share of the basis of the partnership property is the sum of the partner's previously taxed capital, plus the partner's share of partnership liabilities.[907] The partner's previously taxed capital is:[908]

(1) The amount of cash the partner would receive upon a hypothetical sale of all of the partnership assets (immediately after the transfer or death, as the case may be) in a fully taxable transaction for cash equal to the fair market value of the assets[909]; increased by

(2) The amount of tax loss that would be allocated to the partner on the hypothetical transaction; and decreased by

(3) The amount of tax gain that would be allocated to the partner on the hypothetical transaction.

c. Inside basis adjustments under section 743(b) do not change or affect capital accounts,[910] and because the adjustments only apply to the transferee, they are not made to the common basis of the partnership.[911] The partnership will compute its taxable income, gain, loss, and deduction without regard to the inside basis adjustments under section 743(b), and then allocate these amounts among all the partners under the principles of section 704(b) of the Code. At this point, the inside basis adjustments then come into consideration. The partnership will adjust the transferee partner's distributive share of income, gain, loss, and deduction to reflect the adjustments. For example, if the partnership sells an asset that has a basis adjustment, the amount of the adjustment will reduce or increase the transferee's distributive share of the gain or loss from the sale of the asset.[912] Also, If a positive adjustment is made to depreciable (or amortizable) property, then the adjustment will increase the transferee's share of depreciation (or amortization) from that property. In effect, the transferee is treated as if he or she purchased new property for a price equal to the adjustment.[913]

3. Basis Adjustments under Section 734(b)

a. Despite their similarities, there are a number of important distinctions between the inside basis adjustments upon a transfer of a partnership interest under section

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[906] § 734(b)(2).

[907] Treas. Reg. § 1.743-1(d)(1).

[908] Treas. Reg. § 1.743-1(d)(1)(i)-(iii).

[909] Treas. Reg. § 1.743-1(d)(2).

[910] Treas. Reg. § 1.704-1(b)(2)(iv)(m).

[911] Treas. Reg. § 1.743-1(j)(1). There is a limited exception in the case of certain distributions to a transferee partner. *See* Treas. Reg. § 1.734-2(b)(1).

[912] Treas. Reg. § 1.743-1(j)(3).

[913] Treas. Reg. § 1.743-1(j)(4).

743(b) and the adjustments upon a distribution of partnership property under section 734(b). Generally, a distribution triggers a *possible* (depending upon whether the partnership has a section 754 election in effect or if there is a substantial basis adjustment requiring a mandatory inside basis adjustment) section 734(b) adjustment whenever the distributee recognizes gain or loss, or takes a basis in the distributed property different from that which the partnership had in the property.

b. Unlike adjustments under section 743(b), adjustments under section 734(b) are made to the common inside basis of the partnership assets, so the basis adjustment is made in favor of all of the partners in the partnership (not just for the benefit of a transferee). Section 734(b)(1) and (2) provides that increases or decreases are made to "partnership property."[914] In contrast, adjustments under section 743(b) "shall constitute an adjustment to the basis of partnership property with respect to the transferee partner only."[915]

c. As mentioned above, adjustments under section 743(b) are not reflected in the capital accounts of the transferee partner or on the books of the partnerships.[916] On the other hand, adjustments under section 734(b) result in corresponding adjustments to capital accounts.[917]

d. When evaluating inside basis adjustments under section 734(b) of the Code, one must make a distinction between current and liquidating distributions.

(1) With a current distribution, only gain (not loss) can be recognized to a distributee partner. As such, an adjustment under section 734(b) is triggered when a distributee partner recognizes a gain on distribution of money in excess of outside basis. The amount of gain results in a corresponding increase in the inside basis of partnership property.[918]

(2) With a current distribution, when partnership property (other than money) is distributed, the basis of the property in the hands of the partner is the *lesser* of the inside basis of the property or the distributee partner's outside basis (after reducing outside basis by any money distributed).[919] When the distributee partner's outside basis is less than the inside basis of the distributed property, then the basis of the property is reduced. The amount of "lost" basis results in a corresponding increase in the remaining inside basis of partnership property.[920]

(3) Unlike current distributions, a distributee partner can recognize a loss on a liquidating distribution. Thus, on a liquidating distribution, the inside basis adjustment can increase the basis of partnership (for a gain) or decrease the basis of partnership property (for a loss).[921]

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[914] § 734(b)(1) and (2).

[915] § 743(b) (flush language).

[916] Treas. Reg. § 1.704-1(b)(2)(iv)(*m*)(*2*).

[917] Treas. Reg. § 1.704-1(b)(2)(iv)(*m*)(*4*) and (*5*).

[918] § 734(b)(1)(A).

[919] § 732(a)(1) and (2).

[920] § 734(b)(1)(B)

[921] § 734(b)(1)(A) and (2)(A).

(4) Further, unlike a current distribution, when partnership property (other than money) is distributed in a liquidating distribution, the basis of the property can be increased if the liquidated partner's outside (after reducing outside basis by any money distributed) is greater than the inside basis of the asset distributed.[922] The inside basis of the property has its basis replaced by the outside basis of the liquidated partnership interest.[923] If liquidated property has its basis increased, then the inside basis adjustment would correspond to a reduction of inside basis of remaining partnership property under section 734(b)(2)(B) of the Code.

(5) For liquidating distributions, unlike current distributions, there is a mandatory inside basis adjustment when there is a substantial basis reduction with respect to a distribution of partnership property.[924] This would occur if the partner recognized a loss of more than $250,000 upon liquidation, or the basis of liquidated property is increased by more than $250,000. Either of these events would require the partnership to reduce the basis of its remaining assets under section 734(b) of the Code by the total amount of the loss or basis increase even if a section 754 election was not in place.

4. Allocating Inside Basis Adjustments under Section 755

a. The Treasury Regulations provide that the inside basis adjustment is divided between two classes of partnership assets: (i) "ordinary income property," and (ii) "capital gain property."[925] For these purposes, capital gain property includes capital assets and section 1231(b) property, and all other property (including unrealized receivables and recapture items under section 751(c) of the Code) is ordinary income property.[926] Next the portion of the adjustment allocated to each class of assets is then further divided among the assets in each class. The mechanism for making the allocation in this second step is different depending on whether the inside basis adjustment is under section 734(b) (e.g., distributions) or section 743(b) (e.g., transfers or death of a partner) of the Code.

b. As mentioned above, inside basis adjustments under section 743(b) of the Code only apply to the transferee. The Treasury Regulations treat the total amount of these adjustments as a net amount, which means that positive adjustments can be made with respect to some assets (or one class of assets), and negative adjustments can be made with respect to other assets (or class). For purposes of calculating the amount to be allocated to each class and to each asset with a class, the Treasury Regulations employ a hypothetical transaction pursuant to which you can calculate the transferee's allocable share of gain or loss from each asset if immediately after the transfer the partnership made a cash sale of all of the partnership assets for fair market value.[927]

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[922] § 732(b) and Treas. Reg. § 1.732-1(b).

[923] Certain limitations apply to section 751 assets. *See* § 732(c)(1)(A) and § Treas. Reg. 1.732(c)(1)(i).

[924] § 734(a), (b), and (d).

[925] Treas. Reg. § 1.755-1(a).

[926] *Id.*

[927] Treas. Reg. §1.755-1(b)(1)(ii).

c. If the purchaser of a partnership interest or the fair market value of the asset upon the death of a partner is equal to the selling partner's or deceased partner's share of the partnership assets, then the general result will be that the inside basis adjustments under section 743(b) will exactly offset the buyer's gain or loss inherent in each asset. However, that is not always the case. If the buyer pays a premium over asset value, then under the residual method utilized under section 1060 of the Code, the excess will be allocated to goodwill or other section 197 intangibles. If the buyer purchases at a discount below fair market value (or more likely in the estate planning context, the deceased partner's partnership interest is valued at a discount for purposes of section 1014 of the Code), the Treasury Regulations first allocate the adjustment to ordinary income property to the extent possible, and then provide a mechanism to allocate the shortfall based upon two factors: (i) unrealized appreciation in each asset, and (ii) each asset's relative fair market value.[928]

d. In contrast with the hypothetical sale approach used for section 743(b) adjustments, the Treasury Regulations under section 755 allocate the section 734(b) adjustments on the transaction that triggers the adjustment (e.g., gain or loss upon a distribution of cash or change in the basis of an asset upon distribution to a partner). If the adjustment is caused by the recognition of gain or loss to the distributee, the section 734(b) adjustment can only be applied to capital gain property.[929] If, on the other hand, the adjustment is caused by a change in the basis of any asset within a particular class (ordinary income property or capital gain property), then the adjustment must be assigned only to assets in the same class.[930] If the partnership as no assets in the appropriate class, the adjustment is deferred until the partnership acquires an asset in that class.[931]

e. Once the adjustment is assigned to the appropriate class, positive adjustments (increases to the basis of partnership property) are first allocated to assets with unrealized appreciation in proportion to their relative appreciation. Once all of the unrealized appreciation has been eliminated, then the remaining amount is divided among the properties of the class in proportion to their relative fair market values.[932] Negative basis adjustments are allocated first to assets within the relevant class which have unrealized depreciation in proportion to their relative unrealized depreciation. Once all of the unrealized depreciation has been eliminated, then the adjustment is allocated among all assets in the class in proportion to their adjusted basis (not fair market value).[933] The inside basis of property cannot be reduced below zero.[934]

5. Mandatory Inside Basis Adjustments

a. Even in the absence of a section 754, the Code provides that a partnership must make mandatory inside basis adjustments under the following circumstances:

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[928] *See* Treas. Reg. § 1.755-1(b)(3)(ii).

[929] Treas. Reg. § 1.755-1(c)(1)(ii).

[930] Treas. Reg. § 1.755-1(c)(1)(i).

[931] Treas. Reg. § 1.755-1(c)(4).

[932] Treas. Reg. § 1.755-1(c)(2)(i).

[933] Treas. Reg. § 1.755-1(c)(2)(ii).

[934] Treas. Reg. § 1.755-1(c)(3).

(1) There is a distribution of property that results in a "substantial basis reduction" with respect to the distribution (requiring a mandatory basis adjustment under section 734(b) of the Code).[935]

(2) There is a transfer of a partnership interest when the partnership has a "substantial built-in loss" immediately after the transfer (requiring a mandatory basis adjustment under section 743(b) of the Code).

b. A "substantial basis reduction" is deemed to occur when upon a distribution of property there is any loss to the distributee partner or an increase in the basis of the distributed property to the distributee partner (or a combination of the two) that exceeds $250,000.[936] In other words, if there had been a section 754 election in place, a distribution under these circumstances would have resulted in a negative inside basis adjustment that exceeds $250,000. As discussed above, losses to the partner and increases to the basis of distributed property only occur on liquidating distributions (not current distributions).

c. Since the enactment of TCJA, a partnership is deemed to have "substantial built-in loss" if:

(1) The partnership's adjusted basis in the partnership property exceeds the fair market value of such property by more than $250,000.[937]

(2) Effective for transfers of partnership interests after December 31, 2017, "the transferee partner 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."[938]

L. Partnership Divisions

1. Generally

a. Divisions of partnerships are generally not specifically defined in the Code or under state law. A partnership division is any transaction that converts a single partnership into two or more resulting partnerships. A division of a partnership can be accomplished in a number of different ways, sometimes referred to as, "assets-over, assets-up, and interests-over."[939]

(1) Assets-Over: Divided partnership contributes some of its assets (and perhaps liabilities) to a recipient partnership in exchange for an interest in the recipient partnership, followed by a distribution of the interests in the recipient partnership to the partners.

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[935] § 734(a)(1).

[936] §§ 734(d) and 734(b)(2).

[937] § 743(d)(1)(A).

[938] § 743(d)(1)(B).

[939] Cassady V. Brewer, *Coming Together and Breaking Apart: Planning and Pitfalls in Partnership Mergers and Divisions*, 43rd Annual Southern Federal Tax Institute (2008), Outline F, F-13.

(2) Assets-Up: Divided partnership contributes some of its assets (and perhaps liabilities) to some or all of its partners, and the partners then contribute those assets (and liabilities, if any) to the recipient partnership for interests in the recipient partnership.

(3) Interests-Over: Some or all of the partners in the divided partnership contribute a portion of their interest in the divided partnership to the recipient partnership in exchange for interests in the recipient partnership, followed by a liquidating distribution of assets (and perhaps liabilities) into the recipient partnership.

b. To avoid unintended transfer tax consequences, tax planners must be wary of the special valuation rules of Chapter 14, in particular, section 2701.

(1) Section 2701 includes a "transfer" of an interest in a family-controlled partnership to a member of the transferor's family, pursuant to which the transferor keeps an applicable retained interest.[940] "Transfer" is broadly defined and is deemed to include "a contribution to capital or a redemption, recapitalization, or other change in the capital structure of a corporation or partnership."[941]

(2) Importantly in this context, section 2701 does not apply to a transfer "to the extent the transfer by the individual results in a proportionate reduction of each class of equity interest held by the individual and all applicable family members in the aggregate immediately before the transfer."[942] The Treasury Regulations provide the following example: "Section 2701 does not apply if P owns 50 percent of each class of equity interest in a corporation and transfers a portion of each class to P's child in a manner that reduces each interest held by P and any applicable family members, in the aggregate by 10 percent even if the transfer does not proportionately reduce P's interest in each class."[943] This exception is often referred to as the "vertical slice exception."

(3) In addition, section 2701 does not apply to any right with respect to an applicable retained interest if such interest is the same class as the transferred interest,[944] or the same as the transferred interest, without regard to non-lapsing differences in voting power (or, for a partnership, non-lapsing differences with respect to management and limitations on liability).[945]

(4) Consequently, most divisions of partnerships for estate planning purposes (assuming no gifts are intended as a result of the division) will result in the partners in the divided partnership being the same partners in the recipient partners and retaining the same pro rata interest in both the divided and the recipient partnership.

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[940] § 2701.

[941] § 2701(e)(5).

[942] Treas. Reg. § 25.2701-1(c)(4).

[943] *Id.*

[944] § 2701(a)(2)(B).

[945] § 2701(a)(2)(C). Non-lapsing provisions that are necessary to comply with the partnership allocation requirements will be treated as non-lapsing differences with respect to limitations on liability. Treas. Reg. § 25.2701-1(c)(3).

2. Tax Treatment of Partnership Divisions

a. Partnership divisions are governed by section 708(b)(2)(B). The Treasury Regulations issued in 2001,[946] provide that the IRS will not respect the "interests-over" form of partnership division described above. In addition, while both an assets-over and assets-up method will be respected under the Treasury Regulations, there is a preference to treat the transaction as an assets-over transaction.[947]

b. In the assets-over form, the divided partnership transfers assets to the recipient partnership in exchange for interest in the recipient partnership, followed by a distribution of the recipient partnership interests to the partners.[948] Parity of ownership interests will likely exist between the divided partnership and the recipient partnership because of the Chapter 14 considerations mentioned above. As such, the distribution of the recipient partnership interest to the partners will be current distributions rather than liquidating distribution because no partner is terminating his or her interest in the divided partnership. Because of this parity of ownership, it is unlikely that the "mixing bowl" transaction (as discussed above) will trigger any gain or loss.[949] Furthermore the preamble to the Treasury Regulations point out that when a division results in a pro rata division, there are no section 704(c) implications.[950] Similarly, given the parity of ownership before and after the division, there should be no gain resulting from a deemed distribution of cash under section 752 because the division will not result in a change in the share of the liabilities of the partners.

c. The resulting basis that the partners have in their respective interests in the divided partnership and the recipient partnership depend on what assets and liabilities are contributed and distributed as a result of the division.

d. In a division, the Treasury Regulations provide that a "resulting partnership"[951] (a partnership that has at least 2 partners from the prior partnership) will be considered a continuation of the prior partnership if the partners in the resulting partnership had an interest of more than 50 percent in the capital and profits of the prior partnership.[952] All resulting partnerships that are considered a continuation of the prior partnership are subject to all preexisting tax elections (for example, a section 754 election) that were made by the prior partnership.[953] Thus, in pro rata divisions where all of the partners retain the same ownership in the resulting partnerships, all of the resulting partnerships will be considered continuing partnerships, retaining all prior tax elections of the divided partnership.[954]

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[946] T.D. 8925, 66 Fed. Reg. 715 (Jan. 4, 2001).

[947] *See* Treas. Reg. § 1.708-1(d)(3).

[948] Treas. Reg. § 1.708-1(d)(3)(i)(A). The transitory ownership by the divided partnership of all the interests in the recipient partnership is ignored. Treas. Reg. § 1.708-1(d)(5) Ex. 3-6.

[949] §§ 704(c)(1)(B), 737 and Treas. Reg. §§ 1.704-4(c)(4), 1.737-2(b)(2).

[950] T.D. 8925, 66 Fed. Reg. 715 (1/4/01). Non-pro rata divisions are still being reviewed.

[951] Treas. Reg. § 1.708-1(d)(4)(iv)

[952] Treas. Reg. § 1.708-1(d)(1).

[953] Treas. Reg. § 1.708-1(d)(2)(ii).

[954] *See* PLR 9015016 (seven continuing partnerships with same owners in the same proportions).

e. There is a narrow anti-abuse provision in the Treasury Regulations with respect to partnership divisions. It provides that if a partnership division is "part of a larger series of transactions, and the substance of the larger series of transactions is inconsistent"[955] with the form, the IRS may recast the larger series of transactions in accordance with their substance.

3. Partnership Divisions in Tax Basis Management

a. The importance of tax-free partnership divisions in the new paradigm of estate planning cannot be overstated. The unitary basis rules applicable to partnership interests do not allow taxpayers to differentiate between low or high basis lots of partnership interests. The partnership division rules effectively allow taxpayers to segregate particular assets within a partnership into a new partnership and provide a separate outside basis in those assets through the new partnership. Because the basis of partnership property distributed in-kind to a partner is determined by the outside basis of the partner's interest, careful partnership divisions allow taxpayers to determine what the tax basis of the in-kind property will be upon distribution (rather than determined by an aggregate basis under the unitary basis rule).

b. Furthermore, divisions allow taxpayers to isolate the particular assets that they wish to benefit from an inside basis adjustment under sections 743 and 734, as the case may be. As mentioned above, the inside basis adjustments under section 755 are made at an entity level and apply across all of the assets within the partnership. Careful partnership divisions would allow taxpayers to determine what assets would be the subject of the inside basis adjustment and perhaps separately choose to make a section 754 election for the new partnership, rather than the original partnership.

M. Death of a Partner

1. Generally

a. The transfer of a deceased partner's interest in a partnership will not result in gain or loss, even if the deceased partner's share of liabilities exceeds outside basis.[956]

b. The estate's outside basis in the partnership will equal the fair market value of the partnership interest for estate tax purposes (which is net of partnership liabilities), plus the estate's share of partnership liabilities, minus any value attributed to items of IRD owned by the partnership. The Treasury Regulations provide, "The basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of his death or at the alternate valuation date, increased by his estate's or other successor's share of partnership liabilities, if any, on that date, and reduced to the extent that such value is attributable to items constituting income in respect of a decedent (see section 753 and paragraph (c)(3)(v) of § 1.706-1 and paragraph (b) of § 1.753-1) under section 691."[957]

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[955] Treas. Reg. § 1.708-1(d)(6). *See also* Treas. Reg. § 1.708-1(c)(6)(ii) for an example of an abusive series of transactions that involved a partnership division and merger.

[956] *See* Elliott Manning and Jerome M. Hesch, *Sale or Exchange of Business Assets: Economic Performance, Contingent Liabilities and Nonrecourse Liabilities (Part Four)*, 11 Tax Mgmt. Real Est. J. 263, 272 (1995).

[957] Treas. Reg. § 1.742-1.

c. Because only the net equity value (after taking into account partnership liabilities) is included in the gross estate for estate tax purpose but the "step-up" in basis is grossed up to include the estate's share of partnership liabilities, one of the ways to leverage the "step-up" in basis prior to the death of a partner is to borrow at the partnership level and distribute the proceeds of the loan to the partners (often referred to as a "refinancing" in the commercial real property business). The procurement of the loan and the subsequent distribution of the proceeds should (assuming the partnership liability is nonrecourse and the distributions are made proportionately to the partners) be a tax free distribution. As mentioned above in the upside of debt portion of these materials, in order to take advantage of this "step-up" in basis on the partnership interest, the partner must engage in another step to transfer the loan proceeds out of the gross estate. This second step would not necessarily be needed in the context of nonresident alien partners because, as discussed earlier in these materials, often a basis adjustment under section 1014 is available without any U.S. estate tax inclusion.

d. Unless a section 754 election applies, no adjustment is made to the tax basis of the partnership property as a result of the partner's death. The lack of an inside basis adjustment puts the estate (or the successor in interest) at risk of being taxed on unrealized gain in the partnership at the time of the decedent's death.

2. Inside Basis Adjustments at Death

a. If a section 754 election is timely made or in place at the time of a partner's death, the estate or successor to the partnership interest gets the benefit of an inside basis adjustment over the partnership's assets under section 743.

(1) The inside basis adjustment will not, however, "step-up" the basis of partnership assets that would be considered IRD if held by the deceased partner individually and unrealized receivables of the partnership.[958]

(2) The IRS has affirmatively ruled that the inside basis adjustment applies to the entire partnership interest that is considered community property upon the death of the deceased spouse/partner (even if the estate of the deceased partner is admitted as a partner and the surviving spouse is not admitted as a partner).[959] The rule applies regardless of which spouse predeceases the other.

(3) The inside basis adjustment is limited by the fair market value of the deceased partner's interest in the partnership. As such, to the extent that valuation discounts are applicable to the partnership interest, the inside basis adjustment will be limited to the extent of such discounts. To the extent little or no transfer taxes would be payable upon the death of a partner, practitioners may want to reduce or eliminate such valuation discounts, thereby maximizing the inside basis adjustment with a section 754 election. Further, because the inside basis adjustment under section 743 is applied to all of the assets in the partnership at the time of the death of the partner, the adjustment does not allow tax practitioner to proactively choose which asset will get the benefit of the "step-up" in basis. For this reason, practitioners may want to consider distributing certain property in-kind to the partner prior to the partner's death and allowing the partner to own the property outside the partnership at the time of death. Valuation

[958] §§ 1014(c), 691(a)(1), Treas. Reg. § 1.691(a)(1)-1(b), and *Woodhall v. Commissioner*, 454 F.2d 226 (9th Cir. 1972).

[959] Rev. Rul. 79-124, 1979-1 C.B. 224.

discounts will not apply, and if the partner's outside basis is very low, the distributed property will have a very low basis in the hands of the partner. In this manner, practitioners can maximize the size of the "step-up" in basis and also choose the asset that they wish to receive the basis adjustment at death.

(4) As mentioned above, the adjustment under section 743(b) is the difference between the successor partner's tax basis in partnership interest (generally, fair market value at the date of death under section 1014(a), increased by the partner's share of partnership liabilities and reduced by items of IRD) and the successor partner's proportionate share of the basis of the partnership property. In calculating the partner's proportionate share of the partnership's tax basis, the Treasury Regulations assume a fully taxable hypothetical sale of the partnership's assets. This taxable sale is deemed to occur immediately after the transfer that triggers the inside basis adjustment. The IRS has ruled that the transfer in question, for purposes of section 743(b), is the date of the decedent partner's death.[960] As such, practitioners should consider what effect the death of the partner might have on the value of the partnership assets in determining the inside basis adjustment.

b. Even in the absence of a section 754 election, there is a mandatory downward inside basis adjustment if, at the time of death, the partnership has a substantial built-in loss (more than $250,000).[961] For example, if A owns 90% of a partnership. At the time of A's death, if the partnership owns property worth $9 million but with a tax basis of $10 million, then the partnership will be required to make a mandatory downward basis adjustment of $900,000 (assuming A's share the partnership's basis is 90% of the total basis). [962]

3. Section 732(d) Election: Avoiding the Section 754 Election

a. As mentioned above, even with no section 754 election, the estate or successor in interest can achieve the same benefits of an inside basis adjustment if the partnership makes a liquidating distribution of property within two years of the date of death and if the successor partner makes an election under section 732(d).[963] The election must be made in the year of the distribution if the distribution includes property that is depreciable, depletable, or amortizable. If it does not include such property, the election can wait until the first year basis has tax significance. [964]

b. The basis adjustment is computed under section 743(b), which relates the basis adjustments due to sales or transfer of partnership interest (during lifetime, or more notably for this discussion, at death). The inside basis adjustment is made artificially to all of the partnership property owned on the date of death (for purposes of determining the transferred inside basis to the distributee with respect to the property distributed). In other words, it is allocated to all of the partnership property whether actually distributed or not.[965] If any property for which the distributee/transferee would have had an inside basis adjustment is distributed to

[960] Rev. Rul. 79-84, 1979-1 C.B. 223 (partnership interest owned by grantor trust).

[961] § 743(b).

[962] *See* IRS Notice 2005-32, 2005-1 C.B. 895.

[963] Treas. Reg. § 1.732-1(d)(1)(iii).

[964] Treas. Reg. § 1.732-1(d)(2).

[965] Treas. Reg. §§ 1.732-1(d)(1)(vi), 1.743-1(g)(1) and (5), Ex. (ii).

another partner, the adjustment for such distributed property is reallocated to remaining partnership property.[966]

c. The election under section 732(d) can be a significant planning opportunity especially when planners would like to avoid having a section 754 election in place. As mentioned above, once the section 754 election is made, it is irrevocable unless the IRS gives permission to revoke the election. Because the inside basis adjustments under section 743(b) only apply to the transferees of the partnership interests (not to the partnership as a whole), having a section 754 election in place requires having a different set of basis calculations for the transferees of the interest. The book keeping requirements become quite onerous as partnership interests are often distributed at death to multiple trusts or beneficiaries and become even more so as additional partners pass away.

d. If the distribution of property is made pursuant to provision in the partnership agreement that requires a mandatory in-kind liquidation of the deceased partner's interest based on the partner's positive capital account balance, then the estate would have a good argument to say that the value of the partner's interest for purposes of section 1014(a) should not entail valuation discounts. This would, in turn, increase the inside basis adjustment on the assets claimed with the section 732(d) election. Giving the manager of the LLC or general partner of the partnership the discretion to determine what assets to distribute in liquidation of the partnership interest could give considerable planning opportunities to pick and choose which assets to receive the inside basis adjustment based on the needs of the distributee partner. While the assets received would likely not receive full fair market value (because, as mentioned above, the inside basis adjustment is artificially allocated across all of the partnership assets whether distributed or not), some planning opportunities could exist by distributing assets to other partners prior to the liquidation because the nominal inside basis adjustment that would have been allocated to those assets would be adjusted to the remaining partnership property.

N. Partnership Terminations

1. Prior to the enactment of TCJA, a partnership was treated as terminated for tax purposes if:

a. No part of any "business, financial operation, or venture of the partnership continues to be carried on by any of its partners,"[967] or

b. Within a twelve month period there is a "sale or exchange of 50 percent or more of the "total interest in partnership capital and profits."[968]

2. The latter termination event is often referred to as a "technical termination" because the termination often did not necessarily end the partnership's existence. However, a technical termination closes the partnership's taxable year, terminates certain partnership elections, and can restart the depreciation recovery periods for certain types of property.[969]

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[966] Treas. Reg. §§ 1.743-1(g)(2) and (5), Ex. (iv).

[967] § 708(b)(1)(A).

[968] § 708(b)(1)(B).

[969] *See e.g.*, §§ 708(a), 706(c)(1), 168(i)(7), and Treas. Reg. § 1.708-1(b)(3).

3. With the enactment of TCJA, effective for partnership taxable years beginning after December 31, 2017, the technical termination rule under section 708(b)(1)(B) of the Code is repealed.[970] As a result, a partnership is considered terminated only if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners.

4. Any partnership activity will suffice to continue a partnership and keep it from terminating.[971] For example, it's been held that the mere collection of promissory notes is sufficient to keep a partnership from terminating.[972]

O. Maximizing the "Step-Up" and Shifting Basis

1. Given the limitations of the basis adjustment at death, practitioners may want to consider distributing certain property in-kind to the partner prior to the partner's death and allowing the partner to own the property outside the partnership at the time of death. Valuation discounts will not apply, and if the partner's outside basis is very low, the distributed property will have a very low basis in the hands of the partner. In this manner, practitioners can maximize the size of the "step-up" in basis and also choose the asset that they wish to receive the basis adjustment at death.

2. Consider the following scenario: FLP owns 2 assets, one with very high basis and one with very low basis, neither of which is a marketable security. The assets have been in the FLP for more than seven years. The partners consist of younger family members and a parent. Assume that the parent's outside basis in the FLP is zero. As discussed above, the traditional advice of allowing the parent to die with the FLP interest and making a section 754 election after death will likely create an inside basis adjustment that is limited by a significant valuation discount under section 743. Assume further that the partnership intends on selling the very low basis asset relatively soon. What might be a way to maximize the "step-up" in basis that will occur at the parent's death and also create tax basis for the low basis asset that will be sold? The partnership should make a section 754 election and distribute the high basis asset, in-kind, to the parent in full or partial liquidation/redemption of the parent's interest in the partnership. What is the result of this distribution?

3. Because the distribution is not cash or marketable securities, neither the partner nor the partnership will recognize any gain or loss upon a distribution of the property.[973] In addition, because the assets have been in the partnership for more than seven years, there are no concerns about triggering any gain to another partner under the "mixing bowl" or the "disguised sale" rules. The basis of the distributed property in the hands of the parent is based on the tax basis that the partnership had in the property prior to the distribution. The basis of the distributed property will, however, be limited to the outside basis of the partner's partnership interest, as adjusted for cash distributions (reduction in basis) and changes in liabilities because the distributed property is encumbered with debt. This limitation, effectively, transfers the

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[970] § 13504 of TCJA.

[971] *See* § 708(a).

[972] *See Baker Commodities v. Commissioner*, 415 F.2d 519 (9th Cir. 1969), and *Foxman v. Commissioner*, 41 T.C. 535 (1964), *aff'd*, 392 F.2d 466 (3rd Cir. 1965).

[973] § 731(a)-(b) and Treas. Reg. § 1.731-1(a)-(b). This assumes the property distributed is not a "hot asset" under section 751 of the Code.

inherent gain in the partnership interest (outside basis) to the distributed property. In other words, the basis of the asset now held by the parent is zero. Because the parent now owns the property individually and outside of the partnership, upon the parent's death, the property will get a full "step-up" in basis to fair market value, free of any valuation discounts.

4. Because a section 754 election was made, an adjustment of inside basis under section 734(b) occurs. The adjustment results in an increase to the inside basis of the partnership assets. The increased basis adjustment is allocated first to appreciated property in proportion to the amount of unrealized appreciation, with any remaining increase allocated to all of the properties within the same class (capital gain or ordinary) in proportion to fair market values. Thus, there is a possibility of allocating basis to an asset above its fair market value, creating the possibility of a recognizable loss to the partners. The result, in this case, is the tax basis that was "stripped" from the high basis asset when it was distributed to the parent (and became a zero basis asset) is allocated to the only other remaining asset in the partnership (the low basis asset that will be sold). Thus, the low basis asset becomes a high basis asset, reducing or eliminating the gain to be recognized when it is sold. Unlike adjustments under section 743(b), adjustments under section 734(b) (upon a distribution of partnership property to a partner) are made to the common inside basis of the partnership assets, so the basis adjustment is made in favor of all of the partners in the partnership (not just for the benefit of a transferee).

5. The type of basis management discussed above is predicated upon a number of factors that must be that must orchestrated well in advance of the actual transaction. In particular, the movement of tax basis and the maximization of the "step-up" is predicated upon: (i) the selective use of the section 754 election (not necessarily at death but certainly upon distribution of assets in-kind); (ii) the isolation of the assets to be used in the basis shift; (iii) the avoidance of the triggering gain under the "mixing bowl" and "disguised sale" rules; and (iv) the manipulation of outside basis, so that the partner to receive the property has zero or very low basis in his or her partnership interest. As such, planners should consider evolving the partnership over time to put the taxpayers in the best position to take advantage of the type of flexibility that the partnership rules allow.

6. By way of example, practitioners should consider setting up a partnership that is funded with all manner of assets that might be used in this type of planning (high and low basis assets, depreciable and non-depreciable assets, closely held company interests, cash, etc.). The more assets the taxpayers contribute, the more options will be available in the future. The only type of asset planners should consider avoiding is marketable securities. This is because, generally, a distribution consisting of marketable securities generally is treated as a distribution of cash (rather than property).[974] Thus, regardless of the basis in the marketable securities, a distribution may cause the distributee partner to recognize gain because of insufficient outside basis. However, as discussed later, there is an important exception to this rule that might allow practitioners to create a separate partnership holding only marketable securities and still allow the types of tax basis management discussed herein. Once the assets have been contributed, it is critical that the assets remain in the partnership for at least seven years to avoid the "mixing bowl" and "disguised sale rule" problems.

7. As discussed in more detail above, distributions of marketable securities are generally treated as cash. There is, however, an important exception to this rule for distributions

[974] § 731(c).

of securities from an "investment partnership" to an "eligible partner."[975] An "investment partnership" is defined as a partnership substantially all of whose assets consist of specified investment-type assets and has never been engaged in a trade or business.[976] Specified investment-type assets include (1) money, (2) stock in a corporation, (3) notes, bonds, debentures, or other evidences of indebtedness, (4) interest rate, currency, or equity notional principal contracts, (5) foreign currencies, and (6) derivative financial instruments (including options, forward or futures contracts and short positions).[977] An "eligible partner" is one who, before the date of distribution, did not contribute to the partnership any property other than specified investment-type assets permitted to be held by an investment partnership.[978] As such, if taxpayers wish to proactively manage the basis of marketable securities in the manner discussed in this article, taxpayers must have a partnership that *from inception* has essentially only held marketable securities and has never engaged in a trade or business. Hence, practitioners should consider having taxpayers create partnerships that only hold marketable securities and having it hold the securities for at least seven years.

8. During the seven year period, if at all possible, the partnership should avoid making a section 754 election because of the limitations of the inside basis adjustment at death and the onerous record keeping requirements discussed above. Once the seven year period has expired, then the assets of the partnership (that is hopefully free of a section 754 election) are ripe for proactive tax basis management. Once an opportunity arises for the type of planning discussed above (e.g., a potential sale of a low basis asset or the failing health of a partner), then the partnership can then proceed to isolate the appropriate assets in tax free "vertical slice" division. The assets to be carved out of the larger partnership into a smaller partnership would be those assets selected to receive the basis and those that would have their basis reduced upon distribution. Careful consideration should be given to reducing the outside basis of the distributee partner through disproportionate distributions of cash or shifting basis to other partners by changing the allocable share of partnership debt under section 752 (e.g., by converting nonrecourse debt to recourse debt through a guarantee by the other partners).[979]

9. Upon distribution of the higher basis assets to the distributee partner, the inside basis adjustment would be applied across all of the remaining assets in the partnership, but only those assets that have been spun off the larger partnership are in this partnership. Thus, allowing for a larger basis increase to those assets (rather than having the basis increase apply to all of the assets of the larger partnership and never creating an asset fully flush with tax basis). A section 754 election is required to effectuate the inside basis shift under section 734, but the election would only apply to the smaller, isolated partnership. As such, the record keeping requirements are kept to a minimum and are totally eliminated when and if the smaller partnership is dissolved and liquidated. Remember, in a vertical slice division, the isolated partnership is considered a continuation of the larger partnership, and the elections of the previous partnership follow to the new partnership. By keeping the larger partnership free of a section 754 election, it allows practitioners to selectively choose when and over what assets it would apply to in the future.

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[975] §§ 731(c)(3)(C)(i) and 731(c)(3)(A)(iii).

[976] § 731(c)(3)(C)(i).

[977] § 731(c)(3)(C)(i)(I) through (VIII).

[978] § 731(c)(3)(C)(iii)(I).

[979] *See* Treas. Reg. § 1.752-2(b).

P. Basis Shifts to Diversify a Concentrated Stock Position

1. Introduction

a. Investors with a low-basis "single stock" or concentrated stock position often look for strategies that allow them to diversify (or hedge) the concentrated position and that either defer the recognition of or eliminate the recognition of capital gain. For example, prepaid variable forward strategies allow investors to hedge the underlying stock position and provide funds to invest in a diversified portfolio, and exchange funds allow investors to contribute their concentrated stock positions to a partnership and after at least seven years, leave the partnership with a "diversified" portfolio consisting of the stocks contributed by the other partners. The prepaid variable forward strategy only defers the recognition of capital gain, and although the exchange fund allows for a tax free method of getting a portfolio of stocks different from the concentrated position, there is no guarantee that the portfolio of stocks received is of high quality or appropriately diversified. In addition, all of these strategies come at a cost that might include investment management fees, relinquishment of upside appreciation, or less than 100% of value invested in a diversified portfolio. Carefully utilizing the basis rules in a family limited partnership may be a superior alternative to the foregoing.

b. All of the strategies discussed in this section assume that (i) the partnership entity is an "investment partnership" under section 731(c)(3)(C) of the Code, and (ii) all of the assets in the partnership have been contributed more than seven years ago or have been purchased by the partnership. As such, distributions of marketable securities are not treated as distributions of cash under section 731(c) of the Code, and the "mixing bowl" rules do not apply. Further, assume the disguised sale rules do not apply, and the relevant anti-abuse rules would not apply to recharacterize the partnership transactions.

2. Shifting Basis from a Diversified Position to a Concentrated Position

a. Assume a FLP owns $100 million of assets comprised of: (i) $50 million of Stock A, a publicly-traded security, with zero basis, and (ii) $50 million of a diversified portfolio of marketable securities (or shares in a diversified stock exchange-traded fund, ETF) with $50 million of basis. The FLP is owned equally by family members of the first generation (G1 Partners) and of the second generation (G2 Partners), each generation holding a 50% interest in the FLP. To simplify the example, the two generational groups of partners will be referred to collectively (and separately) as the G1 and G2 Partners. Each of the G1 and G2 Partners has $25 million of outside basis, and each of the partner groups have a capital account balance of $50 million. The FLP was formed more than seven years ago when the G1 and G2 Partners each contributed an equal amount of Stock A,[980] and recently one-half of the Stock A position was sold for cash and a diversified portfolio of marketable securities. The G1 and G2 Partners each recognized $25 million of capital gain. As a result, the adjusted tax bases and capital accounts are:

[980] The contribution would have been a non-taxable event under section 721(a) of the Code even though the FLP would have constituted an investment company under sections 721(b) and 351(e) of the Code. The contributions of Stock A did not result in any diversification. Treas. Reg. §§ 1.351-1(c)(1)(i) and 1.351(1)(c)(5).

Partnership Holding Stock A & Diversified Portfolio				
	Partnership	*Inside Basis*	*§ 704(b) Book Value*	*Gain*
	Stock A	$0	$50,000,000	
	Diversified Portfolio	$50,000,000	$50,000,000	
	TOTAL	**$50,000,000**	**$100,000,000**	
(%)	*Partners*	*Outside Basis*	*Book Capital Account*	*Gain*
50%	G1 Partners	$25,000,000	$50,000,000	
50%	G2 Partners	$25,000,000	$50,000,000	
	TOTAL	**$50,000,000**	**$100,000,000**	

b. The FLP wishes to sell the remaining position in Stock A for cash in an effort to diversify the concentrated position in Stock A. If the FLP sells the Stock A position, the results are straightforward. The FLP recognizes $50 million of capital gain, and G1 and G2 are each allocated 50% of the gain ($25 million each), as follows:

Partnership Sells Stock A for Cash				
	Partnership	*Inside Basis*	*§ 704(b) Book Value*	*Gain*
	Cash	$50,000,000	$50,000,000	$50,000,000
	Diversified Portfolio	$50,000,000	$50,000,000	
	TOTAL	**$100,000,000**	**$100,000,000**	**$50,000,000**
(%)	*Partners*	*Outside Basis*	*Book Capital Account*	*Gain*
50%	G1 Partners	$50,000,000	$50,000,000	$25,000,000
50%	G2 Partners	$50,000,000	$50,000,000	$25,000,000
	TOTAL	**$100,000,000**	**$100,000,000**	**$50,000,000**

c. Instead of selling Stock A, assume the FLP makes a 754 election or has one in effect at such time, and the FLP could makes an in-kind distribution of the diversified portfolio to the G1 Partners in a liquidating distribution (G1's capital account balance and the diversified portfolio each have a value of $50 million). Under section 732(b) of the Code, the diversified portfolio in the hands of the G1 partners has a basis of $25 million (having been reduced from $50 million). Under section 734(b) of the Code, the partnership's assets (Stock A) are increased by "the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution… over the basis of the distributed property to the distributee."[981] In other words, the FLP basis in Stock A is increased by $25 million. The resulting adjusted tax bases, capital accounts of the remaining G2 Partners, and assets held by the former G1 Partners are:

[981] § 734(b)(1)(B).

Partnership Distributes Diversified Portfolio to G1 Partners (754 Election/734(b) Adjustment)				
	Partnership	*Inside Basis*	*§ 704(b) Book Value*	*Gain*
	Stock A	$25,000,000	$50,000,000	
	TOTAL	**$25,000,000**	**$50,000,000**	
(%)	*Partners*	*Outside Basis*	*Book Capital Account*	*Gain*
100%	G2 Partners	$25,000,000	$50,000,000	
	TOTAL	**$25,000,000**	**$50,000,000**	

Diversified Portfolio	*Tax Basis*	*Fair Market Value*
Former G1 Partners	$25,000,000	$50,000,000

d. If the FLP subsequently sells the Stock A position for its fair market value and then purchases a diversified portfolio, then only $25 million of gain will be recognized. The overall result is that all of Stock A will have been diversified, but only $25 million (rather than $50 million) was recognized. Of course, the G1 Partners continue to have an unrealized $25 million capital gain, but that gain can be deferred indefinitely and possibly eliminated with a "step-up" in basis upon the death of the G2 Partners, as illustrated below:

Partnership Sells Stock A and Reinvests in a New Diversified Portfolio				
	Partnership	*Inside Basis*	*§ 704(b) Book Value*	*Gain*
	New Diversified Portfolio	$50,000,000	$50,000,000	$25,000,000
	TOTAL	**$50,000,000**	**$50,000,000**	**$25,000,000**
(%)	*Partners*	*Outside Basis*	*Book Capital Account*	*Gain*
100%	G2 Partners	$50,000,000	$50,000,000	$25,000,000
	TOTAL	**$50,000,000**	**$50,000,000**	**$25,000,000**

Diversified Portfolio	*Tax Basis*	*Fair Market Value*
Former G1 Partners	$25,000,000	$50,000,000

3. Using Debt to Exchange a Concentrated Position for a Diversified Position

a. Assume a FLP that has one asset, $100 million of a publicly traded security, Stock A, that has zero basis. The FLP is owned by family members, 10% by first generation (G1 Partners) and 90% by the younger generations (G2 Partners). The two generational groups of partners will be referred to collectively (and separately) as the G1 and G2 Partners. The adjusted tax bases and capital accounts are:

PARTNERSHIP HOLDING STOCK A				
	Partnership	*Inside Basis*	*§ 704(b) Book Value*	*Gain*
	Stock A	$0	$100,000,000	
	Cash	$0	$0	
	Debt		$0	
	TOTAL	**$0**	**$100,000,000**	
(%)	*Partners*	*Outside Basis*	*Book Capital Account*	*Gain*
10.0%	G1 Partners	$0	$10,000,000	
90.0%	G2 Partners	$0	$90,000,000	
	TOTAL	**$0**	**$100,000,000**	

b. The family is considering winding up the affairs of the FLP and liquidating the partnership. They are also looking for ways to tax efficiently diversify the concentrated position in Stock A. Instead of selling Stock A and recognizing $100 million of gain, the FLP borrows $90 million from a third party lender. The third party lender, as a condition for the loan, requires a pledge of the $100 million of the Stock A held by the partnership, and (given the size of the loan against a concentrated stock position) it also requires the G1 Partners (who have significantly more net worth than the G2 Partners) to personally guarantee the loan and post additional personal assets as collateral for the loan, in case the FLP is unable to pay any portion of the loan. The G1 Partners agree with the G2 Partners to be solely responsible for the repayment of any partnership liabilities with respect to this loan and give up any right of reimbursement from the G2 Partners. Assume, under the current and proposed Treasury Regulations, the partnership liabilities under section 752 of the Code are properly allocated to the G1 Partners because they bear the economic risk of loss. When the $90 million loan is procured, the adjusted tax bases, capital accounts, and books of the partnership are:

PARTNERSHIP BORROWS $90 MILLION, G1 PARTNERS BEAR ECONOMIC RISK OF LOSS				
	Partnership	*Inside Basis*	*§ 704(b) Book Value*	*Gain*
	Stock A	$0	$100,000,000	
	Cash	$90,000,000	$90,000,000	
	Debt		($90,000,000)	
	TOTAL	**$90,000,000**	**$100,000,000**	
(%)	*Partners*	*Outside Basis*	*Book Capital Account*	*Gain*
10.0%	G1 Partners	$90,000,000	$10,000,000	
90.0%	G2 Partners	$0	$90,000,000	
	TOTAL	**$90,000,000**	**$100,000,000**	

c. The FLP then purchases a diversified marketable securities portfolio in the form of shares in an exchange traded fund (ETF). After the purchase, the partnerships books are:

PARTNERSHIP BUYS ETF WITH LOAN PROCEEDS				
	Partnership	*Inside Basis*	*§ 704(b) Book Value*	*Gain*
	Stock A	$0	$100,000,000	
	ETF	$90,000,000	$90,000,000	
	Debt		($90,000,000)	
	TOTAL	**$90,000,000**	**$100,000,000**	
(%)	*Partners*	*Outside Basis*	*Book Capital Account*	*Gain*
10.0%	G1 Partners	$90,000,000	$10,000,000	
90.0%	G2 Partners	$0	$90,000,000	
	TOTAL	**$90,000,000**	**$100,000,000**	

d. Later, assuming the FLP makes a 754 election or has one in effect, the FLP distributes the ETF to the G2 Partners in liquidation of their interest in the FLP. The capital account balance of the G2 Partners and the fair market value of the ETF are $90 million. Under section 732(b) of the Code, the ETF in the hands of the G2 partners has a basis of zero.[982] Under section 734(b) of the Code, the partnership's assets (Stock A) are increased by the $90 million of excess basis that was stripped from the ETF. The results are:

§ 754 ELECTION AND INSIDE BASIS ADJUSTMENT UNDER § 734				
	Partnership	*Inside Basis*	*§ 704(b) Book Value*	*Gain*
	Stock A	$90,000,000	$100,000,000	
	Cash	$0	$0	
	Debt		($90,000,000)	
	TOTAL	**$90,000,000**	**$10,000,000**	
(%)	*Partners*	*Outside Basis*	*Book Capital Account*	*Gain*
100%	G1 Partners	$90,000,000	$10,000,000	
	TOTAL	**$90,000,000**	**$10,000,000**	

ETF	*Adjusted Basis*	*Fair Market Value*
Former G2 Partners	$0	$90,000,000

e. Assuming no changes in value and ignoring interest and other costs, when the FLP then sells $90 million of Stock A (90% of the partnership's holdings) to repay the loan, the FLP will recognize $9 million of gain. The gain will be reflected in the outside basis of the G1 Partners, as follows:

[982] In this example, the G1 partners bear the economic risk of loss and the partnership liability is recourse to the G1 partners. As a result, the outside bases of the G1 partners are increased by the total liability under section 752(a) of the Code. If, in contrast, the partnership liabilities were considered nonrecourse liabilities and all of the partners had their outside bases increased by a proportionate amount of the liability, you would get the same result (the ETF in the hands of the G2 partners has a basis of zero) because the interests of the partners are fully liquidated. As a result, when the G2 partners exit the partnership and they are no longer share any of the partnership liabilities, there is a deemed distribution of money under section 752(b) of the Code, reducing their outside bases to zero, which is then followed by a distribution of the ETF with an inside basis of $90 million.

PARTNERSHIP SELLS ENOUGH STOCK A TO REPAY LOAN				
	Partnership	*Inside Basis*	*§ 704(b) Book Value*	*Gain*
	Stock A	$0	$10,000,000	
	Cash	$90,000,000	$90,000,000	$9,000,000
	Debt		($90,000,000)	
	TOTAL	**$90,000,000**	**$10,000,000**	
(%)	*Partners*	*Outside Basis*	*Book Capital Account*	*Gain*
100%	G1 Partners	$99,000,000	$10,000,000	$9,000,000
	TOTAL	**$99,000,000**	**$10,000,000**	

f. The subsequent repayment of the loan to the third party lender will decrease the outside basis of the G1 Partners under section 752(b) of the Code:

PARTNERSHIP PAYS OFF THIRD PARTY LOAN				
	Partnership	*Inside Basis*	*§ 704(b) Book Value*	
	Stock A	$9,000,000	$10,000,000	
	Cash	$0	$0	
	Debt		$0	
	TOTAL	**$9,000,000**	**$10,000,000**	
(%)	*Partners*	*Outside Basis*	*Book Capital Account*	
100%	G1 Partners	$9,000,000	$10,000,000	
	TOTAL	**$9,000,000**	**$10,000,000**	

g. If the FLP subsequently liquidates and winds up its affairs, assuming no changes in values, the end result is exactly the same as it would have been if G2 had contributed its allocable share of Stock A to a third party exchange fund and then liquidated its share of the fund seven years later. In this strategy, however, there is no need to wait seven years (the "mixing bowl" period was tolled in the FLP), the diversified portfolio is chosen by the family (rather than what may be held by the exchange fund including non-equity assets [e.g., real estate investments] that are typically held by exchange funds to avoid investment company status), and there is minimal gain:

LIQUIDATION OF PARTNERSHIP AND END RESULT			
Former Partner	*Adjusted Basis*	*Fair Market Value*	*Gain*
G1 (STOCK A)	$9,000,000	$10,000,000	$9,000,000
G2 (ETF)	$0	$90,000,000	$0

Q. Basis Shifts with Grantors and Grantor Trusts

1. Generally

a. When reduced down to its simplest form, basis shifting transactions involve a partnership holding a low and a high basis asset, a partner having a low outside basis in his or her partnership interest, and a distribution of the high basis asset to the low outside basis partner. Often, however, a partnership may not have any assets with sufficient basis in order to effectuate the basis shift.

b. In the previous example dealing with marketable securities, the partnership used leverage to purchase an asset, thereby acquiring a high basis asset. If, however, partnership debt is not an option, a contribution of a high basis asset to the partnership should be considered. The difficulty with using contributed property in this type of planning is that the distribution of the high basis asset may trigger a taxable gain under the disguised sale and mixing bowl transaction rules.

c. Contributions by a grantor to a partnership that has a grantor trust (IDGT) as a partner may be a way to reduce the risk of triggering gain because of the unitary basis rules. As mentioned earlier in these materials, the unitary basis rules require that a grantor and an IDGT will share outside basis (and capital account), and as a result, contributions of high basis assets by one or the other will result in a proportional increase in the outside basis that is shared by both partners.

2. Basis Shift Example

a. A limited partnership (LP) has an S corporation as general partner, with 100% of the limited partnership interests owned by an IDGT. Assume that the S corporation owns a sufficient interest in the LP to be recognized as partner for tax and state law purposes (e.g., 1%), but for purposes of this illustration, its interest in the partnership will be ignored. The LP owns Asset A with an inside basis of zero and a fair market value of $100x. The IDGT owns 100% of the limited partnership interests which have an outside basis of zero and a capital account of $100x. For tax reasons, the partnership would like Asset A to have tax basis.

b. Grantor contributes Asset B, which has an adjusted basis of $100x and a fair market value of $100x, to the LP in exchange for 50% of the limited partnership interests. After the contribution, grantor and IDGT are equal partners, each owning an equal share of all of the limited partnership interests. Due to unitary basis and capital account rules, grantor and IDGT share an outside basis of $100x and a capital account of $200x. LP owns Asset A ($0 basis/$100x in value) and Asset B ($100x basis/$100x in value).

c. So long as grantor and IDGT are considered the same taxpayer, they will continue to share an outside basis of $100x such that if Asset B (high basis asset) is distributed to either of them, it's unlikely that a basis reduction would occur because the basis that is shared by both of them is equal to the tax basis of Asset B. However, what if grantor trust status is relinquished with respect to the IDGT?

d. When grantor trust status is lost, the grantor is deemed to make a transfer of the partnership interest held by the trust, which is now a separate taxpayer, as a non-grantor trust. In this example, grantor is deemed to make a transfer of 50% of the limited partnership interests to the trust, which requires an allocation of outside basis and capital account to the transfer. Prior to the transfer, the unitary basis of all of the limited partnership interests was $100x and the capital account was $200x. 50% of the capital account or $100x will go to the trust upon the deemed transfer. As discussed above, according to Revenue Ruling 84-53, the amount of basis that is allocated to the transfer depends on the relative fair market values of the transferred interest and the entire interest prior to the transfer.

e. Let's assume in "Version 1" of this example, the fair market value of 100% of the limited partnership is equal to the capital account balance of $200x (liquidation value) because the sole shareholder of the S corporation is the grantor who is the transferor in this

deemed transfer. The grantor has the power to compel liquidation of the LP. If the deemed transfer of the 50% limited partnership interest to the trust carries a 30% valuation discount, then $35x of basis will pass to the trust ($65x will remain with the grantor), as follows:

$$\text{Transferor's Adjusted Basis } \$100x \times \frac{\text{Fair Market Value (Discounted) Transferred Portion } \$70x}{\text{Fair Market Value Transferor's Entire Portion } \$200x} = \text{Transferee's Adjusted Basis } \$35x$$

f. The resulting partnership books after the deemed transfer are as follows:

LP: Version 1 (After Deemed Transfer)			
	Partnership	*Inside Basis*	*§ 704(b) Book Value*
	Asset A	$0	$100
	Asset B	$100	$100
	TOTAL	**$100**	**$200**
(%)	*Partners*	*Outside Basis*	*Book Capital Account*
50%	Grantor	$65	$100
50%	Trust (Former IDGT)	$35	$100
	TOTAL	**$100**	**$200**

g. Assuming a section 754 election is in place, if Asset B is distributed to the trust in liquidation of its interest in the LP, the resulting partnership books and position of the trust are as follows:

LP: Version 1 (After Liquidating Distribution to Trust)			
	Partnership	*Inside Basis*	*§ 704(b) Book Value*
	Asset A	$65	$100
	TOTAL	**$65**	**$100**
(%)	*Partners*	*Outside Basis*	*Book Capital Account*
100%	Grantor	$65	$100
	TOTAL	**$65**	**$100**
	Asset B	*Tax Basis*	*Fair Market Value*
	Trust (Former IDGT)	$35	$100

h. Version 1 of this example results in a shift of $65x of basis to Asset A with $35x remaining with Asset B now owned by the trust outside of the partnership.

i. In "Version 2" of this example, everything is the same except the fair market value of 100% of the limited partnership is not equal to a liquidation value of $200x. Rather, the fair market value of the limited partnership interests held by the grantor have a 30% valuation discount associated with them (because in Version 2, perhaps, the grantor is not have control of the S corporation general partner of LP). The value of the grantor's interests prior to the deemed transfer is $140x. If the deemed transfer of the 50% limited partnership interest to the trust carries a 30% valuation discount, then $50x of basis will pass to the trust ($50x will remain with the grantor), as follows:

$$\text{Transferor's Adjusted Basis } \$100x \times \frac{\text{Fair Market Value (Discounted) Transferred Portion } \$70x}{\text{Fair Market Value Transferor's Entire Portion } \$140x} = \text{Transferee's Adjusted Basis } \$50x$$

j. The resulting partnership books after the deemed transfer are as follows:

LP: Version 2 (After Deemed Transfer)			
	Partnership	*Inside Basis*	*§ 704(b) Book Value*
	Asset A	$0	$100
	Asset B	$100	$100
	TOTAL	**$100**	**$200**
(%)	*Partners*	*Outside Basis*	*Book Capital Account*
50%	Grantor	$50	$100
50%	Trust (Former IDGT)	$50	$100
	TOTAL	**$100**	**$200**

k. Assuming a section 754 election is in place, if Asset B is distributed to the trust in liquidation of its interest in the LP, the resulting partnership books and position of the trust are as follows:

LP: Version 2 (After Liquidating Distribution to Trust)			
	Partnership	*Inside Basis*	*§ 704(b) Book Value*
	Asset A	$50	$100
	TOTAL	**$50**	**$100**
(%)	*Partners*	*Outside Basis*	*Book Capital Account*
100%	Grantor	$50	$100
	TOTAL	**$50**	**$100**
	Asset B	*Tax Basis*	*Fair Market Value*
	Trust (Former IDGT)	$50	$100

l. Version 2 of this example results in a shift of $50x of basis to Asset A with $50x remaining with Asset B now owned by the trust outside of the partnership, which may seem less effective, but as discussed below, it may solve a taxable gain issue under the mixing bowls transaction rules.

3. Possible Income Tax Implications of the Basis Shifts

a. Generally

(1) As mentioned above, whenever property is contributed to a partnership and, within a certain period of time, partnership property is distributed to a partner, there is the potential to trigger gain under the disguised sale and mixing bowl transaction rules.

(2) In the example above, the LP held Asset A that had an inside basis of zero and a fair market value of $100x. Assume that the LP was formed by contribution of Asset A to LP in exchange for 100% of the limited partnership interests, and assume that there has been no change in the value of Asset A since contribution.

(3) The tax implication of Version 1 and Version 2 in the example above depend, in large part, on how long the asset has been held by the partnership.

b. Disguised Sale

(1) As discussed above, if a partner who has contributed appreciated property to a partnership receives a distribution of any other property or cash generally within two years of the contribution, based on the applicable facts and circumstances, the distribution may cause the partner to recognize gain as of the original date of contribution with respect to his or her contributed property under the "disguised sale" rules. Thus, assuming no facts or circumstances that would properly characterize the transaction as a sale, the operating holding period for Asset A is two years.

(2) If Asset A has been held by the partnership for less than two years at the time of the distribution of Asset B, then the disguised sale will be presumed to have occurred. Interestingly, it likely would have not have made a difference whether the grantor

originally contributed Asset A to LP (and subsequently transferred 100% of the limited partnership interests to the IDGT) or if the IDGT originally contributed Asset A to the LP because they would be considered the same taxpayer under the grantor trust rules. As such, both the grantor trust and the IDGT would be considered the contributing partner. Also note that the Code provides that the elements of a disguised sale can occur if (i) there is a contribution to the partnership by a partner, (ii) there is a "transfer of money or other property by the partnership to such partner (or another partner),"[983] and (iii) the transfers "when viewed together, are properly characterized as a sale or exchange of property."[984]

(3) In either Version 1 or Version 2 in the example above, if Asset A has been held by the partnership for two years or less, a disguised sale is deemed to occur, resulting in a deemed sale of Asset A for $100x and resulting in $100x of gain. The basis that could have been shifted to Asset A in the basis shifts above would not reduce the amount of gain because a disguised sale is calculated as of the original date of contribution.

c. Mixing Bowl Transaction

(1) As discussed above, the mixing bowls transaction provisions of sections 704(c)(1)(B) and 737 of the Code have a seven year time limit. Both operative sections of the mixing bowl transaction rules are operative in this example. If Asset A has been in the partnership for more than two years but seven years or less at the time of the distribution of Asset B, then the mixing bowl transaction rules will be triggered and a taxable event will be deemed to have occurred, but the gain differs in Version 1 and Version 2.

(2) Section 704(c)(1)(B) provides if contributed property is distributed within seven years of the date of contribution to any partner other than the partner who contributed such property, the contributing partner must generally recognize a taxable gain or loss in the year of distribution. [985] Further, with respect transfers of partnership interests, the Treasury Regulations provide, for section 704(c) purposes, "If a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. If the contributing partner transfers a portion of the partnership interest, the share of built- in gain or loss proportionate to the interest transferred must be allocated to the transferee partner."[986] Specifically to contributed property distributions to another partner, the Treasury Regulations provide, "The transferee of all or a portion of the partnership interest of a contributing partner is treated as the contributing partner for purposes of section 704(c)(1)(B) and this section to the extent of the share of built-in gain or loss allocated to the transferee partner."[987]

(3) Section 737 provides if a partner contributes appreciated property to the partnership and, within seven years of the date of contribution, that partner receives a distribution of any property other than the contributed property, such partner generally

[983] § 707(a)(2)(B)(ii).

[984] § 707(a)(2)(B)(iii).

[985] § 704(c)(1)(B).

[986] Treas. Reg. § 1.704-3(a)(7).

[987] Treas. Reg. § 1.704-4(d)(2).

will be required to recognize gain upon the receipt of such other property.[988] Thus, section 737 only applies to property received that was not otherwise contributed by such partner.

(4) Under section 737(a), a partner who has contributed section 704(c) property and who receives a distribution of property within seven years thereafter is required to recognize gain in an amount equal to the *lesser* of:

(a) The excess (if any) of the fair market value (other than money) received in the distribution over the adjusted basis of such partner's outside basis immediately before the distribution reduced (but not below zero) by the amount of money received in the distribution (the "excess distribution");[989] or

(b) The "net precontribution gain,"[990] which is the net gain (if any) which would have been recognized by the distributee partner under section 704(c)(1)(B) if, at the time of the distribution, all section 704(c) property contributed by the distributee partner within 7-years of the distribution that is still held by the partnership were distributed to another partner.[991]

(5) As discussed in more detail in the mixing bowl transaction section in these materials, although there is some debate as to whether a transferee under section 737 is treated as a contributing partner, the consensus view is that a transferee steps into the shoes of the transferor as the contributing partner.

(6) In the example above, grantor and IDGT are essentially both contributors of the appreciated Asset A (section 704(c) property) and of the high basis asset, Asset B (as far as the unitary basis rules are concerned). When the IDGT converts to a non-grantor trust, there is a deemed transfer of 50% of the limited partnership interests to the trust. Prior to the deemed transfer, grantor (as the taxpayer) was the contributor of both assets. After the transfer, the trust, as transferee (now a separate taxpayer), steps into the grantor's shoes but only with respect to ½ of each of Asset A and Asset B. It is similar to how they would be treated under the mixing bowl transaction rules if grantor and the trust had formed LP by each contributing an undivided ½ interest in Asset A and Asset B in exchange for 50% each of the limited partnership interests.

(7) When Asset B is distributed to the trust in both versions of the example above, one-half of Asset B is being returned to the trust. That portion that is being "returned" to the trust does not trigger section 704(c)(1)(B) because that one-half portion of Asset B was deemed to have been contributed by the trust (transferee steps into the shoes of the grantor as contributor). Section 737 applies to other property distributed to the contributing partner. The trust is deemed to be the contributor of one-half of Asset A. In the example, the distribution of the *other* one-half of Asset B (the one-half that was contributed by the grantor and

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[988] §§ 704(c)(1)(B) and 737.

[989] § 737(a)(1).

[990] § 737(a)(2).

[991] § 737(b). Other than a partner who owns, directly or indirectly, more than 50 percent of the capital or profits interest in the partnership. *See* Treas. Reg. § 1.737-1(c)(1). Further, any losses inherent in section 704(c) property contributed by the distributee partner within the preceding 7-year period are netted against gains in determining net precontribution gain. *See* Treas. Reg. § 1.737-1(e), Ex. 4(iv).

retained by the grantor because only 50% is transferred to the trust) to the trust will trigger section 737.

(8) The amount of gain under section 737 is a lesser of the excess distribution, and the net precontribution gain.

(a) In Version 1, the outside basis of the trust is $35x, and the inside basis of Asset A is $65 after the distribution but zero at the time of the distribution. The excess distribution is $15x (fair market value of the *other* one-half of Asset B [$50x] over the trust's outside basis [$35x]). The net precontribution gain under section 704(c)(1)(B) is $25x. It is limited to 25x because the trust is the deemed contributor of one-half of Asset A. The *other* one-half of Asset A has $50x of gain, but the trust's portion of that gain is 50% of that. In all, because section 737 uses a lesser of rule, Version 1 would result in $15x of gain.

(b) In Version 2, the outside basis of the trust is $50x, and the inside basis of Asset A is $50 after the distribution but zero at the time of the distribution. The excess distribution is zero (fair market value of the *other* one-half of Asset B [$50x] over the trust's outside basis [$50x]). The net precontribution gain under section 704(c)(1)(B) is $25x, as explained above. Version 2 would result in *no gain*.

(9) As illustrated, in this type of basis shift, when the appreciated contributed asset has been in the partnership for more than two years but for seven years or less, the amount of gain that might result is a function of how much outside basis is allocated to the distributee partner, the trust. That, in turn, is often a function of the valuation discounts that might be applicable to the partnership interests at the time of the deemed transfer when the grantor trust converts to a non-grantor trust.

(10) If, in the example above, Asset A has been held by LP for more than seven years, the mixing bowl transactions rules would not be applicable, and both Version 1 and Version 2 would result in *no gain*.

4. PLR 201633021

a. PLR 201633021 involved Trust 1 and Trust 2 which were non-grantor trusts because the grantor had passed away. Trust 1 and Trust 2 provides for the benefit of the same beneficiaries. The governing document of Trust 2 provides that Trust 1 retains the power, solely exercisable by Trust 1, to revest the net income of Trust 2 in Trust 1; provided, however, that such power shall lapse on the last day of such calendar year. Trust 2 further provides that income includes (i) any dividends, interest, fees and other amounts characterized as income under § 643(b) of the Code, (ii) any net capital gains realized with respect to assets held less than twelve months, and (iii) any net capital gains realized with respect to assets held longer than twelve months. The ruling provides that the trustee "proposes to transfer funds from Trust 1 to Trust 2."

b. Section 678(a) provides that a person other than the grantor shall be treated as the owner of any portion of a trust with respect to which: (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or (2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677 of the Code, inclusive, subject a grantor of a trust to treatment as the owner thereof.

c. The IRS concluded, "Trust 1 will be treated as the owner of the portion of Trust 2 over which they have the power to withdraw under § 678(a). Accordingly, Trust 1 will take into account in computing their tax liability those items which would be included in computing the tax liability of a current income beneficiary, including expenses allocable to which enter into the computation of distributable net income. Additionally, Trust 1 will also take into account the net capital gains of Trust 2."

d. Essentially, the ruling provides that because Trust 1 will be treated as the owner of Trust 2, the two trusts are now one taxpayer for income tax purposes. If two non-grantor trusts can become a single taxpayer by the use of withdrawal powers, then as illustrated in the previous example, the unitary basis rules for partnerships can be used to effectively shift basis from one trust to the other, provided sufficient time is allowed to pass after the contribution to the partnership.

e. Due consideration should be given to having non-grantor trusts that have received a step-up in basis on its assets (e.g., QTIP trusts or foreign trusts) becoming the owner of other non-grantor trusts that have assets that are in need of basis (or vice versa). If these two "non-grantor trusts" contribute their respective assets to a partnership (another partner is required) and sufficient time passes (ideally, more than seven years), then theoretically the section 678 power can be relinquished, resulting in a transfer of outside basis from one trust to the other. A subsequent liquidation of the partnership would transfer the outside basis to the underlying property distributed in such liquidation.

R. Family Partnership Examples

1. Example 1: Indemnifications and Divisions

a. The following hypothetical illustrates how easily partnerships can facilitate tax basis management in fairly typical estate-planning scenarios. The facts are as follows:

(1) Assume that Mr. and Mrs. Developer are married with three adult children. Exclusive of their home, vacation home, and other personal use assets, Mr. and Mrs. Developer have a net worth of approximately $25 million. Most of Mr. and Mrs. Developer's wealth derives from constructing, owning, and leasing "General Dollar" stores across Georgia, a state that does not have a state death tax. All of the General Dollar store properties are held by General Dollar Lessor, LLC, which is a wholly owned subsidiary of Mr. and Mrs. Developer's family partnership, "Developer Family Partnership, LLLP" (hereinafter "FLLLP"). Assume General Dollar Lessor, LLC has no assets other than the General Dollar stores that it owns and leases. FLLLP was formed many years ago to be the family "holding company."[992]

(2) General Dollar Lessor, LLC has a gross fair market value of approximately $31 million subject to recourse debt of $10 million which is secured by all of its assets (for a net value of $21 million). The debt also is personally guaranteed by Mr. Developer. Due to depreciation and past like-kind exchanges, the adjusted basis of the assets held by General Dollar Lessor, LLC is only $10 million.

[992] If FLLLP has been in existence for more than seven years, and no appreciated or depreciated property has been contributed to the FLLLP by the partners within the past seven years, then the FLLLP will avoid the "mixing bowl" and "disguised sale" rules of §§ 704(c)(1)(B), 707(a)(2)(B), 731(c), 737, and 751(b). *See* above for further discussion of these rules.

(3) FLLLP owns $9 million in publicly-traded securities in addition to its ownership of 100% of General Dollar Lessor, LLC. Essentially, the $9 million in publicly traded securities was accumulated by investing cash flow and earnings distributed to FLLLP from General Dollar Lessor, LLC. In turn, FLLLP would distribute some of the cash flow and earnings to its partners (especially for them to pay taxes), but FLLLP would retain and invest any amounts not distributed to its partners. The aggregate adjusted basis of the FLLLP in the publicly-traded securities is $6 million. A significant portion of the securities have bases equal to their face values (e.g., bonds).

(4) The aggregate outside bases of the partners of FLLLP in their partnership interests is $16 million. The ownership of FLLLP is split roughly 70% to Mr. Developer and 30% to his three adult children as follows:

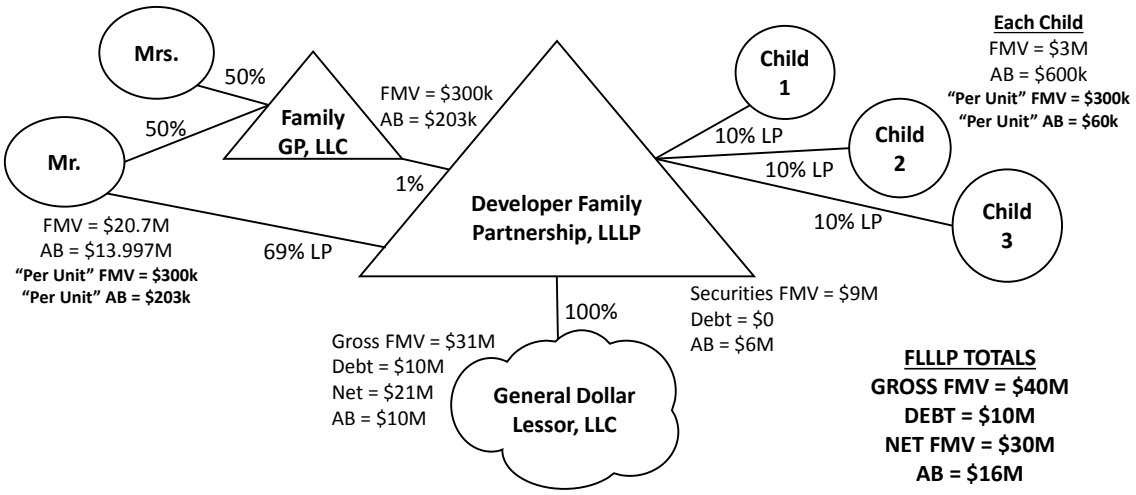
(a) Mr. and Mrs. Developer own 50% each in FLLLP GP, LLC, which in turn owns a 1% general partner interest in FLLLP. The outside basis of FLLLP GP, LLC in its GP interest in FLLLP is $203,000 (rounded). The non-discounted value of FLLLP GP, LLC's 1% GP interest in FLLLP is $300,000.

(b) Mr. Developer owns 69 limited partner "LP Units." These LP Units correspond to an aggregate 69% interest in FLLLP (1% per LP Unit). Mr. Developer's LP Units have a total outside basis of $13,997,000 (rounded) and a non-discounted value of $20,700,000.

(c) Each adult child owns 10 LP Units (corresponding to a 10% interest in FLLLP for each child). Each child's outside basis in his/her LP Units is $600,000 and the non-discounted value of each child's 10 LP Units is $3 million, respectively.

(d) Mr. and Mrs. Developer have their full $10.68 million applicable credit available and have a basic estate plan that leaves all of their assets to their three adult children and their families.

(5) A diagram of the FLLLP ownership structure is set forth below. In the diagram, individuals are represented by circles, partnerships (including entities treated as partnerships for income tax purposes) are represented by triangles, and disregarded entities are represented as clouds:



(6) Based upon the foregoing facts, the capital accounts and bases of Mr. and Mrs. Developer and their children in their partnership interests (their "outside bases") in FLLLP are as follows:[993]

	Developer (Includes Family GP, LLC)			Children		
	Capital Accounts	Outside Basis	Fair Market Value	Capital Acounts	Outside Basis	Fair Market Value
Initial Balances	$4,200,000	$14,200,000	$21,000,000	$1,800,000	$1,800,000	$9,000,000

b. Pursuant to the Treasury Regulations,[994] the $10 million debt of General Dollar Lessor, LLC is treated as "partner nonrecourse debt" with respect to Mr. Developer. The debt is treated as "partner nonrecourse debt" because it is guaranteed by Mr. Developer, and he therefore bears the economic risk of loss with respect to the loan if (as one is required to assume under the Treasury Regulations) General Dollar Lessor, LLC's assets became worthless and the liability became due. Accordingly, the debt of General Dollar Lessor, LLC is treated as recourse to Mr. Developer.[995] Therefore, the entire $10 million of the liability is allocated to Mr. Developer for purposes of determining his outside basis in FLLLP.[996] This is

[993] *See* Treas. Reg. § 1.704-1(b)(2)(iv) for the rules regarding the maintenance of capital accounts for partners in a partnership. *See* § 705 and the Treasury Regulations thereunder for the rules regarding the determination of a partner's basis in his or her partnership interest. For the sake of simplicity, the capital accounts and outside bases of Mr. and Mrs. Developer and the children are aggregated here (including, of course, the capital accounts and outside bases of Mr. and Mrs. Developer held through Family GP, LLC).

[994] Treas. Reg. § 1.704-2(b)(4).

[995] Treas. Reg. § 1.752-1(a)(1).

[996] *See* Treas. Reg. § 1.752-2.

why Mr. Developer's aggregate outside basis in FLLLP ($14.2 million) is disproportionately higher than the aggregate outside basis ($1.8 million) of the children in FLLLP.

c. Assume that Mrs. Developer predeceases Mr. Developer and leaves all of her assets to him. Next, Mr. Developer dies leaving all of his partnership interests in FLLLP to his three adult children in equal shares. Further assume for this purpose that Mr. Developer's combined[997] partnership interests in FLLLP have a non-discounted value of $20 million. If Mr. Developer's combined partnership interests in FLLLP are discounted by 25% for estate tax purposes, then their value will be $15 million (75% of $20 million). This discounted estate-tax value results in very little step-up in outside basis in the FLLLP as compared to Mr. Developer pre-death outside basis of $14.2 million.

d. On the other hand, if prior to his death Mr. Developer's children had indemnified Mr. Developer for 30% (i.e., their combined percentage share of FLLLP) of any liability on the $10 million debt of General Dollar Lessor, LLC, then the outside bases of Mr. Developer and his children in FLLLP would have been as reflected in the table below:

	Developer (Includes Family GP, LLC)			Children		
	Capital Accounts	Outside Basis	Fair Market Value	Capital Acounts	Outside Basis	Fair Market Value
Initial Balances	$4,200,000	$14,200,000	$21,000,000	$1,800,000	$1,800,000	$9,000,000
Children Indemnify 30% Debt		($3,000,000)			$3,000,000	
TOTALS	$4,200,000	$11,200,000	$21,000,000	$1,800,000	$4,800,000	$9,000,000

(1) Under the Treasury Regulations,[998] this simple step of indemnifying Mr. Developer for 30% of the $10 million debt—a step contemplated by the Treasury Regulations[999]—would shift a debt allocation of $3 million of the $10 million General Dollar Lessor, LLC debt to the children.[1000]

(2) This shift would not change the percentage interests of the partners or the values of their partnership interests. As noted above, though, it clearly would increase by $3 million the amount of the potential basis step-up to Mr. Developer's estate upon his death even after taking into account the estate-tax valuation discount on Mr. Developer's partnership interests in FLLLP.

e. Moreover, proactive tax basis management could be taken a step further if, prior to Mr. Developer's death, the FLLLP implemented a "vertical slice" partnership division

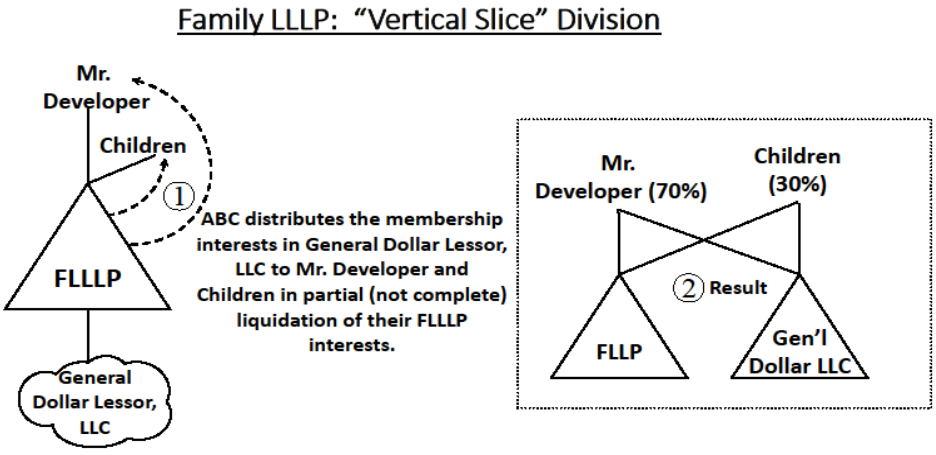
[997] That is, his 69% limited partner interest held directly in FLLLP and his 1% general partner interest held through Family GP, LLC.

[998] Treas. Reg. §§ 1.752-1(a)(1) and 1.752-2.

[999] *See* Treas. Reg. § 1.752-2T(b)(3)(i)(A) (stating that contractual obligations "such as . . . indemnifications" outside the partnership agreement are to be taken into account in determining the partners' economic risk of loss and shares of liabilities for outside basis purposes).

[1000] Technically, under §§ 752(a) and (b), this shift in the allocation of the $10 million debt of General Dollar Lessor, LLC is treated as a constructive distribution of cash to Mr. Developer and a constructive contribution of cash by the children thereby decreasing and increasing, respectively, their outside bases. Because the shift is treated as a constructive distribution of cash to Mr. Developer, the advisor must keep in mind § 731(a)(1), which provides that a distribution of cash (constructive or otherwise) from a partnership to a partner that exceeds the partner's outside basis results in gain to that partner. Here, though, the $3 million constructive distribution is far less than Mr. Developer's outside basis.

under section 708(b)(2)(B) (an "assets-over" transaction, as discussed above). Specifically, a "vertical slice" division of FLLLP would involve a pro rata distribution by the FLLLP of the membership interests in General Dollar Lessor, LLC to Mr. Developer and his children. The marketable securities would remain within the FLLLP while the real estate assets would remain within General Dollar Lessor, LLC. The diagram below illustrates such a division.



(1) Thus, as a result of a "vertical slice" division of FLLLP, Mr. Developer and his children would own 70%/30%, respectively, of two separate partnerships: the FLLLP (which would own $9 million in securities) and General Dollar Lessor, LLC (which would own $31 million in real estate subject to debt of $10 million). As discussed above, this type of "vertical slice" division of FLLLP would not run afoul of the "mixing bowl" or "disguised sale" rules.

(2) Significantly, the partnership division would also avoid the special rule of section 731(c) that treats a distribution of marketable securities as a distribution of cash. This is because the division does not involve a distribution of the securities. Otherwise, under section § 731(c), a distribution of marketable securities with a fair market value in excess of a partner's outside basis can trigger gain to the partner.[1001]

(3) The effect of a "vertical slice" division on the capital accounts and outside bases of Mr. Developer and his children with respect to FLLLP and General Dollar Lessor, LLC are set forth below:

[1001] § 731(a)(1).

	Developer (Includes Family GP, LLC)			Children		
P'ship Division--FLLLP	Capital Accounts	Outside Basis	Fair Market Value	Capital Accounts	Outside Basis	Fair Market Value
Initial Balances	$4,200,000	$14,200,000	$21,000,000	$1,800,000	$1,800,000	$9,000,000
Spin Out Gen'l Dollar Lessor	$0	($10,000,000)	($14,700,000)	$0	$0	($6,300,000)
TOTALS	$4,200,000	$4,200,000	$6,300,000	$1,800,000	$1,800,000	$2,700,000
General Dollar Lessor, LLC	Capital Accounts	Outside Basis	Fair Market Value	Capital Accounts	Outside Basis	Fair Market Value
Initial Balances	$0	$10,000,000	$14,700,000	$0	$0	$6,300,000
Children Indemnify 30% Debt		($3,000,000)			$3,000,000	
TOTALS	$0	$7,000,000	$14,700,000	$0	$3,000,000	$6,300,000

f. With the marketable securities and real estate assets now segregated, upon Mr. Developer's death the discount taken with respect to the estate's partnership interest in FLLLP might be less, thus facilitating a higher step-up in basis in the securities. The estate's partnership interest in General Dollar Lessor, LLC would be subject to a significant discounting, but indemnification of Mr. Developer by the children (as discussed above) could prevent the discount from effectively nullifying the benefit of the basis step-up.

2. Example 2: In-Kind Distributions and Section 754 Election

a. Partner indemnification of debt is not the only means to engage in tax basis management with partnerships. In the right circumstances, the estate-planning advisor should consider in-kind distributions of property from a family partnership to one or more partners.

b. Consider the following hypothetical situation:

(1) Assume that ABC Family LLC owns raw land held for long-term investment. A has a 33.34% interest in ABC Family LLC, while each of A's adult children, B and C, have a 33.33% interest in ABC Family LLC. Each member of ABC Family LLC has an outside basis in his membership interest of $1.5 million.

(2) Assume further that the raw land held by ABC Family LLC is unencumbered and consists of the following three parcels of land: Parcel 1 has an adjusted basis of $4 million but a value of only $2 million; Parcels 2 and 3 each have an adjusted basis of $250,000 and a value of $5 million. Thus, ABC Family LLC is worth a total of $12 million and has an aggregate adjusted basis of $4.5 million in the land. Each member's interest in ABC Family LLC therefore is worth $4 million before taking into account any valuation discounts. Notice as well that the aggregate inside basis of ABC Family LLC in the raw land ($4.5 million) is equal to the aggregate outside basis (3 x $1.5 million = $4.5 million) of the members of ABC Family LLC.[1002] Further assume that all capital contributions to ABC Family LLC are outside the seven year prohibition such that the "mixing bowl" and "disguised sale" rules are not implicated.[1003]

[1002] Typically, absent the death of a partner or a sale or exchange of a partner's partnership interest, the aggregate inside basis of a partnership in its property will equal the aggregate outside basis of the partners in their partnership interests.

[1003] If ABC Family LLC has been in existence for at least seven years, and no appreciated or depreciated property has been contributed to the ABC Family LLC by the partners within the past seven years, then the ABC Family LLC will avoid the "mixing bowl" and "disguised sale" rules of Sections 704(c)(1)(B), 707(a)(2)(B), 731(c), 737, and 751(b).

c. Section 754 Election and Tax Basis Management

(1) Assume that A dies leaving his entire 33.34% membership interest in ABC Family LLC to his children, B and C. Assume that A's membership interest has an outside basis of $1.5 million and a value of $4 million at the time of A's death.[1004] ABC Family LLC typically would make a section 754 election to optimize the estate's step-up in basis in A's membership interest. Pursuant to section 743(b), the election allows A's estate (which ultimately benefits B and C) to adjust its proportionate share of ABC Family LLC's inside basis in the land by a net amount of $2.5 million (i.e., an amount equal to the outside basis step-up in A's membership interest from $1.5 million to $4 million).[1005]

(2) It is important to remember that the adjustment under section 743(b) is personal to the transferee partner (A's estate, and ultimately B and C). The adjustment is thus made to the transferee's (the estate's) *share of the inside basis* of the partnership in its property, not the partnership's basis in the property itself.[1006] In the case of ABC Family LLC, the estate's share (as well as B's and C's respective shares) of the inside basis of the partnership in the land is as follows: Parcel 1 equals $1.334 million (one-third of inside basis of $4 million) and Parcels 2 and 3 equal $83,334 (one-third of inside basis of $250,000 in each parcel).

(3) Next, under section 755, the amount of the adjustment under section 743(b) ($2.5 million) must be allocated among the individual items of ABC Family LLC's property. The adjustment to the basis of items of partnership property is determined by reference to what would be the allocation of gains and losses to the transferee partner (A's estate) from a hypothetical sale of the partnership's property.[1007] Moreover, the allocation of the adjustment across items of partnership property is made by reference to the net amount of the adjustment. Therefore, some items of partnership property (such as built-in loss property) may be subject to a negative adjustment while other items of partnership property (such as built-in gain property) are subject to a positive adjustment.[1008]

(4) If, on a hypothetical sale, after A's death ABC Family LLC sold all of its property for its then fair market value, the gain and loss from such a sale would be allocated to A's estate as follows: $1.583 million gain [one-third of the built-in gain of $4.75 million ($5 million less adjusted basis of $.25 million)] from each of Parcels 2 and 3; and $.667 million loss (one-third of the $2 million built-in loss) from Parcel 1. Accordingly, the $2.5 million net adjustment under section 743(b) for the estate with respect to ABC Family LLC is allocated as follows:

(a) decrease the estate's share of inside basis in Parcel 1 to $.667 million (i.e., the estate's pre-adjustment share of inside basis of $1.334 million attributable to Parcel 1 less the estate's $.667 million allocable share of loss on a hypothetical sale); and

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[1004] For the sake of simplicity, this example assumes no discounted value on the 33.34% membership interest held by A's estate. Even if A's membership interest is subject to a valuation discount, however, the same principles illustrated here apply.

[1005] *See* Treas. Reg. § 1.743-1(b).

[1006] *See* § 743(b) (flush language).

[1007] Treas. Reg. § 1.755-1(b)(1)(ii).

[1008] Treas. Reg. § 1.755-1(b)(1).

(b) increase the estate's share of inside basis in Parcels 2 and 3 to $1.667 million each (i.e., the estate's pre-adjustment share of inside basis of $83,334 per parcel plus the estate's $1.583 million per parcel allocable share of gain from a hypothetical sale).

(5) The ultimate goal of these complicated adjustments is to ensure that if ABC Family LLC sold all of its assets for their fair market values at the time of A's death, the estate would benefit from the step-up in basis and (on a net basis) would not be allocated gain or loss from the sale. And, if we re-examine the facts of our hypothetical, we see that by virtue of the adjustments under section 743(b) this result is, in fact, produced. In particular, the estate's inside share of basis with respect to Parcels 1 and 2 has been adjusted to $1.667 million each. Thus, if Parcels 1 and 2 sell for their respective fair market values of $5 million each, the estate's one-third share of the proceeds from each parcel would be $1.667 million (one-third of $5 million), exactly equal to the estate's adjusted share of inside basis per parcel. Thus, no gain or loss with respect to the sale of either Parcel 1 or 2 will be recognized by the estate. Likewise, if Parcel 1 sold for its fair market value of $2 million, the estate's share of the proceeds would be $.667 million (one-third of $2 million), exactly equal to the estate's adjusted share of inside basis with respect to Parcel 1. Again, no gain or loss will be recognized by the estate with respect to the sale of Parcel 1.

d. Benefits to B and C as A's Heirs

(1) If we now examine ABC Family LLC from the perspective of B and C, the heirs to A's estate, we see that on balance the step-up in basis, the section 754 election, and the corresponding adjustments under section 743(b) benefit B and C. B and C benefit because $2.5 million of built-in gain within ABC Family LLC that would have been allocable to A prior to his death is now offset by the net $2.5 million adjustments made to Parcels 1, 2, and 3.[1009]

(2) Upon closer examination, however, we also see that the result of the $2.5 million net adjustment is not entirely beneficial to B and C. First, there is no question that B and C benefit from the positive adjustment attributable to the estate's share of inside basis in Parcels 2 and 3. The adjustment reduces the taxable gain that B and C will report from a sale of either Parcel 2 or 3 by ABC Family LLC. On the other hand, though, the negative adjustment to the estate's share of inside basis in Parcel 1 is unfavorable. This negative adjustment reduces

[1009] More specifically, B's and C's shares of inside basis in ABC Family LLC's property were $1.334 million each in Parcel 1 and $83,334 each in Parcels 2 and 3 prior to A's death. Without the section 754 election and the corresponding adjustments under section 743(b), B's and C's shares of inside basis simply would have reflected their inherited portions of A's inside basis prior to his death: B's and C's share of inside basis in Parcel 1 would have been $2 million each [$1.334 million plus $.666 million, which is one-half of A's former share ($1.334 million) of inside basis in Parcel 1]; and B's and C's respective shares of inside basis in Parcels 2 and 3 would have been $.125 million each [$83,334 plus $41,666, one-half of A's former share ($83,334) of inside basis in each of Parcels 2 and 3].

By virtue of sections 754 and 743(b), however, B's and C's shares of inside basis in Parcels 1, 2, and 3 are as follows: B's and C's respective shares of inside basis in Parcel 1 are lower--$1.667 million each [$1.334 million plus $.3335 million, one-half of the estate's adjusted share ($.667 million) of inside basis in Parcel 1]; B's and C's respective shares of inside basis in Parcels 2 and 3 are higher--$.9175 million each [$83,334 plus $.834 million, one-half of the estate's adjusted share ($1.667 million) of inside basis in each of Parcels 2 and 3].

the amount of loss that B and C would report from a sale of Parcel 1 by ABC Family LLC had the section 754 election not been made.

(3) Put differently, the section 754 election and corresponding adjustments apply across every item of partnership property. There is no ability to pick and choose which assets to adjust so that built-in gain is reduced while built-in loss is preserved. Nonetheless, ABC Family LLC perhaps could have distributed the built-in loss property, Parcel 1, to A in partial redemption of A's 33.34% membership interest in order to better optimize the favorable aspects of the section 754 election.

e. Distributing Loss Property to Optimize Section 754 Election

(1) Under section 731, a current (i.e., non-liquidating) in-kind distribution of property (other than money) to a partner generally does not result in the recognition of gain or loss to the partnership or to the distributee partner.[1010] Instead, the distributee partner takes a basis in the property equal to but not in excess of the distributing partnership's basis, and the distributee partner reduces his outside basis in his partnership interest by an amount equal to his basis in the distributed property.[1011] Moreover, if the distributing partnership makes (or has in effect) a section 754 election and the distributed property had a basis in the partnership's hands higher than the distributee partner's outside basis in his partnership interest, then the excess results in a positive adjustment under section 734(b) to the distributing partnership's basis in its remaining assets.[1012] Unlike the adjustments under section 743(b) (e.g., arising upon the death of partner), the adjustment under 734(b) is not personal to the distributee partner. Instead, where it applies, section 734(b) creates an upward or downward adjustment in the partnership's basis in its remaining property. Then, under section 755, the adjustment under section 734(b) is allocated across the partnership's remaining property according to unrealized appreciation or depreciation among classes and items of property (in accordance with the methodology set forth in the Treasury Regulations).[1013]

(2) If we apply these rules in the context of ABC Family LLC, and assume that Parcel 1 (the built-in loss property) is distributed to A prior to his death, then we can produce a more favorable result to B and C (A's heirs) than is produced if Parcel 1 is not distributed and ABC Family LLC makes a section 754 election upon A's death.

(3) To wit, recall that ABC Family LLC is worth $12 million and that A, B, and C own membership interests in ABC Family LLC worth $4 million each (assuming no valuation discount).[1014] A, B, and C have an outside basis of $1.5 million each in their membership interests. Parcel 1 is a built-in loss property with a basis of $4 million and a value of $2 million. Parcels 2 and 3 are each built-in gain properties with adjusted bases of $20,000 each and values of $5 million each.

[1010] § 731(a)-(b). Under section 731(c), though, an in-kind distribution of marketable securities can be treated as a distribution of money triggering gain (but not loss) to the distributee partner.

[1011] §§ 732(a) and 733.

[1012] *See* § 734(b).

[1013] *See* Treas. Reg. § 1.755-1(c).

[1014] Again, for the sake of simplicity, this example assumes no discounted value.

(4) Assume that ABC Family LLC distributes Parcel 1 to A prior to his death in partial redemption of his membership interest and also makes a section 754 election. Under the rules of subchapter K, the following results obtain:

(a) Under sections 731 and 732, A takes Parcel 1 with a value of $2 million and a basis of $1.5 million (exactly equal to A's outside basis in his partnership interest).

(b) Under section 733, A's outside basis in his interest in ABC Family LLC is reduced to zero.

(c) A's percentage interest in ABC Family LLC is reduced to 20% (because A is left with a membership interest worth $2 million in a partnership worth $10 million).[1015]

(d) B's and C's percentage interests in ABC Family LLC increase to 40% each (because they each have membership interests worth $4 million in a partnership worth $10 million).

(e) *Most importantly*, an adjustment under section 734(b) in the amount of $2.5 million arises from the distribution of Parcel 1 to A (e.g., $4 million inside basis in Parcel 1 less A's $1.5 million outside basis in his membership interest immediately prior to the distribution).

(5) Then, under section 755, the $2.5 million adjustment under section 734(b) must be allocated across Parcels 2 and 3 in proportion to the unrealized gain in each parcel. The unrealized gain in each of Parcels 2 and 3 is the same: $4.75 million. ABC Family LLC therefore increases its inside basis in Parcels 2 and 3 by $1.25 million each. This leaves ABC Family LLC holding Parcels 2 and 3 worth $5 million each with an inside adjusted basis of $1.5 million each ($.25 million plus $1.25 million).

(6) Next, assume that A dies holding his 20% membership interest in ABC Family LLC and Parcel 1. A's membership interest had a non-discounted value of $2 million and a basis of zero. Parcel 1 had a value of $2 million and a basis of $1.5 million. A's estate steps up its basis in the ABC Family LLC membership interest from zero to $2 million. A's estate steps up its basis in Parcel 1 from $1.5 million to $2 million. Furthermore, under section 754, the $2 million step-up in the estate's outside basis in its membership interest in ABC Family LLC gives rise to a $2 million adjustment under section 743(b). That $2 million positive adjustment increases the estate's (and ultimately B's and C's) share of inside basis in Parcels 2 and 3 by $1 million each. This $1 million positive adjustment under section 743(b) is in addition to the $1.25 million positive adjustment under section 734(b) that previously had been made to Parcels 2 and 3 as result of the distribution of Parcel 1 to A.

(7) B and C thus inherit from A Parcel 1 with a value of $2 million and a basis of $2 million. There is no longer a trapped, built-in loss in Parcel 1. B and C also inherit from A his 20% interest in ABC Family LLC, leaving B and C owning 50% each of ABC

[1015] As discussed above, non-pro-rata distributions of property in family partnerships almost always should result in adjustment of the partners' percentage interests in the partnership. Otherwise, the special valuation rules of Chapter 14 will come into play.

Family LLC. Due to the combination of the adjustments under sections 734(b) and 743(b) though, Parcels 2 and 3 effectively have an adjusted basis to B and C of $2.5 million each determined as follows:

(a) Parcels 2 and 3 each had $1.5 million basis after the IRC § 734(b) inside basis adjustments (described above) upon the distribution of Parcel 1 to A.

(b) A's death gives rise to a $2 million adjustment under section 734(b) to the estate's share of inside basis in Parcels 2 and 3 which remain held by ABC Family LLC.

(c) Under section 755, this $2 million positive adjustment must be allocated across Parcels 2 and 3 to increase the estate's share of inside basis attributable to Parcels 2 and 3.

(d) The Treasury Regulations under section 755 allocate the $2 million adjustment in proportion to relative fair market values of assets inside ABC Family LLC.

(e) Because Parcels 2 and 3 have the same value ($5 million each), the estate's $2 million adjustment under section 743(b) is allocated equally between Parcels 2 and 3.

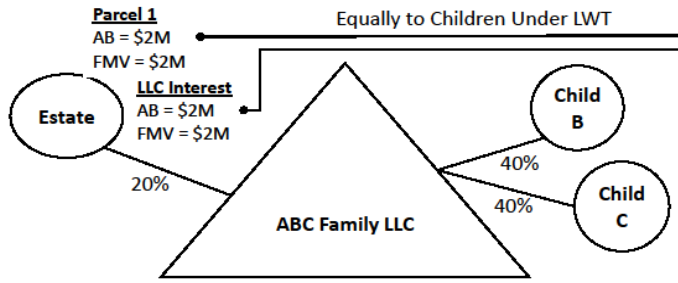
(f) Therefore, the estate's share of the inside basis of ABC Family LLC in Parcels 2 and 3 is $1 million each.

(g) B and C then inherit the estate's share of ABC Family LLC's $1 million inside basis in Parcels 2 and 3.

(h) When combined with ABC Family LLC's existing inside basis of $1.5 million each in Parcels 2 and 3, B's and C's inside shares of basis in Parcels 2 and 3 are now $2.5 million each.

(8) A diagram illustrating the ultimate results to A's estate and to B and C is set forth below:

ABC Family LLC Alternative Two: Step-Up at Death in Parcel 1 and LLC Interest



Each Child as Heir
Parcel 1 (One-Half Ea.)
FMV = $1M ($2M Total)
AB = $1M ($2M Total)
No more "trapped" capital loss.
LLC Interests Each
FMV = $4 + $1 = $5M
AB = $1.5 + $1 = $2.5M
The $2M IRC 743(b) adjustment (i.e., the amount of the basis step up in the estate's LLC interest) is personal to estate/children (i.e., no change to "inside" basis), but B and C adjust their shares of inside basis with respect to Parcels 2 and 3. This reduces the discrepancy between outside basis and FMV in Parcels 2 and 3 as to B and C.

"Inside" Basis
Parcel 2 = $1.5M AB & $5M FMV
Parcel 3 = $1.5M AB & $5M FMV
TOTALS = $3M AB & $10M FMV

B&C's Adjusted Share of Inside Basis
Parcel 2 = $2.5M AB & $5M FMV
Parcel 3 = $2.5M AB & $5M FMV
TOTALS = $5M AB & $10M FMV

Advantage: When A Dies and Parcel 1 Passes to Children, Basis Equals Value Such That There Is No Trapped Built-In Capital Loss in Parcel 1. The excess basis that was in Parcel 1 benefits B & C with respect to Parcels 2 and 3.

(9) As can be seen from the foregoing analysis and the diagram, the carefully planned distribution of Parcel 1 optimizes the results of the section 754 election. In other words, the basis and value of Parcel 1 in B's and C's hands is equal, avoiding receipt of property with built-in loss that can be realized only upon sale. Further, B's and C's inside shares of basis in Parcels 2 and 3 within ABC Family LLC are higher ($2.5 million each versus $1.835 each) than where Parcel 1 is not distributed and A dies holding a 33.34% interest in ABC Family LLC.

(10) In short, the carefully planned distribution of Parcel 1 re-allocated $2 million of excess basis to Parcels 2 and 3 to reduce their built-in gain, rather than trapping a large portion of that excess basis as built-in loss in Parcel 1.

S. Planning with Charitable Entities

1. Generally

a. One of the tax benefits of having a partner that is a charitable entity is its tax-exempt status. When a charitable entity holds a partnership interest, however, due regard should be given to unrelated business taxable income[1016] and excess benefit transactions.[1017] Further, if the charitable entity is a private foundation, planners should consider the rules relating to self-dealing transactions[1018] and excess business holdings.[1019] A full discussion of these and other related rules is beyond the scope of these materials. For purposes of these materials, it is assumed that the charitable partner is a public charity, and the assets in the partnership do not

[1016] § 511.

[1017] § 4958.

[1018] § 4941

[1019] § 4943.

give rise to unrelated business taxable income, excess benefit transactions, or private inurement issues.

b. If a donor makes a charitable contribution of a partnership interest to charity, the donor may be entitled to a charitable deduction (for income and transfer tax purposes). If the partnership interest is appreciated (outside basis is less than the fair market value), then the amount of the charitable deduction may be reduced under section 170(e) of the Code. If a partnership interest is sold in a taxable transaction, the character of the gain recognized by the selling partner is capital subject to recharacterization as ordinary income under section 751(a) of the Code for gain attributable to "hot assets" (ordinary income items like unrealized receivables, inventory items, etc.) held by the partnership.[1020]

c. The Code provides that all contributions of "ordinary income property," regardless of the type of charitable done, must be reduced by the amount of ordinary income that would have resulted if the donor had sold the contributed property at its fair market value at the time of the contribution.[1021] For these purposes, ordinary income includes any gain attributable to "hot assets" of the partnership, and any short-term capital gain attributable with respect to the partnership interest. The capital gain attributable to a partnership interest will be short-term or long-term depending on the transferor partner's holding period in the partnership interest. Notwithstanding the unitary basis requirement for partnership interests, the Treasury Regulations provide that a partner can have multiple holding periods for a single partnership interest.[1022]

d. The Code further provides that a donor's contribution of capital gain property will be further reduced by "the amount of gain which would have been long-term capital gain"[1023] if the donor contributes the property to a private foundation (other than private operating foundations, distributing foundations, and foundations with a common fund).[1024] If the donor contributes the partnership interest to a public charity, the donor will be entitled to a charitable deduction equal to the fair market value of the interest (assuming there is no reduction for ordinary income due to "hot assets" in the partnership). However, the income tax deduction will be limited to 30%[1025] (not 50%[1026]) of the donor's contribution base for the taxable year.[1027] A donor may avoid limiting the deduction to 30% if the donor elects to be subject to section 170(e)(1)(B) of the Code.[1028] Pursuant to the election, the amount of the contribution is reduced by the amount that would have been long-term capital gain (if the contributed property had been sold for its fair market value at the time of contribution). If the election is made, then the contribution is subject to the 50% limitation, rather than the 30% limitation.

[1020] § 741.

[1021] § 170(e)(1)(A).

[1022] Treas. Reg. § 1.1223-3.

[1023] § 170(e)(1)(B).

[1024] § 170(e)(1)(B)(ii)

[1025] *See* § 170(b)(1)(C).

[1026] *See* § 170(b)(1)(A).

[1027] § 170(b)(1)(C)(i).

[1028] § 170(b(1)(C)(iii).

e. A charitable contribution of a partnership interest generally will not cause the donor to recognize gain or loss. However, there may be gain if, as a result of the transfer, there is a deemed reduction in partnership liabilities under section 752(d) of the Code or if the partnership interest is subject to a liability in excess of outside basis, so that the transfer is considered a part sale/part gift. In such circumstances, the donor will recognize gain (but not loss) for the excess of any liability over the outside basis in the partnership interest.[1029] In addition, ordinary income may be triggered under section 751(a) of the Code if the partnership owns hot assets if there is a deemed transfer of partnership liabilities,[1030] and the contribution may also accelerate inherent gain in an installment obligation owned by the partnership.[1031]

2. Basis Shifting with Charitable Entities

a. As discussed above, Revenue Ruling 84-53 provides that when a partner transfers (gratuitous or taxable) a partnership interest and the interest carries a valuation discount, a disproportionately smaller amount of basis is transferred to the transferee. Further, as discussed in these materials, a tax basis "shift" is predicated upon the partnership distributing a higher inside basis asset (in-kind) to a partner whose outside basis in the partnership is lower than the distributed asset. With these rules in mind, a gift of a non-controlling partnership interest to a charitable entity may provide significant tax basis planning opportunities.

b. Consider the following highly simplified hypothetical:

(1) Taxpayer creates a limited partnership and contributes to the partnership the following assets:

(a) Asset A with a zero basis and fair market value of $100; and

(b) Asset B with $100 basis and fair market value of $100.

(2) As a result of the contribution, the taxpayer takes back a 1% general partnership interest and 99% limited partnership interest. Assume another person contributes and owns a nominal interest in the partnership to ensure that the entity is a partnership for income tax purposes, rather than a disregarded entity (see the discussion later in these materials). For purposes of this hypothetical, ignore the existence of this nominal partner. Outside basis in the taxpayer's partnership interest is $100 and his capital account is $200. Assume for purposes of this example that the taxpayer's interest (prior to any transfer) in the partnership remains at $200 (no valuation discounts).

[1029] Treas. Reg. § 1.1001-1(e), *Diedrich v. Commissioner*, 457 U.S. 191 (1982), *aff'd* 643 F.2d 499 (8th Cir. 1981), *rev'g* T.C. Memo 1979-441, 29 T.C.M 433 (gain recognized with a net gift where gift tax paid by the donees exceeded the basis of property transferred), *Estate of Levine v. Commissioner*, 72 T.C. 780 (1979), *aff'd*, 634 F.2d 12 (2d Cir. 1980) (gain realized on net gift of encumbered property).

[1030] *See* Rev. Rul. 64-102, 1984-2 C.B. 119 (shift of liability upon the admission of a new partner resulting in income to the partners under Section 751(b) of the Code).

[1031] *See* Tennyson v. United States, 76-1 USTC ¶9264 (W.D. Ark. 1976) and Rev. Rul. 60-352, 1960-2 C.B. 208 (gift of interest in partnership holding an installment receivable is a disposition of the receivable accelerating the gain).

(3) Taxpayer donates 50% of the limited partnership interest to charity (retaining the 1% general partnership interest and a 49% limited partnership interest). Assume the value of the limited partnership interest carries a 50% valuation discount. In other words, the value for income and gift tax purposes is $50.[1032]

(4) Under Revenue Ruling 84-53, the basis of charity's partnership interest is only $25, and taxpayer's outside basis is $75:

$$\text{Transferor's Adjusted Basis } \$100 \times \frac{\text{Fair Market Value (Discounted) Transferred Portion } \$50}{\text{Fair Market Value Transferor's Entire Portion } \$200} = \text{Transferee's Adjusted Basis } \$25$$

(5) Notwithstanding the foregoing, charity's capital account, under the Treasury Regulations,[1033] is $100.

$$\text{Transferor's Capital Account } \$200 \times \text{Percentage Transferred } 50\% = \text{Transferee's Capital Account } \$100$$

(6) At least seven years after the contribution of the assets, assuming the assets remain in the partnership and there has been no change in the values, the partnership liquidates charity's interest (according to its capital account balance) and distributes Asset B ($100 basis and fair market value of $100) to charity. Assume the LLC has a section 754 election in place at the time of the distribution of Asset B.

(7) The basis of Asset B owned by charity has its basis replaced by charity's outside basis in the partnership. As a result, Asset B's basis is $25. Charity can then sell the Asset B and recognize the gain in a tax-exempt environment.

(8) With the section 754 election, the $75 of basis reduction (basis strip) results in an increase in the basis to Asset A under section 734(b) of the Code. Asset A's basis goes from zero to $75. As discussed in in more detail above, the basis adjustment under section 734(b) is to partnership property, so if the partnership sells Asset A, the basis increase will benefit all of the remaining partners (the taxpayer and any transferees of the taxpayer's retained interest).

3. Creating Basis and Shifting Charitable Deductions

a. Please note that the following discussion preceded the enactment of TCJA. Effective for partnership taxable years beginning after December 31, 2017, TCJA amends section 704(d) of the Code to specifically provide that the basis limitation on the deductibility of partnership "losses" applies to a partner's distributive share of charitable contributions and foreign taxes paid (which had been exempted from such limitation under the Treasury

[1032] Assuming the charitable entity is a public charity and the partnership does not have any "hot asset" under section 751 of the Code, the taxpayer will receive a $50 income tax deduction. *See* § 170(e)(1)(A).

[1033] Treas. Reg. §§ 1.704-1(b)(2)(iv)(l) and 1.704-1(b)(5), Ex. 13.

Regulations).[1034] This limitation does not, however, apply to the excess of fair market value over adjusted basis on charitable contributions of appreciated property.[1035]

b. Under a number of circumstances, the charitable income tax deduction is limited to the basis of the property contributed to charity. For example, when a donor makes a contribution of tangible personal property to a charitable organization where the use by the charity is unrelated to the charitable function or purpose of the organization, the deduction is reduced by the long-term capital gain had the donor sold the property on the date of contribution.[1036] For example, a gift of an appreciated work of art to a public charity that is not a museum or whose function and purpose is totally unrelated to art would result in an income tax deduction equal to tax basis.

c. Consider the following scenarios:

(1) Donor owns a $10 million work of art with zero basis. Donor wishes to contribute the art to a public charity for an unrelated use. If the donor gives the art to the charity during his or her lifetime, then the donor will receive no income tax deduction.

(2) If donor dies and bequeaths the art to charity in his or her Will, then the art will get a "step-up" in basis, and the donor's estate will get the benefit of a charitable estate tax deduction but not an income tax deduction.

(3) If donor dies and bequeaths the art, outright, to his or her surviving spouse, then the art will get a "step-up" in basis, and the estate will get the benefit of the marital deduction for the artwork passing to the spouse. The surviving spouse can subsequently gift the art to the charity, and the surviving spouse would get the benefit of a $10 million charitable income tax deduction.

(4) What if the spouse is unable to effectively use the resulting income tax deduction? Is there some way of shifting those charitable deductions to other family member who would make better use of the deductions?

d. When a partnership makes a charitable contribution of property, it is not considered a partnership expense. Rather, the charitable contribution is accounted separately by the partners under section 702(a)(4) of the Code.[1037] The Treasury Regulations under section

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[1034] § 13503 of TCJA. *See* § 704(d)(3)(A).

[1035] § 704(d)(3)(B).

[1036] § 170(e)(1)(B)(i).

[1037] Treas. Regs. § 1.702-1(a)(4). Deductions for previous charitable contributions are not included in the computation of partnership taxable income. §§ 702(a)(4), 703(a)(2)(C). Consequently, deductions for charitable contributions are not subject to the limitations of Section 704(d) of the Code. However, they are taken into account by the partners, and each partner determines separately whether she has exceeded the applicable limitation on previous charitable deductions. Furthermore, charitable contributions must be appropriately classified so that limitations imposed on the deductibility of certain classes of such contributions may be applied. In PLR 8753015, the IRS held that charitable contributions made by a partnership are not subject to limitation by the at-risk rules and the passive loss limitations. Citing section 1.703-1(a)(2)(iv) of the Treasury Regulations, the IRS explained that each partner separately, rather than the partnership, is treated as having made the contribution; the resulting charitable contribution deduction, thus, is not allocable to the partnership's business and is not allocable to an activity to which those rules applies.

704(d) of the Code (general limitation on the allowance of losses) do not list charitable contributions among the specific items of loss which are subject to the section 704(d) limitation (limited to basis). Under section 705(a)(2)(B) of the Code, a partnership contribution of property to charity reduces each partner's outside basis by the amount of the partner's share of the partnership's basis in the contributed property, but not below zero. [1038]

e. Importantly, a partner's charitable deduction for the contribution of appreciated property by the partnership does not seem to be limited to his or her share of the partnership's basis in the assets.[1039] Thus, contributions of appreciated property by partnerships preserve the tax benefit of receiving a deduction at fair market value for the contribution of appreciated property; the unrealized appreciation is not transferred to the partner's interest in the partnership.[1040]

f. Reconsider the foregoing scenario with the surviving spouse who now owns the $10 million of art with a tax basis equal to fair market value. The spouse contributes the $10 million of art to a partnership and the spouse's child contributes highly-appreciated (zero basis) property of equal value (perhaps another work of art). The spouse and the child each take back a 50% ownership interest in the partnership. The spouse's outside basis is $10 million, and the child's outside basis is zero.[1041] If the partnership then donates the artwork contributed by the spouse to the charity and then allocates the income tax deduction equally to the 2 partners, the spouse and child would each be able to claim $5 million of charitable income tax deduction. Under section 705(a)(2)(B) of the Code, spouse's outside basis in his or her partnership interest would be reduced by $5 million. The child's outside basis remains at zero, but the child would still be able to claim a $5 million charitable income tax deduction.

g. Section 704(c)(1)(A) of the Code provides "income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution." Could the rules under section 704(c) of the Code prevent the result in the example above because the charitable deduction allocated to the child was effectively created by the spouse's contribution? It does not seem so. By its terms, the Treasury Regulations provide that "Section 704(c) Property" only includes property if "at the time of contribution its book value differs from the contributing partner's adjusted tax basis"[1042] (book value meaning fair market value at the time of contribution). The spouse partner in the foregoing example did not contribute property with any built-in gain or loss because the basis equaled fair market value at the time of contribution.[1043] Furthermore, the

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[1038] Rev. Rul. 96-11, 1996-1 C.B. 140.

[1039] *See* PLR 8405084.

[1040] *See also* PLR 200208019, in which the IRS considered whether the members of a partnership were entitled to a charitable deduction on account of the partnership's grant of a conservation easement to a charitable organization. The IRS concluded that each partner was entitled to a charitable deduction equal to each partner's distributive share of the gift.

[1041] § 722.

[1042] Treas. Reg. § 1.704-3(a)(3)(i).

[1043] *See* PLR 9616015 (Because fair market value of timber rights contributed by an Alaska native entity to a partnership was the same at the time of contribution as when they were granted, the rights did not constitute Section 704(c) Property and the partnership's items of income, gain, loss, and deduction are allocable under Section 704(b) of the Code).

section 704(c) methods of allocation (traditional, traditional with curative allocations, and remedial allocations)[1044] in the Treasury Regulations focus exclusively on allocating built-in gain or loss if the partnership sells the contributed property or if the contributed property is subject to amortization, depletion, depreciation or other cost recovery. Nothing under section 704(c) and the Treasury Regulations would seem to prevent the partners from sharing the charitable income tax deduction, as described in the example above.[1045]

4. Charitable Family Limited Partnership

a. Purpose and Mechanics

(1) The purpose of a charitable partnership is to enable a donor to:

(a) Make a larger charitable gift than the donor would feel comfortable making otherwise;

(b) Make a charitable gift when the donor is making substantial gifts to the donor's descendants; and

(c) Sell appreciated assets without incurring gain. In the discussion below a transaction with the donor's children is generally assumed. However, the transaction may also be undertaken with grandchildren or other descendants, or with trusts for the benefit of descendants.

(2) The donor creates a limited partnership. The other initial partner may be the donor's spouse or children. Generally, forming a limited partnership between a donor and spouse is better than involving children because it reduces the opportunity for the IRS to claim that the donor made a gift upon the formation of the partnership. The partnership may have 10,000 units of which 100 would be general partnership units and 9900 would be limited partnership units. Thus, 99% of the "equity" in the partnership is represented by the limited partnership units while 1% of the partnership controls it.

(3) The partnership can be funded with whatever assets the donor desires. Ideally appreciated assets would be used and care must be taken to avoid the investment company rules.[1046] The effects on valuation of funding options should be considered as well. For example, if real property is contributed, more different parcels usually create lower values, e.g. a partnership that contains some undeveloped land and rental properties of various types may be discounted more than a partnership that owns only one kind of real estate.

[1044] Treas. Reg. § 1.704-3(b), -3(c), and -3(d).

[1045] The mixing bowl rules under sections 704(c)(1)(B) and 737 of the Code would not apply either because that requires a distribution of the contributed property to another partner or a distribution of other property to the contributing partner. That did not occur.

[1046] § 721(b) provides gain is realized on the contribution of property to a partnership if the partnership would be treated as an "investment company" under § 351(e). Section 351(e) of the Code and the Treasury Regulations provide that any contributions will be deemed to be a transfer to an investment company if the transfer results, directly or indirectly, in diversification of the transferor's interests, and the transferee is, in pertinent part, a corporation more than 80 percent of the value of whose assets are held for investment and are stocks or securities, or interests in regulated investment companies, or real estate investment trusts.

(4) The donor would contribute the 9900 limited partnership units to a charity. A community foundation is often a good choice because through the foundation the donor is able to benefit multiple charitable beneficiaries. Private foundations are not a good choice because of the self-dealing limitations nor are public charities that are controlled or substantially influenced by the donor.

(5) Section 170 of the Code allows the donor to receive and income tax deduction for the contribution of limited partnership units so long as the contribution is not viewed as being of a partial interest. That is, in order for an income tax deduction to be available the partnership must be respected so that the charity is viewed as receiving partnership units rather than a partial interest in the assets of the partnership. For that reason, the charity should receive the full benefits of the units it receives including income distributions, and the partnership formalities should be followed completely. In general, the same considerations as a donor would follow to minimize or avoid the application of section 2036(a)(1) of the Code (transfers with retained enjoyment or control) in the FLP context are applicable here. The amount of the donor's income tax deduction depends on the fair market value of the units which must be determined by appraisal.[1047]

(6) Most charities do not desire to retain limited partnership interests and thus will want to sell the units. Experience suggests that the most likely purchasers will be one or more members of the donor's family. That may be the children, grandchildren, or trusts for their benefit. The charity should be willing to sell the units for their fair market value which is appraised value. The net effect is that the charity receives appraised value and the children, or other purchasers of the units, receive the value of the partnership above the appraised value.

b. Economics of the Basic Transaction

(1) With Children

(a) Is the transaction beneficial to the family and to the charity? Stated differently, is it a good deal? To illustrate, let us begin with a donor with $1,000,000 in cash. The donor, who has used her gift tax exemption, intends to give $700,000 of that to charity and $300,000 to her children. Of the $300,000 for the donor's children, gift tax of about $86,000 will be owed netting to the children about $214,000.

(b) The $700,000 given to charity will remove $700,000 from the donor's estate but will save the donor about $280,000 in income tax (assuming a combined 40% federal and state rate). If the donor took that $280,000 and paid gift tax of $80,000 (assuming a 40% tax rate) the donor's children would receive about $200,000. So, the donor's children would receive $214,000 plus $200,000 for about $414,000 in this transaction. Charity would have $700,000.

(c) The same transaction with the partnership would have the following results. First, assume that the partnership is funded with $1,000,000 and that the 9900 limited partnership units are valued at $700,000 (approximately a 30% discount). The donor receives a $700,000 income tax deduction upon making the gift to charity which is same as above. If the donor takes the income tax savings and gives them to the children, they will net $200,000.

[1047] *See* Treas. Reg. § 1.170A-13.

(d) If the children purchase the partnership units from the charity for $700,000, the units would have $990,000 of underlying value. If (when) the donor transfers the 100 general partnership units to the children that value may be unlocked. If it is unlocked, the children will have paid $700,000 for something worth $990,000.

(e) The total benefit to the children is, therefore, $200,000 from the charitable deduction and $290,000 from the unlocking of partnership value for a total of $490,000. The children are ahead by $76,000. Of course, consideration should be given to the children's adjusted basis.

(2) With Grandchildren or Trusts for Descendants

(a) The transaction becomes more favorable when assets are moved down more than one generation. To illustrate, a donor with $300,000 of cash will pay $86,000 in gift tax and $61,000 in generation-skipping tax (at the 40% rate, tax exclusive because a direct skip), leaving the children with $153,000. Similarly, the donor who makes a charitable gift of $700,000 and receives and income tax deduction of $280,000 may give only $143,000 to the grandchildren after payment of gift and generation-skipping transfer tax. Thus the grandchildren would receive $153,000 plus $143,000, which is $296,000.

(b) Recall that the yield of the charitable partnership transaction does not vary regardless of the purchaser of the limited units; if grandchildren or a trust for descendants is the purchaser, the benefit remains at $217,500 net of capital gains tax. The value of income tax deduction to the grandchildren remains $143,000. So the grandchildren receive if the partnership is used a total of $360,500. The increase to the grandchildren from using the partnership is $360,500 minus $296,000, which is $64,500. If the donor must sell assets to pay gift tax and generation-skipping transfer tax, the benefits are likewise substantially increased.

(3) Enhancement of the Transaction

(a) If appreciated assets are used to fund the partnership, the transaction may be enhanced. If the assets are sold while the charity owns the limited units, the 99% of the gain realized by the partnership would be allocated to the charity and thus escape income tax. Under the disguised sale rules, a partner who contributes assets to a partnership must recognize gain from the sale of the assets within two-years; however, that rule causes the owner of the limited units to be taxed, in effect, rather than the donor/contributor.

(b) In almost every situation the assets inside the partnership should be sold while the charity is the substantial partner. Otherwise, the donee's lack of basis tends to reduce the overall tax benefits.

(4) Role of the Charity

(a) The charity's role is that of an independent charity looking out for its own best interest. To that end, it will require an appraisal, at a minimum, before selling the limited partnership units. The appraisal may be the same as the donor's appraisal, although the better practice would be to have an independent review. In addition, the charity may have other procedures it follows, such as review of acceptance and disposition of partnership units by special committees; requirements that it be indemnified against liability and unrelated business income tax before it accepts the units; and "shopping" the units to potentially interested purchasers (e.g. "advertising" the availability of units to the financial community through private communications, notification to the charity's board, etc.).

(b) Charities are required to disclose the disposition of contributed nonmarketable assets sold within three years of receipt by filing a Form 8282 (Donee Information Return) within 125 days after the disposition. In many instances charities have as policy the retention of nonmarketable assets during the three-year period. If the partnership units are to be retained, then another appraisal will be required at the time of the sale and should be procured by the charity.

(c) An independent charity is best to ensure that the IRS does not conclude that the sale of the units was conducted in other than an arms-length manner. Although private foundations should not be used for this purpose – because of concerns about self-dealing arising not only from the sale of the units but also from the acquisition and retention of the units – supporting organizations may be. Special care should be taken to ensure that all decisions about the retention and sale of the units are made by persons other than the donor or the donor's family.

(5) Poor Children

(a) A common concern about the charitable partnership is that the children do not have sufficient assets to purchase the limited partnership units. Generally, it is a concern raised by the charity. Experience suggests that it is not a concern in most family situations. The reason would appear to be that most persons who are ready to contribute significant amounts to charity have already given significant amounts to their descendants or at least in trust for their descendants. However, if that is not the case, or if the costs of generating the funds is prohibitive (e.g., the basis of the purchaser in the assets to be sold to raise cash to purchase the units is zero or very low), then a variation may be used.

(b) The partnership may sell the assets it owns and generate cash. With that cash it may redeem partnership units from the charity, at the appropriately discounted value, thereby, indirectly, increasing the value of the remaining units. To illustrate, suppose donor creates a partnership with 100 general partnership units and 9900 limited partnership units and gives the 100 general partnership units to a trust for the benefit of the donor's descendants (value is 1% of the amount in the partnership; a $1,000,000 partnership produces a $10,000 gift). The trustee, as general partner, orders all of the assets of the partnership to be sold and then negotiates to redeem the charity's units at appraised value. If the charity's 9900 limited units are redeemed for $700,000 the partnership has only 100 general partnership units remaining and owns $300,000 in assets. As before, gain will be triggered if the partnership is liquidated. In many instances it may be desirable to retain the form of a general partnership interest in which case a few limited units may be given to the trust or to the donor's descendants.

(c) Transactions structured in this manner have been advocated across the country by a number of different entities and planners. In certain versions the redemption occurs at deeply discounted values, supported, in some instances, by giving the charity the rights to put the units to the partnership for specified amounts. To illustrate, the partnership might provide for a 50-year term during the first year of which the charity would have the right to put the units for 2% of the partnership's book value, during the second year for 4%, and so forth. Planners will need to evaluate such arrangements carefully, particularly given the IRS position with respect to such transactions, discussed below.

c. IRS Position

(1) As might be expected, the IRS has identified some potential areas of abuse with charitable family limited partnerships. In 2001, the IRS Exempt Organizations Continuing Professional Education (hereinafter, 2001 EO CPE) identified the "CHAR-FLIP" (an extreme version of the charitable family limited partnership transaction described above) as the "years favorite charity scam."[1048] As provided in 2001 EO CPE, "The charitable family limited partnership technique is touted as avoiding the capital gain tax on the sale of the donor's appreciated assets, allowing the donor to continue to control the assets until some subsequent sale date, often many years in the future, and still provide the donor with a current charitable deduction on his or her income tax return. Another 'benefit' is reducing estate taxes."

(2) 2001 EO CPE describes the CHAR-FLIP as follows:[1049]

> A typical charitable family limited partnership works as follows: Donor "D", having substantially appreciated assets, which are often not readily marketable, such as real estate or proprietary interest in a closely held business, sets up a donor family limited partnership ("DFLP"). D transfers highly appreciated assets to DFLP in exchange for both a general and limited partnership interest with the general partnership interest comprising a very modest 1 or 2 percent of the total partnership interests. The DFLP agreement usually provides for a term of 40 to 50 years.
>
> D contributes a large percentage of the DFLP interest to charity "Z", usually as much as 95 to 98 percent, in the form of a limited partnership interest. D will usually retain the general partnership interest. D may also retain a modest limited partnership interest or transfer such an interest to D's children. D obtains an independent appraisal of the value of the partnership interests in order to establish the fair market value of the IRC 170(c) charitable contribution deduction. Z receives whatever assets are held by DFLP at the end of the partnership term, assuming the partnership interest was not sold prior to the expiration of the partnership term.

[1048] 2001 Exempt Organizations Continuing Professional Education, Chapter G: Control and Power: Issues Involving Supporting Organizations, Donor Advised Funds and Disqualified Person Financial Institutions, p. 128 (hereinafter, 2001 EO CPE).

[1049] 2001 EO CPE, p. 128.

D claims an IRC 170(c) tax deduction based on the value of the gift of the partnership interest to Z. The value likely has been discounted to take into account the lack of Z control and management of partnership operations as well as the lack of marketability of the limited partnership interest in the context of a closely held business.

The key point is control. Control remains with D as the general partner. Z holds a limited partnership interest with no voice in the day to day management or operations of the partnership.

If appreciated property held by DFLP is sold by DFLP, most of the gain escapes taxation by virtue of the IRC 501(c)(3) exempt status of Z. Only the modest limited or general partnership interests held by D and his family are subject to capital gain taxation.

D generally receives a management fee as compensation for operating and managing the partnership.

Z holds a DFLP interest that may produce current income (although many charitable family limited partnerships produce little or no income) as well as an interest in a (hopefully) appreciating asset which will be sold or exchanged no later than the expiration of the partnership term, usually 40 years or even 50 years.

One of the aspects of the "CHAR-FLIP" is a feature which gives a DFLP the right to sell the property to D or his family at a price specified in the partnership agreement. This right is essentially a put option. While such option may serve to benefit Z, the option is often viewed by critics of this technique as working more for the benefit of D or his family than for Z.

(3) Among the identified issues with the foregoing described transaction were private inurement and benefit, unrelated business income under section 511 of the Code, and excess benefit transaction under section 4958 of the Code. If the charity is a private foundation, then some additions issues were self-dealing under section 4941 of the Code and excess business holdings under section 4943 of the Code.

d. Given the issues identified by the IRS, practitioners should consider one or all of the following with charitable family limited partnership planning:

(1) Transfer the GP interest to a family trust contemporaneously or soon after contribution to charity in order to avoid the argument of donor control;

(2) Distribute the net income of the partnership annually;

(3) Allow charity to sell its limited partnership units, if the charity can find a buyer;

(4) Do not grant an option;

(5) Do not sell the partnership property to donor or donor's family (or trust); and

(6) Do not provide any compensation to or for the benefit of the general partner.

T. Sale of Partnership Interests vs. Distributions In-Kind

1. Taxable Sale of Partnership Interests

a. If a partner sells his or her partnership interest in a taxable transaction, the transferor recognizes gain or loss in accordance with the rules of section 1001.[1050] The transferee takes a cost basis in the acquired partnership interest,[1051] but the transferee's capital account is not based on the consideration tendered. The capital account of the transferee carries over from the transferor partner.[1052] The purchased partnership interest carries with it the transferor's share of section 704(c) gain (both forward and reverse) in the partnership's assets.[1053]

b. The character of the gain recognized by the selling partner is capital subject to recharacterization under section 751(a) for "hot assets," as discussed in more detail above.[1054] Capital gain or loss is recognized as it would be under section 1001 less the amount of ordinary income (or plus the amount of ordinary loss) recharacterized under section 751(a).[1055]

c. Section 1(h) provides that the tax rate on the capital gain portion of the sale is determined by looking through to the partnership assets at the time of the sale.[1056] As a result, the transferor partner may recognize capital gain at a 20%, 25%, and 28% rate (along with the 3.8% Medicare Tax, if applicable to the taxpayer) depending on the nature of the assets in the partnership. The capital gain will be short-term or long-term depending on the transferor partner's holding period in the partnership interest. Notwithstanding the unitary basis requirement for partnership interests, as discussed above, the Treasury Regulations provide that a partner can have multiple holding periods for a single partnership interest.[1057] As a result, the sale of a partnership interest can result in ordinary income, short-term capital gain, and long-term capital gain at a multitude of different rates.

d. As discussed below, a distribution of assets, rather than a sale of the partnership interest (particularly when the partner is exiting the partnership) may result in much better results for the exiting partner. The distribution is not subject to the look-through rule of section 1(h).

e. As discussed above, if the partnership has a section 754 election in place, the inside basis of the partnership's assets will be adjusted based upon the value of the consideration furnished by the purchasing partner. This will essentially give the income

[1050] § 741.

[1051] § 742.

[1052] Treas. Reg. § 1.704-1(b)(2)(iv).

[1053] Treas. Reg. § 1.704-3(a)(7).

[1054] § 741.

[1055] Treas. Reg. § 1.751-1(a)(2).

[1056] § 1(h)(5)(B), (h)(9), (h)(10) and Treas. Reg. § 1.1(h)-1(a).

[1057] Treas. Reg. § 1.1223-3.

purchasing partner a fair market value basis in each of the partnership assets (assuming no valuation discount), so that if the partnership were to sell the assets at that time, no additional gain or loss would be borne by the incoming partner.[1058]

f. A partnership terminates for tax purposes (i) on the sale or exchange of 50% or more interests in the capital and profits of the partnership within any consecutive 12 month period,[1059] or (ii) sale of all other partnership interests to one remaining partner or a single new partner.[1060] When a partnership is terminated, there is a deemed transfer of the assets from the old partnership to a new partnership, followed by a transfer of the interests in the new partnership to the partners of the old partnership (exactly like the "assets-over" transaction described above for partnership divisions).[1061] The primary downside of a technical termination is that the partnership's depreciable tangible assets (but not for section 197 intangibles) is treated as newly placed in service as of the date of the technical termination.[1062] The successor partnership must depreciate the adjusted basis of tangible assets as newly acquired assets placed in service on the termination date. On the other hand, qualified property placed in service by the terminated partnership during the taxable year of termination may be eligible for the first year "bonus" depreciation under §168(k), as mentioned above.

g. Importantly, despite the foregoing downside, a technical termination does not create any new section 704(c) amounts,[1063] and does not start a new seven year period for purposes of the mixing bowl provisions.[1064] The termination does not trigger application of section 731(c) (distributions of marketable securities),[1065] allows carryover of the inside basis adjustment under section 743(b) in assets of the terminated partnership.[1066]

2. Liquidating Distributions

a. The treatment of distribution (both current and liquidating) is discussed in more detail above.

b. As mentioned above, if the liquidating distribution includes cash, then gain or loss is recognized based on the amount of outside basis on the partnership interest prior to the distribution. Ordinary income will be generated under section 751(b) to the extent that

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[1058] In fact, in this instance, the gain or loss would be allocated to the purchasing partner in an amount equal to the gain or loss that would have been allocated to the transferor partner had there been no taxable sale of the interest, and then the inside basis adjustment under section 743(b) then offsets the gain or loss allocated. The effect is the same. *See* Treas. Reg. § 1.743-1(j)(3)(ii), Ex. 2.

[1059] § 708(b)(1)(B) and Treas. Reg. § 1.708-1(b)(2).

[1060] § 708(b)(1)(A), Treas. Reg. § 1.708-1(b)(1) and Rev. Rul. 99-6, 1991-1 C.B. 432.

[1061] Treas. Reg. § 1.708-1(b)(4).

[1062] Treas. Reg. § 1.708-1(b)(4), § 168(i)(7)(B) (final flush language), and § 197(f)(2).

[1063] Treas. Reg. §§ 1.704-3(a)(3)(i), 1.704-4(c)(3), and 1.708-1(b)(4), Ex. (iii).

[1064] Treas. Reg. §§ 1.704-4(a)(4)(ii) and 1.737-2(a),

[1065] Treas. Reg. § 1.731-2(g).

[1066] Former Treas. Reg. § 1.743-2, T.D. 8717, 62 Fed. Reg. 25,498 (May 9, 1997). The provision was omitted when the Treasury Regulations were rewritten by T.C. 8747, 64 Fed. Reg. 69,903 (Dec. 15, 1999).

certain "hot assets" are in the partnership.[1067] To the extent the distributee partner recognizes capital gain, the gain will be taxed at 20% (never 25% or 28%) because there is no look-through rule under section 1(h).[1068] As one author points out, "While there is no obvious reason why the higher capital gain rates can apply to dispositions of partnership interests but not to distributions, that is the way the statute is written."[1069] If a section 754 election is in place, any gain recognized by a distributee will not be also be allocated to the remaining partners (thereby avoiding the higher capital gain tax rates in the future for the remaining partners). If the liquidating distribution does not include cash in excess of outside basis, no gain will be recognized but ordinary income may be generated under section 751(b).

c. If property in-kind is distributed, the outside basis of the partnership interest replaces the basis of the distributed assets.[1070] Ordinary income assets take a carryover basis, with any outside basis remaining going to the capital gain and section 1231 assets distributed.[1071] Assuming a section 754 election, if the distributed capital assets receive additional basis after the distribution (or if there is a substantial basis reduction with respect to such distribution exceeding $250,000), then the partnership must adjust the inside basis of the remaining assets downward by that amount.[1072] If the distributed capital asset results in a basis reduction, the partnership will receive an upward inside basis adjustment if a section 754 election is in place.[1073] All of these adjustments are made pursuant to section 734(b) and are therefore for the benefit of the partnership and the remaining partners. If the distribution in-kind is not in liquidation of the distributee partner's interest, the inside basis adjustment shifts results in a basis shift from the distributee partner to the non-distributee partners.[1074]

3. Planning for FLPs: Sales vs. Distributions

a. Given the disparate treatment of taxable sales of partnership interests and distributions of partnership property, families in FLPs will often find distributions of assets in-kind more advantageous than a taxable sale of a partnership interest.

b. A number of strategies can be devised to take advantage of lower income tax bracket partners (including individuals or non-grantor trusts residing in no income tax states or private foundations). By way of example, one strategy might be distributing appreciated property to the lower income tax rate partner (not in liquidation of the partnership) prior to a

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[1067] One thing to note, however, section 751(b) only applies to "substantially appreciated" inventory. *See* §§ 751(b)(1)(A)(ii) and 751(a)(2). To the extent that inventory exists but is not substantially appreciated, a distribution of cash in liquidation of a partnership interest will be considered capital gain, but a taxable sale of such interest would generate ordinary income under section 751(a). "Substantial appreciation" is defined in section 751(b)(3).

[1068] The rule only applies to the sale or exchange of an interest. *See* § 1(h)(9) and Treas. Reg. § 1.1(h)-1(a).

[1069] Howard E. Abrams, *Now You See It; Now You Don't: Exiting a Partnership and Making Gain Disappear*, 50 Tax Mgmt. Mem. No. 4 (Feb. 16, 2009).

[1070] § 732(b).

[1071] § 732(c).

[1072] § 734(b)(2)(B).

[1073] § 734(b)(1)(B).

[1074] *See* Howard E. Abrams, *The Section 734(b) Basis Adjustment Needs Repair*, 57 Tax Law. 343 (2004).

taxable sale of the assets. This puts the appreciated property in hands of the lower income tax bracket partner

4. Another strategy might include a non-liquidating distribution of cash[1075] in partial redemption of most of the departing partner's interest in the partnership (triggering gain), followed then by a taxable sale of the remaining partnership interest to another family taxpayer. This takes advantage of the no look-through feature of distributions, and with a section 754 election in place, a common inside basis adjustment in favor of the partnership under section 734(b) for the cash distribution, and then an inside basis adjustment in favor of the purchasing partner under section 743.

U. 704(c) Elections That Shift Income Tax Items

1. A full discussion of section 704(c) is beyond the scope of this outline, but estate planners should be aware of certain elections under section 704(c) that can be used under the correct circumstances that could shift income tax liabilities among different taxpayers.[1076]

2. When a partner contributes property to a partnership that has a fair market value different (more or less) than its tax basis, section 704(c)(1)(A) ensures that the inherent tax characteristics associated with such difference will ultimately be allocated to the contributing partner. Upon contribution, the contributing partner's capital account is credited with an amount equal to the fair market value of the property, and when the contributed property is sold by the partnership, any inherent gain or loss (as calculated at the time of contribution) will be allocated to the contributing partner.[1077] In that manner, section 704(c) ensures that the inherent gain or loss is not allocated to the non-contributing partners. As the Treasury Regulations provide, "The purpose of section 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss. Under section 704(c), a partnership must allocate income, gain, loss, and deduction with respect to property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution."[1078]

3. When the contributed property is depreciable property (e.g., commercial real estate or equipment), section 704(c) attempts to put the non-contributing partners in the same position they would be if the depreciable property had been contributed when the tax basis was equal to the fair market value.

a. By way of example, partner A contributes depreciable property worth $1,000,000 and with a tax basis equal to $400,000. Assume, the property has a remaining depreciable life of 5 years. Partner B contributes $1,000,000 of cash. Partner A and B are equal 50% partners.

[1075] The partnership could borrow the proceeds to effectuate the cash distribution. Care should be given to ensure that undesirable partnership liability shifts do not occur in the transaction. Thus, taxpayers should consider borrowing on a nonrecourse basis but having certain remaining partners guarantee the debt.

[1076] For an excellent article on using section 704(c) allocation in the family partnership context, see Thomas N. Lawson, *Using Curative and Remedial Allocations to Enhance the Tax Benefits of FLPs*, 9 Est. Plan. No. 8, pg. 12 (Aug. 2009).

[1077] *See* Treas. Reg. § 1.704-1(b)(2)(iv)(d)(1).

[1078] Treas. Reg. § 1.704-3(a)(1).

(1) For book purposes, the depreciable property is depreciated over the remaining 5 years based on the $1,000,000 book value. Assuming straight line depreciation that would be $200,000 per year.[1079] For tax purposes, because the property only has $400,000 of tax basis, the partnership only has $80,000 of depreciation per year.

(2) Absent section 704(c), A and B would be allocated $40,000 each of depreciation per year. This would be $60,000 less depreciation than B would have been allocated had the property actually had a tax basis of $1 million (as assumed for book purposes). Said another way, for the same equal contribution to become an equal partner, B will have $60,000 more taxable income per year. In theory, A is effectively shifting taxable income to B because A has already enjoyed more of the depreciation previously.

(3) Section 704(c) attempts to cure this anomaly. The Treasury Regulations provide, "For section 704(c) property subject to amortization, depletion, depreciation, or other cost recovery, the allocation of deductions attributable to these items takes into account built-in gain or loss on the property. For example, tax allocations to the noncontributing partners of cost recovery deductions with respect to section 704(c) property generally must, to the extent possible, equal book allocations to those partners."[1080] As such, all of the tax depreciation must be allocated to B until B has received tax depreciation equal to his share of the book depreciation. In other words, all $80,000 of depreciation will be allocated to B each year.[1081] As a result, A has more taxable income and is effectively "recapturing" the depreciation taken prior to the contribution.

(4) This method of allocation is sometimes referred to as the "traditional method."

b. As a result, in the family context, when dealing with depreciable property, under the "traditional method," section 704(c) serves to disproportionately allocate depreciation deductions to the non-contributing partner. Thus, families could form a partnership and use the traditional method of allocations under section 704(c) to their advantage particularly if the non-contributing partner is:

(1) A high income taxpayer (including a non-grantor taxable trust),

(2) Holding property that has basis and that is not depreciable (e.g., cash or marketable securities); or

(3) Has an investment that generates significant passive income each year.

4. You will note, in the previous example, B will be allocated $80,000 of tax depreciation per year, not the $100,000 that B would have received if the depreciable property had a tax basis of $1 million at the time of the contribution. Over the remaining 5 years, B will

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[1079] Treas. Reg. § 1.704-1(b)(2)(iv)(g)(3) provides that book depreciation must bear the same relationship to book value that tax depreciation bears to adjusted tax basis. If adjusted tax basis is zero, book depreciation can be any reasonable method.

[1080] Treas. Reg. § 1.704-1(b)(1).

[1081] *See* Treas. Reg. § 1.704-3(b)(2), Ex. 1.

be allocated, in aggregate, $400,000 of depreciation deductions (which is $100,000 less than the $500,000 B would have received if the property had $1 million of tax basis). This result is due to what is referred to as the "ceiling rule." [1082] The ceiling rule mandates that the partnership cannot allocate more depreciation than it actually has for tax purposes. The Treasury Regulations provide that partnerships can override the effect of the ceiling rule by making "curative" allocations or, alternatively, "remedial" allocations, as discussed in more detail below.

5. A partnership may elect to make "reasonable" [1083] curative allocations to correct distortions created by the ceiling rule. This is often referred to as the "traditional method with curative allocations."

a. Pursuant to this election, the partnership may allocate other tax items (not related to the contributed property) of income, gain, or deduction.[1084] Thus, because B in the traditional method above will be allocated $20,000 less depreciation each year, if the partnership has other depreciable property, it could allocate $20,000 of other depreciation to B.

b. Alternatively, if the partnership does not have other depreciable property, it could allocate $20,000 of ordinary income to A, which has the same effect as an allocation of depreciation to B.[1085]

c. Note, however, in the family context, whether an allocation of depreciation to B or ordinary income to A is economically holistically better to the family is dependent upon their individual circumstances of the taxpayers. What if A has significant net operating losses? What if B is a non-grantor trust subject to very high state income taxes?

d. There is no requirement that curative allocations must offset the entire distortion created by the ceiling rule, and curative allocations can be limited to taking depreciation from a specific set of assets or to specific items of income.[1086]

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e. Generally, curative allocations must be made over the remaining depreciation life of the asset, [1087] but if the remaining depreciation life is very short in comparison to its actual economic life, under certain circumstances, the IRS could invoke the anti-abuse rule and invalidate the curative allocation.

6. The Treasury Regulations allow a third allocation method, often referred to as the "remedial allocation."[1088]

[1082] Treas. Reg. § 1.704-3(a)(1). "The total income, gain, loss, or deduction allocated to the partners for a taxable year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the taxable year (the ceiling rule)."

[1083] *See* Treas. Reg. § 1.704-3(c)(3).

[1084] Treas. Reg. § 1.704-3(c)(1).

[1085] *Id.*

[1086] *Id.*

[1087] *See* Treas. Reg. § 1.704-3(c)(4), Ex. 2.

[1088] *See* Treas. Reg. § 1.704-3(d).

a. Unlike curative allocations which are made from actual partnership tax items, remedial allocations involve the creation of notional tax items by the partnership (not dependent upon the actual tax items recognized by the partnership).[1089] Furthermore, unlike curative allocations, remedial allocations must fully offset the disparity created by the ceiling rule.[1090]

b. Under the remedial allocation method, if the ceiling rule results in a book allocation to a non-contributing partner different from the corresponding tax allocation, the partnership makes a remedial allocation of tax items to the non-contributing partner equal to the full amount of the limitation caused by the ceiling rule, and a simultaneous, offsetting remedial allocation of tax items to the contributing partner.[1091]

c. From the partner's standpoint, remedial allocations have the same effect as other tax items actually recognized by the partnership from both a tax liability and outside basis standpoint.[1092]

d. Unlike curative allocation, when it comes to depreciable property, the time period is different for remedial allocations. As discussed above, curative allocations are generally made over the remaining depreciable life of the property.[1093] Under the remedial allocation method, a partnership must bifurcate its book basis in the contributed property for purposes of calculating depreciation.

e. The portion of book basis in the property equal to the tax basis in the property at the time of contribution is recovered generally over the property's remaining depreciable life of the property (under section 168(i)(7) or other applicable part of the Code).[1094] With respect to the portion of the book value (fair market value at the time of contribution) in excess of the tax basis (the partnership's remaining book basis in the property), it is recovered using any applicable recovery period and depreciation (or other cost recovery) method, including first-year conventions, available to the partnership as if newly purchased property of the same type as the contributed property that is placed in service at the time of contribution.[1095] As discussed above, for residential real property that would generally be 27.5 years. However, for certain types of qualified property (e.g., certain leasehold improvements), it could mean 50% bonus depreciation under section 168(k) in the first year.[1096]

7. Generally, curative allocations will be more desirable than remedial allocations for families because curative allocations will be taken over the life of the remaining depreciable life of the contributed property. Furthermore, curative allocations do not have to

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[1089] *See* Treas. Reg. § 1.704-3(d)(4).

[1090] Treas. Reg. § 1.704-3(d).

[1091] Treas. Reg. § 1.704-3(d)(1).

[1092] Treas. Reg. § 1.704-3(d)(4)(ii).

[1093] *See* Treas. Reg. § 1.704-1(b)(2)(iv)(g)(3).

[1094] Treas. Reg. § 1.704-3(d)(2).

[1095] *Id.*

[1096] This provision currently requires extension each year and was recently extended by the Tax Increase Prevention Act of 2014, P.L. 113-295 (December 19, 2014) to include certain property placed in service through 2014.

fully negate the disparity in the ceiling rule. As such, families have the flexibility to tailor the use of curative allocations to the tax situation of the partners.

8. Anti-Abuse Rule for Allocation Methods

a. Echoing the general anti-abuse provisions discussed above, the Treasury Regulations provide that any "allocation method (or combination of methods) is not reasonable if the contribution of property (or event that results in reverse section 704(c) allocations) and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability."[1097] It also provides that any reference to partners above includes both "direct and indirect" partners, and an "indirect partner" is "any direct or indirect owner of a partnership, S corporation, or controlled foreign corporation … or direct or indirect beneficiary of a trust or estate, that is a partner in the partnership."[1098]

b. Example 3 in the Treasury Regulations describes a situation where the contributed property only has one year remaining in its depreciable life (although the economic life is 10 years) and the contributing partner has an expiring net operating loss.[1099] The proposed curative allocation is to offset the entire disparity between book value and tax basis in the first year. The example concludes that the curative allocation is unreasonable because income would be allocated to a partner with a low marginal tax rate from a partner with a high marginal tax rate "within a period of time significantly shorter than the economic life of the property." However, the example goes on, if the partnership makes curative allocations over the economic life of the property (10 years) then the allocation would be deemed reasonable.[1100]

c. It should be noted that the anti-abuse rules do not necessarily apply for state income tax purposes (although most state income tax regimes are tied to the Federal tax liability). When the anti-abuse rules refer to the present value of aggregate tax liability, it refers only to the Federal income tax. Therefore, there are likely allocations that would not result in any Federal income tax savings that would be deemed reasonable, but could result in significant state income tax savings (e.g., partners in high and low income tax states).

d. The Treasury Regulations do not require a particular election to apply curative or remedial allocations. However, the partnership agreement needs to reflect the allocation chosen by the partnership.

V. PLANNING WITH DISREGARDED ENTITIES

A. Generally

1. A "disregarded entity" has come to mean an entity that is ignored for Federal income tax purposes (but is legally recognized for other purposes as a separate entity for state law

[1097] Treas. Reg. § 1.704-3(a)(10)(i).

[1098] Treas. Reg. § 1.704-3(a)(10)(ii).

[1099] Treas. Reg. § 1.704-3(c)(4), Ex. 3.

[1100] *See also* Treas. Reg. § 1.704-3(b)(2), Ex. 2 for an example of an unreasonable use of the traditional method involving the contribution of property having on year of remaining depreciable life.

purposes).[1101] As the Treasury Regulations provide, "if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner." [1102] Effectively, the entity is "disregarded as an entity separate from its owner if it has a single owner," [1103] and this applies for "federal tax purposes."[1104]Generally, there are three types of entities that are considered "disregarded" for tax purposes: (a) single-owner entities (like wholly-owned LLCs) that have not elected corporate treatment, (b) qualified subchapter S corporation subsidiaries, and (b) qualified real estate investment trust subsidiaries. For purposes of these materials, only LLCs are discussed.

2. Despite the single owner requirement, the IRS has ruled that if an entity is wholly owned by two spouses as community property, it will nevertheless be considered a disregarded entity, provided the spouses report the entity as such.[1105] The ruling does not require that the parties file a joint return. It further provides that a change in reporting position (presumably by either spouse) will be treated as a conversion of the entity (e.g., to a partnership). The ruling provides that the business entity must be "wholly owned" by the spouses as community property and "no person other than one or both spouses would be considered an owner for federal tax purposes."[1106]

3. Further, the IRS has ruled that a state law partnership formed between an entity disregarded under the elective classification (wholly owned LLC of a corporation) regime and its owner (the corporation) is itself disregarded because it only has one owner for tax purposes.[1107]

B. Are Grantor Trusts Disregarded Entities?

1. While many practitioners believe a grantor trust (grantor trust as to both the income and the corpus and over the entire trust[1108]) is treated like a disregarded entity, the law is not clear.[1109] In *Rothstein v. Commissioner*,[1110] the taxpayer purchased property from his grantor trust with an installment note. The taxpayer then resold the property to a third party, computing the resulting gain using a cost basis arising from the original purchase from the grantor trust. While the IRS argued that the trust should be treated as a disregarded entity, the court held for the taxpayer. In coming to its conclusion, the court interpreted the phrase "shall be treated as the

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[1101] Generally, a business entity that is not classified as a corporation (eligible entity), that has a single owner, and that has not elected to be taxed as an association taxed as a corporation. See Treas. Reg. § 301.7701-3(a) and -3(b)(1)(ii).

[1102] Treas. Reg. § 301.7701-2(a).

[1103] Treas. Reg. § 301.7701-3(b)(1)(ii).

[1104] Treas. Reg. §§ 301.7701-1(a) and -2(c)(2).

[1105] Rev. Proc. 2002-69, 2002-2 C.B. 831.

[1106] *Id.*

[1107] Rev. Rul. 2004-77, 2004-2 C.B. 119.

[1108] See Treas. Reg. § 1.671-3.

[1109] *See* Mark L. Asher, *When to Ignore Grantor Trusts: The Precedents, a Proposal, and a Prediction*, 41 Tax. L. Rev. 253 (1986).

[1110] 735 F.2d 704 (2nd Cir. 1984).

owner of the trust assets"[1111] as applying only for purposes of including the trust's income and deductions.

2. Echoing the *Rothstein* ruling, Professor Jeffrey N. Pennell writes, as to grantor trusts being disregarded for tax purposes:[1112]

> The Code and Regs, however, are not entirely consistent with that treatment. Instead, every grantor trust rule (§§673-677) begins by saying "The grantor shall be treated as the owner of any portion of a trust . . ." The significance of this is found in §671:
>
> > Where it is specified . . . that the grantor . . . shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor . . . those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust.
>
> Notice that this does not mention losses, which are considered along with gains only in determining the trust's income. This also does not say that an exchange with a grantor trust is not recognized, or that the trust is ignored…
>
> In a nutshell, then, the tax attributes of a grantor trust are reported by the grantor on the grantor's income tax return, as if the trust's income (which includes net gain in excess of any offsetting losses), deductions, and credits belonged to the grantor.
>
> The actual treatment, however, is as if the trust's DNI was entirely taxable to the grantor. Losses would offset gains in the trust for this purpose, and gain that is attributed out to the grantor thus would be less. But excess losses are trapped in the trust by virtue of the rule in §642(h) ... And these results apply only to the extent the grantor is treated as the owner of the trust. It is not necessarily true for the entire trust, depending upon application of the portion rules.
>
> As a result, the conclusion articulated by various authorities that the trust is "ignored" is not what either the Code or Regulations themselves actually specify. Yet the government itself makes pronouncements that are interpreted by taxpayers in a vast number of different situations to mean that a grantor trust is treated as if it did not exist. This especially is true involving transfers by a grantor into an intentionally defective grantor trust, based on the government's ruling position that the grantor can have no gain or loss on a transfer involving the grantor trust — that an exchange between the grantor and the trust is not a gain or loss realization event

3. Notwithstanding the foregoing, the IRS has ruled in Revenue Ruling 85-13,[1113] on facts similar to *Rothstein*, that the taxpayer in question did not obtain cost basis when he purchased the assets from the grantor trust. Specifically, the ruling provides:[1114]

[1111] § 671.

[1112] *Jeffrey N. Pennell*, (Mis)Conceptions about Grantor Trusts, 50th Annual Southern Federal Tax Institute, Outline V, p. 1-2 (Oct. 2015).

> In Rothstein, as in this case, section 671 of the Code requires that the grantor includes in computing the grantor's tax liability all items of income, deduction, and credit of the trust as though the trust were not in existence during the period the grantor is treated as the owner. Section 1.671-3(a)(1) of the regulations. It is anomalous to suggest that Congress, in enacting the grantor trust provisions of the Code, intended that the existence of a trust would be ignored for purposes of attribution of income, deduction, and credit, and yet, retain its vitality as a separate entity capable of entering into a sales transaction with the grantor. The reason for attributing items of income, deduction, and credit to the grantor under section 671 is that, by exercising dominion and control over a trust, either by retaining a power over or an interest in the trust, or, as in this case, by dealing with the trust property for the grantor's benefit, the grantor has treated the trust property as though it were the grantor's property. The Service position of treating the owner of an entire trust as the owner of the trust's assets is, therefore, consistent with and supported by the rationale for attributing items of income, deduction, and credit to the grantor.
>
> The court's decision in Rothstein, insofar as it holds that a trust owned by a grantor must be regarded as a separate taxpayer capable of engaging in sales transactions with the grantor, is not in accord with the views of the Service.

4. Consistent with Revenue Ruling 85-13, the IRS has ruled that an LLC created by the taxpayer and the taxpayer's grantor trust will be treated as a disregarded entity because the LLC is deemed to have only one taxpayer-owner.[1115]

5. For purposes of this outline and the discussion herein, the government's position under Revenue Ruling 85-13 (grantor trusts are ignored for income tax purposes) is assumed to be correct. In reality, the vast majority of practitioners treat grantor trusts as disregarded entities for all income tax purpose, having all tax items (including losses) reported by the grantor and ignoring all transactions between the grantor and his or her grantor trust. As such, it is assumed if all interests in an LLC are owned by a grantor and grantor trusts, the LLC is treated, at least for Federal income tax purposes, as a disregarded entity.

[1113] Rev. Rul. 85-13, 1985-1 C.B. 184.

[1114] *Id.* *See also* Rev. Rul. 88-103, 1988-2 C.B. 304; PLR 8729023 (grantor and grantor trust will be treated as a single taxpayer for purposes of qualifying for involuntary conversion treatment under § 1033 of the Code); Rev. Rul. 2004-86, 2004-2 C.B. 191 (a taxpayer may exchange interests in a grantor trust—a Delaware statutory trust—for real property and qualify for like-kind treatment under § 1031 of the Code). *But see* Rev. Rul. 2004-88, 2004-2 C.B. 165 (disregarded entity will be treated as an entity separate from its owner for purposes of the TEFRA unified audit rules); Treas. Reg. § 1.001-2(c), Ex. 5 (if a grantor trust holds a partnership interest and the trust ceases to be a grantor trust, then it is treated as a disposition of the partnership interest); Prop. Treas. Reg. § 1.108-9(c)(1), (c)(2) (cancellation of indebtedness rules only apply if the grantor, not the grantor trust, is bankrupt or insolvent).

[1115] PLR 200102037.

C. May Discounts Be Used When Valuing Interests in Disregarded Entities?

1. The critical issue for estate planning purposes is whether valuation discounts must be disregarded when valuing transfers (gifts, bequests, sales, and exchanges) of interests in disregarded entities to and among the grantor and grantor trusts. Does the "willing buyer/willing seller" standard[1116] apply to transfers of interests in disregarded entities? In other words, just as transfers between a grantor and grantor trust are ignored for Federal income tax purposes, are they also ignored for Federal transfer tax purposes?

2. In *Pierre v. Commissioner*,[1117] the Tax Court held the transfers of interests in a disregarded entity should be valued for gift tax purposes as transfers of interests in the entity, rather than transfers of the underlying assets of the entity. The Tax Court pointed out, "[s]tate law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed." As such, the transferred interests in the disregarded entity would qualify for marketability and minority interest discounts. In the case at issue, however, the court concluded that the step transaction applied, in part, because the entity was funded (cash and marketable securities) by the taxpayer less than two weeks prior to the transfers of the entity interests. The taxpayer transferred her entire interest in the wholly-owned LLC to two trusts (9.5% gift and 40.5% sale to each trust).

3. Importantly, the Tax Court in *Pierre* wrote:[1118]

> While we accept that the check-the-box regulations govern how a *single-member LLC* will be taxed for Federal tax purposes, i.e., as an association taxed as a corporation or as a disregarded entity, we do not agree that the check-the-box regulations apply to disregard the LLC in determining how a *donor* must be taxed under the Federal gift tax provisions on a transfer of an ownership interest in the LLC. If the check-the-box regulations are interpreted and applied as respondent contends, they go far beyond *classifying* the LLC for tax purposes. The regulations would require that Federal law, not State law, apply to define the property rights and interests transferred by a donor for valuation purposes under the Federal gift tax regime. We do not accept that the check-the-box regulations apply to define the property interest that is transferred for such purposes. The question before us (i.e., how a transfer of an ownership interest in a validly formed LLC should be valued under the Federal gift tax provisions) is not the question addressed by the check-the-box regulations (i.e., whether an LLC should be taxed as a separate entity or disregarded so that the tax on its operations is borne by its owner). To conclude that because an entity elected the *classification* rules set forth in the check-the-box regulations, the long-established Federal gift tax valuation regime is overturned as to single-member LLCs would be "manifestly incompatible" with the Federal estate and gift tax statutes as interpreted by the Supreme Court.

[1116] *See generally* Treas. Reg. §§ 20.2031-1(b) and 25.2512-1 and Rev. Rul. 59-60, 1959-1 C.B. 237.

[1117] *Pierre v Commissioner*, 133 T.C. 24 (2009).

[1118] *Id.*

4. In other cases, courts have generally supported the position that transfers of interests in disregarded entities are entitled to valuation discounts based on the rights of the transferee under applicable state law and under the LLC operating agreement.[1119]

D. Conversion of Disregarded Entity to Partnership

1. Given that grantor trust status must necessarily terminate with the death of the grantor, all disregarded entities owned by a grantor and one or more grantor trusts will be converted to another type of entity upon the death of the grantor (unless, in theory, the grantor's interest is transferred to the trust and the trust is the only other member of the LLC). It is important then to understand the tax consequences of the conversion of the disregarded entity to (most likely) a partnership.

2. In Revenue Ruling 99-5,[1120] the IRS provided guidance on the tax issues involved in a conversion of a disregarded entity to a partnership. The ruling addresses 2 situations with respect to a wholly-owned LLC that is disregarded for tax purposes and that is initially owned by a single member A. The ruling assumes that the LLC has no liabilities, the assets are not subject to any indebtedness, and all of the assets are capital assets or property described in section 1231 of the Code.

a. In situation 1, B purchases 50% of A's ownership in the LLC for $5,000. The ruling concludes that the LLC is converted to a partnership when B purchases the interest in the LLC from A. The purchase of the LLC interest is treated for tax purposes as if B purchased 50% of each of the LLC's assets (which are, in turn, treated as if held by A for tax purposes). Immediately thereafter, A and B are deemed to contribute their respective interests in those assets to a newly formed partnership. Under such treatment, the ruling further provides:

(1) Member A recognizes gain or loss on the deemed sale under section 1001 of the Code. However, there is no further gain or loss under section 721(a) of the Code for the contribution of asset to the partnership in exchange for partnership interests in the newly formed entity.

(2) Under section 722 of the Code, B's outside basis in the partnership is $5,000, and A's outside basis is equal to A's basis in A's 50% share of the assets in the LLC. Under section 723 of the Code, the partnership's tax basis in the assets is the adjusted basis of the property in A and B's hands immediately after the deemed sale.

(3) Under section 1223(1) of the Code, A's holding period for the partnership interest includes his or her holding period in the assets held by the LLC, and B's holding period for the partnership interests begins on the day following the date of B's purchase of the LLC interest from A.[1121] Under section 1223(2) of the Code, the partnership's holding period for the assets deemed transferred to it includes A's and B's holding periods for such assets.

[1119] *See e.g.*, *Estate of Mirowski v. Commissioner*, T.C. Memo. 2008-74 (Mar. 26, 2008). *But see Pope & Talbot Inc., et al. v. Commissioner*, 105 T.C. 574 (1995) (The court ignored the existence of a newly created partnership in valuing the tax paid upon a distribution of the interests to its shareholders under section 311 of the Code).

[1120] Rev. Rul. 99-5, 1999-1 C.B. 434.

[1121] The ruling cites Rev. Rul. 66-7, 1966-1 C.B. 188.

b. In situation 2, B contributes $10,000 in the LLC for a 50% ownership interest in the LLC. In this instance, as in the previous situation, the ruling concludes that the LLC is converted to a partnership when B contributes the cash to the LLC in exchange for an ownership interest in the partnership. A is treated as contributing all of the assets of the LLC to a newly formed partnership. Under such treatment and facts, the ruling provides:

(1) There is no gain or loss to A or B under section 721(a) of the Code.

(2) Under section 722 of the Code, B's outside basis is equal to $10,000, and A's outside basis is his or her basis in the assets of the LLC which A is treated as contributing to the new partnership. Under section 723 of the Code, the basis of the property contributed to the partnership by A is the adjusted basis of that property in A's hands. The basis of the property contributed to the partnership by B is $10,000, the amount of cash contributed to the partnership.

(3) Under section 1223(1) of the Code, A's holding period for the partnership interest includes A's holding period in the LLC assets deemed contributed when the disregarded entity converted to a partnership. B's holding period for the partnership interest begins on the day following the date of B's contribution of money to the LLC. Under section 1223(2), the partnership's holding period for the assets transferred to it includes A 's holding period.

3. Unfortunately, the foregoing ruling does not address (i) non-taxable transactions like sales or exchanges of a disregarded entity interests between a grantor and his or her grantor trust (situation 1 is a taxable sale) or (ii) contributions of assets to a disregarded entity by a grantor or grantor trust. Under those circumstances, how should the tax basis be allocated among the grantor and the grantor trust? It seems that given the IRS's position in Revenue Ruling 85-13 that grantor trusts are "ignored" or also disregarded, that the unitary basis rules would apply in such a way that if B was a grantor trust in the situations described in Revenue Ruling 99-5, B's outside would not be $5,000/$10,000 respectively. Rather, the aggregate basis of A (the grantor) and B (the grantor trust) would be allocated pursuant to the unitary basis rules, as discussed in more detail above (essentially B would receive a portion of A's basis in the transferred asset).

4. Further, the ruling does not address the conversion of a disregarded entity to a partnership when grantor trust status is lost and the trust holds only a portion of the entities interest.

E. Conversion of Partnership to Disregarded Entity

1. In Revenue Ruling 99-6,[1122] the IRS provided guidance on the tax issues involved in a conversion of partnership to a disregarded entity. The ruling addresses 2 situations with respect to an LLC that is classified as a partnership but becomes a disregarded entity when a transaction consolidates all of the ownership with a single member. The ruling provides that the LLC has no liabilities, and the assets are not subject to any indebtedness.

[1122] Rev. Rul. 99-6, 1999-6 I.R.B. 6.

a. In situation 1, A and B are equal partners in an LLC taxed as a partnership. A sell's his or her entire interest in the LLC to B for $10,000. The ruling concludes the partnership terminates under section 708(b)(1)(A) when B purchases A's entire interest. A must treat the transaction as a sale of A's partnership interests, and with respect to the treatment of B, there is a deemed liquidating distribution of all of the assets to A and B, followed by B treated as acquiring the assets deemed to have been distributed to A in liquidation of A's interests. Under such treatment:

(1) A has gain or loss resulting from the sale of the partnership interest under section 741 of the Code. As discussed above, section 741 of the Code provides that gain or loss resulting from the sale or exchange of an interest in a partnership shall be recognized by the transferor partner, and that the gain or loss shall be considered as gain or loss from a capital asset, except as provided in section 751 of Code (relating to "hot assets," unrealized receivables and inventory items).

(2) B's basis in the assets attributable to A's one-half interest in the partnership is $10,000 under section 1012 of the Code. B does not get to retain the holding period of the partnership on such assets deemed liquidated and distributed to A under section 735(b) of the Code. Rather, these are newly acquired assets, and B's holding period for these assets begins on the day immediately following the date of the sale.

(3) With respect to B's portion of the deemed liquidation, B will recognize gain or loss (if any) under section 731(a) of the Code (generally, no gain or loss except to the extent that any money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution, assuming there are no "hot assets" in the partnership). B's basis in the assets received in the deemed liquidation of B's interest is determined under section 732(b) of the Code (generally, the adjusted basis of B's interest in the partnership, reduced by any money distributed in the same transaction). Under section 735(b) of the Code, B's holding period for the assets includes the partnership's holding period for such assets.[1123]

b. In situation 2, C and D are equal partners in an LLC taxed as a partnership. C and D sell their entire interests in the LLC to E, an unrelated person, for $20,000 ($10,000 each). As under the previous situation, the ruling concludes the partnership terminates under section 708(b)(1)(A) when E purchases all of the LLC interests. C and D must treat the transaction as a sale of their respective partnership interests, and with respect to E, there is a deemed liquidating distribution of all of the assets to C and D, followed by E treated as acquiring all of the former assets of the partnership from C and D.

(1) C and D have gain or loss under section 741 of the Code.

(2) E's basis in the assets in the partnership is $20,000 under section 1012 of the Code, and E's holding period begins on the day immediately following the date of the sale.

2. In typical estate planning transactions, a conversion from a partnership to a disregarded entity could occur in a taxable transaction (e.g., sale of a partnership interest from a non-grantor trust to another partner) or in a non-taxable transfer (e.g., the distribution of a

[1123] Except for inventory items. *See* §735(a)(2).

partnership interest from a non-grantor trust to a beneficiary that is the only other partner or in a gratuitous transfer of the partnership interest (subject to gift or estate tax) to the only other partner. Presumably, the Revenue Ruling 99-6 would apply to the taxable transactions, but it is unclear how they might apply to the non-taxable transactions.

F. Disregarded Entities: Subchapter K and Capital Accounts

1. One of the practical benefits of utilizing disregarded entities with grantor trusts is that the income tax consequences of every transaction (transfers of partnership interests, contributions of capital, distributions, etc.) can be essentially ignored until there is a conversion event, whether that occurs because of the death of the grantor, relinquishing grantor trust status, or admitting a partner that is not the grantor for tax purposes. As long as 100% of the ownership interest is held by the grantor or grantor trusts, there are no complications relating to the allocation of built-in gains and losses under section 704(c) of the Code (or "reverse 704(c)" due to the admission of new partners), no recognition events due to the sale or exchange of a partnership interest, and no need to account for inside or outside basis.

2. Even if a partner has more than one interest in a partnership (held individually or through grantor trusts, presumably) that partner is deemed to have a single capital account. Maintaining capital accounts only becomes important when the disregarded entity is converted to a partnership or if there is a liquidation of the disregarded entity among the members. As discussed in more detail above, the "safe harbor" Treasury Regulations provide that an allocation will have "economic effect" if, in part, the partnership maintains capital accounts under the Treasury Regulations,[1124] and the partnership makes liquidating distributions in accordance with the partners' positive capital account balances.[1125]

3. The Treasury Regulations provide that upon a transfer of all or a part of a partnership interest, the transferor's capital account "that is attributable to the transferred interest carries over to the transferee partner."[1126] The Treasury Regulations take the position that the portion of the transferor's capital account that carries over to the transferee equals the percentage of the transferor's total interest that is sold or transferred. This methodology is not how tax basis is allocated. As discussed above, in Revenue Ruling 84-53,[1127] the IRS ruled in the context of calculating outside basis of a transferred partnership interest, "the basis of the transferred portion of the interest generally equals an amount which bears the same relation to the partner's basis in the partner's entire interest as the fair market value of the transferred portion of the interest bears to the fair market value of the entire interest."[1128]

4. As discussed in more detail above, each partner is deemed to have a single unitary basis for all interests held in a partnership. Similarly, each partner has a single capital account for all interests in the same partnership. The Treasury Regulations provide, "a partner who has more than one interest in a partnership shall have a single capital account that reflects all

[1124] Treas. Reg. § 1.704-1(b)(2)(iv).

[1125] Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2).

[1126] Treas. Reg. § 1.704-1(b)(2)(iv)(l).

[1127] Rev. Rul. 84-53, 1984-1 C.B. 159.

[1128] *Id.* The ruling relies Treasury Regulation § 1.61-6(a) which provides that when a part of a larger property is sold, the basis of the entire property shall be equitably apportioned among the several parts for purposes of determining gain or loss on the part sold.

such interests, regardless of the class of interests owned by such partner (e.g., general or limited) and regardless of the time or manner in which such interests were acquired."[1129]

5. In the disregarded entity context, B owns a wholly-owned LLC that is recapitalized into preferred and common shares. B transfers the preferred shares to grantor trust C and the common shares to grantor trust D. The allocation of tax basis and capital account has no meaning in this context because it remains a disregarded entity. What if C becomes a non-grantor trust? The IRS has taken the position that when grantor trust status is lost, it will be treated as if the grantor transferred the interest to trust C at that time. If that is the case, what value is used for determining the allocation of outside basis? Certainly, Chapter 14 value under section 2701 of the Code can't be the answer because what if the preferred shares are deemed to have a zero value under section 2701 of the Code because they do not fall under the qualified payment interest exception? Revenue Ruling 99-5 would treat the loss of grantor trust status as a conversion from a disregarded entity to a partnership (deemed transfer) which would treat C as having purchased a portion of the LLC's assets and then contributed them to a new partnership. What portion of the assets is C deemed to have purchased and how does one value that? For capital account purposes, should the common shares get any balance if the preferred liquidation preference is equal to the section 704(b) book value at that time?

G. Planning Opportunities with Disregarded Entities[1130]

1. Inherent Leverage with No Income Tax Consequences

a. Because transfers of less than 100% of a disregarded entity to a grantor trust (another disregarded entity) will likely carry valuation discounts (see the discussion above), but liquidations must occur according to positive capital accounts, there is inherent wealth transfer leverage in any zeroed-out transfer to an IDGT or GRAT (if and when the disregarded entity or converted entity is finally liquidated). This assumes that the contribution or transfer to the trust carries a valuation discount, but the liquidation will occur on basis that does not include the discount. It further assumes the transfer and the ultimate liquidation is not subject to recharacterization under the economic substance doctrine under section 7701(o) of the Code or non-statutory doctrines like substance-over-form, step-transaction, or sham-transaction.

b. While grantor trust status is retained, the grantor will continue to be treated as if the grantor owned all of the assets for income tax purposes. This allows the assets in the IDGT or GRAT to grow without the burden of paying income tax, which is borne by the grantor. If the grantor also has a power to exchange assets of equivalent value under section 675(4)(C) of the Code, assets that carry a valuation discount can be exchanged to further increase the wealth transfer. For example, if the IDGT directly holds assets that have been liquidated from a disregarded entity, then those assets could be reacquired with shares in another disregarded entity but the value of which carries a discount. All of these transactions can be consummated without recognizing any gain or loss.

[1129] Treas. Reg. § 1.704-1(b)(2)(iv)(b).

[1130] *See* Richard A. Oshins and David A. Handler, *Estate Planning with Disregarded Entities*, presented at the Society of Trust and Estates Practitioners Institute on Tax Estate Planning and the Economy (Jan. 2014) for an excellent discussion of the topic and additional planning opportunities including using a disregarded entity with a residence in lieu of a qualified personal residence trust and a tiered LLC strategy to maximize the leverage of an installment sale.

2. Disregarded Entities and S Corporations

a. S corporations cannot have more than one class of stock, which generally requires that all of the outstanding stock must have identical rights to distributions and liquidation proceeds, but the S corporation may have voting and non-voting shares.[1131] In addition, partnerships are not eligible S corporation shareholders.[1132] Because of the single class of stock requirement, S corporation shareholders are not able bifurcate their economic interests into preferred and common interests and effectuate transactions similar to a preferred partnership freeze or reverse freeze.

b. S corporation shareholders may be able to create preferred and commons interests through a disregarded entity. Pursuant to this idea, S corporation shareholder would create a wholly-owned LLC that is treated as a disregarded entity and contribute his or her S corporation shares to the entity. The disregarded entity would then recapitalize its shares into preferred and common shares, thereby allowing the taxpayer to do a forward or reverse freeze transaction with his or her IDGT. While the taxpayer is alive and the trust remains a grantor trust, the individual taxpayer should continue to be deemed the eligible S corporation shareholder.[1133] The IRS has ruled that an S corporation may be owned by a partnership or a limited liability company (or a combination of them) as long as the partnership and limited liability company are disregarded for income tax purposes.[1134] If the disregarded entity is liquidated during the life of the grantor, then the S corporation shares will be distributed among the grantor and the trust, which will either remain a grantor trust or become either an electing small business trust[1135] or a qualified subchapter S trust.[1136]

c. If, however, the grantor dies prior to the liquidation of the disregarded entity, then an issue arises as to whether the entity will be deemed to have converted to a partnership (as an entity owned by a non-grantor trust and the estate of the taxpayer), thereby terminating the S corporation status of the corporation. This termination might be avoided, as follows:

d. If the operating agreement of the disregarded entity requires an immediate termination and liquidation upon the death of the grantor, then the LLC would, in theory, cease to exist and the assets (the S corporation shares) would immediately be divided among the estate of the decedent and the trust (that must also qualify as an ESBT or QSST).[1137] In most forward freeze transactions, the grantor would hold a preferred interest that had a fixed liquidation amount, and the trust would hold any excess value. The value of the S corporation

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[1131] *See* § 1361(b)(1)(D), Treas. Reg. § 1.1361-1(l)(1).

[1132] *See* § 1361(b)(1)(B).

[1133] *See* § 1361(c)(2)(A)(i) allowing grantor trusts of U.S. citizens and residents to be S corporation shareholders.

[1134] PLR 200513001.

[1135] § 1361(c)(2)(A)(v).

[1136] § 1361(d)(1)(A) treating such qualified subchapter S trusts as grantor trusts of U.S. citizens or residents under § 1361(c)(2)(A)(i).

[1137] *See Guzowski v. Commissioner*, T.C. Memo 1967-145. A partnership that ceased to exist based on the stated term in the partnership agreement was not deemed to be the shareholder. The partners were deemed to be the shareholders.

shares would need to be determined in allocating the fixed liquidation amount to the estate, with any excess shares passing to the trust.

e. Another possible way of avoiding S corporation termination is to ensure that upon the death of the taxpayer, the LLC shares held by the decedent would pass directly to the trust, thereby unifying 100% of the LLC ownership in the trust (which is either an ESBT or QSST). It appears that bequeathing the shares under the decedent's Will may still cause termination of S status. The IRS has ruled that if a corporation's stock is subject to the possession of the executor or administrator of the decedent's estate, the estate is considered a shareholder as of the date of death, notwithstanding the fact that applicable state law provides that legal title to the stock passes directly to the heirs under the Will.[1138] However, termination might still nonetheless be avoided by providing that the LLC interests pass directly to the trust outside of probate. The operating agreement could provide an immediate transfer of the grantor's interest in the LLC to the trust, similar to a transfer on death provision or beneficiary designation. Whether a transfer on death provision in a revocable living trust (as opposed to under the Will) would also be effective is unclear.

f. Even if there is a deemed termination of S corporation status, The IRS has granted relief in circumstances where the S corporation stock was held by disregarded entities and the death of the grantor caused the termination. In PLRs 201730002 and 200841007, the IRS concluded that a termination of S corporation status caused by the death of the grantor—during life the taxpayer had created grantor trusts that held shares in a disregarded entity that, in turn, owned S corporation shares—was inadvertent within the meaning of section 1362(f) of the Code. In both rulings, the taxpayer was granted relief and S corporation status was maintained after the death of the taxpayer.[1139] Of course, private letter rulings have no precedential value, so practitioners are advised to obtain a ruling in advance to ensure that S corporation status will not be terminated.

3. Eliminating Outstanding Installment Notes

a. As mentioned above, the conversion from grantor to non-grantor trust (e.g., death of the grantor) is treated as a transfer by the grantor of the underlying property in the trust. Often, the original transfer of the property is pursuant to an installment sale to an IDGT, with the purchase effectuated by a promissory note from the IDGT to the grantor and the IDGT's debt obligations collateralized by the transferred property. If the promissory note is outstanding at the time of conversion from grantor to non-grantor trust, gain will be recognized to the extent that the debt encumbering the property is in excess of its tax basis.[1140]

b. Grantors and their IDGTs may be able to use disregarded entities to eliminate the potential gain and provide for a step-up in basis on the underlying assets upon the death of the grantor. To illustrate how this might be accomplished, consider an IDGT that holds an asset worth $100x and an adjusted basis of $0, but the asset is encumbered by a $50x liability of the IDGT to the grantor, as evidenced by an installment note (e.g., paying interest annually and

[1138] Rev. Rul. 62-116, 1982-2 C.B. 207.

[1139] *See also* PLRs 200237014, 200237011, 9010042, and 8934020 where the IRS ignored momentary ownership of a newly formed corporation's stock by a partnership during the process of incorporating the partnership or taking remedial measures.

[1140] *See, e.g.*, *Crane v. Commissioner*, 331 U.S. 1 (1947); see also, Treas. Reg. §§ 1.1001-2(a)(4)(v), 1.1001-2(c), *Ex. 5*, and Rev. Rul. 77-402, 1977-2 C.B. 222, in the partnership context.

with an outstanding principal amount of $50x) held by the grantor. If the grantor dies, (i) the promissory note would be includable in the grantor's estate and get a "step-up" in basis, (ii) the asset in the IDGT would be out of the grantor's estate but would not get a "step-up" in basis, and (iii) $50x of gain would have to be recognized by the estate because of the liability in excess of tax basis.

c. To avoid this result, the grantor and the IDGT could simultaneously contribute their respective interests in the property and the debt to a newly formed LLC. IDGT would contribute the asset, along with its $50x liability to grantor, to the LLC. Grantor would contribute the installment note with a principal amount of $50x. Assuming, the net value of the asset and the promissory note were both equal to $50x, IDGT and grantor would be equal (each 50% owners) members in the LLC, but the LLC would continue to be a disregarded entity because they are considered the same taxpayer. As such, the contribution of the asset (subject to the debt) and the promissory note should not have any tax ramifications.

d. The LLC, as a separate legal entity, now owns an asset with a gross value of $100x, has a debt liability of $50x, and it owns the right to receive the $50x debt. In other words, if a person has a debt but also owns the right to be paid on the debt, the debt should by law be extinguished. Further, because the LLC is disregarded and the members of the LLC are the same taxpayer due to the grantor trust rules, the extinguishment of the debt should have no tax ramifications. This leaves the LLC simply holding an asset worth $100x (and no liabilities) with the IDGT and grantor each owning 50% of the LLC.

e. Upon the death of the grantor, there is a deemed transfer of 50% of the LLC to the trust (no longer a grantor trust) which converts the disregarded entity to a partnership for tax purposes under situation 1 of Revenue Ruling 99-5. As discussed above, such a conversion is treated as an acquisition of the LLC assets by the members and a contribution of those assets to a new partnership. Significantly, if the conversion is treated this way, then for step-up in basis purposes, the estate does not own a 50% interest in a partnership, rather the estate is deemed to own 50% of the assets which are simultaneously contributed to a partnership at death. As such, the estate should be entitled to claim a step-up in basis under section 1014(a) of the Code for 50% of the value of the asset in the LLC without risk of losing basis due to valuation discounts.

f. Under sections 722 and 723 of the Code, the estate should have an outside basis in the LLC of $50x, and the LLC should have an inside basis of $50x on the asset which is worth $100x. Practitioners taking this position will likely want to report the inclusion of 50% LLC asset in the estate of the grantor, rather than a 50% interest in the LLC, and out of an abundance of caution, ensure that the LLC makes a section 754 election, entitling it to an inside basis adjustment under section 743(b), in case there is a question as to whether the LLC has $50x of inside basis on the asset.

VI. CONCLUSION

A. Estate planners tailor tax strategies to the client's non-tax objectives. Traditionally, the primary taxes were those involved in wealth transfer taxation – the estate, gift, and generation-skipping transfer taxes. As the amount insulated from those taxes by ever increasing Applicable Exclusion Amounts (the temporary doubling of the Applicable Exclusion Amount under TCJA) strategies to minimize the income tax consequences of the client's planning become increasingly necessary. Just as there are many estate, gift and, generation-skipping tax planning strategies, so too are there multiple income tax planning strategies.

B. This paper deals with methods to acquire new basis for assets, and to shift that basis within a family to the owner who needs it the most or can make the best use of it. Much of that planning is not new but has not been consistently used in everyday practice. To illustrate, for decades a client has been able to make gifts to a *Crummey* trust for the benefit of the client's parents, and the *Crummey* trust has been able to give the parents general powers of appointment so that when the parents die the assets will receive new basis before passing back to or for the benefit of the client. Why has the strategy been rarely used? Because until recently the amount the parents could have in their estates without incurring estate tax has been small ($600,000 from 1981 to 2001, with gradual increases thereafter). Since 2012 the amount has exploded making this planning shockingly attractive.

C. Similarly, new developments in the partnership, international, and grantor trust areas have created new planning opportunities. No client could possibly benefit from every strategy discussed in these materials, or even most of the strategies. On the other hand, it will be the rare client whose family could not benefit from at least one of them. We are at the beginning of a new frontier with exciting times ahead.

Joint Revocable Trusts:
Domestic and International Considerations and Pitfalls

Estate Planning Council of Greater Miami
8th Annual Estate Planning Symposium
February 11, 2020

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Agenda

- Joint Revocable Trust Basics
- Community Property v. Separate Property
- Planning Considerations For Domestic Clients
- Planning Considerations for International Clients

Joint Revocable Trust (JRT) Basics

- JRTs are typically used to hold the assets of a married couple during their lifetimes without separate title
- More commonly used to hold community property, but occasionally used to hold separate property (or a mix of community and separate property)
- One or both spouses are usually trustee
- Trust terms vary greatly - typical terms are discussed later
- Each spouse will generally have a pour-over will that passes any separate property to the decedent's share on death
    - Pour-over wills are not typical for international clients
- JRTs may also be used for non-spouses. Drafting to avoid gift and estate tax issues becomes more difficult in the absence of a marital deduction
    - A joint tenancy agreement is an alternative option in this scenario
- When is a joint "irrevocable" trust appropriate?

Separate Property

- Income earned by the efforts of spouses resident in separate property jurisdictions, such as Florida, are separate property
- Each spouse owns his or her assets separately notwithstanding joint title or the expectations of the spouses
  - Joint accounts are incomplete gifts - whomever contributed the assets remains owner until the other takes the assets out, or one owner dies (in the case of a survivorship account), (completing the gift)
  - Legal title does not necessarily prove ownership - one spouse can be holding assets for the other - but absent unusual circumstances title is the best indicator of ownership
  - Inchoate rights to equitable division of property on divorce or elective share on death do not give a spouse any property rights unless or until the other spouse dies first or the couple divorces

Community Property

- No universal definition - general theory is that it is like a partnership between the spouses of which property/income/debts acquired after marriage is owned/shared 50-50 regardless of title
- Title does not control what is community property
- On the death of a spouse the survivor is entitled to 50% of the community property, and community property is divided equally on divorce
- General exceptions:
  - Gifts and inheritances received by one spouse during marriage
  - Separate property of one spouse prior to marriage
- Upon death of first spouse, 100% of the community property of the spouses receives a "stepped up" (or "stepped down") adjustment of the historic cost basis to current fair market value

Community Property (cont'd)

- United States:
  - Separate property is the dominant marital property regime (e.g. Florida)
  - 9 U.S. states have community property laws + Guam + Puerto Rico (and a few others have special laws to establish community property)
- Foreign countries
  - Typically civil law countries - have some form of community property
  - Does the foreign jurisdiction provide the spouses with a "vested interest" in the marital property?
  - IRS recognizes the following countries as having community property systems that provide a "vested interest": Belgium, Brazil, Colombia, Dominican Republic, Mexico, France, Guatemala, Philippines, Montenegro, Netherlands, Portugal, Spain, Sweden, and Venezuela. (IRM § 21.8.1.15)

Separate Property or Community Property?

- Residents of a separate property state may still own community property traceable to earnings from time resident in community property jurisdictions
- In SFL very common for individuals to migrate from a LATAM jurisdiction with community property
- Tracing of marital assets can be challenging when spouses move around
  - What local law applies? The laws of where the marriage was celebrated? The laws where first marital domicile was established? The laws where the marriage is registered?
  - General rule of the U.S. is that marital property retains it character, but can be changed (Doctrine of mutation)
  - Most civil law countries say character of marital property does not change (Doctrine of immutation)
  - Conflict of law issues. See Estate of Charania, 133 T.C. No. 7 (2009)

Separate Property or Community Property? (cont'd)

- Be careful with jurisdictions that recognize common law marriages (e.g., Texas which is a community property state); or jurisdictions that treat domestic partners subject to community property laws but are not "married" for U.S. federal tax purposes (e.g., California)
- Could be different answer depending on the context (i.e., divorce laws, succession laws, tax laws)
- Need to review marital agreements for choice of law provisions
- Federal law can preempt state law in certain circumstances. IRA withdrawals, self-employment taxes, earned income credits, US savings bonds, railroad retirement benefits, and social security benefits are all deemed to be separate property

Separate Property or Community Property? (cont'd)

- F.S. § 732.216 et seq - Florida Uniform Disposition of Community Property Rights at Death Act
  - Applies to property that was community property under the laws of another jurisdiction or is traceable to community property
  - Tenants by the entireties property ("TBE") is not community property
  - Property acquired during marriage while domiciled in a jurisdiction where it could have been acquired as community property is presumed to be community property (burden of proof on the challenger of community property status)
  - Real property in Florida and all personal property acquired during marriage while domiciled in a jurisdiction where it could not have been acquired as community property and which has rights of survivorship are presumed not to be community property (burden of proof on the proponent of community property status)
  - On death, one-half of the property to which the statute applies is the property of the surviving spouse and one-half passes through the decedent spouse's estate (but is not included in the "elective estate" for elective share calculation purposes)

JRTs for Community Property

- JRTs are often used to keep track of community property and dispose of it on death
- While title to property does not determine its community property status, it can become difficult to trace what is, and is not, community property
- Having one account titled in the name of a revocable trust and labeled as community property makes it easier to keep track during life and divide and dispose of on the death of the first to die
- Typically during the joint lives joint consent is needed to withdraw assets from this account, or either spouse can withdraw the assets but the character remains community property
- Typically on death 50% passes from the first spouse - perhaps to a credit shelter and marital trust - and the remaining 50% becomes a fully revocable trust as to the surviving spouse
- The ease of tracking, and dividing, community property makes a joint revocable trust the preferred solution for community property

JRTs for Community Property (cont'd)

- However, when there are also separate assets - such as for a Florida resident couple who brought community property from another jurisdiction - things can get complicated.
  - Most clients prefer to keep just one joint trust for separate and community property
  - This means that a joint revocable trust may have separate subtrusts - a community property portion and a separate property portion (which in turn can be separated into the property of one or the other spouse)
    - The separate property share is often fully revocable by the respective owner spouse as to his or her portion

JRTs for Separate Property

- Some clients without community property prefer a JRT because it is "easier to understand":
  - JRT appears to match the joint ownership of property that they already maintain
  - JRT appears to match the informal understanding that all property belongs to "both spouses"
  - JRT does not force the spouse's to separate title between spouses in order to take advantage of revocable trust advantages, which separation can be very uncomfortable for spouses who consider all property joint
- However, perceived simplicity is an illusion
  - As is noted above, separate property is legally separate no matter how the spouses' informal understanding
  - Using a JRT does not change the legal separation of property but can confuse what portion is attributable to which spouse

JRTs for Separate Property (cont'd)

- JRTs are often drafted as if the property really was "joint," creating serious issues with interpretation
  - A common error is the inclusion of language making the trust revocable by "the grantors" or "the grantors during their lifetimes." It is often not clear whether the surviving grantor continues to have a power of revocation or whether the trust becomes irrevocable on the death of the first spouse
  - Without clear separation of assets, JRT potentially transmutes property that would not be subject to division on divorce into marital property subject to division
  - A JRT can confuse which spouse is the owner, potentially giving a creditor of one spouse access to the assets of the other spouse

JRTs for Separate Property (cont'd)

- Funding a JRT with tenants by the entireties ("TBE") property likely gives up the creditor protection inherent in TBE
  - Several states recognize TBE trusts but in the absence of any law on the topic it is inadvisable to rely on it in a Florida trust
- Funding a JRT with separate property, if that property is not sufficiently segregated
  - could be treated as a gift to the spouse (e.g., if each spouse can revoke as to 50%, rather than just as to his or her share of the assets)
    - Eligible for marital deduction only if spouse is a US citizen
  - could result in one spouse's property passing to a credit shelter trust for his or her own benefit, such that the survivor is a grantor of the trust for his or her benefit - losing creditor protection and confusing estate tax characteristics

JRTs for Separate Property (cont'd)

- According to the IRS, there is no basis step-up for assets not originating with the first to die if those assets pass to a trust with the other spouse as a beneficiary (even if the first to die has a GPOA over those assets) due to the rules of 1014(e) rejecting step up on assets received within a year of death and passing to the original owner of the asset
- However, there are some benefits to JRT in some circumstances
  - A JRT can limit survivor's ability to revoke, locking in a joint dispositive plan
  - A JRT can by use of general power of appointment (GPOA) use the first to die's applicable exclusion amount even if he or she otherwise has insufficient assets

JRTs for International Clients

- JRTs commonly used by LATAM based married clients from community property jurisdictions
- Most trusts are established in offshore trust law jurisdictions such as Cayman, Bahamas, BVI, ect. However, seeing more trusts established in the US that are foreign trusts for US tax purposes
- Most LATAM jurisdictions do not recognize common law trusts, and so trusts are not easily understandable for clients from these countries
- In some cases, a local country foundation could be used instead of a trust (e.g., Panama foundation)
- Not all LATAM community property jurisdictions provide that community property assets retain community property character when transferred into trust/foundation - this could be important for planning
- All of the non-tax planning considerations for domestic clients are similar, but planning also needs to take into consideration possible local forced heirship laws
- JRTs may be only choice for US bank accounts based on financial institution

JRTs for International Clients (cont'd)

- Often offshore JRTs are not drafted with the assistance of a US tax lawyer which can create US tax issues if JRT holds US assets or has US beneficiaries
- Common US tax planning considerations
  - Grantor trust limitation rules for NRA settlors
  - Understanding who is a "grantor" and who is an "owner" under the grantor trust rules
  - Understanding the grantor trust "portion" rules
  - Using the right US estate tax blocker structure for US situs assets
  - Effective basis step up planning for trust assets and blocker structure assets (i.e., check the box)
  - The need to restructure the JRT on death of first spouse to avoid potentially punitive US income tax results for US beneficiaries of the trust
  - Careful with JRTs when one spouse is NRA and the other spouse is US
  - If trust established under US state law but still foreign for US tax purposes be careful with FBAR reporting and other information return reporting

Drafting Considerations for JRT (Taxable Estates)

- Option I - First to die directs 50% (via general power of appointment over sufficient assets of survivor) on death
  - In lieu of 50%, the amount passing can by formula be an amount sufficient to fund a credit shelter trust
  - Poorer spouse gets assets for credit shelter trust without dividing assets during life
  - This planning is less relevant than in the past due to portability
    - But portability does not cover GST and appreciation, or asset protection
  - The IRS by private letter ruling has agreed that Section 2036 does not apply to include the credit shelter trust assets traceable to the survivor's contribution to the JRT in the taxable estate of the survivor. This conclusion is not certain, and PLRs cannot be cited as precedent, but the IRS has not been challenging this position so it appears fairly safe

Drafting Considerations for JRT (Taxable Estate)

- Option II - First to die directs 100% (via general power of appointment over all assets) on death
  - Advantages:
    - Asset protected trust for the survivor?

      May be subject to fraudulent transfer rules and time period as to assets originating with survivor
    - Step up in basis on 100% of assets? There is likely no step up in basis in assets traceable to the survivor. According to the IRS, Section 1014(e) prevents step-up on assets acquired within one year of death and passing back to the original owner. Arguably a trust for the survivor should not trigger the 1014(e) limitation but the IRS by private letter ruling has ruled that it does.
  - Disadvantages
    - First to die could disinherit survivor (other than elective share)
    - Survivor still needs a revocable trust at that point if has any other assets

Drafting Considerations for JRT (Non-Taxable Estate)

- No concern about taxable gift on funding, so can require both spouses' consent to amend, revoke, or withdraw
- No concern about estate or gift tax, so can just split any way on death of first to die - even though some of survivor's assets might be what is passing

Drafting Considerations for JRT (International Client)

- Each spouse should have sole power to revoke their "portion" of the trust assets deemed contributed to the JRT to avoid adverse party limitation rule from applying
  - Doubt as to relying upon § 672(e) to save you
  - If the trust will have US beneficiaries draft a power for the surviving spouse to revoke the entirety of the trust (or alternatively grant the surviving settlor a GPOA). This facilitates the continuing benefit of grantor trust status during the surviving settlor's death as to 100% of the trust and delays the application of the potentially punitive "throwback tax" rules
- Make clear that upon a settlor's incapacity that his or her legal guardian can revoke on behalf of the settlor or other person who has unrestricted authority to exercise such power on the grantor's behalf
  - Consider the necessity of local power of attorney documents to coordinate such power
  - Likely avoid the other spouse as the person to exercise such power because of adverse party limitations

Drafting Considerations for JRT (International Client) (cont'd)

- It is not common for offshore trusts to give the settlor a power to direct income or grant a right to income to the settlor so may need to draft into the trust document to assure basis step up planning
- Settlors are usually not the trustee for an offshore trust. The power to remove and replace the trustee is important power and should it be a joint power or not?
    - Protectors are commonly used in offshore trusts and will hold the power to remove and replace the trustee. Also need to be careful of GPOA risk if such power is held by a US person.
- Is QDOT language necessary for taxable US situs assets?
- Consider US tax savings clauses to make clear the intent
- If letter of wishes assume it will be treated as part of the trust instrument for US tax purposes and draft carefully

Drafting Considerations for JRT (International Client) (cont'd)

- If a US governed law trust consider giving power to independent Protector to decide whether to keep the trust a foreign trust or a domestic trust on the death of the settlors
- If offshore trust make sure language to allow for decanting of trust assets later if there will be US beneficiaries
- Consider fiduciary accounting issues that could arise in the future and draft appropriately. Most offshore trust law jurisdictions do not have similar rules like the Uniform Principal and Income Act

Questions

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ESTATE PLANNING
COUNCIL *of Greater Miami*

8th Annual Estate Planning Symposium

Tax and Retirement Planning Roundtable – The SECURE Act and the New Age of IRAs, 401(k)s, and Qualified Plans

By:
Philip Herzberg, CFP®, CTFA, AEP®, MSF
Benjamin D. Bohlmann, CPA
Patricia L. Green, CPA, CSEP

The SECURE Act Becomes Law

- The **S**etting **E**very **C**ommunity **U**p for **R**etirement **E**nhancement **(SECURE)** Act, signed into law December 20, 2019 (majority of provisions became effective on January 1st, 2020), includes sweeping changes to retirement savings laws that will impact individuals in or nearing retirement, new parents, small business owners, and employees.

  - Required Minimum Distribution (RMD) Age Raised to 72
  - Age Limit Eliminated for Traditional IRA Contributions
  - New Exception to the 10% Penalty for Birth or Adoption
  - IRA Contributions for Fellowship and Stipend Payments
  - Employer Liability Protection for Annuities in Plans
  - Goodbye, Stretch IRA

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Pivotal SECURE Act Retirement Plan Provisions

- Part-time workers can participate in 401(k) plans
  - Long-term, part-time employees who work at least 500 hours in at least 3 consecutive years will be eligible to participate in firm's 401(k) plan.
- **Multiple Employer Retirement Plans (MEPs) for Small Businesses**
  - Unrelated small businesses can band together to create at Pooled Employer Plan (PEP), which permit them to share costs, investment lineup, and administrative costs, in offering a plan to employees.
  - Tax credit of $500 for small businesses that establish a retirement plan

- Annuities within 401(k) plans
  - SECURE Act addresses challenges employers had previously experienced in offering annuities within retirement plans. Rules permit employers to select annuity provider in retirement plans (**ERISA Fiduciary Safe Harbor)**.
  - **Lifetime Income Disclosure** – New disclosure to plan participants that will illustrate projected monthly income in retirement based on their assets.
- Employers may adopt employer-funded retirement plans up to due date of the employer's tax return.

Key SECURE Non-Retirement-Related Changes

- Qualified Education Expenses for 529 Plan funds expanded for student loans and apprenticeships
  - $10,000 lifetime limit, per-person, to pay for qualified education loans.
- Kiddie Tax reverts applicable children's income to be subject to child's parents' marginal tax rate (effective for 2020)
  - Taxpayers may elect to apply these rules to prior 2018 & 2019 tax years.
- Tax Extenders Revive Tax Breaks (effective through 2020)
  - Exclusion from gross income for discharge of qualified principal residence indebtedness
  - Mortgage insurance premium deduction
  - Qualified tuition and related expenses deduction
  - Residential energy efficiency, renewable energy, and green initiatives.
- Adjusted Gross Income (AGI) 'hurdle' rate that must be exceeded to deduct qualified medical expenses remains 7.5% AGI (2019 & 2020).

Elimination of Stretch IRA

- Does not amend or replace (with one exception) any of the existing regulations
- Adds a new section 401(a)(9)(H) which adds a new payout period for all designated beneficiaries
- The definition of designated beneficiary does not change
  - Conduit trust and its conduit beneficiary still qualify as a designated beneficiary
  - See-through accumulation trust doesn't change and its countable beneficiaries are still the participant's designated beneficiaries

Categories of Beneficiaries

- Old law
  - Beneficiary who is not a designated beneficiary – distribution within 5 years if participant died before Required Beginning Date (RBD) or the remaining life expectancy of the participant if participant died on or after his RBD
  - Designated beneficiary – life expectancy payout

- New law
  - Beneficiary who is not a designated beneficiary - No change
  - Designated beneficiary – 10-year payout period
  - Eligible designated beneficiary (EDB) – life expectancy payout (until age of maturity or death of beneficiary)

New Payout Period

- IRC Sec 401(a)(9)(H)
  - Adds to existing rules, new payout period of 10 years that applies to all designated beneficiaries with the exception of five categories

  - Five categories of beneficiaries - "**Eligible Designated Beneficiaries (EDB)**"- are excluded from the 10-year payout and can use life expectancy. The 10-year rule kicks in upon the death of the EDB or the age of maturity for minor child.
    - Surviving spouse
    - Minor child (only until reaching age of maturity)
    - Disabled beneficiary
    - Chronically ill individual
    - Less than 10 years younger beneficiary

See-Through Trusts as Beneficiary

- Conduit trust – all distributions made from the retirement plan to the trust during the lifetime of the conduit beneficiary of the trust must be passed out immediately to the individual life beneficiary. The conduit beneficiary is the sole beneficiary of the trust during his/her lifetime
  - 10-year rule
  - Eligible Designated Beneficiary (EDB) – life expectancy payout

- Accumulation trust – trustee can "accumulate" retirement plan distributions in the trust during the lifetime of the initial beneficiary(ies) for possible later distributions to another beneficiary. All beneficiaries who might ever be entitled to receive such accumulated distributions are "counted" as beneficiaries for applying minimum distribution rules. All countable beneficiaries must be identifiable individuals.

How SECURE Affects Trusts

- Conduit Trusts
  - If the beneficiary is a designated beneficiary, all retirement benefits will be paid out to the beneficiary within 10-year payout period
  - If the beneficiary is an "eligible designated beneficiary (EDB)," EDB can still receive a life expectancy payout
- Accumulation Trusts
  - If any "countable" beneficiary is not an individual, the trust does not qualify as a see-through trust and must take distributions within the 5 year or life expectancy of the participant rule.
  - If qualifies as a see-through trust no longer need to look at the age of the older beneficiary, distributions will be under the 10-year rule.
  - An accumulation trust cannot qualify for EDB treatment because the EDB is not the sole "countable" beneficiary.
  - Exception for EDB treatment is for an accumulation trust for a disabled or chronically ill beneficiary if they are the life beneficiary.

Planning Ideas

- If decedent died in 2019 and there is still time, surviving spouse could disclaim so the contingent beneficiary can take under the pre-SECURE rules over their life expectancy.
- Surviving Spouse can still take advantage of the pre-SECURE Act distribution rules
- Charitable Remainder Trust if charitably inclined and want to provide a stream of income to a beneficiary over a period of time.
- ROTH conversion if owner is in a lower tax bracket than the designated beneficiaries
- Charity as beneficiary
- Qualified charitable deductions directly from IRA if age 70 ½ up to $100,000 a year

5 Reasons to Convert to Roth IRA

- Tax rate arbitrage
  - Those who expect surviving spouse to require large distributions for living expenses because the single tax brackets are "compressed."
  - Those who expect their beneficiaries to have higher tax rate at distribution than the account owners current year tax rate.
- Increase tax-free savings by paying conversion tax with non-IRA funds.
- Client is young and will not need the conversion amount for retirement. Funds are enabled to grow over long-time horizon.
- No RMDs prevent draining of IRA or qualified account and increase tax planning flexibility
- Favorable tax treatment for surviving spouse, as compressed single tax rates will not apply to RMDs.

Roth Conversion Benefit for IRA Trusts

- Roth IRA conversions for your clients may eliminate the trust tax on those Required Minimum Distributions (RMDs) when their grandchildren inherit a large IRA held by a trust.

- RMDs alone on large inherited IRAs will exceed $12,950 in unearned income and be taxed at the highest trust tax rate if income is retained in the trust.
  - IRA distributions are **unearned** income.

- Even though beneficiary inheriting Roth IRA may still be subject to 10-year rule, post-death RMDs from inherited Roth will be tax-free.

Qualified Charitable Distributions (QCDs)

- IRA owners and beneficiaries who are actually **age 70 ½ and older** can direct up to $100,000 per year from their IRA to a qualified charity tax-free to fulfill all or a portion of their annual required minimum distribution.
  - **Qualified Charitable Distributions (QCDs)** are not tax-deductible. Donor can give funds to multiple charities.
  - This charitable contribution lowers amount of income subject to taxation and can possibly reduce Medicare premiums.
  - Adjustment is required for amount that can be distributed to charity if IRA contributions are being made.

- Fortunately, the SECURE Act provisions make no changes to the age of 70 ½ or later at which you may begin to use your IRAs and Inherited IRAs to make QCDs.
  - You can reduce your necessary IRA Required Minimum Distribution (RMD) amount or Inherited IRA 10-year payout amount to keep taxable income lower and to increase tax savings.

Charitable Tax Break

- Qualified Charitable Distributions (QCDs) strategy is more valuable after legislative changes from 2017 Tax Cuts and Jobs Act (TCJA) because the higher new standard deduction means fewer clients will be itemizing expenses and taking deductions for charity.
  - Must be direct gifts from IRA to charity or via check payable from IRA to the charity.
  - Can only be made from Traditional IRAs (not non-deductible portion), Roth IRAs, and inactive SEP and SIMPLE IRAs

Possible Family Wealth Planning Opportunities

- Retirement Trust – protects retirement assets for beneficiaries
  - Trustee has discretion about when and how much of the funds are to be distributed to a beneficiary.
- Life insurance - larger inheritances, post-death control, and less tax
  - IRA owner would utilize after-tax amount of annual Required Minimum Distribution (RMD) to purchase life insurance to replace wealth lost due to accelerated income tax under 10-year payout rule.
  - Life insurance can be retained in the trust for the beneficiary or paid out over time, simulating the best parts of the "stretch IRA," but without all the tax and trust complications.
- Charitable Trust – reduces taxes and provides for charity in future
  - Permits the retirement assets to continue growing tax-deferred, even when assets are distributed from the retirement account into trust.

Biographies

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Philip Herzberg delivers strategic financial planning advice to high net worth individuals and families as a Client Advisor for The Lubitz Financial Group. He is a Certified Financial Planner® professional, Certified Trust and Financial Advisor, and Accredited Estate Planner® designee with almost 15 years of professional experience. Serving on The Lubitz Financial Group's Financial Planning and Advisory Committees, Philip utilizes this experience to help clients implement tax-efficient investment, retirement, and estate planning strategies. A Northwestern University graduate with a Bachelor of Science in Speech with departmental honors, he earned a Master of Science in Finance from Florida International University with a graduate certificate in Investments. Recognized as a devoted ambassador to his profession, Philip is Immediate Past President of the Estate Planning Council of Greater Miami, Past President of the Financial Planning Association (FPA®) of Florida, and Past President of the FPA of Miami. A Journal of Financial Planning Tax & Estate columnist, Mr. Herzberg has authored or contributed to over 50 peer-reviewed estate, tax, and financial planning articles. He has been cited as an authority in regional and national media publications, including *the Wall Street Journal, Morningstar, Marketwatch, Barron's, InvestmentNews, Financial Advisor Magazine, Miami Herald*, and *South Florida Sun-Sentinel.* He is also a featured speaker for local and national professional organization audiences, such as the Estate Planning Council, Florida Institute of Certified Public Accountants (FICPA), FPA, the United Way of Miami-Dade, and the Jewish Community Foundation's Professional Advisory Council (PAC). Philip delights in altruistically giving back to his South Florida community. The recipient of the Joan & Douglas Gross Community Service Award for his stewardship as Young Leadership Division (YLD) Mitzvah Co-Chair, Philip proudly serves on the Jewish Federation of Broward County's Finance and Chai Care Committees.

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Benjamin Bohlmann is the managing partner and a founder of Bohlmann Accounting Group PLLC, a Miami-based boutique CPA firm. Bohlmann Accounting Group serves small and mid-sized private enterprises and family groups from all over the world. Benjamin leads 15 dedicated professionals, advises dynamic business owners on complex and diversified multi-national structures, and collaborates with family groups to assure wealth for future generations.

Benjamin participates in the Society of Trust and Estate Professionals (STEP), is the immediate past Chair of the Beacon Council's International Advisory Committee, the incoming chair of HistoryMiami's Endowment Board and sits on the Executive Committee of DFK USA, an international association of independent accounting firms.

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Patricia Green is a Tax Director and leads the Trust and Estate Practice in EisnerAmper's Florida offices. She has over 30 years of experience providing tax services to small businesses, individuals, trusts and estates. Patricia's has expertise in tax compliance, estate and gift tax, wealth transfer, and succession planning. She serves as an advisor to businesses, entrepreneurs and high net worth individuals.

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