PRACTICAL PARTNERSHIP SOLUTIONS
TO
COMMON CLIENT SITUATIONS

Paul S. Lee, J.D., LL.M.
Chief Tax Strategist
The Northern Trust Company
New York, NY
Email: PSL6@ntrs.com

TABLE OF CONTENTS

Disclosure:
These materials do not constitute and should not be treated as, legal, tax or other advice regarding the use of any particular tax, estate planning or other technique, device or suggestion, or any of the tax or other consequences associated with them. Although reasonable efforts have been made to ensure the accuracy of these materials and the presentation, neither Paul S. Lee nor The Northern Trust Corporation assumes any responsibility for any individual's reliance on the written or oral information presented during the presentation. Each attendee should verify independently all statements made in the materials and during the presentation before applying them to a particular fact pattern, and should determine independently the tax and other consequences of using any particular device, technique or suggestion before recommending it to a client or implementing it for a client.

Last Updated: February 29, 2024

PRACTICAL PARTNERSHIP SOLUTIONS
TO
COMMON CLIENT SITUATIONS

Paul S. Lee, J.D., LL.M.
Chief Tax Strategist
The Northern Trust Company
New York, NY
Email: PSL6@ntrs.com

I. INTRODUCTION

A. Focus of These Materials

1. 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"[1] act, more commonly known as the "Tax Cuts and Jobs Act" ("TCJA") became law. TCJA made significant changes to the U.S. income tax system including reducing the top income tax rate while 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. For the most part, these changes became 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,"[2] 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.

2. From a transfer tax perspective, effective for estates of decedents dying and gifts made after December 31, 2017, TCJA adds new subparagraph section 2010(c)(3) of the Internal Revenue Code of 1986, as amended (hereinafter, the "Code" and all references to a "section" will refer to a section of the Code, unless otherwise noted) that temporarily doubles the basic exclusion amount from $5 million to $10 million, which means, as adjusted for inflation, the basic exclusion amount (or BEA) for 2024 is $13.61 million per person.[3] As a result, the GST tax exemption amount for 2024 is also $13.61 million per person.[4]

3. For many years, one of the primary reasons practitioners utilized entities taxed as partnerships (limited partnerships, limited liability companies, etc.) in estate planning was to take advantage of valuation discounts for transfer tax purposes. Notwithstanding the failed issuance of proposed regulations under section 2704 of the Code, the IRS is clearly taking aim at eliminating valuation discounts for family-owned entities. Under the current law, though, transfer tax liabilities will continue to decrease over time regardless of valuation discounts. With income tax planning coming to the fore, estate planning will become increasingly focused on

[1] 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."

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

[3] Rev. Proc. 2023-34, 2023-48 I.R.B. 1287.

[4] *See* § 2631(c) 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.

proactive tax basis management (e.g., maximizing the "step-up" in basis) and income tax deferral and avoidance.

4. In this type of planning landscape, no entity provides more flexibility than entities taxed as partnerships (and disregarded entities). These materials will discuss common client situations and how partnerships (or disregarded entities) can be used to solve them. The emphasis will be on techniques that are *understandable, straightforward, and actionable*.

B. Focal Point of Partnership Taxation: Section 704(c) Property

1. A threshold partnership tax concept that must be addressed before discussing the planning techniques in these materials is how subchapter K of the Code deals with "section 704(c) property." Section 704(c) property is created when a partner contributes property under section 721 (tax free exchange of property for an interest in a partnership) and the fair market value of the property differs from its adjusted basis. When this occurs, the partner's capital account is credited based on the fair market value of the property,[5] but because it is a nontaxable exchange, the contributing partner's outside basis and the partnership inside basis are each equal to the adjusted basis of the property.[6] Why is this an issue?

2. The Treasury Regulations under section 704(b) point out that when appreciated (or depreciated, meaning with an unrealized loss) property is contributed to a partnership, the book value (fair market value at the time of contribution) reflected in the capital account of the contributing partner will be different from the adjusted tax basis of the property as reflected on the partnership's balance sheet. In such case, depreciation, depletion, amortization, and gain or loss with respect to such property "as computed for book purposes" will be "greater or less" than they would be "as computed for tax purposes."[7] This is often referred to as a "book/tax disparity."[8] Assuming that the partnership elects to follow capital account rules described in the Treasury Regulations[9] (which will almost always be the case[10]), then there is a "tax follows book" principle.

3. Pursuant to section 704(c)(1)(A), items of income, gain, loss, and deduction determined for tax purposes with respect to property contributed must be shared among partners in a manner that takes into account the variation between the partnership's adjusted tax basis in the property and the fair market value of the property at the time of contribution. Said another way, section 704(c)(1)(A) seeks to ensure that the historical tax characteristics at contribution associated with such difference will ultimately be allocated to the contributing partner. Thus, for example, 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.[11] In that

[5] *See* Treas. Reg. § 1.704-1(b)(2)(iv)(*b*).

[6] §§ 722 and 723.

[7] Treas. Reg. § 1.704-1(b)(4)(i).

[8] A book/tax disparity is also created when there is a revaluation of the partnership's assets. *See* Treas. Reg. 1.704-1(b)(2)(iv)(f).

[9] *See* Treas. Reg. § 1.704-1(b)(2)(iv).

[10] The Treasury Regulations provide a safe harbor to ensure that allocations will have economic effect, which requires, in part, capital accounts will be maintained according to Treas. Reg. § 1.704-1(b)(2)(iv). Treas. Reg. § 1.704-1(b)(2)(i).

[11] *See* Treas. Reg. § 1.704-1(b)(2)(iv)(d)(1).

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 pre-contribution 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."[12]

4. Because the fair market value is of the contributed property is reflected in the contributing partner's capital account, if the partnership subsequently sells the property at the same value (e.g., at a gain), then the gain must be allocated to the contributing partner but capital account must remain unaffected by the realization of that gain. Capital accounts already reflect the unrealized appreciation. Because of this, the Treasury Regulations provide, "In these cases the capital accounts of the partners are required to be adjusted solely for allocations of the book items to such partners…, and the partners' shares of the corresponding tax items are not independently reflected by further adjustments to the partners' capital accounts."[13]

> **Example**: A and B create a newly-formed AB Partnership as equal partners. A contributes Asset A with an adjusted basis of $40x and fair market value of $100x, and B contributes cash of $100x to AB Partnership. Both A and B's capital accounts reflect a "book" value of $100x each. A's "tax" account is $40x, and B's "tax" account is $100x. AB Partnership sells Asset A for $110x. Pursuant to section 704(c)(1)(A), $60x of gain will be allocated to Partner A, and the remaining $10 of gain will be allocated equally to A and B under section 704(b) of the Code. The $60x of gain allocated to A under section 704(c)(1)(A) will increase A's outside basis ("tax" account) to $100x but there will be no corresponding increase to A's capital account ("book" account). The remaining $10x of gain allocated equally under section 704(b) to A and B will increase both partners' tax and book account by $5x each. The result is both A and B will each have a tax account (outside basis) of $105x and book account (capital account) of $105x.

5. Generally, property may not be aggregated for purposes of making allocations under section 704(c). The Treasury Regulations generally provide that section 704(c) allocations apply on a property-by-property basis.[14] That being said, the following types of property may be aggregated, as long as they are contributed by one partner in a single tax year: (i) depreciable property, other than real property, included in the same general asset account of the contributing partner and the partnership under section 168; (ii) property, other than real property, with a zero adjusted basis; and (iii) inventory, other than "qualified financial assets,"[15] that does not use a specific identification method of accounting.[16]

---

[12] Treas. Reg. § 1.704-3(a)(1).

[13] Treas. Reg. § 1.704-1(b)(4)(i).

[14] Treas. Reg. § 1.704-3(a)(2).

[15] Generally includes any personal property (including stocks and securities) that is actively traded. Treas. Reg. § 1.704-3(e)(3)(ii)(A).

[16] Treas. Reg. § 1.704-3(e)(2).

6. As discussed later in these materials, section 704(c) property must be considered whenever property is distributed because the distribution may be deemed a "mixing bowl" transaction. Section 704(c) is also implicated when inside basis adjustments are determined and allocated, if there is a section 754 election in place or if there is a mandatory inside basis adjustment.

C. Tax Planning with Partnerships and Anti-Abuse Rules

1. In these materials, a number of planning techniques are discussed that accomplish certain taxpayer objectives with little or no tax due or provide novel methods of accomplishing those objects, often with superior after-tax results than the traditional method. For example, some of the techniques discussed herein involve innovative ways of moving tax basis from one asset to another. While it is not believed that any of the techniques discussed herein are "loopholes" or abusive from a tax policy standpoint, some discussion about the anti-abuse rules in the context of partnerships and estate planning is warranted.

2. In 1995, the IRS issued "anti-abuse" Treasury Regulations[17] 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 manner inconsistent with the intent of subchapter K.[18] The breadth of these provisions are potentially infinite, but generally apply to artificial arrangements.

3. 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;[19]

b. The form of each partnership transaction must be respected under substance over form principles;[20] 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."[21]

4. 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:

---

[17] Treas. Reg. § 1.7701-2.

[18] Treas. Reg. § 1.7701-2(b).

[19] Treas. Reg. § 1.7701-2(a)(1).

[20] Treas. Reg. § 1.7701-2(a)(2).

[21] Treas. Reg. § 1.7701-2(a)(3).

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 is 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 have little or no participation in profits other than a preferred return that is a payment for the use of capital.[22]

5. 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.[23]

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.[24]

[22] Treas. Reg. § 1.7701-2(c).

[23] Treas. Reg. § 1.7701-2(d), Ex. 9.

[24] Treas. Reg. § 1.7701-2(d), Ex. 10.

6. 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,[25] 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 allocated under section 704(c) to the contributor is no longer a partner. The Treasury Regulations conclude that this situation is abusive.[26]

7. There are additional anti-abuse rules for specific Code sections in subchapter K of the Code. These are discussed in the portions of these materials that discuss these Code sections.

8. In addition to these anti-abuse rules, some mention should be made about the codification of the economic substance doctrine under section 7701(o) of the Code.[27] 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."[28] 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."[29] 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.

9. Notwithstanding the existence of these codified 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.[30]

---

[25] 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.

[26] 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).

[27] Health Care and Education Reconciliation Act of 2010, P.L. 111-152, § 1409 (Mar. 30, 2010).

[28] § 7701(o)(1).

[29] § 7701(o)(5)(B).

[30] Treas. Reg. § 1.7701-2(i).

II. MAXIMIZING THE BASIS ADJUSTMENT UNDER SECTION 1014

A. "Staggering Distributions" (Avoiding the Section 754 Election)

1. Background

a. When an interest in a partnership is included in the gross estate of a decedent, providing a basis adjustment to the partnership interest under section 2014, more often than not, the partnership will make a section 754 election (or already have one in place) and rely upon the inside basis adjustment under section 743(b) to "step-up" the basis of the assets inside the partnership. There are certainly valid reasons to rely on the inside basis adjustment. For example, the taxpayer may want to keep the assets in the partnership for tax reasons (e.g., ensuring that if there is a sale of the partnership assets, there would be reduced capital gain exposure to the transferees of the partnership interest) or for non-tax reasons (e.g., keeping control of the assets, rather than putting them in the hands of the transferees of the partnership interest). Unfortunately, the inside basis adjustment and the how it is allocated to each of the partnership assets under section 755 of the Code is formulaic and can be a blunt instrument, when a more tax efficient way to allot the basis adjustment under section 1014 might be available.

b. What is described in this portion of the materials is a strategy that can allocate basis in a more precise manner than the section 743(b) inside basis adjustment. It produces, in the right set of circumstances, a superior after-tax result for taxpayers. To understand the circumstances in which to consider this technique and how it works, one needs an understanding of the treatment of different types of partnership distributions, the "disguised sale" and "mixing bowl" rules, and the inside basis adjustment under sections 743(b) and 755. A summary of these rules are discussed below.

c. Certain types of partnership assets like commercial real property that collateralize partnership debt lend would not lend itself to this technique. There are many reasons why this would be the case. It is much more difficult to subdivide and distribute undivided interests in real property, which might be required. Second, if there is partnership debt, a distribution of real property may cause a deemed distribution under section 752(b) due to a reduction of a partner's share of liabilities. Third, transfers (distributions) of real property often require the payment of a transfer tax levied under state law. Marketable securities are ideal for this technique because they can be easily divided, transferred, and valued. That being said, other types of assets can be used in this technique.

2. Non-Liquidating "Current" Distributions

a. Cash Distributions May Result in Gain and Ordinary Income

(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.[31] Since most family-owned partnerships, commons referred to as "family limited partnerships" (FLPs) are structured as "pro rata" partnerships,[32] it is important to

---

[31] Treas. Reg. § 1.761-1(d).

[32] This is generally due to the "same class" exception under section 2701(a)(2)(B) of the Code. 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-

recognize that, generally, there is no gain or loss on pro rata current distributions regardless of the type of asset being distributed,[33] unless cash distributed exceeds the outside basis of the partnership interest of any of the partners.[34]

(2) Distributions of cash (including a reduction in a partner's share of liabilities and distributions of marketable securities)[35] to a partner reduces the partner's outside basis, with gain recognized to the extent the cash distributed exceeds outside basis.[36] No loss is ever recognized on a current distribution.[37] Any gain resulting from a current distribution of cash is considered capital gain that would result from a sale of the partner's interest.[38]

(3) 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).[39] The definitions of these types of assets (often 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,[40] and recapture property, but only to the extent unrealized gain is ordinary income. "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).[41]

(4) 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.[42] If the partner acquired his or her partnership interest by contributing property to the partnership (typically in a nonrecognition[43] transaction), the holding period of the property transferred is added to the partnership interest's holding period.[44] If the partner acquires the partnership interest at different

---

lapsing differences with respect to management and limitations on liability)." Treas. Reg. § 25.2701-1(c)(3).

[33] § 731(a)(1) and Treas. Reg. §§ 1.731-1 and 1.732-1(b).

[34] § 731(a)(1) and Treas. Reg. § 1.731-1(a).

[35] § 731(c) and Treas. Reg. § 1.731-2.

[36] § 733(a) and Treas. Reg. § 1.733-1.

[37] §§ 731(a)(2) and 731(b). A loss may only occur with a liquidating distribution. Treas. Reg. §1.731-1(a)(2).

[38] § 731(a).

[39] § 751.

[40] § 751(b) and Treas. Reg. § 1.751-1(b)(2), (d)(1).

[41] § 751(d)(1). Inventory items will be treated as section 751(b) property if the inventory items have "appreciated substantially in value," which will exist if their "fair market value exceeds 120 percent of the adjusted basis to the partnership of such property." § 751(b)(3)(B).

[42] *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).

[43] § 721.

[44] §§ 1223(1), 1223(2), and 723; Treas. Reg. §§ 1.1223-1(b) and 1.723-1.

times, the partnership interest will have different holding periods, allocated in proportion to the fair market value of the contributed property.[45]

b. Property Distributions Are Generally Nontaxable

(1) Neither the partner nor the partnership will recognize any gain or loss upon a distribution of property,[46] unless the property is a marketable security (treated as cash)[47] 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.[48]

(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 basis").[49] 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.[50] 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.[51] 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.[52] 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.[53]

---

[45] 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).

[46] § 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.

[47] § 731(c) and Treas. Reg. § 1.731-2.

[48] Treas. Reg. § 1.752-1(e) and (g).

[49] § 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).

[50] *See* Treas. Reg. §§ 1.732-1, 1.736-1(b)(1), and 1.743-1(d)(1).

[51] § 732(c)(1)(A)(i) and Treas. Reg. §1.732-1(c)(1)(i).

[52] § 735(a).

[53] § 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.

3. Liquidating Distributions

a. Cash Distributions Can Result in Gain and Loss

(1) Liquidating distributions (whether in one distribution or a series of distributions) terminate the liquidated partner's entire interest in a partnership.[54] Liquidating distributions are treated the same as current distributions except a loss may be recognized,[55] and the basis of property distributed to a partner may be increased (discussed below).[56] The only way to recognize a loss upon a liquidating transfer is if the distribution consists only of cash (but not including marketable securities[57]) and section 751 assets (hot assets).[58]

(2) Most FLPs 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)."[59] In order to qualify for this exception, it generally requires that distributions must be made proportionately and at the same time (but not necessarily the same assets). In order to effectuate a disproportionate distribution of property to a partner, one would need to redeem a portion of the partner's interest (reduce percentage ownership) in a current distribution or liquidate the partner.

b. Basis of Distributed Property Can Increase or Decrease

(1) 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.[60] 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.[61] 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 increased cost recovery deductions.

(2) 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

---

[54] § 761(d).

[55] § 731(a)(2) and Treas. Reg. § 1.731-1(a)(2).

[56] § 732(b), 732(c), and Treas. Reg. § 1.732-1(b).

[57] § 731(c)(1) refers to § 731(a)(1), the gain provision, not § 731(a)(2), the loss provision.

[58] § 731(a)(2). Treas. Reg. §§ 1.731-1(a)(2) and 1.732-1(c)(3).

[59] Treas. Reg. § 25.2701-1(c)(3).

[60] § 732(c)(1)(A) and Treas. Reg. § 1.732-1(c)(1)(i).

[61] § 732(b) and Treas. Reg. § 1.732-1(b).

may result in a loss to the withdrawing partner,[62] and a property distribution may result in an increased adjusted tax basis.[63] 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,"[64] which will exist if the amount exceeds $250,000.[65] 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.[66]

(3) 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.[67] 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.[68] 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.[69] These rules are discuss

4. Distributions in "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-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 "anti-

[62] § 734(b)(2)(A) and Treas. Reg. §1.734-1(b).

[63] § 734(b)(2)(B) and Treas. Reg. §1.734-1(b).

[64] § 734(a).

[65] § 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.

[66] *See* IRS Notice 2005-32, 2005-1 C.B. 895.

[67] Treas. Reg. § 1.755-1(c)(2).

[68] Treas. Reg. § 1.755-1(c)(2)(i).

[69] Treas. Reg. § 1.755-1(c)(2)(ii).

mixing bowl" 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 "anti-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.[70]

(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.[71] 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.[72]

(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).[73]

(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.[74]

(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 partnership interest, the share of built- in gain or loss proportionate to the interest transferred must be allocated to the transferee partner."[75] Specifically to contributed property distributions

[70] § 704(c)(1)(B).

[71] § 704(c)(2)(B)(i) and Treas. Reg. § 1.704-4(a).

[72] Treas. Reg. § 1.704-4(b).

[73] Treas. Reg. § 1.704-4(d)(1)(i).

[74] § 704(c)(1)(B)(iii) and Treas. Reg. § 1.704-4(e).

[75] Treas. Reg. § 1.704-3(a)(7).

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."[76]

(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),"[77] 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.[78]

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 <u>other than the contributed property</u>, such partner generally will be required to recognize gain upon the receipt of such other property.[79] 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.[80]

(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 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");[81] or

[76] Treas. Reg. § 1.704-4(d)(2).

[77] Treas. Reg. § 1.704-4(f)(1).

[78] Treas. Reg. § 1.704-4(f)(2), Ex. 2.

[79] §§ 704(c)(1)(B) and 737.

[80] § 737(d)(1) and Treas. Reg. § 1.737-3(d).

[81] § 737(a)(1).

(b) The "net precontribution gain,"[82] 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.[83]

(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.[84] 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.[85] If the distributed property is subject to a liability, it is the gross value of the property that is used in the calculation.[86]

(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."[87] 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."[88]

(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."[89] 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).[90] It seems, however, the consensus view is that a transferee steps in the shoes of the transferor as the contributing partner. One partnership treatise

---

[82] § 737(a)(2).

[83] § 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).

[84] Treas. Reg. § 1.737-1(b)(2).

[85] *Id.*

[86] Treas. Reg. § 1.737-1(e), Ex. 2.

[87] § 737(d)(1) and Treas. Reg. § 1.737-2(d)(1).

[88] Treas. Reg. § 1.737-3(b)(2).

[89] Treas. Reg. § 1.737-1(c)(2)(iii).

[90] *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 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).

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."[91] 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."[92] 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."[93]

(7) The character of the gain is determined by reference to the "proportionate character of the net precontribution gain,"[94] 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.[95] Further, the basis of the distributed property is adjusted to reflect the recognized gain on the partner's outside basis.[96]

(9) Marketable securities are generally treated as money for purposes of section 737.[97] In determining "net precontribution gain" under section 737, however, marketable securities contributed to the partnership are treated as contributed property.[98]

(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."[99] 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 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).[100]

---

[91] 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

[92] Id. at ¶ 19.08[2][e], fn. 167.

[93] Willis, Pennell, Postlewaite & Lipton, *Partnership Taxation*, Sixth Edition (Thompson Reuters, 2017), ¶ 13.02[1][a][v].

[94] § 737(a) [flush language] and Treas. Reg. § 1.737-1(d).

[95] § 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.

[96] § 737(c)(1) and Treas. Reg. § 1.737-3(b)(1).

[97] §§ 737(c)(1), 737(e), and Treas. Reg. § 1.731-2(a).

[98] Treas. Reg. § 1.731-2(g)(i)-(iii).

[99] Treas. Reg. § 1.737-4(a).

[100] Treas. Reg. § 1.737-4(b), Ex. 1.

5. Distributions and the "Disguised Sale" Rules

a. If a partner who has contributed appreciated property to a partnership receives a distribution of any other property or cash within two years of the contribution, based on the applicable facts and circumstances, the distribution will likely cause the partner to recognize gain with respect to his or her contributed property under the "disguised sale" rules. [101] In such case, the contributing partner is treated as having engaged in a transaction with the partnership "other than in his capacity as a member of the partnership" and "the transaction shall … be considered as occurring between the partnership and one who is not a partner."[102] Thus, in this instance, the partner will recognize gain on the deemed sale of the appreciated property to the partnership, and the partnership holds the property with a cost basis and new holding period.

b. The Treasury Regulations recognize two different types of disguised sales that occur between a partner and a partnership: (i) sales of property by a partner to the partnership (the foregoing example),[103] and sales of property by the partnership to a partner.[104] The latter can occur if, for example, the partnership distributes appreciated property to a partner who, within two years of such transfer, contributes or had contributed cash to the partnership. If this is treated as a disguised sale, the partnership recognizes gain on the distributed property, which is allocated to all of the partners under section 704(b), and the purchasing partner's contribution (cash) is consideration for the property, not a contribution to the partnership. The disguised purchasing partner has a cost basis in the property, and a new holding period, instead of transferred basis and tacked holding period had it been considered a partnership distribution. As discussed later, a disguised sale transaction can occur between two partners when it is determined that a purported contribution and distribution by two partners is treated as a taxable sale of a partnership interest by one partner to the other.[105]

c. As illustrated above, if it is determined that a transfer of property by a partner to a partnership and a transfer of consideration by a partnership to the partner is a sale exchange of that property (disguised sale), then such transfers are not treated as a contribution and distribution under section 721 and 731 of the Code.[106] In such instant, purported distributions in 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.[107] The sale is considered to take place on that date the partnership is considered the owner of the property.[108] If the transfer of the consideration from the partnership to the partner occurs after the transfer of property to the partnership, the partner and the partnership are treated as if, on the date of the sale, the partnership transferred to the partner an obligation to transfer to the partner money or other

---

[101] § 707(a)(2)(B).

[102] §§ 707(a)(1) and 707(a)(3).

[103] *See* Treas. Reg. § 1.707-3.

[104] *See* Treas. Reg. § 1.707-6(a).

[105] § 707(a)(2)(B), flush language ("such transfers shall be treated… as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.").

[106] Treas. Reg. § 1.707-3(a)(2).

[107] § 707(a)(2) and Treas. Reg. § 1.707-3.

[108] Treas. Reg. § 1.707-3(a)(2).

consideration at a later date.[109] If there is a difference in the amount between the contribution and the value of the property distributed that is attributable to the time between the two events, the difference is considered imputed interest.[110] If a purported contribution to a partnership is determined to be a property transferred in a disguised sale, it may result in the transferor not being considered a partner at all, and it may result in a determination that no partnership exists.[111]

d. 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,"[112]

(2) "there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner),"[113] and

(3) The two transfers, "when viewed together, are properly characterized as a sale or exchange of property."[114]

e. 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."[115] For non-simultaneous transfers and distributions, a disguised sale occurs if the "subsequent transfer is not dependent on the entrepreneurial risks of partnership operations."[116] The Treasury Regulations provide two rebuttable presumptions in determining whether a disguised sale has occurred:

(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;"[117] 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." [118]

f. 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,

---

[109] *Id.*

[110] *See* Treas. Reg. § 1.707-6(d), Ex. 1.

[111] See Treas. Reg. § 1.707-3(a)(3).

[112] § 707(a)(2)(B)(i).

[113] § 707(a)(2)(B)(ii).

[114] § 707(a)(2)(B)(iii).

[115] Treas. Reg. § 1.707-3(b)(1)(i).

[116] Treas. Reg. § 1.707-3(b)(1)(ii).

[117] Treas. Reg. § 1.707-3(c)(1).

[118] Treas. Reg. § 1.707-3(d).

the facts and circumstances existing on the date of the earliest of such transfers are the ones considered in determining whether a sale exists."[119] 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;

(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.

g. 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

---

[119] Treas. Reg. § 1.707-3(b)(2).

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."[120] 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."[121]

h. 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).

i. 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.[122]

j. When a contribution by one partner, usually a new partner, is followed, or preceded, by a distribution to another partner, the transaction can be recharacterized as a disguised sale of all (but often a portion) of a partnership interest.[123] Treating a transfer of property to another partner as a distribution, rather than a sale of a partnership, is advantageous because the distributee partner can apply the entire outside basis of the partnership interest against what could be characterized as consideration for only a portion of the interest.[124] Unlike

[120] Treas. Reg. § 1.707-6(a).

[121] Treas. Reg. § 1.707-6(b)(1).

[122] Treas. Reg. §§ 1.707-3(c) and 1.707-8 (requiring the filing of Form 8275).

[123] § 707(a)(2)(B), flush language ("such transfers shall be treated… as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.").

[124] *See* Treas. Reg. § 1.731-1(c)(3) ("Section 731 does not apply to a distribution of property, if, in fact, the distribution was made in order to effect an exchange of property between two or more of the partners... Such a transaction shall be treated as an exchange of property."). *See also Communications Satellite Corp. v. United States*, 625 F.2d 997 (Ct. Cl. 1980) (no disguised sale by members who received distributions of part of their contributions when new members joined and made contributions that were under formula designed to put new members in same position as if they were original members) and *Jupiter Corp. v. United States*, 2 Cl. Ct. 58 (1983) (no disguised sale when capital contributed by new limited partners was distributed to general partner because different types of interests made it difficult to see how there was "sale" of partnership interest that withdrawing partner did not own).

the disguised sales discussed above, a disguised sale of a partnership interest will be deemed a taxable transaction between the selling and purchasing partner, notwithstanding the involvement of the partnership.

> **Example**: AB Partnership has two partners, A and B. A has a 2/3 partnership interest in AB Partnership with an outside basis of $120x and capital account of $200x. B has a 1/3 interest in AB Partnership with an outside basis of $60x and capital account of 100x. C would like to be admitted as a partner, and C is willing to pay $100x of cash to become a partner of AB Partnership. A would like to reduce his or her partnership interest by one-half (a 1/3 interest). If C purchased one-half of A's interest for $100x of cash, then A would recognize $40x of gain (adjusted basis of the sold partnership interest is $60x—50% of A's outside basis of $120x). C would have a 1/3 partnership interest with an outside basis of $100x, capital account of $100x, and a new holding period on the partnership interest.
>
> Alternatively, the foregoing could be accomplished in the following steps: (i) AB Partnership distributes Asset A with an inside basis of $100x and fair market value of $100x to A; and (ii) C contributes $100x of cash to AB Partnership in exchange for an equal 1/3 interest in the partnership (A, B, and C would be equal 1/3 partners in the partnership). If the latter transaction is not recast as a disguised sale, then under sections 731 and 732: (i) A would not recognize any gain on the transaction; (ii) A would own Asset A with a basis and fair market value of $100x with a tacked holding period; and (iii) A would still have a 1/3 partnership interest with an outside basis of $20x and capital account of $100x. If the transaction is deemed to be a disguised sale, then it would be treated as a sale by A of one-half of A's partnership interest, resulting in gain to A of $40x.

6. 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.[125] For these purposes, marketable securities includes financial instruments (stocks, equity interests, debt, options, forward or futures contracts, notional principal contracts and other derivatives) and foreign currencies which are actively traded.[126] 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."[127] Further, the Code provides that a marketable security includes "any financial instrument the value of which is determined substantially by reference to marketable securities."[128]

b. There are a number of applicable exceptions to the foregoing treatment of distributions of marketable securities, including: (1) distributions of contributed securities to

---

[125] § 731(c).

[126] § 731(c)(2)(A) and (C).

[127] § 731(c)(2)(B)(ii).

[128] § 731(c)(2)(B)(iii).

the partner who contributed them;[129] (2) distributions of securities that were not marketable when acquired by the partnership and are distributed within five years of becoming marketable;[130] and (3) distributions of securities from an "investment partnership" to an "eligible partner."[131]

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.[132] 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).[133] 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.[134]

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.[135]

e. If one of these exceptions does 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.[136] The amount of marketable securities treated as cash is reduced (and the potential recognized gain is reduced) by, according to the section 731(c)(3)(B) of the Code:

> (i) 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
>
> (ii) 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 as used under clause (i).[137]

---

[129] § 731(c)(3)(A) and Treas. Reg. § 1.731-2(d)(1).

[130] § 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.

[131] §§ 731(c)(3)(C)(i) and 731(c)(3)(A)(iii).

[132] § 731(c)(3)(C)(i).

[133] § 731(c)(3)(C)(i)(I) through (VIII).

[134] § 731(c)(3)(C)(ii)(I) and Treas. Reg. § 1.731-2(e)(3)(i).

[135] § 731(c)(3)(C)(iii)(I).

[136] § 731(c)(3)(B) and Treas. Reg. § 1.731-2(a) and (j), Ex. 1.

[137] § 731(c)(3)(B)(i) and (ii).

f. Notwithstanding the fact that the Code speaks in terms of the "same class and issuer as the distributed securities," the flush language of section 731(c)(3)(B) gives permission for the Treasury Regulations to aggregate securities. As such section 1.731-2(b)(2) of the Treasury Regulations provides that the foregoing reduction is:

> (i) The distributee partner's distributive share of the net gain, if any, which would be recognized if all the marketable securities held by the partnership were sold (immediately before the transaction to which the distribution relates) by the partnership for fair market value; over
> (ii) The distributee partner's distributive share of the net gain, if any, which is attributable to the marketable securities held by the partnership immediately after the transaction, determined by using the same fair market value as used under paragraph (b)(2)(i) of this section.

g. Thus the reduction applies to "all marketable securities held by the partnership" and the reduction reflects not only the marketable security distributed but also any reduction in the distributee partner's gain in all of the marketable securities. According to the preamble, when the Treasury Regulations were proposed, "This provision allows a partner to withdraw the partner's portion of appreciation in the partnership's marketable securities without recognizing gain on the transaction. As a result, section 731(c) generally applies only when a partner receives a distribution of marketable securities in exchange for the partner's share of appreciated assets other than marketable securities."[138]

h. As to aggregating all marketable securities, the preamble explains:

> Under authority of section 731(c)(3)(B), the proposed regulations provide that all marketable securities held by a partnership are treated as marketable securities of the same class and issuer as the distributed securities. Treating all marketable securities as a single class asset for this purpose is consistent with the basic rationale of section 731(c) that marketable securities are the economic equivalent of money. As a result, the amount of the distribution that is not treated as money will depend on the partner's share of the net appreciation in all partnership securities, not on the partner's share of the appreciation in the type of securities distributed.

i. Any unrealized loss in the marketable securities is not recognized, either by the partnership or the partner.[139]

j. 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.[140] The basis of distributed securities when no gain is recognized will be based on the general rule of section 732 for distributions. 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.[141] As a result, the

---

[138] PS-2-95, 61 Fed. Reg. 28 (Jan. 2, 1996).

[139] § 731(b).

[140] § 731(c)(4)(A) and Treas. Reg. § 1.731-2(f)(1)(i).

[141] § 731(c)(5) and Treas. Reg. § 1.731-2(f)(1)(ii).

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). The foregoing rules and resulting outside basis of the distributee-partner and in the security can be complicated:

> **<u>Example 1</u>**: Partnership distributes a marketable security with an inside basis of $10x and a fair market value of $50x to P, a partner, who has an outside basis of $30x and a capital account of $200x. Under section 731(c) of the Code, P is treated receiving a distribution of $50x cash, which is more than P's outside basis, and P recognizes $20x of gain. P's outside basis is not affected by the gain. The distribution of the marketable security reduces P's outside basis by $10x (inside basis of the partnership), so after the distribution, P's outside basis is $20x, and P's capital account is $150x (reduced by the fair market value of the security). The marketable security in P's hands has a resulting basis of $30x (gain is added to the basis of the security).

> **<u>Example 2</u>**: Same facts as example 1, except the marketable security has an inside basis of $40x. P recognizes $20x of gain. The inside basis of the security is higher than P's outside basis. As a result, P's resulting outside basis is $0x, and capital account is $150x. The distribution of the marketable security results in an initial reduction of basis to $30 (limited by P's outside basis) but then the resulting gain is added to the security. The marketable security in P's hands has a resulting basis of $50x.

k. 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.[142] 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).[143] Therefore, for purposes of sections 733 and section 734 of the Code, a distribution of marketable securities is treated as a property distribution.

l. 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. [144]

m. The Treasury Regulations under section 731(c) of the Code contain an anti-abuse provision which provides generally, "The provisions of section 731 (c) and this section must be applied in a manner consistent with the purpose of section 731(c) and the substance of the transaction. Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 731(c) and this section, the Commissioner can recast

[142] § 731(c)(5) and Treas. Reg. § 1.731-2(f)(2).

[143] Treas. Reg. § 1.731-2(j), Ex. 6(iv).

[144] § 731(a)(1) and Treas. Reg. § 1.731-2(f)(1)(ii), (j), Ex. 5.

the transaction for Federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of section 731(c) and this section."[145] The provision goes on to provide three examples:[146]

(1) A change in partnership allocations or distribution rights with respect to marketable securities may be treated as a distribution of the marketable securities subject to section 731(c) if the change in allocations or distribution rights is, in substance, a distribution of the securities;

(2) A distribution of substantially all of the assets of the partnership other than marketable securities and money to some partners may also be treated as a distribution of marketable securities to the remaining partners if the distribution of the other property and the withdrawal of the other partners is, in substance, equivalent to a distribution of the securities to the remaining partners; and

(3) The distribution of multiple properties to one or more partners at different times may also be treated as part of a single distribution if the distributions are part of a single plan of distribution.

7. Section 754 Election and Inside Basis Adjustments

a. Generally

(1) 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.

(2) 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 partner. 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.

(3) 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

[145] Treas. Reg. § 1.731-2(h).

[146] *Id.*

in question (sale, exchange, death or distribution) occurs.[147] 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.[148] 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).[149]

b. Basis Adjustments under Section 743(b) Are Hypothetical

(1) 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:

(a) 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;"[150] or

(b) 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."[151]

(2) 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.[152] The partner's previously taxed capital is:[153]

(a) 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;[154] increased by

(b) The amount of tax loss that would be allocated to the partner on the hypothetical transaction; and decreased by

(c) The amount of tax gain that would be allocated to the partner on the hypothetical transaction.

---

[147] 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.

[148] § 754 and Treas. Reg. § 1.754-1(a).

[149] Treas. Reg. § 1.754-1(c)(1).

[150] § 734(b)(1).

[151] § 734(b)(2).

[152] Treas. Reg. § 1.743-1(d)(1).

[153] Treas. Reg. § 1.743-1(d)(1)(i)-(iii).

[154] Treas. Reg. § 1.743-1(d)(2).

(3) Inside basis adjustments under section 743(b) do not change or affect capital accounts,[155] and because the adjustments only apply to the transferee, they are not made to the common basis of the partnership.[156] 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.[157] 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.[158]

c. Basis Adjustments under Section 734(b) Are Actual

(1) Despite their similarities, there are a number of important distinctions between the inside basis adjustments upon a transfer of a partnership interest under section 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.

(2) 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."[159] In contrast, adjustments under section 743(b) "shall constitute an adjustment to the basis of partnership property with respect to the transferee partner only."[160]

(3) 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.[161] On the other hand, adjustments under section 734(b) result in corresponding adjustments to capital accounts.[162]

---

[155] Treas. Reg. § 1.704-1(b)(2)(iv)(m).

[156] 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).

[157] Treas. Reg. § 1.743-1(j)(3).

[158] Treas. Reg. § 1.743-1(j)(4).

[159] § 734(b)(1) and (2).

[160] § 743(b) (flush language).

[161] Treas. Reg. § 1.704-1(b)(2)(iv)(*m*)(*2*).

[162] Treas. Reg. § 1.704-1(b)(2)(iv)(*m*)(*4*) and (*5*).

(4) When evaluating inside basis adjustments under section 734(b) of the Code, one must make a distinction between current and liquidating distributions.

(a) 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.[163]

(b) 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).[164] 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.[165]

(c) 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).[166]

(d) 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.[167] The inside basis of the property has its basis replaced by the outside basis of the liquidated partnership interest.[168] 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.

(e) 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.[169] 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.

---

[163] § 734(b)(1)(A).

[164] § 732(a)(1) and (2).

[165] § 734(b)(1)(B)

[166] § 734(b)(1)(A) and (2)(A).

[167] § 732(b) and Treas. Reg. § 1.732-1(b).

[168] Certain limitations apply to section 751 assets. *See* § 732(c)(1)(A) and § Treas. Reg. 1.732(c)(1)(i).

[169] § 734(a), (b), and (d).

d. Allocating Inside Basis Adjustments under Section 755

(1) 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."[170] For these purposes, "capital gain property" includes capital assets and section 1231(b) property. All other property (including unrealized receivables and recapture items under section 751(c) of the Code) is considered "ordinary income property."[171] 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) (i.e., distributions of property) or section 743(b) (i.e., sale or exchange of a partnership interest or death of a partner) of the Code.

(2) 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 within a class, the Treasury Regulations employ a hypothetical transaction pursuant to which you must 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.[172] Keep in mind, even a straightforward "pro rata" partnership with each partner having a percentage interest in the partnership and no special allocations of tax items, the amount of gain or loss may be disproportionate due to section 704(c) or "reverse" 704(c) allocations (partnership revaluations, often referred to as "book ups").[173]

(3) If the purchase price 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 (as reflected in the capital account and such partner's share of the inside basis 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, [174] and then provide a mechanism to allocate the shortfall (in the capital gain class)

---

[170] Treas. Reg. § 1.755-1(a).

[171] *Id.*

[172] Treas. Reg. § 1.755-1(b)(1)(ii).

[173] *See* § 743(b), flush language ("A partner's proportionate share of the adjusted basis of partnership property shall be determined in accordance with his interest in partnership capital and, in the case of property contributed to the partnership by a partner, section 704(c) (relating to contributed property) shall apply in determining such share.").

[174] *See* Treas. Reg. § 1.755-1(b)(2).

based upon two factors: (i) unrealized appreciation (or depreciation) in each asset, and (ii) each asset's relative fair market value.[175]

(4) More specifically, in allocating this shortfall, the amount of basis adjustment to each item of property within the class of capital gain property is the amount of income, gain, or loss that would be allocated to the transferee (attributable to the acquired partnership interest) from the hypothetical sale of item;[176] minus the product of:[177]

(a) "The total amount of gain or loss … that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all items of capital gain property, minus the amount of the positive basis adjustment to all items of capital gain property or plus the amount of the negative basis adjustment to capital gain property;"[178] multiplied by

(b) "A fraction, the numerator of which is the fair market value of the item of property to the partnership, and the denominator of which is the fair market value of all of the partnership's items of capital gain property."[179]

(5) 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.[180] 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.[181] If the partnership has no assets in the appropriate class, the adjustment is deferred until the partnership acquires an asset in that class.[182]

(6) 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.[183] 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

---

[175] *See* Treas. Reg. § 1.755-1(b)(3)(ii).

[176] § 1.755-1(b)(3)(ii)(A).

[177] § 1.755-1(b)(3)(ii)(B).

[178] § 1.755-1(b)(3)(ii)(B)(1).

[179] § 1.755-1(b)(3)(ii)(B)(2).

[180] Treas. Reg. § 1.755-1(c)(1)(ii).

[181] Treas. Reg. § 1.755-1(c)(1)(i).

[182] Treas. Reg. § 1.755-1(c)(4).

[183] Treas. Reg. § 1.755-1(c)(2)(i).

adjusted basis (not fair market value).[184] The inside basis of property cannot be reduced below zero.[185]

8. "Staggering" Distributions with No Section 754 Election

a. When a decedent's partnership interest is included in the gross estate, the estate will often claim a valuation discount for lack of marketability and control. This is often the case with estates when estate tax is payable (i.e., the gross estate exceeds the decedent's Applicable Exclusion Amount and there is no ability to "zero-out" the estate tax with the marital deduction because there is no surviving spouse). The valuation discount represents a 40% Federal estate tax savings, which is typically greater than the income tax savings from a basis adjustment under section 1014 of the Code (i.e., 20% for capital assets and 37% for ordinary income assets). As a result, the "step-up" in basis to the partnership interest is reduced by the valuation discount, which in turn, reduces the inside basis adjustment under section 743(b), if the partnership has a section 754 election in place.

> **Example 1**: A and B form AB Partnership. A contributes shares of a publicly-traded company Z (Stock Z), which have a fair market value of $10 million and an adjusted basis of zero, in exchange for a 50% interest in AB Partnership. B contributes Stock Z shares, which have a fair market value of $10 million and an adjusted basis of $4 million, in exchange for a 50% interest in AB Partnership. Although AB Partnership would be considered an "investment company" under sections 721(b) and 351(e), the contributions to the partnership does not result in diversification. Thus, the contribution does not result in gain recognition and under section 721(a), A receives a partnership interest that has an outside basis of zero and a capital account of $10 million. B receives a partnership interest that has an outside basis of $4 million and a capital account of $10 million.
>
> Soon thereafter, A passes away. On date of death, the value of Stock Z has not changed. The fair market value of A's partnerships interest is appraised at $7 million, due to a 30% valuation discount. The partnership makes a section 754 election to make a corresponding inside basis adjustment under section 743(b) to the assets in the partnership.
>
> Under section 743(b)(1), A's estate (the transferee) is entitled to an increase in partnership inside basis equal to 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." The estate's basis in the partnership interest, under section 1014, 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."[186] As a result, since there are no liabilities or IRD in this example, the estate's basis in the partnership interest is $7 million.

[184] Treas. Reg. § 1.755-1(c)(2)(ii).

[185] Treas. Reg. § 1.755-1(c)(3).

[186] Treas. Reg. § 1.742-1(a). *See also* Treas. Regs. §§ 1.743-1(c) and 1.752-1 through 1.752-5.

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.[187] There are no partnership liabilities. The partner's previously taxed capital, in this example, is 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, *decreased* by the amount of tax gain that would be allocated to the partner on the hypothetical transaction.[188] The amount the estate would receive in the hypothetical sale, in this example, is $10 million (A's capital account balance at death), and the amount of gain that would be allocated to the estate is $10 million. The latter is due to the fact that A contributed shares of Stock Z when it was (and still is) worth $10 million, and under section 704(c), all of that gain must be allocated to A's estate, as transferee. The hypothetical gain attributable to the other assets (the shares of Stock Z contributed by B) in the partnership are allocated to B under section 704(c). As a result, the estate's previously taxed capital (and proportionate share of the adjusted basis of the partnership property) is zero ($10 million minus $10 million). The excess of the basis to the estate (the transferee) is $7 million ($7 million minus zero), As a result, under section 743(b)(1), the increase in inside basis is equal to $7 million.

The positive $7 million inside basis adjustment under section 743(b) will be allocated to the partnership assets according to section 755. All of the assets in this example are capital assets, so the entire basis adjustment is allocated to that class. In this simple example, only the property contributed by A would result in gain to the estate (transferee) due to the section 704(c) rules. As a result, the entire $7 million inside basis adjustment would be applied to the Stock Z contributed by A, and none would be applied to the Stock Z contributed by B. As a result, the Stock Z contributed by A has an inside basis of $7 million and a fair market value of $10 million.

b. In the foregoing example, the result is that the Stock Z contributed by A before date of death has it's basis increased from zero to $7 million. If the partnership subsequently distributes the basis-adjusted Stock Z to A's estate, under the Treasury Regulations, A's estate will get the benefit of that upward basis adjustment, [189] but B would not, if any shares of the Stock Z contributed by A were to be distributed to B.[190]

Example 1 (Continued): The partnership distributes the shares of Stock Z to A's estate, and the estate in turn distributes the stock to C, the sole beneficiary of A's estate. The partnership distribution to the estate will not be a taxable event even though the distributed property is a marketable security, which normally would be considered money under section 731(c) for determining whether gain is recognized as a result of the distribution. The partnership, in this example, qualifies as an "investment partnership" under section 731(c)(2)(C), which is

[187] Treas. Reg. § 1.743-1(d)(1).

[188] Treas. Reg. § 1.743-1(d)(1)(i)-(iii).

[189] *See* Treas. Reg. § 1.743-1(g)(1).

[190] *See* Treas. Reg. § 1.743-1(g)(2).

excepted from the rule under section 731(c). Even if the partnership did not qualify as an "investment partnership," because the partnership only holds marketable securities, it would be entitled to a full reduction of the gain under section 731(c)(3)(B) and the Treasury Regulations thereunder, as discussed earlier in these materials.[191]

Assuming Stock Z has not changed in value, C holds Stock Z, having an adjusted basis of $7 million and a fair market value of $10 million. B wishes to make charitable donations and to diversify out of Stock Z. To that end, B donates half of the stock to charity and sells the other half for cash, reinvesting the after tax proceeds in a diversified portfolio of stocks. The economic results can be summarized as follows:

SUMMARY OF THE SECTION 743(b) INSIDE BASIS ADJUSTMENT	
Savings Due to $5 Mil. Charitable Deduction @ 37.0% Rate	$1,850,000
Unrecognized Gain of $1.5 Mil. Due to Charitable Donation @ 23.8% Rate	$357,000
$1.5 Mil. Recognized Capital Gain Tax on $5 Mil. Sale of Stock Z @ 23.8%	($357,000)
Total Net Tax Benefit	**$1,850,000**
After-Tax Amount Reinvested in Diversified Portfolio	***$4,643,000***
TOTAL ECONOMIC BENEFIT	**$6,493,000**

c. As example 1 above illustrates, the section 743(b) inside basis adjustment results in a proportionate increase in the adjusted basis of all of the shares of Stock Z contributed by A. The economic results would have been better if the taxpayer could have donated half of the stock charity at an adjusted basis of zero, and sold the remaining stock for no capital gain or even a loss. This is when foregoing the section 754 election would make sense. In the example, the outside basis of A's partnership interest was "stepped-up" to $7 million. Perhaps there is a way to apportion the upward basis adjustment in a more efficient manner, resulting in a better economic outcome.

Example 2: All the facts are the same as above, however, the partnership does not make a section 754 election. This results in A's estate having a partnership interest with $7 million of outside basis and a capital account (liquidation value) of $10 million. The $10 million of Stock Z contributed by A has an adjusted basis of zero and a fair market value of $10 million. If the partnership liquidates the estate's interest in the partnership by distributing the Stock Z to the estate, the result would be the same as the previous example. As noted in these materials, if property is distributed in a liquidating distribution (or series of liquidating distributions), it will result in the distributed property having the same adjusted basis as the outside basis of the partnership interest. In other words, when Stock Z is distributed to the estate in a liquidating distribution, Stock Z will have an adjusted basis of $7 million.

Instead of a liquidation of the estate's interest in the partnership, for a significant non-tax reason, the partnership distributes $5 million of Stock Z to the estate in a non-liquidating (current) distribution that reduces the estate's interest in the

[191] In particular, Treas. Reg. § 1.731-2(b)(2).

partnership. Under section 732(a)(1), the estate now holds shares of Stock Z with an adjusted basis of zero and value of $5 million. The estate's remaining interest in the AB Partnership with an outside basis of $7 million and a capital account of $5 million. The estate distributes the $5 million of Stock to C, and C donates the stock to charity.

The following taxable year, for a significant non-tax reason, the partnership decides to terminate and liquidate. In liquidation of the estate's interest, the remaining Stock Z contributed by A is distributed to A's estate. Under section 732(b), because the estate's partnership interest has an outside basis of $7 million, the estate receives Stock Z with $7 million of adjusted basis (and value of $5 million). The estate distributes the Stock Z to C, and C sells the stock for $5 million, recognizing a capital loss of $2 million.[192] C reinvests the cash proceeds in a diversified portfolio of stocks The economic results of this plan can be summarized as follows:

SUMMARY OF "STAGGERING DISTRIBUTIONS"	
Savings Due to $5 Mil. Charitable Deduction @ 37.0% Rate	$1,850,000
Unrecognized Gain of $5 Mil. Due to Charitable Donation @ 23.8% Rate	$1,190,000
Savings from ($2 Mil.) Capital Loss on $5 Mil. Sale of Stock Z @ 23.8%	$476,000
Total Net Tax Benefit	**$3,516,000**
After-Tax Amount Reinvested in Diversified Portfolio	***$5,000,000***
TOTAL ECONOMIC BENEFIT	**$8,516,000**

As one can see, in example 2, the total economic benefit to C, calculated in terms of tax savings and reinvested assets, is $2,023,000 greater than example 1.

d. In example 2 above, the shares of Stock Z were contributed by A and distributed back to A's transferee (A's estate). This avoids any question about whether the distribution could be a taxable event under the "anti-mixing bowl" rules. As discussed above, a partnership distribution to the original contributor (or transferee of the contributor) is not considered a "mixing bowl" transaction. It is possible to get the same result if other partnership property is distributed to A's estate, but to avoid gain under the "mixing rules" under section 737, the distribution must occur after 7 years of the contribution by A. Further, if the distributed property was contributed by another partner, to avoid recognition to the contributing partner under section 704(c)(1)(B), the distribution must occur after 7 years of the contribution by the other partner.

e. In example 2 above, the partnership terminated and liquidated. The implication is that the remaining shares of Stock Z contributed by B will be distributed to B. The ultimate result is the Stock Z will be returned to B with an adjusted basis of $4 million and fair market value of $10 million. If only the estate's partnership interest was liquidated and the entity had remained in existence and taxed as partnership, the remaining assets in the partnership would have to reduce inside basis by $2 million, even in the absence of a section 754 election. As noted

[192] The basis of any property received by a beneficiary in a distribution from an estate is the adjusted basis of such property in the hands of the estate before the distribution, adjusted for any gain or loss recognized to the estate or trust on the distribution. § 643(e)(1).

herein, partnerships must make mandatory basis adjustments under section 734(b) if there is a distribution of property that results in a "substantial basis reduction" with respect to the distribution.[193] 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.[194] 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). In example 2, a liquidation of the estate's partnership interest results in a basis increase in the basis of Stock Z of $2 million (from $5 million to $7 million). As a result, the basis of the partnership assets (the Stock Z contributed by B) would have its basis reduced by from $4 million to $2 million. This basis reduction can be cured by liquidating B's interest with the Stock Z. The liquidation of B's interest ($4 million of outside basis) with the shares B contributed would result in the Stock having its adjusted basis restored to $4 million.

f. Of course, if C, in the example above, intends to sell and diversify out of $10 million of Stock Z (100% of the stock), there would be no difference between an inside basis adjustment under section 743(b) or the "staggering distributions." In both circumstances, C would recognize $3 million of long-term capital gain, On the other hand, if C plans to sell less than $10 million of Stock Z, the "staggering distributions" option is a better alternative. For example, if C plans to sell $7 million of Stock Z, with the section 743(b) inside basis adjustment, C would recognize $2.1 million of long-term capital gain ($7 million of Stock Z with an adjusted basis of $4.9 million). With the "staggering distributions," C would not recognize any capital gain. Further, even if C has no charitable intent, C might hold on to the remaining $3 million of Stock Z with an adjusted basis of zero, anticipating a "step-up" in basis under section 1014 upon C's passing. What if C, in this example, is actually two different trusts, one of which is a marital deduction trust that will be included in the surviving spouse's estate and the other is a "credit shelter" trust that will not be included in the surviving spouse's estate. If the executor of A's estate had the authority, could the executor "pick and choose" to fund the marital trust with $3 million of Stock Z with and adjusted basis of zero and then fund the "credit shelter" trust with $7 million of Stock Z with an adjusted basis of $7 million?[195]

B. Eliminating Valuation Discounts

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

---

[193] § 734(a)(1).

[194] §§ 734(d) and 734(b)(2).

[195] *See* Rev. Proc. 64-19, 1964-1 C.B. 684 (In choosing assets to fund a marital trust, the ruling requires a funding of assets that are fairly representative of all appreciation and depreciation in the value of all assets available for funding from date of death to funding. It says nothing with regard to the adjusted basis of those assets).

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 Basic 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 BEA in order to increase the income tax basis of the assets under section 1014.

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*,[196] 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 partner to put his or her partnership interest at death for fair market value would seem to be outside the 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 with Disregarded Entities

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

[196] 140 T.C. 86 (2013), *rev'd*, *Estate of James A. Elkins, Jr. v. Commissioner*, 767 F.3d 443 (5th Cir. 2014).

(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."[197] Since the effective date of section 2704 of the Code, the vast majority (maybe all) of the 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.[198] 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.[199] The proposed regulations were officially withdrawn as of October 20, 2017.[200]

(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)[201] 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.

(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.[202]

---

197 § 2704(b)(3)(B).

198 *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.).

199 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].

200 FR Doc. 2017-22776, 82 Fed. Reg. 48779.

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

202 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

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

b. Where retaining limited liability of a partner is important, the partner should utilize a wholly-owned limited liability company that is treated as a disregarded entity for Federal tax purposes.[203] 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,[204] interest exchange[205] and dissolution, or other merger transaction.

c. 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.[206]

C. Avoiding "Step-Down" Even with No Section 754 Election

1. Generally

a. When a decedent passes away owning an asset that has an adjusted basis greater than its fair market value, it will result in a "step-down" in tax basis to fair market value under section 1014. For that reason, the common advice provides that prior to death, taxpayers should recognize any unrealized losses. These losses can offset any gains that the taxpayers will recognize, even if that is on a decedent's last income tax return. Unfortunately, individual taxpayers, estates, and trusts may not carryback capital losses to offset gains in previous taxable years.[207] Further, the IRS has held that capital losses (and carryovers of the same) are only deductible by the taxpayer who sustained the loss.[208] If spouses sell securities or other capital assets held jointly at a loss in the year of death of one of the spouses, then half of the loss can be allocated to the surviving spouse and can be carried forward.[209] If the loss is attributable only to the decedent spouse, any capital loss carryforwards, not otherwise offset by gains on the last return, are lost. As such, taxpayers should be vigilant to recognize losses as soon as possible and offset those losses by recognizing gain on assets that are owned by the taxpayer and the taxpayer's intentionally defective grantor trusts (IDGTs).

---

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)."

[203] 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).

[204] *See* § 1141(a)(1) of the UPA

[205] *See* § 1131(a) of the UPA.

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

[207] *See* § 1212.

[208] Rev. Rul. 74-175, 1974-1 C.B. 52.

[209] The IRS considers someone married for the entire year that a decedent dies, as long as the surviving spouse does not remarry during that year.

b. In contrast, if a taxpayer makes a gift, under section 1015(a) of the Code, the donee's basis in the property will be the same as it would be in the hands of the donor (carryover basis).[210] As a result of the foregoing, any unrealized gain in appreciated gifted property is taxable to the donee, unless the gift itself is characterized as a taxable disposition triggering gain to the donor (such as in the case of a gift of an installment obligation).[211] In addition, section 1015(d) increases the basis for gift taxes paid in connection with a gift to the extent attributable to the excess of the value of the property at the time of the gift over the transferor's basis immediately before the gift. 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.[212]

2. Conversion of Grantor Trust Due to the Death of the Grantor

a. If grantor trust status is terminated due to the grantor's death, clearly the grantor-decedent is no longer considered the owner of the trust property for income tax purposes. The IRS has ruled that upon the death of the grantor, the trust springs into existence as a separate taxpayer.[213] As such, the trust assets are deemed to be transferred to the new taxpayer, but it's not clear what type of transfer it is, and whether, under some circumstances, it could be considered a taxable event.

b. Notably, while acknowledging there is no Code section that explicitly addresses the issue, some commentators have asserted categorically that gain or loss is not recognized by a transfer in connection with the death of the owner.[214] They cite *Crane*, *Diedrich*, section 1.1001-2 of the Treasury Regulations in support of the claim that dispositions of property with debt in excess of basis only results in gain recognition with lifetime transfers, although they do not, collectively or individually, say that. This view is exacerbated by an IRS ruling that gratuitously stated "death … is generally not treated as an income tax event,"[215] even though the ruling itself was not addressing the income tax consequences of a conversion of a trust's status due to the death of any individual. In furtherance of this notion that a transfer at death is never a

[210] § 1015(a).

[211] *See* § 453B.

[212] *See* Treas. Reg. § 1.1015-1(a)(1) & (2). 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.

[213] Rev. Rul. 57-51, 1957-1 C.B. 171. *See also* Rev. Rul. 79-84, 1979-1 C.B. 223 (Upon the of the grantor, there is a deemed transfer of a partnership interest to the revocable trust that owned the interest at death for section 743(b) purposes because the partnership had a section 754 election in place.) and Treas. Reg. 1.671-4(h) ("Following the death of the decedent, the trust or portion of a trust that ceases to be treated as owned by the decedent, by reason of the death of the decedent, may no longer report under this section.").

[214] *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) and 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).

[215] CCA 200923024 (Dealing with a conversion from non-grantor to grantor trust status, discussed later in these materials).

recognition event, some commentators have pointed to Revenue Ruling 73-183.[216] In the ruling, a taxpayer purchased stock at $30 per share and later died when the stock had a fair market value of $20 per share. Under section 1014 of the Code, the stock's basis was adjusted to $20 per shares. Notwithstanding the foregoing, the estate of the taxpayer sought guidance on whether a loss is recognized on the taxpayer's final income tax return as a result of the transfer of the stock to the estate. The ruling held that no gain or loss is recognized when stock is transferred from the decedent to the estate, whether the adjusted basis prior to death was less than or in excess of the fair market value on the date of death. These arguments ignore the fact that most transfers at death result in a basis adjustment to fair market value under section 1014 of the Code. If a decedent dies with appreciated property, subject to a nonrecourse debt that is in excess of the property's tax basis prior to death, when the property is "stepped-up" to fair market value, the property no longer has debt in excess of basis.

c. Estates of decedents who died in 2010 could elect to apply the modified carryover basis regime of now repealed section 1022 of the Code, instead of being subject to the estate tax regime that had been reinstated retroactively for that year.[217] Generally, section 1022 of the Code provided that recipients of property from estates that elected out of the estate tax would receive property with a basis equal to the lesser of the adjusted basis of the decedent or the property's fair market value.[218] It provided for certain modifications including the ability to increase the aggregate adjusted basis of estate property up to $1.3 million, [219] with additional increases of up to $3.0 million for property passing to a surviving spouse, outright or to a QTIP trust.[220] The drafters of the Code section clearly understood that if property passes by death but with carryover basis, rather than with a basis adjustment under section 1014 of the Code, gain would be recognized if any property had debt in excess of basis. To that end, they added a specific provision which provides, "In determining whether gain is recognized on the acquisition of property from a decedent by a decedent's estate or any beneficiary other than a tax-exempt beneficiary, and from the decedent's estate by any beneficiary other than a tax-exempt beneficiary, and in determining the adjusted basis of such property, liabilities in excess of basis shall be disregarded."[221] What is particularly telling is, as written, if property with debt in excess of basis had passed from the estate to a tax exempt beneficiary (i.e., charitable organization), gain would have been recognized.

d. In the mid-1970's, with the 1976 Tax Reform Act,[222] Congress eliminated the "step-up in" basis and enacted a carryover basis regime under predecessor section 1023 of the Code which would have been applied for decedents dying after December 31, 1979. At that time, learned commentators noted that, on the death of the decedent, gain will be recognized upon a transfer of the decedent's property in an amount equal to the difference

[216] Rev. Rul. 73-183, 1973-1 C.B. 364.

[217] The election out of the estate tax regime is not in the Code. *See* Notice 2011-66, 2011-35 I.R.B. 184, Rev. Proc. 2011-41, 2011-35 I.R.B. 188, and Notice 2011-76, 2011-40 I.R.B. 479.

[218] § 1022(a)(2).

[219] § 1022(b)(2)(B)

[220] § 1022(c)(1).

[221] § 1022(g)(1).

[222] P.L. 94-455 (Oct. 4, 1976). *See also* P.L. 95-600 (Nov. 6, 1978).

between basis and liability.[223] In coming to that conclusion they concluded, "transfer effected at death should not be taxed any differently so far as the decedent transferor is concerned than are inter vivos transfers. Any gain or loss recognized on a transfer at death should be reported on the decedent's final return."[224] The carryover basis regime at death was repealed retroactively in 1980, so it never came into effect.[225] One of the reasons for the repeal was likely the debt in excess of basis issue.

e. The debatable issue at hand does not involve property included in the gross estate of a decedent and which gets a basis adjustment under section 1014 of the Code. There is no question that upon the death of the grantor, property in a revocable living trust, for example, that is "transferred" to a trust that is now a non-grantor trust, even if encumbered by a mortgage that is in excess of its basis, will not be considered a recognition event.[226] That is because of the basis adjustment at death. The issue is what happens when IDGT assets, which are designed not to be included in the estate of the grantor-decedent, are "transferred" to a non-grantor trust. What is the resulting basis of the assets in the IDGT? Is there recognition of gain if the assets are subject to a debt (i.e., the IDGT installment obligation) that is in excess of the basis of the assets?

f. Notwithstanding arguments to the contrary,[227] the IRS recently issued Revenue Ruling 2023-2,[228] holding that there is no basis adjustment under section 1014 to the assets of a trust on the death of an individual "who is the owner of the trust under chapter 1 of the Code (chapter 1) if the trust assets are not includible in the owner's gross estate pursuant to chapter 11 of the Code (chapter 11)."[229] In the ruling, the individual taxpayer established an irrevocable trust and funded it with assets in a transfer that was a completed gift for gift tax purposes. The individual retained a power over the trust that caused him to be treated as its owner for income tax purposes under the grantor trust rules. However, the individual did not hold a power over the trust that would result in the inclusion of the trust's assets in his or her gross estate for transfer tax purposes. By the date of the taxpayer's death, the fair market value of the asset had appreciated. At that time, the trust liabilities did not exceed the basis of the trust assets and neither the individual nor the trust held a note on which the other was the obligor. In coming to the conclusion that the basis of the assets after the death of the individual "is the same as the basis of Asset immediately prior to A's death,"[230] the IRS reasoned the basis of the trust assets

---

[223] Louis A. DelCotto and Kenneth F. Joyce, *Inherited Excess Mortgage Property: Death and the Inherited Tax Shelter*, 34 Tax L. Rev. 569 (1979).

[224] *Id.* at 569.

[225] P.L. 96-223 (Apr. 2, 1980).

[226] Query what would happen if the amount of nonrecourse debt exceeded both basis and the fair market value of the property? Would the holding in *Tufts* require a recognition of gain to the extent of the debt in excess of fair market value?

[227] *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.

[228] Rev. Rul. 2023-3, 2023-16 I.R.B. 658.

[229] *Id.*

[230] *Id.*

are not adjusted under section 1014 because the assets were "not acquired or passed from a decedent as defined in § 1014(b)."[231]

g. Revenue Ruling 2023-2 is in agreement with the conventional view that assets in an IDGT that are not included in the grantor's gross estate will not receive a "step-up" in basis under section 1014. In Chief Counsel Advice 200937028[232] a taxpayer transferred assets into a trust and reserved the power to substitute assets, and the trust assets did not qualify for a basis adjustment under section 1014(b)(1) through (b)(10) of the Code. 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)."[233]

h. The implication of Revenue Ruling 2023-2 with respect to the tax basis of property that is owned by the IDGT if that if the property is not encumbered with debt, the transfer is akin or may actually be a gift for income tax purposes. The result is that the trust will not realize income when the deemed transfer occurs, no sale or exchange occurs, and the trust will take a basis in the property as determined under section 1015 of the Code. A termination of grantor trust status upon the death of the grantor is effectively a transfer of the underlying trust assets, as if the assets had been transferred by gift under section 1015(a) or, alternatively, section 1015(b), as proposed in an excellent article (but which gets to the same result). [234] In that article, the authors argue that section 1015(b) of the Code specifically should apply to determine the basis of assets in IDGTs when termination of grantor trust status is caused by the death of the grantor. Section 1015(b) of the Code provides if property is acquired "by transfer in trust (other than by a gift, bequest, or devise), the basis shall be the same as it would be in the hands of the grantor, increased in the amount of gain or decreased in the amount of loss recognized to the grantor on such transfer."[235] Thus, if the death of the grantor is not a taxable event for income tax purposes, then the acquired basis is simply the donor's basis prior to death. In addition, if the property secures a nonrecourse debt that is in excess of the property's basis, then gain will be recognized (and the amount of gain will be added to the resulting adjusted basis of the property). The IRS has implied this result already. For example, the IRS ruled that when property transferred to a grantor trust is transferred to the grantor under the terms of the trust instrument at

[231] *Id.*

[232] CCA 200937028.

[233] *Id.*

[234] Austin Bramwell and Stephanie Vara, *Basis of Grantor Trust Assets at Death: What Treasury Should Do*, Tax Notes (Aug. 6, 2018) p. 793 (Aug. 6, 2018).

[235] § 1015(b)

the termination of the trust, its basis is the same as the basis of the property in the hands of the grantor upon the original contribution.[236]

3. Mandatory Inside Basis Adjustments Due to "Substantial Built-In Loss"

a. Even in the absence of a section 754, section 743(d)(1) of the Code provides that a partnership must make mandatory inside basis adjustments if 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).[237] Since the enactment of TCJA, a partnership is deemed to have "substantial built-in loss" if:

(1) The partnership's total adjusted bases in partnership property exceeds the properties' total fair market value by more than $250,000 immediately after the transfer of the partnership interest;[238] or

(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."[239]

b. Evaluating whether a transfer (including a transfer due to the death of a partner) will trigger a mandatory basis adjustment, the determination must be made both at the entity level and at the transferee partner level. If either of the conditions are met, it requires a mandatory basis adjustment under section 743(b). Further, because the second condition is determined from the point of view of the transferee, you can have a "substantial built-in loss" without the partnership itself having an overall built-in loss.

c. The following is an example of a "substantial built-in loss" determined at the partnership level:

Example: AB Partnership has two equal partners, A and B. The partnership does not have any liabilities. The balance sheet of the partnership is as follows:

AB Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	$500,000	$500,000	Partner A	$900,000	$750,000
Asset B	$400,000	$500,000	Partner B	$900,000	$750,000
Asset C	$900,000	$500,000			
Total	**$1,800,000**	**$1,500,000**	**Total**	**$1,800,000**	**$1,500,000**

[236] Rev. Rul. 72-406, 1972-2 C.B. 462. *See also Pierre S. Du Pont v. Commissioner*, 18 B.T.A. 1028 (1930).

[237] There is also a mandatory inside basis adjustment when 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). § 734(a)(1).

[238] § 743(d)(1)(A).

[239] § 743(d)(1)(B).

The partnership has a "substantial built-in loss" because the total inside basis of the partnership assets is $300,000 higher than the fair market value of those assets. At that time, B passes away. Assume that the fair market value of B's interest is $750,000 (B's capital account balance just prior to death). As a result, the outside basis of B's partnership interest is decreased by $150,000 ($900,000 to $750,000) under section 1014. If the partnership did not have a section 754 election in place, and there wasn't a mandatory inside basis adjustment, the partnership balance sheet would look, as follows:

AB Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	$500,000	$500,000	Partner A	$900,000	$750,000
Asset B	$400,000	$500,000	B's Estate	$750,000	$750,000
Asset C	$900,000	$500,000			
Total	**$1,800,000**	**$1,500,000**	**Total**	**$1,650,000**	**$1,500,000**

Without an inside basis adjustment, Asset C could be sold for a total loss of $400,000, and the estate's share of that loss ($200,000) could be allocated to the transferees of B's estate even though the partnership interest had its basis "stepped-down" under section 1014. However, because the partnership had a "substantial built-in loss" immediately after the transfer of the partnership interest due to B's death, the inside basis adjustments under section 743 must be made, as follows:

AB Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	$500,000	$500,000	Partner A	$900,000	$750,000
Asset B	$450,000	$500,000	B's Estate	$750,000	$750,000
Asset C	$700,000	$500,000			
Total	**$1,650,000**	**$1,500,000**	**Total**	**$1,650,000**	**$1,500,000**

Note, despite B's partnership interest getting a "step-down" in basis, the inside basis adjustment under section 743 results in a $50,000 "step-up" to Asset B and a $200,000 "step-down" to Asset C (in aggregate a total decrease in inside basis of $150,000, which is equal to the "step-down" in basis under section 1014). These inside basis adjustments are notional and only apply to B's estate or the transferees of the estate, but it has the net effect of eliminating B's share of unrealized gain or loss in the partnership assets. Prior to death, B's share of unrealized gain in Asset B was $50,000, and B's share of unrealized loss in Asset C was $200,000. After death, due to the "step-down" in basis under section 1014 and the mandatory basis adjustment, B's estate has no unrealized gain or loss in Assets B and C.

d. The following is an example of a "substantial built-in loss" determined from the perspective of the transferee:

Example: AB Partnership has two equal partners, A and B. The partnership does not have any liabilities. The balance sheet of the partnership is as follows:

AB Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	$500,000	$700,000	Partner A	$800,000	$800,000
Asset B	$100,000	$500,000	Partner B	$800,000	$800,000
Asset C	$1,000,000	$400,000			
Total	**$1,600,000**	**$1,600,000**	**Total**	**$1,600,000**	**$1,600,000**

The partnership itself does not have a "substantial built-in loss" because the total inside basis of the partnership assets is equal to the fair market value of those assets. At that time, B passes away. Assume that the fair market value of B's interest is $800,000 (B's capital account balance just prior to death), which is equal to B's outside basis on date of death. As a result, there is no net change in the basis of B's partnership interest under section 1014. If the partnership did not have a section 754 election in place, and there wasn't a mandatory inside basis adjustment, the partnership balance sheet would look, as follows:

AB Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	$500,000	$700,000	Partner A	$800,000	$800,000
Asset B	$100,000	$500,000	B's Estate	$800,000	$800,000
Asset C	$1,000,000	$400,000			
Total	**$1,600,000**	**$1,600,000**	**Total**	**$1,600,000**	**$1,600,000**

Without an inside basis adjustment, Asset C could be sold for a total loss of $600,000, and the estate's share of that loss ($300,000) could be allocated to the transferees of B's estate even though the partnership interest did not get "stepped-down" under section 1014. However, because the estate (the transferee) would be allocated a loss of more than $250,000, the partnership is deemed to have a "substantial built-in loss." As a result the inside basis adjustments under section 743 must be made, as follows:

AB Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	$600,000	$700,000	Partner A	$800,000	$800,000
Asset B	$300,000	$500,000	B's Estate	$800,000	$800,000
Asset C	$700,000	$400,000			
Total	**$1,600,000**	**$1,600,000**	**Total**	**$1,600,000**	**$1,600,000**

Note, despite no change to B's outside basis, the inside basis adjustment under section 743(b) results in a "step-up" to Assets A and B of $100,000 and $200,000 respectively and a $300,000 "step-down" to Asset C (in aggregate no net change to the inside basis of the partnership assets). These inside basis adjustments are notional and only apply to B's estate or the transferees of the estate, but it has the net effect of eliminating B's share of unrealized gain or loss in the partnership assets. Prior to death, B's share of unrealized gain in Assets A and B was $100,000 and $200,000 respectively, and B's share of unrealized loss in Asset C was $300,000. After death, even with no net change in outside basis under section 1014 and the mandatory basis adjustment, B's estate has no unrealized gain or loss in Assets A, B and C.

e. In 2014, the IRS published proposed Treasury Regulations on the application of section 704(c)(1)(C) (contributions of built-in loss property).[240] These same proposed regulations provide rules that would apply if a partnership has a substantial built-in loss immediately after a transfer. These proposed rules will be effective for transfers of partnerships occurring on or after the regulations are finalized.[241] They have not yet been finalized. In such case, the proposed rules provide that the partnership would be treated as having a section 754 election in effect for the year of the transfer but only with respect to that transfer.[242] Any subsequent transfer would need to be tested separately to determine whether a mandatory basis adjustment is required.

f. The proposed regulations also contain an anti-abuse provision for built-in loss transactions. It provides, "if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of one or more of these paragraphs, the Commissioner may recast the transaction for Federal income tax purposes, as appropriate, to achieve tax results that are consistent with the purpose of these paragraphs."[243] It provides these two examples of potentially abusive situations:

(1) "Property held by related partnerships may be aggregated if the properties were transferred to the related partnerships with a principal purpose of avoiding the application of the substantial built-in loss provisions in section 743 and the regulations;"[244] and

(2) "A contribution of property to a partnership may be disregarded if the transfer of the property was made with a principal purpose of avoiding the application of the substantial built-in loss provisions in section 743 and the regulations thereunder."[245]

4. Mandatory "Step-Down" of Partnership Assets

a. Partnership Interest Is Included in the Gross Estate

(1) In the last example above, the death of Partner B, resulted in a net mandatory basis adjustment of zero, but the appreciated assets (Asset A and Asset B) had their adjusted bases increased (to eliminate the estate's share of gain in those assets) and the loss

[240] REG-144468-05, 79 Fed. Reg. 3,042 (Jan. 16, 2014).

[241] Prop. Treas. Reg. § 1.743-1(p).

[242] Prop. Treas. Reg. § 1.743-1(k)(1)(iii).

[243] Prop. Treas. Reg. § 1.743-1(m).

[244] Prop. Treas. Reg. § 1.743-1(m)(1).

[245] Prop. Treas. Reg. § 1.743-1(m)(2).

property (Asset C) had its adjusted basis decreased by $300,000 (to eliminate the estate's share of the unrealized loss in Asset C). The net result is effectively as if B died directly owning a one-half interest in Assets A, B, and C. Partner B's interest in the appreciated property would get a "step-up" in basis, and Partner B's interest in the loss property would get a "step-down" in basis.

(2) If AB Partnership had liquidated prior to Partner B's death, B would hold one-half of: (i) Asset A (adjusted basis of $250,000 and fair market value of $350,000), (ii) Asset B (adjusted basis of $50,000 and fair market value of $250,000), and (iii) Asset C (adjusted basis of $500,000 and fair market value of $200,000). If, at that point, former Partner B passes away, then Assets A and B will get a "step-up" in basis to fair market value, and Asset C would get a "step-down" in basis. This is the exactly the same result inside AB Partnership as the last example with the mandatory basis adjustment under section 743(d)(1)(B). Unfortunately, this still results in Partner B, B's estate, and the transferees of the estate not getting the benefit of recognizing the loss in Asset C. The only way for former Partner B (and his or her heirs) to get the economic benefit of the loss, is to have B sell the one-half interest in Asset C and having gains to be offset by that loss prior to B's passing.

(3) If Asset C remains inside AB Partnership and the partnership sells a one-half interest in Asset C, if AB Partnership is a family-owned partnership, then the partnership may not be able to specially allocate that loss just to Partner B because of section 2701 concerns. Assuming that is the case, AB Partnership will have to allocate any loss equally to Partners A and B, so the only way for Partner B to get the entire $300,000 loss, all of Asset C must be sold or exchanged. This may not be what Partner A wishes, perhaps because Partner A believes his or her interest in Asset C will eventually be profitable. As such, the most effective solution to this issue is to liquidate the partnership.

b. Partnership Interest Is Subject to a Valuation Discount

(1) The last example assumed Partner B's partnership interest had a value for estate planning purposes equal to Partner B's capital account balance. This represents liquidation value, and thus the example assumes no valuation discount for lack of marketability and control. As noted at the beginning of these materials, a valuation discount often saves more in transfer taxes than the income tax savings from a "step-up" in basis. In addition, the IRS has an incentive to impose valuation discounts especially for those estates that do not have any estate taxes payable (i.e., estates with gross estates less than the decedent's BAE or large estates that have no estate tax payable because of the marital deduction). As discussed below, a valuation discount will exacerbate a reduction in inside basis when a mandatory basis adjustment is imposed.

Example: Same facts as the last example. The balance sheet of the partnership is as follows:

AB Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	$500,000	$700,000	Partner A	$800,000	$800,000
Asset B	$100,000	$500,000	Partner B	$800,000	$800,000
Asset C	$1,000,000	$400,000			
Total	**$1,600,000**	**$1,600,000**	**Total**	**$1,600,000**	**$1,600,000**

B passes away. Assume that the fair market value of B's interest is $600,000 (25% valuation discount to B's capital account balance just prior to death). As a result, there is $200,000 "step-down" in basis to B's partnership interest under section 1014. As we know from the last example, because the estate (the transferee) would be allocated a loss of more than $250,000, the partnership is deemed to have a "substantial built-in loss." As a result the inside basis adjustments under section 743 must be made, as follows:

AB Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	$512,500	$700,000	Partner A	$800,000	$800,000
Asset B	$237,500	$500,000	B Estate	$600,000	$800,000
Asset C	$650,000	$400,000			
Total	**$1,400,000**	**$1,600,000**	**Total**	**$1,400,000**	**$1,600,000**

The total inside basis adjustment is the difference between the transferee's outside basis ($600,000) and the transferee's share of the basis of the partnership property, which is the sum of the sum of the partner's previously taxed capital, plus the partner's share of partnership liabilities. There are no liabilities in this example. The partner's previously taxed capital is $200,000, determined as follows: (i) $800,000 (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); plus (ii) $300,000 (the amount of tax loss from Asset C that would be allocated to the partner on the hypothetical transaction); less (iii) the $300,000 (the amount of tax gain from Assets B and C that would be allocated to the partner on the hypothetical transaction). As a result, the total net inside basis adjustment under section 743(b) is -$200,000 ($600,000 outside basis minus partner's share of the partnership property of $800,000).

Unlike the previous example, which had a net zero basis adjustment, the basis adjustment in this instances is -$200,000. That negative adjustment is allocated to each asset in the following amounts:[246]

Asset A has an upward basis adjustment of $87,500 ($100,000 gain on hypothetical sale *minus* [$200,000 net inside basis adjustment *multiplied by*

[246] See Treas. Reg. § 1.755-1(b)(3)(iv), Ex. 2

($700,000 value of Asset A *divided by* $1,600,000 value of all assets)] = $12,500).

Asset B has an upward basis adjustment of $137,500 ($200,000 gain on hypothetical sale *minus* [$200,000 net inside basis adjustment *multiplied by* ($500,000 value of Asset B *divided by* $1,600,000 value of all assets)] = $62,500).

Asset C has a downward adjustment of $350,000 (-$300,000 loss on hypothetical sale *minus* [$200,000 net inside basis adjustment *multiplied by* ($400,000 value of Asset C *divided by* $1,600,000 value of all assets)] = $50,000).

The net result with respect to the transferee's interest in each asset, as follows:

The transferee's share of basis in Asset A in $337,500 and a value of $350,000 (unrealized gain of $12,500).

The transferee's share of basis in Asset B in $187,500 and a value of $250,000 (unrealized gain of $62,500).

The transferee's share of basis in Asset C in $150,000 and a value of $200,000 (unrealized gain of $50,000).

(2) As can be seen, when there isn't a full basis adjustment under section 1014 to capital account value due to valuation discounts, the assets in the partnership do not get a full inside basis adjustment that eliminates all of the transferee's unrealized gain or loss in the partnership property. In this instance, even Asset C, which was at a loss at the time of death, ends up with an unrealized gain. The results may seen idiosyncratic, but the Treasury Regulations prorate the shortfall based upon the value of the assets, not the unrealized gain or loss in the assets.[247]

c. Deemed Transfer on a Conversion from Grantor to Non-Grantor Trust

(1) As noted above, the conversion of an IDGT to a non-grantor trust due to the death of the grantor is treated as a transfer of the trust assets by the grantor. Revenue Ruling 2023-2 makes clear that, assuming the assets are not encumbered with debt, the transfer is akin or may actually be a gift for income tax purposes. The basis of the trust assets will carryover and likely to be determined under section 1015(a) like a gift or section 1015(b) (transfer in trust, other than by a gift, bequest, or devise).

(2) If one of the trust assets is a partnership interest and the partnership has a "substantial built-in loss" as defined in section 743(d)(1), it's unclear whether the transfer will trigger a mandatory inside basis adjustment. The policy reason that it should not trigger the mandatory inside basis adjustment is the deemed transfer of the partnership interest to the trust does not result in any change in the outside basis of the partnership interest. For example, if a taxpayer makes a gift of a partnership interest to his or her child, by way of example, and the partnership has a "substantial built-in loss," section 743(d)(1) does not apply. That is because it only applies "In the case of a transfer of an interest in a partnership by sale or

[247] *See* Treas. Reg. § 1.755-1(b)(3)(ii)(B)(2).

exchange or upon the death of a partner…”[248] The assumption is that the phrase “upon the death of a partner” refers to an individual partner owning the interest at the time of his or her death, not to a deemed transfer caused by the conversion from grantor to non-grantor trust. However, this position is not without doubt.

(3) In Revenue Ruling 79-84,[249] the IRS held that a deemed transfer of a partnership interest to a grantor trust caused by the death of the grantor requires an inside basis adjustment under section 743(b) because the partnership had a section 754 election in place. The ruling provides:[250]

> Before A's death, A had powers over T of the types described in sections 676 and 677 of the Code, and T was therefore a grantor trust. Additionally, T held a partnership interest. Under the principles of Rev. Rul. 77-402 , A is considered to have been the partner during this period for federal income tax purposes. Further, at the time of A's death T ceased to be a grantor trust. The partnership interest is thus considered to have been transferred from A to T at that time. As a result, a transfer of a partnership interest occurred upon the death of a partner.

The phrase “upon the death of a partner” is a direct reference to the same phrase in section 743(b). However, the grantor trust in the ruling is a revocable trust and, as such, the partnership interest will get a basis adjustment under section 1014.

(4) If the partnership in question does not have a “substantial built-in loss,” even with a section 754 election in place, under most circumstances the inside bases of the assets would not be adjusted because the outside basis has not changed. However, we have seen an example where, upon the death of a partner, the partnership interest is included in the gross estate but the outside basis remains unchanged and a mandatory inside basis adjustment is nonetheless required under section 743(d)(1).

<u>Example</u>: AB Partnership has two equal partners, A and T. T is an IDGT. The grantor of the IDGT is B. The partnership does not have any liabilities. The balance sheet of the partnership is as follows:

AB Partnership Balance Sheet					
Assets			Capital Accounts		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	$500,000	$700,000	Partner A	$800,000	$800,000
Asset B	$100,000	$500,000	IDGT (B)	$800,000	$800,000
Asset C	$1,000,000	$400,000			
Total	**$1,600,000**	**$1,600,000**	**Total**	**$1,600,000**	**$1,600,000**

The partnership itself does not have a “substantial built-in loss” because the total inside basis of the partnership assets is equal to the fair market value of those assets. However, there is a “substantial built-in loss” at the partner level. At that

[248] § 743(b)

[249] Rev. Rul. 79-84, 1979-1 C.B. 223.

[250] *Id.*

time, B passes away and there is a deemed transfer of the trust's interest from B to the trust. If the partnership does not have a section 754 election in place, and a mandatory inside basis adjustment is not required, the partnership balance sheet would look, as follows, after B's death:

AB Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	$500,000	$700,000	Partner A	$800,000	$800,000
Asset B	$100,000	$500,000	Taxable Trust	$800,000	$800,000
Asset C	$1,000,000	$400,000			
Total	**$1,600,000**	**$1,600,000**	**Total**	**$1,600,000**	**$1,600,000**

Under these circumstances, if Asset C is sold, the trust will be allocated a ($300,000) loss.

However, if the deemed transfer is deemed to be "upon the death of a partner" under section 743(b), a mandatory inside basis adjustment is required and the result would be as follows:

AB Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	$600,000	$700,000	Partner A	$800,000	$800,000
Asset B	$300,000	$500,000	Taxable Trust	$800,000	$800,000
Asset C	$700,000	$400,000			
Total	**$1,600,000**	**$1,600,000**	**Total**	**$1,600,000**	**$1,600,000**

It's notable that the inside basis adjustment in this example creates an upward adjustment to Assets A and B so they can be sold without any allocation of gain to the non-grantor trust.

d. Deemed Transfer on a Conversion with Debt in Excess of Basis

(1) As noted above, if an IDGT holds assets that collateralize a liability that is greater than the basis of those assets, upon the death of the grantor, the deemed transfer will cause the recognition of gain to the extent of the debt. In this circumstance, the transfer would be considered a taxable sale or exchange that would cause a mandatory inside basis adjustment if the partnership had a "substantial built-in loss."

(2) However, it's unlikely that there would be any gain if the partnership interest is the only asset collateralizing the debt. As the examples in this section show, the outside basis of the partners in a "substantial built-in loss" partnership is often equal to or greater then the partners' capital accounts. Most likely where there would be an issue is when the partnership interest is just one of the assets collateralizing a debt and the collateralized assets, in the aggregate, have an adjusted basis that is less than the outstanding debt.

III. TAX FREE EXCHANGES OF PROPERTY

A. Generally

1. As discussed in these materials, contributions of property in exchange for an interest in a partnership are generally non-recognition events. In addition, distributions of partnership property to partners are also generally nontaxable. Before the "anti-mixing bowl" rules were enacted, taxpayers would use partnerships as a vehicle to exchange assets and property interests without recognizing any gain. Of course, taxpayers can gift property to each other with little to no income tax consequences, but the transfers may carry gift tax consequences and the IRS might recast related transfers as recognition events.

2. Partnerships are one of the only vehicles in the Code that will allow taxpayers to exchange property interests in a tax free manner.[251] However, that requires taxpayers to have patience because the "anti-mixing bowl" rules have a 7-year holding period in order avoid recognition caused by the distribution of partnership property to a contributing partner or to a non-contributing partner. For this reason, it is often recommended that taxpayers fund partnerships as soon as possible to start the holding period for "mixing bowl" purposes and to keep the assets in the partnership unless there is a compelling tax reason to distribute the property.

B. Swapping Property Interests

1. Simple Example of Avoiding the "Anti-Mixing Bowl" Rules

> **Example**: Partners A, B, and C form ABC Partnerships. Under section 721, the partners make the following contributions of non-depreciable capital assets, at three different times but in the same year: (i) Partner A contributes Asset A, which has an adjusted basis of $0x and fair market value of $100x; (ii) Partner B contributes Asset B, which has an adjusted basis of $20x and fair market value of $100x; and (iii) Partner C contributes Asset C, which has an adjusted basis of $50x and fair market value of $100x. More than seven years after the last contribution, the ABC Partnership liquidates and makes the following liquidating distributions: (i) Asset C to Partner A; (ii) Asset A to Partner C; and (iii) Asset B to Partner C.
>
> Because the liquidating distributions occur more than seven years after the last contribution of the partners, there is no "mixing bowl" transaction and the distributions are tax free. In addition, the adjusted bases of the assets held by the former partners are as follows: (i) Asset C held by A has an adjusted basis of $0x; (ii) Asset A held by B has an adjusted basis of $20x; and (iii) Asset B held by C has an adjusted basis of $50x. As a result, A, B, and C have accomplished a tax free exchange properties, and the tax basis that each had with their original property is now reflected in the property that they received.

---

[251] Exchanges between grantor's and IDGTs are income tax free, so are most transfers from non-grantor trusts to beneficiaries. These vehicles, however, often involve transfers that are taxable gifts or have the same effect of a taxable gift like an installment sale to an IDGT (which transfer appreciation out of the grantor's gross estate).

2. Swapping Interests in Different Properties

Example: After the death of their parents, siblings, A, B, and C. find themselves equal partners in three different partnerships that own rental real estate in different parts of the United States, as follows:

(i) Partnership 1 holds rental property in California (CA Property) with a fair market value of $300x and an adjusted basis of zero. Each of the siblings has a 1/3 interest in Partnership 1, and each of their partnership interests have an outside basis of zero and a capital account of $100x. The parents contributed the CA Property to the partnership 10 years ago.

(ii) Partnership 2 holds rental property in New York (NY Property) with a fair market value of $330x and an adjusted basis of zero. Each of the siblings has a 1/3 interest in Partnership 2, and each of their partnership interests have an outside basis of zero and a capital account of $110x. The parents contributed the NY Property to the partnership 15 years ago.

(iii) Partnership 3 holds rental property in Florida (FL Property) with a fair market value of $300x and an adjusted basis of zero. Each of the siblings has a 1/3 interest in Partnership 3, and each of their partnership interests have an outside basis of zero and a capital account of $100x. The parents contributed the FL Property to the partnership 5 years ago.

Each year, all three of the partnerships distribute 100% of the net rental income to the partners. Partner A is a resident of California, but Partner A must file and pay income taxes in A's resident state of California and also New York. Partner B is a resident of New York, but Partner B must file and pay income taxes in B's resident state of New York and also California. Partner C is a resident of Florida, but Partner C, a resident of a state that has no state income tax, must file and pay income taxes in both California and New York.

Partners A, B, and C wish to exchange their 1/3 interests in each of the rental properties in a manner that results in the following: (i) Partner A will own 100% of the CA Property; (ii) Partner B will own 100% of the NY Property; and (iii) Partner C will own 100% of the FL Property. They wish to accomplish the foregoing in an income tax free manner (or in the most tax efficient way) and without making (or being deemed to have made) taxable gifts to each other.

3. Common Mistake: Contribution to a New Partnership

a. Many practitioners know that partnerships can be used to accomplish tax free exchanges of property interests. To that end, a common initial reaction to the foregoing scenario is for each of the partnerships to contribute their respective properties to a newly created partnership under section 721.[252]

[252] Followed by a liquidation of each of the contributing partnerships (distributing interests in the newly-created partnership), making the partners of the contributing partnerships equal partners in the newly-created partnership.

Example (Common Mistake): Under section 721: (i) Partnership 1 contributes the CA Property to newly-created Partnership 4 in a tax free exchange for a partnership interest in Partnership 4; (ii) Partnership 2 contributes the NY Property to newly-created Partnership 4 in a tax free exchange for a partnership interest in Partnership 4; and (iii) Partnership 1 contributes the FL Property to newly-created Partnership 4 in a tax free exchange for a partnership interest in Partnership 4. Partnership 4 owns all of the rental real estate. The net effect, even if Partnerships 1, 2, and 3 remain in existence or liquidate (distributing partnership interests in Partnership 4 to the partners), is Partners A, B, and C will own a 1/3 interest in each of the rental properties.

Unfortunately, the contribution to a newly-created Partnership 4 (whether or not Partnership 1, 2, and 3 remaining in existence) will restart the holding period for "mixing bowl" purposes. This means the partners will need to wait an additional 7 years before the properties can be exchanged in a tax free manner, notwithstanding the fact that the properties have been held in a partnership for a minimum of 5 years.

b. A better solution is to merge the partnerships and their respective properties into one partnership that is deemed to be a continuation of all of the partnerships. The Code provides a methodology to merge partnerships, the challenge is to ensure that the merger is a nontaxable event and does not restart the holding period of any of the properties for "mixing bowl" purposes.

4. Merger of the Partnerships

a. Partnership mergers are governed by section 708(b)(2)(A) of the Code. When two or more partnerships merge, the "resulting" partnership is considered the continuation of the merging or consolidating partnership whose partners (members) own an interest of more than 50% in the capital and profits of the resulting partnership.[253] If under the preceding rule the resulting partnership can be considered a continuation of more than one of the merging or consolidating partnerships, then the resulting partnership will be considered a continuation of the partnership that contributed the assets with the greatest fair market value.[254]

b. The Treasury Regulations provide that the taxable year of the merged or consolidated partnership are terminated, and the date of termination is the date of merger or consolidation.[255] The Treasury Regulation go on to provide, "The resulting partnership shall file a return for the taxable year of the merging or consolidating partnership that is considered as continuing. The return shall state that the resulting partnership is a continuation of such merging or consolidating partnership."[256] In other words, the merged or consolidated partnerships, although terminated, are deemed to continue for partnership tax purposes but now in the form of the resulting partnership.

[253] § 708(b)(2)(A) and Treas. Reg. § 1.708-1(c)(1).

[254] Treas. Reg. § 1.708-1(c)(1).

[255] Treas. Reg. § 1.708-1(c)(2).

[256] *Id.*

c. The Treasury Regulations recognize two forms of merger or consolidation of partnerships, the "assets-over" form (which is the default characterization) and the "assets-up" form.[257] Under the assets-over form,[258] the merged or consolidated partnership that is considered terminated contributes all of its assets and liabilities to the resulting partnership in exchange for an interest in the resulting partnership. Immediately thereafter, the terminated partnership distributes its interest in the resulting partnership to its partners in liquidation of the of the terminated partnership. Under the assets-up form,[259] the merged or consolidated partnership that is considered terminated distributes all of its assets to its partners in liquidation of the partners' interests in the terminated partnership. Immediately thereafter, the partners of the terminated partnership contribute the distributed assets to the resulting partnership in exchange for interests in the resulting partnership.

d. As discussed in more detail earlier, when property is distributed to partners, careful consideration should be given to the avoid a "mixing bowl" transaction. Under section 704(c)(1)(B), 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. [260] Under section 737, 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.[261]

e. Where pre-existing section 704(c) property is contributed to a partnership, the interest in the new partnership received in exchange for the section 704(c) property is treated as successor section 704(c) property.[262] Where section 704(c) property is contributed to a resulting partnership in connection with an assets-over merger, a portion of the distributed interest in the resulting partnership will be treated as successor section 704(c) property. As such, section 704(c)(1)(B) technically could apply to the extent that a distributee partner who did not contribute the pre-existing section 704(c) property receives an interest in the resulting partnership that is successor section 704(c) property to such property. However, the Treasury Regulations provides: [263]

> Section 704(c)(1)(B) and this section do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement.

As such, with an assets-over merger, the merged partnership's contribution of 704(c) property to the resulting partnership in exchange for an interest in the resulting partnership under section 721

[257] Treas. Reg. § 1.708-1(c)(3).

[258] Treas. Reg. § 1.708-1(c)(3)(i).

[259] Treas. Reg. § 1.708-1(c)(3)(ii).

[260] § 704(c)(1)(B).

[261] §§ 704(c)(1)(B) and 737.

[262] Treas. Reg. § 1.704-3(a)(8).

[263] Treas. Reg. § 1.704-4(c)(4).

and the liquidating distribution of the resulting partnership interest to the partners of the merged partnership will not trigger section 704(c)(1)(B). However, a subsequent distribution of the section 704(c) property by the resulting partnership will however be subject to section 704(c)(1)(B).[264]

f. In an assets-over merger, with respect to a partner who previously contributed section 704(c) property, a portion of the resulting partnership interest that is distributed to such partner may be attributable to property that other partners contributed or that was separately acquired by the partnership. To the extent that a distributee partner who contributed section 704(c) property receives an interest in the resulting partnership that is not successor section 704(c) property to the property originally contributed by such partner, section 737 technically could apply. However, the Treasury Regulations provide:[265]

> Section 737 and this section do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement.

As such, with an assets-over merger, transfer by a merged partnership (transferor) of all of its assets and liabilities to a resulting partnership (transferee) in a section 721 exchange, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement. However, a subsequent distribution of property by the transferee partnership to a partner of the transferee partnership that was formerly a partner of the transferor partnership is subject to section 737 to the same extent that a distribution from the transferor partnership would have been subject to section 737.

g. As noted above, there is an additional approved form of merger in the Treasury Regulations, an "assets-up" form.[266] In an assets-up merger, the merging or consolidated partnerships "distributes all of its assets to its partners (in a manner that causes the partners to be treated, under the laws of the applicable jurisdiction, as the owners of such assets) in liquidation of the partners' interests in the terminated partnership, and immediately thereafter, the partners in the terminated partnership contribute the distributed assets to the resulting partnership in exchange for interests in the resulting partnership."[267] For a number of reasons, the "assets-up" form is not preferable in a merger. First, as noted, it requires the partners to be treated as owing the assets under state law. Ownership, however transitory, may cause a revaluation of the property for real property tax purposes, result in the imposition of a transfer tax, and make the assets subject to the creditor claims of the partners.

h. From a "mixing bowl" standpoint, section 704(c)(1)(B) does not apply when the contributed 704(c) property is distributed to the contributing partner. Further, the Treasury Regulations provide a portion of a contributed property may even be distributed to another partner in a merger, so long as a portion of that property (and no other property) also is distributed to the contributing partner and the built-in gain or loss in such portion (determined

[264] *Id.*

[265] Treas. Reg. § 1.737-2(b)(1).

[266] Treas. Reg. § 1.708(c)(3)(ii).

[267] *Id.*

immediately after the distribution) is at least equal to the section 704(c) gain or loss that would have been recognized by such contributing partner had the property been sold to an unrelated party by the partnership.[268] Unless one or both of the foregoing exist, then gain or loss will be triggered under section 704(c)(1)(B). Under section 737, there is some protection from triggering gain on the distribution of assets because any distribution any portion of the distributed property that consists of property previously contributed by the distributee partner will not be taken into account in determining the amount of the excess distribution or the partner's net pre-contribution gain. However, if a contributing partner received property other than previously contributed section 704(c) property, then gain will be recognized under section 737. Simply put, there is no overriding protection against a "mixing bowl" transaction with an assets-up merger, as there is with an assets-over merger.

> **<u>Example (Continued)</u>**: Instead of creating a newly-created partnership, Partnerships 1 and 3 contribute all of their assets (CA and FL Properties) and liabilities (none) to Partnership 2 under section 721, in exchange for interests in Partnership 2. Immediately thereafter, Partnerships 1 and 3 distribute their interests in Partnership 2 to A, B, and C, in full liquidation and termination of Partnerships 1 and 3. Partnership 2 now owns the CA, NY, and FL Properties, A, B, and C are equal partners, and each of them has a 1/3 interest in Partnership 2, each having $0x of outside basis and a capital account balance of $310x (the sum of all their capital account balances in all three of the partnerships before the merger).
>
> As discussed above, this is an "assets-over" merger of Partnerships 1 and 3 (the terminating or consolidating partnerships) into Partnership 2 (the resulting partnership). For "mixing bowl" purposes, the merger is nontaxable. For holding period purposes, since Partnerships 1 and 3 are deemed to continue through Partnership 2. As a result, Properties A, B, and C are deemed to have been contributed to Partnership 2, ten, fifteen, and five years, respectively, ago

5. Liquidation of the Resulting Partnership

a. In anticipation of eventually liquidating the resulting partnership, the resulting partnership should consider creating a holding company structure, pursuant to which each property is contributed to a separate, wholly-owned limited liability company that is treated as a disregarded entity for Federal income tax purposes. The contribution is a nontaxable event. The 100% ownership interest of each holding LLC can be distributed to each of the partners in lieu of the actual underlying property, and the partners will have limited liability under state law.

b. The partners will have to deal with any differences in value in the underlying value. In the example above, the NY Property is $30x greater than the CA and FL Properties. That value difference must be remedied before the liquidation of Partnership 2. Otherwise, upon liquidation of Partnership 2, Partners A and C can receive their respective properties they wish to have (CA and FL Properties), but they will be given a small interest in the NY Property LLC: B will have an approximately 94% ownership interest ($310x capital account/$330x value of the NY Property) and A and C will own approximately 3% each ($10x capital account/$330x value of the NY Property). B could purchase A and C's interest in the NY

[268] Treas. Reg. § 1.704-4(c)(2).

Property LLC, paying $10x equally to A and C, but that will be a taxable event. A and C will each recognize $10x of gain.

c. Alternatively, before the liquidation of Partnership 2, B could contribute $20x to Partnership 2 (increasing B's capital account to $330x, which is equal to the value of the NY Property), which would be distributed to Partners A and C on liquidation of Partnership 2. This latter option will likely result in recognition of gain in two possible ways: (i) the liquidation of Partnership 2 will cause A and C to each have $10x of gain because their outside basis is zero; and/or (ii) the contribution of $20x of cash and the subsequent distribution of the NY Property LLC, which will occur approximately 2 years after the contribution of cash, will be treated as a "disguised sale" under section 707(a)(2)(B).

d. A nontaxable option from an income tax perspective is after the liquidation of Partnership 2, A and C could gift B their interests in the NY Property LLC. However, that could result in gift tax being payable or in a significant reduction of B and C's BEA. As noted earlier, the siblings do not want to make (or be deemed to make) any taxable gifts.

e. One other option is to accumulate (rather than distribute) additional assets (i.e., cash) at the partnership level to sufficiently increase A, B, and C's capital accounts to allow each partner to receive 100% ownership of their desired property and a certain amount of cash.

> **<u>Example (Continued)</u>**: For the next two years, Partnership 2 receives rental income from the CA, NY, and FL Properties, Except for $60x of cash, Partnership 2 distributes all of the rental income. At the end of year 2, A, B, and C's each have an interest in Partnership 2 with an outside basis of $20x and capital account of $330x. After two years have elapsed (the FL Property now has been in a partnership for more than seven years), Partnership 2 liquidates and makes the following distributions: (i) to Partner A, 100% ownership of the CA Holding LLC and $30x in cash; (ii) to Partner B, 100% ownership of the NY Holding LLC; and (iii) to Partner C, 100% ownership of the CA Holding LLC and $30x in cash.
>
> Over the two years, each partner is allocated $20x of ordinary (rental). The net tax result of the foregoing transaction is: (i) Partner A owns 100% of the CA Property with an adjusted basis of $0x, received $30x in cash, and recognized $10x in gain on liquidation of Partnership 2 (prior to the liquidation, A had $20x of outside basis); (ii) Partner B owns 100% of the NY Property with an adjusted basis of $20x (prior to liquidation, B had $20x of outside basis); and (iii) Partner C owns 100% of the FL Property with an adjusted basis of $0x, received $30x in cash, and recognized $10x in gain on liquidation of Partnership 2 (prior to the liquidation, A had $20x of outside basis).rtnership for more than seven years), Partnership 2 liquidates and makes the following distributions: (i) to Partner A, 100% ownership of the CA Holding LLC and $30x in cash; (ii) to Partner B, 100% ownership of the NY Holding LLC; and (iii) to Partner C, 100% ownership of the CA Holding LLC and $30x in cash.
>
> Over the two years, each partner is allocated $20x of ordinary (rental). The net tax result of the foregoing transaction is: (i) Partner A owns 100% of the CA Property with an adjusted basis of $0x, received $30x in cash, and recognized

$10x in gain on liquidation of Partnership 2 (prior to the liquidation, A had $20x of outside basis); (ii) Partner B owns 100% of the NY Property with an adjusted basis of $20x (prior to liquidation, B had $20x of outside basis); and (iii) Partner C owns 100% of the FL Property with an adjusted basis of $0x, received $30x in cash, and recognized $10x in gain on liquidation of Partnership 2 (prior to the liquidation, C had $20x of outside basis).

IV. POST-DIVORCE SLAT PARTNERSHIPS

A. Generally

1. With the temporary doubling of the BEA, which is due to expire in 2026, many married taxpayers have created and made significant taxable gifts to fund irrevocable trusts, pursuant to which the other spouse (beneficiary spouse) is a current or potential beneficiary. Typically, the trust provides for discretionary distributions of income and principal to or for the benefit of the beneficiary spouse. Theoretically, this would allow both of the spouses to use their respective BEAs, but still retain a beneficial interest (holistically, as a couple) in the gifted assets. These are often referred to as "Spousal Lifetime Access Trusts" (SLATs).

2. The gift tax marital deduction under section 2523 and section 1041(a)(1), which provides that there is no gain or loss on transfers between spouses (discussed in more detail below), allow spouses to transfer assets between themselves without any transfer or income tax consequences. Prior to funding a SLAT, many couples will transfer or exchange assets among themselves to ensure each spouse has enough assets to exhaust their respective BEAs or to reduce the risk of the "reciprocal trust doctrine"[269] applying to the SLAT transfers. As a result, one SLAT will often hold different assets than the other SLAT.

3. Under most circumstances, grantor trust status is preferred because it allows the transferor spouse to continue to report the income on his or her personal income tax return and also because the transferor spouse can transact with the grantor trust without income tax consequences.[270] For those reasons, it is common for SLATs to have a provision that is described in section 675(4)(C) pursuant to which the transferor spouse retains the right, at any time, to withdraw trust assets and substitute, in their place, other assets of equivalent value.

4. Section 677(a)(1) provides, in pertinent part, that the grantor will be treated as the owner of any portion of a trust if the income from that portion may, without the consent of an adverse party,[271] be distributed to or accumulated for future distribution to the grantor or the grantor's spouse. In addition, section 672(e) provides grantors will be treated as holding any power or "interest" held by an individual to whom the grantor was married "at the time of the creation of such power or interest"[272] or whom the grantor married after such creation. There is

[269] *See Lehman v. Commissioner*, 109 F.2d 99 (2nd Cir. 1940), *U.S. v. Est. of Grace*, 395 U.S. 316 (1969), *Est. of Bischoff v. Commissioner*, 69 T.C. 32 (1977), and PLR 200426008. *See also Est. of Levy v. Commissioner*, T.C. Memo 1983-453.

[270] Rev. Rul. 85-13, 1985-1 C.B. 184, and § 675(4)(C).

[271] Generally, an adverse party is anyone who has a substantial beneficial interest (including a power of appointment) in the trust that would be adversely affected by the exercise or nonexercised of the relevant power to alter beneficial enjoyment. § 672(a).

[272] § 672(e)(1).

no provision in the Code or the Treasury Regulation that would cause this treatment to terminate if the spouses divorce. Thus, section 672(e) operates to extend the application of section 677(a) even after the spouses divorce. If trust income is or may be distributed or accumulated for future distribution to the grantor's spouse (without the consent of an adverse party), section 677(a) treats the grantor (transferor spouse) as the deemed owner. If the spouse's status as a mandatory or discretionary recipient of trust income is a trust "interest" within the meaning of section 672(e), then that status would continue to be attributed to the grantor even after a divorce and the trust would remain a grantor trust. Grantor trust status would seem to remain even if the former spouse renounced his or her interest in the trust and even if the former spouse died. Grantor trust status would remain in place, theoretically, until the grantor (transferor spouse) dies because there is no grantor trust power to release when section 672(e) is operative.

5. SLATs are not often written to require the consent of an adverse party to make a distribution to a spouse. As such, most SLATs are grantor trusts, and as discussed above, are likely to retain grantor trust status after divorce. Even if the former spouse, by the terms of the trust, is eliminated as a beneficiary of the SLAT upon divorce, or the former spouse renounces his or her interest in the trust as part of the divorce settlement, the SLAT will still be a grantor trust.

6. Many couples are not wealthy enough to give up their beneficial interest in the trust, so they are in the difficult situation of having to be the taxpayer responsible for paying income taxes on assets being held for the benefit of the former beneficiary spouse. The income tax burden on the former spouses will often not be proportionate due to differences in the value or nature of the assets in each of the SLATs. Further, unless there is a tax reimbursement clause in the SLAT, the grantor (transferor spouse) will have ongoing income tax liabilities attributable to the SLAT assets without access to those assets to pay the tax.

7. Unfortunately, a tax reimbursement clause is not a panacea to this situation. In Revenue Ruling 2004-64,[273] the IRS ruled that the grantor is not treated as having made a taxable gift, if the grantor pays the tax attributable to the inclusion of a grantor trust's income in the grantor's taxable income. If the trust instrument provides that the grantor must be reimbursed by the trust for the income tax payable by the grantor attributable to the trust's income, the full value of the trust assets will be includible in the grantor's gross estate under section 2036(a)(1). Finally, the ruling provides, "If, however, the trust's governing instrument or applicable local law gives the trustee the discretion to reimburse the grantor for that portion of the grantor's income tax liability, the existence of that discretion, by itself (whether or not exercised) will not cause the value of the trust's assets to be includible in the grantor's gross estate."[274] Many practitioners interpret the foregoing language to imply that if the trustee consistently makes tax reimbursement distributions to the grantor, then the assets will be included in the estate of the grantor under 2036(a)(1).

8. In addition, the IRS recently issued a legal memorandum that concludes that the modification of a grantor trust to add a discretionary tax reimbursement clause constitutes a taxable gift by the trust beneficiaries (presumably to the grantor) because the addition constitutes a "relinquishment of a portion of the beneficiaries' interest in the trust."[275] Prior to the

[273] Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

[274] *Id.*

[275] ILM 202352018.

modification, the IRS noted that neither state law or the governing trust instrument required or provided authority to the trustee to reimburse the grantor for income taxes attributable to assets in the trust. Furthermore, under the state law in question, the primary beneficiary (and issue) consented to the modification. The ruling distinguishes this situation from the ones in Revenue Ruling 2004-64 because the latter involved a governing instrument that provided for a mandatory or discretionary right of reimbursement. It goes on to say that there would also be a taxable gift if the modification was pursuant to a state statute that provides beneficiaries with a right of notice and a right to object to the modification and a beneficiary fails to exercise their right of objection. The ruling does not provide any meaningful discussion of how the gift should be valued. Rather it simply states, "The gift … of a portion of their interests in trust should be valued in accordance with the general rule for valuing interests in property for gift tax purposes in accordance with the regulations under § 2512 and any other relevant valuation principles under subtitle B of the Code."[276]

9. Prior to the enactment of TCJA, section 682 would have been a workable solution to the divorcing SLAT problem. Generally, section 682(a) had provided that if spouses are divorced from each other, the amount of any income one of them receives or is entitled to receive from a trust will be included in the recipient's gross income and will not be included in the gross income of the other spouse. TCJA repealed section 682 for spouses who divorce after December 31, 2018.[277] In addition, TCJA repealed section 71 (which provided that alimony or separate maintenance payments must be included in the gross income of the recipient) and section 215 (which provided a deduction for the payor of alimony or separate maintenance payments), effective beginning January 1, 2019.[278]

10. A partnership could be a possible solution to the problem, but in order to get optimal results, the spouses and the SLATs will likely need to rearrange and equalize the SLAT assets. The only way to do that without causing an income taxable event is to rely on section 1041, as discussed below.

B. Section 1041

1. Section 1041 provides there is no gain or loss on a transfer of property from an individual to (or trust for the benefit of) his or her spouse or former spouse, but only if the transfer is "incident to the divorce."[279] In such cases, the transfer of the property "shall be treated as acquired by the transferee by gift,"[280] and "the basis of the transferee in the property shall be the adjusted basis of the transferor."[281] That being said, basis, as determined under section 1041(b)(2) differs from the basis that would be determined under section 1015 in two important ways. First, as discussed above, if the basis of property is greater than its fair market value at the time of the gift (property with an unrealized loss), then for purposes of determining loss on a subsequent taxable sale, the basis is limited to fair market value at the time of the gift. Under section 1041(b)(2), the transferee takes the transferor's basis regardless of the relationship between value and basis at the time of the transfer. Second, also discussed above, section

[276] *Id.*

[277] *See* § 11051(b)(1)(C) of TCJA.

[278] *See* §§ 11051(a) and 11051(b)(1)(B) of TCJA.

[279] § 1041(a).

[280] § 1041(b)(1).

[281] § 1041(b)(2).

1015(d) increases the basis for gift taxes paid in connection with a gift to the extent attributable to the excess of the value of the property at the time of the gift over the transferor's basis immediately before the gift. There is no corresponding provision in section 1041(b)(2).

2. It should be noted that the nonrecognition provision of section 1041(a) does not apply if the spouse or former spouse is a nonresident alien.[282] Further, it will not apply to the extent "the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject"[283] exceeds the total adjusted basis of the property transferred. In the latter instance, gain will be recognized to the extent of the debt in excess of basis, and the adjusted basis of the property in the hands of the transferee will be increased to reflect such gain.[284]

3. In order for SLATs to rearrange and equalize their assets, practitioners will likely need to ensure the SLATs are a grantor trust as to the entire trust. Frequently overlooked are the "portion" rules which point out that grantor trust status does not necessarily apply to the entire trust.[285] The Code provides that the grantor is treated as the owner of only that portion of a trust as to which the requisite power or interest exists, and "portion" can be defined in a number of ways. For example, a grantor with a reversion or a power to revoke the trust in its entirety may be treated as the owner of the entire trust under section 676 of the Code, meaning that every item of income, deduction, and credit in the trust is attributed to that deemed owner. Similarly, the grantor (or any nonadverse party who is a trustee) with unrestricted powers over income and corpus would generate entire trust portion treatment under section 674 of the Code. On the other hand, if grantor trust status is conferred by section 677(a) of the Code alone (income that may be paid to the grantor or the grantor's spouse), the trust is a grantor trust only as to the income portion (not the corpus).[286] Not only must grantor trust status apply to both income and corpus of the trust, but it must apply to all of the assets of the trust. For example, under section 675(3) of the Code (borrowing of the trust's assets by the grantor), it is unclear whether grantor trust status relates only to amounts actually borrowed and not repaid by the end of the taxable year, or whether it applies to all income or corpus that could have been borrowed.[287] A provision that is described in section 675(4)(C) pursuant to which the transferor spouse retains the right, at any time, to withdraw any or all of the trust assets and substitute in their place other assets of equivalent value would confer grantor trust status over the entire trust under the portion rules. If the SLATs do not contain this type of power, a modification might be required prior to equalizing between SLATs.

4. In the context of SLATs section 1041 would allow SLATs to exchange property in such a manner that each SLAT would own half or have an undivided one-half interest in all of the combined assets of the SLATs. The reason this is important is to avoid complications under section 704(c) after the assets are contributed to a partnership.

---

[282] § 1041(d).

[283] § 1041(e).

[284] § 1041(e), flush language. *See also Crane v. Commissioner*, 331 U.S. 1 (1947) and *Commissioner v. Tufts*, 461 U.S. 300 (1983), Rev. Rul. 77-402, 1977-2 C.B. 222, and Treas. Reg. § 1.1001-2(c), Ex. 5.

[285] *See* Treas. Reg. § 1.671-3.

[286] *See* § 677(a) and Treas. Reg. § 1.677(a)-1(g), Ex. 1.

[287] *See Bennett v. Commissioner*, 119 T.C. 157 (2002) with *Benson v. Commissioner*, 76 T.C. 1041 (1981).

C. Section 704(c) Considerations

1. If SLATs, prior to contribution to a partnership, exchange their assets in such a manner that each SLAT would own half or have an undivided one-half interest in all of the combined assets of the SLATs it would ensure that each spouse would be responsible for exactly one-half of the unrealized gain (or loss) for section 704(c) purposes. It also ensures that each SLAT will have exactly a 50% interest in the partnership, so any future income items allocated under section 704(b) will also be allocated equally.

2. In addition to the foregoing, if the partnership makes a distribution of property, under the "mixing bowl" rules up to one-half of each asset can be distributed to either SLAT or former spouse without creating a taxable event. The Treasury Regulations provide:

a. "Section 704(c)(1)(B) and this section do not apply to a distribution of an undivided interest in property to the extent that the undivided interest does not exceed the undivided interest, if any, contributed by the distributee partner in the same property… The portion of the undivided interest in property retained by the partnership after the distribution, if any, that is treated as contributed by the distributee partner, is reduced to the extent of the undivided interest distributed to the distributee partner."[288]

b. "The distribution of an undivided interest in property is treated as the distribution of previously contributed property to the extent that the undivided interest does not exceed the undivided interest, if any, contributed by the distributee partner in the same property… The portion of the undivided interest in property retained by the partnership after the distribution, if any, that is treated as contributed by the distributee partner, is reduced to the extent of the undivided interest distributed to the distributee partner."[289]

D. Post-Divorce SLAT Partnership

> **Example**: Spouse A and Spouse B created trusts for the benefit of each other. Spouse A created and funded "SLAT B" which provides for discretionary income and principal for the benefit of Spouse B and their descendants. Currently SLAT B owns $12 million in rental real estate with an adjusted basis of zero and $6 million of growth equities with an adjusted basis of $3 million. Spouse B created and funded "SLAT A" which provides for discretionary income and principal for the benefit of A and their descendants. Currently SLAT Spouse A owns $10 million in private equity investments with an adjusted basis of $4 million and $6 million of high dividend paying equities with an adjusted basis of $4 million. Spouse A and Spouse B are getting divorced.
>
> In total, SLAT A holds $16 million in assets with $8 million of unrealized gain, and SLAT B holds $18 million in assets with $16 million of unrealized gain. As discussed above, due to sections 677(a)(1) and 672(e), for Federal income tax purposes, Spouse A is the deemed owner of the SLAT B assets, and Spouse B is the deemed owner of the SLAT A assets. Assume both SLATs have a "swap power" described in section 675(4)(C). From a potential income tax liability standpoint, Spouse A is at a significant disadvantage. The rental real estate will

[288] Treas. Reg. § 1.704-4(c)(6).

[289] Treas. Reg. § 1.737-2(d)(4).

produces ordinary income, and SLAT B has $15 million of unrealized gain, most of which is subject to depreciation recapture. In addition, the value of SLAT B's assets is $2 million greater than the value in SLAT A. Furthermore, Spouse A will not have any input on the management of the assets in SLAT B.

1. If the SLATs, in this example, contributed their respective assets into a partnership, the tax situation will essentially be unchanged. Section 704(c) mandates that Spouse A (transferor spouse and owner of the SLAT B assets for income tax purposes) will continue to be responsible for the $16 million of unrealized gain, and Spouse B (transferor spouse and owner of the SLAT A assets for income tax purposes) will continue to be responsible for $8 million of unrealized gain attributable. In addition, SLATs A and B will not have equal ownership of the partnership because SLAT B would be contributing more assets to the partnership than SLAT A.

2. For the post-divorce SLAT partnership to work effectively, the parties should endeavor to contribute the same amount to the partnership, so that the SLATs (and their owners for income tax purposes) are equal partners. Since SLAT B has $2 million more in assets, SLAT B could choose to just contribute $16 million of assets, distribute $2 million to the descendants, or perhaps decant $2 million to another trust for the benefit of the descendants. If the SLATs simply exchanged assets so that each SLAT owned one-half of all of the assets in both SLATs (each SLAT owning $17 million in assets), SLAT B would be deemed to have made an excess transfer of $1 million to SLAT A. Under those circumstances, Spouse A (transferor spouse and grantor of the assets in SLAT B) could be deemed to have made $1 million contribution to SLAT A of which Spouse A is a beneficiary. Thus, a portion of the assets of SLAT A could be includible in the estate of Spouse A under section 2036(a)(1). Once the values have been equalized, SLAT A and SLAT B can exchange one-half of all of their assets,

Example (Continued): In order to equalize the value of the assets of the SLATs, the trustee of SLAT B decants $2 million of the growth equities with an adjusted basis of $1 million to a separate trust for the benefit of the descendants. SLAT A and SLAT B then exchange one-half of their respective assets. Once the exchange is complete, both SLAT A and SLAT B will each own $14 million of assets, as follows: (i) one-half undivided interest in the real estate (value of $6 million and an adjusted basis of zero); (ii) $2 million of growth equities with an adjusted basis of $1 million; (iii) $5 million of private equity investments with an adjusted basis of $5 million; and (iv) $2 million of high dividend paying equities with an adjusted basis of $1 million. For income tax purposes Spouse A is deemed to own all of the assets of SLAT B, and Spouse B is deemed to own all of the assets of SLAT A. As a result, this exchange of assets will not be a taxable event under section 1041, and the SLATs will have carryover basis. This exchange can happen prior to the divorce when A and B are still married or the transfers can occur "incident to the divorce" (within one year after the date on which the marriage ceases or related to the cessation of the marriage).

3. Once the assets have been equalized and exchanged, before or after the divorce, the SLATs should contribute their respective assets to a newly-created partnership under section 721. SLAT A (Spouse B taxpayer) and SLAT B (Spouse A taxpayer) each have a 50% ownership interest in the partnership. Importantly, for section 704(c) purposes, Spouse A and Spouse B will be deemed to contribute exactly half of all of the assets in the partnership.

Example (Continued): SLATs A and B contribute their respective one-half interest in the rental real estate, growth equities, private equity investments, and high dividend paying equities to a newly-created partnership in a tax free exchange under section 721. Both SLAT A and SLAT B hold a 50% interest in the partnership. Because SLAT A and SLAT B have contributed exactly one-half of each asset in the partnership, all of the income, gain, loss, profit, and other tax items will be allocated equally, under sections 704(c) and 704(b). In addition, the partnership agreement should include a tax distribution provision mandating an annual distribution of cash, distributed equally to each SLAT, in an amount equal to two times the Federal and state income tax liability (attributable to the partnership allocations) of either Spouse A or Spouse B, whichever is greater for that taxable year. Each SLAT can then distribute the tax distribution to Spouse A and Spouse B, so that each of them can pay the income taxes attributable to the assets in their grantor trusts.

4. In addition, the parties can negotiate other terms of the partnership agreement like how the assets of the partnership will be managed and who determines when the partnership will make additional distributions. That being said, the partnership agreement should provide that all partnership distributions will be made equally and with the same asset. This ensures that no distribution will be taxable under the "anti-mixing bowl" rules. It also ensures that the value of the assets in each of the SLATs will be equal.

V. MARKETABLE SECURITIES, PRIVATE EQUITY, VENTURE CAPITAL & CARRY

A. Introduction

1. From an income tax planning standpoint, partnerships, funded only with cash, are the ideal taxpayer to make investments in marketable securities, private equity, and venture capital. The primary reason is that if the partnership is only funded with cash and there are no property contributions, then no "mixing bowl" transaction can occur. This gives the partnership freedom to distribute partnership property without having to worry about a 7-year holding period and provides significant leeway to make disproportionate distributions of property.[290]

2. As discussed below, a disproportionate distribution of property is a critical element of a "basis shift," moving the basis of from one partnership asset to another partnership asset. A basis shift relies on an inside basis adjustment under section 734(b), and as noted above, the allocation of the basis adjustment is formulaically applied across all of the assets in the partnership. As a result, if taxpayers are seeking to shift the basis to a specific asset or set of assets, then the partnership will often need to be restructured. This is where a partnership division is critical, as will be discussed in more detail below.

B. The Basic Elements of Basis Shifting

1. Boiled down to its purest form, partnership basis shifting requires the following elements: (i) a partnership that owns a low basis asset (or group of assets) and a high basis asset (or group of assets); (ii) the low and high basis asset must have either been purchased by the partnership (with cash) or if they were contributed, they were contributed more than 7 years ago; and (iii) a partner (or group of partners) who has little or no outside basis in its partnership interest. Assuming all of these elements are present, basis stripping and shifting

[290] Although section 751(b), dealing with distributions of property when the partnership has "hot" (ordinary income) assets, could be an issue.

occurs when the partnership makes a distribution of the high basis asset to the low outside basis partner when the partnership has a section 754 election in place.

> **Example**: ABC Partnership owns two assets and has a section 754 election in place. Asset A has an inside basis of $0x and a fair market value of $100x. Asset B has an inside basis of $100x and a fair market value of $100x. Assets A and B are capital assets. ABC Partnership has three partners, A, B, and C, who are not equal partners (but their proportionate ownership interest is unimportant). The outside basis of C's partnership interest is $0x and a capital account of $100x. ABC Partnership distributes Asset B (the high basis asset) to C in liquidation of C's partnership interest.
>
> As discussed in these materials, Asset B will have its basis reduced to the outside basis of C's partnership interest, which is $0x. This is sometimes referred to as the "basis strip." C owns Asset B outside of the partnership with an outside basis of $0x and a fair market value of $100x. It should be noted that if this was a non-liquidating "current" distribution (e.g., C's capital account was $150x), you would have the same result and C would still be a partner.
>
> Because ABC Partnership has a section 754 election in place, under section 734(b), the adjusted basis of partnership property (the only asset remaining in the ABC Partnership is Asset A) is increased by the amount of basis what was stripped from Asset B upon the distribution to C. As a result, Asset A (as the only asset remaining in the partnership) will have its inside basis increased to $100x. This is sometimes referred to as the "basis shift." The end result is the tax basis that was on Asset B has been "shifted" to Asset A.

2. Although the elements of a basis strip and shift are straightforward, the path to creating an efficient structure to accomplish the shift is quite complex. If the assets used in this technique were contributed to the partnership, the 7-year holding period to avoid triggering gain under the "anti-mixing bowl" rules is often the most difficult factual hurdle for many clients. It is just simply too long for many clients. In addition, in order to have an efficient basis shift (i.e., tax basis is added to a specific asset in an amount equal to or close to the fair market value of that asset), then the asset (or group of assets) receiving the basis must be the only asset left in the partnership. Otherwise, the basis increase created from the strip will be allocated across a number of partnership assets, none of which will likely get a full basis increase to fair market value. Furthermore, as discussed here, both assets in the basis strip and shift must be of the same class (i.e, both capital assets or both ordinary income assets). Practitioners should also remember that if the partnership has "hot" (ordinary income) assets, a disproportionate distribution of a capital asset (or vice versa) may trigger gain under section 751(b). Thus, it is recommended that partnerships only hold one class of property (i.e., only capital assets). This is why, as discussed below, partnership divisions are a critical step in basis shifting, in particular, vertical slice divisions (sometimes referred to as "pro rata" divisions). A vertical slice division is a tax free method of segregating classes of assets and, more importantly, isolating the low and high basis assets that will be the subject of the basis strip and shift into its own partnership. Lastly, the partner (or partners) receiving the distributed asset must have a low outside basis. As one can see, creating an efficient basis shift environment is much more difficult to create, than the actual mechanics of it. However, it is possible. By way of example:

a. 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) when assets other than marketable securities are held by the partnership.[291] 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" problems.

b. 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. 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), 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, 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).[292]

c. 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.

---

[291] § 731(c).

[292] *See* Treas. Reg. § 1.752-2(b).

C. 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."[293]

(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.

(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.[294] "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."[295]

(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."[296] 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."[297] This exception is often referred to as the "vertical slice exception."

---

[293] Cassady V. Brewer, *Coming Together and Breaking Apart: Planning and Pitfalls in Partnership Mergers and Divisions*, 43[rd] Annual Southern Federal Tax Institute (2008), Outline F, F-13.

[294] § 2701.

[295] § 2701(e)(5).

[296] Treas. Reg. § 25.2701-1(c)(4).

[297] *Id.*

(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,[298] 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).[299]

(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.

2. Tax Treatment of Partnership Divisions

a. Partnership divisions are governed by section 708(b)(2)(B). The Treasury Regulations issued in 2001,[300] 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.[301]

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.[302] 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 distributions because no partner is terminating his or her interest in the divided partnership. Because of this parity of ownership, it is unlikely that a "mixing bowl" transaction (as discussed above) will exist and the transaction will not cause a recognition of any gain or loss.[303] In particular, the preamble to the final Treasury Regulations on partnership mergers and divisions, the IRS and Treasury clearly asserted the following:[304]

> In the preamble to the proposed regulations, the IRS and Treasury requested comments as to whether expanded exceptions under sections 704(c)(1)(B) and 737 would be appropriate in the context of partnership divisions. Most commentators agreed that it would not be wise to expand the current exceptions. In a related point, some commentators stated that the contribution of assets in a

---

[298] § 2701(a)(2)(B).

[299] § 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).

[300] T.D. 8925, 66 Fed. Reg. 715 (Jan. 4, 2001).

[301] *See* Treas. Reg. § 1.708-1(d)(3).

[302] 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.

[303] §§ 704(c)(1)(B), 737 and Treas. Reg. §§ 1.704-4(c)(4), 1.737-2(b)(2).

[304] T.D. 8925, 66 Fed. Reg. 715 (1/4/01).

> division should not create new section 704(c) property or section 737 net precontribution gain.
>
> To the extent that a partnership division merely affects a restructuring of the form in which the partners hold property (that is, each partner's overall interest in each partnership property does not change), the IRS and Treasury agree that a partnership division should not create new section 704(c) property or section 737 net precontribution gain. However, it is not clear that this result is necessarily appropriate where a division is non-pro rata as to the partners, where some property is extracted from or added to the partnerships in connection with the division, or where new partners are added to the ownership group in connection with the division. The IRS and Treasury intend to study this issue and request comments in this regard.

Although the aforementioned Treasury Regulations did not incorporate the foregoing position (a pro rata or "vertical slice" division does not create new section 704(c) property or section 737 net precontribution gain) into the regulations in 2001, it still seems to be the IRS's position. For example, in 2009, the IRS invited comments on multiple layers of forward and reverse 704(c) gain and loss to partnerships and tiered partnerships, including in the context of mergers and divisions.[305] On issue 18 for comment, the IRS asked, "Assuming a partnership division should not create new section 704(c) property (or section 737 precontribution gain) when each partner's overall interest in each partnership property does not change, how should section 704(c) layers be created and maintained when a division is not pro rata or other changes in partners or property interests occur at the time of the division?"[306]

c. In addition, given the parity of ownership before and after a pro rata 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.

d. 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.

e. In a division, the Treasury Regulations provide that a "resulting partnership"[307] (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.[308] 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.[309] 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.[310]

---

[305] *See* IRS Notice 2009-70, 2009-34 I.R.B. 255.

[306] *Id.*

[307] Treas. Reg. § 1.708-1(d)(4)(iv)

[308] Treas. Reg. § 1.708-1(d)(1).

[309] Treas. Reg. § 1.708-1(d)(2)(ii).

[310] *See* PLR 9015016 (seven continuing partnerships with same owners in the same proportions).

f. 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"[311] 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.

D. 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 or if not,

[311] 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.

the partnership only holds marketable securities, 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,[312] 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. The FLP's balance sheet, adjusted bases, and capital accounts are as follows:

FLP Balance Sheet (Stock A and Diversified Portfolio)					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Stock A	$0	$50,000,000	G1 Partners	$25,000,000	$50,000,000
Diversified Portfolio	$50,000,000	$50,000,000	G2 Partners	$25,000,000	$50,000,000
Total	**$50,000,000**	**$100,000,000**	**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:

[312] The contribution would have been a nontaxable 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).

FLP Balance Sheet (Stock A Sold for Cash)					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Cash ($50,000,000 of Gain)	$50,000,000	$50,000,000	G1 Partners	$50,000,000	$50,000,000
Diversified Portfolio	$50,000,000	$50,000,000	G2 Partners	$50,000,000	$50,000,000
Total	**$100,000,000**	**$100,000,000**	**Total**	**$100,000,000**	**$100,000,000**

c. Instead of selling Stock A, assume the FLP makes a 754 election or has one in effect at such time, and the FLP 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 now has an adjusted 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."[313] 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:

FLP Balance Sheet (Distribution of Diversified Portfolio to G2 Partners & Section 734(b) Basis Adjustment)					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Stock A	$25,000,000	$50,000,000	G1 Partners	$25,000,000	$50,000,000
Total	**$25,000,000**	**$50,000,000**	**Total**	**$25,000,000**	**$50,000,000**
OUTSIDE OF THE PARTNERSHIP					
	Tax Basis	Fair Market Value			
Diversified Portfolio	$25,000,000	$50,000,000	Former G2 Partners		

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) of gain was recognized. Of course, the G2 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.

313 § 734(b)(1)(B).

FLP Balance Sheet (Sale of Stock A and Reinvestment in New Diversified Portfolio)					
Assets			Capital Accounts		
	Tax Basis	Book Value		Outside Basis	Capital Account
New Diversified Portfolio ($25,000,000 of Gain)	$50,000,000	$50,000,000	G1 Partners	$50,000,000	$50,000,000
Total	**$50,000,000**	**$50,000,000**	**Total**	**$50,000,000**	**$50,000,000**
OUTSIDE OF THE PARTNERSHIP					
	Tax Basis	Fair Market Value			
Diversified Portfolio	$25,000,000	$50,000,000	Former G2 Partners		

3. Using Debt to Exchange a Concentrated Position for a Diversified One

a. Assume a FLP that has one asset, $100 million of a publicly traded security, Stock A, with an adjusted basis of zero. The FLP is owned by family members, 2% of the partnership is owned equally by the parents, as separate property (G1 Partners) and 98% by or for the benefit of the younger generation (G2 Partners). The two generational groups of partners will be referred to collectively (and separately) as the G1 and G2 Partners. The FLP's balance sheet, adjusted bases, and capital accounts are as follows:

FLP Balance Sheet (Stock A and No Partnership Liabilities)					
Assets			Liabilities		
	Tax Basis	Book Value			Amount
Stock A	$0	$100,000,000	None		$0
Total Assets	**$0**	**$100,000,000**	**Total Liabilities**		**$0**
			Capital Accounts		
				Outside Basis	Capital Account
			G1 Partners	$0	$2,000,000
			G2 Partners	$0	$98,000,000
			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 $98 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 $98 million loan is procured, the adjusted tax bases, capital accounts, and books of the partnership are, as follows:

FLP Balance Sheet (Partnership Loan and Recourse Debt Allocation)					
Assets			Liabilities		
	Tax Basis	Book Value			Amount
Stock A	$0	$100,000,000	Loan		$98,000,000
Cash	$98,000,000	$98,000,000			
Total Assets	**$0**	**$198,000,000**	**Total Liabilities**		**$98,000,000**
			Capital Accounts		
				Outside Basis	Capital Account
			G1 Partners	$98,000,000	$2,000,000
			G2 Partners	$0	$98,000,000
			Total Equity	**$98,000,000**	**$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 as follows:

FLP Balance Sheet (Purchases Diversified ETF)					
Assets			**Liabilities**		
	Tax Basis	Book Value			Amount
Stock A	$0	$100,000,000	Loan		$98,000,000
Diversified ETF	$98,000,000	$98,000,000			
Total Assets	**$0**	**$198,000,000**	**Total Liabilities**		**$98,000,000**
			Capital Accounts		
				Outside Basis	Capital Account
			G1 Partners	$98,000,000	$2,000,000
			G2 Partners	$0	$98,000,000
			Total Equity	**$98,000,000**	**$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 is $98 million. Under section 732(b) of the Code, the ETF in the hands of the G2 partners has a basis of zero. Under section 734(b) of the Code, the partnership's assets (Stock A) are increased by the $98 million of excess basis that was stripped from the ETF. The results are:

FLP Balance Sheet (Liquidating Distribution of Diversified ETF to G2 Partners)					
Assets			**Liabilities**		
	Tax Basis	Book Value			Amount
Stock A	$98,000,000	$100,000,000	Loan		$98,000,000
Total Assets	**$98,000,000**	**$100,000,000**	**Total Liabilities**		**$98,000,000**
			Capital Accounts		
				Outside Basis	Capital Account
			G1 Partners	$98,000,000	$2,000,000
			Total Equity	**$98,000,000**	**$2,000,000**
OUTSIDE OF THE PARTNERSHIP					
	Tax Basis	Fair Market Value			
Diversified ETF	$0	$98,000,000	Former G2 Partners		

e. Assuming no changes in value and ignoring interest and other costs, when the FLP then sells $98 million of Stock A (98% of the partnership's holdings) to repay the loan, the FLP will recognize $1.96 million of gain (the $98 million of Stock A that is sold as an adjusted basis of $96.04 million of basis—98% of $98 million). The gain will be reflected in the outside basis of the G1 Partners, as follows:

FLP Balance Sheet (Sale of $98 Million of Stock A for Cash)					
Assets			**Liabilities**		
	Tax Basis	Book Value			Amount
Stock A	$0	$2,000,000	Loan		$98,000,000
Cash ($1,960,000 of Gain)	**$98,000,000**	**$98,000,000**			
Total Assets	**$98,000,000**	**$100,000,000**	**Total Liabilities**		**$98,000,000**
			Capital Accounts		
				Outside Basis	Capital Account
			G1 Partners	$99,960,000	$2,000,000
			Total Equity	**$99,960,000**	**$2,000,000**
OUTSIDE OF THE PARTNERSHIP					
	Tax Basis	Fair Market Value			
Diversified ETF	$0	$98,000,000	Former G2 Partners		

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:

FLP Balance Sheet (Repayment of Loan with Cash)					
Assets			**Liabilities**		
	Tax Basis	Book Value			Amount
Stock A	$0	$2,000,000	Loan		$0
Cash	**$0**	**$0**			
Total Assets	**$0**	**$2,000,000**	**Total Liabilities**		**$0**
			Capital Accounts		
				Outside Basis	Capital Account
			G1 Partners	$1,960,000	$2,000,000
			Total Equity	**$1,960,000**	**$2,000,000**
OUTSIDE OF THE PARTNERSHIP					
	Tax Basis	Fair Market Value			
Diversified ETF	$0	$98,000,000	Former G2 Partners		

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 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:

After Liquidation of FLP (End Results)			
Former Partner (Owner)	**Asset**	**Tax Basis**	**Fair Market Value**
G1	Stock A	$1,960,000	$2,000,000
G2	Diversified ETF	$0	$98,000,000

h. In this example, the G1 Partners bore 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 nonrecourse and all of the partners had their outside bases increased by a proportionate amount of the liability, you would get the same results (the ETF in the hands of the G2 partners has a basis of zero). When the G2 Partners are liquidated their collective outside basis is initially $96,040,000 (98% of $98 million of nonrecourse liabilities). When the partnership interests of the G2 Partners are liquidated, the G2 Partners are exiting the partnership and, as a result, they no longer have a share of the partnership liabilities. There is a deemed distribution of money under section 752(b) of the Code, reducing their collective outside bases to zero, which is then followed by a distribution of the ETF with an inside basis of $98 million.

After the liquidation of the G2 Partner, the G1 Partners (who initially had an outside basis of $1.96 million, reflecting its two percent share of the nonrecourse liabilities) share of the nonrecourse liabilities increase from $1.96 million to $98 million because they are the only remaining partners. When the partnership sells $98 million of the Stock A to repay the loan, the partnership will recognize $1.96 million of gain, which is allocated to the G1 Partners and the outside basis of the G1 Partners increases to $99.96 million. When the loan is repaid, the outside basis of the G1 Partnership is reduced by $98 million to $1.96 million.

E. Application to Other Types of Investments

1. Private Equity and Venture Capital Investments

a. Up to this point, the discussion in this section, has been limited to a partnership's direct investment in marketable securities. However, basis shifting can be utilized with private equity and venture capital investments, and even the carried interest of a private equity or venture capital principal. Private equity and venture capital funds have three common features: (i) investments in the funds are almost exclusively limited to cash; (ii) the funds are typically partnerships for Federal income tax purposes, with the investors holding limited partnership interests; and (iii) the funds will often distribute successful investments in-kind (rather than selling the investment and distributing the cash proceeds) to the investors. Thus, as discussed above, these investments are perfectly suited to have a partnership, funded exclusively with cash, be the investor in these funds.

b. When an in-kind property distribution is made to the partnership, the investor partnership will hold both the in-kind distributed property and its limited partnership interest in the funds. Because the property is distributed to the partnership, it does not constitute section 704(c) property because there has been no contribution of property to the investor partnership. As a result, the 7-year holding period of the "anti-mixing bowl" rules does not apply, and a basis shift can be accomplished without concern about the 7-year holding period of the "anti-mixing bowl" rules. Whether the distributed in-kind distribution is a marketable security or not, it is likely best to do a pro rata (vertical slice) division of the partnership so that the distributed in-kind property and the limited partnership interest in the fund are in separate, mirror image partnerships. This is advisable because it ensures with a leveraged basis shift (as discussed above) the shifted tax basis is allocated solely to the in-kind property, and if the in-kind property is a marketable security, the distributed security will not be treated as a distribution of cash under section 731(c)(3)(B) and the Treasury Regulations thereunder.[314]

2. Carried Interest

a. Private equity and venture capital managers are commonly compensated, in part, through carried interest which vests when the underlying portfolio investments meet certain profit or valuation targets. Carried interest is generally defined as a share of the profits of an investment that is paid to the investment manager in excess of the amount of capital that the manager contributes to the fund. Typically, carried interest is granted in the form of an interest in the partnership (the fund). Usually the general partner or manager of the private equity or venture capital fund is a separate entity taxed as a partnership and the private equity and venture capital principals hold a partnership interest in the general partner/manager.

[314] Treas. Reg. § 1.731-2(b)(2).

b. In Revenue Procedure 93-27,[315] the IRS provided guidance on the receipt of a partnership interest for services provided to the partnership. In the ruling the IRS defined a capital interest as "an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership"[316] as determined at the time of the receipt of the partnership interest. A profits interest is defined as a "partnership interest other than a capital interest."[317] The ruling provides that if a person receives a profits interest for providing services to or for the benefit of a partnership in a partner capacity or in anticipation of becoming a partner, the receipt of the interest is not a taxable event for the partner or the partnership. This safe harbor does not apply, however, if (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets (e.g., high-quality debt securities or high-quality net leases), (2) within two years after receipt, the partner disposes of the profits interest, or (3) the profits interest is an interest in a publicly-traded partnership. In Revenue Procedure 2001-43,[318] the IRS clarified the 1993 revenue procedure, providing whether an interest granted to a service provider is a profits interest is tested at the time the interest is granted, even if, at that time, the interest is "substantially nonvested."[319] The 2001 ruling provides, "where a partnership grants an interest in the partnership that is substantially nonvested to a service provider, the service provider will be treated as receiving the interest on the date of its grant," provided the following conditions are met:[320]

(1) "The partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant and the service provider takes into account the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest;"

(2) "Upon the grant of the interest or at the time that the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation, or otherwise) for the fair market value of the interest;" and

(3) All the conditions of the 1993 revenue procedure are also satisfied.

c. The foregoing revenue procedures provide a safe harbor method for private equity and venture capital funds to grant carried interest to the manager of the fund (and its employees) in a manner that is not considered compensation upon grant, when the profits interest vests, or importantly, when the carried interest is earned (upon meeting certain profit or valuation targets). Rather, it allows the manager and its employees to be treated as a partner upon grant and taxed as a partner on its distributive share of partnership profits and losses. For this reason, carried interest is often structured to meet the requirements of the revenue procedures.

---

[315] Rev. Proc. 93-27, 1993-2 C.B. 343.

[316] *Id.* at section 2.01.

[317] *Id.* at section 2.02.

[318] Rev. Proc. 2001-43, 2001-34 I.R.B. 191.

[319] *See* Treas. Reg. § 1.83-3(b).

[320] Rev. Proc. 2001-43, 2001-34 I.R.B. 191, section 4.

d. Section 1061: Carried Partnership Interests

(1) Effective for tax years beginning after December 31, 2017, TCJA inserts a permanent "replacement" section 1061 of the Code[321] for certain partnership interests held in connection with the performance of services, addressing the tax treatment of a profits interest in a partnership in exchange for the performance of services (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"[322] one or more "applicable partnership interests"[323] 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. The overall effect of the provision is that the preferential long-term capital gain rate applies to gain passed through to holders of carried interests only if the fund held the asset giving rise to the gain for more than three years.

(2) 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,"[324] 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."[325] 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.[326] There is also an exception for a partnership interest held directly or indirectly by a "corporation."[327] 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.[328] The partnership interests held by the two corporations are not applicable partnership interests. The 2020 final Treasury Regulations[329] ("1061 Final Regulations") make clear that the term "corporation" does not include an S corporation.[330]

(3) An "applicable trade or business" is defined as "any activity conducted on a regular, continuous, and substantial basis which … consists"[331] of:

---

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

[322] § 1061(a)(1) and (2).

[323] § 1061(a).

[324] § 1061(c)(1).

[325] § 1061(c)(4)(B).

[326] § 1061(c)(1).

[327] § 1061(c)(4)(A).

[328] Conf. Rep. on P.L. 115-97, ¶ 10,611.99 (12/22/2017).

[329] T.D. 9945.

[330] Treas. Reg. 1.1061-3(b)(2). In addition, the term does not include a passive foreign investment company as to which the shareholder has a qualified electing fund election in effect under section 1295 of the Code.

[331] § 1061(c)(2).

(a) "[R]aising or returning capital,"[332] and

(b) Either: "(i) investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition), or (ii) developing specified assets."[333]

(4) "Specified assets" means:[334]

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

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

(c) Real estate held for rental or investment;

(d) Cash or cash equivalents;

(e) 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.

(5) 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.[335]

(6) If a taxpayer "transfers any applicable partnership interest, directly or indirectly, to a person related to the taxpayer,"[336] 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."[337] 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.[338]

---

[332] § 1061(c)(2)(A).

[333] § 1061(c)(2)(B).

[334] § 1061(c)(3).

[335] *See* § 475(c)(2).

[336] § 1061(d)(1).

[337] § 1061(d)(1)(A).

[338] § 1061(d)(1)(B).

(7) A “related person” for this purpose is:

(a) 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),[339] or

(b) 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.”[340]

(8) Prior to the issuance of the 1061 Final Regulations, it was unclear how expansive the term “transfer” would be interpreted. It could have included gifts, transfers to grantor trusts, and sales or exchanges. The Treasury Regulations provide that the term “transfer” for these purposes only includes transfers that would be a taxable sale or exchange, or specifically, “the term transfer means a sale or exchange in which gain is recognized by the Owner Taxpayer under chapter 1 of the Internal Revenue Code.”[341] Thus, a gift of an applicable partnership interest to family members, directly or in trust (grantor or non-grantor), will not cause an acceleration of gain with respect to such interest. Planners should, however, be wary of sales to IDGTs and the loss of grantor trust status when the note is outstanding. As in these materials, if the debt obligation is still outstanding and the debt is in excess of the basis of the applicable partnership interest, gain may be recognized, causing an acceleration of income under section 1061(d)(1) of the Code.

e. Sometimes carried interest is paid in-kind to the general partner/manager of the private equity or venture capital fund. As noted above, an in-kind distribution of property to a partnership does not constitute section 704(c) property. While a basis shift is possible at the general partner/manager level, the pro rata division and corresponding distribution of property to the partners will often require the consent of some or all of the partners of the general partner/manager. As such, the individual partner of the general partner/manager should (if allowable) endeavor to hold their partnership interest in the general partner/manager in a separate family-owned partnership. Then, if the general partner/manager partnership distributes an in-kind distribution of the individual partner’s share of the carried interest, then the partnership division and basis shift can be accomplished at the family-owned partnership level.

---

[339] § 1061(d)(2)(A).

[340] § 1061(d)(2)(B).

[341] Treas. Reg. § 1.1061-5(b).

VI. DISPROPORTIONATELY ALLOCATING PARTNERSHIP INCOME

A. Preferred Partnership Structures

1. Generally

a. Unlike S corporations which require that they only have one economic class of stock, partnerships can be structured to provide different classes of ownership and economic interests. In the family-owned entity context, if different ownership interests are utilized, careful consideration must be given to section 2701 of the Code because, as discussed in detail below, the "same class"[342] exception will not be available. Notwithstanding the foregoing, "preferred" partnership interests can be created that avoid the punitive effects of section 2701, namely the "zero valuation" rule.[343]

b. The ability to segregate the economic interest of a pool of partnership assets into preferred and common interests has profound practical implications and provides a flexible structure to maximize the benefits of certain planning structures that seek to maximize the income and transfer tax savings for families. By way of example, consider a client who is interested in transferring assets to the client's children, but not at the expense of the client's cash flow needs. In a traditional FLP structure, all partnership interests in the FLP are a single class share, with all allocations of income and distributions shared pro rata according to capital account balances. Thus, with a traditional FLP structure, if a client transfers a 40% of the partnership interest to the client's children, then the client also relinquishes the right to receive 40% of the cash flow from the partnership. Many clients would be reluctant to make that transfer if they felt that such a drop in cash flow would jeopardize their lifestyle in the future. A preferred partnership structure would allow a client to maintain a fixed priority to cash flow (perhaps all of the current cash flow), freeze the value for estate tax purposes, but still transfer the future appreciation in the partnership's assets. This type of transaction, often called a forward freeze where the client retains the preferred and transfers the common, is often quite appealing to clients.

c. Preferred partnership structures allow for at least 2 classes of interest, one which provides for a preferred return to the holder. The remaining class or classes of interest (the common shares) will receive any economic benefit from the partnership property above the preferred return. Commonly, a preferred partnership structure will provide the preferred shares with the following rights:

(1) Preferred right to cash flow of the partnership. This is commonly stated as a fixed dollar amount, fixed percentage of a liquidation preference amount or a variable percentage of a liquidation preference amount.

(2) One critical issue is whether the preferred payment is paid regardless of whether profits are made by the partnership or whether the amount payable is contingent upon the partnership being profitable. As discussed below, guaranteed payment preferred interests are payable regardless of partnership profits whereas qualified payment interest right preferred interests are contingent upon the partnership being profitable.

---

[342] § 2701(a)(2)(B).

[343] § 2701(a)(3)(A).

(3) Upon dissolution of the partnership, the preferred holders will receive liquidating distributions of a certain amount (liquidation preference amount) or certain percentage of the partnership assets.

d. By consequence, the common interest holders will have a residual interest in any cash flow, liquidation proceeds and earnings of the partnership after the preferred interest holders have been paid. As such, from an economic standpoint, the preferred holder's return is capped at the preferred rate or payment, and the common holder's return is any excess return above the preferred interest.

e. Preferred partnership structures come in two general forms. A "forward freeze" (sometimes referred as a traditional freeze) involves the transferor retaining the preferred interest and transferring (gifting or selling to an IDGT for an installment note) a common interest. A "reverse freeze" involves the transferor retaining common and transferring the preferred interest. Preferred interests can be created in many different forms, but for estate planning purposes, most practitioners will likely limit the preferred interest to those that would be a "qualified payment right" or a guaranteed payment (as discussed herein). At this point, it is unclear how a "profits interest" is characterized under section 2701 of the Code, and as such, these materials do not discuss profits only interests.[344]

2. Chapter 14 (Section 2701) Considerations

a. Generally

(1) Section 2701 of the Code provides that in determining whether a gift has been made and the value of such gift, when a person transfers interest in a corporation or partnership (or LLC) to a "member of the transferor's family"[345] the value of any of the following rights shall be treated as zero[346] (broadly defined as an "applicable retained interest"):

(a) A "distribution right,"[347] if immediately before the transfer, the transferor and "applicable family members"[348] have "control"[349] of the entity;[350] or

---

[344] *See e.g.*, CCA 201442053 (transferor's sons were granted the right to future profits) and Richard L. Dees, *Is Chief Counsel Resurrecting the Chapter 14 "Monster"?*, 145 Tax Notes 1279 (Dec. 15, 2014).

[345] § 2701(a). A "member of the transferor's family" means: (a) the transferor's spouse, (b) a lineal descendant of the transfer or the transferor's spouse, or (c) the spouse of any such lineal descendant. § 2701(e)(1).

[346] § 2701(a)(3)(A).

[347] A "distribution right is a right to receive distributions with respect to an equity interest" but does not include: (i) any rights to receive distributions "with respect to an interest that is of the same class as, or a class that is subordinate to, the transferred interest;" (ii) any extraordinary payment right; and (iii) any rights that are specifically excepted in section 25.2701-2(b)(4) of the Treasury Regulations. Treas. Reg. § 25.2701-2(b)(3).

[348] For purposes of determining control, this includes the transferor's spouse, an ancestor of the transferor or the transferor's spouse, or the spouse of any such ancestor and any lineal descendant of any parent of the transferor or the transferor's spouse. §§ 2701(e)(2) and 2701(b)(2)(C). In other words, it expands the definition to capture siblings of the transferor and the transferor's spouse and their descendants.

[349] If the entity is partnership (which would be the most likely choice of entity for a family investment entity), control means: (a) holding at least 50% of the capital or profits interests in the partnership, or (b) in the case of a limited partnership, the holding of any interest as a general partner. § 2701(b)(2)(B).

(b) A liquidation, put, call, or conversion right[351] (sometimes referred to as an "extraordinary payment right,"[352] which is defined differently in the Treasury Regulations as a "put, call, or conversion right, any right to compel liquidation, or any similar right, the exercise or nonexercise of which affects the value of the transferred interest.").

(2) For these purposes, a "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."[353] However, these would not be considered a transfer if "the interests in the entity held by the transferor, applicable family members, and members of the transferor's family before and after the transaction are substantially identical."[354]

(3) For purposes of these materials, it is assumed that a transfer is being made to an applicable family member, the partnership in question is a control entity, and the retained interest includes a distribution right. As such, in this portion of the materials dealing with preferred partnership structures, it is assumed that section 2701 technically applies to the transactions proposed herein. However, the transfer tax results will differ based upon whether certain exceptions to the broad rule (notably, the zero valuation rule) are applicable.

b. Pertinent Exceptions

(1) Generally

(a) There are a number of notable exceptions under section 2701 to consider in preferred partnership planning. Some exceptions represent transfers or other transactions that are wholly exempt from section 2701. These types of transactions will be valued under normal gift tax rules.

(b) Other types of exceptions include interests or rights that are neither considered extraordinary payment rights nor distributions rights. As such, they are not considered applicable retained interests. Depending on the type of transaction, normal gift tax rules may or may not apply to the transfer.

(c) These materials will discuss only those exceptions that are pertinent to the focus of these materials.

(2) Same Class Exception

(a) Section 2701 does not apply to any right with respect to an applicable retained interest if such interest is: (i) The same class as the transferred interest,[355] or

---

[350] § 2701(b)(1)(A).

[351] § 2701(b)(1)(B).

[352] *See* Treas. Reg. § 25.2707-2(b)(2).

[353] § 2701(e)(5).

[354] § 2701(e)(5).

[355] § 2701(a)(2)(B).

(ii) such interest is proportionally the same as the transferred interest, without regard to nonlapsing differences in voting power (or, for a partnership, nonlapsing differences with respect to management and limitations on liability).[356]

(b) With respect to this exceptions, 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)."[357]

(c) The Treasury Regulations provide that non-lapsing provisions that are necessary to comply with the partnership allocation requirements of the Code will be treated as non-lapsing differences with respect to limitations on liability.[358] Further, a right that lapses by reason of Federal or State law will be treated as a non-lapsing differences unless the Treasury determines that it is necessary to treat such right as a lapsing right in order to accomplish the purposes of Section 2701.[359]

(d) This same class exception is the one most relied upon in estate planning and is the primary reason that most FLPs have a single class share structure (all profits, losses, tax items, and distributions are shared proportionately according to capital accounts, for example). Furthermore, if an existing partnership is recapitalized from a single class share partnership to a preferred and common structure, then as long as the original owners receive a proportional amount of both the preferred and common shares, then the "same class" exception applies to such recapitalization.

(3) Vertical Slice Exception

(a) 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."[360]

(b) 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."[361]

[356] § 2701(a)(2)(C).

[357] Treas. Reg. § 25.2701-1(c)(3).

[358] *Id.*

[359] § 2701(a)(2) and Treas. Reg. § 25.2701-1(c)(3).

[360] Treas. Reg. § 25.2701-1(c)(4).

[361] *Id.*

(4) Guaranteed Payment Exception

(a) Excluded from the definition of "distribution right" is "any right to receive any guaranteed payment described in section 707(c) of a fixed amount."[362] As such, guaranteed payment interests are not considered applicable retained interests.

(b) The Treasury Regulations provide that a fixed amount under this exception is the right to receive a payment "the amount of which is determined at a fixed rate (including a rate that bears a fixed relationship to a specified market interest rate)."[363] Specifically, it does not include a payment that is contingent as to time or amount.

(5) Junior Equity Interest Exception

(a) A distribution right does not include a right to distributions with respect to any interest which is junior to the rights of the transferred interest.[364]

(b) The Treasury Regulations also exempt an interest that is of the same class, or a class that is subordinate to, the transferred interest.[365]

(c) This is one of the most significant exceptions under section 2701 from an estate planning standpoint. Essentially, it is an exception relied upon with a reverse freeze, the transfer of the preferred or senior equity interest (with the retention of the junior equity or common interest by the transferor). As an exception, normal gift tax rules apply to such transfer of the preferred interest, along with any applicable valuation discounts for lack of marketability and minority interest discount. This is particularly beneficial because a transfer of a preferred interest with a "guaranteed" return of, for example, 8% annually (if that is the preferred rate) can be contributed at a discount to a grantor retained annuity trust[366] or charitable lead annuity trust[367] when the section 7520 (the assumed internal rate of return) is significantly lower than that, for example 2.4%. In that instance, an automatic arbitrage between the 8% return on the preferred (not even taking into account the effective rate of return due to any applicable valuation discount) against the 2.4% is created, thus guaranteeing wealth transfer of 5.6% annually.

c. Qualified Payment Interests

(1) Assuming none of the exceptions above apply, for a distribution right (applicable retained interest) to avoid zero valuation under section 2701 of the Code, it must be considered a "qualified payment."

(2) A qualified payment "means any dividend payable on a periodic basis under any cumulative preferred stock (or a comparable payment under any partnership

---

[362] § 2701(c)(1)(B)(iii).

[363] Treas. Reg. § 25.2701-2(b)(4)(iii). *See* § 707(c).

[364] § 2701(c)(1)(B)(i).

[365] Treas. Reg. § 25.2701-2(b)(3)(i).

[366] § 2702.

[367] *See* §§170(f)(2), 642(c), 2055(e)(2)(B) and 2522(c)(2)(B).

interest) to the extent that such dividend (or comparable payment) is determined at a fixed rate."[368] A payment will be treated as a "fixed rate" if the payment is "determined at a rate which bears a fixed relationship to a specified market interest rate."[369]

(3) The Treasury Regulations provides that a qualified payment is:

(a) "A dividend payable on a periodic basis (at least annually) under any cumulative preferred stock, to the extent such dividend is determined at a fixed rate."[370]

(b) Any other cumulative distribution payable on a periodic basis (at least annually) with respect to an equity interest, to the extent determined at a fixed rate or as a fixed amount."[371]

(4) A qualified payment made up to 4 years following its due date will be treated as having been made on the due date.[372] If a qualified payment is made after the 4 year grace period, the unpaid qualified payments essentially accrue interest at the "appropriate discount rate"[373] (the discount rate applied in determining the value of the qualified payment right at the time of the original transfer under Section 2701).

(5) If there are unpaid qualified payments, upon a "taxable event"[374] (generally, the transfer of the qualified payment interest during lifetime or at death or the termination of the interest holder's right to the qualified payments), additional transfers taxes may become payable. The additional transfer taxes that become payable are implemented by increasing the taxable gifts of the transferor or the transferor's taxable estate, as the case may be, and is calculated through a series of computations that, significantly, assume all payments were made on the date payment was due and such payments were "reinvested by the transferor as of the date of payment at a yield equal to the discount rate."[375]

(6) A qualified payment right that has no additional bells and whistles (in particular, liquidation, put, call, or conversion rights) will be valued without regard to Section 2701, using traditional gift tax rules.[376]

(7) If a qualified payment right has certain bells and whistles ("1 or more liquidation, put, call, or conversion rights with respect to such interest"[377]), the value of the qualified payment right will be determined as if these bells and whistles are exercised in a

---

[368] § 2701(c)(3)(A).

[369] § 2701(c)(3)(B). *See* Treas. Reg. § 25.2701-2(b)(6)(ii).

[370] Treas. Reg. § 25.2701-2(b)(6)(i)(A).

[371] Treas. Reg. § 25.2701-2(b)(6)(i)(B).

[372] § 2701(d)(2)(C).

[373] *See* § 2701(d)(2)(A) and Treas. Reg. § 25.2701-4(c)(3).

[374] § 2701(d)(3) and Treas. Reg. § 25.2701-4(b).

[375] § 2701(d(2)(A)(i)(II).

[376] § 2701(a)(3)(C).

[377] § 2701(a)(3)(B)(ii).

manner resulting in the lowest value being determined for such rights.[378] The Treasury Regulation labels these types of bell and whistle as an "extraordinary payment right" and defines them "any put, call, or conversion right, any right to compel liquidation, or any similar right, the exercise or nonexercise of which affects the value of the transferred interest. A call right includes any warrant, option or other right to acquire one or more equity interests."[379] This is sometimes referred to as the "lower of" rule, which essentially requires that a qualified payment preferred interest will not be valued according to its terms (preferred rate, liquidation coverage, etc.) but rather will have a value, if lower, of the extraordinary payment right (for example, if the preferred interest provides a conversion right to common interest that have a value less than the qualified payment right).

(8) The Code provides that a transferor or applicable family member may make an election to treat a distribution right that is not a qualified payment under the definition above to treat it as a qualified payment.[380] The election applies to specified amounts to be paid at specified times and "only to the extent that the amounts and times so specified are not inconsistent with the underlying legal instrument giving rise to such right."[381]

d. Subtraction Method of Valuation

(1) If section 2701 applies to a transfer, the value of the transferred interest will be determined using the "subtraction method" described in the Treasury Regulations.[382] The value of the transferred interest is determined in the 4 steps (simplified for purposes of this outline):

(a) Step 1: Determine the fair market value of all family-held[383] interests in the entity immediately before the transfer. Fair market value is determined assuming that all of the interests are held by one individual (presumably to eliminate minority interest discount issues but still allow for discounts due to lack of marketability). [384] There has been some commentary that having all of the interest held by one individual essentially means that the value in this step is liquidation value. However, in the guidance cited in the commentary, both the taxpayer and the IRS stipulated that the value of the company was book value and the question of whether lack of marketability should be assigned to such interests was not at issue.[385]

(b) Step 2: Subtract the value of all family-held senior equity[386] interests (e.g., the preferred interests). If the interest is an applicable retained interest

---

[378] § 2701(a)(3)(B) and Treas. Reg. § 25.2701-2(a)(3). *See also* § 25.2701-2(a)(5).

[379] Treas. Reg. § 25.2701-2(b)(2).

[380] § 2701(c)(3)(C)(ii).

[381] § 2701(c)(3)(C)(ii).

[382] Treas. Reg. § 25.2701-3.

[383] For these purposes, "family" means the transferor, applicable family members, and any lineal descendants of the parents of the transferor or the transferor's spouse (held directly or through attribution). *See* Treas. Regs. §§ 25.2701-3(a)(2)(i) and 25.2701-2(b)(5)(i).

[384] Treas. Reg. § 25.2701-3(b)(1)(i).

[385] *See* TAM 9447004.

[386] Senior equity interest is "an equity interest in the entity that carries a right to distribution of income or capital that is preferred as to the rights of the transferred interest." Treas. Reg. § 25.2701-3(a)(2)(ii).

held by the transferor and applicable family members, the value as determined under section 2701 of the Code. This value could, obviously be zero by application of the zero valuation rule. If held by persons other than the transferor and applicable family members, the value is the fair market value.[387] In traditional forward freeze planning, the retained preferred interest is commonly structured to be a qualified payment interest in an effort to minimize the value of the transferred common interest (determined ultimately in step 4 below). Section 2701 of the Code prevents taxpayers from over valuing the qualified payment preferred interest through the "lower of" rule discussed above. As such, planners need to avoid creating an extraordinary payment right or distribution right that would be valued at less than full fair market value (e.g., the liquidation value of the preferred interest). As pointed out in the context of Revenue Ruling 83-120, the preferred rate will be affected by the preferred payment coverage and the protection of the liquidation preference.

(c) Step 3: Allocate the balance among the transferred interests and other family-held subordinate equity interests, as follows: (i) if more than one class of family-held subordinate equity interest exists, the remaining value is allocated in a manner that would most fairly approximate their value if all zero-valued rights under section 2701 did not exist; and (ii) if there is no "clearly appropriate method" of allocation, the remaining value is allocated in proportion to their fair market values without regard to section 2701 of the Code.[388]

(d) Step 4: Apply certain discounts and other appropriate deductions, but only to the extent permitted by the Treasury Regulations. The Treasury Regulations provide if the value of the transferred interest would have been determined (but for Section 2701) with a "minority or similar discount," the amount of the gift is reduced by the excess of a "pro rata portion of the fair market value[389] of the family-held interests of the same class" over "the value of the transferred interest (without regard to section 2701)."[390] The IRS has ruled that "minority or similar discount" includes a "discount for lack of marketability" with respect to the transferred interest.[391] The Treasury Regulations provide, the value of the family-held interests of the same class is "determined as if all voting rights conferred by family-held equity interests were held by one person who had no interest in the entity other than the family-held interests of the same class, but otherwise without regard to section 2701."[392] It stands to reason also that non-preferred limited partnership interests should also be entitled to an additional discount for being subordinate to the rights of the preferred interests with respect to cash flow distributions and liquidation proceeds (sometimes referred to as a "subordination discount"). As a result, non-preferred limited partnership interests will often be entitled to a significantly larger valuation discount than single class share FLP interests. As a result, even when the subtraction

---

[387] The Treasury Regulations provide, "the fair market value of an interest is its pro rata share of the fair market value of all family-held senior equity interests of the same class (determined, immediately after the transfer, as is [if] all family-held senior equity interests were held by one individual)." Treas. Reg. § 25.2701-3(b)(2)(i)(A).

[388] Treas. Reg. § 25.2701-3(b)(3).

[389] The Treasury Regulations provide, the value is "determined as if all voting rights conferred by family-held equity interests were held by one person who had no interest in the entity other than the family-held interests of the same class, but otherwise without regard to section 2701." Treas. Reg. § 25.2701-3(b)(4)(ii)(A).

[390] Treas. Reg. § 25.2701-3(b)(4)(ii).

[391] TAM 9447004.

[392] Treas. Reg. § 25.2701-3(b)(4)(ii)(A).

method is applied to a transfer, the value of the gift is often much smaller than most practitioners anticipate.

(2) 10% Minimum Value Rule

(a) If section 2701 applies to a transfer of a "junior equity interest," then such transferred interest must be assigned at least that pro rata value which it would have if the total value of all of the common stock of the corporation, or junior equity interests of a partnership (or LLC), were equal to 10 percent of the sum of (a) the total value of all of the equity interests in the entity, plus (b) the total amount of indebtedness of the entity to the transferor and applicable family members.[393]

(b) For purposes of the 10% Minimum Value Rule, the following types of indebtedness are included in this calculation: (i) short-term indebtedness with respect to the current conduct of the partnership's trade or business; (ii) third-party debt solely because it is guaranteed by the transferor or an applicable family member; and (iii) amounts set aside in a qualified deferred compensation arrangement, to the extent unavailable for use by the partnership.[394]

(c) For purposes of the 10% minimum value rule, a "junior equity interest" as, "common stock or, in the case of a partnership, any partnership interest under which the rights to income and capital are junior to the rights of all other classes of partnership interests."[395]

(d) Many practitioners wrongly believe that the 10% minimum value rule creates a phantom gift each time a forward freeze transaction occurs (transferor retains the preferred interest and transfers the common interest, even when the preferred interest is a qualified income right). The only time a phantom gift would occur under the minimum value rule is if the value of the common interest transferred is less than 10% of the total value of the entity.

e. Revenue Ruling 83-120

(1) Many commentators[396] and the IRS in rulings[397] have asserted that the appropriate standard for valuing the preferred interest is under Revenue Ruling 83-120,[398] pertaining to preferred corporate stock. The Revenue Ruling provides a methodology for

---

[393] § 2701(a)(4).

[394] Treas. Reg. § 25.2701-3(c)(3)(i).

[395] Treas. Reg. § 25.2701-3(c)(2). The Treasury Regulations go on to provide, "Common stock means the class or classes of stock that, under the facts and circumstances, are entitled to share in the reasonably anticipated residual growth in the entity." *Id.*

[396] *See, e.g.,* Milford B. Hatcher, Jr. and Edward M. Manigault, *Warming Up to the Freeze Partnership*, Estate & Personal Financial Planning (June 2000).

[397] *See, e.g.,* PLR 9324018.

[398] Rev. Rul. 83-120, 1983-2 C.B. 170.

valuing preferred interests, based upon 3 primary factors:[399] yield, preferred payment coverage and protection of the liquidation preference.

(2) Yield of the preferred interest is compared with the dividend yield of "high-grade, publicly traded preferred stock." The required credit rating is not explicitly stated in the ruling. The ruling does point out, however, that "If the rate of interest charged by independent creditors to the [entity] on loans is higher than the rate such independent creditors charge their most credit worthy borrowers, then the yield on the preferred [interest] should be correspondingly higher than the yield on the high quality preferred stock."[400]

(3) The ruling provides that "Coverage of the dividend is measured by the ratio of the sum of the pre-tax and pre-interest earnings to the sum of the total interest to be paid and the pre-tax earnings needed to pay the after-tax dividends."[401] Obviously, in the partnership context, due to pass-thru taxation under Subchapter K, concerns about pre-tax earnings and after-tax dividends are not relevant. Coverage is further supported if the partnership agreement provides that the preferred payment can be satisfied from both cash flow of the partnership and distributions in-kind of partnership assets.

(4) Protection of the liquidation preference is determined by comparing the value of the partnerships assets (net of liabilities) to the liquidation preference amount. In other words, what is the ratio of preferred interests in comparison to non-preferred interests?

(5) From a planning perspective, dividend (preferred payment) coverage and liquidation protection are within the control of the planner (whereas the yield on publicly-traded preferred stocks is determined by the vagaries of the market at the time of the purported transfer). In other words, if a FLP is being recapitalized into a qualified payment preferred FLP, then how much dividend coverage or liquidation protection is a function of the sizing between the preferred and common interests. For example, dividend coverage and liquidation protection would be quite different if AB partnership, which holds $10,000,000 of assets is structured, as follows: (i) A holding a 7% preferred on a $5,000,000 liquidation preference amount and B holding the common shares, and (ii) A holding a 7% preferred on a $9,000,000 liquidation preference amount and B holding the common shares. In the first instance, the effective yield that must be paid from the portfolio is 3.5% per year and there is 2:1 ratio of liquidation protection ($10,000,000 of assets to satisfy a $5,000,000 liquidation preference), and in the second instance, the effective yield is 6.3% and there is a 10:9 ratio of liquidation protection ($10,000,000 of assets to satisfy a $5,000,000 liquidation preference). In the latter instance, the value of the preferred interest would most likely be much less than the liquidation preference of $9,000,000 because the required yield from the partnership is considerably higher (less dividend coverage) and there is very little cushion of liquidation protection.

(6) In addition, the amount of dividend coverage and liquidation protection will affect the preferred rate. The preferred rate will generally be lower if the capital

---

[399] The ruling also indicates that voting rights and lack of marketability are secondary factors, but these may cancel each other out in many instances. Rev. Rul. 83-120, 1983-2 C.B. 170 at Sections 4.01, 4.05 and 4.06.

[400] Rev. Rul. 83-120, 1983-2 C.B. 170 at Section 4.02.

[401] Rev. Rul. 83-120, 1983-2 C.B. 170 at Section 4.03.

coverage and liquidation protection is greater. Generally, particularly with forward freeze planning, in order to maximize the future value of the transferred common interests, planners will seek to lower the preferred rate (the cash flow required to be paid on the preferred) as much as possible by providing sufficient dividend coverage and liquidation protection. The object is to lower to preferred rate to match the market rate, as instructed by Revenue Ruling 83-120.

3. Traditional Forward Freeze: Qualified Payment Interests

a. As discussed above, traditional forward freeze planning is often utilized with clients who wish to retain cash flow but also transfer appreciation (if there is appreciation above the cash flow preference). The potential for appreciation depends, of course, on the underlying assets held by the FLP, and also on the capital structure of the preferred FLP. By way of example, consider a preferred FLP holding $10 million in assets, capitalized with voting preferred shares bearing an 8% preferred rate and $5 million liquidation preference ($400,000 preferred distribution). Assume that the common shares are non-voting, and they have been transferred (gifted or sold) to an IDGT. If the underlying assets appreciate by 10% ($1 million of appreciation), then after they payment of the preferred payment, $600,000 of appreciation will accrue for the benefit of the common holder. If, on the other hand) the preferred FLP is capitalized with preferred shares bearing an 8% preferred rate and a $4 million liquidation ($320,000 preferred distribution), then $680,000 of appreciation will accrue for the benefit of the common holder.

b. In the previous example, of course, the value of the transferred common interest to the IDGT would be different because the common shares would have an initial nominal or liquidation value of $5 million and $6 million respectively. However, where the preferred shares are structured as qualified payment rights (e.g., cumulative annual payments at a fixed rate) under section 2701 of the Code, the subtraction method provides a mechanism to claim significant valuation discounts on the common interests. As noted above, when planning with qualified payment rights, the key to minimizing the value of the common interests is to maximize the value of the retained qualified preferred interest in step 2 of the subtraction method (in this example, $5 or $4 million, which is equal to the liquidation preference). Assuming the starting value in step 1 is $10 million (as discussed above, the value in step 1 is likely to be reduced for lack of marketability), then if the value of the senior (preferred) equity interest is liquidation value, then step 3 would provide a nominal value for the common interest of $5 or $6 million). In step 4 of the subtraction method, the taxpayer is allowed to apply all appropriate deductions, which include lack of marketability, minority interest (because the common is non-voting), and subordination discounts. In other words, the common interests will carry larger valuation discounts than a single class share FLP share would carry.

c. If, for example, the $5 million common interest is entitled to a 40% valuation, then the common interest will carry a gift tax value of $3 million, and if the FLP assets appreciate by 10%, then after payment of the preferred interest, the $600,000 of wealth accruing to the common represents a 20% increase in value in comparison to the value calculated under the subtraction method. In contrast, if the FLP had been structured as a single class share FLP and if a transfer of 50% of the FLP only carried a 20% discount, then the common would have a gift tax value of $4 million, and the appreciation accruing to the common (50% of 10% appreciation or $500,000) would only represent a 12.5% increase in value over the gift tax value. As one can see, a traditional forward freeze with a qualified payment preferred interest allows taxpayers to retain significant cash flow but also transfer the common interests with greater valuation discounts and potential for appreciation with the common.

d. In a traditional forward freeze, the client will retain the preferred interest, which might be includible in the client's gross estate. Practitioners should consider including a provision in the partnership agreement that provides upon death the preferred interest will be liquidated in an amount equal to the liquidation preference. This should limit the value of the preferred interest to its liquidation value (capital account balance, which will include any unpaid but accrued preferred payments). This should alleviate the risk of the preferred interest actually carrying a valuation premium for estate tax purposes if preferred rates have dropped. Further, whether a section 754 election is in place or not, any assets received in liquidation of the preferred interest will receive a basis equal to the liquidation value.

4. "Busted" (Non-Qualified) Preferred Interests

a. A "busted" section 2701 preferred interest (sometimes referred to as the "intentionally defective preferred interest") involves the creation of a preferred interest in a partnership or limited liability company that is *not* a qualified payment right under section 2701(c)(3) and gifting the common interest in a manner that mandates the "zero valuation" rule under the "subtraction method." Typically, the preferred interest payment is non-cumulative, thereby intentionally failing the definition of a "qualified payment."

b. This technique would have had particular relevance in light of the temporary doubling of the Base Exclusion Amount to $13.61 million per person for 2024 and the Anti-Clawback Regulations. However, the recently issued Proposed Anti-Abuse Regulations,[402] if passed as written, would eliminate the ability to get credit for the use of the bonus exclusion, as described herein. For example, taxpayer owns an LLC that holds $13.61 million in assets. Taxpayer recapitalizes the LLC into preferred and common interests. The preferred interests have a $6.805 million liquidation preference and a 8% non-cumulative preferred annual payment ($544,400). The preferred holder has the right to put the preferred interest to the LLC at any time for the liquidation preference. The LLC has the right to liquidate the preferred interest for $6.805 million at the death of the preferred holder. The taxpayer gifts the common interests to an IDGT.

(1) The preferred interest is not a "qualified payment" under section 2701(c)(3). As such, the value of the gifted common interest will be determined using the "subtraction method" described in the Treasury Regulations,[403] with the preferred interest (family-held senior equity[404] interest) being assigned a value of zero in step 2 of the subtraction method.

(2) The value attributed (with the preferred interest having a zero value) to transferred common interest may be entitled to valuation discounts. The Treasury Regulations provide if the value of the transferred interest would have been determined (but for section 2701) with a "minority or similar discount," the amount of the gift is reduced by the excess of a "pro rata portion of the fair market value[405] of the family-held interests of the same

[402] REG-118313-21, 87 Fed. Reg. 24918 (4/27/22) (the "Proposed Anti-Abuse Regulations").

[403] Treas. Reg. § 25.2701-3.

[404] Senior equity interest is "an equity interest in the entity that carries a right to distribution of income or capital that is preferred as to the rights of the transferred interest." Treas. Reg. § 25.2701-3(a)(2)(ii).

[405] The Treasury Regulations provide, the value is "determined as if all voting rights conferred by family-held equity interests were held by one person who had no interest in the entity other than the family-held interests of the same class, but otherwise without regard to section 2701." Treas. Reg. § 25.2701-3(b)(4)(ii)(A).

class" over "the value of the transferred interest (without regard to section 2701)."[406] The Service has ruled that "minority or similar discount" includes a "discount for lack of marketability" with respect to the transferred interest (when the preferred interest was valued at zero).[407]

c. For the sake of simplicity, we assume, under the subtraction method with the zero valuation rule applying in this example, the gift of the common is calculated to be exactly $12.92 million. Why would a taxpayer consider making this gift? The answer lies in the calculation of the estate tax upon the taxpayer's death. The tentative federal estate tax (before credits) is essentially computed against the sum of the decedent's taxable estate,[408] and the "amount of adjusted taxable gifts."[409] The Treasury Regulations provide that if an individual (referred to as the "initial transferor") makes a transfer subject to section 2701, "in determining the Federal estate tax with respect to an initial transferor, the executor of the initial transferor's estate may reduce the amount on which the decedent's tentative tax is computed under section 2001(b)… by the amount of the reduction."[410]

(1) Assuming there has been no subsequent transfer of the retained preferred interest, the amount of the reduction (to adjusted taxable gifts) is the "amount by which the initial transferor's taxable gifts were increased as a result of the application of section 2701 to the initial transfer."[411]

(2) In other words, in our simple example, the amount of the reduction is exactly $6.03 million (the increase of the gift of the common or the value of preferred interest if it had been a "qualified interest"). However, because the non-cumulative preferred can be liquidated at $6.46 million, the amount includible is also $6.46 million. As such, these two amounts will cancel each other out, and the value in the gross estate attributable to the preferred interest is zero.

d. The Treasury Regulations provide the following example that makes it clear that the reduction in adjusted taxable gifts is frozen in value:

> P, an individual, holds 1,500 shares of $1,000 par value preferred stock of X corporation (bearing an annual noncumulative dividend of $100 per share that may be put to X at any time for par value) and 1,000 shares of voting common stock of X. There is no other outstanding common stock of X.[412]
>
> P continues to hold the preferred stock until P's death. The chapter 11 value of the preferred stock at the date of P's death is the same as the fair market value of the preferred stock at the time of the initial transfer. In computing the Federal

[406] Treas. Reg. § 25.2701-3(b)(4)(ii).

[407] TAM 9447004.

[408] § 2001(b)(1)(A).

[409] § 2001(b)(1)(B).

[410] Treas. Reg. § 25.2701-5(a)(3).

[411] Treas. Reg. § 25.2701-5(b)(2).

[412] Treas. Reg. § 25.2701-5(d)(1)(i).

estate tax with respect to P's estate, P's executor is entitled to a reduction of $1,500,000 under paragraph (a)(3) of this section.[413]

e. A significant practical benefit to the taxpayer is that for as long as the taxpayer holds the preferred interest, the taxpayer presumably can choose to receive the preferred payment or not. If no preferred payment is received, all of the appreciation effectively passes to the common interests. On the other hand, the preferred holder always has the option to receive the distribution if the cash flow is needed for any reason. The preferred interest is frozen in value with a reduction for estate tax purposes that essentially “zeroes-out” the estate tax liability attributable to the preferred. Prior to the issuance of the Proposed Anti-Abuse Regulations, decedents would have gotten the added benefit of the claw-back adjustment, but the proposed Treasury Regulations cast serious doubt on that. If passed, as written, no claw-back adjustment (credit for the use of the bonus exclusion) will be given for transfers “described in §25.2701-5(a)(4) or §25.2702-6(a)(1) of this chapter.”[414] As such, a single taxpayer using both the base and bonus exclusion on this type of transfer would not get the benefit of the claw-back adjustment. However, spouses, using both of their respective original Base Exclusion Amounts (no bonus) in separate transfers would get the reduction to adjusted taxable gifts described above, along with the credit attribute to the original Base Exclusion Amount.

5. Reverse Freeze Planning

a. As mentioned above, reverse freeze planning involves the transferor retaining the common interest and transferring the preferred interest. Because the transferor is transferring the preferred cash flow preferences, a reverse freeze is only for those individual who do not need to retain the cash flow. The primary transfer tax benefit of a reverse freeze is that it qualifies under the junior equity exception under section 2701. As such, normal gift tax rules apply in valuing the transferred preferred interest. Because preferred rates tend to be significantly higher than the interest rate or discount rate associated with many zeroed-out transfer techniques, a reverse freeze can provide a consistent and steady appreciation above the so-called hurdle rate associated with GRATs, CLATs, and installment sales. This arbitrage is can be further increased by the valuation discounts that would be associated with the preferred interest.

b. For example, consider a preferred partnership that holds $10 million of assets, capitalized as follows: a preferred interest with a $6 million liquidation preference and a cumulative annual cash flow preference of 8% ($480,000), and a common interest having a nominal value of $4 million based on its initial capital account. The preferred interest is non-voting, and the common is voting. A grantor who holds all of the preferred and common interests make a transfer of the preferred interest. Because normal gift tax rules apply, assume that the preferred interests carry a 25% valuation discount due to lack of control and marketability. The resulting transfer tax value is $4.5 million, but the annual cash flow is $480,000, which represents an annual return of over 10% in comparison to the transfer tax value. Whether the transfer is a taxable gift, zeroed-out transfer to a GRAT, or a sale to an IDGT for an installment note, a greater than 10% annual return is a sizeable amount of wealth transfer each year, particularly if the 7520 rate and AFR rates remain relatively low.

[413] Treas. Reg. § 25.2701-5(d)(3), Ex. 2.

[414] Prop. Treas. Reg. § 20.2010-1(c)(3)(i)(C).

c. If, in this example, the partnership assets have less than 4.8% annual return, then the assets in the partnership will go down in value after the preferred payment of $480,000 each year, thereby reducing the value of the common interest held by the grantor. If, on the other hand, the partnership assets are by 10% in the first year, then 5.2% of the appreciation will accrued to retained common interest. As one can see, the capital ratio between the preferred and common interests should be carefully considered depending on the expected return of the underlying assets and the objectives and situation of the client.

6. Disproportionately Allocating Income

a. The most flexible vehicles available to practitioners to "split" income among taxpayers are entities taxed as partnerships. While an S corporation will spread the entity's income across the shareholders, the capital structure of an S corporation investment is limited to one class of stock so there is no ability to disproportionately allocate income to certain shareholders (who are taxed at lower marginal income tax brackets and who may not be subject to state income tax) to the exclusion of other shareholders (who are already at the highest income tax brackets and who may be residents of a high income tax state like California).[415]

b. Generally, the Code and the IRS take the position that if a partner holds a preferred interest in a partnership, then taxable income should follow with the preferred interest payment.

(1) For guaranteed payment rights, the taxation to the partnership and the partners is relatively straightforward. A partnership that makes a guaranteed payment to partner is entitled to either deduct the payment as an ordinary and necessary business expense[416] of the partnership or capitalize[417] the expense as a capital expenditure, depending on the nature of the payment.[418] The partner receiving the guaranteed payment must include the payment as ordinary income[419] in the year in which the partnership paid or accrued the payment under its method of accounting.[420]

(2) For the other types of preferred interests, the allocation of income is a bit more convoluted. Generally, the income allocated to the preferred payment depends on the distributive share of the partnership. The McKee, Nelson and Whitmire treatise provides that the Service expects a preferred return to be matched by a corresponding allocation of available income or gain.[421] The Treasury Regulations, in the context of the disguised sale rules, provide that a preferred return means "a preferential distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched, to the extent available, by an allocation of gain."[422]

[415] § 1361(b)(1)(D).

[416] § 162(a).

[417] § 263.

[418] § 707(c).

[419] *See* § 61(a).

[420] § 706(a) and Treas. Reg. §§ 1.706-1(a)(1) and 1.707-1(c).

[421] McKee, Nelson and Whitmire, *Federal Taxation of Partnerships and Partners*, ¶ 13.02[3][b][iii], at 3-19 (3d ed. 1997).

[422] Treas. Reg. § 1.707-4(a)(2).

c. With the goal of disproportionately allocating income to lower taxed individuals, practitioners should consider a "reverse freeze" transfer where the higher taxed individual transfers the preferred interest to the lower taxed individual. As discussed above, this transfer is excepted under section 2701 of the Code, and normal gift tax rules would apply to such transfer.

7. Trust to Trust Preferred Partnership

a. Consider the following hypothetical situation:

(1) Trust A is an irrevocable resident trust of State A, which is a no or low income tax state. Trust B is an irrevocable resident trust of State B, which is a high income tax state. Trust A and Trust B were created many years ago by grantors who are now deceased, and both trusts are held for benefit of the same beneficiaries. The terms of both trusts, particularly the provisions describing the beneficial interests of the beneficiaries, are substantially similar to each other. Trust A and Trust B each hold $10 million in publicly-traded securities.

(2) Trust A and Trust B consolidate their assets by contributing them to a limited liability company (now holding $20 million), with Trust A receiving preferred interests in the LLC, and with Trust B receiving common interests in the LLC, as follows: (i) the preferred interest held by A; and (ii) the common interest held by B retains all of the residual interest in any annual cash flow, liquidation proceeds, and earnings of the LLC after the preferred interest holders have been paid. The preferred interest held by A is structured as follows:

(a) $10 million liquidation preference (upon dissolution of the LLC, this amount will be paid to the preferred partner in cash or in-kind before any liquidating distributions are made to the common holder); and

(b) An annual, cumulative preferential right to partnership cash flow equal to 10% of the liquidation preference ($1,000,000 annually).

(3) Each year, the LLC pays $1,000,000 of cash flow to Trust A. The portfolio of the LLC generates $1,000,000 or less of taxable income (capital gain and portfolio income). Assuming no tax items need to be allocated to Trust B under section 704(c) of the Code, all of the taxable income will be allocated to Trust A, the low or no state income tax Resident Trust. No income will be allocated to Trust B.

b. There are strong arguments to support the conclusion that when Trust A and Trust B create the preferred LLC described above, section 2701 of the Code either does not apply or at worst has no transfer tax consequences:

(1) Section 2701 of the Code is gift tax provision. For it to apply, Trust A or Trust B must be making a gift to the other. For example, as a result of the formation of the LLC, Trust B is deemed to make a gift to Trust A. It is unclear whether an irrevocable trust can even make a gift like that. The original transfer to Trust B was made by a grantor or testator who is now deceased.

(2) Perhaps, there is a deemed gift from the beneficiaries of Trust B to the beneficiaries of Trust A. As mentioned above, section 2701 of the Code provides that in determining whether a gift has been made and the value of such gift, when a person transfers an

interest in a partnership to a "member of the transferor's family"[423] the value of certain "applicable retained interests" will be treated as zero.[424] Further, "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."[425] A "member of the transferor's family" means: (a) the transferor's spouse, (b) a lineal descendant of the transferor or the transferor's spouse, or (c) the spouse of any such lineal descendant.[426] For these purposes, an individual is treated as holding any interest to the extent held indirectly through a trust.[427] If the beneficiaries of Trust A are making a gift to the beneficiaries of Trust B, aren't they making a gift to themselves because they have the same beneficial interests in both trusts? For a taxable gift to occur, property must be transferred for less than adequate and full consideration in money or money's worth.[428]

(3) As discussed above, the vertical slice exception of section 2701 of the Code provides "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."[429] This is often referred to as the vertical slice exception. The Treasury Regulations provide, for interests held in trust:

> A person is considered to hold an equity interest held by or for an estate or trust to the extent the person's beneficial interest therein may be satisfied by the equity interest held by the estate or trust, or the income or proceeds thereof, assuming the maximum exercise of discretion in favor of the person. A beneficiary of an estate or trust who cannot receive any distribution with respect to an equity interest held by the estate or trust, including the income therefrom or the proceeds from the disposition thereof, is not considered the holder of the equity interest.[430]

c. In our hypothetical, the beneficial interest of the beneficiaries of Trusts A and Trust B are substantially similar. It would seem that even if Section 2701 of the Code applied, the vertical slice exception would also apply. That being said, out of an abundance of caution, practitioners should structure the preferred interest as a qualified payment right.

d. The preferred interest held by Trust A provides for a cumulative fixed annual payment of $1 million to Trust A, so it is considered a qualified payment interest. This avoids the risk of the zero valuation rule applying and reduces the value of any deemed gift from Trust A to Trust B under the subtraction method (as discussed in more detail later in this outline). When one runs through the attribution rules, given that the beneficiaries have substantially similar beneficial interests in both trusts, it is likely any net gift would be nominal (if section 2701 of the Code actually applied to this hypothetical).

---

[423] § 2701(a).

[424] § 2701(a)(1)(3)(A).

[425] § 2701(e)(5).

[426] § 2701(e)(1).

[427] § 2701(e)(3).

[428] § 2512(b).

[429] Treas. Reg. § 25.2701-1(c)(4).

[430] Treas. Reg. § 25.2701-6(a)(4)(i).

B. Contributions of Depreciable Property and Section 704(c)

1. When 704(c) property is 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"[431] at the time of contribution. To that end, the Treasury Regulations instruct, "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.."[432] Said another way, the Treasury Regulations provide that section 704(c) allocations should follow a "tax follows book" methodology, and in this instance, book depreciation will exceed tax depreciation. 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.

Example: A and B form AB Partnership as equal partners. The partnership agreement provides that the partnership will make allocations under section 704(c) using the traditional method. A contributes Asset A, depreciable property with an adjusted basis of $400x and a fair market value of $1,000x. Assume, Asset A has a remaining (straight-line) depreciable life of 5 years. B contributes $1,000x of cash.

Absent section 704(c), A and B would each be allocated $40x of tax depreciation per year ($400x/5 years = $80x total tax depreciation), and at the end of the first taxable years, tax and book capital accounts would be as follows:

	A		B	
	Tax	Book	Tax	Book
Initial Contributions	$400x	$1,000x	$1,000x	$1,000x
Asset A-Depreciation No § 704(c)	(-$40x)	(-$100x)	(-$40x)	(-$100x)
Ending Balance	$360x	$900x	$960x	$900x

As the table shows, B, the contributing partner, is allocated $60x less depreciation than B should be receiving based on book value. Said another way, for the same equal contribution to become an equal partner, B will have $60x more taxable income per year. In theory, A is effectively shifting taxable income to B because A has already enjoyed more of the depreciation prior to the contribution.

Under the "tax follows book" methodology, tax depreciation should follow, to the extent possible, book depreciation. Under the traditional method, all of the tax depreciation of the partnership ($80x) will be allocated to B. [433] The result at the end of the first taxable year are as follows:

---

[431] Treas. Reg. § 1.704-3(b)(1).

[432] *Id.*

[433] *See* Treas. Reg. § 1.704-3(b)(2), Ex. 1.

	A		B	
	Tax	Book	Tax	Book
Initial Contributions	$400x	$1,000x	$1,000x	$1,000x
Asset A-Depreciation § 704(c)	0	(-$100x)	(-$80x)	(-$100x)
Ending Balance	$400x	$900x	$920x	$900x

The net result for B, is that B's book-tax disparity is reduced from $60x in the previous hypothetical to $20x, and A's book-tax disparity is not increased.

2. In the family partnership context, when dealing with depreciable property, section 704(c) serves to disproportionately allocate depreciation deductions to the noncontributing 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: (i) a high income taxpayer (including a non-grantor taxable trust); (ii) holding property that has basis and that is not depreciable (e.g., cash or marketable securities); or (iii) has an investment that generates significant passive income each year.

3. In the previous example, B will be allocated $80x of tax depreciation per year, not the $100x that B would have received if the depreciable property had a tax basis equal to its book value on contribution ($1,000x). Over the remaining 5 years, B will be allocated, in aggregate, $400x of depreciation deductions (which is $100x less than the $500x B would have received if the property had $1,000 of tax basis). As discussed earlier, this result is due to the ceiling rule.[434] Without any curative or remedial allocations, over the 5-year expected life of Asset A, the projected tax and book capital accounts would look as follows:

Years 1-5	A		B	
	Tax	Book	Tax	Book
Initial Contributions	$400x	$1,000x	$1,000x	$1,000x
Asset A-Depreciation § 704(c)	0	(-$500x)	(-$400x)	(-$500x)
Ending Balance	$400x	$500x	$600x	$500x

4. You will note in the previous example, the ceiling rule prevents B, the noncontributing partner, from being allocated B's full share of depreciation deductions (as measured by reductions in book value). To resolve this, the partnership can make curative allocations, as illustrated by the following example:

Example: A and B form AB Partnership as equal partners. The partnership agreement provides that the partnership will make allocations under section 704(c) using the traditional method with curative allocations. A contributes

[434] 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)."

Asset A, depreciable property with an adjusted basis of $400x and a fair market value of $1,000x. Assume, Asset A has a remaining (straight-line) depreciable life of 5 years. B contributes $1,000x of cash that AB Partnership uses to purchase, Asset B. Asset B is depreciable property with a depreciable life of 5 years. In the first year, AB Partnership elects to make a special $20x curative allocation of depreciation attributable to Asset B to Partner B, with any excess depreciation $100x to B and remining $80x to A, as follows:

Year 1	A		B	
	Tax	Book	Tax	Book
Initial Contributions	$400x	$1,000x	$1,000x	$1,000x
Asset A-Depreciation § 704(c)	0	(-$100x)	(-$80x)	(-$100x)
Asset B-Depreciation Curative Allocation			(-$20x)	
Asset B-Depreciation § 704(b)	(-$80x)	(-$100x)	(-$100x)	(-$100x)
Ending Balance	$320x	$800x	$800x	$800x

If AB Partnership continues to make this curative allocation over the 5-year depreciable life of Asset B, the result over that period would be as follows:

Years 1-5	A		B	
	Tax	Book	Tax	Book
Initial Contributions	$400x	$1,000x	$1,000x	$1,000x
Asset A-Depreciation § 704(c)	0	(-$500x)	(-$400x)	(-$500x)
Asset B-Depreciation Curative Allocation			(-$100x)	
Asset B-Depreciation § 704(b)	(-$400x)	(-$500x)	(-$500x)	(-$500x)
Ending Balance	$0x	$0x	$0x	$0x

5. Alternatively, if the partnership does not have other depreciable property, it could allocate $20x of ordinary income to A, which has the same effect as an allocation of depreciation to B.[435] 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.[436]

.

6. Generally, curative allocations must be made over the remaining depreciation life of the asset, [437] but if the remaining depreciation life is very short in comparison to its actual

[435] *Id.*

[436] *Id.*

[437] *See* Treas. Reg. § 1.704-3(c)(4), Ex. 2.

economic life, under certain circumstances, the IRS could invoke the anti-abuse rule and invalidate the curative allocation.

7. As noted above, a disparity created by the ceiling rule can also be cured under the remedial allocation method. The amount of 704(b) book depreciation allowed is determined differently under the remedial allocation method than under the traditional method or the traditional method with curative allocations (which must use the rules under section 1.704-1(b)(2)(iv)(*g*)(*3*) to determine book cost recovery).[438] Under the remedial allocation method, a partnership must bifurcate its section 704(b) book basis in the contributed property for purposes of calculating depreciation. 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).[439] 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.[440]

8. As mentioned above, a remedial allocation is reasonable only if it has the same tax attributes as the tax item limited by the ceiling rule. To that end, the Treasury Regulations provide that if the item limited by the ceiling rule consists of depreciation or other cost recovery allowance from contributed property, the offsetting remedial allocation must be income of the type produced (directly or indirectly) by that property.[441]

9. 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 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.

VII. AVOIDING GAIN ON A GRANTOR TRUST CONVERSION

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 purposes).[442] 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."[443] Effectively, the entity is "disregarded as an entity separate from its owner if it has a single

---

[438] *See* Treas. Reg. § 1.704-3(d)(2).

[439] *Id.*

[440] *Id.*

[441] Treas. Reg. § 1.704-3(d)(3).

[442] 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).

[443] Treas. Reg. § 301.7701-2(a).

owner,"[444] and this applies for "federal tax purposes."[445] 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.[446] 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."[447]

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.[448]

B. 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,[449] 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

---

[444] Treas. Reg. § 301.7701-3(b)(1)(ii).

[445] Treas. Reg. §§ 301.7701-1(a) and -2(c)(2).

[446] Rev. Proc. 2002-69, 2002-2 C.B. 831.

[447] *Id.*

[448] Rev. Rul. 2004-77, 2004-31 I.R.B. 119.

[449] Rev. Rul. 99-5, 1999-1 C.B. 434.

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.[450] 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.

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) nontaxable 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

---

[450] The ruling cites Rev. Rul. 66-7, 1966-1 C.B. 188.

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). 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. Again, it seems that an allocation of the unitary basis is warranted, as discussed above.

C. Eliminating Outstanding Installment Debt when Debt is in Excess of Basis

1. 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.[451]

2. 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 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.

3. 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.

4. 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.

[451] *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.

5. 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.

6. 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.

VIII. CONCLUSION

Entities taxed as partnerships (or treated as disregarded) provide an incredibly flexible and powerful platform for planners. Unfortunately, flexibility also means complexity and the risk of unintended tax consequences. However, for those estate planners willing to roll up their sleeves and wade into the deep end of subchapter K, the rewards to their clients can be great. Hopefully, despite the all of the complexity of subchapter K, these materials provide a handful of *understandable, straightforward, and actionable* planning ideas that address *common and identifiable* client problems or situations.