FUNDAMENTALLY FUN SOLUTIONS TO PERILOUS   
  
INCOME TAX PITFALLS IN ESTATE PLANNING

Turney P. Berry  
WYATT, TARRANT & COMBS, LLP  
400 West Market Street, Suite 2000  
Louisville, Kentucky 40202-3227  
502.562-7505 – Direct Dial  
[tberry@wyattfirm.com](mailto:tberry@wyattfirm.com)

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**FUNDAMENTALLY FUN SOLUTIONS**

**TO PERILOUS INCOME TAX PITFALLS**

**IN ESTATE PLANNING**

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**Disclosure:**

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Paul S. Lee

The Northern Trust Company

New York, New York

Turney P. Berry

Wyatt, Tarrant & Combs LLP

Louisville, Kentucky

Melissa J. Willms

Davis & Willms, PLLC

Houston, Texas

1. FOUNDATIONAL CONCEPTS
   1. Focus of These Materials
      1. Estate planning, as we know, is more than just simply drafting testamentary documents like Last Wills and Testaments or revocable living trusts, which are passive documents that determine how assets are distributed and passed down to the beneficiaries of the decedent. In such cases, the income tax consequences are generally straightforward. To wit, most assets (other than those that are considered income in respect of a decedent[[1]](#footnote-2) (IRD), will get a basis adjustment to fair market value under section 1014 of the Internal Revenue Code of 1986, as amended (the “Code”), and each beneficiary’s receipt of those assets is not considered taxable income.[[2]](#footnote-3)
      2. Inter vivos estate planning is much more involved and varied. We, as estate planners, transfer assets to, from, and among individuals, trusts, and business entities. These transfers can take the form of gifts, sales, exchanges, distributions, contributions, installment obligations, and loans. Often the primary purpose of these transfers is to reduce the value of our clients’ gross estates in order to save future estate taxes, with secondary consideration of the income tax consequences, if at all. These transfers and transactions can have a myriad of income tax consequences and sometimes the results are unintended and unanticipated.
      3. These materials are, in one sense, a resource to understand the fundamentals of income taxation, with a focus on the consequences of the estate planning transfers, transactions, and techniques often utilized when our clients are alive and after their deaths. In addition, this paper will address areas where the income tax consequences are unclear (or unknown) but will provide proposals for what should be (or could be) the correct answer. Finally, the discussion herein will focus on common income tax pitfalls and provide practical solutions that resolve or ameliorate the tax consequences of such missteps. These materials will not, however, go into the basics and fundamentals of specialized portions of the income tax Code that have been and should be covered in other outlines like grantor trusts, income taxation of trusts and estates (subchapter J), and the income taxation of business entities. A basic understanding of those areas are assumed in these materials. That being said, these materials will discuss partnerships and disregarded entities in some detail, since these tend to be used most often in estate planning.
   2. Income Tax Planning Basics and Central Rulings
      1. Income Tax Planning Strategies Generally
         1. Income tax planning is about reducing, eliminating, or deferring the income tax liability of taxpayers. The most beneficial income tax planning for taxpayers results in the elimination of a potential tax liability. The exclusion of income or capital gain typically involves targeted Code sections. By way of example, section 121 of the Code provides exclusion of gain from the sale of a principal residence, section 1202 of the Code provides a 100% exclusion on eligible gain on the sale of Qualified Small Business Stock (QSBS),[[3]](#footnote-4) and section 1400Z-2 eliminates future appreciation on a qualifying investment in a Qualified Opportunity Zone (QOZ) fund by giving the taxpayer an election to increase the basis of his or her investment to fair market value upon a taxable sale of the QOZ investment.[[4]](#footnote-5) That being said, the most common tax situation that eliminates taxable gain is the basis adjustment at death under section 1014 of the Code. What makes the basis adjustment at death so powerful is that it is unlimited and is not directly tied to whether the estate will pay any estate taxes at that time or at all. The estate may be under the decedent’s basic exclusion amount (currently, $11.7 million) under section 2010 of the Code, and even for very large estates, if there is a surviving spouse and the estate takes advantage of the marital deduction under section 2056 or 2056A of the Code, then no estate taxes will be currently payable, but there is still a basis adjustment to fair market value at date of death. No election is required, but it is a basis adjustment which means it can cause a step-up or a step-down in basis.
         2. When elimination is not possible, tax planners will look for opportunities to make realization events unrecognizable for tax purposes and thus untaxable at that time. A common example is a like-kind exchange under section 1031 of the Code which allows investors in real property to sell the investment, even for cash, and reinvest the proceeds in other real property investments without recognizing a taxable gain. This type of tax free exchange allows taxpayers to defer the gain indefinitely if he or she is willing to continue to stay invested in “like-kind” property indefinitely (or until the property is subject to a basis adjustment under section 1014 of the Code). Another example is contributing property in-kind to a business entity in exchange for ownership interests in the business entity (i.e., stock in a corporation or interests in a partnership under sections 351 and 721, respectively, of the Code).
         3. When elimination and nonrecognition are not available, strategies that provide for a deferral of gains or income is often the strategy of choice. Of course, deferral provides the most tax savings when future income tax rates are the same or are lower in the future. Whereas, if a taxpayer knows that tax rates will be higher in the future, a taxable event and payment of the tax currently, may result in more savings than deferral. A common deferral tool is the installment method of accounting, which allows a taxpayer to defer the recognition of gain on a disposition of property and to spread the taxation of that gain over the time when installment payments are received.[[5]](#footnote-6)
         4. Last, but not least, tax planners can attempt to reduce the effective income tax payable by having it paid at lower rates. A simple example of the foregoing is when a non-grantor trust distributes of trust income to an individual beneficiary who is taxed at a lower marginal income tax rate than the trust (which will be taxed at the highest marginal income tax rate once taxable income exceeds $13,050).[[6]](#footnote-7) Another technique to reduce the effective tax payable is to convert the character of the income from, for example, ordinary income to capital gain. For example, it might be possible to sell inventory property to a spouse (a non-taxable event under section 1041 of the Code pursuant to which the spouse receives a carryover basis). If the spouse holds the purchased property for investment, then the spouse may be able to get capital gain treatment on a subsequent sale of the property.[[7]](#footnote-8)
      2. *Cottage Savings*: Taxable Exchange or Not
         1. One of the basic tenets in income tax planning is whether a transaction will be considered a sale, exchange, or other disposition that will be recognized for income tax purposes. When an exchange of property occurs and the property transferred by both parties are similar in nature, no realization event is deemed to occur for tax purposes.[[8]](#footnote-9) In an important U.S. Supreme Court case, *Cottage Savings Association v. Commissioner*,[[9]](#footnote-10) the taxpayer, a savings and loan association exchanged interest in a pool of residential mortgages for another savings and loan association’s interest in a pool of residential mortgages. Both of the parties to the exchange claimed a loss on the exchange. For Federal Home Loan Bank Board accounting purposes, the mortgages were treated as having been exchanged for “substantially identical” ones from the other savings and loan association.
         2. Under the Treasury Regulations, an exchange of property constitutes a “disposition of property”[[10]](#footnote-11) under section 1001(a) of the Code (gain or loss is realized from the exchange) if the property being exchanged is differs “materially either in kind or in extent.”[[11]](#footnote-12) The Supreme Court interpreted the foregoing to mean that properties will be “materially different” if holders of the property enjoy “legal entitlements that are different in kind or extent.”[[12]](#footnote-13) The Supreme Court held that the transaction easily satisfied the “material difference” test because the interests exchanged derived from loans that were made to different obligors and secured by different residences, and as such, the exchanged interests were “legally distinct entitlements.”[[13]](#footnote-14) It’s notable in *Cottage Savings* the Supreme Court held that there was a taxable exchange between the parties, even though each of them was left with an asset that was economically equivalent to the transferred asset.
         3. In response to *Cottage Savings*, the IRS issued Treasury Regulations regarding debt instrument modifications and the factors to consider to determine whether such modifications are sufficiently significant to be deemed an exchange of the original debt instrument for the modified debt instrument.[[14]](#footnote-15) In a number of private letter rulings, the IRS has cited *Cottage Savings* and held that a split or partition of a trust is not an exchange of property differing materially in kind or extent.[[15]](#footnote-16) The principles set out in *Cottage Savings* have broad applicability in estate planning, especially in the context of trust modifications and decanting.
      3. *Crane* and *Tufts*: Nonrecourse Debt, Basis, and Gain
         1. Two seminal U.S. Supreme Court cases established how debt (particularly, nonrecourse debt) is treated for income tax purposes, *Crane v. Commissioner[[16]](#footnote-17)* and *Commissioner v. Tufts*.[[17]](#footnote-18) In *Crane*, the taxpayer inherited, as the sole beneficiary of her husband’s estate, an apartment building and lot subject to a mortgage, which secured a debt of $255,000 (and accumulated interest in arrearage of $7,042.50) on the date of death. The property was appraised for federal estate tax purposes at a value exactly equal to the principal debt. The taxpayer was allowed to continue to operate the apartment building (collecting rent, paying necessary expenses and taxes, etc.) and for 7 years, the taxpayer remitted the net rental to the mortgagee. During that period, the taxpayer reported gross rentals as income and claimed, and was allowed, deductions for taxes, operating expenses, interest on the mortgage, and depreciation on the building. However, the arrearage of interest increased to $15,857.71, at which point the mortgagee threatened foreclosure on the property. Prior to foreclosure, the taxpayer sold the property, subject to the mortgage, to a third party in return for $3,000 cash (paying from that sum, $500 in sale expenses).
         2. The taxpayer reported $1,250 of capital gain on the sale. Under the law at the time, only 50% of the net gain realized on a sale of a capital asset was taxable if the property had been held for more than 2 years (1/2 of $3,000 cash less $500 expenses). The taxpayer’s position was that the basis of the property received at her husband’s death was the net equity (excess of the value over the debt), which was zero (despite having claimed depreciation deductions). Neither the taxpayer nor the purchaser of the property assumed the mortgage, making it nonrecourse debt, so the net taxable amount realized was $3,000 minus zero adjusted basis.
         3. The IRS determined that the taxpayer realized $23,767.03. The IRS contended that the property inherited by the taxpayer was not the net equity, but the appraised value. Taking into account allowable depreciation on the building, the basis of the building at the time of the sale was $178,997.40. The amount realized includes the net cash of $2,500 plus the principal amount of the mortgage, totaling $257,500.
         4. The Supreme Court concluded that, based on the 1938 tax act in effect at the time, the apartment building and lot received a basis adjustment at death equal to the fair market value of the property, undiminished by the mortgage (not the net equity). As to the amount realized from the purchase, the Supreme Court concluded it should include the principal amount of the mortgage, regardless of whether the mortgagor was personally liable on the debt or not. The opinion provides:[[18]](#footnote-19)

[W]e think that a mortgagor, not personally liable on the debt, who sells the property subject to the mortgage and for additional consideration, realizes a benefit in the amount of the mortgage as well as the boot… [W]e are no more concerned with whether the mortgagor is, strictly speaking, a debtor on the mortgage, than we are with whether the benefit to him is, strictly speaking, a receipt of money or property. We are rather concerned with the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations. If he transfers subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another.

* + - 1. The foregoing part of the opinion contains an infamous footnote. The footnote reads, “Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case.”[[19]](#footnote-20) It wasn’t until the *Tufts* case in 1983 that the Supreme Court affirmatively addressed the situation that arises when nonrecourse debt is not only in excess of basis but also fair market value of the property securing the debt.
      2. In *Tufts*, an individual builder and his wholly owned corporation formed a general partnership which purchased lots and constructed apartments for rental. On formation, no partner made any capital contributions, but the partnership secured a $1,851,500 nonrecourse mortgage to build the apartments. Subsequently, the builder admitted four friends and relatives as general partners, none of whom made any capital contributions. Over the next few years, the partners made relatively small capital contributions totaling $44,212 and took deductions for losses and depreciation of $439,972. The partnership became unprofitable due to layoffs by major employers in the area, and as a result, the partnership was unable to make the payments due on the debt. In August of 1972, each partner sold his partnership interest to a third party, receiving as consideration the purchaser’s assumption of the mortgage and reimbursement of each partner’s sale expenses (up to $250). The principal amount of the debt at the time of the sale was $1,851,500. The partners reported a total loss of $55,740, under the assumption the amount realized (and presumably the fair market value) was $1,400,000 with a sale of property having a basis of $1,455,740.
      3. As the opinion points out, the Code provides, “In the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.”[[20]](#footnote-21) To that end, section 1001 of the Code provides that gain on the “sale or other disposition of property”[[21]](#footnote-22) is defined as the excess of the amount realized over the adjusted basis. The amount realized is “the sum of any money received plus the fair market value of the property (other than money) received.”[[22]](#footnote-23) The issue in *Tufts* is what is the amount realized when there is a disposition of property encumbered by a nonrecourse mortgage that is in excess of the property’s fair market value.
      4. Without overruling *Crane*,[[23]](#footnote-24) the Supreme Court ruled that the amount realized includes the amount of nonrecourse debt assumed by the purchaser, even if that amount the value of the property. In coming to that conclusion, the Supreme Court pointed out that when a taxpayer obtains a loan (recourse or nonrecourse), because the purchaser takes on the obligation to repay the debt in the future, the receipt of the loan is not income to the taxpayer (and the repayment of the loan principal has no tax effect). Further, when debt is used to purchase property, because of the obligation to repay, the taxpayer is entitled to include the amount of the loan of the basis in the property. Under section 1012 of the Code, the loan is part of the taxpayer’s cost of the purchase of the property. *Crane* made clear that a nonrecourse loan is afforded the same treatment as a recourse loan. All of this assumes that the mortgage will be paid in full. As such, the Supreme Court concluded:

*Crane* teaches that the Commissioner may ignore the nonrecourse nature of the obligation in determining the amount realized upon disposition of the encumbered property. He thus may include in the amount realized the amount of the nonrecourse mortgage assumed by the purchaser. The rationale for this treatment is that the original inclusion of the amount of the mortgage in basis rested on the assumption that the mortgagor incurred an obligation to repay. Moreover, this treatment balances the fact that the mortgagor originally received the proceeds of the nonrecourse loan tax-free on the same assumption. Unless the outstanding amount of the mortgage is deemed to be realized, the mortgagor effectively will have received untaxed income at the time the loan was extended and will have received an unwarranted increase in the basis of his property.[[24]](#footnote-25)

* + - 1. Notably, in support of *Crane* and ultimately confirmed by *Tufts* in 1983, Treasury Regulations adopted in 1980 provide, “the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.”[[25]](#footnote-26) Notably, for purposes of the foregoing, the Treasury Regulations provide:
         1. “The sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability;”[[26]](#footnote-27)
         2. “A disposition of property includes a gift of the property or a transfer of the property in satisfaction of liabilities to which it is subject;”[[27]](#footnote-28) and
         3. “The fair market value of the security at the time of sale or disposition is not relevant for purposes of determining … the amount of liabilities from which the taxpayer is discharged or treated as discharged. Thus, the fact that the fair market value of the property is less than the amount of the liabilities it secures does not prevent the full amount of those liabilities from being treated as money received from the sale or other disposition of the property.”[[28]](#footnote-29)
      2. The *Crane* and *Tufts* decisions established critically important tax principles that have far reaching implications from an income tax planning standpoint. They establish that debt is included in the cost basis of property acquired, whether the purchaser assumes personal liability or not (recourse or nonrecourse is irrelevant). A sale, disposition, or other transfer of property subject to nonrecourse debt (whether a sale, gift, distribution, assignment or any other situation where a different taxpayer takes ownership of the property) is treated as a “sale or other disposition” under section 1001(a) of the Code. The amount realized on such “sale or other disposition” is the amount of the nonrecourse debt, even if such amount exceeds the fair market value of the property. Most importantly, there is gain to the transferor to the extent that debt is in excess of basis. These principles are incorporated throughout the Code. For example, taxpayers can trigger gain on contributions of appreciated property subject to debt to a controlled corporation in exchange for stock under section 351 of the Code[[29]](#footnote-30) and to partnerships in exchange for a partnership interest under section 721 of the Code.[[30]](#footnote-31)
    1. *Rothstein* and Rev. Rul. 85-13: Transactions with Grantor Trusts
       1. In *Rothstein v. United States*,[[31]](#footnote-32) the taxpayer held 300 shares of a corporation that built warehouses for rental. The taxpayer contributed the shares to an irrevocable trust for the benefit of his three children. The taxpayer’s wife was the trustee. A few years later, the taxpayer purchased the remaining 300 shares held by the other shareholder for $500,000, to be paid at a later date. Soon thereafter, the taxpayer then purchased from the trust the 300 shares he had originally contributed in exchange for an “unsecured promissory note” (in actuality, an installment note) for a principal amount of $320,000, bearing interest at 5%. A few months later, the taxpayer who now owned 100% of the shares of the corporation, dissolved the corporation, with all of the property of the corporation distributed to the taxpayer in liquidation. The taxpayer then replaced and refinanced the existing $200,000 mortgage with a $700,000 mortgage and used the excess $500,000 of loan proceeds to pay the other shareholder. On the taxpayer’s return, the taxpayer claimed deductions for $16,000 in interest on the promissory note to the trust and a short-term capital loss of $33,171 on the liquidation of the corporation.[[32]](#footnote-33)
       2. The IRS assessed a deficiency against the taxpayer based on a disallowance of the interest deduction and based upon a position that the liquidation resulted in a gain, not a loss. The IRS based both on the contention that the irrevocable trust was a grantor trust under section 675(3) of the Code. The foregoing provides that a grantor trust status is created if “[t]he grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. The preceding sentence shall not apply to a loan which provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor.”[[33]](#footnote-34) If the trust is a grantor trust, then under section 671 of the Code the grantor is treated as the “owner” of the property. As such, the IRS argued, the interest deduction should be disallowed, the sale by the trust should be ignored for income tax purposes, and as a result, the basis of the shares in the corporation on liquidation should be reduced by $320,000.
       3. The court agreed that the trust was a grantor trust under section 675(3). However, notwithstanding that, the court held for the taxpayer. In coming to that conclusion it examined what “ownership” under the grantor trust rules means. To wit, section 671 of the Code provides:

Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual.[[34]](#footnote-35)

Pursuant to a strict reading of the foregoing, the court concluded that “ownership” means that the trust’s income, deductions, and credits will be attributed to the grantor. As stated by the court:

Section 671 makes it plain that it was not Congress’s intention that the taxation of grantor/”owners” be governed by what might otherwise seem the sensible general principle that a taxpayer may not have meaningful dealings with himself. Rather, the statute envisions (1) that the income and deductions of the grantor and the trust will be computed in the normal fashion, the trust being treated as a fully independent taxpaying entity, and (2) that the relevant “items of income, deductions, and credits against tax” that would ordinarily appear on the trust’s return will instead “be included in computing the taxable income and credits of the grantor”. Nowhere does § 671 direct that the grantor’s basis in property purchased from the trust be deemed any different from what it would otherwise be, namely, his cost in acquiring it—in this case $320,000, the amount of taxpayer’s note. Nor does the statute contain anything authorizing the Commissioner to disallow an interest deduction on the ground that grantor’s payments were made to the trust. Consistently with the objective of *Clifford* to prevent high-bracket taxpayers from shifting income to low-bracket trusts over which they retain or exercise excessive controls, § 671 dictates that, when the grantor is regarded as “owner”, the trust’s income shall be attributed to him—this and nothing more.[[35]](#footnote-36)

* + - 1. Echoing the *Rothstein* ruling, Professor Jeffrey N. Pennell writes, as to grantor/grantor trust transactions being ignored for income tax purposes:[[36]](#footnote-37)

The Code and Regs, however, are not entirely consistent with that treatment. Instead, every grantor trust rule (§§673-677) begins by saying “The grantor shall be treated as the owner of any portion of a trust . . .” The significance of this is found in §671:

Where it is specified . . . that the grantor . . . shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor . . . those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust.

Notice that this does not mention losses, which are considered along with gains only in determining the trust’s income. This also does not say that an exchange with a grantor trust is not recognized, or that the trust is ignored…

In a nutshell, then, the tax attributes of a grantor trust are reported by the grantor on the grantor’s income tax return, as if the trust’s income (which includes net gain in excess of any offsetting losses), deductions, and credits belonged to the grantor.

The actual treatment, however, is as if the trust’s DNI was entirely taxable to the grantor. Losses would offset gains in the trust for this purpose, and gain that is attributed out to the grantor thus would be less. But excess losses are trapped in the trust by virtue of the rule in §642(h) ... And these results apply only to the extent the grantor is treated as the owner of the trust. It is not necessarily true for the entire trust, depending upon application of the portion rules.

As a result, the conclusion articulated by various authorities that the trust is “ignored” is not what either the Code or Regulations themselves actually specify. Yet the government itself makes pronouncements that are interpreted by taxpayers in a vast number of different situations to mean that a grantor trust is treated as if it did not exist. This especially is true involving transfers by a grantor into an intentionally defective grantor trust, based on the government’s ruling position that the grantor can have no gain or loss on a transfer involving the grantor trust — that an exchange between the grantor and the trust is not a gain or loss realization event.

* + - 1. Notwithstanding the foregoing, the IRS issued Revenue Ruling 85-13,[[37]](#footnote-38) and on facts similar to *Rothstein*, the IRS ruled the taxpayer in question did not obtain a new cost basis when he purchased the assets from the grantor trust. Specifically, the ruling provides:[[38]](#footnote-39)

In Rothstein, as in this case, section 671 of the Code requires that the grantor includes in computing the grantor’s tax liability all items of income, deduction, and credit of the trust as though the trust were not in existence during the period the grantor is treated as the owner. Section 1.671-3(a)(1) of the regulations. It is anomalous to suggest that Congress, in enacting the grantor trust provisions of the Code, intended that the existence of a trust would be ignored for purposes of attribution of income, deduction, and credit, and yet, retain its vitality as a separate entity capable of entering into a sales transaction with the grantor. The reason for attributing items of income, deduction, and credit to the grantor under section 671 is that, by exercising dominion and control over a trust, either by retaining a power over or an interest in the trust, or, as in this case, by dealing with the trust property for the grantor’s benefit, the grantor has treated the trust property as though it were the grantor’s property. The Service position of treating the owner of an entire trust as the owner of the trust’s assets is, therefore, consistent with and supported by the rationale for attributing items of income, deduction, and credit to the grantor.

The court’s decision in Rothstein, insofar as it holds that a trust owned by a grantor must be regarded as a separate taxpayer capable of engaging in sales transactions with the grantor, is not in accord with the views of the Service.

* + - 1. The estate planning implications of Revenue Ruling 85-13 are far reaching. Most notably, it has given rise to installment sales to intentionally defective grantor trusts (IDGTs)—trusts that are grantor trusts for income tax purposes but the assets of which will not be includible in the estate of the grantor.[[39]](#footnote-40) Installment sales to IDGTs allow grantors to “sell” appreciated assets, often with valuation discounts applied to the purchase price, in exchange for an installment note bearing interest at the applicable federal rate (AFR).[[40]](#footnote-41) The estate planning result of this transaction is the grantor owning an asset that is “frozen” in value (principal amount of the note, the return on which is generally at a low interest rate) and all future appreciation on the asset removed from the gross estate of the grantor. All of this is accomplished without any income tax implications as long as the grantor is still alive and grantor trust status is maintained at least until the note is satisfied. It has also given rise to transactions between beneficiaries and their beneficiary deemed owner trusts[[41]](#footnote-42) (BDOTs) or beneficiary deemed inheritor’s trust (BDITs)[[42]](#footnote-43)—trusts the assets of which are not includible in the estate of the beneficiary but which are deemed “owned” by the beneficiary under section 678 of the Code.[[43]](#footnote-44) Unless and until the IRS revokes Revenue Ruling 85-13, it is obligated to follow its published rulings.[[44]](#footnote-45) More importantly for purposes of these materials, the IRS has not definitively ruled on a number of critical income tax issues: (i) what is the basis of assets sold to an IDGT when grantor trust status is terminated due to the death of the grantor?; (ii) is there a taxable event if grantor trust status is terminated due to the death of the grantor and the IDGT holds assets with debt in excess of basis?; and (iii) if an IDGT holds a promissory note from the grantor and grantor trust status is terminated, what is the basis of the promissory note?
  1. Capital Asset, Like a Capital Asset, or Just Ordinary?
     1. Introduction
        1. In addition to tax basis (which is discussed in more detail later in these materials), one of the most important income tax concepts and determinations is whether a sale or exchange of property will result in a capital gain or loss. For non-corporate taxpayers (individuals, trusts, and estates) the Code makes a distinction between gains or losses with respect to “capital assets” and ordinary income (including ordinary gains and losses). Historically and today, capital gains (particularly gains on a capital asset that has been held for more than one year, a “long-term,” as opposed to a “short-term” capital asset[[45]](#footnote-46)) have been afforded preferential tax treatment. Currently, the top Federal long-term capital gain rate is 20%,[[46]](#footnote-47) which is significantly lower than the top ordinary income tax rate of 37%.[[47]](#footnote-48)
        2. For estate planning clients, particularly if the clients are not involved in an active trade or business, most personal and investment assets (stocks, bonds, artwork, collectibles, residences, real property, etc.) will be capital assets. Depending on the nature of the capital asset, it may be taxed at a different capital gain tax rate, like artwork or other collectibles which are taxed at 28%.[[48]](#footnote-49) As discussed later in these materials, sales or exchanges of certain capital assets with related parties will be taxed at ordinary rates. Other times, an asset that initially starts as a capital asset, will be taxed as inventory, depending on the activities of the client (investor v. dealer), which is also taxed at ordinary rates.
        3. Capital asset characterization is not elective.[[49]](#footnote-50) Generally, capital gain tax treatment is preferable when there is gain from the sale or exchange of an asset, and when there is a loss, it is preferable that the asset be an ordinary asset (not a capital asset). That is an oversimplification because, for example, the Code provides for a netting of long-term capital gains and losses and short-term capital gains and losses in the calculation of a non-corporate taxpayer’s tax liability each taxable year.[[50]](#footnote-51) Thus, for example, if an individual taxpayer has significant long-term capital gains in one year, it is advantageous to have short-term capital losses to offset the gain for that taxable year.
     2. Capital Asset Defined
        1. Section 1221(a) of the Code defines a capital asset by exclusion. It provides, a “capital asset” is property held by the taxpayer (whether or not connected with his trade or business), but then excludes certain categories of property. The categories of excluded property most relevant to these materials include:
           1. Stock in trade, property includible in inventory, or property held primarily for sale to customers in the ordinary course of business;[[51]](#footnote-52)
           2. Depreciable property (defined in section 167 of the Code) or real property used in a trade or business;[[52]](#footnote-53)
           3. A patent, invention, model or design, secret formula or process, copyright, a literary, musical, or artistic composition, or a letter or memorandum or similar property held by its creator (or certain transferees in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of the creator);[[53]](#footnote-54) and
           4. Accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of inventory-like property.[[54]](#footnote-55)
        2. The first category of property excluded from the definition of capital asset—stock in trade, inventory, property held primarily for sale to customers in the ordinary course of business—is meant, generally, to distinguish between profits and losses generated in the normal course of business, as opposed to gains and losses realized on property due to appreciation or depreciation in value over a period of time. In some circumstances, for example, for taxpayers invested in the stock market, it is the difference between being considered a dealer or trader, as opposed to an investor. The determination is based on the facts and circumstances surrounding the property and the taxpayer in question. For example, the courts have held the difference between real property held for investment purposes (capital asset) as opposed to held for sale to customers in the ordinary course of business is determined by a number of factors including: (i) the nature and purpose of the acquisition of the property; (ii) duration of ownership; (iii) the frequency and substantiality of sales; (iv) the extent of taxpayer’s efforts in subdividing, developing and advertising the property; (v) whether the taxpayer used a business office or selling agents; and (vi) the time and effort spent by the taxpayer in sales.[[55]](#footnote-56)

* + - 1. When property is acquired by gift or bequest, the probability that the property will be considered a capital asset goes up, notwithstanding the activities of the donor of the property. Because the donee or beneficiary did not purchase the property, the courts seem to be more inclined to allow capital treatment to a sale or exchange, particularly if the sale or exchange is to liquidate the gift or inheritance.[[56]](#footnote-57) On the other hand, if the donee or beneficiary proceeds to subdivide, make improvements, and perform such other functions that are similar to a real property developer, then capital gain tax treatment could be lost.[[57]](#footnote-58)
    1. Taxed Like a Capital Asset: Section 1231 Property
       1. As mentioned above, section 1221(a)(2) of the Code excludes from capital treatment depreciable property or real property used in a trade or business. Notwithstanding the foregoing, section 1231(a) of the Code, in a roundabout manner, provides “section 1231 gains” and “section 1231 losses” will be treated as “gains and losses from sale or exchanges of capital assets.”[[58]](#footnote-59) Section 1231 gains and losses result from the sale or exchange of “property used in the trade or business,”[[59]](#footnote-60) which in turn is defined as depreciable or real property that is used in the taxpayer’s trade or business and held for more than one year, which is not (echoing the excluded list of properties that would not be considered capital assets under section 1221(a)(1)): inventory, property held primary for sale to customers in the ordinary course of business, patent, invention, model or design, secret formula, process, copyright, etc.[[60]](#footnote-61) This type of property is often referred to as “section 1231 property.” The Code specifically provides that section 1231 property will include timber, coal, iron ore, livestock (but not poultry), and unharvested crops.[[61]](#footnote-62)
       2. In the context of these materials, an issue that often arises is whether the property is being used in a trade or business and if it is, in part, being used for personal use. Gain or loss from the sale of property held partly for business us and partly for personal use must be allocated between the two uses.[[62]](#footnote-63) Under section 165(c)(1) of the Code, individuals may deduct only losses incurred in a trade or business, and section 1231(a)(3)(B) of the Code defines section 1231 losses as those arising from the sale or exchange of certain property held in a trade or business. Section 1231(b) of the Code defines property used in the trade or business as being of a character which is subject to the allowance for depreciation. Sections 165 and 1231 of the Code prevent the deduction of the portion of a loss that is properly allocable to personal use. As such section 1231 of the Code also does not apply to gains from the disposition of property held for personal use.[[63]](#footnote-64)
       3. When a taxpayer acquires property by gift or bequest is not indicative of whether the property will continue to be or will become section 1231 property. It all depends on what the recipient taxpayer does with the property.[[64]](#footnote-65) The courts have ruled that if a decedent used property as a personal residence but the beneficiary-recipient uses the property in a trade or business (i.e., rental property), a subsequent disposition of the property would qualify as a sale of section 1231 property.[[65]](#footnote-66)
       4. Section 1231 of the Code applies to depreciable property, which can be tangible or intangible property, if held for more than one year, used in the taxpayer's trade or business (or held for the production of income) and is property “of a character which is subject to the allowance for depreciation provided in section 167.”[[66]](#footnote-67) It must have a useful life of at least one year and a maximum useful life that can be calculated with reasonable accuracy.[[67]](#footnote-68) Most tangible assets (not including land) are allowed depreciation deductions if the assets are used in a trade or business held for the production of income.[[68]](#footnote-69) These deductions are meant to represent a reasonable allowance for exhaustion, wear, tear, and obsolescence. Revenue Ruling 87-56[[69]](#footnote-70) provides a helpful list of types of tangible property for which depreciation deductions are allowable, including: (i) buildings, (ii) improvements made or added directly to land (e.g., sidewalks, fencing, etc.), (iii) business furniture or fixtures that are not structural components of the building, (iv) machinery and equipment used in the trade or business, and (v) automobiles and trucks. The intangible assets eligible to be section 1231 property are generally described in section 197 of the Code. The “depreciation” deductions are actually “amortization” deductions under section 197(a) of the Code, and such amortizable assets are deductible ratably over a 15-year period.[[70]](#footnote-71) Pursuant to section 197(f) of the Code, any amortizable “section 197 intangible” is treated as property of a character that is subject to depreciation. The IRS has published an instructive list of section 197 intangibles that would qualify as section 1231 property and it includes goodwill, trade names, trademarks, customer lists, etc.[[71]](#footnote-72)
    2. Holding Period
       1. As mentioned herein, the time during which a taxpayer has held or owned an asset can be a critical factor in determining the resulting tax liability on the sale or exchange of that asset. Section 1222 provides if a capital asset is held for more than one year, gain or loss is treated as long-term capital gain or loss.[[72]](#footnote-73) Further, if a capital asset is held for one year or less, gain or loss is treated as short-term capital gain or loss.[[73]](#footnote-74) The primary benefit of having a long-term holding period on a capital asset (or section 1231 property) is that gain from the sale or exchange of the asset is eligible to be taxed at the preferential tax rate of 20%.[[74]](#footnote-75)
       2. There are many instances in the Code where one taxpayer’s holding period can be transferred to and included as part of another taxpayer’s holding period. This is often referred to as “tacking” of a holding period. Section 1223(2) of the Code says in determining the holding period for which a taxpayer has held property, the taxpayer can include the period for which the property was held by another person if the property has “for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.”[[75]](#footnote-76) A common example in estate planning is when a donor makes a gift of appreciated property to a donee. Gifted property has a carryover basis under section 1015 of the Code.
       3. Tacking also applies to tax-free exchanges of property under sections 351 (contributions of property in exchange for shares of stock in a controlled corporation), 355 (distributions of stock of a controlled corporation), 721 (contributions of property in exchange for a partnership interest), 1031 (like-kind exchange), and 1033 (involuntary conversions). In the foregoing tax-free exchanges, what holding period does the taxpayer have in the exchanged property received (e.g., stock or partnership interest)? Section 1223(1) of the Code provides, “In determining the period for which the taxpayer has held property received in an exchange, there shall be included the period for which he held the property exchanged if … the property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged, and, in the case of such exchanges the property exchanged at the time of such exchange was a capital asset as defined in section 1221 or property described in section 1231.”[[76]](#footnote-77) In other words, the taxpayer’s holding period in the property received in the exchange is the same as the property transferred by the taxpayer. This is often referred to as a “carryover” holding period.
       4. A person acquiring property from a decedent whose basis is determined under section 1014 of the Code is considered as being held by the person for more than one year, regardless of how long the decedent held the property.[[77]](#footnote-78) Therefore, any post-death gains or losses will be treated as long-term gains or losses, even if the property is sold within one year of the decedent's death.
  1. Related Party Rules and Transactions
     1. Generally
        1. Because transactions between related parties (family members and controlled entities) are easily manipulated to create gain or loss, shift income, or otherwise save overall income tax liability, as desired, without truly changing the economic position of the family as whole, Congress enacted a number of Code provisions to curb certain transactions that were deemed abusive. As such, any transaction between and among family members and their entities need to be filtered through these “related party” provisions to determine whether the desired tax result can be achieved.
        2. Notwithstanding the specific “related party” Code provisions discussed in these materials, the IRS may also rely on non-statutory principles like substance-over-form, step-transaction, and sham-transaction doctrines to recast certain transactions among and between related parties.[[78]](#footnote-79) Some mention should be made about the codification of the economic substance doctrine under section 7701(o) of the Code.[[79]](#footnote-80) 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.”[[80]](#footnote-81) 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.”[[81]](#footnote-82) 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.

* + 1. Section 267: Disallowance of Losses Between Related Parties
       1. Section 267(a)(1) of the Code provides, “No deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in any of the paragraphs of subsection (b). The preceding sentence shall not apply to any loss of the distributing corporation (or the distributee) in the case of a distribution in complete liquidation.”[[82]](#footnote-83) The disallowance of a loss is determined on an asset-by-asset basis. In other words, if a transaction involves a sale or exchange of several properties, there is no netting of gains against losses.[[83]](#footnote-84) That being said, section 267(d) of the Code, under certain circumstances, permits losses previously disallowed to be netted against gains on the subsequent sale of the same asset.[[84]](#footnote-85) Section 267(a)(1) of the Code does not apply to any transfer described in section 1041(a) of the Code, which provides no gain or loss shall be recognized on a transfer of property to a spouse or former spouse (but only if incident to a divorce).[[85]](#footnote-86)
       2. As mentioned above, pursuant to section 267(d) of the Code, if a taxpayer acquires property by purchase or exchange from a transferor who sustained a loss that was disallowed under section 267(a)(1), then any gain realized by the taxpayer on the subsequent sale or other disposition of the property is recognized only to the extent that the gain exceeds the amount of the loss as is properly allocable to the property.[[86]](#footnote-87) In short, it’s the previously disallowed loss offset rule, which only serves to offset potential gain and can’t be used to recognize a loss. This rule also applies to sale or disposition of property (i.e., partnership interest) by the taxpayer if the taxpayer’s basis is determined directly or indirectly by reference to other property acquired by the taxpayer (i.e., property contributed to a partnership under section 721 of the Code in exchange for the partnership interest) from a transferor through a sale or exchange in which a loss sustained by the transferor was disallowed.[[87]](#footnote-88) This rule, however, does not apply under certain circumstances. It does not apply “to the extent any loss sustained by the transferor (if allowed) would not be taken into account in determining a tax imposed under section 1 or 11 or a tax computed as provided by either of such sections”[[88]](#footnote-89) (i.e., tax exempt entity). It also does not apply to any transferee (for example, a done or a person acquiring property from a decedent where basis is determined under section 1014 of the Code) who acquired the property in any manner other than by purchase or exchange.[[89]](#footnote-90) The Treasury Regulations contain a set of good examples about how this rule applies:[[90]](#footnote-91)

Example 1

H sells to his wife, W, for $500, certain corporate stock with an adjusted basis for determining loss to him of $800. The loss of $300 is not allowable to H by reason of section 267(a)(1) and paragraph (a) of § 1.267(a)-1. W later sells this stock for $1,000. Although W’s realized gain is $500 ($1,000 minus $500, her basis), her recognized gain under section 267(d) is only $200, the excess of the realized gain of $500 over the loss of $300 not allowable to H. In determining capital gain or loss W’s holding period commences on the date of the sale from H to W.

Example 2

Assume the same facts as in example (1) except that W later sells her stock for $300 instead of $1,000. Her recognized loss is $200 and not $500 since section 267(d) applies only to the nonrecognition of gain and does not affect basis.

Example 3

Assume the same facts as in example (1) except that W transfers her stock as a gift to X. The basis of the stock in the hands of X for the purpose of determining gain, under the provisions of section 1015, is the same as W’s, or $500. If X later sells the stock for $1,000 the entire $500 gain is taxed to him.

Example 4

H sells to his wife, W, for $5,500, farmland, with an adjusted basis for determining loss to him of $8,000. The loss of $2,500 is not allowable to H by reason of section 267(a)(1) and paragraph (a) of § 1.267 (a)-1. W exchanges the farmland, held for investment purposes, with S, an unrelated individual, for two city lots, also held for investment purposes. The basis of the city lots in the hands of W ($5,500) is a substituted basis determined under section 1031(d) by reference to the basis of the farmland. Later W sells the city lots for $10,000. Although W’s realized gain is $4,500 (10,000 minus $5,500), her recognized gain under section 267(d) is only $2,000, the excess of the realized gain of $4,500 over the loss of $2,500 not allowable to H.

* + - 1. Section 267(a)(1) applies to indirect sales or exchanges, but the Code and the Treasury Regulations are silent as what would be considered indirect sales or exchanges. The courts have disallowed losses under section 267 (or a predecessor section) in a wide variety of circumstances including:
         1. Sales and purchases of the same securities among (but not between) a husband’s and wife’s separate accounts;[[91]](#footnote-92)
         2. Sale of stock by husband and wife to a friend who then sold the stock back to them at the same price;[[92]](#footnote-93)
         3. Involuntary sale of property at a public auction to the taxpayer’s spouse or family members;[[93]](#footnote-94) and
         4. Repurchase of stock by taxpayer’s controlled corporation after the fact that the stock had been foreclosed upon by the seller who was the taxpayer’s creditor.[[94]](#footnote-95)
      2. The persons referenced above (related parties) include:[[95]](#footnote-96)
         1. Members of a family, which is defined as including brothers and sisters (including half siblings), spouse, ancestors, and lineal descendants;[[96]](#footnote-97)
         2. An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;
         3. Two corporations which are members of the same controlled group (as defined in section 1563(a) of the Code but with “more than 50 percent” substituting for “at least 80 percent”);[[97]](#footnote-98)
         4. A grantor and a fiduciary of any trust;
         5. A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;
         6. A fiduciary of a trust and a beneficiary of such trust;
         7. A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;
         8. A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;
         9. A person and a tax exempt organization under section 501 of the Code and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual;
         10. A corporation and a partnership if the same person owns more than 50 percent in value of the outstanding stock of the corporation and more than 50 percent of the capital interest, or the profits interest, in the partnership;
         11. An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation;
         12. An S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation; and
         13. An executor of an estate and a beneficiary of such estate, except in the case of a sale or exchange in satisfaction of a pecuniary bequest.
      3. Constructive ownership rules in section 267(c) will cause stock owned by one related party to be deemed owned by another. As mentioned above, an individual and a corporation are considered to be related to the extent that the individual owns, directly or indirectly, more than 50% of the value of all of the corporation’s outstanding stock.[[98]](#footnote-99) For this determination, the constructive ownership rules reattribute direct and indirect ownership of certain other shareholders to the shareholder being tested for related party status:[[99]](#footnote-100)
         1. Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;
         2. An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family— brothers and sisters (including half siblings), spouse, ancestors, and lineal descendants;
         3. An individual owning (but not including any stock owned directly or indirectly by or for his family) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner; and
         4. In applying the foregoing, stock constructively owned by a person by reason of the application of (1) above shall be treated as actually owned by such person, but stock constructively owned by an individual by reason of the application of (2) or (3) above shall not be treated as owned by him for the purpose of again applying either of such paragraphs in order to make another the constructive owner of such stock.
    1. Section 707(b): Sales or Exchanges of Property with Controlled Partnerships
       1. Section 707(b)(1) of the Code provides, “No deduction shall be allowed in respect of losses from sales or exchanges of property (other than an interest in the partnership), directly or indirectly, between[[100]](#footnote-101)—a partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest, or the profits interest, in such partnership, or[[101]](#footnote-102)—two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests.”[[102]](#footnote-103) The loss is treated the same way as a disallowed loss under section 267(a)(1) of the Code, described above. As such, under section 267(d) of the Code, the disallowed loss may be allowed if the transferee subsequently sells the property at a gain.[[103]](#footnote-104)
       2. Section 707(b)(2) of the Code provides, “In the case of a sale or exchange, directly or indirectly, of property, which in the hands of the transferee, is property other than a capital asset as defined in section 1221—between a partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest, or profits interest, in such partnership, or[[104]](#footnote-105)—between two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests,[[105]](#footnote-106) any gain recognized shall be considered as ordinary income.” [[106]](#footnote-107) This provision recharacterizes gain, typically converting what would be considered capital gain in the hands of the transferor to ordinary income based upon how the property would be treated in the hands of the transferee. By way of example, the transferor-partner sells real property held for investment for a gain to a controlled partnership that is a dealer in the purchased real property. The transferor partner’s gain is taxed at ordinary rates.
       3. The constructive ownership rules of section 267(c)(1), (c)(2), (c)(4), and (c)(5) of the Code are applied to determine the capital or profit interest percentage in the partnership.[[107]](#footnote-108) As a result, the capital or profits interest owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is considered to be owned proportionately by or for its shareholders, partners, or beneficiaries. In addition, an individual is considered to own the stock owned, directly or indirectly, by or for his family—brothers and sisters (including half siblings), spouse, ancestors, and lineal descendants. The capital or profit interest attributed to family members may be reattributed to family members.[[108]](#footnote-109)
       4. It should be noted that section 707(b)(1) of the Code is applied in conjunction with section 267(a)(1) of the Code, the latter having a broader applicability. By way of example, Partner A owns 1/3 of the capital and profits interest in Partnership ABC. Brother of Partner A sells property to Partnership ABC at a net loss of $900. The loss is not disallowed under section 707(b)(1) because it is not a “controlled partnership” due to brother’s interest under the constructive ownership rules being less than 50% (1/3 interest). However, any transaction described in section 267(a)(1) between a partnership and a person other than a partner is considered a transaction with the seller and each of the members of the partnerships.[[109]](#footnote-110) As such, 1/3 of the loss ($300 loss from the deemed 1/3 sale from sister to Partner A) is disallowed under section 267(a)(1) of the Code.

* + 1. Section 108: Cancellation of Debt and Related Party Acquisitions
       1. The Code provides gross income includes “income from the discharge of indebtedness,”[[110]](#footnote-111) sometimes referred to as cancellation of debt (COD) income. If a debtor owes the bank $10,000, but negotiates with the bank to settle his entire obligation for the repayment of $9,000, the debtor has $1,000 of COD income. If, on the other hand, the spouse of the debtor acquires the debt from the bank for $9,000, does the debtor still have $1,000 of COD income? The Code provides that this will be deemed COD income to the debtor. Section 108(e)(4)(A) of the Code provides, “For purposes of determining income of the debtor from discharge of indebtedness,… the acquisition of outstanding indebtedness by a person bearing a relationship to the debtor specified in section 267(b) or 707(b)(1) from a person who does not bear such a relationship to the debtor shall be treated as the acquisition of such indebtedness by the debtor.”[[111]](#footnote-112)
       2. The related persons are defined by cross reference to sections 267 and 707(b) of the Code, but with some notable modifications. First, family is modified to include only a person’s spouse, children, grandchildren, parents, and any spouses of the person’s children or grandchildren.[[112]](#footnote-113) Note, that brothers and sisters are not included. So, in the example above, if the brother had acquired the debt from the bank, the debtor would not have COD income at the time of acquisition.
       3. In addition, the Code further provides that “two entities which are treated as a single employer under subsection 414(b) or 414(c) of section 414 shall be treated as bearing a relationship to each other which is described in section 267(b).”[[113]](#footnote-114) Section 414(b) of the Code applies to members of a controlled group of corporations. Section 414(c) of the Code applies to partnerships, proprietorships, trades or businesses (whether or not incorporated) that are under common control. These include parent-subsidiary groups, brother-sister groups, or combined groups of trades or businesses under common control.[[114]](#footnote-115) A complete discussion of these rules are beyond the scope of these materials. But in summary, a controlling interest is determined differently if the organization is a corporation, trust or estate, partnership, or sole proprietorship. [[115]](#footnote-116) Further, common control is determined differently depending on the type of group (i.e., parent-subsidiary v. brother-sister).[[116]](#footnote-117) Finally, very specific constructive ownership rules apply to direct and indirect ownership by and among individuals, spouses, partners, shareholders, beneficiaries, partnerships, corporations, trusts, and estates.[[117]](#footnote-118)
       4. Section 108(e)(4)(A) applies to both direct and indirect acquisitions of indebtedness.[[118]](#footnote-119) A direct acquisition occurs when the debt is acquired from a person who is not related to the debtor by a person related to the debtor, or a person who becomes related to the debtor on the date the debt is acquired.[[119]](#footnote-120) An indirect acquisition occurs when the owner of the debt anticipates becoming related to the debtor when the debt is acquired and actually becomes related to the debtor.”[[120]](#footnote-121) While determined based on all the facts and circumstances, there is a presumption that the holder of the debt acquired the debt in anticipation of becoming related to the debtor if the holder becomes related to the debtor within six months of the date of acquisition.[[121]](#footnote-122)
    2. Other Notable Related Party Provisions
       1. Section 336(a) of the Code provides, “gain or loss shall be recognized to a liquidating corporation on the distribution of property in complete liquidation as if such property were sold to the distributee at its fair market value.”[[122]](#footnote-123) However, no loss will be recognized to a liquidating corporation on the distribution of any property to a related person (within the meaning of section 267 of the Code, without any modifications) if (i) the distribution is not pro rata, or (ii) the distributed property is disqualified property.[[123]](#footnote-124) As such, if the liquidating distribution results in the loss property being distributed to the related person in proportion to the related parties ownership in the corporation, then the loss is allowable. Disqualified property is defined as “any property which is acquired by the liquidating corporation in a transaction to which section 351 applied, or as a contribution to capital, during the 5-year period ending on the date of the distribution.”[[124]](#footnote-125) The foregoing also includes any other property “if the adjusted basis of such property is determined (in whole or in part) by reference to the adjusted basis” of disqualified property, as defined above. In other words, it would include any other property received, for example, in a like-kind exchange under section 1031 of the Code, or pursuant to a contribution of property in exchange for a partnership interest under section 721 of the Code.
       2. Section 1033 of the Code generally provides gain is not recognized from an involuntary conversion, including if the property in question is compulsorily or involuntarily converted (including the “destruction, theft, seizure, requisition, or condemnation of the converted property, or the sale or exchange of such property under threat or imminence of requisition or condemnation”[[125]](#footnote-126)). Non-recognition under section 1033 does not apply if the replacement property or stock acquired is from a related person (within the meaning of sections 267(b) or 707(b) of the Code, without any modifications[[126]](#footnote-127)).[[127]](#footnote-128) If, however, during the 2-year period within which converted property must be replaced,[[128]](#footnote-129) the related person acquired the property or stock from an unrelated person, then the acquisition is treated as an acquisition from an unrelated person.[[129]](#footnote-130)
       3. Under section 1031 of the Code, like-kind exchange treatment between related parties are non-recognition events.[[130]](#footnote-131) If, however, the taxpayer or the related party “disposes” of the property received in the exchange within 2 years of the last transfer, then both the taxpayer and the related party must recognize gain or loss with respect to the exchange property.[[131]](#footnote-132) For purposes of the foregoing, the following do not trigger gain and loss: (i) any disposition after the earlier of the deaths of the taxpayer or the related person, (ii) disposition in a compulsory conversion under section 1033 of the Code if the exchange occurred before the threat or imminence of such conversion, or (iii) any disposition “with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax.”[[132]](#footnote-133)
       4. Section 1239(a) of the Code provides, “In the case of a sale or exchange of property, directly or indirectly, between related persons, any gain recognized to the transferor shall be treated as ordinary income if such property is, in the hands of the transferee, of a character which is subject to the allowance for depreciation provided in section 167.”[[133]](#footnote-134) Section 1239 has its own definition of “related persons” but borrows the constructive ownership rules of section 267(c) of the Code. The definition describes “related persons” in three broad categories of relationship: (i) a person and all “controlled entities” with respect to such person; (ii) a taxpayer and any trust in which the taxpayer (or spouse) is a beneficiary (unless the interest is a remote contingent interest[[134]](#footnote-135)); and (iii) an executor of an estate and a beneficiary of such estate (other than a sale or exchange in satisfaction of a pecuniary bequest).[[135]](#footnote-136) As to controlled entity relationships, persons are related if the following relationships exist (in all instances, ownership is determined measuring actual as well as constructive ownership under Section 267(c) of the Code):[[136]](#footnote-137)
          1. A shareholder and a corporation that more than 50% of the stock of which is owned directly or indirectly by or for that shareholder;
          2. A partner and a partnership that more than 50% of the capital interest or profit interest in which is owned directly or indirectly by or for that partner;
          3. Two corporations that are members of the same controlled group;
          4. A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation, and more than 50% of the capital interest, or the profits interest, in the partnership;
          5. An S corporation and another S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation; and
          6. An S corporation and a C corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation.

1. CURRENT INCOME AND ESTATE PLANNING LANDSCAPE
   1. Tax Cuts and Jobs Act
      1. Permanence and Expiration
         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”[[137]](#footnote-138) act, more commonly known as the “Tax Cuts and Jobs Act” (“TCJA”) became law. TCJA makes significant changes to the U.S. income tax system including reducing the top income tax rate 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.
         2. A complete discussion of the TCJA is beyond the scope of this outline, but a number of significant changes were made to the income and transfer taxation of individuals and partnerships, disregarded entities, and other non-corporate entities. These are discussed in detail in these materials.
         3. Unless otherwise indicated, all changes are effective for tax years beginning after December 31, 2017, and most of the provisions will expire after December 31, 2025, due to the “Byrd rule,”[[138]](#footnote-139) as adopted by the U.S. Senate, which require the affirmative vote of three-fifths of the members (60 Senators if no seats are vacant), which did not occur with TCJA. Thus, most of the provisions of TCJA will “sunset,” reverting back to the law that was in place when the provisions were enacted (as discussed later in these materials).
      2. Pertinent Changes to the Income Taxation of Individuals and Trusts
         1. TCJA adds subsection 1(j) to the Code, which temporarily decreases the highest Federal ordinary income tax rate from 39.6% to 37% (in 2021, for individual taxpayers with taxable income over $523,600, married individuals filing joint returns with taxable income over $628.300, and trusts and estates with taxable income over $13,050, all subject to annual inflation adjustments).[[139]](#footnote-140)
         2. TCJA temporarily increases the standard deduction in 2021 to $12,550 for single filers and $25,100 for joint return filers,[[140]](#footnote-141) but also temporarily limits the deduction for state and local sales, income, or property tax to $10,000.[[141]](#footnote-142)
         3. TCJA adds new subsection 67(g) of the Code that temporarily suspends all miscellaneous itemized deductions that are subject to the 2 percent of adjusted gross income floor (for example, unreimbursed employee expenses, tax preparation fees, and other expenses to produce or collect income or expenses to manage, conserve, or maintain property held to produce income).[[142]](#footnote-143)
         4. Effective as of 2018, TCJA permanently amends the measure of inflation used for indexing of both income and transfer tax purposes, relying on “chained CPI” (Chained Consumer Price Index for All Urban Consumers or C-CPU-I) rather than CPI (CPI-U) used prior to the enactment of TCJA.
      3. Pertinent Changes to Transfer Taxation
         1. Temporary Doubling of Transfer Tax Exclusions/Exemptions
            1. Effective for estates of decedents dying and gifts made after December 31, 2017, TCJA adds new subparagraph section 2010(c)(3) to the Code that temporarily doubles the basic exclusion amount from $5 million to $10 million, which means, as adjusted for inflation, the basic exclusion amount (or BEAT) for 2021 is $11.70 million per person.[[143]](#footnote-144)
            2. As a result, the GST tax exemption amount for 2021 will also be $11.70 million per person.[[144]](#footnote-145)
         2. Clawback and Anti-Clawback Regulations
            1. In order to address the issue of “clawback” (the risk that prior gifts covered by a gift tax exclusion that is greater than the estate tax exclusion available at the time of death, thereby giving rise to the risk of an additional estate tax liability), TCJA adds section 2001(g)(2) of the Code, which provides, “The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out this section with respect to any difference between—(A) the basic exclusion amount under section 2010(c)(3) applicable at the time of the decedent’s death, and (B) the basic exclusion amount under such section applicable with respect to any gifts made by the decedent.”[[145]](#footnote-146)
            2. The estate tax calculation under section 2001(b) of the Code starts with a tentative tax on the combined amount of the taxable estate and adjusted taxable gifts (i.e., gifts made after 1976 that are not brought back into the gross estate) without any reduction due to credits. [[146]](#footnote-147) From that amount, section 2001(b)(2) of the Code says to subtract the amount of gift tax that would have been payable if the rate schedule in effect at the decedent’s death had been applicable at the time of the gifts.[[147]](#footnote-148) The Code does not make clear, in this part of the calculation, whether to use the unified credit amount that was applied at the time of the gift or apply the credit amount available at death, which is where the risk of clawback theoretically occurs.[[148]](#footnote-149) The final step in the estate tax calculation applies the estate tax applicable credit amount.
            3. On November 26, 2019, the IRS issued final Treasury Regulations[[149]](#footnote-150) (the “Anti-Clawback Regulations”) to “solve” the risk of clawback. The Anti-Clawback Regulations adopt the rule initially proposed in 2018[[150]](#footnote-151) and provides:[[151]](#footnote-152)

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

* + - * 1. The “solution” in the Anti-Clawback Regulations is to revise the unified credit against the estate tax under section 2010 of the Code, rather than the hypothetical gift tax under section 2001 of the Code. The preamble to the proposed Treasury Regulations published in 2018 asserts this approach was the “most administrable solution.”[[152]](#footnote-153) The preamble to the proposed Treasury Regulations describes a 5-step process for calculating the Federal estate tax. The first three steps determine the net tentative tax due (tax on the gross estate reduced by gift tax calculated on taxable gifts after 1976, reduced by all credits available on such gifts). Step 4 requires a determination of the allowable estate tax credit equal to the applicable exclusion amount in effect at the date of death. To address clawback, the preamble explains that the Anti-Clawback Regulations modify the amount in Step 4 such that “As modified, Step 4 of the estate tax determination therefore would require the determination of a credit equal to the tentative tax on the AEA[[153]](#footnote-154) as in effect on the date of the decedent’s death, where the BEA[[154]](#footnote-155) included in that AEA is the larger of (i) the BEA as in effect on the date of the decedent’s death under section 2010(c)(3), or (ii) the total amount of the BEA allowable in determining Step 2 of the estate tax computation (that is, the gift tax payable).”[[155]](#footnote-156) As explained by a 2018 release, “the proposed regulations provide a special rule that allows the estate to compute its estate tax credit using the higher of the BEA applicable to gifts made during life or the BEA applicable on the date of death.”[[156]](#footnote-157)
        2. The practical effect of the foregoing “solution” is that in order for taxpayers to take advantage of the temporary increase in the basic exclusion amount under TCJA, taxpayers must first make a taxable gift that exhausts the original basic exclusion amount, or potentially the taxpayer’s applicable exclusion amount. In other words, there is no opportunity for taxpayers to make a taxable gift of $5.85 million (the temporary increase amount for 2019) “off the top” and still preserve the original $5.85 million of exclusion that existed prior to the enactment of TCJA. The preamble to the Anti-Clawback Regulations provides:[[157]](#footnote-158)

Specifically, the increased BEA[[158]](#footnote-159) as adjusted for inflation is a “use or lose” benefit and is available to a decedent who survives the increased BEA period only to the extent the decedent “used” it by making gifts during the increased BEA period. The final regulations include Example 2 in § 20.2010-1(c)(2)(ii) to demonstrate that the application of the special rule is based on gifts actually made, and thus is inapplicable to a decedent who did not make gifts in excess of the date of death BEA as adjusted for inflation.

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

* + - * 1. For clients with taxable estates equal to or less than the original BEA, there is no need to make any taxable gifts (other than, perhaps, annual exclusion gifts). As discussed later in these materials, preserving the BEA for estate tax purposes in order to get a “free” step-up in basis on assets is recommended for these clients. For the ultra-wealthy with taxable estates far in excess of the temporarily doubled BEA, large taxable gifts that exhaust the original BEA and the temporary increase are likely to be the best advice. For the “middle class” wealthy, roughly defined as individuals with taxable estates of $5.85 million to $25 million (married couples with $11.70 to $50 million), the advice is much more complicated, highly dependent on a number of factors including whether the client can afford to make a gift in excess of the original BEA in order to get the transfer tax benefit of the temporary increase under TCJA. To that end, practitioners should consider spousal lifetime access trusts, preferred partnership freezes (i.e., retention of the preferred interest and transfer of the common interest), or other similar planning techniques that might allow the taxpayer indirect (or direct) access to gifted assets if needed. In addition, for married clients, careful consideration should be given to whether to make a “split-gift” election under section 2513 of the Code in one or more taxable years since when the election is in effect, all taxable gifts for the year (whether made by one spouse or the other) are deemed to be made one-half by each spouse.[[159]](#footnote-160) For example, consider a married couple that makes an $11.70 million taxable gift in 2021 from the assets owned by one of the spouses, intending to use a portion of the increased (bonus) exclusion before expiration at the end of 2025. If a split-gift election is in place, each spouse will be deemed to have made a $5.85 million gift, exhausting each of their original BEAs, leaving each with no remaining exclusion in 2026 (other than any inflation-adjustment for that year). If, on the other hand, there is no split-gift election, then the gifting spouse will have utilized $11.70 million of his or her exclusion, and the non-gifting spouse would still retain the original BEA.
        2. The preamble to the Anti-Clawback Regulations make clear that the Treasury Department is considering and reserving the right to issue an anti-abuse provision to “prevent the application of the special rule to transfers made during the increased BEA period that are not true inter vivos transfers, but rather are treated as testamentary transfers for transfer tax purposes.”[[160]](#footnote-161) The examples mentioned in the preamble include “transfers subject to a retained life estate or other retained powers or interests, and certain transfers within the purview of chapter 14 of subtitle B of the Code.” [[161]](#footnote-162) Such anti-abuse provisions would be issued to “ensure that bona fide inter vivos transfers are not subject to inconsistent treatment for estate tax purposes,” but such “inconsistent treatment does not arise with regard to transfers that are treated as part of the gross estate for estate tax purposes, rather than as adjusted taxable gifts.”[[162]](#footnote-163)
  1. Section 199A: Qualified Business Income of “Pass-Thru” Entities[[163]](#footnote-164)
     1. TCJA adds new section 199A of the Code (Qualified Business Income) for the benefit of any “taxpayer other than a corporation.”[[164]](#footnote-165) As such, this provision applies to sole proprietors, independent contractors, disregarded entities, partnership, and S corporations. In short and in great simplification, section 199A of the Code provides a 20% deduction for the “qualified business income” from a “qualified trade or business,” which generally means any trade or business other than a “specified service trade or business” or the trade or business of “performing services as an employee” (other than a certain threshold amount). The section 199A deduction expires January 1, 2026.[[165]](#footnote-166)
     2. Generally, for taxpayers whose taxable income exceeds the threshold amounts (defined below) the section 199A deduction will be limited based, in whole or in part, on: (i) the type of trade or business engaged in by the taxpayer; (ii) the amount of W-2 wages paid with respect to the trade or businesses; and (iii) the unadjusted basis immediately after acquisition of qualified property held for use in the trade or business. The latter two limitations are often referred to as the “wages and basis” limitations, and these limitations can significantly limit the deduction under section 199A.
     3. Qualified Business Income
        1. “Qualified business income”[[166]](#footnote-167) is the net amount of “qualified items” with respect to any “qualified trade or business” of the taxpayer but does not include any qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income (such items of income are separately afforded a deduction under section 199A of the Code). In addition, qualified business income does not include:[[167]](#footnote-168) (i) any reasonable compensation paid to the taxpayer for services rendered with respect to the trade or business; (ii) any guaranteed payment[[168]](#footnote-169) for services rendered with respect to the trade or business; and (iii) to the extent provided in regulations, any amount paid or incurred by a partnership to a partner who is acting other than in his or her capacity as a partner for services.[[169]](#footnote-170)
        2. “Qualified items” are only included in the definition of qualified business income to the extent such items of income that are effectively connected with the conduct of a U.S. trade or business within the meaning of section 864(c) of the Code.[[170]](#footnote-171) Specific “investment items” are excluded, including:[[171]](#footnote-172)
           1. Any item of short-term and long-term capital gain or loss;
           2. Any dividend, income equivalent to a dividend, or payment in lieu of dividends;
           3. Any interest income, other than interest income which is properly allocable to a trade or business;
           4. Any gain or loss from commodities transactions, other than those entered into in the normal course of the trade or business or with respect to stock in trade or property held primarily for sale to customers in the ordinary course of the trade or business, property used in the trade or business, or supplies regularly used or consumed in the trade or business;
           5. Any foreign currency gains from section 988 transactions, other than transactions directly related to the business needs of the business activity;
           6. Net income from notional principal contracts, other than those clearly identified hedging transactions that are treated as ordinary income; and
           7. Any amount received from an annuity that is not used in the trade or business of the business activity.
        3. “Qualified trade or business” means any trade or business other than a “specified service trade or business,” or the “trade or business of performing services as an employee.”[[172]](#footnote-173)
        4. “Specified service trade or business” includes:
           1. Services that are excluded from the definition of “qualified trade or business” under section 1202(e)(3)(A) of the Code (qualified small business stock, as discussed in more detail later in these materials) but carves out engineering and architecture services for these purposes,[[173]](#footnote-174) leaving services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees or owners; or
           2. Services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.[[174]](#footnote-175)
        5. The foregoing exclusion from the definition of a qualified business for specified service trades or businesses phases in for a taxpayer with taxable income in excess of a “threshold amount” and becomes fully effective once taxable income exceeds the threshold amount by $50,000 ($100,000 in the case of a joint return).[[175]](#footnote-176) The initial “threshold amount” was $157,500 for each taxpayer (twice the amount in the case of a joint return).[[176]](#footnote-177) This amount has been adjusted for inflation since 2019,[[177]](#footnote-178) and in 2021 the threshold amount is $164,900.[[178]](#footnote-179) For trusts and estates, the threshold amount is determined based on the highest income tax bracket for trusts and estates (for 2021, $13,050).
        6. The amount of the deduction for each taxable year of the taxpayer under section 199A of the Code is equal to the ***SUM*** of:
           1. The *lesser* of:

The “combined qualified business income amount of the taxpayer,”[[179]](#footnote-180) or

20 percent of “the excess (if any) of—(i) the taxable income of the taxpayer for the taxable year, over (ii) the sum of any net capital gain (as defined in section 1(h)) plus the aggregate amount of the qualified cooperative dividends, of the taxpayer for the taxable year,” [[180]](#footnote-181) **PLUS**

* + - * 1. The *lesser* of:

20 percent of the “aggregate amount of the qualified cooperative dividends of the taxpayer for the taxable year,”[[181]](#footnote-182) or

The “taxable income (reduced by the net capital gain (as so defined)) of the taxpayer for the taxable year.”[[182]](#footnote-183)

* + - 1. The foregoing resulting amount may not exceed the taxable income of the taxpayer for the taxable year (reduced by net capital gain).[[183]](#footnote-184)
      2. “Combined qualified business income” is the **SUM** of:
         1. The sum of “deductible amount for each trade or business,”[[184]](#footnote-185) **PLUS**
         2. 20 percent of the “aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year.”[[185]](#footnote-186)
      3. The “deductible amount for each trade or business” is the *lesser* of:
         1. 20 percent of the taxpayer’s “qualified business income with respect to the qualified trade or business,”[[186]](#footnote-187) or
         2. The “greater of—(i) 50 percent of the W–2 wages with respect to the qualified trade or business, or (ii) the sum of 25 percent of the W–2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property.”[[187]](#footnote-188)
      4. “Qualified property” means tangible property of a character subject to depreciation that is held by, and available for use in, the qualified trade or business at the close of the taxable year, and which is used in the production of qualified business income, and for which the depreciable period has not ended before the close of the taxable year. [[188]](#footnote-189) The depreciable period with respect to qualified property of a taxpayer means the period beginning on the date the property is first placed in service by the taxpayer and ending on the later of (i) the date 10 years after that date, or (ii) the last day of the last full year in the applicable recovery period that would apply to the property under section 168 of the Code (without regard to section 168(g) of the Code—alternative depreciation for certain types of property).[[189]](#footnote-190)
      5. The foregoing alternative calculation with W-2 wage will allow real estate businesses with large capital investments (regardless of whether financed) but very few employees to qualify for the section 199A deduction. It should be noted that there does not seem to be a distinction between qualified property acquired before or after the effective date of the TCJA.
      6. In the case of partnerships (and S corporations), the Code provides that section 199A of the Code will be applied at the partner (shareholder) level, each partner (shareholder) will take into account such person’s allocable share of each qualified item, and each partner (shareholder) will be treated as having W-2 wages and unadjusted basis “immediately after acquisition of qualified property for the taxable year in an amount equal to such person’s allocable share of the W–2 wages and the unadjusted basis immediately after acquisition of qualified property of the partnership or S corporation for the taxable year (as determined under regulations prescribed by the Secretary).”[[190]](#footnote-191) For these purposes: (i) W-2 wages are determined in the same manner as the partner’s (shareholder’s) allocable share of wage expense; (ii) a partner’s (shareholder’s) allocable share of the unadjusted basis shall be determined in the same manner as the partner’s (shareholder’s) allocable share of depreciation; and (iii) for purposes of an S corporation, an allocable share shall be the shareholder’s pro rata share of an item (wage expense or depreciation).[[191]](#footnote-192)
      7. Trusts and estates are eligible for the deduction under section 199A of the Code. To that end, the Code provides that rules similar to those under section 199(d)(1)(B)(i) (as in effect on December 1, 2017) for the apportionment of W-2 wages and unadjusted basis immediately after acquisition of qualified property.[[192]](#footnote-193)
      8. Pertinent Provisions of the 199A Final Regulations
         1. Generally

On February 8, 2019, the Treasury Department issued final Treasury Regulations under section 199A (the “199A Final Regulations”), along with anti-avoidance rules under section 643(f) of the Code (the “643(f) Final Regulations”). [[193]](#footnote-194) A complete discussion of all of the provisions of the final regulations is beyond the scope of these materials, but certain provisions are important to note.

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

* + - * 1. Trade or Business Defined

Trade or business is not defined in section 199A of the Code. The 199A Final Regulations adopts a definition of “trade or business” as used in section 162(a) of the Code, dealing with the deductibility of ordinary and necessary business expenses. Thus, “trade or business” means “a trade or business that is a trade or business under section 162 (a section 162 trade or business) other than the trade or business of performing services as an employee.”[[194]](#footnote-195)

Solely for purposes of 199A, “trade or business” is extended to include the rental or licensing of tangible or intangible property to a related trade or business if the rental or licensing and the other trade or business are commonly controlled, as defined in the aggregation rule discussed below but regardless of whether such rental or licensing trade or business can be aggregated under the entire rule.[[195]](#footnote-196)

* + - * 1. Aggregation

As written, the section 199A deduction is limited and calculated based separately for each trade or business. However, a taxpayer can have a trade or business that is operated across multiple legal entities. Thus, with the wages and basis limitations applied at each trade or business, there could potentially be very little allowable deduction under section 199A. A question arose as to whether, in order to maximize the section 199A deduction, taxpayers would need to legally restructure (e.g., merge entities) some or all of their trades or businesses. In response, the 199A Final Regulations permits (but does not require) aggregation of separate trades or businesses.[[196]](#footnote-197)

Under the 199A Proposed Regulations, aggregation is permitted but only if the individual (which includes a non-grantor trust and an estate[[197]](#footnote-198)) can satisfy the following requirements:

The same person or group of persons, directly or indirectly, by attribution under sections 267(b) or 707(b) of the Code, owns 50 percent or more of each trade or business to be aggregated, meaning in the case of such trades or businesses owned by an S corporation, 50 percent or more of the issued and outstanding shares of the corporation, or, in the case of such trades or businesses owned by a partnership, 50 percent or more of the capital or profits in the partnership;[[198]](#footnote-199)

The ownership requirement described above exists for a majority of the taxable year, including the last day of the taxable year, in which the items attributable to each trade or business to be aggregated are included in income;[[199]](#footnote-200)

All of the items attributable to each trade or business to be aggregated are reported on returns with the same taxable year, not taking into account short taxable years;[[200]](#footnote-201)

None of the trades or businesses to be aggregated is a specified service trade or business;[[201]](#footnote-202) and

The trades or business to be aggregated satisfy at least two of the following (based on facts and circumstances): (i) the trades or businesses provide products and services that are the same or customarily offered together; (ii) the trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources; and (iii) the trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group.[[202]](#footnote-203)

Once an individual chooses to aggregate businesses, the individual must consistently report the aggregated trades or business in all subsequent taxable years.[[203]](#footnote-204) An individual may add a newly created or nearly acquired (whether through a non-recognition transaction or not) trade or business.[[204]](#footnote-205) Furthermore, if there is a “significant change in facts and circumstances” and a previously aggregated trade or business no longer qualifies under the rules, then the trade or business will no longer be aggregated, but the individual can reapply for aggregation if allowable under the rules set above.[[205]](#footnote-206)

On the other end of the spectrum, the 199A Final Regulations have rules where an individual or “relevant passthrough entity”[[206]](#footnote-207) (RPE) conducts multiple trades or businesses and has items of qualified business income that are properly attributable to more than one trade or business, the taxpayer or entity must allocate those items among the several trades or businesses to which they are attributable using a “reasonable method based on all the facts and circumstances.”[[207]](#footnote-208) The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect the income of each trade or business. It remains to be seen whether pass-through entities that would not qualify under the aggregation option will choose to legally merge or otherwise combine and rely upon this rule instead.

* 1. Section 643(f) Final Regulations: Multiple Trust Provisions
     1. The 643(f) Final Regulations provide, “A trust formed or funded with a principal purpose of avoiding, or of using more than one, threshold amount for purposes of calculating the deduction under section 199A will not be respected as a separate trust entity for purposes of determining the threshold amount for purposes of section 199A.”[[208]](#footnote-209) This provision applies for taxable years ending after December 22, 2017.[[209]](#footnote-210) The 199A Final Regulations then cite the 643(f) Final Regulations.
     2. Section 643(f) of the Code authorizes the Treasury Department to issue Treasury Regulations pursuant to which 2 or more trusts would be treated as 1 trust if: (i) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries; and (ii) a principal purpose of such trust is the avoidance of a tax.[[210]](#footnote-211) For this purpose, spouses (the Code section actually reads, husband and wife) are treated as one person.[[211]](#footnote-212) Until now, Treasury Regulations had not been issued.
     3. The 643(f) Final Regulations provide:[[212]](#footnote-213)

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

* + 1. The proposed Treasury Regulations issued in 2018[[213]](#footnote-214) provided a “principal purpose” provision which read, “A principal purpose for establishing or funding a trust will be presumed if it results in a significant income tax benefit unless there is a significant non-tax (or non-income tax) purpose that could not have been achieved without the creation of these separate trusts.”[[214]](#footnote-215) This provision and the examples noted below were stricken from the 643(f) Final Regulations. The preamble to the 643(f) Final Regulations, in response to comments to the proposed regulations, explained:

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

* + 1. The proposed regulations provided two examples. The first was a straightforward example where multiple and nearly identical trusts were created to solely maximize the section 199A deduction, and the trusts were aggregated into a single trust.[[215]](#footnote-216) The second read, as follows:[[216]](#footnote-217)

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

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

* + 1. Even though the foregoing example was removed, it seems to imply that the aggregation of multiple trusts into one trust would not be applicable if, for example, a grantor created separate trusts for each of his or her children (and their descendants as remainder beneficiaries) even if each of the trust provisions were otherwise identical. Moreover, if significant differences existed between different trusts for the same group of beneficiaries, it would seem that aggregation would not be applicable either. The issue is how significant must such non-tax differences be to avoid the application of aggregation of the trusts.
    2. The effective date for the 643(f) Final Regulations apply to taxable years ending after August 16, 2018.[[217]](#footnote-218) Although the preamble to the proposed regulation explains that it could apply to arrangements and trusts created prior to that point, “In the case of any arrangement involving multiple trusts entered into or modified before August 16, 2018, the determination of whether an arrangement involving multiple trusts is subject to treatment under section 643(f) will be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 643(f).”[[218]](#footnote-219)
    3. The preamble to the proposed regulation points out, “The application of proposed §1.643(f)-1, however, is not limited to avoidance of the limitations under section 199A and proposed §§1.199A-1 through 1.199A-6.”[[219]](#footnote-220) Thus, for example, this rule might apply to one of the limitations on the sale of section 1202 (qualified small business stock) gain, as discussed in more detail below, which are limited to the definition a particular taxpayer.
  1. 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[[220]](#footnote-221) for certain partnership interest 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 (often referred to as a carried interest). The provision treats as short-term capital gain taxed at ordinary income rates the amount of the taxpayer’s net long-term capital gain “with respect to”[[221]](#footnote-222) one or more “applicable partnership interests”[[222]](#footnote-223) 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,”[[223]](#footnote-224) 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.”[[224]](#footnote-225) 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.[[225]](#footnote-226) There is also an exception for a partnership interest held directly or indirectly by a “corporation.”[[226]](#footnote-227) 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.[[227]](#footnote-228) The partnership interests held by the two corporations are not applicable partnership interests. The 2020 final Treasury Regulations[[228]](#footnote-229) (“1061 Final Regulations”) make clear that the term “corporation” does not include an S corporation.[[229]](#footnote-230)
       3. An “applicable trade or business” is defined as “any activity conducted on a regular, continuous, and substantial basis which … consists”[[230]](#footnote-231) of:
          1. “[R]aising or returning capital,”[[231]](#footnote-232) and
          2. Either: “(i) investing of in (or disposing of) specified assets (or identifying specified assets for such investing or disposition), or (ii) developing specified assets.”[[232]](#footnote-233)
       4. “Specified assets” means:[[233]](#footnote-234)
          1. Securities (as defined under rules for mark-to-market accounting for securities dealers);
          2. Commodities (as defined under rules for mark-to-market accounting for commodities dealers);
          3. Real estate held for rental or investment;
          4. Cash or cash equivalents;
          5. Options or derivative contracts with respect to such securities, commodities, real estate, cash or cash equivalents, as well as an interest in a partnership to the extent of the partnership’s proportionate interest in the foregoing.
       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.[[234]](#footnote-235)
       6. If a taxpayer “transfers any applicable partnership interest, directly or indirectly, to a person related to the taxpayer,”[[235]](#footnote-236) 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.”[[236]](#footnote-237) 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.[[237]](#footnote-238)
       7. A “related person” for this purpose is:
          1. A member of the taxpayer’s family within the meaning of the attribution rules under section 318(a)(1) of the Code (spouse, children, grandchildren, and parents),[[238]](#footnote-239) or

* + - * 1. 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.”[[239]](#footnote-240)
      1. 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.”[[240]](#footnote-241) 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 discussed later 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.
  1. Before TCJA and ATRA: When In Doubt, Transfer Out
     1. Notwithstanding the enactment of TCJA, the year 2013, with the enactment of the American Taxpayer Relief Act of 2012[[241]](#footnote-242) (“ATRA”) and the imposition of the 3.8% Medicare contribution tax on unearned passive income or net investment income[[242]](#footnote-243) (hereinafter, the “3.8% Net Investment Income Tax”) that was enacted as part of the Health Care and Education Reconciliation Act of 2010 (“HCERA”),[[243]](#footnote-244) which amended the Patient Protection and Affordable Care Act (“PPACA”),[[244]](#footnote-245) marked the beginning of a significant change in perspective for estate planners.
     2. For many years, estate planning entailed aggressively transferring assets out of the estate of high-net-worth individuals during their lifetimes to avoid the imposition of estate taxes at their deaths and consequently giving up a potential “step-up” in basis adjustment under section 1014 of the Internal Revenue Code of 1986, as amended (the “Code”). Because the estate tax rates were significantly greater than the income tax rates, the avoidance of estate taxes (typically to the exclusion of any potential income tax savings from any “step-up” in basis) was the primary focus of tax-based estate planning for wealthy individuals.
     3. By way of example, consider the planning landscape in 2001. The Federal estate and gift tax exemption equivalent was $675,000. The maximum Federal transfer tax (collectively, the estate, gift, and generation-skipping transfer tax) rate was 55%, and the law still provided for a state estate tax or inheritance tax Federal credit. Because virtually all of the states had an estate or inheritance tax equal to the credit, the maximum combined Federal and state transfer tax rate was 55%. The combined Federal and state income tax rates were significantly lower than that. Consider the maximum long-term capital gain and ordinary income tax rates of a highly taxed individual, a New York City taxpayer. At that time, the combined maximum Federal, state, and local income tax rate for long-term capital gains was approximately 30% and for ordinary income, less than 50%.[[245]](#footnote-246) As a result, the gap between the maximum transfer tax rate and the long-term capital gain tax rate for a New York City taxpayer was approximately 25%. In other words, for high income, high-net-worth individuals in NYC, there was a 25% tax rate savings by avoiding the transfer tax and forgoing any “step-up” in basis. Because this gap was so large (and larger in other states), estate planning recommendations often came down to the following steps, ideas and truths.
        1. Typically, as the first step in the estate planning process, make an inter vivos taxable gift using the $675,000 exemption equivalent, thereby removing all future appreciation out of the estate tax base.
        2. Use the exemption equivalent gift as a foundation to transfer additional assets out of the estate during lifetime (for example, a “seed” gift to an IDGT to support the promissory note issued as part of an installment sale to the IDGT).[[246]](#footnote-247)
        3. Draft trusts and other estate planning structures to avoid estate tax inclusion for as many generations as possible (for example, leveraging the generation-skipping transfer (“GST”) tax exemption by applying it to the seed gift to the IDGT and establishing the trust in a jurisdiction that has abolished the rule against perpetuities).
        4. Forgo any “step-up” in basis adjustment at death on the assets that have been transferred during lifetime, because the transfer tax savings were almost certainly much greater than any potential income tax savings that might result from the basis adjustment at death.
        5. Know that the income tax consequences of the various estate planning techniques were appropriately secondary to avoiding the transfer tax.
        6. Know that the state of residence of the decedent and the decedent’s beneficiaries would not significantly affect the foregoing recommendations or ideas because of the large gap between the transfer tax and the income tax existing consistently across all of the states.
        7. As a result, there was an enormous amount of consistency in the estate planning recommendations across the U.S., where the only differentiating factor was the size of the gross estate. In other words, putting aside local law distinctions like community vs. separate property, almost all $20 million dollar estates had essentially the same estate plan (using the same techniques in similar proportions).
     4. The enactment of ATRA marked the beginning of a “permanent” change in perspective on estate planning for high-net-worth individuals. The large gap between the transfer and income tax rates, which was the mathematical reason for aggressively transferring assets during lifetime, has narrowed considerably, and in some states, there is virtually no difference in the rates. With ATRA’s very generous applicable exclusion provisions, the focus of estate planning has, for the time being, become less about avoiding the transfer taxes and more about avoiding income taxes.
  2. ATRA: The “Permanent” Tax Landscape
     1. Generally
        1. As mentioned above, many of the income and transfer tax provisions of the TCJA affecting individuals will expire in 2026. As such, the “permanent” tax landscape for estate planners was transformed in 2013 due to increased income tax rates, and falling transfer tax liability, at both the Federal and state level. On the Federal side, the income and transfer tax provisions that became effective January 1, 2013, were enacted as part of ATRA, PPACA, and HCERA (the 3.8% Net Investment Income Tax). At the state level, many states increased their income tax rates,[[247]](#footnote-248) and a number of states continued the trend of repealing their state death tax (estate and inheritance tax).[[248]](#footnote-249)
        2. A complete discussion of all of the provisions of the Federal laws and the state laws is beyond the discussion of this paper. So, this paper will limit the discussion to the most relevant provisions.
     2. Pertinent Provisions of ATRA
        1. Federal Transfer Tax Landscape (Assuming No TCJA)
           1. Summary of the Pertinent Transfer Tax Provisions

The top estate, gift, and GST tax rate is 40%.[[249]](#footnote-250)

The basic exclusion amount for each individual is $5 million,[[250]](#footnote-251) indexed for inflation after 2011[[251]](#footnote-252) ($5.85 million for 2021).[[252]](#footnote-253)

The applicable exclusion amount[[253]](#footnote-254) (sometimes referred to as the “Applicable Exclusion Amount” or the “Applicable Exclusion”) is the sum of base exclusion amount and in the case of a surviving spouse, the deceased spousal unused exclusion amount (the “DSUE Amount”).[[254]](#footnote-255)

Reunification of the estate, gift and GST tax system (providing a GST exemption amount equal to the basic exclusion amount under section 2010(c)).[[255]](#footnote-256)

Repeal of the “sunset” provision with respect to the foregoing transfer tax provisions.[[256]](#footnote-257)

* + - * 1. Basic Exclusion Amount

ATRA “permanently” provides for a cost-of-living increase to the Applicable Exclusion Amount but does not provide for a decrease even in the event of deflation. [[257]](#footnote-258) The Applicable Exclusion Amount can grow to a very large number.

By way of example, if the cost-of-living index increases at a compound rate of 2.7% over the next 10 and 20 years (the cost-of-living adjustment from 1983 to 2016 has averaged 2.6% and the median has been 2.7%[[258]](#footnote-259)), the basic exclusion amount will grow as follows:

|  |  |  |  |
| --- | --- | --- | --- |
| FORECASTED BASIC EXCLUSION AMOUNT (NO TCJA)  ($ MILLION) | | | |
|  | 2021 | 2031 | 2041 |
| 2.7% COLI | $5.85 | $7. 46 | $9.97 |

* + - 1. Pertinent Income Tax Provisions (Assuming No TCJA)
         1. Increase of the highest Federal ordinary income tax bracket to 39.6%.[[259]](#footnote-260)
         2. Increase of the highest Federal long-term capital gain bracket to 20%.[[260]](#footnote-261)
         3. Increase of the highest Federal “qualified dividend income” rate to 20%.[[261]](#footnote-262)
    1. 3.8% Net Investment Income Tax: Generally
       1. A full and complete discussion of the 3.8% Net Investment Income Tax (“NIIT”) is beyond the scope of this paper, but a general understanding is important. Fortunately, there are a number of better resources for that discussion.[[262]](#footnote-263)
       2. Section 1411 imposes a 3.8% excise tax on “net investment income”[[263]](#footnote-264) (“NII”) which includes:
          1. “Gross income from interest, dividends, annuities, royalties, and rents,”[[264]](#footnote-265) (passive income), other than such passive income that is “derived in the ordinary course of a trade or business”[[265]](#footnote-266) that is not a “Passive Activity or Trading Company” (as defined below);
          2. Gross income derived from a “Passive Activity or Trading Company,” which is defined as:

A trade or business that is “a passive activity (within the meaning of section 469) with respect to the taxpayer;”[[266]](#footnote-267) or

A trade or business that trades in “financial instruments or commodities (as defined in section 475(e)(2)).”[[267]](#footnote-268)

* + - * 1. Gain “attributable to the disposition of property other than property held in a trade or business not described”[[268]](#footnote-269) as a Passive Activity or Trading Company; or
        2. Gross income from the investment of working capital.[[269]](#footnote-270)
      1. In arriving at NII, the Code provides for “deductions . . . which are properly allocable to such gross income or net gain.”[[270]](#footnote-271)
      2. For individuals, the NIIT is imposed on the lesser of:[[271]](#footnote-272)
         1. NII; or
         2. The excess of:

“modified adjusted gross income for such taxable year”[[272]](#footnote-273) (“MAGI”), over

The “threshold amount”[[273]](#footnote-274) ($200,000 for individual taxpayers, $250,000 for joint taxpayers, and $125,000 for married taxpayers filing separately).[[274]](#footnote-275)

* + - 1. For estates and trusts, the NIIT is imposed on the lesser of:[[275]](#footnote-276)
         1. The undistributed NII for the taxable year, over
         2. The excess of:

Adjusted gross income (as defined in §67(e)),[[276]](#footnote-277) over

“[T]he dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year”[[277]](#footnote-278) ($13,050 of taxable income for 2021).[[278]](#footnote-279)

* + - 1. The threshold amount for individuals does not increase with cost-of-living adjustments, but the taxable income amount threshold for trusts and estates does because it’s tied to the highest income tax bracket for those entities.
      2. With respect to a disposition of a partnership interest or S corporation shares, the net gain will be subject to the NIIT but “only to the extent of the net gain which would be so taken into account by the transferor if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest.”[[279]](#footnote-280)
      3. The following are excluded from the definition of NII:
         1. Distributions from “a plan or arrangement described in section 401(a), 403(a), 403(b), 408, 408A or 457(b),”[[280]](#footnote-281) specifically referring to: [[281]](#footnote-282)

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

A qualified annuity plan under section 403(a);

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

An individual retirement account (IRA) under section 408;

A Roth IRA under section 408A; and

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

* + - * 1. Gain or other types of income that generally would not be taxable under the Code, including: [[282]](#footnote-283)

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

Deferred gain under the installment method under § 453.

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

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

* + 1. 3.8% Net Investment Income Tax: Trusts and Pass-Through Entities
       1. Generally
          1. If an individual, estate, or trust owns or engages in a trade or business, the determination of whether the income is derived in an active or passive trade or business is made at the owner’s level.[[283]](#footnote-284)
          2. If an individual, estate, or trust owns an interest in a trade or business through a partnership or S corporation, the determination of whether the income is derived in an active or passive trade or business is made at the interest-holder level.[[284]](#footnote-285) Provided, however, the issue of whether the gross income is derived from trading in financial instruments or commodities is determined at the entity level.[[285]](#footnote-286)
          3. A trust, or any portion of a trust, that is treated as a grantor trust is not subject to the 3.8% Net Investment Income Tax.[[286]](#footnote-287) The grantor will be deemed to have received all of the income from the trade or business. Hence, whether such trade or business is passive or active is determined at the grantor/owner level.
       2. Non-Grantor Trusts
          1. The application of the 3.8% Net Investment Income Tax to trusts that own closely-held business interests is controversial, and there is considerable uncertainty how a fiduciary that owns interests in a closely-held business can materially participate and thereby avoid the imposition of the tax. Whereas for individuals a bright-line test exists to measure material participation, no such test exists for trusts and estates.
          2. In *Mattie K. Carter Trust v. U.S.*,[[287]](#footnote-288) the court held that in determining material participation for trusts the activities of the trust’s fiduciaries, employees, and agents should be considered. The government argued that only the participation of the fiduciary ought to be considered but the court rejected that argument. In *Frank Aragona Trust v. Commissioner*,[[288]](#footnote-289) the Tax Court held that the trust qualified for the real estate professional exception under section 469(c)(7) (deemed material participation) because three of the six co-trustees were full time employees of the trust-wholly owned LLC that managed the rental properties. In addition, the Tax Court also considered the activities of co-trustees that had co-ownership interests in the entities held by the trust, reasoning that the interests of the co-trustees were not majority interests, were never greater than the trust’s interests in the entities, and were compatible with the trust’s goals.
          3. Notwithstanding the foregoing, the IRS ruling position is that only the fiduciary’s activities are relevant. The IRS reaffirmed this ruling position in TAM 201317010. The ruling explains the IRS rationale as follows:

The focus on a trustee’s activities for purposes of § 469(h) is consistent with the general policy rationale underlying the passive loss regime. As a general matter, the owner of a business may not look to the activities of the owner's employee's to satisfy the material participation requirement. *See* S. Rep. No. 99-313, at 735 (1986) (“the activities of [employees] . . . are not attributed to the taxpayer.”). Indeed, because an owner's trade or business will generally involve employees or agents, a contrary approach would result in an owner invariably being treated as materially participating in the trade or business activity. A trust should be treated no differently. A trustee performs its duties on behalf of the beneficial owners. Consistent with the treatment of business owners, therefore, it is appropriate in the trust context to look only to the activities of the trustee to determine whether the trust materially participated in the activity. An interpretation that renders part of a statute inoperative or superfluous should be avoided. *Mountain States Tel. & Tel. Co. v. Pueblo of Santa Ana*, 472 U.S. 237, 249 (1985).[[289]](#footnote-290)

* + - * 1. At issue in the ruling were the activities of “special trustees” who did the day-to-day operations and management of the companies in question but lacked any authority over the trust itself. The ruling states:

The work performed by A was as an employee of Company Y and not in A's role as a fiduciary of Trust A or Trust B and, therefore, does not count for purposes of determining whether Trust A and Trust B materially participated in the trade or business activities of Company X and Company Y under § 469(h). A's time spent serving as Special Trustee voting the stock of Company X or Company Y or considering sales of stock in either company would count for purposes of determining the Trusts' material participation. However, in this case, A's time spent performing those specific functions does not rise to the level of being "regular, continuous, and substantial" within the meaning of § 469(h)(1). Trust A and Trust B represent that B, acting as Trustee, did not participate in the day-to-day operations of the relevant activities of Company X or Company Y. Accordingly, we conclude that Trust A and Trust B did not materially participate in the relevant activities of Company X or Company Y within the meaning of § 469(h) for purposes of § 56(b)(2)(D) for the tax years at issue.[[290]](#footnote-291)

* + - * 1. The need for a trustee to be active may affect the organization of business entities held in trust. For instance, a member-managed LLC may be more efficient than a manager-managed LLC unless a fiduciary is the manager.
      1. Pass-Through Entities
         1. The proposed Treasury Regulations issued in 2013[[291]](#footnote-292) (the “2013 Proposed Regulations”) provide that the exception for certain active interests in partnerships and S corporations will apply to a “Section 1411(c)(4) Disposition.” A Section 1411(c)(4) Disposition is defined as the sale of an interest in any entity taxed as a partnership or an S corporation[[292]](#footnote-293) (a “Pass-Through Entity”) by an individual, estate, or trust if: (1) the Pass-Through Entity is engaged in one or more trades or businesses, or owns an interest (directly or indirectly) in another Pass-through Entity that is engaged in one or more trades or businesses, other than the business of trading in financial instruments or commodities; and (2) one or more of the trades or businesses of the Pass-Through Entity is not a passive activity (defined under section 469 of the Code) of the transferor.[[293]](#footnote-294) Therefore, if the transferor (e.g., the trustee of a non-grantor trust) materially participates in one or more of the Pass-Through Entity’s trades or businesses (other than trading in financial instruments or commodities), then some or all of the gain attributable to the sale of an interest in such entity would be exempt from the NIIT.
         2. The 2013 Proposed Regulations provide two possible methods of determining the amount of gain or loss from a Section 1411(c)(4) Disposition. The simplified method is available to a taxpayer if the gain of the transferor is $250,000 or less (including gains from multiple sales that were part of a plan).[[294]](#footnote-295) If the gain exceeds $250,000, the transferor may use the simplified method if the sum of the transferor’s share during the “Section 1411 Holding Period” (generally, the year of sale and the preceding two years) of separately stated items of income, gain, loss, and deduction of a type that the transferor would take into account in calculating NII is 5% or less than the sum of all separately stated items of income, gain, loss, and deduction allocated to the transferor over the same period of time, and the gain is $5 million or less.[[295]](#footnote-296) Generally, the simplified method determines the amount gain or loss subject to NII by multiplying it by a fraction, the numerator of which is the sum of NII items over the Section 1411 Holding Period, and the denominator of which is the sum of all items of income, gain, loss, and deduction allocated to the transferor during the same period.[[296]](#footnote-297)
         3. If the transferor does not qualify for the simplified method,[[297]](#footnote-298) then the 2013 Proposed Regulations provide that the transferor must include gain or loss that the transferor would have taken into account if the Pass-Through Entity had sold all of its “Section 1411 Property” for fair market value immediately before the disposition of the interest.[[298]](#footnote-299) Section 1411 Property generally is the property owned by the Pass-Through Entity that if disposed by the entity would result in net gain or loss allocable to the transferor (partner or S corporation shareholder) would be considered NII of the transferor (deemed sale of the activities, on an activity-by-activity basis, in which the transferor does not materially participate).[[299]](#footnote-300)
         4. These rules apply in to all entities taxed as partnerships (limited liability companies, limited partnerships, general partnerships, etc.) and S corporations.
      2. Qualified Subchapter S Trusts
         1. A qualified subchapter S trust (QSST)[[300]](#footnote-301) is an eligible shareholder of an S corporation. Generally, a QSST may have only one beneficiary (who also must be a U.S. citizen or resident)[[301]](#footnote-302) who may receive income or corpus during the beneficiary’s lifetime, and all of its income[[302]](#footnote-303) must be distributed (or required to be distributed) currently to that beneficiary while the trust holds S corporation stock.[[303]](#footnote-304) A trust that has substantially separate and independent shares, each of which is for the sole benefit of one beneficiary, may qualify as a QSST as to each share.[[304]](#footnote-305) If the trust holds other assets in addition to the S corporation stock, all of the fiduciary accounting income must be distributed, not just amounts attributable to the S corporation distributions.[[305]](#footnote-306) The beneficiary of a QSST is taxed on all of the QSST’s income and losses from the S corporation reported on Schedule K-1 (as if the beneficiary was the grantor of the trust for grantor trust purposes under section 678 of the Code).[[306]](#footnote-307) In contrast, when the QSST sells the S corporation stock, the QSST is taxable on any resulting gain.[[307]](#footnote-308)
         2. For 3.8% Net Investment Income Tax purposes, the material participation (or lack thereof) of the beneficiary of a QSST determines to what extent the Schedule K-1 income from the S corporation will be subject to 3.8% Net Investment Income Tax at the beneficiary level. On the other hand, for sales of interests in an S corporation by the QSST, material participation (and the applicability of a Section 1411(c)(4) Disposition, as discussed above) is determined at the trust (trustee) level. The preamble to the 2013 Proposed Regulations provide, in pertinent part:[[308]](#footnote-309)

In general, if an income beneficiary of a trust that meets the QSST requirements under section 1361(d)(3) makes a QSST election, the income beneficiary is treated as the section 678 owner with respect to the S corporation stock held by the trust. Section 1.1361–1(j)(8), however, provides that the trust, rather than the income beneficiary, is treated as the owner of the S corporation stock in determining the income tax consequences of the disposition of the stock by the QSST… For purposes of section 1411, the inclusion of the operating income or loss of an S corporation in the beneficiary’s net investment income is determined in a manner consistent with the treatment of a QSST beneficiary in chapter 1 (as explained in the preceding paragraph), which includes the determination of whether the S corporation is a passive activity of the beneficiary under section 469… [T]hese proposed regulations provide that, in the case of a QSST, the application of section 1411(c)(4) is made at the trust level. This treatment is consistent with the chapter 1 treatment of the QSST by reason of §1.1361–1(j)(8). However, these proposed regulations do not provide any special computational rules for QSSTs within the context of section 1411(c)(4) for two reasons. First, the treatment of the stock sale as passive or nonpassive income is determined under section 469, which involves the issue of whether there is material participation by the trust.

* + - 1. Electing Small Business Trusts
         1. An electing small business trust (ESBT) [[309]](#footnote-310) is another non-grantor trust that is an eligible S corporation shareholder. Unlike a QSST, an ESBT may have multiple beneficiaries[[310]](#footnote-311) who can have discretionary interests in the income and principal of the trust.[[311]](#footnote-312) For income tax purposes, an ESBT is treated as two separate trusts: (i) a portion that holds S corporation stock (the “S portion”); and (ii) a portion that holds all other assets (the “non-S portion”).[[312]](#footnote-313) Notwithstanding the foregoing, the grantor trust rules take precedence over the ESBT rules.[[313]](#footnote-314) The S portion is treated as a separate taxpayer, and income reported to the trust on the Schedule K-1 is taxed at the highest individual income tax rates for each type of income, and the distribution deduction is not taken into account.[[314]](#footnote-315)
         2. For 3.8% Net Investment Income Tax purposes, the S and non-S portions continue to be calculated separately for determining the amount of undistributed NII but are combined for purposes of determining if, and to what extent, the ESBT will be subject to the 3.8% Net Investment Income Tax.[[315]](#footnote-316) As discussed in more detail above, as with other non-grantor trusts, material participation (and the applicability of a Section 1411(c)(4) Disposition) is determined at the trustee level.
      2. Charitable Remainder Trusts
         1. It is unknown how the 3.8% Net Investment Income Tax will be applied to charitable remainder trusts[[316]](#footnote-317) (CRTs), particularly when dealing with commercial real property and how the income and gain therefrom will be taxed to the non-charitable beneficiary of the CRT.
         2. Because commercial real property is depreciable, planners should be aware of how the sale of such property in a CRT will affect the taxation of the distribution under the “tier” rules. Generally, the sale of most commercial real property will give rise to “unrecaptured § 1250 gain,”[[317]](#footnote-318) which is taxed at a maximum Federal rate of 25%.[[318]](#footnote-319) As a result, if commercial real property is sold in a CRT, the tier rules include gain taxed at 25%, as well as regular long-term gains at 20%. In addition, any gains and rental income from the property may or may not be considered NII, depending on the active (material participation) or passive participation of the parties involved (donor, recipient, or trustee) and the property in question.[[319]](#footnote-320)
         3. It is unclear, at this point, how and whether the activities of the donor, recipient, and/or trustee will cause all or a portion of the income and gain attributable to the real property to be excluded or subject to the 3.8% Net Investment Income Tax when distributed from the CRT.[[320]](#footnote-321) Many questions remain unanswered. For example, if the trustee is an active participant as to the rental property, does that immediately exclude all of the gain and income even if the donor/recipient is not materially participating? If the donor is an active participant as to the property prior to contribution, does that mean all of the gain on a subsequent sale by the trustee of the CRT is excluded from the 3.8% Net Investment Income Tax? Or does that mean only pre-contribution gain is excluded and post-contribution gain is NII? What if the active donor is also the sole trustee or co-trustee of the CRT?
    1. Disparity among the States
       1. The state estate and inheritance tax (collectively, “state death tax”) landscape has changed significantly since 2001 when almost every state had an estate and/or inheritance tax that was tied to the then existing Federal state death tax credit.[[321]](#footnote-322) As the law stands today, the Federal state death tax credit has been replaced by a Federal estate tax deduction under section 2058 of the Code, and only 15 states (including Washington, D.C.) still retain a generally applicable state death tax.[[322]](#footnote-323) In those states with a death tax, the rates and exemption can vary significantly. For example, Washington’s estate tax provides for a top rate of 20% and an exemption of $2 million per person (indexed for inflation starting January 1, 2014). Pennsylvania, on the other hand, provides for an inheritance tax rate of 4.5% for transfers to descendants, with almost no exemption. When taken in conjunction with the transfer tax provisions of ATRA (both the top Federal tax rate at 40% and the high basic exclusion amount), the combined Federal and state transfer tax cost to high-net-worth individuals has significantly fallen, when compared to 2001, by way of example.
       2. State and local income tax laws and rates vary as well. A number of states have no state and local income tax (Florida, Texas, Nevada, New Hampshire, and Washington) and other states (California, Hawaii, Minnesota, New Jersey, New York, and Oregon) have relatively high income tax rates. When taken in conjunction with the income tax provisions of ATRA and the 3.8% Net Investment Income Tax, the combined Federal and state income tax cost to most taxpayers has significantly risen since 2001.
       3. Thus, the current estate planning landscape is characterized by significantly lower transfer tax costs, higher income tax rates, and significant disparity among the states when one compares the two taxes. As mentioned above, in 2001, for a New York City resident there was a 25% difference between the maximum transfer tax rate and the long-term capital gain tax rate. Today, that difference is approximately 13%.[[323]](#footnote-324) In contrast, consider the tax rates in California. Because California does not have a state death tax, but currently has the highest combined income tax rate in the U.S., the difference between the transfer tax rate and the long-term capital gain tax rate is less than 4%.[[324]](#footnote-325) Notably, the top combined ordinary and short-term capital gain tax rate in California is greater (approximately, 44% to 54%) than the transfer tax rate.
       4. If one considers the “gap” (the difference between the transfer tax and the income tax rates) as a proxy for how aggressively estate planners will consider transferring assets out of an estate during lifetime, then one can see large differences among the states. On one side, there is California, where there is a very small or negative difference, compared to Washington where there is a very large gap (approximately 28% difference above the long-term capital gain tax rate).[[325]](#footnote-326)
       5. As a result, the consistency that had existed across the U.S. for similarly situated clients (distinguished only by the size of the potential gross estate) no longer exists. Instead, estate plans vary based on the state of residence of the client. For example, arguably California residents should be more passive in their estate plans, choosing more often than not, to simply die with their assets, than Washington residents. This is because the income tax savings from a potential “step-up” in basis may, in fact, be greater than the transfer tax cost, if any.

E. Planning in the “Permanent” Landscape

* + 1. Given how large the basic exclusion amount is and will be in the foreseeable future, it is clear that the focus of estate planning has moved away from simply avoiding the transfer tax and has become more focused on the income tax. Much of the planning analysis is about measuring the transfer tax cost against the income tax savings of allowing the assets to be subject to Federal and state transfer taxes. Plans should vary based upon a number of variables, such as:
       1. Time horizon or life expectancy of the client;
       2. Spending or lifestyle of the client, including charitable giving;
       3. Size of the gross estate;
       4. Future return of the assets;
       5. Tax nature of the types of assets (for example, to what extent will a potential “step-up” in basis benefit the client and the beneficiaries?);
       6. Expected income tax realization of the assets (for example, when is it likely that the asset will be subject to a taxable disposition?);
       7. State of residence of the client;
       8. State of residence and marginal income tax bracket of the likely beneficiaries; and
       9. Expectations about future inflation.
    2. Ignoring (or prior to) the current uncertainty regarding changes to the existing transfer tax laws, including a potential reduction to the basic exclusion amount and elimination of a basis adjustment at death, estate planners should seek to use as little of a client’s basic exclusion amount as possible during lifetime because it represents an ever-growing amount that will provide a potential “step-up” in basis with little or no transfer tax cost at death. This conclusion assumes that “zeroed-out” estate planning techniques like installment sales to IDGTs and or “zeroed-out” grantor-retained annuity trusts[[326]](#footnote-327) (“GRATs”) will still be available. These “zeroed-out” techniques can accomplish effectively the same amount of wealth transfer as a taxable gift but without using any or a significant portion of a client’s basic exclusion amount. A taxable gift that uses all or a portion of a taxpayer’s basic exclusion amount does not, in and of itself, reduce the taxpayer’s overall transfer tax liability. A reduction of transfer taxes occurs only if and when the gifted asset appreciates (including any appreciation effectively created by valuation discounts) outside of the donor’s estate. That is essentially the same concept as an installment sale to an IDGT and a GRAT, except that those techniques require appreciation above a certain rate, like the applicable federal rate[[327]](#footnote-328) (“AFR”) or the section 7520 rate.[[328]](#footnote-329)
    3. Because the “step-up” in basis often comes at little or no transfer tax cost, estate planners will seek to force estate tax inclusion in the future and reduce income taxes by leveraging the basis adjustment under section 1014 of the Code. This is discussed in more detail later in these materials.
    4. The state of residence of the client and his or her beneficiaries should also influence the estate plan. For instance, if a client is domiciled in California, and his or her beneficiaries live in California, then dying with the assets may be the extent of the tax planning. On the other hand, if the beneficiaries live in a state like Texas that has no state income tax, then transferring the assets out of the estate during the lifetime of the client may be warranted. As a result, estate planners should ask clients two questions that, in the past, did not significantly matter: (i) where are you likely to be domiciled at your death? and (ii) when that occurs, where is it likely that your beneficiaries (children and grandchildren) will reside, even in the future?

F. Portability Considerations

* + 1. One of the newer features on the estate planning landscape is portability. A full discussion of the planning implications of portability is beyond the scope of this outline and there are resources publicly available that cover the subject in a comprehensive manner.[[329]](#footnote-330) In the context of the “new paradigm” in estate planning discussed above, portability, at least in theory, can provide additional capacity for the surviving spouse’s estate to benefit from a “step-up” in basis with little or no transfer tax costs.
    2. In traditional bypass trust planning, upon the death of an individual who has a surviving spouse, assets of the estate equal in value to the decedent’s unused basic exclusion amount fund a trust (typically for the benefit of the surviving spouse). The trust is structured to avoid estate tax inclusion in the surviving spouse’s estate. The marital deduction portion is funded with any assets in excess of the unused Applicable Exclusion Amount. The bypass trust avoids estate tax inclusion in the surviving spouse’s estate. From an income tax standpoint, however, the assets in the bypass trust do not receive a basis adjustment upon the death of the surviving spouse. Furthermore, while the assets remain in the bypass trust, any undistributed taxable income above $13,050 of taxable income (for 2021) will be subject to the highest income tax rates at the trust level.[[330]](#footnote-331)
    3. In portability planning, the decedent’s estate would typically pass to the surviving spouse under the marital deduction, and the DSUE Amount would be added to the surviving spouse’s basic exclusion amount, giving the surviving spouse an applicable exclusion amount. Because all of the assets passing from the decedent to the surviving spouse in addition to the spouse’s own asset will be subject to estate taxes at his or her death, the assets will receive a basis adjustment. Additional income tax benefits might be achieved if the assets that would otherwise have funded the bypass trust are taxed to the surviving spouse, possibly benefiting from being taxed at a lower marginal income tax bracket. In addition, if the bypass trust would have been subject to a high state income tax burden (for example, California), having the assets taxed to a surviving spouse who moves to a low or no income tax state would provide additional income tax savings over traditional bypass trust planning.
    4. Of course, there are other considerations, including creditor protection and “next spouse” issues, which would favor by-pass trust planning. However, from a tax standpoint, the trade-off is the potential estate tax savings of traditional by-pass trust planning against the potential income tax savings of portability planning. Because the DSUE Amount does not grow with the cost-of-living index, very large estates ($20 million or above, for example) will benefit more with traditional by-pass trust planning because all of the assets, including any appreciation after the decedent’s death, will pass free of transfer taxes. On the other hand, smaller but still significant estates (up to $7 million, for example) should consider portability as an option because the combined exclusions, the DSUE Amount frozen at $11.7 million (for death in 2021) and the surviving spouse’s basic exclusion amount of $11.7 million but growing with the cost-of-living index, is likely to allow the assets to pass at the surviving spouse’s death with a full step-up in basis with little or no transfer tax costs (unless the assets are subject to significant state death taxes at that time).
    5. In evaluating the income tax savings of portability planning, planners should consider that even for very large estates, the surviving spouse has the option of using the DSUE Amount by making a taxable gift to an IDGT. The Treasury Regulations make clear that the DSUE Amount is applied against a surviving spouse’s taxable gift first before reducing the surviving spouse’s basic exclusion amount.[[331]](#footnote-332) The IDGT would provide the same estate tax benefits as the bypass trust would have, but importantly, the trust would be taxed to the surviving spouse as a grantor trust thus allowing the trust assets to appreciate out of the surviving spouse’s estate without being burdened by income taxes.[[332]](#footnote-333) If the assets appreciate, then this essentially solves the problem of the DSUE Amount being frozen in value. Moreover, if the IDGT provides for a power to exchange assets of equivalent value with the surviving spouse,[[333]](#footnote-334) the surviving spouse can exchange high basis assets for low basis assets of the IDGT prior to death and essentially effectuate a “step-up” in basis for the assets in the IDGT.[[334]](#footnote-335) The ability to swap or exchange assets with an IDGT is discussed in more detail below.
    6. Portability planning is slightly less appealing to couples in community property states because, as discussed below, both halves of all community property get a basis adjustment on the first spouse’s death. Thus, the need for additional transfer tax exclusion in order to benefit from a potential subsequent “step-up” in basis is less crucial. This is not true, however, for assets that are depreciable (commercial real property) or depletable (mineral interests). As discussed later in these materials, these types of assets might receive a “step-up” in basis but over time, the basis of the assets will be reduced by the ongoing depreciation deductions. As such, even in community property states, if there are significant depreciable or depletable assets, portability should be considered.
  1. Transfer Tax Cost vs. Income Tax Savings from the “Step-Up”
     1. One of the first steps in analyzing a client’s situation is trying to measure the potential transfer tax costs against the income tax savings that would arise from a “step-up” in basis at death. Under the current state of law, this is not an easy endeavor. First, the basic exclusion amount will continue to increase. Both the rate of inflation and the lifespan of the client are outside the planner’s control. In addition, as mentioned in the previous section, if the client dies in a state that has a death tax, the calculation of the transfer tax cost will be complicated by that state’s exemption and rate. Third, the income tax savings of a “step-up” in basis must be measured in relation to the beneficiaries who may live in a different state than the decedent.
     2. Although a “step-up” in basis is great in theory, no tax will be saved if the asset is at a loss at the time of death resulting in a “step-down” in basis, the asset has significant basis in comparison to its fair market value at the time of death, or the asset will not benefit at all because it is considered income in respect of a decedent[[335]](#footnote-336) (IRD). Furthermore, even if the assets will benefit from a significant “step-up” in basis, the only way to capture the income tax benefits of the basis adjustment is to sell the asset in a taxable disposition. Many assets, like family-owned businesses, may never be sold or may be sold so far in the future that the benefit of a “step-up” is attenuated. In addition, even if the asset will be sold, there may be a significant time between the date of death of the decedent when the basis adjustment occurs and the taxable disposition, so some consideration should be given to quantifying the cost of the deferral of the tax savings. Finally, the nature of the asset may be such that even if the asset will not be sold in a taxable disposition, it may confer economic benefit to the beneficiaries. For example, if the asset that receives a “step-up” in basis is either depreciable or depletable under the Code,[[336]](#footnote-337) the deductions that arise do result in tax benefits to the owners of that asset. In addition, an increase in the tax basis of an interest in a partnership or in S corporation shares may not provide immediate tax benefits, but they do allow additional capacity of the partner or shareholder to receive tax free distributions from the entity.[[337]](#footnote-338) These concepts and how certain assets benefit or don’t benefit from the basis adjustment at death are discussed in more detail below.
     3. Estate planners should seek to maximize the “step-up” in basis by ensuring that the assets that are includible in the estate of a decedent are the type of assets that will:
        1. Benefit from a “step-up” (avoiding the inclusion of cash or property that has a basis greater than fair market value);
        2. Benefit the most from the “step-up” (for example, very low basis assets, collectibles, and “negative basis” assets); and
        3. Provide significant income tax benefits to the beneficiaries (assets are likely to be sold in a taxable transaction after “step-up” or depreciable/depletable assets giving rise to ongoing income tax deductions).
     4. In considering tax basis management in estate planning, estate planners will need to take a bifurcated approach based upon the tax nature of the assets. For clients who are likely to own primarily low-basis assets that would benefit the most from a step-up in basis (e.g., creators of intellectual property or real estate developers), the estate plan will be centered around dying with the assets and benefiting from the “step-up” in basis. To the extent the assets will be subject to Federal or state transfer taxes, then consideration must be given to ensuring that estate taxes can be paid on a timely or orderly manner. Thus, common features of the plan might include maintaining life insurance held by an irrevocable life insurance trust, qualifying for the payment of transfer taxes pursuant to the deferral provisions of section 6166, or securing a *Graegin*[[338]](#footnote-339) loan.[[339]](#footnote-340) For those clients who are likely to own assets that would not likely benefit from the “step-up” in basis (e.g., IRA assets, actively managed publicly-traded investment portfolios, or other high basis asset), then transferring the assets out of the estate would be paramount to the extent the assets would be subject to a significant Federal or state transfer tax liability. Finally, for those clients, who have both types of assets and whose assets would be subject to a significant transfer tax liability, the strategy would involve transferring the high basis assets out of the estate through a combination of zeroed-out transfer strategies and exercising the “swap” power proactively if the assets are held in a grantor trust, as discussed later in this article.
     5. When clients are in a situation where no estate taxes will be due, referred to as a “free-base” situation, then estate planners should seek to maximize the value of certain assets because the “step-up” in basis is based on fair market value (rather than trying to reduce the value for transfer tax purposes). A “free-base” situation can arise when the assets includible in the estate are less than the decedent’s remaining basic exclusion amount (or potentially, remaining applicable exclusion amount) or are because of a marital deduction transfer under section 2056 to the surviving spouse.[[340]](#footnote-341) In these “free-basing” situations, practitioners will need to consider when valuation discounts are warranted and when the discounts should be removed.
     6. In addition to the foregoing, estate planners will increasingly seek to:
        1. Maximize the value of certain assets because the “step-up” in basis is based on fair market value (rather than trying to reduce the value for transfer tax purposes); and
        2. Intentionally create estate tax inclusion, especially if the decedent lives in a state with no state death tax and if the decedent has a significant unused basic exclusion amount (or potentially, applicable exclusion amount) above his or her assets.
  2. Community Property Considerations
     1. Given the pivotal role the “step-up” in basis has in estate planning now, community property states have a significant advantage over separate property states because both the decedent’s and the surviving spouse’s one-half interest in community property will receive a basis adjustment to fair market value under section 1014(b)(6) of the Code. Because the unlimited marital deduction under section 2056 essentially gives couples the ability to have no transfer taxes on the first spouse’s death, this “step-up” in basis provides an immediate income tax savings for the benefit of the surviving spouse (rather than the subsequent beneficiaries). Of course, community property states could cause a significant disadvantage for property that has decreased in value, which would cause a step-down in basis to both halves of community property.
     2. This theoretically provides a bifurcated approach to estate planning for spouses with community property:
        1. During the lifetimes of both spouses, limit inter vivos transfers and maximize value of the assets in order to benefit the most from the basis adjustment under section 1014(b)(6) of the Code.
        2. During the lifetime of the surviving spouse, with assets in excess of the Available Exclusion Amount (taking into account any amounts that might have been “ported” to the surviving spouse), transfer as much wealth as possible out of the estate through inter vivos transfers and other estate planning techniques. Further, through the use of family limited partnerships (“FLPs”) and other techniques, attempt to minimize the transfer tax value of the assets that would be includible in the estate of the surviving spouse.
     3. Notably, with the U.S. Supreme Court’s decisions in *U.S. v. Windsor*[[341]](#footnote-342) and *Obergefell v. Hodges*[[342]](#footnote-343)and the issuance of Revenue Ruling 2013-17[[343]](#footnote-344) and proposed regulations addressing definitions of terms related to marital status,[[344]](#footnote-345) the tax ramifications are far reaching for same-sex couples owning community property. The basis adjustment at death for community property and other planning considerations, including electing into community property status, are discussed in more detail later in these materials.

1. BASIS, GIFTS, AND BEQUESTS: OH MY!
   1. Basis
      1. Generally
         1. Basis is one of the most fundamental and ubiquitous concepts in income tax planning. In part, it represents a taxpayer’s investment in property, and it is the measuring stick that the Code uses to determine if the taxpayer’s investment in the property has appreciated or depreciated at the time that the property is sold. For example, section 1001(a) of the Code provides, “The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis… and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.”[[345]](#footnote-346)
         2. Basis is not just important for determining the amount of gain and loss on a sale or exchange of an asset. It can determine the extent by which a taxpayer can receive distributions of cash without triggering gain (e.g., distributions of cash from a partnership to a partner),[[346]](#footnote-347) the amount of losses that the taxpayer can be allocated (e.g., to a partner of a partnership),[[347]](#footnote-348) or the amount of deductions that can be taken by a taxpayer with respect to an investment activity (e.g., the at-risk rules).[[348]](#footnote-349) Basis also establishes the amount upon which depreciation or other cost recovery deductions are based.[[349]](#footnote-350) Thus, it is not a surprise that the term “basis” is associated with and called many different things, depending on the tax situation: adjusted basis, cost basis, carryover basis, outside basis, inside basis, tax basis, etc.
      2. Adjustments to Basis and Recapture
         1. Other than assets acquired upon the death of a decedent (discussed later in these materials), the initial basis in an asset is measured by the taxpayer’s cost to acquire the asset (cost basis).[[350]](#footnote-351) From there the Code provides for adjustments that increase or decrease the initial cost basis. Hence, the term “adjusted basis.”[[351]](#footnote-352)
         2. The most common upward adjustment to basis are:
            1. Capital improvements,[[352]](#footnote-353) which are generally costs incurred to prolong the life of or enhance the value of an asset (as opposed to expenses incurred to maintain the property, which are not added to basis but might be deductible in the year paid);
            2. Capitalized expenditures,[[353]](#footnote-354) which are generally expenses that will yield benefits in the future in the taxpayer’s business or income producing activities (for example, costs incurred to sell an asset);[[354]](#footnote-355) and
            3. Carrying charges,[[355]](#footnote-356) which are expenses like real property taxes or interest, and the taxpayer has elected to capitalize, rather than deduct.
         3. The most common downward adjustments to basis are referred to as cost recovery deductions, coming in three general types: depreciation, amortization, and depletion. As mentioned earlier in these materials, depreciation is the Code’s version of deductible allowances for the exhaustion, wear, tear, and obsolescence with respect to certain property. When a taxpayer takes or is entitled to take a depreciation deduction, the basis of the depreciable asset must be reduced by the allowable deduction (even if the taxpayer did not claim the deduction).[[356]](#footnote-357) The amount of the deduction each year depends on the type of property and when the property was placed in service. For property placed in service after 1986, the system for deducting depreciation is called Modified Accelerated Cost Recovery System (MACRS).[[357]](#footnote-358) Amortization refers to cost recovery deductions of certain intangible assets.[[358]](#footnote-359) Depletion refers to cost recovery deductions related to the exhaustion of certain natural resources like oil, gas, timber, etc.[[359]](#footnote-360)
         4. When depreciable, amortizable, or depletable assets are sold at a gain, they are subject to “recapture.” Often taxpayers are able to use cost recovery deductions to offset ordinary income generated by their business or income-producing activities (e.g., depreciation deductions from real property investments that offset rental income). If the depreciable, amortizable, or depletable asset is then sold at a gain, sections 1245 and 1250 of the Code treat the gain attributable to the cost recovery deduction as ordinary income, rather than capital gain. The two Code sections are mutually exclusive to each other. Section 1250 property is defined as any depreciable real property other than section 1245 property.[[360]](#footnote-361) Personal property (tangible and intangible) is subject to recapture under section 1245 of the Code, but real property may be subject to either section 1245 or 1250, depending on the use to which it is put and, for Accelerated Cost Recovery System[[361]](#footnote-362) (ACRS) property, the recovery method chosen by the taxpayer.[[362]](#footnote-363) The distinction between the two Codes sections is significant. Section 1250 recapture is taxed at a 25% rate,[[363]](#footnote-364) and section 1245 recapture is taxed at ordinary rates, the top rate of which today is 37%.[[364]](#footnote-365)
   2. Income Tax Consequences of Gifts
      1. The most common estate planning technique is making a taxable gift. Quite simply, it results in the removal of the asset from the donor’s gross estate (sometime at the cost of using some portion or all of the donor’s basic exclusion amount (along with any future appreciation). Under section 102(a) of the Code, the receipt of the asset is not income to the donee.[[365]](#footnote-366) Once received, any income generated on gifted property after the date of the gift is shifted from the donor's income tax return to the donee's income tax return.
      2. 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).[[366]](#footnote-367) 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, as discussed later in these materials).[[367]](#footnote-368) 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.[[368]](#footnote-369)
      3. The basis of the gifted property is increased by any Federal gift tax paid attributable to any appreciation in the gifted property.[[369]](#footnote-370) In that instance, the amount of the increase is an amount (not in excess of the gift tax paid) which bears the same ratio to the amount paid as the amount the fair market value of the gift exceeds the donor’s basis immediately before the gift bears to the “amount of the gift.”[[370]](#footnote-371) Thus, for example, if a gifted asset has a fair market value of $100 and a basis of $75, and the donor pays $40 in gift tax, the resulting basis of the gifted asset held by the donee will be $85 ($75 basis in the donor’s hands plus 25% [$25 net appreciation/$100 value] x $40 in gift tax).
      4. In the case of gifts between spouses, the basis is determined under section 1041 of the Code, not section 1015 of the Code.[[371]](#footnote-372) Applicable to transfers of property to (or in trust for the benefit of) a spouse or former spouse (but only if incident to a divorce), section 1041(b)(2) of the Code provides the transferee’s basis shall simply the transferor’s adjusted basis.[[372]](#footnote-373) This applies whether the gifted asset has an adjusted basis that is less than, equal to, or greater than the fair market value at the time of the gift[[373]](#footnote-374) and regardless of whether the gifted has debt in excess of basis.[[374]](#footnote-375)
      5. When a "net gift" is made (i.e., the gift taxes on the transfer, which are the legal obligation of the donor, are instead assumed by the donee as a condition of the gift), pursuant to *Diedrich v. Commissioner*,[[375]](#footnote-376) the donor will realize gain to the extent the gift tax paid exceeds the donor's adjusted basis in the property. As previously mentioned during the discussion of the *Crane* and *Tufts* cases, when a gift is made of property subject to nonrecourse indebtedness, the donor will realize gain to the extent that the indebtedness exceeds the basis of the property.[[376]](#footnote-377) The "amount realized" is equal to the outstanding balance of the nonrecourse obligation, and the fair market value of the property is irrelevant to the computation. In contrast, if the gifted property is subject to recourse debt, the donor will realize gain to the extent that indebtedness assumed by the donee exceeds the basis of the property.[[377]](#footnote-378) The transfer of a passive-activity asset by lifetime gift does not trigger the recognition of any suspended passive activity losses.[[378]](#footnote-379)
      6. In the case of the gratuitous forgiveness of indebtedness, the Code contains conflicting provisions relating to whether the donee has received gross income.[[379]](#footnote-380) It has been held that the forgiveness of indebtedness which is a true gift (i.e., made gratuitously and with donative intent) is not included in gross income.[[380]](#footnote-381)
   3. Income Tax Consequences of Bequests, Devises, or Inheritance
      1. As with gifts, section 102(a) provides, “Gross income does not include the value of property acquired by … bequest, devise, or inheritance.”[[381]](#footnote-382) As such, the receipt of property by a beneficiary, devisee, or heir is not income to such taxpayer. Unlike a gift, however, under section 1014(a)(1) of the Code, the “basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent” is the “fair market value of the property at the date of the decedent's death.”[[382]](#footnote-383) The foregoing general rule is often referred to as the “step-up” in basis at death, under the assumption that assets generally appreciate in value. However, many assets depreciate in value, and this general rule will mean a loss of tax basis to fair market value at date of death (a “step-down” in basis). For purposes of the rest of materials, we refer to the general rule of section 1014(a)(1) as a “step-up” in basis, whether the asset has appreciated or depreciated at the time of the decedent’s death.
      2. The Code goes on to say that if the executor of the estate elects an alternate valuation date under section 2032 or special use valuation under section 2032A, then the basis is equal to the value prescribed under those Code sections.[[383]](#footnote-384)
      3. If land, or some portion thereof, that is subject to a qualified conservation easement is excluded from the estate under section 2031(c), then “to the extent of the applicability of the exclusion,” the basis will be the “basis in the hands of the decedent”[[384]](#footnote-385) (“carryover basis”).[[385]](#footnote-386)
      4. In the context of partnerships, typically the “step-up” in basis is reflected in the partnership interest owned by a decedent partner at the time of his or her death. If a section 754 election is made, then the basis of the assets inside the partnership will be adjusted to reflect the “step-up” in the partnership interest. As discussed later in these materials, how those basis adjustments are reflected and allocated is complex and often results in less than ideal results for individual taxpayers.
   4. Defining “Property Acquired From a Decedent”
      1. Generally
         1. The Treasury Regulations state, “The purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent that is equal to the value placed upon such property for purposes of the federal estate tax.”[[386]](#footnote-387) In other words, the basis adjustment at death under Section 1014(a) of the Code is tied directly to the imposition of the estate tax.
         2. However, there are a number of situations where the basis adjustment at death is available without inclusion of the property in a U.S. gross estate. As such, understanding some of the different ways in which property is “acquired from a decedent” is important, separate from the question of whether estate tax has or will be imposed on such property.
      2. Section 1014(b)(1): Bequest, Devise, or Inheritance
         1. Section 1014(b)(1) of the Code provides, “Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent”[[387]](#footnote-388) is considered “to have been acquired from or to have passed from the decedent.”[[388]](#footnote-389)
         2. Property acquiring a “step-up” in basis under this subsection does not necessarily need to be included in a decedent’s gross estate, particularly when nonresident alien decedents are involved.[[389]](#footnote-390)
      3. Section 1014(b)(2): Revocable and Retained Income Trusts
         1. Section 1014(b)(2) of the Code provides, “[p]roperty transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust”[[390]](#footnote-391) is considered “to have been acquired from or to have passed from the decedent.”
         2. As discussed later in these materials, except for certain assets (non-U.S. situs) held by trusts created by or controlled by nonresident aliens, these assets would be includible in the decedent’s gross estate under section 2036 of the Code (due to the retained income interest) or section 2038 of the Code (due to the right of revocation).
      4. Section 1014(b)(3): Retained Control Trusts
         1. Section 1014(b)(3) of the Code provides, “property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust”[[391]](#footnote-392) is considered “to have been acquired from or to have passed from the decedent.”
         2. As discussed later in these materials, except for certain assets (non-U.S. situs) held by trusts created by or controlled by nonresident aliens, these assets would be includible in the decedent’s gross estate under section 2038 of the Code (because of the retained powers over assets).
      5. Section 1014(b)(4): Exercised Testamentary General Power of Appointment
         1. Section 1014(b)(4) of the Code provides, “[p]roperty passing without full and adequate consideration under a general power of appointment exercised by the decedent by will”[[392]](#footnote-393) is considered “to have been acquired from or to have passed from the decedent.”
         2. Assets passing pursuant to the exercise of a testamentary general power of appointment would also be includible in the power holder’s estate under section 2041 of the Code, whether or not exercised, under section 2041 of the Code and entitled to a basis adjustment under section 1014(b)(9) of the Code.
         3. If a nonresident alien is granted a testamentary power of appointment over appreciated non-U.S. situs property and the power is exercised in the will of the nonresident alien decedent, it is conceivable such property would receive a “step-up” in basis under section 1014(b)(4) of the Code.
      6. Section 1014(b)(6): Community Property
         1. Section 1014(b)(6) of the Code provides, “[p]roperty which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate under chapter 11 of subtitle B (section 2001 and following, relating to estate tax)”[[393]](#footnote-394) is considered “to have been acquired from or to have passed from the decedent.”
         2. Community property considerations, and planning opportunities with such property, are discussed in more other parts of these materials.
      7. Section 1014(b)(9): Assets Subject to U.S. Estate Tax
         1. Section 1014(b)(9) of the Code provides, “property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate under chapter 11 of subtitle B”[[394]](#footnote-395) is considered “to have been acquired from or to have passed from the decedent.”
         2. This provision is essentially the catch-all provision that provides a basis adjustment at death under section 1014(a) of the Code if any asset, or portion thereof, is included in a decedent’s gross estate. Prior to its enactment, because a joint interest in property is deemed to have been acquired by lifetime transfer (not by “bequest, devise, or inheritance” as required by section 1014(b)(1) of the Code), the joint interest would have been included in the decedent’s gross estate for estate tax purposes but would not have been entitled to a “step-up” in basis. In enacting this provision, the legislative history states there is “no justification for denying property included in a decedent's gross estate for estate tax purposes a new basis at date of death.”[[395]](#footnote-396)
         3. Strangely, the Code provides a reduction of the “step-up” in basis on cost recovery-type property: “if the property is acquired before the death of the decedent, the basis shall be the amount determined under subsection (a) reduced by the amount allowed to the taxpayer as deductions in computing taxable income under this subtitle or prior income tax laws for exhaustion, wear and tear, obsolescence, amortization, and depletion on such property before the death of the decedent.”[[396]](#footnote-397) Unusually, any basis adjustment allowed solely by reason of section 1014(b)(9) of the Code is reduced by "the amount allowed to the taxpayer as deductions . . . for exhaustion, wear and tear, obsolescence, amortization and depletion on such property before the death of the decedent." This limitation apparently applies only when someone other than the decedent owns depreciable, amortizable or depletable property which is nevertheless includible in the decedent's taxable estate.
         4. The Treasury regulation interpreting the provision is entitled, "Special rule for adjustment to basis when property is acquired from a decedent prior to his death." It appears to have originated at a time when assets given away within three years of death were taxed to the decedent under a prior version of section 2035 of the Code.[[397]](#footnote-398) Its application is not, however, limited to that situation. Thus, for example, the provision has been applied to depreciated property held by the decedent and another as joint tenants with rights of survivorship[[398]](#footnote-399) and property held by spouses as tenants by the entirety.[[399]](#footnote-400) If an owner of the property was able to claim a deduction for depreciation, amortization or depletion during the decedent's lifetime, this provision prevents the owner from recouping that deduction as a result of having the property included in another person's estate. Thus, for example, assume that A made a gift of depreciable property with a basis of $50,000 to B, and retained a life estate. Prior to A's death, B claimed depreciation deductions of $20,000. When A dies, the property, valued at $80,000, is included in determining the value of A's gross estate under Section 2036(a)(1). Pursuant to Section 1014(b)(9), B's adjusted basis in the property as of the date of the decedent's death is $60,000 ($80,000, the fair market value at the decedent's death, less $20,000, the total depreciation deduction actually allowed to B).[[400]](#footnote-401)
      8. Section 1014(b)(10): QTIP Marital Trusts
         1. Section 1014(b)(10) of the Code provides, “[p]roperty includible in the gross estate of the decedent under section 2044 (relating to certain property for which marital deduction was previously allowed)”[[401]](#footnote-402) is considered “to have been acquired from or to have passed from the decedent.”
         2. This provision provides the basis adjustment for assets held in qualified electing QTIP trusts under sections 2056(b)(7) and 2523(f) of the Code for which an estate or gift tax marital deduction was granted. There is some additional discussion regarding the basis adjustment at the death for assets subject to debt held in QTIP trusts later in these materials.
   5. Basis Consistency and Reporting Rules for Property Acquired from a Decedent
      1. Generally
         1. On July 31, 2015, the President signed the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015[[402]](#footnote-403) (commonly referred to as the “Highway Bill”) into law. Among the non-expiring provisions in the Highway Bill are provisions that create new sections 1014(f) and 6035 of the Code.[[403]](#footnote-404) Pursuant to these provisions, taxpayers acquiring property from a decedent whose estate was required to file a Federal estate tax return must report their adjusted tax basis consistently with the value of the property as finally determined for Federal estate tax purposes, or if not finally determined, the value as reported by the statement made under section 6035 of the Code. Specifically, beneficiaries cannot claim a higher basis than the estate tax value. Further, the executor is required to furnish the IRS and to each person acquiring any interest in property included in the gross estate a statement of value and any other information prescribed by the IRS.
         2. Section 6035 imposes reporting requirements for individuals who are required to file a Form 706 under section 6018(a) (e.g., an executor) or under section 6018(b) (e.g., a recipient of the decedent). If a Form 706 must be filed, the reporting party is now also required to report valuation information to the IRS and to each person acquiring any interest in property included in the decedent’s gross estate. The statement must be delivered within 30 days of the earlier of the date the return is filed or the date the estate tax return was due (with extensions). If the value is subsequently adjusted (e.g., by audit or amendment), a supplemental statement must be provided within 30 days. The penalty for each failure is $250, to a maximum of $3 million, and if the failure to report was intentional, the penalty is increased to $500, with exceptions for reasonable cause. [[404]](#footnote-405) No penalty applies for over-reporting.
         3. If a taxpayer claims a tax basis on his or her income tax return in excess of the basis reported under section 1014(f) of the Code, a 20% penalty[[405]](#footnote-406) is applied to the underpayment arising from the “inconsistent estate basis reporting.”[[406]](#footnote-407) The 6-year statute of limitations applies in the case of an overstatement of basis.[[407]](#footnote-408)
         4. Note that section 1014(f)(1) of the Code limits application of the section to situations where Federal estate tax values have been determined. Section 1014(f)(3) defines “determined” in such a way that ordinarily a return would need to be filed. Furthermore, section 1014(f) of the Code only applies to “property whose inclusion in the decedent's estate increased the liability for the tax imposed by chapter 11.”[[408]](#footnote-409)
         5. These provisions apply to estate tax returns (and related income tax returns) required to be filed after July 31, 2015.[[409]](#footnote-410)
      2. Temporary and Proposed Regulations[[410]](#footnote-411)
         1. Introduction
            1. On March 4, 2016, the Department of Treasury published temporary and proposed regulations providing guidance regarding the basis consistency and information reporting rules of IRC §§ 1014(f) and 6035. The proposed regulations apply to property acquired from a decedent or by reason of the death of a decedent whose federal estate tax return is filed after July 31, 2015.
            2. The proposed regulations clarify various definitions contained in IRC §§ 1014(f) and 6035. “Information Return” means Form 8971, “Information Regarding Beneficiaries Acquiring Property from a Decedent,” and the “Statement” required to be furnished to each beneficiary. Prop. Reg. § 1.6035-1(g)(2). “Statement” means the payee statement described as Schedule A of the Information Return.[[411]](#footnote-412)
            3. The proposed regulations also provide guidance on the following topics: (1) property subject to the basis consistency rules; (2) reporting requirements; (3) property subject to the reporting requirements; (4) reporting due dates; (5) the effect of post-death adjustments to basis; (6) identity of the beneficiaries who must receive a Statement; (7) supplemental information and treatment of subsequently-discovered property; (8) reporting subsequent transfers; and (9) beneficiaries’ inability to contest estate tax value.
         2. Property Subject to the Basis Consistency Rules
            1. Generally, all property included in the decedent’s gross estate (including property the basis of which is determined in whole or in part with reference to property in the gross estate, such as like-kind exchange property or property subject to an involuntary conversion) that generates a federal estate tax in excess of allowable credits (other than a credit for a prepayment of tax) is subject to the basis consistency rules.[[412]](#footnote-413) If the estate pays no federal estate tax, then none of the estate property is subject to the basis consistency rules, although the property may be subject to the reporting rules.[[413]](#footnote-414)
            2. Property that qualifies for an estate tax charitable or marital deduction under sections 2055, 2056 or 2056A of the Code are excluded from the property subject to the basis consistency rules because such property does not generate estate tax liability.[[414]](#footnote-415)
            3. In addition, tangible personal property for which an appraisal is not required under section 20.2031-6(b) of the Treasury Regulations is not subject to the basis consistency rules. The proposed regulations are not clear whether this exception applies if the aggregate value of all tangible personal property is under the $3,000.00 threshold provided in the regulations or whether the exception applies to each item of tangible personal property the value of which is under the $3,000.00 threshold. However, an example in the proposed regulations indicates that this exception applies for any individual item the value of which is under $3,000.00.[[415]](#footnote-416) A further indication that the exception applies to each item the value of which is under $3,000.00 is found in the Instructions to Form 706, which requires an appraisal only for those items valued at more than $3,000.00, although keep in mind that Instructions are not binding.
         3. Reporting Requirements
            1. An “executor” who is required to file a federal estate tax return pursuant to IRC § 6018(a) is required to provide an Information Return (i.e., Form 8971 and Schedule A) to the IRS and a Statement (i.e., Schedule A) to each beneficiary who will receive property that was included in the decedent’s gross estate.[[416]](#footnote-417)
            2. This reporting requirement does not apply if the executor is not required by IRC § 6018(a) to file a federal estate tax return, but files a federal estate tax return for other reasons (e.g., to make a portability election, a GST tax exemption allocation or a protective filing to avoid any penalty if an asset value is later determined to require the filing of a return).[[417]](#footnote-418)
            3. The due date for providing an Information Return and Statement to the IRS and the Statements to the beneficiaries is the earlier of 30 days after the due date of the federal estate tax return or 30 days after the date the federal estate tax return is actually filed.[[418]](#footnote-419)
         4. Property Subject to the Reporting Requirements
            1. Generally, all property required to be reported on a federal estate tax return (including property the basis of which is determined in whole or in part with reference to property in the gross estate, such as like-kind exchange property or property subject to an involuntary conversion) is subject to the reporting requirement.[[419]](#footnote-420) This includes property included in the gross estate but not held by the estate, such as property held in a revocable trust established by the decedent. Regarding property owned by a deceased nonresident alien, only the property that is subject to the U.S. estate tax is reportable.[[420]](#footnote-421) For a decedent holding community property, the reporting requirement only applies to the decedent’s one-half of community property.[[421]](#footnote-422)
            2. Four classes of property are exempt from the reporting requirement: (a) cash (other than a coin collection or other coins or bills with numismatic value); (b) income in respect of a decedent (as defined in section 691 of the Code); (c) tangible personal property for which an appraisal is not required under section 20.2031-6(b) of the Treasury Regulations; and (d) property sold, exchanged or otherwise disposed of (and therefore not distributed to a beneficiary) by the estate in a transaction in which capital gain or loss is recognized.[[422]](#footnote-423)
         5. Effect of Post Death Adjustments
            1. The proposed regulations recognize that post-death adjustments to a property’s basis may still occur after the valuation date for estate tax purposes. A beneficiary’s initial basis in property acquired from the decedent or as a result of the decedent’s death will be the value of such property as reported on the federal estate tax return. However, the beneficiary’s initial basis may be adjusted due to the operation of other provisions of the Code governing basis.[[423]](#footnote-424)
            2. Such adjustments could include gain recognized by the decedent’s estate upon distribution of the property, post-death capital improvements and depreciation and post-death adjustments to the basis of an interest in a partnership or S corporation.[[424]](#footnote-425)
            3. The basis of property subject to debt (whether recourse or non-recourse) is the gross up value of the property and thus, post-death payments on such debt will not result in an adjustment to the property’s basis.[[425]](#footnote-426)
         6. Identity of the Beneficiaries Who Must Receive a Statement
            1. Statements must be provided to any person receiving reportable property (referred to as a “beneficiary”).[[426]](#footnote-427) There is no exception to exclude reporting to a beneficiary who receives property which is not subject to the basis consistency rules (e.g., bequests that qualify for the marital or charitable deduction). If a beneficiary is a trust or another estate, the statement is provided to the trustee or the executor not the beneficiaries of that trust or estate.[[427]](#footnote-428)
            2. If the executor has not identified the property that will be distributed to each beneficiary by the due date for submitting the Information Return and Statements, the executor must report on the Statement for each such beneficiary all of the reportable property that could be used to satisfy that beneficiary’s interest.[[428]](#footnote-429) The proposed regulations further provide, “Once an exact distribution has been determined, the executor may, but is not required to, file and furnish a supplemental Information Return and Statement.”[[429]](#footnote-430)
            3. If a beneficiary cannot be located by the reporting due date, the executor must still file the Information Report and must explain the efforts made to locate the beneficiary. Prop. Reg. § 1.6035-1(c)(4). A supplemental report must be filed within 30 days of locating the beneficiary. Prop. Reg. § 1.6035-1(c)(4).
            4. For life estates, a beneficiary includes “the life tenant, the beneficiary of a remainder interest is remainderman(men) identified as if the life tenant were to die immediately after the decedent, and the beneficiary of a contingent interest is a beneficiary, unless the contingency has occurred prior to the filing of the Form 8971. If the contingency subsequently negates the inheritance of the beneficiary, the executor must do supplemental reporting…to report the change of beneficiary.”[[430]](#footnote-431) The inclusion of a contingent beneficiary as a beneficiary who must receive a Statement may be a drafting error, but until such time as the proposed regulations are finalized or amended, executors must report the basis of life estate property to contingent beneficiaries.
         7. Supplemental Information and Subsequently-Discovered Property
            1. An executor must file supplemental Information Returns and Statements if any change occurs that causes the reported information to be incorrect.[[431]](#footnote-432) No supplement is required to: (i) correct an inconsequential error or omission within the meaning of section 301.6772-1(b) of the Treasury Regulations; or (2) specify the actual distribution of property previously reported as being available to satisfy the interests of multiple beneficiaries.[[432]](#footnote-433) The due date of the supplement is 30 days after: (1) the final value is determined, (2) incorrect or incomplete information is discovered or (3) a supplemental federal estate tax return is filed reporting additional assets.[[433]](#footnote-434)
            2. If property is later discovered and reported on a supplemental federal estate tax return before the period of limitation on assessment of tax expires, such property’s basis for basis consistency purposes will be the final value as shown on the supplement to the federal estate tax return.[[434]](#footnote-435) However, if the discovered property is not reported on a supplemental federal estate tax return before the limitation period expires, the basis of such property is zero.[[435]](#footnote-436)
         8. Reporting Subsequent Transfers
            1. If property that previously was reported or is required to be reported is distributed or transferred (by gift or otherwise) by the beneficiary to a related transferee in a transaction in which the related transferee determines its basis, in whole or in part, by reference to the beneficiary/transferor’s basis, the beneficiary/transferor must, within 30 days of the transfer, file with the IRS a supplemental Statement and furnish a copy to the transferee.[[436]](#footnote-437)
            2. If the subsequent transfer occurs before the final value is determined for estate tax purposes, then the transferor must also give the executor a copy of the Statement.[[437]](#footnote-438) “A related transferee means any member of the transferor’s family as defined in section 2704(c)(2), any controlled entity…and any trust of which the transferor is a deemed owner for income tax purposes.[[438]](#footnote-439)
   6. Section 1014(e): The One Year Conundrum
      1. Section 1014(e) provides that if “appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent’s death,”[[439]](#footnote-440) and the property is “acquired from the decedent by (or passes from the decedent to) the donor of such property (or spouse of such donor),”[[440]](#footnote-441) then the property will not receive a “step-up” in basis and it will have the basis in the hands of the decedent before the date of death.[[441]](#footnote-442)
      2. For purposes of the foregoing, the Code provides that carryover basis shall apply to any appreciated property “sold by the estate of the donor or by a trust of which the decedent was the grantor” but only “to the extent the donor of such property (or the spouse of such donor) is entitled to the proceeds from such sale.”[[442]](#footnote-443)
      3. This rule does not apply if the property passes to the issue of the original donor, and it is unclear whether this rule applies if the property is placed in trust where the original donor or donor’s spouse is a potential beneficiary.[[443]](#footnote-444) In *Estate of Kite v. Commissioner*[[444]](#footnote-445) prior to her husband’s death, the surviving spouse funded an inter vivos QTIP trust for the benefit of her husband with appreciated assets. Her husband died a week after the QTIP trust was created and funded. The surviving spouse reserved a secondary life estate for the benefit of the surviving spouse, and the inclusion in her husband’s estate was offset with a QTIP election. As such, after her husband’s death, the appreciated assets were held in a marital trust for the surviving spouse, the original donor of the assets. Two other marital trusts were created for the benefit of the surviving spouse. The three marital trusts engaged in a series of transactions that effectively terminated the marital trusts, with a subsequent sale of the assets by the surviving spouse to the children for a deferred annuity. These transactions were at issue in the case, and the Tax Court concluded that a taxable gift was deemed to occur upon the sale of the marital trust assets under section 2519. However, in a footnote, the Tax Court provided that all of the assets in the marital trusts, including the appreciated assets gifted to the husband shortly before death, received a step-up in basis under section 1014 of the Code.[[445]](#footnote-446) The decision and the result of the case (in particular the with respect to section 1014(e)) have been criticized by a number of commentators.[[446]](#footnote-447)

E. Community Property and Elective/Consensual Community Property

* + 1. The Code provides a special rule for community property. Section 1014(b)(6) provides that “property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate”[[447]](#footnote-448) shall be deemed to have been acquired from or to have passed from the decedent.
    2. There are currently nine community property states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. There are four states that are separate property states but they allow couples to convert or elect to treat their property as community property: Alaska,[[448]](#footnote-449) Kentucky,[[449]](#footnote-450) South Dakota,[[450]](#footnote-451) and Tennessee.[[451]](#footnote-452) Generally, these elective or “consensual community property” laws allow resident and nonresident couples to classify property as community property by transferring the property to a qualifying trust, and for nonresidents, a qualifying trust requires at least one trustee who is a resident of the state or a company authorized to act as a fiduciary of such state, and specific language declaring the trust asset as community property.
    3. Clearly, for residents of separate property states, taking advantage of the “consensual community property” laws of another state has the potential for a basis adjustment under section 1014(b)(6). There has been no direct ruling on whether that would be the case under the laws of Alaska or Tennessee. However, a number of commentators have argued that assets in such “consensual community property” arrangements would, indeed, receive a full “step-up” in basis under section 1014(b)(6).[[452]](#footnote-453) A professional fiduciary must be designated in Alaska or Tennessee in order to invoke the respective statutes and the administrative expense ought to be weighed against the potential benefit, taking into consideration the uncertainty.
  1. Establishing Community Property and Maintaining the Character
     1. Given how valuable the full “step-up” in basis under section 1014(b)(6) can be for community property, practitioners should pay special attention to methods of transmuting separate property to community property and maintaining the community property even if the couple moves to a separate property state. Married couples who move from a separate property state and establish residence in a community property state can typically transmute their separate property to community property by way of agreement.[[453]](#footnote-454) By way of example, California provides “married persons may by agreement or transfer, with or without consideration… transmute separate property of either spouse to community property.”[[454]](#footnote-455) As long as the couple has the intent to remain permanently in the community property state, the transmutation could occur immediately upon establishing residency in the state. In other words, there is no time requirement after establishing residency when transmutation would be considered valid.
     2. Generally, if a couple moves from a community property state to a separate property state, the property will continue to maintain its community property status (but see below). However, maintaining that status to maximize the benefit of section 1014(b)(6) can be a challenge. For example, if community property is sold to purchase real property located in a separate property state, some courts have provided that the real property is held by the couple as tenants in common, notwithstanding the fact that the source of the funds is community property. Furthermore, if one spouse transfers assets to another spouse outright (as often happens in the estate planning process to “equalize” the estates of the spouses who are now living in a separate property state), the property is no longer considered community property. Generally income from community property and reinvestments of such income will retain its community property character. Money earned while domiciled in a separate property state will obviously be considered separate property. It is quite easy for commingling of funds to occur if, for example, an asset is bought with both community and separate property. Tracing of the funds and the income from such funds will be required from that point forward. As such, practitioners in separate property states should pay special attention to those clients who move from community property states and may want to consider ways to ensure and make clear how such property will continue to be held and reinvested.
     3. Sixteen separate property states (Alaska, Arkansas, Colorado, Connecticut, Florida, Hawaii, Kentucky, Michigan, Minnesota, Montana, New York, North Carolina, Oregon, Utah, Virginia, and Wyoming) have enacted the Uniform Disposition of Community Property Rights at Death Act (“UDCPRDA”). UDCPRDA provides that property that was originally community property will retain its character as such for testamentary purposes. The UDCPRDA is limited in scope,[[455]](#footnote-456) and is not a tax statute. It is not clear whether decedents with surviving spouses who live in a state that has enacted the UDCPRDA are in a better position to claim the “step-up” in basis under section 1014(b)(6), than those decedents who do not. Regardless, some practitioners worry that the UDCPRDA does not mandate community property treatment for section 1014 purposes at all, rather it merely means that the property will be treated “the same as” community property for state law purposes. Section 1014(b)(6) requires that property be treated as community property under the law of some state; if a state does not have the concept of community property, does the UDCPRDA treat non-community property as if it were community property, or does it transmute non-community property into community property? There appears to be no definitive Federal tax authority on the point.

1. TAX BASIS MANAGEMENT: MAXIMIZING & MULTIPLYING “STEP-UP”
   1. Generally
      1. As discussed above, estate planning has increasingly focused on the income tax savings resulting from the “step-up” in basis. Estate planners should seek to maximize the “step-up” in basis by ensuring that the assets that are includible in the estate of a decedent are the type of assets that will:
         1. Benefit from a “step-up” (avoiding the inclusion cash or property that has a basis greater than fair market value)
         2. Benefit the most from the “step-up” (for example, very low basis assets, collectibles, and “negative basis” assets); and
         3. Provide significant income tax benefits to the beneficiaries (assets are likely to be sold in a taxable transaction after “step-up” or depreciable/depletable assets giving rise to ongoing income tax deductions).
      2. In considering tax basis management in estate planning, estate planners should take a bifurcated approach based upon the tax nature of the assets. For clients who are likely to own primarily low-basis assets that would benefit the most from a step-up in basis (e.g., creators of intellectual property or real estate developers), the estate plan will be centered around inclusion of those assets and benefiting from the “step-up” in basis. Then, to the extent the assets will be subject to Federal or state transfer taxes, then consideration must be given to ensuring that estate taxes can be paid on a timely or orderly manner. Thus, common features of the plan might include maintaining life insurance held by an irrevocable life insurance trust, qualifying for the payment of transfer taxes pursuant to the deferral provisions of section 6166, or securing a *Graegin*[[456]](#footnote-457) loan.[[457]](#footnote-458) For those clients who are likely to own assets that would not likely benefit from the “step-up” in basis (e.g., IRA assets, actively managed publicly-traded investment portfolios, or other high basis asset), then transferring the assets out of the estate would be paramount to the extent the assets would be subject to a significant Federal or state transfer tax liability. Finally, for those clients, who have both types of assets and whose assets would be subject to a significant transfer tax liability, the strategy would involve transferring the high basis assets out of the estate through a combination of zeroed-out transfer strategies and exercising the “swap” power proactively if the assets are held in a grantor trust, as discussed later in this article.
      3. When clients are in a situation where no estate taxes will be due (a “free-base” situation), then estate planners should seek to maximize the value of certain assets because the “step-up” in basis is based on fair market value (rather than trying to reduce the value for transfer tax purposes). A “free-base” situation can arise when the assets includible in the estate are less than the decedent’s remaining applicable exclusion amount or a marital deduction transfer under section 2056 to the surviving spouse.[[458]](#footnote-459) In these “free-basing” situations, practitioners will need to consider when valuations discounts are warranted and when the discounts should be removed. Of course, what is a free-base situation today may become an estate tax situation tomorrow. The estate tax on $8.2 million, the difference between an $11.7 million applicable exclusion and a $3.5 million applicable exclusion is $3,280,000 (28% of the total $11.7 million estate).
      4. In addition to the foregoing, estate planners should seek to: (a) maximize the value of certain assets because the “step-up” in basis is based on fair market value (rather than trying to reduce the value for transfer tax purposes); and (b) intentionally create estate tax inclusion, especially if the decedent lives in a state with no state death tax and if the decedent has significant unused Available Exclusion Amount above his or her assets.
   2. Tax Nature of Particular Assets
      1. Generally
         1. Understanding how and to what extent assets will benefit from a “step-up” in basis is critical to the estate planning process. Obviously, certain assets like highly-appreciated assets will benefit more from the “step-up” in basis at death than cash (which has a basis equal to its face value which is equal to its fair market value) or property at a loss (a “step-down” in basis). Moreover, appreciated assets like gold that are considered “collectibles”[[459]](#footnote-460) under the Code, benefit more from a step-up in basis than other appreciated capital assets because the Federal long-term capital gain tax rate for collectibles is 28%, rather than 20%.
         2. A list of asset categories or types starting with those that benefit the most from the “step-up” in basis and ending with those that benefit the least (or actually suffer a “step-down” in basis), might look like this:
            1. Creator-owned intellectual property (copyrights, patents, and trademarks), intangible assets, and artwork;
            2. “Negative basis” commercial real property limited partnership interests;
            3. Oil & gas investment assets (to be sold after date of death);
            4. Investor/collector-owned artwork, gold, and other collectibles;
            5. Low basis stock or other capital asset;
            6. Roth IRA assets;
            7. Oil & gas investment assets (to be held after date of death);
            8. Qualified Small Business Stock (QSBS);
            9. High basis stock;
            10. Cash;
            11. Passive Foreign Investment Company (PFIC) Shares;
            12. Stock or other capital asset that is at a loss;
            13. Variable annuities;
            14. Qualified Opportunity Zone (QOZ) investments; and
            15. Traditional IRA and qualified plan assets.
         3. A full discussion of every asset type listed above is beyond the scope of these materials, but a number of them deserve additional consideration and discussion.
      2. Creator-Owned Intellectual Property, Intangible Assets and Artwork
         1. Generally
            1. In the hands of the creator, intellectual property, intangible assets and artwork represent the type of asset that, from a tax standpoint, benefits greatly from the “step-up” in basis. For the most part, during the lifetime of the creator, these assets have little or no basis in the hands of the creator, and the sale, exchange, disposition, licensing or other exploitation of these types of assets are considered ordinary income to the creator. If the asset is transferred in a “carry-over” basis transaction like a gift, the tax attributes carry to the donee. On the other hand, if the creator of the asset dies with the asset, the asset is entitled to a “step-up” in basis and the asset becomes a long-term capital gain asset in the hands of the beneficiaries.
            2. Patents, copyrights, and trademarks are common assets, but intangible rights might also include the right of publicity, defined loosely as the right of an individual to have a monopoly on his or her own name, likeness, attributes, etc. In the case of well-known artists, actors, and celebrities, this right of publicity can be quite valuable. Some states, like New York, do not recognize a postmortem right to publicity,[[460]](#footnote-461) while approximately 19 states have specifically codified the postmortem right to publicity. Notably, California[[461]](#footnote-462) has codified the postmortem right to publicity, which lasts for a term of 70 years after the death of the personality. Further, the California statute specifically provides that such rights are freely transferable during lifetime or at death.
            3. As one can see, each of these intangible assets has its own peculiarities (e.g., the duration of the intangible rights) that may affect its value at the date of transfer (whether during lifetime or at death) and that may affect whether the asset or particular rights can be transferred at all.
         2. Copyrights
            1. Under U.S. law, copyright protection extends to “original words of authorship fixed in any tangible medium of expression,” which includes: “(1) literary works; (2) musical works, including any accompanying words; (3) dramatic works, including any accompanying music; (4) pantomimes and choreographic works; (5) pictorial, graphic, and sculptural works; (6) motion pictures and other audiovisual works; (7) sound recordings; and (8) architectural works.”[[462]](#footnote-463) The courts have ruled that computer software constitutes protected literary works.[[463]](#footnote-464)
            2. Knowing the duration of an existing copyright is critical to understanding what value a copyright may have today and what value a copyright may have in the future.

For works copyrighted on or after January 1, 1978, a copyright’s duration is based upon the life of the author plus 70 years.[[464]](#footnote-465)

For works copyrighted prior to January 1, 1978, a copyright’s duration was 28 years, with the author (and his or her estate) having the right to renew and extend the term for another 67 years (for a total of 95 years).[[465]](#footnote-466)

* + - * 1. For works copyrighted on or after January 1, 1978, the author (or the author’s surviving spouse or descendants if the author is deceased) has a right to terminate any transfer or assignment of copyright by the author 35 years after the transfer or assignment.[[466]](#footnote-467) These termination rights apply “in the case of any work other than a work made for hire, the exclusive or nonexclusive grant of a transfer or license of copyright or of any right under a copyright, executed by the author on or after January 1, 1978, otherwise than by will.”[[467]](#footnote-468) Because only the author has the right of termination during his or her lifetime, even if a gift is made of the copyright, the author’s continued right of termination calls into question how the copyright can be irrevocably transferred (especially since there seems no mechanism to waive the termination right) and appropriately valued for transfer tax purposes.
        2. Payments to the creator of a copyright on a non-exclusive license give rise to royalty income, taxable as ordinary income.[[468]](#footnote-469) An exclusive license (use of substantially all of the seller’s rights in a given medium) is treated as a sale or exchange. When the creator is the seller, it is deemed to be a sale of an asset that is not a capital asset,[[469]](#footnote-470) so it is taxed at ordinary rates. By contrast, if the seller is not the creator, capital asset treatment under section 1221 is available if such seller is not a dealer.[[470]](#footnote-471) Notwithstanding the foregoing, if the creator/author of the copyright, gifts the asset (carryover basis transaction), a sale or exchange by the donee is not afforded capital treatment either.[[471]](#footnote-472) A gift for estate planning purposes, therefore, may have the unintended effect of prolonging ordinary income treatment after the death of the author/creator of the copyright.
        3. In contrast, upon the death of the author/creator who still owns the asset at death, the copyright is entitled to a “step-up” in basis to full fair market value under section 1014 and the asset is transformed into a long-term capital gain asset. Because the basis of the copyright included in the creator’s estate is no longer tied to that of the creator, the asset no longer falls within the exclusion from capital asset treatment under section 1221(a)(3) and, thus, are capital assets in the hands of the creator’s beneficiaries. The copyright is deemed to immediately have a long-term holding period even if it is sold within 1 year after the decedent’s death.[[472]](#footnote-473)
      1. Patents
         1. Individuals who patent qualifying inventions are granted the “right to exclude others from making, using, offering for sale, or selling”[[473]](#footnote-474) such invention for a specified term. The term for a utility or plant patent is 20 years, beginning on the earlier of the date on which the application for the patent was filed.[[474]](#footnote-475) The term for a design patent is 14 years from the date of grant.[[475]](#footnote-476)
         2. Similar to the taxation of copyrights, payments received for a transaction that is not considered a sale or exchange or payments received for a license will be considered royalty income, taxable as ordinary income.[[476]](#footnote-477)
         3. Prior to the enactment of TCJA, the sale or exchange of a patent could be afforded capital gain treatment if the transaction qualified under section 1235 of the Code or because the Treasury regulations specifically provide that a patent or invention are not considered “similar property”[[477]](#footnote-478) to a copyright, which is excluded from capital gain treatment.[[478]](#footnote-479) In addition, capital gain treatment under section 1231 of the Code would be possible but only if the patent is considered to have been “used in a trade or business.”[[479]](#footnote-480)
         4. Effective for dispositions after December 31, 2017, TCJA amended section 1221(a)(3) of the Code providing that “a patent, invention, model or design (whether or not patented), and a secret formula or process”[[480]](#footnote-481) which is held either by the taxpayer who created the property or a taxpayer with a substituted or transferred basis from the taxpayer who created the property (or for whom the property was created) will be specifically excluded from the definition of a capital asset. In addition, TCJA makes a conforming amendment to section 1231(b)(1)(C) of the Code, specifically listing “a patent, invention, model or design (whether or not patented), and a secret formula or process” (just like a copyright) as an asset that is excepted from the term “property used in a trade or business.” [[481]](#footnote-482) As such the sale or exchange of such property will no longer qualify for capital gain tax treatment unless it falls under section 1235 of the Code.
         5. Like the tax treatment of the creator of a copyright, if the creator dies with a patent, the asset is entitled to a “step-up” in basis to full fair market value under section 1014, and the asset is transformed into a long-term capital gain asset.
         6. Section 1235 Transactions

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

Section 1235 provides that a “transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 1 year.”[[482]](#footnote-483)

Only an individual may qualify as a holder, regardless of whether he or she is in the business of making inventions or in the business of buying and selling patents.[[483]](#footnote-484) Specifically, a qualified “holder” includes (i) the creator of the patent,[[484]](#footnote-485) or (ii) “any other individual who has acquired his interest in such property in exchange for consideration in money or money's worth paid to such creator prior to actual reduction to practice of the invention covered by the patent,”[[485]](#footnote-486) provided that in such instance, the individual is not an employer of the creator or related to the creator.[[486]](#footnote-487) As such, a trust, estate, or corporation will not qualify as a holder under section 1235, although a transfer to a grantor trust would not likely disqualify a subsequent sale or exchange to capital gain treatment.[[487]](#footnote-488) An entity taxable as a partnership does not qualify as a holder, but each individual in the partnership may qualify separately as such.[[488]](#footnote-489)

A sale or exchange by a qualified holder to a “related person” will not qualify for capital-gain treatment under section 1235.[[489]](#footnote-490) A “related person” is generally defined by reference to section 267(b) and includes (i) the holder’s spouse, ancestors, and lineal descendants (but not siblings);[[490]](#footnote-491) (ii) a fiduciary of any trust of which the holder is the grantor; (iii) any corporation, partnership, or other entity in which the holder (and other related persons) own 25% or more of the ownership interests.[[491]](#footnote-492)

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

If a qualified holder sells his or her interest in a patent under section 1235 and later dies before all payments are received, the estate and/or beneficiary of the deceased reports the payments as long-term capital gain as IRD.[[492]](#footnote-493)

* + - 1. Artwork
         1. The taxation of artwork in the hands of the artist is the same as it would be for the creator of a copyright, as discussed above. Generally, all payments pursuant to a license and a taxable sale or exchange of the artwork give rise to ordinary income.[[493]](#footnote-494) A third-party collector or investor in the artwork might qualify for capital gain treatment or section 1231 treatment, as long as the property is not held out for sale in the ordinary course of a trade or business (inventory).[[494]](#footnote-495) Similarly, capital gain treatment is not available to a donee of the artist because the donee’s basis is determined by reference to the artist’s basis.[[495]](#footnote-496)
         2. Artwork in the hands of a collector or investor (third-party other than the creator or a donee of the creator) is considered a collectible under the Code and would be subject to the 28% long-term capital gain tax, rather than 20%.[[496]](#footnote-497) Under the Code, a “collectible” is any work of art, rug, antique, metal, gem, stamp, coin, alcoholic beverage, or any other tangible personal property designated by the IRS as such.[[497]](#footnote-498)
         3. As with copyrights and patents, the basis of property in the hands of a person acquiring property from a deceased artist is the fair market value of the property at the date of the artist’s death or on the alternate valuation date, if so elected.[[498]](#footnote-499) The artwork in the hands of the estate or the artist’s beneficiaries becomes a capital asset, qualifying for long-term capital gain treatment.[[499]](#footnote-500)
    1. “Negative Basis” and “Negative Capital Account” Partnership Interests
       1. “Negative basis” is the colloquial phrase used to describe a situation where the liabilities in a partnership (as also shared by the partners) are in excess of the tax basis of the partnership assets (and consequently, often in excess of the basis of the partners’ interests in the partnership). Of course, because the basis of an asset may not go below zero the phrase “negative basis” is technically incorrect. Regardless, often it is common in those situations for a taxable sale of the partnership property (or of the partnership interest) to create “phantom gain.” Even successful real property investment partnerships may have “negative basis” assets where the underlying developed real property has been fully depreciated and cash from one or more refinancings has been distributed to the owners or partners.
       2. The following example illustrates how this “negative basis” problem can arise and how costly a taxable event would be from an income tax standpoint:
          1. Taxpayer borrows $10 million to buy an office building in 1983 (assume for purposes of this example, the entire purchase price is properly allocated to the office building, which is depreciable). Over the next 30 years, the property appreciates in value, the taxpayer fully depreciates the original basis of $10 million in the building to zero,[[500]](#footnote-501) borrows against the property, and takes the borrowed funds tax free. As a result in 2014, the office building is worth $20 million, has zero adjusted tax basis, and has a mortgage on the building of $15 million ($5 million of net equity in the property).
          2. Note, because the property was placed in service in 1983, an accelerated method of depreciation was allowable on the property.[[501]](#footnote-502) As such, a taxable sale of the property will be subject to recapture under the Code. Because the property was placed in service prior to 1986, recapture is under section 1245 (rather than section 1250, which, as discussed above, generally applies to real property).[[502]](#footnote-503) As such, the total amount of the depreciation deductions is subject to recapture as ordinary income.[[503]](#footnote-504)
          3. If the building is sold for $20 million in a taxable transaction, the gain would break down as follows:

Amount Recognized: $20,000,000

Adjusted Basis: $ ------

Recapture: $10,000,000 ordinary income

Long-Term Capital Gain: $10,000,000 long-term capital gain

Assuming the building is located in a high tax jurisdiction like New York City, and the taxpayer is in the highest income tax bracket, the ordinary rate would be approximately 48% and the long-term capital gain rate would be approximately 37%. The total tax liability would be $8.5 million. After repayment of the $15 million of debt, the taxpayer (who would net $5 million in cash from the transaction before taxes) would actually be in deficit by approximately -$3.5 million after the payment of income taxes.

* + - * 1. Compare the result if the taxpayer died owning the building (assume for simplicity’s sake, the building no longer has a mortgage). The building would get a “step-up” in basis under section 1014(a) to fair market value, the recapture and long-term capital gain tax problem would be eliminated. If the taxpayer has $5.85 million of Applicable Exclusion available, the maximum estate tax liability (assuming a top state death tax rate of 16% and state death tax exemption equal to the federal exclusion amount) is approximately $7.0 million (maximum blended rate of 49.6%). If the applicable exclusion amount grows to $8 million for example, then the estate tax liability falls to a bit less than $6.0 million. If the foregoing building was in California, the income tax liability would be greater, and the estate tax cost would be even less because California does not have a death tax. With an applicable exclusion amount of $5.85, the estate tax liability is less than $5.7 million.
        2. Property placed in service after 1986 will not have as egregious of an income tax problem because the gain would not have recapture calculated under section 1245. Rather, section 1250 would be the applicable recapture provision. “Section 1250 property” means any real property, with certain exceptions that are not applicable,[[504]](#footnote-505) that is or has been property of a character subject to the allowance for depreciation.[[505]](#footnote-506) Section 1250(a)(1)(A) provides that if section 1250 property is disposed of, the “applicable percentage” of the lower of the “additional depreciation” in respect of the property or the gain realized with respect to the disposition of the property shall be treated as ordinary income. In short, section 1250 provides that all or part of any depreciation deduction in excess of straight-line depreciation is recaptured as ordinary income. [[506]](#footnote-507) Under the current depreciation system, straight-line depreciation is required for all residential rental and nonresidential real property.[[507]](#footnote-508) As such, section 1250 recapture is typically not a problem for property placed in service after 1986. The Code does, however, tax “unrecaptured section 1250 gain” at a 25% tax rate. Unrecaptured section 1250 gain is essentially the lesser of all depreciation on the property or the net gain realized (after certain losses) to the extent not treated as ordinary income under section 1250.[[508]](#footnote-509)
        3. From an estate planning perspective, it is important to remember that even if recapture is inherent in an appreciated property, it does not apply to a disposition by gift or to a transfer at death, unless the recapture would be considered income in respect of a decedent.[[509]](#footnote-510)
      1. Today, most real property investments are not held individually, but are held in an entity taxable as a partnership (a limited liability company or limited partnership). When real property investments are subject to refinancing followed by a distribution of the loan proceeds, the partnership debt rules under section 752 must be considered when determining the income tax cost of selling such property. Any increase in a partner’s share of partnership liabilities (whether recourse or nonrecourse to such partner) is treated as a contribution of money by the partner to the partnership, resulting in an increase in the partner’s basis in his or her partnership interest (“outside basis”).[[510]](#footnote-511) Any decrease in a partner’s share of partnership liabilities is treated as a distribution of money by the partnership to the partner, resulting in a decrease in the partner’s outside basis.[[511]](#footnote-512) A partner’s outside basis may not be reduced below zero, so a deemed distribution of money that arises from a decrease in a partner’s share of liabilities will give rise to gain recognition.[[512]](#footnote-513)

* + - 1. In the example above, consider if a limited partnership (or limited liability company taxed as a partnership) had borrowed the $10 million on a nonrecourse basis to purchase the building. As *Crane* and *Tufts* held, the $10 million of nonrecourse debt provides basis in the building,[[513]](#footnote-514) which in turn provides depreciation deductions on the property. In the partnership context, this creates “nonrecourse deductions.”[[514]](#footnote-515) Generally, nonrecourse deductions must be allocated in accordance with each partner’s interest in the partnership.[[515]](#footnote-516) The partnership debt also provides outside basis to the partners for their share of partnership liabilities.[[516]](#footnote-517) As the partnership takes depreciation deductions, the basis of the property is reduced, and the outside basis of the partners is also reduced.[[517]](#footnote-518) Eventually, in this simplified example, the basis of the building is zero, and so are the outside bases of the partners. In contrast to how basis is handled, the capital accounts of the partners start at zero and do not increase when the partnership borrows the $10 million, because the partners have not made any contributions of money or property to the partnership and debt is ignored in determining each partner’s capital accounts.[[518]](#footnote-519) However, as the partnership takes depreciation deductions, the partners are allocated nonrecourse deductions, which reduce not only their outside bases, as mentioned, but also their capital accounts. In other words, assuming any income from the building is fully offset by interest expenses on the debt, the capital accounts of the partners go negative.[[519]](#footnote-520) At the end of 30 years, the partners have a -$10 million capital account balance and zero outside basis, and the partnership has a $20 million building, collateralizing $10 million of nonrecourse debt. When the partnership borrows an additional $5 million against the net equity in the building in a refinancing, the partners get an additional $5 million in outside basis, thereby allowing the partnership to distribute the $5 million to the partners tax free.[[520]](#footnote-521) In the end, the partners have zero outside basis and negative capital account balances of -$15 million, and the partnership owns a $20 million building with zero basis, which collateralizes $15 million of debt. Debt is in excess of basis. As noted above, this paradigm is often referred to by the misnomer, “negative basis.”[[521]](#footnote-522)
      2. A transfer by the taxpayer, whether a taxable sale or a gift to a non-grantor trust, will create “phantom gain” and *Tufts* and *Crane* tell us that any disposition will be considered a sale or exchange to the extent debt is in excess of basis. A partner who sells a partnership interest must include in income the partner’s allocable share of the partnership’s recapture from depreciated partnership property.[[522]](#footnote-523) The transfer results in a decrease in the transferor partner’s share of liabilities, which in turn is treated as a distribution of money to the partner when the partner has an outside basis of zero, resulting in gain in a donative transfer or additional gain in the case of taxable sale.[[523]](#footnote-524)
      3. When dealing with highly appreciated, depreciable assets like real property and partnership debt, taxable sales of the property and inter vivos transfers of partnership interests can be problematic.[[524]](#footnote-525) In recent years, given reduced transfer tax rates and large applicable exclusion amounts, it has often made more economic sense to die owning these assets than to transfer them during the partner’s lifetime but decreases in the applicable exclusion could change that result. The transfer of a partner's interest on death is a disposition that does not result in gain or loss recognition, even if the liability share exceeds outside basis.[[525]](#footnote-526) The outside basis of the decedent receives a “step-up” in basis to fair market value (net of liabilities) but is also increased by the estate’s share of partnership liabilities.[[526]](#footnote-527) Further, if the partnership makes an election under section 754, the underlying assets in the partnership will also receive a “step-up” in basis.[[527]](#footnote-528)
      4. Even if a section 754 election is not made, the estate or the successor beneficiaries of the partnership interest can get the benefit of a “step-up” in the underlying assets if the successor partner makes an election under section 732(d) and if the partnership distributes the assets for which there would have been a basis adjustment.[[528]](#footnote-529) The election must be made in the year of the distribution if the distribution includes property that is depreciable, depletable, or amortizable. If it does not include such property, the election can wait until the first year basis in which has a tax significance. [[529]](#footnote-530)
    1. Traditional IRA and Qualified Retirement Assets
       1. In 2020, the Investment Company Institute estimated that total retirement assets were over $33 trillion (including government plans, private defined benefit plans, defined contribution plans and individual retirement accounts).[[530]](#footnote-531) Assets in IRAs and defined contribution plans totaled more than one-half of the total at approximately $16.3 trillion. Although IRA and qualified retirement assets make up one of the largest asset types of assets owned by individuals, they are one of the most problematic from an estate planning perspective.
       2. IRA and qualified retirement assets are not transferable during the lifetime of the owner,[[531]](#footnote-532) so the assets are never candidates for lifetime gifts unless the owner is willing to incur a taxable distribution of the assets. As such, to the extent not drawn-down prior to death, the assets are includible in the estate for transfer tax purposes,[[532]](#footnote-533) and by definition, the assets will use some or all of the decedent’s applicable exclusion amount, unless the assets are transferred to a surviving spouse under the marital deduction under section 2056 or to a charitable organization under section 2055.[[533]](#footnote-534) To make things worse, IRA and qualified retirement assets are considered income in respect of a decedent (IRD) under section 691.[[534]](#footnote-535) IRD assets are not entitled to a “step-up” in basis,[[535]](#footnote-536) and all distributions (whether paid over time or not) to a beneficiary are taxable as ordinary income.[[536]](#footnote-537) Even though the beneficiary is entitled to an income tax deduction[[537]](#footnote-538) (“IRD deduction”) for estate taxes payable by virtue of the inclusion of the assets, there is no Federal income tax deduction for state death taxes that might be payable, and given the reduced Federal transfer tax rate of 40% and the cost-of-living increase on the applicable exclusion amount, many taxpayers will have very little or no IRD deduction to shelter the on-going ordinary income tax problem.
       3. A distribution from a decedent’s IRA to a surviving spouse may be “rolled over” to another qualified retirement plan or IRA, thereby deferring the recognition of income.[[538]](#footnote-539) In addition, if the surviving spouse is the beneficiary of all or a portion of the decedent’s IRA, the surviving spouse may also elect to treat the decedent’s IRA as his or her own IRA.[[539]](#footnote-540) In both of the foregoing cases, the IRD problem discussed above continues after the death of the surviving spouse (unless the surviving spouse remarries).
       4. Because of the income tax liability built-in to retirement plans and IRAs, they should be among the first assets considered for clients who intend to benefit charity at death. Many techniques are available beyond outright charitable gifts including, for example, testamentary funding of a charitable remainder trust.[[540]](#footnote-541)
       5. Contrast the foregoing treatment with Roth individual retirement plans (“Roth IRAs”).[[541]](#footnote-542) Roth IRA assets are treated similarly to assets in a traditional IRA in that: (i) the account itself is not subject to income tax;[[542]](#footnote-543) (ii) distributions to designated beneficiaries are subject to essentially the same required minimum distribution rules after the death of the original Roth IRA owner;[[543]](#footnote-544) and (iii) surviving spouses may treat a Roth IRA as his or her own and from that date forward the Roth IRA will be treated as if it were established for the benefit of the surviving spouse.[[544]](#footnote-545) In contrast to a traditional IRA, distributions to a qualified beneficiary are not taxable to the beneficiary,[[545]](#footnote-546) and as discussed above, are not subject to the 3.8% Net Investment Income Tax.[[546]](#footnote-547) The overall result for decedents with Roth IRA assets, the qualified beneficiaries of the Roth IRA effectively receive the benefit of a “step-up” in basis. Since 2010,[[547]](#footnote-548) all taxpayers regardless of adjusted gross income[[548]](#footnote-549) can convert traditional IRA assets into a Roth IRA. The conversion is considered a taxable event causing the converted amount to be includible in gross income and taxable at ordinary income tax rates.[[549]](#footnote-550) Taxpayers can also make direct taxable rollovers from qualified company-based retirement accounts (section 401(k), profit sharing, section 403(b), and section 457 plans) into a Roth IRA.[[550]](#footnote-551) Individuals who have excess qualified retirement assets, have sufficient funds to pay the resulting tax liability from outside of the retirement account, and who are not planning to donate the asset to a charitable organization are should consider a Roth IRA conversion. Notwithstanding the clear benefits of passing the Roth IRA assets to children and grandchildren outside of the scope of the IRD provisions, not many individuals are willing to pay the income tax cost of the conversion.
    2. Passive Foreign Investment Company (PFIC) Shares
       1. A PFIC is a foreign corporation, 75% or more of the gross of which is “passive,”[[551]](#footnote-552) or the average percentage of assets that produce passive income of which is at least 50%.[[552]](#footnote-553) The PFIC rules do not apply to any U.S. taxpayer who is a 10% shareholder of a controlled foreign corporation.[[553]](#footnote-554)
       2. The PFIC rules generally provide that when a U.S. shareholder receives a distribution from a PFIC, rather than treating them under the normal rules of U.S. taxation (e.g., dividend treatment), a special tax regime applies. Under the PFIC tax regime, distributions from a PFIC will be treated either as “excess” or “nonexcess” distributions.
          1. An excess distribution is any portion that exceeds 125% of the average distributions made to the shareholder with respect to the shareholder’s shares within the 3 preceding years (or shorter if the shareholder has held the shares for less than 3 years).[[554]](#footnote-555) All other distributions or portions thereof are treated as nonexcess distributions.
          2. With respect to nonexcess distributions, the normal rules of U.S. taxation apply, which generally results in dividend treatment.[[555]](#footnote-556) However, the dividend will not be considered a qualified dividend taxable at 20% because a PFIC will never be a “qualified foreign corporation.”[[556]](#footnote-557)
       3. The portion of any distribution that is considered an excess distribution will first be allocated to each day in the shareholder’s holding period for the shares.[[557]](#footnote-558) Any portion so allocated to the current year and the non-PFIC years will be included in the year of receipt as ordinary income (not qualified dividends).[[558]](#footnote-559)
       4. The portion of the excess distribution that is allocated to other years (the “PFIC years”) is not included in the shareholders income, but is subject to a “deferred tax.”[[559]](#footnote-560) The deferred tax is added to the tax that is otherwise due. In computing the “deferred tax” the shareholder multiplies the distribution allocated to each PFIC year by the top marginal tax rate in effect for that year.[[560]](#footnote-561) The shareholder then adds all of the “unpaid” tax amounts for all of the PFIC years, and then computes interest on those unpaid tax amounts as if the shareholder had not paid the tax for the PFIC years when due using the applicable federal underpayment rate.[[561]](#footnote-562) The deferred tax and interest are separate line items on the individual shareholder’s income tax return.[[562]](#footnote-563)
       5. The sale of PFIC shares are considered excess distributions to the extent the consideration for the sale is in excess of the shareholder’s tax basis in the PFIC shares.[[563]](#footnote-564) Thus, effectively the gain is treated as ordinary income, which is treated as realized ratable over the seller’s holding period for purposes of determining the deferred tax and interest for prior years.
       6. U.S. shareholders of a PFIC may make a “qualified elective fund” (QEF) election to avoid the excess distribution regime. If the shareholder makes a QEF election, the shareholder must include in gross income a pro rata share of the PFIC’s ordinary income and net capital gain each taxable year.[[564]](#footnote-565) If a shareholder makes this election, he or she must have access to the PFIC’s books and records so the allocable share of the PFIC’s income and gain can be calculated.
       7. The death of a U.S. shareholder is not a taxable disposition of the PFIC shares if the death results in a transfer to a domestic U.S. estate or directly to another U.S. taxpayer.[[565]](#footnote-566) By contrast, a transfer upon the death of a U.S. shareholder to a testamentary trust or to a foreign person will be considered at taxable disposition.[[566]](#footnote-567) The proposed Treasury Regulations treat a transfer upon death as a transfer by the shareholder immediately prior to death and thus reportable in the decedent’s last tax return.[[567]](#footnote-568)
       8. If the PFIC shares are held in a grantor trust, the grantor’s death is a taxable disposition unless one of the exceptions applies.[[568]](#footnote-569)
       9. PFIC shares are nominally eligible for a “step-up” in basis. However, section 1291(e)(1) provides that a succeeding shareholder’s basis in PFIC shares is the fair market value of the shares on date of death but then reduced by the difference between the new basis under section 1014 and the decedent’s adjusted basis immediately before date of death.[[569]](#footnote-570) Thus, a succeeding shareholder’s basis in PFIC shares received from a decedent is limited to the adjusted basis of the decedent prior to death.
       10. The foregoing basis reduction rule does not apply to PFIC shares received by a succeeding U.S. shareholder upon the death of a nonresident alien decedent if the decedent was a nonresident alien during his or her entire holding period.[[570]](#footnote-571)
    3. Qualified Small Business Stock (QSBS)[[571]](#footnote-572)
       1. Section 1202 of the Code excludes a percentage of gain (50%, 75%, or 100%, depending on the original acquisition date) on the sale or exchange of “Qualified Small Business Stock” (QSBS) held for more than five years, and the percentage of exclusion (hereinafter referred to as the “Exclusion Percentage”) depends on the date on which the QSBS was acquired. Although a certain percentage of gain is excluded, the non-excluded gain, defined in the Code as “section 1202 gain,” is taxed at a maximum 28% rate,[[572]](#footnote-573) not the 20% preferential long-term capital gain rate. Section 1202 gain is defined as the excess of “the gain which would be excluded from gross income under section 1202 but for the percentage limitation in section 1202(a),” over “the gain excluded from gross income under section 1202”[[573]](#footnote-574) (hereinafter referred to as, “Section 1202 Gain”). The following chart shows the maximum effective exclusions and rates, including the NII 3.8% tax and the AMT:[[574]](#footnote-575)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Acquisition**  **Date** | **Exclusion**  **Percentage** | **Maximum**  **QSBS**  **Rate** | **Maximum**  **QSBS**  **AMT Rate[[575]](#footnote-576)** | **Maximum Rate**  **(No QSBS)** |
| Aug. 11, 1993 to  Feb. 17, 2009 | 50%[[576]](#footnote-577) | 15.90% | 16.88% | 23.80% |
| Feb. 18, 2009 to  Sep. 27, 2010 | 75%[[577]](#footnote-578) | 7.95% | 9.42% | 23.80% |
| **After**  **Sep. 27, 2010** | **100%[[578]](#footnote-579)** | **0.00%** | **0.00%** | **23.80%** |

* + - 1. The maximum tax savings from QSBS comes from stock acquired after September 27, 2010. Interestingly, under some circumstances the sale of QSBS stock might be subject to a higher rate than if section 1202 did not apply (e.g., stock entitled to a 50% exclusion under section 1202 sold during a time when the taxpayer’s highest tax bracket is 15%). It’s important to note that section 1202 is not elective. Section 1202 is not elective, thus in those instances, a taxpayer would be better off intentionally losing QSBS status by, for example, failing the 5-year holding requirement or making a disqualifying transfer, as discussed in more detail below.

* + - 1. In calculating any tax liability associated with the sale of QSBS, it is important to make a distinction between Section 1202 Gain (as defined above), gain that is excluded under section 1202(a) of the Code ( the “Excluded Section 1202 Gain”), and the taxable gain that is not subject to section 1202 (the “Non-Section 1202 Gain”). As noted above, Section 1202 Gain is taxed at a maximum rate of 28% (31.8%) and is carefully defined in terms of gain that would be excluded but for the percentage limitations noted above. By consequence, Section 1202 Gain is also limited by the “Per-Issuer Limitation,” discussed below, which limits the total amount of gain that is subject to the percentage exclusions. Any other gain, namely Non-Section 1202 Gain is taxed at the preferential 20% (23.8%) long-term capital gain tax rate. Non-Section 1202 Gain can include the unrecognized gain inherent in appreciated assets contributed to the corporation in exchange for stock in the corporation under section 351 of the Code. Under section 358 of the Code, the stock received in the corporation will receive a carryover basis, but for purposes of the Per-Issuer Limitation, discussed below, the fair market value of the contributed property is used in calculating the tenfold multiplier of the “Per-Issuer Limitation.”
      2. The Code provides a “Per-Issuer Limitation,” which prescribes the maximum gain that can be excluded under section 1202(a) of the Code. Section 1202(b)(1) of the Code provides, “If the taxpayer has eligible gain for the taxable year from 1 or more dispositions of stock issued by any corporation, the aggregate amount of such gain from dispositions of stock issued by such corporation which may be taken into account … for the taxable year shall not exceed the greater of—”[[579]](#footnote-580)
         1. “$10,000,000 reduced by the aggregate amount of eligible gain taken into account by the taxpayer . . . for prior taxable years and attributable to dispositions of stock issued by such corporation” (the “$10 Million Per Taxpayer Limitation”),[[580]](#footnote-581) or
         2. “10 times the aggregate adjusted bases of qualified small business stock issued by such corporation and disposed of by the taxpayer during the taxable year” (the “10 Times Basis Limitation”).[[581]](#footnote-582)
      3. A taxpayer that receives QSBS “by gift” or “at death” retains its character as QSBS, and the taxpayer is treated as having acquired the stock in the same manner as the transferor with a tacking of the transferor’s holding period.[[582]](#footnote-583) If the transfer is “at death,” the QSBS receives a “step-up” in basis under section 1014, but appreciation after date of death would continue to be eligible for gain exclusion under section 1202. Because of the gain exclusion and gain rollover aspects of QSBS, most taxpayers should seek to make inter vivos transfers of these assets out of their gross estates to the extent they exceed their transfer tax exclusions (both state and Federal). Simply put, heirs will not benefit as much from a “step-up” in basis because of the gain exclusion features of QSBS, and QSBS status can be retained and transferred through donative transfers to donees. One possible planning technique to multiply the benefit of the QSBS exclusion which is subject to the $10 Million Per Taxpayer Limitation (for QSBS shares that have less than $1 million of adjusted basis) is to make gifts to family members (e.g., children, but not spouses[[583]](#footnote-584)) and non-grantor trusts (treated as separate taxpayers and might include inter vivos marital deduction trusts for the benefit of a spouse).
      4. There is potential for shareholders of a QSBS corporation to exclude as much as $500 million of gain (assuming the $50 million gross asset limitation is met but not exceeded, and depending on how certain provisions are interpreted, perhaps even more) if tax basis management is carefully considered prior to the (and maybe even after) original issuance of the QSBS.
         1. For purposes of the 10 Times Basis Limitation, the Code provides that “the adjusted basis of any stock shall be determined without regard to any addition to basis after the date on which such stock was originally issued.”[[584]](#footnote-585) For that reason, a “step-up” in basis at death or a partnership basis shift (discussed later in these materials) during lifetime are unhelpful in increasing the exclusion tenfold.
         2. In order for a company to qualify for QSBS status, the “aggregate gross assets” of the corporation before and after the original issuance must not exceed $50 million. For purposes of this calculation, the term “aggregate gross assets” means the “amount of cash and the aggregated adjusted bases of other property held by the corporation.”[[585]](#footnote-586) As such, a corporation can qualify for QSBS status even if the fair market value at the time of issuance is greater than $50 million. However, the Code further provides that for these purposes, “the adjusted basis of any property contributed to the corporation (or other property with a basis determined in whole or in part by reference to the adjusted basis of property so contributed) shall be determined as if the basis of the property contributed to the corporation (immediately after such contribution) were equal to its fair market value as of the time of such contribution.”[[586]](#footnote-587) This latter provision presumably added to prevent shareholders (or partners in predecessor entities) from “stuffing” the corporation with low basis, high value assets.
      5. It is common for companies that eventually become corporations that are eligible for QSBS status to start as entities taxed as a partnership (e.g., limited liability company). The conversion from partnership to C corporation can be accomplished a number of different ways, including making an election under a state law statute. Most conversions are non-taxable events for income tax purposes, often involving contribution of assets under section 351 of the Code, liquidations of the partnership, or distribution of assets from the partnership in some combination. Under most circumstances, the end result is the original partners receive shares in the new C corporation equal to the inside basis of the assets of the partnership or to the outside basis in their partnership interests (but without credit for partnership liabilities reflected in in the outside basis).[[587]](#footnote-588) Notwithstanding that treatment on conversion, section 1202 of the Code provides two special rules with respect to basis for QSBS purposes:
         1. “In the case where the taxpayer transfers property (other than money or stock) to a corporation in exchange for stock in such corporation—such stock shall be treated as having been acquired by the taxpayer on the date of such exchange, and the basis of such stock in the hands of the taxpayer shall in no event be less than the fair market value of the property exchanged.”[[588]](#footnote-589)
         2. “If the adjusted basis of any qualified small business stock is adjusted by reason of any contribution to capital after the date on which such stock was originally issued, in determining the amount of the adjustment by reason of such contribution, the basis of the contributed property shall in no event be treated as less than its fair market value on the date of the contribution.”[[589]](#footnote-590)
      6. These special provision ostensibly allow taxpayers to calculate basis for purposes of section 1202 purposes (and possibly multiplying that basis benefit tenfold):
         1. Based on the fair market value of contributed assets at the time of contribution (e.g., assets held by the LLC when the conversion to C corporation occurred), and
         2. Based on the fair market value of property contributed even after the original issuance.
      7. Owners of companies seeking QSBS status have an opportunity prior to conversion to C corporation status to leverage the “10 times” exclusion by increasing basis in the company (and the resulting stock) without violating the Aggregate Gross Asset Requirement. Strategies that should be considered including:
         1. Valuation of appreciated assets (e.g., technology or other intellectual property) at full fair market value;
         2. Contributions of cash to the company by one or more of the owners because each dollar has the potential of excluding ten dollars of gain;
         3. A contribution of cash to the company by one or more of the owners. Each dollar has the potential of excluding $10 dollars of gain;
         4. Contributions of funds borrowed by the owners and then contributed to the company. However, borrowing at the company level when the company is a partnership in order to increase the cash within the company is likely not to work because even though the partnership liability increases outside basis for the partners the conversion to C corporation results in a reduction of each partner’s share of liabilities (lowering outside basis and possibly triggering gain);[[590]](#footnote-591) and
         5. The sale of assets for a taxable gain or otherwise triggering gain at the company or owner level (consideration should be given to qualifying for installment sale treatment to provide an immediate basis boost but defer the taxable income).
    1. Qualified Opportunity Zone (QOZ) Investments
       1. TCJA enacted section 1400Z-2 of the Code, providing significant tax benefits for taxpayers who have capital gain from the sale or exchange (with an unrelated person) of any type of property (including section 1231 property). Section 1400Z-2 of the Code allows a taxpayer to defer invest an amount equal to the capital gain in a qualified opportunity zone (QOZ) fund during the 180-day period following the sale or exchange. The taxpayer’s potential benefits include a tax free rollover of the capital gain (at the election by the taxpayer),[[591]](#footnote-592) an exclusion of up to 15% of the gain (through an increase in basis),[[592]](#footnote-593) deferral of the remaining gain until December 31, 2026,[[593]](#footnote-594) and permanent exclusion of gain due to post-investment appreciation in the QOZ investment, if held for 10 years or more (through an increase in basis to fair market value upon a sale or exchange).[[594]](#footnote-595)
       2. Gain deferred pursuant to an investment in a qualified opportunity fund under section 1400Z-2(a) of the Code will be included in income if such investment is “sold or exchanged” prior to December 31, 2026. [[595]](#footnote-596) Notwithstanding the “sold or exchanged” language of the Code, the Treasury Regulations restate “sold or exchanged” in terms of an “inclusion event.”[[596]](#footnote-597) An “inclusion event” is generally any transfer to a different taxpayer and includes a “taxpayer's transfer of a qualifying investment by gift, as defined for purposes of chapter 12 of subtitle B of the Code, whether outright or in trust, … regardless of whether that transfer is a completed gift for Federal gift tax purposes, and regardless of the taxable or tax-exempt status of the donee of the gift.”[[597]](#footnote-598)
       3. With regard to grantor trusts, the Treasury Regulations provide, “If the owner of a qualifying investment contributes it to a trust and, under subpart E of part I of subchapter J of chapter 1 of subtitle A of the Code (grantor trust rules), the contributing owner of the investment is the deemed owner of the trust (grantor trust), the contribution to the grantor trust is not an inclusion event. Similarly, a transfer of the investment by the grantor trust to the trust's deemed owner is not an inclusion event.”[[598]](#footnote-599) The Treasury Regulations go on to say, “Such contributions may include transfers by gift or any other type of transfer between the grantor and the grantor trust that is a nonrecognition event as a result of the application of the grantor trust rules (that is, subpart E of part I of subchapter J of chapter 1 of subtitle A of the Code).”[[599]](#footnote-600) In other words, an inclusion event does not include, for example, a grantor’s sale of a QOZ investment to his or her IDGT. With respect to changes in grantor trust status, the Treasury Regulations provide, “In general, a change in the income tax status of an existing trust owning a qualifying investment in a QOF, whether the termination of grantor trust status or the creation of grantor trust status, is an inclusion event.”[[600]](#footnote-601) If grantor trust status is changed by reason of the death of the grantor, it is not considered an inclusion event but certain rules applicable to the death of a taxpayer otherwise apply.[[601]](#footnote-602)
       4. Section 1400Z-2(e)(3) of the Code provides, “In the case of a decedent, amounts recognized under this section shall, if not properly includible in the gross income of the decedent, be includible in gross income as provided by section 691.”[[602]](#footnote-603) In other words, the QOF investment, at least with respect to the deferred gain, will be considered IRD and, to that extent, there is no step-up in basis. If the decedent's investment in a QOF exceeds the elected deferred gain, the investment is considered a mixed-funds investment that is treated as two separate investments—a qualifying investment subject to section 1400Z-2 of the Code, and a non-qualifying investment.[[603]](#footnote-604) Because section 1400Z-2 of the Code is inapplicable to the non-qualifying investment, the recipient's basis in the non-qualifying investment will be entitled to a step-up in basis.
       5. A recipient of a decedent’s qualifying investment is still subject to section 1400Z-2. As such, the basis of the qualifying investment is initially zero, with specified increases for gain recognized at the time of an inclusion event and for qualifying investments held for at least five or seven years. As such, a recipient of a decedent’s qualifying investment is can be zero, zero plus 5%, 10%, or 15% of the deferred gain under section 1400Z-2(b)(2)(B) of the Code (depending on how long the investment is held), or if held for at least 10 years (including the decedent’s holding period)[[604]](#footnote-605) adjusted upwards to reflect the post-investment appreciation under section 1400A-2(c).[[605]](#footnote-606) As such, section 1014 of the Code does not apply to the qualifying investment portion of a QOZ investment of a decedent.
       6. The Treasury Regulations provide the following examples:[[606]](#footnote-607)

(A) Example 1. Taxpayer A, an individual, contributed $50X to a QOF in exchange for a qualifying investment in the QOF in January 2019. This $50X was capital gain that was excluded from A's gross income under section 1400Z-2(a)(1)(A). A's basis in the qualifying investment is zero. As of January 2024, A's basis in the QOF is increased by an amount equal to 10 percent of the amount of gain deferred by reason of section 1400Z-2(a)(1)(A), so that A's adjusted basis in 2024 is $5X. A dies in 2025 and A's heir inherits this qualifying investment in the QOF. A's death is not an inclusion event for purposes of section 1400Z-2. The heir's basis in the qualifying investment is $5X.

(B) Example 2. The facts are the same as in paragraph (g)(6)(ii)(A) of this section (Example 1), except that A dies in November 2027, when the fair market value of the qualifying investment was $75X. A was required to pay the tax on the excess of the deferred capital gain over A's basis as part of A's 2026 income. Therefore, at the time of A's death, A's basis in the qualifying investment is the sum of three basis adjustments: The adjustment made in January 2024 described in paragraph (g)(6)(ii)(A) (Example 1) ($5X); an additional adjustment made as of January 2026 equal to 5 percent of the amount of gain deferred by reason of section 1400Z-2(a)(1)(A) ($2.5X); and the adjustment as of December 31, 2026, by reason of section 1400Z-2(b)(1)(B) and (b)(2)(B)(ii) ($42.5X). Accordingly, the basis of the qualifying investment in the hands of A's heir is $50X.

* 1. Swapping Assets with Existing IDGTs
     1. Generally
        1. Many wealthy individuals have made significant taxable gifts, using all or a significant portion of their applicable exclusion amounts because of the risk of that the exemptions would “sunset” back to 2001 levels. Many of those gifts were made to IDGTs.
        2. A common power used to achieve grantor trust status for the IDGT is one described under section 675(4)(C) of the Code, namely giving the grantor, the power, in a non-fiduciary capacity, to reacquire the trust corpus by substituting other property of an equivalent value.[[607]](#footnote-608) For income tax purposes, transactions between the grantor and the IDGT will be disregarded.[[608]](#footnote-609) As such, grantors may exercise the power to swap high basis assets for low basis assets without jeopardizing the estate tax includibility of the assets and without having a taxable transaction for income tax purposes.
        3. To maximize the benefits of the swap power, it must be exercised as assets appreciate or are sold over time. When exercised properly, this can ensure that only those assets that benefit the most from the step-up will be subject to estate inclusion.
           1. If grantor does not have sufficient other assets borrowing from a third party lender should be considered.
           2. The grantor could provide a promissory note in exchange for the property in the IDGT, but as discussed below, it is unclear what the tax basis of the promissory note will be to the IDGT after the death of the grantor, if any portion of the note remains outstanding at such time.
           3. Because the sudden or unexpected death of the grantor may make a repurchase difficult or impossible, estate planners may want to consider drafting “standby” purchase instruments to facilitate fast implementation of repurchase.
        4. While the Federal income tax consequences of a swap for equivalent value seem clear, practitioners should consult whether the transaction will also be ignored for other local law purposes.
           1. Some states do not recognize grantor trust status or only recognize it under certain circumstances. To illustrate, Pennsylvania does not recognize grantor trust status if the trust is irrevocable. Thus, in Pennsylvania, an IDGT will be subject to state income taxation, and all transactions between the IDGT and the grantor would be taxable events for state tax purposes. [[609]](#footnote-610)
           2. While New York recognizes grantor trust status for income tax purposes, the New York Department of Taxation and Finance has ruled that an exchange of assets between a grantor and his IDGT was a sale for sales tax purposes if the assets transferred would be subject to sales tax for any unrelated taxpayers.[[610]](#footnote-611)
     2. Swapping with a Promissory Note of Grantor
        1. If, under the swap power, a grantor exchanges his or her own promissory note (rather than assets individually owned by the grantor) for assets in an IDGT, the exchange and all payments on the promissory note will be ignored for Federal income tax purposes, as long as grantor trust status remains. However, as discussed in detail later in these materials, it is unclear what tax basis the IDGT has in the promissory note if the grantor dies, thereby terminating grantor trust status.
        2. The IRS claims the basis is zero, although other authorities provide it has a basis equal to the principal amount of the note. If the note has a basis of zero, then the trust will recognize gain upon each payment on the note (along with interest). If the basis is equal to principal amount of the note, each payment will be non-taxable, other than interest.
  2. Valuation Discounts On or Off?
     1. Generally
        1. A common “free-base” situation occurs when the first spouse passes away, and assets are transferred to or for the benefit of the spouse in a transfer that qualifies for the marital deduction under section 2056. In community property states, as mentioned above, the “step-up” in basis will also apply to the assets held by the surviving spouse. Clearly, for income tax purposes, a higher valuation is preferable to a lower valuation. As such, consideration should be given to when valuation discounts should be created and when they should be removed. For example, when both spouses are alive, it is sensible to avoid valuation discounts, and if the assets that would be includible in the surviving spouse’s estate are significantly above the applicable exclusion amount (including any ported amount), then valuation discounts will likely save more in estate taxes than the income tax savings from the subsequent “step-up” at the surviving spouse’s estate. If a quick succession of deaths is a worry, practitioners should be prepared to layer valuation discounts immediately after the first death, so post-mortem estate planning might include the estate creating family limited partnerships prior to the complete settlement of the estate.
        2. Where assets have been divided among generations to create discounts, consideration should be given to undoing those arrangements if the effect is to depress the value of an estate below the amount of Available Exemption Amount in order to increase the income tax basis of the assets.
        3. 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.
        4. 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*,[[611]](#footnote-612) the Tax Court applied section 2703 to ignore a family co-tenancy agreement requiring all owners of fractional interests in art to agree before the art could be sold. The purpose of that agreement was to limit the marketability of each fractional interest. But what might the effect on value be of an agreement which provided, instead, that any fractional owner could compel the sale of the entire asset? Similarly, a provision that allows a shareholder in business to put stock to the business at death for fair market value would seem to be outside the 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, but such gifts may fall within the donor’s unused exclusion and may be the best use for that exclusion.
     2. Conversion to General Partnership
        1. One option for eliminating valuation discounts with family limited partnership interests is to “convert” the limited partnership (or limited liability company) to a general partnership.
           1. Section 2704(b) of the Code will disregard certain “applicable restrictions” on the ability of the partnership to liquidate. However, an exception exists for “any restriction imposed . . . by any Federal or State law.”[[612]](#footnote-613) Since the effective date of section 2704 of the Code, many states have amended their limited partnership and limited liability company statutes to provide for significant restrictions on an owner’s ability to liquidate his or her ownership interest in those entities, thereby rendering section 2704(b) inapplicable.[[613]](#footnote-614) 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.[[614]](#footnote-615) The proposed regulations were officially withdrawn as of October 20, 2017.[[615]](#footnote-616)
           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:

Section 801 of the Uniform Partnership Act (UPA)[[616]](#footnote-617) provides in a partnership at will, dissolution occurs upon a person’s express will to withdraw.

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.

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.

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.[[617]](#footnote-618)

* + - * 1. Furthermore, nothing under section 2704(b) of the Code prohibits being less restrictive in the partnership agreement.
        2. Where retaining limited liability of a partner is important, the partner should consider utilizing a wholly-owned limited liability company that is treated as a disregarded entity for Federal tax purposes.[[618]](#footnote-619) 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,[[619]](#footnote-620) interest exchange[[620]](#footnote-621) and dissolution, or other merger transaction.
        3. 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.[[621]](#footnote-622)
    1. The *Powell* “Solution”
       1. Another planning option that could cause inclusion of FLP assets without valuation discounts is to argue that section 2036(a) of the Code applies, relying on the argument set forth in *Estate of Powell v. Commissioner*.[[622]](#footnote-623)
          1. Pursuant to the facts, the decedent’s son, acting under a power of attorney for the benefit of the decedent, contributed $10 million of cash and securities to a FLP in return for 99% limited partnership interest. The decedent’s two sons contributed unsecured promissory notes to the FLP in exchange for a 1% general partnership interest. The son, acting under the power of attorney, contributed the 99% limited partnership interest to a lifetime charitable lead annuity trust (CLAT) that would pay an annuity amount to charity for the lifetime of the decedent with the remainder passing to the decedent’s sons at the death of the decedent. The son may not have had the authority to make the transfer to the CLAT because the power of attorney only allowed gifts to the principal’s issue up to the federal gift tax annual exclusion. The value of the taxable gift of the remainder interest to the sons was calculated with a 25% valuation discount on the limited partnership interest due to lack of control and marketability. The decedent died 7 days after the contribution to the CLAT.
          2. The IRS argued that the $10 million of contributed assets were includible in the decedent’s estate under the following Code sections: (i) section 2036(a)(1) (retained enjoyment of income); (ii) section 2036(a)(2) (retained right in conjunction with any person to designate who could enjoy the property or its income; (iii) section 2038 (power to alter, amend, revoke, or terminate the transfer at the decedent’s death; and (iv) section 2035(a) (transfer of property within three years of death that otherwise would have been includible sections 2036-2038 of the Code or section 2042 (inclusion of life insurance proceeds). Interestingly, the taxpayer did not contest the application of section 2036(a)(2) or argue that the bona fide transfer for full and adequate consideration exception to section 2036 applied. Rather, the taxpayer contended that section 2036 and 2038 could not apply because the decedent did not own any interest in the FLP at death.
          3. The Tax Court agreed that section 2036(a)(2) applied. In the majority opinion, the Tax Court held that (i) the decedent, in conjunction with all other partners, could dissolve the partnership, and (ii) the decedent, through her son acting under the power of attorney and as a general partner of the FLP, could control the amount and timing of distributions. In previous cases, the courts had applied section 2036(a)(2) to certain FLP cases,[[623]](#footnote-624) but this was the first application of section 2036(a)(2) where the decedent exclusively owned a limited partnership interest.
          4. The majority opinion goes on to explain that the inclusion amount under section 2036 must be adjusted under section 2043(a) of the Code. Although the majority opinion admits that “read in isolation” section 2036(a)(2) would require that the amount includible in the estate would be the full date of death value of the cash and securities transferred to the FLP, it asserts that section 2036(a)(2) must be read in conjunction with section 2043(a) of the Code.

Section 2043(a) of the Code provides, in pertinent part, if there is a transfer of an interest includible under section 2036 “for a consideration in money or money’s worth, but is not a bona fide sale for adequate and full consideration in money or money’s worth,”[[624]](#footnote-625) then the amount includible in the gross estate is “only the excess of the fair market value at the time of death of the property otherwise to be included on account of such transaction, over the value of the consideration received therefor by the decedent.”[[625]](#footnote-626)

As such, the amount includible under sections 2036 and 2043 of the Code is the valuation discount due to lack of control and marketability—the value of the contributed assets ($10 million) less the value of the limited partnership interest received ($7.5 million due to valuation discount of 25%), assuming no change in the value of the transferred assets. The majority opinion refers to this amount as the “hole” in the doughnut. The court refers to the limited partnership interest as the “doughnut,” which would be included in the gross estate if the transfer was deemed void or included in the gift amount if the gift is recognized. The court concluded, in this instance, that the transfer was void or revocable, and as such, the limited partnership was includible in the estate of the decedent.

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

Changes in the value of the transferred assets would affect the required inclusion because sec. 2036(a) includes in the value of decedent’s gross estate the date-of-death value of those assets while sec. 2043(a) reduces the required inclusion by the value of the partnership interest on the date of the transfer. To the extent that any post-transfer increase in the value of the transferred assets is reflected in the value of the partnership interest the decedent received in return, the appreciation in the assets would generally be subject to a duplicative transfer tax. (Conversely, a post-transfer decrease in value would generally result in a duplicative reduction in transfer tax.)[[626]](#footnote-627)

In other words, the date of death value of the limited partnership interest would also be included under section 2033 of the Code, so all of the post-contribution appreciation would also be subject to estate tax. Thus, more value may be included in the gross estate than if the decedent had never contributed assets to the FLP.

* + - * 1. The concurring opinion, which was joined by seven judges, asserts that the planning involved in this case is “best described in aggressive deathbed tax planning.” It then agrees that section 2036(a)(2) of the Code applies because the decedent make a transfer of the $10 million in cash and securities (to the partnership), but the decedent “retained the proverbial ‘string’ that pulls these assets back into her estate.” However, as the concurring opinion provides:

This is where I part company with the Court, because I do not see any “double inclusion” problem. The decedent's supposed partnership interest obviously had no value apart from the cash and securities that she allegedly contributed to the partnership. The partnership was an empty box into which the $10 million was notionally placed. Once that $10 million is included in her gross estate under section 2036(a)(2), it seems perfectly reasonable to regard the partnership interest as having no distinct value because it was an alter ego for the $10 million of cash and securities.

This is the approach that we have previously taken to this problem. *See Estate of Thompson*, 84 T.C.M. (CCH) at 391 (concluding that the decedent's interest in the partnership had no value apart from the assets he contributed to the partnership); *Estate of Harper v. Commissioner*, T.C. Memo. 2002-121, 83 T.C.M. (CCH) 1641, 1654; cf. *Estate of Gregory v. Commissioner*, 39 T.C. 1012, 1020 (1963) (holding that a decedent's retained interest in her own property cannot constitute consideration under section 2043(a)). And this is the approach that I would take here. There is no double-counting problem if we read section 2036(a)(2), as it always has been read, to disregard a “transfer with a string” and include in the decedent's estate what she held before the purported transfer—the $10 million in cash and securities.

Rather than take this straightforward path to the correct result, the Court adopts as the linchpin of its analysis section 2043(a). Neither party in this case advanced any argument based on section 2043(a); indeed, that section is not cited in either party's briefs. And as the Court recognizes, *see* op. Ct. p. 28, we have not previously applied section 2043(a), as the Court does here, to limit the amount includible in a decedent's gross estate under section 2036(a). *See*, *e.g.*, *Estate of Harper*, 83 T.C.M. (CCH) at 1654 (ruling that section 2043(a) “is inapplicable where, as here, there has been only a recycling of value and not a transfer for consideration”). [[627]](#footnote-628)

* + - * 1. While asserting that section 2043(a) is inapplicable in this case, the concurring opinion goes on to opine that even if section 2043(a) did apply, it is not clear that the decedent’s partnership interest (the result of a now disregarded transfer) can constitute consideration in money or money’s wort within the meaning of section 2043(a).
        2. It is unclear how future cases will resolve the double inclusion issue. The *Powell* majority opinion was not joined by a majority of the Tax Court judges. Eight judges represented the majority opinion, seven judges agreed with the result but rejected the double inclusion issue, and two judges concurred with the result only.
      1. If assets are deemed includible for estate tax purposes under section 2036, the assets in a partnership should receive a basis adjustment under section 1014 of the Code without the need for a section 754 election providing an inside basis adjustment under section 743.[[628]](#footnote-629) Under the majority opinion’s theory, a portion of the partnership assets would be included under section 2036, reduced by section 2043(a) (the valuation discount), and a portion would be included under section 2033 (the partnership interest). As such, in order to “step-up” the basis of the underlying assets, a section 754 election may in fact be needed. Of course, as discussed later in these materials, a liquidating distribution of partnership assets would accomplish the same thing.
      2. From a planning standpoint, intentionally claiming applicability of section 2036 of the Code to partnership interests held by a decedent should accomplish the desired result of a “step-up” in basis on the assets in the partnership. However, if the majority opinion’s view of the double inclusion problem is correct, claiming section 2036 should be done with caution. If the partnership assets have not appreciated or have depreciated in value since the contribution, then claiming section 2036 should provide a full step-up in basis. Further, if there is a double inclusion problem because assets have appreciated, then if there is sufficient applicable exclusion amount available to cover the additional inclusion, then there is effectively no cost and the estate would still be in a “free-base” situation.
  1. General Powers of Appointment
     1. Generally
        1. A general power of appointment, as defined in the Code,[[629]](#footnote-630) is a power exercisable in favor of: (i) the power holder, (ii) his or her estate, (iii) his or her creditors, or (iv) creditors of his or her estate. From a transfer tax standpoint, the mere existence of an exercisable general power of appointment at the death (a testamentary general power) of the power holder will cause assets subject to the power to be includible in the power holder’s estate.[[630]](#footnote-631) Moreover, the lack of knowledge of the existence of a general power of appointment will not exclude the property subject to the power form being included in the estate of the deceased power holder.[[631]](#footnote-632)
        2. From an income tax standpoint, if the holder of the power exercises a testamentary general power, the property passing under the power is deemed to have passed from the deceased power holder without full and adequate consideration, and the property will get a “step-up” in basis.[[632]](#footnote-633) If the holder of the power dies without exercising the testamentary general power of appointment, the property that was subject to the power is also deemed to have been acquired from the deceased power holder and such property will receive a “step-up” in basis.[[633]](#footnote-634)
        3. Given the potential income tax savings from the “step-up” in basis if large applicable exclusion amounts persist over time estate planners will need to consider how, under what circumstances, and to what extent a testamentary general power of appointment should be granted to trust beneficiaries, even if the assets have been correctly transferred into a vehicle (like a dynasty trust) that is structured to avoid estate tax inclusion at every generation. So-called “limited general powers” may be helpful in this respect. For example, a power to appoint only to the creditors of the power holder’s estate may be less susceptible to undesirable appointment than a power to appoint more broadly. Further, the exercise of a power may be subject to the consent of another person so long as the person does not have a substantial interest adverse to the exercise of the power in favor of the decedent, his or her estate, his or her creditors, or the creditors of his or her estate.[[634]](#footnote-635)
        4. Consideration should be given to using a “circumscribed general power” that has the following characteristics: (1) a testamentary power, (2) in favor of the creditor of the powerholder’s estate, (3) with the consent of a non-adverse party, (4) only over assets with a fair market value in excess of basis, and (5) capped such that the amount subject to the power when added to the other assets of the powerholder produces a total that is $1,000 less than the powerholder’s basic exclusion amount.
     2. Rights of Creditors
        1. The rights of creditors to property over which a powerholder has a testamentary general power is worth considering. The majority view at common law is that the powerholder of a power, conferred on the powerholder by another, is treated as the beneficial owner of the appointive property for purposes of creditors’ rights only if (1) the power is general *and* (2) the powerholder exercises the power. No distinction is made between a testamentary and a presently exercisable power. Creditors of a powerholder of a *non*-general power, on the other hand, cannot reach the appointive assets even if the power was effectively exercised. The theory is that the donor who creates a non-general power did not intend to benefit the powerholder.
        2. Explaining the distinction between the exercise and non-exercise of a general power for purposes of creditor access, one court noted:

When a donor gives to another the power of appointment over property, the [powerholder]... does not thereby become the owner of the property. Rather, the appointee of the power [meaning, the powerholder], in its exercise, acts as a “mere conduit or agent for the donor.” The [powerholder], having received from the owner of the property instructions as to how the power may be utilized, possesses nothing but the authority to do an act which the owner might lawfully perform.[[635]](#footnote-636)

* + - 1. When the powerholder of a general power exercises the power by will, the view that the appointed property is treated as if it were owned by the powerholder means that the creditors of the powerholder’s estate can reach the appointed property for the payment of their claims.[[636]](#footnote-637) The rule prevails even if this is contrary to the expressed wishes of the donor of the power.[[637]](#footnote-638)
      2. The exercise of the power by will does not confer actual beneficial ownership of the appointive assets on the powerholder for all purposes. The assets do not ordinarily become part of the powerholder’s probate estate. Thus, in terms of priority, the powerholder’s own estate assets are ordinarily used first to pay estate debts, so that the appointive assets are used only to the extent the powerholder’s probate estate is insufficient.
      3. Under the majority view at common law, the powerholder’s creditors can reach the appointive assets only to the extent the powerholder’s exercise was an *effective* exercise. A few states, however, follow the view that even an ineffective exercise entitles the powerholder’s creditors to reach the appointive assets.[[638]](#footnote-639) Moreover, even in states adhering to the majority view, an ineffective exercise can sometimes “capture” the appointive assets for the powerholder’s estate, in which case the appointive assets become part of the powerholder’s probate estate for all purposes, including creditors’ rights.
      4. When the powerholder of a general power makes an inter vivos appointment, treating the appointed assets as if they were owned by the powerholder does not automatically mean that the powerholder’s creditors can subject the appointed assets to the payment of their claims. If the appointment is in favor of a *creditor*, the powerholder’s other, unsatisfied creditors can reach the appointed assets only by having the appointment avoided as a “preference” in bankruptcy proceedings. Apart from bankruptcy, the powerholder can choose to pay one creditor rather than another with his or her owned assets, and the same is true with respect to appointive assets. If the appointment is in favor of a *volunteer* (i.e., the appointment is gratuitous), the powerholder’s creditors can reach the appointed assets only if the transfer is the equivalent of a fraudulent transfer under applicable state law.
      5. In a minority of jurisdictions, the powerholder of a general power, conferred on him or her by another, is *not* treated as the owner of the appointive property even if the power is exercised.[[639]](#footnote-640) Of course, if the powerholder exercises the power in favor of himself or herself or his or her estate, the appointed property becomes owned in the technical sense, and creditors even in states adhering to the minority view would be able to subject the assets to the payment of their claims to the same extent as other property owned beneficially by the powerholder. A minority of states has enacted legislation that affects the rights of the powerholder’s creditors. The legislation is not uniform. Some of the legislation expands the rights of the powerholder’s creditors and some contracts them. The following is a sampling of the legislation:
         1. Michigan legislation expands the rights of the creditors of the powerholder of an unexercised general power. During the powerholder’s lifetime, the powerholder’s creditors can subject the appointive property to the payment of their claims if the power is presently exercisable. If the powerholder has actually made an *inter vivos* exercise of the power, the rules explained above with respect to inter vivos exercises presumably would be applied. At the powerholder’s death, the powerholder’s creditors can subject the appointive property to the payment of their claims. In both instances, however, the appointive property is available only to the extent that the powerholder ’s owned property is insufficient to meet the debts.[[640]](#footnote-641)
         2. New York legislation expands the rights of the powerholder’s creditors in some particulars but restricts them in others. The legislation adopts the same rules as the Michigan legislation, but limits their application to general powers presently exercisable. As to general testamentary powers, the powerholder’s estate creditors can subject the appointive property to the payment of their claims only if the powerholder, as donor, reserved the power in himself or herself; as to general testamentary powers conferred on the powerholder by another, the powerholder’s estate creditors cannot reach the appointive property even when the powerholder’s will exercises the power.[[641]](#footnote-642)
      6. The Uniform Powers of Appointment Act takes the following position. If the power is conferred by another, the rights of the powerholder’s creditors depend on whether the power is general or non-general. If the power is general, the appointive property is subject to a claim of (1) a creditor of the powerholder, to the extent the powerholder’s property is insufficient, if the power is presently exercisable (whether or not actually exercised), and (2) a creditor of the powerholder’s estate, to the extent the estate is insufficient, subject to the right of a decedent to direct the source from which liabilities are paid.[[642]](#footnote-643) If the power is non-general, the general rule is that creditors have no rights in the appointive property.[[643]](#footnote-644)
    1. Formula
       1. One option is to draft a testamentary general power of appointment that by formula absorbs any unused portion of a beneficiary’s unused applicable exclusion amount (including any DSUE Amount). This would provide a “step-up” in basis to those assets subject to the power without causing any Federal estate tax liability. In theory, this formula can be drafted with great precision. However, in practice, it is quite difficult to draft, particularly if the drafting occurs many years from the anticipated and likely exercise (or death of the power holder). Further, as discussed below, the formula may be subject challenge by the IRS.[[644]](#footnote-645)
       2. A testamentary general power of appointment that attempted to achieve the maximum favorable tax results would seem to require the following features:

* + - * 1. A formula that determines the size or amount of the general power of appointment. As mentioned above, in theory, the starting amount of the formula is the applicable exclusion amount as defined in section 2010(c)(2), which would include the basic exclusion amount under section 2010(c)(3)(A), including any increases due to the cost-of-living increase, and any DSUE Amount.
        2. The starting amount would then need to be reduced by any reductions due to taxable gifts that reduced the applicable exclusion amount prior to death and any testamentary transfers that would not otherwise be deductible for Federal estate tax purposes (marital transfers under section 2056 and charitable transfers under section 2055).
        3. Once the size of the power of appointment has been so determined, the formula would need to provide that the power is not simply exercisable against all of the assets in trust, but that it is only exercisable against those assets in the trust that would benefit the most from a “step-up” in basis, given the tax nature of the asset (as discussed above). For example, if the trust only held publicly-traded assets, the formula would need to ensure that the power is exercisable against the lowest basis lots of securities, not against the securities that have unrealized losses or the cash. The formula would likely need to determine the total income tax cost (including state income taxes) to the trust in a constructive liquidation of the assets in a taxable transaction for fair market value and then segregate those assets or portion of assets (like a separate lot of stock) that have the highest relative income tax cost compared to fair market value (the highest “effective” income tax cost). Without this refinement, the basis adjustment under section 1014(a) will be applied across all of the assets whether they benefit from the “step-up” in basis or not, and if the total value of the assets exceed the size of the general power of appointment, no asset will get a full “step-up” in basis.[[645]](#footnote-646)
        4. The formula would likely also distinguish between assets that are and are not likely to be sold or redeemed in a taxable transfer (for example, closely-held C corporation shares in a family-owned business) and those assets that are not likely to be sold but provide some ongoing income tax benefits by virtue of the “step-up” in basis (for example, depreciable and depletable assets).
        5. In determining the “effective” income tax cost in a constructive liquidation of the trust assets, the formula may need to reduce the original size of the power of appointment to take into account any state death tax costs (if the beneficiary dies in a state with a state death tax) that would result from the existence of the general power of appointment. Most states with a death tax have an exemption that is smaller than the Federal applicable exclusion amount, and no state provides for “portability” of a deceased spouse’s unused state death tax exemption. As such, formula would need to take into account the “effective” state death tax cost (in comparison to the fair market value of the asset) and compare that to the income tax savings from the “step-up” in basis for the assets with the highest “effective” income tax cost on the date of death. The formula might then reduce the size of the general power of appointment to so that at the very least the “effective” state death tax cost equals (but likely is less than) the “effective” income tax cost of those assets that would be subject to the power of appointment. Note, some states provide that a general power of appointment is not subject to state death tax.[[646]](#footnote-647) Because of the foregoing, drafters may choose to limit the size of the general power of appointment to the lesser of the applicable exemption amount and any applicable state death tax exemption.
        6. To complicate things further, in determining the size of the general power of appointment, the formula will need to consider differences between the applicable exclusion amount and the any remaining GST exemption the beneficiary may have at the time of death. If, for example, applicable exclusion amount is greater than the beneficiary’s GST exemption, should the general power of appointment be reduced to the lesser of the two amounts thereby foregoing some portion of the available “free” step-up in basis? Or should the general power of appointment be the greater of the two amounts but provide a different disposition of those assets depending on whether GST exemption is applied to such “transfer” (even in the failure to exercise the power of appointment)? In other words, assets receiving both a “step-up” in basis and application of the beneficiary’s GST exemption would continue to stay in the dynasty trust, for example, and assets that only receive “step-up” in basis would be held in a separate “non-exempt” GST trust.
      1. Even if the formula could be so written with such precision, there is a chance that the IRS would challenge the general power of appointment (especially if the beneficiary has a surviving spouse) as indeterminable at the time of death of beneficiary or subject to a contingency or condition precedent, and as such, the formula does not give rise to an exercisable general power of appointment.
         1. As noted above, the size of the general power of appointment should be reduced by any transfers that would not otherwise be deductible for Federal estate tax purposes (marital transfers under section 2056 and charitable transfers under section 2055). Whether a transfer will qualify for the marital deduction or a charitable deduction may be dependent on a QTIP election under section 2056(b)(7)(B)(v) or a qualified disclaimer under section 2518, both of which occur after the date of death. A QTIP election is made on a timely filed estate tax return,[[647]](#footnote-648) and a qualified disclaimer is made 9 months after date of death.[[648]](#footnote-649)
         2. The IRS’s argument might be that despite the crux of the Fifth Circuit’s ruling in *Clayton v. Commissioner,*[[649]](#footnote-650)a QTIP election relates back to the date of death and the same could be said about qualified disclaimers,[[650]](#footnote-651) these actions do not relate to a general power of appointment under section 2041. The election and disclaimer do, however, affect the size of the general power of appointment. As such, they are similar to a contingency that has not yet occurred on the date of death.
         3. In Private Letter Ruling 8516011, the IRS ruled that a marital bequest that was conditioned upon the surviving spouse’s survival of the decedent’s admission to probate would not be included in the surviving spouse’s estate because the spouse died prior to the will being admitted to probate. In the ruling, the IRS stated that even though the spouse had the power to admit the will to probate and thus had a power of appointment, this power of appointment was subject to the formal admission to probate, which in turn requires a substantive determination by the court regarding the validity of the will. As such, the general power of appointment was deemed not to exist for estate tax purposes.[[651]](#footnote-652)
      2. In addition, if the formula allows the grantor to alter the amount subject to the general power of appointment, then there is a potential issue under section 2036 of the Code. For example, if the amount subject to the power is reduced by subsequent taxable gifts or by the taxable bequests under the will, then by choices reserved to the grantor, the general power of appointment may cover more or less assets. On the other hand, if the general power of appointment is not modified by these subsequent factors, it will likely not function as intended. There is a risk that too much will be subject to the general power of appointment (e.g., if grantor leaves 100% of estate to charity or to a spouse) or too little (e.g., if the grantor makes large taxable gifts/bequests).
    1. Trust Director
       1. Because of the complexities of the formula and the risk of challenge by the IRS, estate planners may want to rely upon an independent person to grant or modify the terms of a limited power of appointment and expand it to a general power of appointment.[[652]](#footnote-653) This has the obvious benefit of allowing the trust protector to determine the size of the testamentary power of appointment and the assets that will be subject to the power as the situation and the tax laws change in the future. Such person is referred to in the Uniform Directed Trust Act as a “trust director” but other names include “trust protector” or “trust advisor.”
       2. The power would need to be granted prior to the death of the beneficiary and in writing, in all likelihood. Because of the problems with relying on a formula as discussed above, a trust director may choose to grant a general power of appointment to each beneficiary equal to a fixed pecuniary amount based upon the beneficiary’s estate situation (value of assets, existence of a surviving spouse, structure of the beneficiary’s estate plan, state of domicile, etc.) and the nature of the assets in the trust (making the general power of appointment exercisable only against certain assets or portions of assets). The trust director could provide that the power of appointment will be exercisable at the death of the beneficiary, but can be revoked or modified at any time by the trust director. The trust director might modify such power of appointment, for example, if the beneficiary’s estate situation changed or if certain trust assets are sold.
  1. Forcing Estate Tax Inclusion
     1. Different Strategies for Causing Estate Tax Inclusion
        1. Give someone—trustee, trust director, or person with a power of appointment—the discretion to grant a general power of appointment or to expand a special power of appointment so it becomes general. The power could be granted shortly before death if the step up in basis is desirable given the tax rates in effect at that time (considering, of course, that when a potential power holder is “shortly before” death may not always be easy to determine). Should the person with the power to grant or expand the power be a fiduciary? Should protection be given for a decision to grant or not to grant the power of appointment? Should the general power be able to be rescinded or modified by the person granting the power? Where the circumstances are clearly defined, a formula grant of a general power may be easier, and more successful, than a broadly applicable formula.

* + - 1. Terminate the trust and distribute the assets to one or more beneficiaries. If a beneficiary does not have a taxable estate, then there may be no transfer tax reason to maintain the trust and there may be a negative income tax consequence to such maintenance. Quite obviously, there may be non-tax detriments to a beneficiary having outright ownership of such assets. In such instances, transferring assets from a trust that is not includible in the beneficiary’s estate into a new trust over which the beneficiary has a general power of appointment – perhaps one exercisable only with the consent of a non-adverse party to the creditors of the beneficiary’s estate – may produce a step-up with minimal risk of asset diversion or dissipation.
      2. Include a formula in the trust agreement which would cause estate tax inclusion if appreciation is not sufficient for estate tax benefits to outweigh income tax benefits of a step up
         1. Example: I make a gift of $5 million of stock with a basis of zero to a trust for my children. Trust agreement provides that on my death, if 40% of the excess of the date of death value of any asset over the date of gift value of the asset is less than 23.8% of the excess of the date of death value of the asset over the basis of the asset, the asset is distributable to my estate. The formula could be written as follows if (E)\*(D-G) < (I)(D-B), asset is distributable, where E=estate tax rate, I=income tax rate, D=date of death value, G=date of gift value, B=basis. If the value of the stock is $7.5 million at my death, the stock would be distributed to my estate so that I get the income tax benefit of the step up, which exceeds my transfer tax savings.
         2. Formula creates an “estate tax inclusion period”[[653]](#footnote-654) (“ETIP”) so GST exemption cannot be allocated to the trust.
      3. Appoint the donor as trustee, although many trust agreements provide that the donor may never be named as trustee.
      4. Move the trust from an asset protection jurisdiction to a jurisdiction where donor’s creditors can reach the assets. This would also require that the donor have some beneficial interest in the trust that would cause it to be a self-settled trust.
      5. Estate could take the position that there was an implied agreement of retained enjoyment under section 2036(a)(1). For example, donor begins living in a home gifted to the trust (perhaps pursuant to a qualified residence trust) without paying rent and takes the position that there was an implied agreement at the outset that the donor would be able to do so.
         1. A recent Federal district court case could help in this context. In the 1970’s two cases dealing with the Goodwyn family established the principle that if a trust agreement prohibited the grantor from acting as de facto trustee, the mere fact that the grantor did in fact act as de facto trustee would not established a retained interest under section 2036 of the Code.[[654]](#footnote-655) In the 1973 opinion the court stated:

Under the terms of the deeds creating these trusts, the trustees were granted broad discretionary powers with respect to both the distribution of income to the beneficiaries and the investment and management of the corpus of the trusts. Notwithstanding the designation of Richards and Russell as trustees, it further appears that at all times from the establishment of the trusts until his last illness, the decedent exercised complete control with respect to the purchase and sale of trust assets, investment of any proceeds, and the determination of the amounts, if any, to be distributed to the respective beneficiaries.

The assets of the various trusts, together with other trusts, as well as property owned by the decedent, were accounted for by a single set of records maintained in the offices of the decedent. Except for the Federal income tax returns prepared and filed by the decedent on behalf of the various trusts, no separate records were maintained showing the assets and income of any of these trusts.

The respondent argues that the decedent should be treated as trustee, in fact, possessing such rights and powers as to cause the inclusion of the assets thereof in his gross estate, relying on sections 2033, 2036 (a)(2), and 2038. Section 2033 requires a finding that the decedent had an interest in the assets of the trusts at the time of his death. There is no basis for such a finding. Section 2038(a)(1) relates to "a power" exercisable by the decedent "to alter, amend, revoke, or terminate," the trusts. No such power was reserved by the decedent. Accordingly, in the final analysis the respondent's position is predicated on the determination that by reason of the de facto control exercised by the decedent the trusts are includable in his estate pursuant to section 2036(a)(2). It is clear that the powers granted to the trustees would, if reserved by the decedent, be such as to require the inclusion of the assets of the trusts in the estate of the decedent. *United States v. O'Malley* [66-1 USTC ¶ 12,388], 383 U.S. 627 (1966). Does the fact that the decedent was able to exercise such powers through the cooperation of unrelated trustees require a different result? The question thus presented for decision is whether the value of such trusts is includable in the estate of the decedent by reason of the de facto control over the trusts exercised by the decedent, notwithstanding that no power to exercise such control was reserved to or by the decedent once he resigned his duties as trustee of certain of these trusts.

In the course of the trial of this case, and in his briefs, respondent made no secret of the fact that support for respondent's position was to come from the decision of the U.S. Supreme Court in the case of *United States v. Byrum* then pending on writ of certiorari from the U.S. Circuit Court of Appeals for the Sixth Circuit ([71-1 USTC ¶ 12,763] 440 F.2d 949). The Supreme Court has since rendered its decision in that case. [72-2 USTC ¶ 12,859] 408 U.S. 125 (1972). By that decision, the Supreme Court has rejected the position of the respondent in the instant case that the de facto exercise of control over the management and investment of the trust res is within the ambit of section 2036.

In distinguishing *United States v. O'Malley*, *supra*, the Supreme Court in the Byrum case said:

In our view, and for the purposes of this case, *O'Malley* adds nothing to the statute itself. The facts in that case were clearly within the ambit of what is now § 2036(a)(2). That section requires that the settlor must have "retained for his life \* \* \* the right \* \* \* to designate the persons who shall possess or enjoy the property or the income therefrom." *O'Malley* was covered precisely by the statute for two reasons: (1) there the settlor had reserved a legal right, set forth in the trust instrument; and (2) this right expressly authorized the settlor, "in conjunction" with others, to accumulate income and thereby "to designate" the persons to enjoy it.

It must be conceded that Byrum reserved no such "right" in the trust instrument or otherwise. The term "right," certainly when used in a tax statute, must be given its normal and customary meaning. It connotes an ascertainable and legally enforceable power, such as that involved in *O'Malley*. Here, the right ascribed to Byrum was the power to use his majority position and influence over the corporate directors to "regulate the flow of dividends" to the trust. That "right" was neither ascertainable nor legally enforceable and hence was not a right in any normal sense of that term.

The right or power upon which the tax is predicated must thus be a legal right reserved in the trust instrument, or at least by some form of agreement between the trustees and the settlor. Admittedly, such a right did not exist in the case of the Richards and Russell Trusts. To hold otherwise would not only be contrary to the reasoning of the Supreme Court in the *Byrum* case but would present the insuperable problem of determining to what degree compliance on the part of unrelated trustees with the wishes of the grantor would be sufficient to constitute requisite control over the trust res within the meaning of section 2036.

It would indeed be an unusual situation for a grantor to appoint trustees, whether corporate or otherwise, in the expectation that such trustees would, where given a choice, act contrary to the wishes and intent of the grantor. Notwithstanding that Richards and Russell permitted the decedent full discretion in the management of these trusts, as a matter of law the trustees were responsible and answerable for the decedent's acts on their behalf. *See* 2 Scott, Trusts 1388 (3d ed., 1967); 3 Scott, Trusts 1794 (3d ed., 1967). Had they so elected, Richards and Russell could have taken control of the trust res at any time.

* + - * 1. The 1977 opinion renders an identical holding bolstered by certain legislative history:

There is nothing in the record to show that the trustees could not have undertaken exclusive control of the trust res if they had elected to do so. Whatever power Goodwyn exercised over the trust assets, administration or distribution, he did so on the trustee's behalf and not in his own right.

Because of Goodwyn's failure to have a legally enforceable right, we have already held, following *Byrum*, that the assets of these trusts were not includable in the decedent's estate under 2036(a)(2). Since a similar legal right or power is a prerequisite under section 674(a), consistency appears to require the same decision with respect to the applicability of this section. We see no other possible decision.

Section 671 precludes attributing the income to Goodwyn on any other theory of dominion and control under the definition of gross income, including the Clifford doctrine. We interpret this limitation to mean that if Goodwyn cannot be considered as a trustee, in fact, under the statutory provisions of subpart E, he cannot be considered as such by virtue of the judicial doctrines arising from the Clifford case which Congress intended to limit through the enactment of subpart E. But the protection of section 671, as explained in the House Ways and Means Committee Report, cited *supra*, does not extend to situations involving the assignments of future income.

* + - * 1. With respect to the legislative history of the Internal Revenue Code of 1954, the 1977 opinion states:

While the record indicates that the legal formalities have been complied with, it also indicates that the designated "independent" trustees, whether by agreement or otherwise, entrusted the management of the trusts' assets and the distribution of income therefrom to the sole discretion of the decedent. The decedent kept all the records, made all of the investments and decided the amount to be distributed to beneficiaries. The trustees merely acquiesced in these actions.

On the basis of these facts, the judicial decisions following the Supreme Court's decision in *Helvering v. Clifford* [40-1 USTC ¶ 9265], 309 U.S. 331 (1940), and the later so-called *Clifford* regulations might well warrant the attribution of the income from these trusts to the decedent. However, to the extent these previous principles are not embodied in the present statutory provisions of the Code, they must be considered no longer applicable. Section 671 provides that subpart E represents the sole criterion of dominion and control under section 61 (relating to the definition of gross income) and thereby also under the *Clifford* doctrine.

The Report of the Committee on Ways and Means on the Internal Revenue Code of 1954 explains clearly that this exclusivity was the intent of Congress:

It is also provided in this section [671] that no items of a trust shall be included in computing the income or credits of the grantor (or another person) solely on the grounds of his dominion and control over the trust under the provisions of section 61 (corresponding to sec. 22(a) of existing law). The effect of this provision is to insure that taxability of *Clifford* type trusts shall be governed solely by this subpart. However, this provision does not affect the principles governing the taxability of income to a grantor or assignor other than by reason of his dominion and control over the trust. Thus, this subpart has no application in situations involving assignments of future income to the assignor, as in *Lucas v. Earl* [2 USTC ¶ 496] (281 U.S. 111), *Harrison v. Schaffner* [41-1 USTC ¶ 9355] (312 U.S. 579), and *Helvering v. Horst* [40-2 USTC ¶ 9787] (311 U.S. 112), whether or not the assignment is to a trust; nor are the rules as to family partnerships affected by this subpart.

Consequently, in order for a grantor to be held taxable pursuant to subpart E on the income of a trust which he has established, he must have one of the powers or retained interests proscribed by subpart E.

* + - * 1. So, that’s where the law has stood for many years. Along comes a bad facts makes bad law case, that of *Securities and Exchange Commission v. Wyly*.[[655]](#footnote-656) The issue there was whether certain trusts should be considered grantor trusts for income tax purposes, thus causing the grantors to owe income tax, or whether the trusts were properly considered to be offshore, managed by an Isle of Man trustee. The opinion states:

Section 674(a) provides that: “[t]he grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.” Quoting a prominent tax treatise, defendants concede that the “power of disposition” includes “powers to ‘effect such major changes in the enjoyment of a trust's income and corpus as the addition and elimination of beneficiaries' as well as ‘minor and customary power[s]’ over income and corpus distribution.” Because a non-beneficiary trustee is considered a non-adverse party under the statute, “[s]ection 674(a) captures virtually every trust, including the [IOM] trusts.” Thus, defendants concede that “[u]ltimate liability under [s]ection 674[] … turns on whether any of the statutory exceptions apply.” In his treatise, defendants' expert confirms that the Wylys' had a power of disposition under this statute. *See* Robert T. Danforth, Norman H. Lane, and Howard M. Zaritsky, Federal Income Taxation of Estates and Trusts §9.04[1] (“A right to use trust funds without adequate compensation also affects beneficial enjoyment, because the holder can reduce the assets from which the named beneficiaries can benefit. Thus, a grantor's right to live rent-free in a house owned by the trust is a power of disposition under Section 674(a).”).

According to defendants, the Bulldog Trusts are not grantor trusts because they fall under the section 674(c) exemption. Under that exemption, section 674(a) does not apply to “certain powers that are exercisable by independent trustees.” According to the corresponding IRS regulation, which summarizes the statute, [t]he powers to which section 674(c) apply are powers (a) to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, or (b) to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries). In order for such a power to fall within the exception of section 674(c) it must be exercisable solely (without the approval or consent of any other person) by a trustee or trustees none of whom is the grantor and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor. To determine whether the Bulldog Trusts are covered by this exception, it is necessary to answer three questions: 1) Did the IOM trustees have the power to “distribute, apportion, or accumulate income” or “pay out corpus” to or for a beneficiary or beneficiaries?; 2) Were the IOM trustees a) the grantor, or b) a “related or subordinate” party as defined by the statute?; and 3) Were the trustees able to “exercis[e] [those powers] solely (without the approval or consent of any other person)”?

The first two questions are straightforward. First, the IOM trustees certainly had the power, as set out in the trust deeds, to “distribute, apportion, or accumulate income” or “pay out corpus” to or for a beneficiary. Second, the IOM trustees were neither the grantor, nor one of the individuals on the exclusive list of “related or subordinate” parties defined by the statute. The only remaining question is whether the IOM trustees were able to exercise those powers “solely” or “without the approval or consent of any other person.”

Defendants argue, citing a 1976 Tax Court case, that a grantor may only be taxed on “a power reserved by instrument or contract creating an ascertainable and legally enforceable right, not merely the persuasive control which he might exercise over an independent trustee who is receptive to his wishes.” As such, defendants contend that the Wylys did not share in the power to distribute, apportion, or allocate income, or to pay out corpus, because the trust deeds allocated those powers solely to the IOM trustees. Thus, the Bulldog Trusts fall within the shelter of 674(c)’s “independent trustees exception.”

I disagree. “Such a rigid construction is unwarranted. It cannot be squared with the black-letter principle that ‘tax law deals in economic realities, not legal abstractions.’” As Professor Robert Danforth, the defendants' own expert, writes in his treatise, “[i]t would certainly violate the purpose of the independent trustee rule to require an independent trustee to act with the consent of the grantor or a related or subordinate person.” The Wylys, through the trust protectors who were all loyal Wyly agents, retained the ability to terminate and replace trustees. The Wylys expected that the trustees would execute their every order, and that is exactly what the trustees did.

The evidence amply shows that the IOM trustees followed every Wyly recommendation, whether it pertained to transactions in the Issuer securities, making unsecured loans to Wyly enterprises, or purchases of real estate, artwork, collectibles, and other personal items for the Wylys and their children. The trustees made no meaningful decisions about the trust income or corpus other than at the behest of the Wylys. On certain occasions, such as the establishment of the Bessie Trusts, the IOM trustees actively participated in fraudulent activity along with the Wylys. The Wylys freely directed the distribution of trust assets for personal purchases and personal use. Because the Wylys and their family members were beneficiaries, the IOM trustees were thus “distributing” income for a beneficiary at the direction of the grantors—the Wylys. [[656]](#footnote-657)

* + - * 1. *Wyly* presents potential problems for ordinary trusts if the advisors routinely follow a grantor or beneficiaries “advice.” The *Goodwyn* rule was clear, but if you believe *Wyly* then in many trusts we would likely discover that the grantor or beneficiaries were “pulling the strings” although they had no legal right to do so. However, in the context of obtaining basis for grantors, *Wyly* could be helpful by enabling a grantor to argue for the application of section 2036 unexpectedly. Note particularly that the *Goodwyn* rationales appear to be based on a trustee having authority; if an advisor who is not a fiduciary can direct a trustee, and the trustee must follow the direction, then will *Goodwyn* protect the grantor whose advisor follows the grantor’s advice regularly.
      1. Use a freeze partnership so that grantor’s retained preferred interest gets a basis adjustment at death.
         1. Transfers cash flow and appreciation in excess of the donor’s preferred return and liquidation preference
         2. A section 754 election (discussed below) would allow a corresponding step up to partnership’s inside basis.
         3. Requires payment of a preferred return to donor, which may be difficult if yield on underlying assets is not sufficient
         4. Preferred interest valued at zero unless an exception to section 2701 exists or if an exemption to the zero valuation rule exists (for example, a qualified payment interest)
         5. Even if the section 2701 requirements are not met and preferred interest has a zero value (e.g. because non-cumulative), such that the value of the gift equals the donor’s entire interest in the partnership, at donor’s death the value of preferred is includible in gross estate (put right can ensure that the value at least equals liquidation preference) and there is no transfer tax on the income and appreciation to the extent it exceeds the donor’s preferred return.
    1. Tax consequences of estate tax inclusion
       1. Value of property at death is includible in gross estate.
       2. Section 2001(b) provides that adjusted taxable gifts do not include gifts that are includible in the gross estate. Thus, there is a distinction between including assets in the estate of a beneficiary and including gifted assets in the estate of the donor.
       3. There is no reduction available for gifts treated as having been made by a spouse because of a split-gift election, so estate tax inclusion generally should not be used for property for which a splitgift election was made.
       4. There is a question about how much is excluded from adjusted taxable gifts where less than all of the gifted property is includible in the estate (e.g. because of distributions of income or distributions of appreciation).
          1. This does not seem to be addressed under sections 2001, 2701 and 2702 or the Treasury Regulations thereunder.
          2. Example: I make a completed gift of $5 million of stock with a zero basis to a trust for my children and the stock is included in my estate as a result of one of the methods described above. During my lifetime any appreciation in excess of $5 million is distributed to my children; such a distribution would be free from transfer tax. On my death, the remaining $5 million of stock is includible in my gross estate and the basis in the stock will be stepped up to the value on the date of death and the stock can be sold free from capital gains tax. Is my $5 million gift washed out because it was included in my estate, despite the distributions of appreciation?
          3. Example: Same as the previous except that I retain the right to receive trust income during my lifetime. My income interest does not reduce the value of the gift because it does not meet the requirements of section 2702. All appreciation is distributed to my children during my lifetime. On my death, I receive a basis “step-up” and my adjusted taxable gifts are reduced. Under the Treasury Regulations,[[657]](#footnote-658) however, my adjusted taxable gifts are only reduced by the value of my income interest and not by the full $5 million value of the stock.
  1. “Reverse” Estate Planning: Turning your Poorer Parent into an Asset
     1. Generally
        1. Many clients who have taxable estates also have a surviving parent or parents who lack a taxable estate. A child of a parent whose taxable estate is less than the parent’s applicable exclusion amount may make use of the excess to save income, estate, and generation-skipping taxes if the child can transfer assets upstream, from child to parent, in such a way that the assets are included in the parent’s estate with little likelihood that the parent will divert the transferred assets away from the child or child’s descendants.
        2. Although the benefits of such planning have always existed, the recent increases in the applicable exemption amount have enhanced the benefits of such planning.
     2. Estate and Generation-Skipping Tax Benefits.
        1. To the extent a child transfers assets to an ancestor, the ancestor will include those assets in the ancestor’s estate and may shelter those assets with the ancestor’s estate and GST tax exemptions. Transfers can be made without using the child’s applicable exclusion amount:
           1. Annual exclusion gifts may be made to the ancestors. The gifts may be made outright or in trust depending on circumstances (e.g. ancestors may be given *Crummey[[658]](#footnote-659)* withdrawal rights). Discounted gifts may be made although doing so will add benefits to the transaction only if the discount is unlocked prior to the ancestor’s death. The benefits of annual exclusion gifts may be significant.
           2. Child could make adjusted taxable gifts to the ancestor. Although it may appear that such would be a wasted use of the child’s gift tax exemption, if the ancestor is able to leave the given amount to child and child’s descendants without estate or generation-skipping tax then the only waste would be opportunity cost to the extent that other methods could be found to transfer assets to a parent without making a gift.
           3. Child may create a GRAT that has a vested remainder in ancestor. That is, the GRAT assets, after the annuity term ends, will be paid to ancestor or to ancestor’s estate. The value of the remainder will be included in the ancestor’s estate and will pass in accordance with the ancestor’s estate plan.

The ancestor’s executor may allocate generation-skipping tax exemption to the remainder interest without regard to any ETIP under section 2642(f) because the ancestor has not made an inter vivos transfer of property that would be included in the estate immediately after the transfer. The amount allocated would be equal to the fair market value of the remainder interest. Where the GRAT term is 10 years (or longer), and is back-weighted, the remainder value will remain a comparatively small percentage of the GRAT for the first several years of the term. Upstream GRATs will, in general, have longer terms that GRATs that are designed to transfer assets immediately to children. Commentators have speculated that a GRAT may be created with a vested interest in a child, with that child immediately transferring the remainder interest to that child’s children and allocating that child’s GST exemption at the time of transfer. There is no authority on whether such a transaction achieves the intended result. Private Letter Ruling 200107015 ruled negatively on the assignment of a remainder interest in a charitable lead annuity trust primarily on the grounds that section 2642(e) is specifically designed to limit the ability to leverage generation-skipping tax exemption by using a charitable lead annuity trust. Here the GRAT remainder is not being transferred at the time of its creation, but rather at its fair market value at a later time (the death of the parent owner), which is arguably not abusive.

Use of an Upstream GRAT presents several advantages compared with a child’s assignment of a remainder interest to grandchildren. Because GST exemption that would otherwise be wasted is being used there is no, or certainly less, pressure to keep the remainder interest in parent’s estate at zero or a de minimis value and the value changes depending on when parent dies (a date that in almost all instances will be uncertain). If a concern is that the value of the remainder interest could exceed the threshold beyond which parent’s estate would be required to pay Federal estate tax (or file an estate tax return), then the amount vested in parent could be fixed by a formula tied to the remaining assets in parent’s estate. Suppose a 10 year GRAT is funded with $1,000,000 with annual payments that increase at 20% per year is created in a month when the section 7520 rate is 2.0%. The annual payments required to zero-out the GRAT are $44,125. Further, suppose that parent dies at the end of year 5 when the section 7520 rate is 5.0% and the value of the trust assets have grown at 6% per year. The value of the GRAT will be $975,740 with five years of payments remaining and the value of the remainder will be about $403,000.

* + 1. Income Tax Benefits

Assets included in a parent’s estate for estate tax purposes obtain a new income tax basis under section 1014(b)(9) but not if assets acquired by the parent from a child by gift within one year of the parent’s death pass back to the child or the child’s spouse.[[659]](#footnote-660) Suppose that the assets pay into a trust for descendants but a third party has a power of appointment to add beneficiaries to the trust?

* + 1. Creditor Protection for Child
       1. Assets that a parent transfers in trust to a child may be insulated from the child’s creditors so long as the child’s rights in the trust are properly limited. The sine qua non is that parent must make the transfer into the trust for state law purposes.
       2. The lapse of a *Crummey* withdrawal right may be a state law transfer, although most practitioners and trustees do not treat it as such, except in those states which provide specifically to the contrary (such as under the Uniform Trust Code). A safer approach would be to have parent exercise parent’s power of appointment in favor of a new trust for the benefit of child. If the power is general the parent should become the grantor of the trust for state law purposes.
    2. Limiting Parent’s Ability to Divert Assets
       1. The strategies called for require that parent have a testamentary general power of appointment. A power limited to the appointment of assets to the creditors of a parent’s estate will be a general power under section 2041(b)(1). If it is desirable that a parent have additional discretion the parent could be given a power to appoint to descendants, with or without charities, and such additional powers could be conditioned on the consent of child or others because all that is required in order to capture the tax benefits is the limited testamentary general power.
       2. If a child desires to receive an interest in the assets transferred to parent back from parent (e.g. parent transfers the assets into a trust for child and child’s descendants that is not available to child’s creditors), then giving parent a power that is broader than a power to appoint to the creditors of parent’s estate may be desirable. For example, a parent could be given a power to appoint to parent’s children and the creditors of parent’s estate. Child could ensure that assets were not diverted to a sibling by purchasing from the siblings an assignment of any rights the siblings receive in assets appointed by parent that originated with child. The assignment would be independent of parent but would limit the ability of a creditor (or the government) to argue that the child transferred the assets to parent in a manner that did not give parent any true control. The ability to reach such an agreement with minors is limited.
    3. Parent’s Creditors.
       1. A parent who has or is likely to have creditors will not be a good candidate for these sorts of transactions. Creditors could include health-care providers or Medicaid, tort victims (for example, if parent is still driving), and beneficiaries of legally binding charitable pledges.
       2. In addition, by definition, a parent who is married to someone who is not also child’s parent has a potential creditor at death although in limited instances marriage agreements coupled with state law limitations on the rights of a surviving spouse to take property over which a decedent has a testamentary general power of appointment may make these transactions feasible.
    4. Upstream Sale to a Power of Appointment Trust (UPSPAT)
       1. Suppose a child creates a grantor trust, sells assets to the trust for a note, gives the child’s parent a testamentary general power of appointment over the trust assets so that the assets will be included in the parent’s estate at the parent’s death and receive new basis, and then the trust (which remains a grantor trust with respect to the child ever after the parent’s death) uses the assets to pay off the note. The net effect is that the parent’s net estate is increased by zero or a small amount yet the child receives new basis.
       2. Because the contemplated transaction is not designed to remove assets from the child’s estate for estate tax purposes, the issues under section 2036 that require that the grantor trust be appropriately “seeded” would not apply. However, a sale to an unseeded trust could result in a note having a value less than its stated face value, thus causing child to make a gift. Parent’s guarantee of the note could reduce that risk.
       3. Does the existence of the parent’s general power cause the assets to be stepped-up to full fair market value, or will the value of the note reduce the amount of the step-up? section 2053(a)(4) provides that the value of the taxable estate will be reduced by indebtedness in respect of property included in a decedent’s estate. The Treasury Regulations provide, in relevant part:

A deduction is allowed from a decedent’s gross estate of the full unpaid amount of a mortgage upon, or of any other indebtedness in respect of, any property of the gross estate, including interest which had accrued thereon to the date of death, provided the value of the property, undiminished by the amount of the mortgage or indebtedness, is included in the value of the gross estate. If the decedent’s estate is liable for the amount of the mortgage or indebtedness, the full value of the property subject to the mortgage or indebtedness must be included as part of the value of the gross estate; the amount of the mortgage or indebtedness being in such case allowed as a deduction. But if the decedent’s estate is not so liable, only the value of the equity of redemption (or the value of the property, less the mortgage or indebtedness) need be retuned as part of the value of the gross estate. In no case may the deduction on account of the mortgage or indebtedness exceed the liability therefor contracted bona fide and for an adequate and full consideration in money or money’s worth.[[660]](#footnote-661)

* + - 1. Thus the net increase to parent’s estate would seem to be zero. If parent guaranteed the obligation then this concern would be reduced. Arguably such a step is unnecessary because the regulations may be read as discretionary or optional. Further, outside the trust context, the Supreme Court decision in *Crane v. Commissioner*[[661]](#footnote-662) suggests that the basis increase is based on the fair market value of the property regardless of the associated debt.
      2. If the amount over which parent has a testamentary general power of appointment is limited by formula to an amount that would not increase parent’s taxable estate to more than the federal estate tax exclusion taking into consideration parent’s other assets, then a basis adjustment can be obtained for that amount because there is no need for the debt to offset the assets included in parent’s estate. The trust should provide that it is for the benefit of the child’s descendants, not the child, to avoid the one year prohibition of section 1014(e), as discussed in more detail above.
      3. Might the IRS argue that payment on the note is an indirect return of assets to the child? To the extent the note is not for fair market value that would be a direct return of assets. Suppose the terms of the trust and the sale provided that no assets could be used to pay off the note beyond those required to satisfy the fair market value of the note as determined for federal gift tax purposes. The desired result would be that the amount of the child’s gift would be trapped in the trust and pass other than to a child.
      4. Supposed child “sells” cash to the grantor trust for a promissory note. Section 1014(e) applies, by its terms, only to “appreciated property” acquired by the decedent by gift within one year prior to the decedent’s death. If the cash in the grantor trust is later swapped for child’s appreciated property that would not be appreciated property acquired by gift. The cash might have acquired in part by gift – if the note were not valued at par – but not the appreciated property. Is this extra step valuable in minimizing a challenge?
      5. Does the death of a parent terminate the grantor trust status of the trust? If yes, that would cause the sale to be recognized by child as of that moment, thus undoing the benefits of the transaction. This is unlike a sale to a grantor trust where grantor trust status terminates because the grantor dies where, as discussed later in this outline, the consensus appears to be that death cannot, or ought not, trigger a taxable transaction. The Treasury Regulations provide that a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer – defined as any transfer other than one for fair market value – of property to a trust.[[662]](#footnote-663) Section 678 by its terms confers grantor trust status (or status that is substantially similar to grantor trust status) only in situations involving inter vivos general powers. The IRS ruling position is that an inter vivos right to withdraw makes the power holder a grantor under section 678 but not replacing the true grantor if one still exists. What is the effect of parent’s testamentary general power of appointment? The Treasury Regulations contain two examples that are close but not directly on point:[[663]](#footnote-664)

Example 4. A creates and funds a trust, T. A does not retain any power or interest in T that would cause A to be treated as an owner of any portion of the trust under sections 671 through 677. B holds an unrestricted power, exercisable solely by B, to withdraw certain amounts contributed to the trust before the end of the calendar year and to vest those amounts in B. B is treated as an owner of the portion of T that is subject to the withdrawal power under section 678(a)(1). However, B is not a grantor of T under paragraph (e)(1) of this section because B neither created T nor made a gratuitous transfer to T.

Example 8. G creates and funds a trust, T1, for the benefit of B. G retains a power to revest the assets of T1 in G within the meaning of section 676. Under the trust agreement, B is given a general power of appointment over the assets of T1. B exercises the general power of appointment with respect to one-half of the corpus of T1 in favor of a trust, T2, that is for the benefit of C, B’s child. Under paragraph (e)(1) of this section, G is the grantor of T1, and under paragraphs (e)(1) and (5) of this section, B is the grantor of T2.

* + - 1. Note that this is the same issue which exists with respect to creating a lifetime QTIP trust that is a grantor trust with respect to the creating spouse. After the beneficiary spouse dies, the property may remain in trust for the benefit of the creating spouse and the couple’s descendants becoming, essentially, a credit-shelter trust. However, if the creator spouse remains the grantor of the trust for income tax purposes that will produce a substantial additional transfer tax benefit.[[664]](#footnote-665)
      2. An UPSPAT may be “ready to go” to minimize the risks of delay when a parent (or ancestor) becomes ill. The descendant may create the UPSPAT and transfer assets to it retaining lifetime and testamentary powers of appointment to ensure that the gift is incomplete. An instrument by which the descendant gives up those powers of appointment may be drafted as may the form of a note, leaving only the date and interest rate blank. Thus, on short notice, the descendant may contact the trustee, deliver the instrument surrendering the powers of appointment and, in exchange for that gift, receiving the note. Obviously, a sale document could be completed at the same time if desirable. Prudence suggests that the note be transferred immediately to another party to minimize the risk that the IRS recharacterizes the sale-note-payoff as a return of assets to the descendant.
      3. As in all instances when a general power of appointment is being created for income tax basis purposes, a circumscribed general power of appointment, described earlier, should be used.
    1. Accidentally Perfect Grantor Trust
       1. Similar in many respects to the UPSPAT discussed above is a technique that has been called the “Accidentally Perfect Grantor Trust” (APGT). [[665]](#footnote-666) The transferor uses a parent’s unused Applicable Exemption Amount and GST exemption, benefits from a “step-up” in basis, but still retains grantor trust status after the parent’s death. Pursuant to this technique, a younger generation establishes an IDGT and moves wealth into the IDGT (e.g., pursuant to an installment sale as with the UPSPAT) the terms of which provide that the parent is a beneficiary of the IDGT and is granted a testamentary general power of appointment over the IDGT’s appreciated assets equal to the parent’s unused Applicable Exemption Amount and GST exemption (e.g., pursuant to a formula provision, as discussed above). Upon the death of the parent, the assets may be held for the benefit of the younger generation grantor and his or her descendants.
       2. In order to be successful, the APGT must avoid estate tax inclusion at the younger generation’s level under sections 2036 through 2038, cause estate tax inclusion at the parent’s passing, and provide for a “step-up” in basis for the estate tax includible assets.[[666]](#footnote-667)
       3. From an income tax standpoint, according to the proponents of the APGT, whether the ongoing trust will continue to be a grantor trust with respect to the younger generation or a non-grantor trust depends on whether the parent exercises the general power of appointment or allows it to lapse. The Treasury Regulations provide:

If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, then such person will be treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code.[[667]](#footnote-668)

* + - 1. Thus, if the ongoing trust arises because the parent exercises the general power of appointment, then the parent is the grantor for income tax purposes, and the ongoing trust will be a non-grantor trust for income tax purposes. More significantly, the argument goes, if the ongoing trust is created as a result of the failure to exercise or lapse of the general power of appointment, then the trust will continue to be a grantor trust with respect to the younger generation who is also a potential beneficiary of such trust ongoing trust.
      2. In addition, it would be a challenge for the IRS to know that the grantor/beneficiary is claiming ongoing grantor trust status. From an income tax reporting standpoint, prior to the death of the holder of the testamentary general power of appointment, the Form 1041 (if one believes one should, in fact, be filed) simply states the trust is a grantor trust and all tax items are being reported on the grantor’s personal income tax return. In the year of the power holder’s death, the Form 1041 would be reported the same way with no change in taxes obviously and with, perhaps, a disclosure that grantor trust status will continue to be claimed. All of the changes to tax basis would occur on the grantor’s personal income tax return.
  1. Strategies to Achieve A Step-Up Upon the Death of Each Spouse
     1. Joint Revocable Trusts and the “JEST”
        1. Following in the line of a number of rulings,[[668]](#footnote-669) a planning technique referred to as the “Joint Exempt Step-Up Trust” (“JEST”) has arisen that seeks to give married couples residing in non-community property states some of the same “step-up” in basis enjoyed by couples who die with community property under section 1014(b)(6). The attorneys who developed this technique have published the details of the JEST, including the numerous tax, creditor protection, and other legal issues surrounding the technique.[[669]](#footnote-670)
        2. The basic structure of the JEST is:
           1. Married couple funds a jointly-established revocable trust, with each spouse owning a separate equal share in the trust. Either spouse may terminate the trust while both are living, in which case the trustee distributes 50% of the assets back to each spouse. If there is no termination, the joint trust becomes irrevocable when the first spouse dies. The first dying spouse has a general power of appointment over all trust assets.
           2. Upon the first death, all assets are includible in the estate of the first to die.
           3. Upon the first death, assets equal in value to the first dying spouse’s unused available exemption amount will be used to fund a bypass trust (“Credit Shelter Trust A”) for the benefit of the surviving spouse and descendants. These assets will receive a stepped-up basis and will escape estate tax liability upon the surviving spouse’s death. Any asset in excess of the funding of Credit Shelter Trust A will go into an electing qualified terminable interest property trust (“QTIP Trust A”) under section 2056(b)(7). The assets in the QTIP Trust receive a step-up in basis upon the first spouse’s death and on the surviving spouse’s death.
           4. If the first dying spouse’s share is less than his or her available exemption amount, then the surviving spouse’s share will be used to fund a “Credit Shelter Trust B” with assets equal to the excess exemption. According to the authors of this technique, the assets of the Credit Shelter Trust B will avoid estate taxation at the surviving spouse’s death, notwithstanding that the surviving spouse originally contributed the assets to the JEST and had the power to terminate the trust and reclaim the assets. The authors provide that in order to further assure a step-up in basis on the assets in the Credit Shelter Trust B, it is best that the surviving spouse is not a beneficiary of Credit Shelter Trust B or perhaps to only be a beneficiary that may be added by an independent trust protector in the future.
           5. Any assets remaining of the surviving spouse’s share in excess of what is funded into Credit Shelter Trust B will be used to fund a QTIP Trust B.
           6. The traditional concerns with this sort of planning have been whether there is one or more taxable gifts between the spouses in creating and funding the trust, and whether the desired “step-up” is available. Definitive guidance remains scarce.
     2. Section 2038 Estate Marital Trusts
        1. Another possible method of providing a “step-up” in basis for all marital assets on the death of the first spouse to die is using what is sometimes referred to as a “Section 2038 Estate Marital Trust.” The basic features of a Section 2038 Estate Marital Trust are:
           1. Grantor (the “Grantor Spouse”) contributes assets to a trust for the benefit of his or her spouse (the “Beneficiary Spouse”). The Grantor Spouse can be the sole trustee or co-trustee of the trust. The trustee has the discretion to distribute income and principal only to the Beneficiary Spouse for such spouse’s lifetime. Upon the Beneficiary Spouse’s death, the trust assets pass to the Beneficiary Spouse’s estate.
           2. The Grantor Spouse retains a right to terminate the trust prior to the Beneficiary Spouse’s death. Upon such termination, the trust assets must be distributed outright to the Beneficiary Spouse.
           3. The Grantor Spouse retains the power, in a non-fiduciary capacity, to reacquire or “swap” the trust corpus by substituting other property of an equivalent value.
        2. The trust does not provide for distribution of all income annually[[670]](#footnote-671) or for the conversion of unproductive property[[671]](#footnote-672) as would be required for a general power of appointment marital trust or QTIP Trust. However, the trust should qualify for the gift tax marital deduction because the trust funds are payable only to the Beneficiary Spouse’s estate, and thus the spouse’s interest is not a nondeductible terminable interest under section 2523(b).[[672]](#footnote-673)
        3. The contribution of assets to the trust should be a completed gift notwithstanding the Grantor Spouse’s right to change the manner or time of enjoyment of the assets because the only beneficiary of the trust is the Beneficiary Spouse or the estate of the Beneficiary Spouse.[[673]](#footnote-674)
        4. During the lifetime of the Beneficiary Spouse, the trust will be treated as a grantor trust for income tax purposes with respect to the Grantor Spouse under section 677(a) which provides, in pertinent part, that the “grantor shall be treated as the owner of any portion of a trust… whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor … may be distributed to … the grantor’s spouse”[[674]](#footnote-675) or “held or accumulated for future distribution to … the grantor’s spouse.”[[675]](#footnote-676) Because the Beneficiary Spouse and his or her estate is the sole beneficiary of the lifetime and the remainder interests, grantor trust treatment should be as to all of the assets in the trust and as to both income and principal.[[676]](#footnote-677) Thus, no portion of the trust’s income should be taxable as a non-grantor trust. However, in order to ensure grantor trust status as to all of the assets and tax items of the trust, practitioners might consider having the Grantor Spouse retain the power, in a non-fiduciary capacity, to reacquire the trust corpus by substituting other property of an equivalent value.[[677]](#footnote-678)
        5. If the Beneficiary Spouse dies first, the trust assets will be payable to his or her estate and thus are includible in the gross estate under section 2031 and entitled to a “step-up” in basis.
        6. If the Grantor Spouse dies first, the trust assets will be includible in the gross estate under section 2038. It provides, the gross estate will include the value of all property “[t]o the extent of any interest therein of which the decedent has at any time made a transfer … by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3 year period ending on the date of the decedent's death.”[[678]](#footnote-679)
  2. The Upside of Debt
     1. Generally
        1. As mentioned above, the analysis around estate planning will be measuring the estate and inheritance tax cost (if any) of having an asset includible in the estate against the income tax savings from a “step-up” in basis on the asset. Because both the estate tax liability and the adjusted tax basis at death are measured by the fair market value of the assets, the two taxes are typically in contradistinction to each other. The estate tax cost is offset, in whole or in part, by the “step-up” in basis. The judicious use of debt or other encumbrances may allow taxpayers to reduce estate tax cost but still maintain or increase the “step-up” in basis. In other words, where you don’t want to give away an asset, use it as collateral and give away the borrowed proceeds; if the rate of return on the proceeds exceeds the interest rate paid to the third party lender the taxpayer will come out ahead. This is the equivalent of borrowing and using the cash to buy assets from a grantor trust.
        2. Consider the following examples:
           1. Taxpayer owns an asset worth $10 million and has a $0 adjusted tax basis (for example, fully depreciated commercial real property). At the taxpayer’s death, the amount includible in the gross estate for estate tax purposes under section 2031 and the new adjusted tax basis of the asset under section 1014(a) will each be $10 million. Assuming no estate tax deductions, the taxable estate under section 2051 (taxable estate is determined by taking the gross estate and reducing it by the appropriate deductions) is also $10 million.
           2. Same as above, except the taxpayer has a plan to transfer $9 million of assets out of the taxpayer’s estate prior to death (could be a gift or a GRAT or a discounted sale, or any other bit of cleverness). If the taxpayer transfers the zero basis asset, the taxpayer faces the income tax basis problem. Suppose, therefore, that the taxpayer borrows $9 million, using the asset as collateral for the debt. Ignoring for the moment the $9 million of borrowed cash (which would be includible in the estate), at the taxpayer’s death, the amount includible in the gross estate due to the asset is $10 million, and the adjusted tax basis of the asset is also $10 million.[[679]](#footnote-680) Next, the taxpayer disposes of the $9 million using the preferred technique (gift, GRAT, etc.). Now, the taxable estate is $1 million because the estate is entitled to a deduction under section 2053(a)(4), “for unpaid mortgages on, or any indebtedness in respect of, property where the value of the decedent's interest therein, undiminished by such mortgage or indebtedness, is included in the value of the gross estate.”[[680]](#footnote-681) Thus, the taxpayer’s estate would receive a full “step-up” in basis of $10 million for a taxable estate of $1 million. Of course, if the debt proceeds remained in the estate in full, then gross estate is $19 million (asset + debt) reduced by $9 million of debt on the asset, resulting in a taxable estate of $10 million.
           3. Same as above, except after the loan but prior to death, the taxpayer engages in a series of “zeroed-out” transfers like GRATs or installment sales to IDGTs, with the result that only $4 million of the original $9 million of debt proceeds remain in the estate. The overall result, including the debt proceeds, is the asset would still receive a “step-up” in basis to $10 million but the taxable estate would only be $5 million. The gross estate would be $14 million (asset + debt proceeds) reduced by $9 million of debt on the asset.
           4. Same as above, except after the loan, instead of engaging in “zeroed-out” transfers, the taxpayer exchanges the $9 million of cash from the loan with a $9 million/$0 tax basis asset that is in an IDGT (assets not otherwise includible in the taxpayer’s estate). The overall result is both the $10 and $9 million assets would receive a “step-up” in basis to fair market value (totaling $19 million of basis adjustment), but the taxable estate would be $10 million ($19 million gross estate, reduced by $9 million of debt).
        3. As the foregoing examples show, the key to reducing estate tax exposure and maximizing the “step-up” in basis is (i) ensuring the deductibility of the debt, and (ii) engaging in an additional transaction that reduces estate tax exposure of the debt proceeds or exchanges the debt proceeds (cash) for something that would benefit from a “step-up” in basis. Of course, one of the easiest ways to reduce the estate tax exposure on the loan proceeds is simply to spend it aggressively.
     2. Qualified Unpaid Mortgages and Indebtedness
        1. In order for an estate to obtain a full estate tax deduction for debt owed by the decedent, the Treasury Regulations states that the full value of the asset must be included in the gross estate and the indebtedness must be a liability of the estate:

A deduction is allowed from a decedent's gross estate of the full unpaid amount of a mortgage upon, or of any other indebtedness in respect of, any property of the gross estate, including interest which had accrued thereon to the date of death, provided the value of the property, undiminished by the amount of the mortgage or indebtedness, is included in the value of the gross estate. If the decedent's estate is liable for the amount of the mortgage or indebtedness, the full value of the property subject to the mortgage or indebtedness must be included as part of the value of the gross estate; the amount of the mortgage or indebtedness being in such case allowed as a deduction. But if the decedent's estate is not so liable, only the value of the equity of redemption (or the value of the property, less the mortgage or indebtedness) need be returned as part of the value of the gross estate. In no case may the deduction on account of the mortgage or indebtedness exceed the liability therefor contracted bona fide and for an adequate and full consideration in money or money's worth.[[681]](#footnote-682)

* + - 1. The full value of the unpaid mortgage may be deducted under section 2053(a)(4), even if the property is valued at less than fair market value pursuant to the special use provisions under section 2032A.[[682]](#footnote-683)
      2. The liability underlying the indebtedness must be bona fide and for adequate and full consideration.[[683]](#footnote-684)
      3. As mentioned, if the liability is a charge against the property but the property is not included in the gross estate, there is no estate tax deduction. As such, if a decedent only owned a one-half interest in property, the estate is not entitled to a deduction for the liability.[[684]](#footnote-685) Furthermore, if the asset is real property located outside of the U.S. and is not includible in the gross estate, no deduction may be taken for any unpaid mortgage.[[685]](#footnote-686)
      4. The Treasury Regulations distinguish between a mortgage or indebtedness for which the estate is not liable and which only represents a charge against the property. Under those circumstances, the Treasury Regulations provide that only the “equity of redemption”[[686]](#footnote-687) (value of the property less the debt) will be included in the gross estate, and thus receive the step-up.
    1. Debt on Assets in Trust
       - 1. Given the foregoing, would the same full “step-up” in basis be available for assets in a trust that would be includible for estate tax purposes (or subject to a general power of appointment) if the assets were encumbered by debt? For example, consider a QTIP trust that holds a $5 million asset with an adjusted tax basis of $1 million (perhaps an inter vivos QTIP trust funded with a highly appreciated asset or a testamentary QTIP funded with a $1 million asset that appreciated significantly). The trustee of the QTIP trust borrows $3 million, using the $5 million asset as collateral for the loan, and then distributes the $3 million of loan proceeds to the surviving spouse as a principal distribution. Upon the death of the surviving spouse, does the $5 million asset in the QTIP trust receive an adjusted tax basis of $5 million (fair market value) or $2 million (the net value and the net amount taxable in the surviving spouse’s estate)?
         2. Assets held by a QTIP trust (for which a marital deduction was granted upon funding)[[687]](#footnote-688) are includible under section 2044(a), which provides “[t]he value of the gross estate shall include the value of any property to which this section applies in which the decedent had a qualifying income interest for.”[[688]](#footnote-689) For these purposes, section 2044(c) provides that for purposes of calculating the amount includible in the gross estate of the decedent, the property “shall be treated as property passing from the decedent.”[[689]](#footnote-690) Does the foregoing provision mean that only the net value is includible, similar to the “equity of redemption”[[690]](#footnote-691) concept of section 2053(a)(4) discussed above because the debt is not a legal obligation of the surviving spouse?
         3. The basis adjustment at death on the QTIP property is conferred by section 1014(b)(10). For these purposes, it provides that “the last 3 sentences of paragraph (9) shall apply as if such property were described in the first sentence of paragraph (9).”[[691]](#footnote-692) The latter reference to section 1014(b)(9) is the basis adjustment at death for “property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate under chapter 11 of subtitle B or under the Internal Revenue Code.”[[692]](#footnote-693)
         4. Section 1014(b)(9) provides for a reduction of tax basis for property acquired before the death of the decedent. It provides the tax basis must be “reduced by the amount allowed to the taxpayer as deductions in computing taxable income … for exhaustion, wear and tear, obsolescence, amortization, and depletion on such property before the death of the decedent.”[[693]](#footnote-694) This is in contrast to the basis adjustment under section 1014(b)(4),[[694]](#footnote-695) which applies when a general power of appointment is exercised and which does not require a similar reduction in basis. That being said, section 1014(b)(9), which applies when no other paragraph of section 1014 applies, does not require any other basis reduction (for debt, by way of example). As such, the basis adjustment under section 1014(a) applies which provides the basis shall be the “fair market value of the property at the date of the decedent’s death.”[[695]](#footnote-696)
         5. Does this mean, in the foregoing example, the basis on the asset in the QTIP trust should be $5 million because that is the fair market value of the property at the surviving spouse’s death or can the fair market value of the asset be interpreted as the “net value” of $2 million?
  1. NINGs/DINGs/WINGs and Other Things
     1. Taxpayers in high income tax states often look for opportunities to defer or avoid their state income tax exposure. In light of this objective, the use of “incomplete gift, non-grantor trusts” has arisen in states that do not have an income tax. Most prevalently, practitioners have taken advantage of the laws of Delaware (Delaware incomplete non-grantor trust or “DING”), Nevada (“NING”), and Wyoming (“WING”).[[696]](#footnote-697) Pursuant to this technique, as long as the assets are retained in the DING or NING, the income from such assets will not be subject to state income tax.
     2. Taxpayers may also seek to transfer assets to another taxpayer with the objective of creating another “taxpayer” for Federal income tax purposes and possibly getting certain tax additional tax benefits allowable on a per taxpayer benefit. For example, as mentioned earlier in these materials, under section 1202 of the Code, the QSBS exclusion is, in part, limited to $10 million per taxpayer. If a donor can transfer shares of QSBS to an incomplete gift, non-grantor trust, the trust, as a separate taxpayer, may be able to claim its own $10 million exclusion on the subsequent sale of the QSBS. Ostensibly, this can be accomplished without making a taxable gift. Other tax planners have considered using an incomplete gift, non-grantor trust to get around the $10,000 limitation on deductions for state and local sales, income, or property tax to $10,000.[[697]](#footnote-698) As discussed later in these materials, incomplete gift, non-grantor trusts, given their particular tax characteristics (e.g., incomplete gift, taxpayer separate from the grantor, and estate tax includible) might be helpful in the allocation of outside basis when partnership interest are transferred.
     3. The salient features of NING, DING, and WING planning are:
        1. The taxpayer creates a non-grantor trust;
        2. The taxpayer contributes assets to the trust that the taxpayer no longer wants to be subject to state income tax (or taxable to the taxpayer);
        3. The trust provides that the taxpayer/grantor is a permissible beneficiary of the trust;
        4. The contribution of assets to the non-grantor trust are not considered a taxable gift; and
        5. The assets in the non-grantor trust will be includible in the taxpayer/grantor’s estate for estate tax purposes.
     4. Typically, the incomplete gift, non-grantor trust is structured as an irrevocable trust for the benefit the grantor and specified family members. The beneficial interests of the beneficiaries are purely discretionary. During the grantor's life, distributions can be made only as directed by the holder of a power specifically granted in the trust instrument, and any undistributed income must be accumulated and added to corpus. The trustee's functions are administrative, and trustee has no discretionary powers affecting beneficial enjoyment. At the grantor's death, the remaining trust property is payable as directed by the grantor pursuant to a limited testamentary power of appointment, or in default of appointment specified family members.
     5. The trust instrument authorizes distributions to be made during the grantor's life pursuant to any of three distinct powers: (i) a power, exercisable by unanimous agreement of a distribution committee consisting of two or more beneficiaries (other than the grantor), to distribute trust income or corpus to any one or more beneficiaries (including the grantor); (2) a power, exercisable by a majority of the distribution committee with the grantor's consent, to distribute trust income or corpus to any one or more beneficiaries (including the grantor); and (3) a power, exercisable by the grantor in a nonfiduciary capacity, to distribute corpus to any one or more beneficiaries (other than the grantor or the grantor's spouse) for their health, education, support, and maintenance. The distribution committee is required to have at least two members throughout the grantor's life, and the committee's existence automatically terminates at the grantor's death.
     6. Prior to 1997, a self-settled trust (a trust that provides for the benefit of the grantor) like the one described above would not have qualified as a non-grantor trust. The Treasury Regulations provide, “Under section 677 a grantor is, in general, treated as the owner of a portion of a trust whose income is, or in the discretion of the grantor or a nonadverse party, or both, may be applied in discharge of a legal obligation of the grantor.” Thus, if under state law creditors of the grantor can reach the assets of the trust, then the trust will be considered a grantor trust for income tax purposes. Prior to 1997, all of the states provided that creditors of a grantor could reach the assets of any self-settled trust. Since 1997, a number of states like Alaska, Delaware, Nevada, and Wyoming have enacted “domestic asset protection trusts” that purportedly allow grantors to create self-settled trusts but prohibit creditors of the grantor from reaching the assets in the trust.
     7. A number of rulings under Delaware law affirmed the non-grantor trust status of the DING.[[698]](#footnote-699) All of the rulings relied upon an incomplete gift predicated upon the grantor retaining a special testamentary power of appointment to redirect the trust assets.[[699]](#footnote-700) Notwithstanding that the grantor was a permissible beneficiary of the trust, the rulings avoided grantor trust status through the use of a distribution committee that had to approve any distribution to the grantor. The members of the distribution committee were deemed to be adverse parties (for example, trust beneficiaries) under section 672(a), and as a result, the trust was not a grantor trust.
     8. In 2007, the IRS announced that it was re-examining the question of whether the distribution committee members have a general power of appointment.[[700]](#footnote-701) In 2012, the IRS ruled that the retention of a testamentary power of appointment makes the original transfer incomplete but only with respect to the remainder interest but not the lead interest.[[701]](#footnote-702) Subsequent rulings have confirmed that practitioners have “settled on” typical approaches.[[702]](#footnote-703) Notwithstanding the foregoing, in 2021, the IRS placed incomplete gift, non-grantor trusts on its list of areas under study in which rulings will not be issued until the service resolves the issue through the publication of a revenue ruling, revenue procedure, regulation, or otherwise.[[703]](#footnote-704) An ING trust is an opportunity to avoid state income tax that would have been paid by the taxpayer anyway. Accordingly, the transaction should be structured to minimize the risk of the taxpayer making a taxable gift even if doing so increases the risk of incurring state income tax. Forum and fiduciary shopping is wise; some corporate fiduciaries “new business” officers tout planning that the “fiduciary” officers are unwilling to carry out, and the institution manages this dichotomy by claiming sophistication while imposing various unnecessary burdens on ING transactions (among others).
     9. In 2014, New York enacted a statute that provides “incomplete gift non-grantor trusts” will be treated as grantor trusts, for New York state income tax purposes.[[704]](#footnote-705) An “incomplete gift non-grantor trust” is defined as a New York resident trust (generally, created by a New York resident or domiciliary) that meets the following conditions:
        1. “the trust does not qualify as a grantor trust under section six hundred seventy-one through six hundred seventy-nine of the internal revenue code,” and
        2. “the grantor’s transfer of assets to the trust is treated as an incomplete gift under section twenty-five hundred eleven of the internal revenue code, and the regulations thereunder.”[[705]](#footnote-706)
  2. Private Derivative Contracts to “Transfer” but Still Own for the “Step-Up”
     1. Financial derivatives are a staple in the capital markets. On the other hand, the use of financial derivatives for estate planning purposes is relatively new. The primary benefit of using a derivative (as opposed to the actual underlying asset form which its returns are “derived”) is that the underlying asset does not need to be transferred or even owned.
     2. In the estate planning context, derivatives or contractual rights have been used to “transfer” carried interests in private equity, leveraged buyout, and venture capital funds.[[706]](#footnote-707) The use of a derivative is usually required because the investors in the fund require that the transferor (holder of the carried interest) to retain the carried interest or because the carried interest of the grantor may be subject to a vesting schedule. Furthermore, the use of the derivative arguably avoids complications under section 2701 of the Code.
     3. Generally, “carry derivative” planning involves the creation of an IDGT, and entering into a contractual arrangement with the IDGT. Under the contract, the grantor would be required to pay the IDGT, at a stated future date, an amount based on the total return of the carry (the sum of the distributions the grantor receives and the fair market value of the carried interest on that future date). The contract is typically settled on an expiration date (e.g., 5 years) or upon the death of the grantor, if earlier. The IDGT will typically be funded with a taxable gift, and then pay “fair market value” for the rights under the contract. A professional appraiser determines the fair market value of the contractual rights based upon the particulars of the carried interest (e.g., type of fund, experience of the general partner, strategy, hurdle parameters, etc.), current interest rates, and terms of the contract. Upon settlement, the grantor would pay the trust an amount of cash (or property) equal to the value of the carried interests, plus an amount equal to the distributions (net of any claw backs) less hurdle/strike price (if any).
     4. Private derivatives may be used in estate planning with more common assets where for practical and tax reasons, the taxpayer ought to retain ownership of the property. Consider the following examples.
        1. “Negative basis” commercial real property interests.
           1. If the property is transferred to an IDGT (either by installment sale or taxable gift), upon the death of the grantor the debt in excess of basis will trigger taxable gain. In addition, because the property is held in the IDGT, there will be no “step-up” in basis for the benefit of the grantor’s heirs.
           2. The “step-up” in basis would have eliminated both the “negative basis” problem and recapture of the depreciation under section 1250, which is taxed at 25% (and sometimes under section 1245, which is taxed at ordinary income tax rates).[[707]](#footnote-708)
           3. The transfer of legal title has certain transactional costs (e.g., legal fees and documentary stamp tax), may require consent from a lender, and might trigger a costly reassessment for real property tax purposes.[[708]](#footnote-709)
        2. Creator-owned copyrights.
           1. As mentioned above, it is unclear if the author’s continued right of termination calls into question how the copyright can be irrevocably transferred (especially since there seems no mechanism to waive the termination right) and appropriately valued for transfer tax purposes.
           2. A gift of a copyright may have the unintended effect of prolonging ordinary income treatment after the death of the author/creator of the copyright.
           3. In contrast, upon the death of the author/creator who still owns the asset at death, the copyright is entitled to a “step-up” in basis to full fair market value under section 1014 and the asset is transformed into a long-term capital gain asset.
        3. If the foregoing can be the underlying property in a private derivative, can the contract be leveraged in a way that can double or triple the amount of the potential wealth transfer? For example, if the underlying property is worth $1 million, can a contractual right be structured so that grantor must pay to the IDGT 2 times or 3 times the return of the underlying property?
     5. Potential Issues or Problems
        1. Valuation of the “contractual right” vs. valuation of the underlying property?
        2. Economic risk of loss, particularly to the party (e.g., IDGT) that was expected to benefit from appreciation.
        3. If the contract is not settled prior to death, is the decedent’s obligation deductible for estate tax purposes under section 2053?
        4. Income tax issues upon settlement after death?
        5. Potential Chapter 14 implications, in particular section 2701 as an applicable retained interest and section 2703?
        6. Financial risks that grantor (or IDGT) will be unable to meet the obligations under the contract (or installment note if purchased by the IDGT).

* + 1. Given some of the foregoing issues, it is highly recommended that the obligor grantor settle the contract prior to death. For example, if the contract is not settled prior to death, it is likely the payments to the IDGT will be taxable as ordinary income.
    2. Chapter 14 Issues
       1. Section 2701
          1. The IRS might argue that the contract/derivative rights held by the IDGT (or the note held by the grantor if the transaction involves an installment sale) are an applicable retained interest.
          2. It is unlikely that the interests in the contract will be fall under the definition of an applicable retained interest, which requires a distribution right or a liquidation, put, call, or conversation right.[[709]](#footnote-710)
          3. A number of private letter rulings have held that an option to acquire an equity interest is not an equity interest to which section 2701 would apply.[[710]](#footnote-711)
       2. Section 2703
          1. Section 2703 provides that for transfer tax purposes, the value of any property is determined without regard to any right or restriction relating to the property.[[711]](#footnote-712) A right or restriction means any option, agreement, or other right to acquire or use the property at a price less than the fair market value (determined without regard to the option, agreement, or right) or any restriction on the right to sell or use such property.[[712]](#footnote-713)
          2. A right or restriction will not be disregarded if it satisfies three conditions:

The right or restriction is a bona fide business arrangement;

The right or restriction is not a device to transfer property to members of the decedent’s family for less than full and adequate consideration; and

The terms of the right or restriction are comparable to similar arrangements entered into by persons in an arm’s length transaction.[[713]](#footnote-714)

* + - * 1. Could the IRS argue that the property in the decedent’s estate is being reduced in value by virtue of the existence of the contract?

It is unlikely that this argument would prevail particularly because no property would be specifically required to settle the contract. There is a claim that will be satisfied with property (that would have received a “step-up” in basis), which is simply the fulfillment of the grantor’s obligations under the contract. What if the contract provides that the claim may only be satisfied in cash? How can cash be “reduced” in value?

In Revenue Ruling 80-162,[[714]](#footnote-715) the IRS held that a gift is made upon the grant of an option (if not received for full and adequate consideration), and not when the option is exercised. Under these circumstances, a gift might have been made upon the signing of the contract/derivative but for which full and adequate consideration was received.

1. WHAT ESTATE PLANNERS NEED TO KNOW ABOUT SUBCHAPTER J
   1. Introduction
      1. A complete discussion about the income taxation of trusts and estates under subchapter J is beyond the scope of these materials. The goal here is to arm estate planners with some practical information on how these rules apply. To that end, we present our list of the top income tax issues that every estate planner should know. We don't present them in the order that they appear in the Code, or even in order of importance. There are certainly other income tax issues that merit consideration. We hope that mastery of these ten will give an estate planner a good background to address many fundamental income tax issues that arise in the estate planning and administration context.
      2. Our list starts with (1) understanding the distinction between simple trusts, complex trusts, and estates. We next turn to several important income tax issues that arise when estate or trust assets are distributed. These areas are: (2) the carry-out of "distributable net income" or "DNI"; (3) the charitable deduction; (4) the availability of an interest deduction; and (5) the treatment of trust and estate net losses. Estates, trusts and their beneficiaries can at times recognize gains (and sometimes losses) as a result of funding certain gifts. The paper thus points out (6) the possible recognition of gains by an estate or trust when appreciated assets are distributed; and (7) the impact upon beneficiaries of making unauthorized non-pro rata distributions of assets in kind. Next, we review the sometimes arcane rules that arise with regard to (8) assets which the Code characterizes as "income in respect of a decedent." We then discusses (9) the deductibility of certain administration expenses for income or estate tax purposes, and the need for the executor to make an election in that regard.
   2. Trusts Can Be Simple or Complex (and Estates are Taxed Like Complex Trusts)
      1. Simple Trusts
         1. The Code and Treasury Regulations outline the tax treatment for "simple trusts" and their beneficiaries in sections 651 and 652. In order to qualify as a simple trust: (a) the trust's governing instrument must provide that all of its income (measured under state law – not all of its taxable income; see below for a discussion of the differences) is required to be distributed currently; (b) the trust instrument must not provide that any amounts are to be paid, permanently set aside, or used for charitable purposes; and (c) the trustee must not make any distribution other than current income during the year in question.[[715]](#footnote-716) Note that this last requirement is applied on a year-by-year basis, which means that a trust may be a simple trust in one year and a complex trust in another. If a trust requires that all of its income for the taxable year must be distributed to one or more non-charitable beneficiaries, the trust is a simple trust for that year, so long as no other distributions are made in that taxable year (even if they are permitted or required to be made in that year by the terms of the governing instrument).
         2. The significance of being characterized as a simple trust is that these trusts are allowed a deduction in computing their taxable income for the amount of the income required to be distributed currently (limited to the trust's taxable distributable net income, discussed below), whether or not the income is actually distributed.[[716]](#footnote-717) The amount allowed as a deduction to the trust is included in the income of the beneficiary (or beneficiaries), whether distributed or not.[[717]](#footnote-718) The character of the amounts included in income are the same as the character in the hands of the trust.[[718]](#footnote-719)
      2. Estates and Complex Trusts
         1. Any trust that is not a simple trust, is a "complex trust" (including an otherwise simple trust that distributes amounts in excess of its current fiduciary accounting income in any particular year). For trusts that are complex trusts (and for estates), a deduction is allowed from income for the taxable year for amounts required to be *or otherwise properly distributed to the beneficiaries*.[[719]](#footnote-720) Thus, for complex trusts and estates, a deduction is permitted both as to amounts required to be distributed (referred to as "Tier I" distributions) *and* for amounts that an executor or trustee is permitted (but not required) to distribute but actually distributes (called "Tier II" distributions).
         2. As with simple trusts, the deduction may not exceed the total taxable distributable net income of the estate or trust for that year.[[720]](#footnote-721) The character of the distributed income reported by the beneficiaries is the same as its character in the hands of the trust.[[721]](#footnote-722) The amount allowed as a deduction to the trust is included in the beneficiaries' income.[[722]](#footnote-723) Estates and complex trusts may elect to treat distributions made during the first 65 days of their tax year as though they were made on the last day of the preceding tax year. This election enables executors and trustees to take a look at their taxable income after their books have been closed for the year, to decide whether to shift income out to beneficiaries.[[723]](#footnote-724) Since simple trusts get a deduction regardless of whether the income has actually been paid out, the 65-day rule isn't necessary for them.
      3. Other Differences
         1. The characterization of trusts, or the status of a taxpayer as an estate, presents other differences as well. For example, in lieu of the personal exemption allowed to individual taxpayers under section 151 of the Code,[[724]](#footnote-725) trusts and estates receive a nominal deduction.[[725]](#footnote-726)
         2. For estates, the annual deduction is $600.[[726]](#footnote-727) The allowance for a trust that must distribute all of its income annually (regardless of whether it meets the other requirements to be treated as a simple trust) is $300. For all other trusts, the deduction is $100.[[727]](#footnote-728)
   3. Estate and Trust Distributions Carry Out Distributable Net Income
      1. Distributable Net Income
         1. Broadly speaking, income earned by a trust or estate in any year is taxed to the trust or estate to the extent that the income is retained, but is taxed to the beneficiaries to the extent that it is distributed to them. Executors and trustees must work with state law definitions of "income" that are different from the tax law concept of "taxable income." For example, capital gains are typically principal for state law purposes, even though they are taxable as income for federal income tax purposes. On the other hand, tax-exempt interest constitutes income under state law, even though it is not taxable income. The Code makes an effort to reconcile these differing definitions by using the concept of distributable net income ("DNI").
         2. The Code sets forth a detailed method to determine which trust or estate distributions carry income out to the beneficiaries. Thus, the structure of the payments or distribution from a trust or estate may subject the beneficiary to income tax. For example, the payment of an amount from the residuary of an estate will typically carry out income that has been earned by the estate in the year of payment (i.e., distributable net income) while, as discussed below, the payment of a specific sum will not.[[728]](#footnote-729) DNI is a basic concept of income taxation of trusts, estates and their beneficiaries. It is used as a "measuring rod" for allocating income among the trust or estate and the beneficiaries, and is a concept uniquely applicable to the taxation of trusts and estates. It is the fundamental tool used to implement the conduit principle, that is, a trust or estate is often nothing more than a conduit for property to pass to its beneficiaries. In computing DNI, the personal representative begins with the trust or estate's taxable income, which then must be modified in several respects in order to serve as an effective measure of the maximum allowable deduction to the estate or trust for distributions to beneficiaries (and which beneficiaries must then include in their gross income).
         3. DNI is basically the amount of trust or estate income available for distribution in a particular tax reporting year. It can be classified as a trust's taxable income (before application of the distribution deduction), excluding net capital gains allocated to principal, but including net tax-exempt income, minus allowable deductions and losses.[[729]](#footnote-730) DNI serves three functions. First, trust or estate DNI establishes the maximum amount that a trust or estate can deduct under Code sections 651 and 661 of the Code as a distribution to its beneficiaries. Second, DNI determines the maximum amount that the trust or estate beneficiaries can be taxed upon under Code sections 652 and 662 of the Code. Third, DNI determines the character of a distribution by a trust or estate. Specifically, it is used to characterize and divide distributions into different "classes" of income (such as qualified dividends, rent, passive income, tax-exempt income, etc.). The character of a distribution as taxable or tax-exempt may also affect the maximum deduction allowed to the trust or estate, and the maximum portion of the distribution included in gross income by the beneficiary, because trusts and estates may not deduct (and beneficiaries do not pay tax on) net tax-exempt income when distributed.
         4. In summary, DNI in most cases is the taxable income of an estate or trust (before its distribution deduction), less its net capital gains , plus its net exempt income. The general rule is that any distribution from an estate or trust will carry with it a portion of the estate or trust's DNI. Estate and trust distributions are generally treated as coming first from current income, with tax free distributions of "corpus" arising only if distributions exceed DNI. If distributions are made to multiple beneficiaries, DNI is generally allocated to them pro rata.

Example: Assume that A and B are beneficiaries of an estate worth $1,000,000. During the year, the executor distributes $200,000 to A and $50,000 to B. During the same year, the estate earns income of $100,000. Unless the separate share rule discussed below applies, the distributions are treated as coming first from estate income, and are treated as passing to the beneficiaries pro rata. Therefore, A will report income of $80,000 ($100,000 x ($200,000/$250,000)); B will report income of $20,000 ($100,000 x ($50,000/$250,000)). The estate will be entitled to a distribution deduction of $100,000. If the estate had instead distributed only $50,000 to A and $25,000 to B, each would have included the full amount received in income, the estate would have received a $75,000 distribution deduction, and would have reported the remaining $25,000 as income on the estate's income tax return.

* + - 1. While most trusts must adopt a calendar year end, as discussed above, an estate may elect to use a fiscal year end based upon the decedent's date of death. The estate's fiscal year must end on the last day of a month, and its first year must not be longer than 12 months.[[730]](#footnote-731) If the tax year of the estate and the beneficiary differ, the beneficiary reports taxable DNI not when actually received, but as though it had been distributed on the last day of the estate's tax year.[[731]](#footnote-732) As noted earlier, section 663(b) of the Code permits complex trusts to treat distributions made during the first 65 days of the trust's tax year as though they were made on the last day of the preceding tax year. This election enables trustees to take a second look at DNI after the trust's books have been closed for the year, to shift income out to beneficiaries. The Taxpayer Relief Act of 1997 extended the application of the 65-day rule to estates for tax years beginning after August 5, 1997. As a result, for example, the executor of an estate can make distributions during the first 65 days of Year 2, and elect to treat them as though they were made on the last day of the estate's fiscal Year 1. If the executor makes this election, the distributions carry out the estate's Year 1 DNI, and the beneficiaries include the distributions in income as though they were received on the last day of the estate's Year 1 fiscal year.
    1. Important Exceptions
       1. Specific Sums of Money
          1. Section 663(a)(1) of the Code contains a special provision relating to gifts or bequests of "a specific sum of money" or "specific property." If an executor or trustee pays these gifts or bequests all at once, or in not more than three installments, the distributions will effectively be treated as coming from the "corpus" of the estate or trust. As a result, the estate or trust will not receive a distribution deduction for these distributions. By the same token, the estate or trust's beneficiaries will not be taxed on the estate's DNI as a result of the distribution.
          2. In order to qualify as a gift or bequest of "a specific sum of money" under the Treasury Regulations, the amount of the bequest of money or the identity of the specific property must be ascertainable under the terms of the governing instrument as of the date of the decedent's death. In the case of the decedent's estate, the governing instrument is typically the decedent's Will or revocable trust agreement.
          3. Under the Treasury Regulations, a marital deduction or credit shelter formula bequest does not usually qualify as a gift of "a specific sum of money." The identity of the property and the exact sum of money specified are both dependent upon the exercise of the executor's discretion. For example, as discussed below, an executor may elect to deduct many estate administration expenses on the estate's income tax return, or on its federal estate tax return. If the executor elects the former, the amount of the formula marital gift will be higher than if those expenses are deducted on the estate tax return. Since the issues relating to the final computation of the marital deduction (or credit shelter bequest) cannot be resolved on the date of the decedent's death, the IRS takes the position that these types of bequests will not be considered "a specific sum of money."[[732]](#footnote-733) Thus, funding of formula bequests whose amounts cannot be ascertained at the date of death does carry out distributable net income from the estate.
          4. In addition, amounts that an executor can pay, under the express terms of the Will, only from current or accumulated income of the estate will carry out the estate's DNI.[[733]](#footnote-734)
          5. The transfer of real estate does not carry out DNI when conveyed to the devisee if, under local law, title vests immediately in the distributee, even if subject to administration.[[734]](#footnote-735) State law may provide for immediate vesting either by statute or by common law.[[735]](#footnote-736) Therefore, a transfer by an executor of real property to the person or entity entitled thereto should not carry with it any of the estate's distributable net income. Presumably, this rule applies both to specific devisees of real estate and to devisees of the residue of the estate, otherwise, the no-carry-out rule would be subsumed within the more general rule that specific bequests do not carry out DNI.[[736]](#footnote-737) Note, however, that the IRS national office position[[737]](#footnote-738) appears to limit this rule to specifically devised real estate (not real estate passing as part of the residuary estate) if the executor has substantial power and control over the real property (including a power of sale).
       2. The Tier Rules
          1. As noted above, estates and complex trusts are entitled to deduct both amounts required to be distributed (referred to as "Tier I" distributions) and amounts that an executor or trustee is permitted (but not required) to distribute (called "Tier II" distributions). The significance of this distinction is that if an estate or trust makes both Tier I and Tier II distributions in a year, the pro rata rules that normally characterize distributions to beneficiaries do not apply. Instead, distributions are treated as carrying out DNI first only to Tier I (mandatory) distributees (carried out to them pro rata if more than one).[[738]](#footnote-739) If there is any DNI remaining after accounting for all Tier I distributions, then that DNI is carried out to Tier II distributees (again, pro rata if more than one).[[739]](#footnote-740)
          2. In addition, in determining the amount of DNI available to be carried out to Tier I distributees, any deduction for amounts paid to charitable organizations (discussed below), is ignored.[[740]](#footnote-741) In other words, DNI (computed without regard to the trust or estate's charitable deduction) is carried out to Tier I distributees. Then, the estate or trust is allowed its charitable deduction. Finally, any remaining DNI is carried out to Tier II distributees. As discussed below, no DNI gets carried out to charitable beneficiaries. Nevertheless, the effect of these ordering rules is to treat charities somewhat like an "intermediate" tier when allocating a trust or estate's income among its distributees.
       3. The Separate Share Rule
          1. When the tier rules don't apply (or within each tier when they do apply), estate or trust distributions made to multiple beneficiaries generally carry DNI out to them pro rata.

Example: In a year in which an estate has $10,000 of DNI, the executor distributes $15,000 to A and $5,000 to B. Unless the tier or separate share rules apply, A will include $7,500 of DNI in his income, and B will include $2,500 in his income, since the distributions were made 75% to A and 25% to B. If the $10,000 of DNI was comprised of $5,000 of interest, $2,000 of dividends, and $3,000 of rental income, A will include 75% of each category of income, and B will include 25% of each category. Note also that if A was a Tier I beneficiary, the result would be different and A would include $10,000 of DNI in his income.

* + - * 1. However, when the governing instrument of the trust or estate (e.g., the trust agreement, the Will, or applicable local law) creates separate economic interests in one beneficiary or class of beneficiaries such that the economic interests of those beneficiaries (e.g., rights to income or gains from specific items of property) are not affected by economic interests accruing to another separate beneficiary or class of beneficiaries, then solely for purposes of allocating DNI, the "separate share rule" applies. Under this rule, DNI is allocated among estate beneficiaries based upon distributions of their respective "share" of the estate's or trust's DNI.[[741]](#footnote-742) As a result, executors and trustees have to determine whether the trust agreement, Will or state intestate succession laws create separate economic interests in one beneficiary or class of beneficiaries.

Example: A Will bequeaths all of the decedent's Apple stock to X and the balance of the estate to Y. During the year, the Apple stock pays $20,000 of post-death dividends to which X is entitled under local law. No other income is earned. The executor distributes $20,000 to X and $20,000 to Y. Prior to the adoption of the separate share rule, the total distributions to X and Y would have simply been aggregated and the total DNI of the estate in the year of distribution would have been carried out pro rata (i.e., $10,000 to X and $10,000 to Y). But X has an economic interest in all of the dividends and Y is not entitled to them. Therefore, the distribution to Y must be from corpus. Under the separate share rule, the distribution of $20,000 to X carries out all of the DNI to X. No DNI is carried out to Y. Thus, application of the separate share rule more accurately reflects the economic interests of the beneficiaries resulting from estate distributions.

* + - * 1. Distributions to beneficiaries who don't have "separate shares" continue to be subject to the pro-rata rules. Application of the separate share rule is mandatory. The executor or trustee cannot elect separate share treatment, nor may the executor or trustee elect out of it. The separate share rule has long applied to trusts, but was not applied to estates until 1997. The IRS has issued final regulations applying the separate share rule to estates.[[742]](#footnote-743) In practice, application of the separate share rule to estates is often quite complex. Unlike separate share trusts, which are typically divided on simple fractional lines (e.g., "one-third for each of my children") the "shares" of estates may be hard to identify, let alone account for. Under the final regulations, a revocable trust that elects to be treated as part of the decedent's estate is a separate share. The residuary estate (and each portion of a residuary estate) is a separate share.[[743]](#footnote-744) A share may be considered as separate even though more than one beneficiary has an interest in it. For example, two beneficiaries may have equal, disproportionate, or indeterminate interests in one share which is economically separate and independent from another share in which one or more beneficiaries have an interest. Moreover, the same person may be a beneficiary of more than one separate share.[[744]](#footnote-745) A bequest of a specific sum of money paid in more than three installments (or otherwise not qualifying as a specific bequest under section 663(a)(1) of the Code) is a separate share. If the residuary estate is a separate share, than presumably pre-residuary pecuniary bequests (such as marital deduction formula bequests) are also separate shares.[[745]](#footnote-746) A revocable trust that elects to be treated as part of the decedent's estate is always a separate share, and may itself contain two or more separate shares.[[746]](#footnote-747)
      1. Income from Property Specifically Bequeathed
         1. Under the statutes or common law of most states, a beneficiary of an asset under a Will is entitled not only to the asset bequeathed, but also to the net income earned by that asset during the period of the administration of the estate.[[747]](#footnote-748) Until the adoption of the separate share rule, DNI was reported on a pro rata basis among all beneficiaries receiving distributions. The items of income were not specifically identified and traced. As a result, the beneficiary may well have been taxed not on the income item actually received, but on his or her pro rata share of all income distributed to the beneficiaries. However, since the income earned on property specifically bequeathed appears to be a "separate economic interest," the separate share rule should change this result. This change means that if an estate makes a current distribution of income from specifically bequeathed property to the devisee of the property, the distribution will carry the DNI associated with it out to that beneficiary, regardless of the amount of the estate's other DNI or distributions.
         2. If the estate accumulates the income past the end of its fiscal year, the estate itself will pay tax on the income. When the income is ultimately distributed in some later year, the beneficiary will be entitled to only the net (after tax) income. In addition, the later distribution should not carry out DNI under the separate share rule, since it is not a distribution of current income, and since the accumulation distribution throwback rules (which still apply to certain pre-1985 trusts) do not apply to estates. The separate share rule, while complex to administer, has the advantage of making the income tax treatment of estate distributions more closely follow economic reality.
      2. Interest on Pecuniary Bequests
         1. State law or the governing instrument may provide that a devisee of a pecuniary bequest (that is, a gift of a fixed dollar amount) is entitled to interest on the bequest, typically beginning one year after the date of death. The provision for paying interest on pecuniary bequests does not limit itself to payments from estate income. Under the Uniform Principal and Income Act ("UPIA"), the executor must charge this "interest" expense to income in determining the estate's "net" income to be allocated to other beneficiaries.[[748]](#footnote-749)
         2. Interest payments are not treated as distributions from the estate for DNI purposes. Instead, they are treated as an interest expense to the estate. As a result, they do not carry out estate income.[[749]](#footnote-750) Income tax issues associated with the payment of this interest payment by the estate are discussed below.
  1. Trusts and Estates Get Unlimited Income Tax Deductions for Charitable Distributions
     1. Distributions made to charities are not treated as distributions to "beneficiaries" for purposes of the DNI carry-out rules.[[750]](#footnote-751) Instead, amounts of gross income paid to (or in the case of estates, permanently set aside for) charities are eligible for an income tax charitable deduction.[[751]](#footnote-752) If the distribution generated both a charitable deduction and a deduction for carrying out DNI, the trust or estate would obtain a double benefit for such distributions. Unlike individuals, trusts and estates are not limited in their charitable deductions to a percentage of their adjusted gross income. Trusts and estates can take a deduction for all income so paid. On the other hand, unlike individuals, trusts and estates may not carry forward any unused deductions into a succeeding taxable year.
     2. A special rule affects the timing of charitable deductions. Specifically, if a charitable contribution is paid after the close of a taxable year and on or before the last day of the following year, then the trustee or executor may elect to treat the contribution as paid during the prior taxable year.[[752]](#footnote-753) Again, this one-year look-back has no counterpart for individuals. The character of income distributed to charity is generally a pro rata portion of each component of the trust or estate's income for the year. To the extent that the trust or estate has tax exempt income during the year, the proportion of that income deemed distributed to charity does not qualify for an income tax deduction.[[753]](#footnote-754) The regulations further provide that if a distribution to charity does not qualify for a charitable deduction by reason of section 642(c) of the Code, it is not carried out as part of DNI and therefore is not eligible to be treated as a distribution deduction under section 661 of the Code.[[754]](#footnote-755)
  2. Interest Paid on Pecuniary Bequests May Be Deductible
     1. As noted above, state law or the governing instrument may provide that at some point in time, the devisee of a pecuniary bequest is entitled to interest on the bequest. Many jurisdictions provide that interest begins to accrue one year after the date of death. The UPIA provides that this interest is charged against income to the extent that it is sufficient, and thereafter against principal.[[755]](#footnote-756) For income tax purposes, however, payment of this interest is treated not as a distribution of income, but as an interest expense to the estate and interest income to the beneficiary.[[756]](#footnote-757) Under section 163(h) of the Code, interest is non-deductible "personal interest" unless it comes within an exception, none of which expressly relates to interest on a pecuniary bequest.
     2. Some practitioners have sought to characterize this interest as deductible "investment interest." Section 163(d)(3) of the Code defines "investment interest" as interest paid or accrued on indebtedness properly allocable to property held for investment, and capital gains attributable to that property. Property held for investment is described by reference to section 469(e)(1) of the Code, and includes property that produces interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business. IRS Notice 89-35,[[757]](#footnote-758) provides temporary guidance on allocating interest expense on a debt incurred with respect to certain pass-through entities. Under the Notice, the debt and associated interest expense must be allocated among the assets of the entity using a reasonable method. Reasonable methods of allocating debt among assets ordinarily include pro rata allocation based upon fair market value, book value, or adjusted basis of the assets. Although this Notice does not apply by its terms to indebtedness incurred by an estate in funding a bequest, perhaps these principles can be applied by analogy to estates.
     3. This analysis would probably require the executor to examine the activities of the estate. One could argue that a "debt" to the beneficiary was incurred because the estate failed to distribute its assets to fund the pecuniary bequest promptly. The estate was thus able to retain assets, including assets that generate portfolio income, as a result of its delay in funding the bequest. In effect, the estate could be said to have "borrowed" these assets from the beneficiary during the period that the distribution was delayed, and it is as a result of this borrowing that the interest is owed under the provisions of the governing instrument or local law. This analysis would mean that to the extent that the assets ultimately distributed to the beneficiary (or sold to pay the beneficiary) were assets of a nature that produced interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business, the interest expense would be deductible to the estate as "investment interest."
     4. Oddly, an example contained in the Treasury Regulations relating to the separate share rule states (without explanation) that interest paid on a spouse's elective share that is entitled to no share of estate income, but only statutory interest, is income to the spouse under section 61 , but non-deductible to the estate under section 163(h) of the Code.[[758]](#footnote-759) The focus of this regulation is on the amount of DNI that will be carried out by the distribution; it properly rules that no DNI is carried out. Its characterization of the interest expense as nondeductible under section 163(h) is gratuitous, and can be questioned. It appears that the only case to consider this matter is *Schwan v. United States*.[[759]](#footnote-760) In *Schwan*, the court rejected the executors' argument that the interest was incurred to prevent the forced liquidation of stock held by the estate, noting that the stock had already been transferred to the estate's beneficiary when the interest obligation began to run. The estate, therefore, did not even own the stock when the interest was imposed, and had no interest in preventing its forced liquidation. On these facts, the investment interest question was not squarely before the court.
  3. Net Losses and Excess Deductions Are Wasted, Except in Their Final Year
     1. Generally
        1. Distributions from trusts and estates carry out DNI, but what if the trust or estate has a net loss for the year? Despite the conduit approach to trust and estate taxation, their deductions do not pass directly through to beneficiaries. By reducing DNI, deductions reduce the maximum amounts taxable to beneficiaries, but once DNI is reduced to zero, any excess deductions are generally useless to the beneficiaries. In general, these losses must simply go unused, unless some provision of the Code allows them to be carried forward for use by the trust or estate in a later year.[[760]](#footnote-761)
        2. Thus, a trust or an estate may carry forward a net capital loss under section 1212(b) of the Code, or carry forward a net operating loss incurred in a trade or business under section 172 of the Code, but except in the termination year of the trust or estate (as further discussed below), there is generally no way to pass these net losses out to beneficiaries, or to otherwise use losses for which no carryforward is provided.
     2. Losses and Carryforwards
        1. Section 642(h) of the Code mitigates the waste of excess deductions and unused carryovers for the taxable year in which a trust or estate terminates. This provision has the effect of transferring unused net operating and capital loss carryovers from the terminating trust or estate to its beneficiaries, along with any excess of deductions over gross income for that year.
        2. When a beneficiary inherits an unused carryover under section 642(h) of the Code, he or she may find it somewhat the worse for wear. An inherited carryover cannot be carried back to earlier taxable years of the beneficiary, and in determining a carryover's remaining statutory life, the last taxable year of the trust or estate counts as a full year regardless of how short it may be, as does the beneficiary's tax year that includes the end of the entity's last year.[[761]](#footnote-762)
     3. Excess Deductions
        1. In addition to carryovers, section 642(h)(2) of the Code allows beneficiaries to deduct any excess of the entity's deductions over gross income for its final taxable year. In computing this excess, the deductions allowed by section 642(b) (the deduction in lieu of personal exemption) and section 642(c) of the Code (the charitable deduction) are disregarded. Net operating loss and capital loss carryovers are also disregarded, since they pass independently to beneficiaries under section 642(h)(1) of the Code (except that a net operating loss carryover expiring in the terminating year of the trust or estate is taken into account, to the extent not used by the trust or estate, and hence passes through to beneficiaries under section 642(h)(2) rather than as a carryover under section 642(h)(1) of the Code).[[762]](#footnote-763) Unlike carryovers passing to beneficiaries, excess deductions can be used only in a beneficiary's taxable year that coincides with the year the trust or estate terminates. In addition, historically, the IRS has permitted beneficiaries to take these excess deductions only as itemized deductions, and have not permitted beneficiaries to use excess deductions in computing the beneficiary's adjusted gross income.[[763]](#footnote-764)
        2. Because TCJA eliminated miscellaneous itemized deductions (i.e., those deductions subject to a 2% AGI floor, for individuals for years 2018 through 2025) that regulation meant that beneficiaries would not be able to use most of these excess deductions.[[764]](#footnote-765) Fortunately, however, on May 11, 2020, the IRS and Treasury issued taxpayer friendly proposed regulations under sections 67 and 642 of the Code, and those regulations (largely unchanged) became final on October 19, 2020. Under the regulations, each deduction comprising a section 642(h)(2) of the Code excess deduction retains its separate character, specifically as (i) an amount allowed in arriving at adjusted gross income, (ii) a non-miscellaneous itemized deduction, or (iii) a miscellaneous itemized deduction. The character of these deductions does not change when succeeded to by a beneficiary on termination of the estate or trust.[[765]](#footnote-766) Furthermore, the regulations require that the fiduciary separately state (that is, separately identify) deductions that may be limited when claimed by the beneficiary.[[766]](#footnote-767) The rule that excess deductions may be used by a beneficiary only in the tax year that coincides with the year in which the trust or estate terminates remains unchanged. Therefore, the regulations issued under section 67 of the Code make it clear that important deductions for trusts and estates will not be disallowed as miscellaneous itemized deductions. These include estate or trust administration costs that would not have been incurred if the property were not held in the estate or trust. In addition, the new Treasury Regulations under section 642(h) of the Code change the Treasury's prior treatment of excess deductions so that they will not automatically be disallowed as miscellaneous itemized deductions. Rather, the deductions will essentially retain their separate character in the hands of the beneficiaries in much the same way that the DNI rules preserve the character of income passed out to beneficiaries.
     4. Apportionment Among Beneficiaries
        1. Under section 642(h) of the Code, carryovers and excess deductions pass only to "the beneficiaries succeeding to the property of the estate or trust," who are "those beneficiaries upon termination of the estate or trust who bear the burden of any loss for which a carryover is allowed, or of any excess of deductions over gross income."[[767]](#footnote-768) The succeeding beneficiaries of testate estates are normally the residuary beneficiaries, rather than persons to whom specific property and sums of money are bequeathed. The opposite might be true if an estate is exhausted by specific bequests and legacies, leaving no residue, but there is no authority on point.
        2. If two or more persons succeed to property of the estate or trust, the passed items are allocated among them, "proportionately according to the share of each in the burden of the loss or deductions."[[768]](#footnote-769) The new regulations described above apply the principles outlined in section 1.652(b)-3 of the Treasury Regulations to allocate each item of deduction among the classes of income in the year of termination for purposes of determining the character and amount of the excess deductions under Code Section 642(h)(2).[[769]](#footnote-770)
  4. Estate or Trust May Recognize Gains/Losses When It Makes Distributions In Kind
     1. General Rule
        1. Unless a specific exception applies, all estate or trust distributions, whether in cash or in kind, carry out the estate's or trust's DNI. Generally, the amount of DNI carried out by an in-kind distribution to a beneficiary is the *lesser* of the adjusted basis of the property prior to distribution, or the fair market value of the property at the time of the distribution.[[770]](#footnote-771)
        2. The estate or trust does not generally recognize gain or loss as a result of making a distribution to a beneficiary. This general rule is subject to some important exceptions.
     2. Distributions Satisfying the Estate's or Trust's Obligations
        1. Distributions that satisfy a pecuniary obligation of the estate or trust are recognition events for the estate or trust. The fair market value of the property is treated as being received by the estate or trust as a result of the distribution; therefore, the estate or trust will recognize any gain or loss if the estate's or trust's basis in the property is different from its fair market value at the time of distribution.[[771]](#footnote-772)
        2. Thus, for example, if the estate owes a debt of $10,000, and transfers an asset worth $10,000 with a basis of $8,000 in satisfaction of the debt, the estate will recognize a $2,000 gain.
     3. Distributions of Assets to Fund Pecuniary Gifts
        1. A concept related to the "discharge of obligation" notion is a distribution of assets to fund a bequest of "a specific dollar amount." Payment of a bequest described as a fixed dollar amount (e.g., "I give $100,000 to Phil, if he survives me.") may give rise to gain recognition if funded with property in kind, as opposed to cash. In addition, a formula pecuniary (dollar-amount) bequest is typically treated as a "specific dollar amount" for this purpose.

Example. A formula gift requires an executor to distribute $400,000 worth of property. If the executor properly funds this bequest with assets worth $400,000 at the time of distribution, but with an adjusted cost basis of only $380,000 at the date of death, the estate will recognize a $20,000 gain.

* + - 1. The rules that apply this concept to formula bequests should not be confused with the "specific sum of money" rules that govern DNI carry outs. As noted above, unless the formula language is drawn very narrowly, most formula gifts do not constitute gifts of a "*specific sum of money*," exempt from DNI carryout, because they usually cannot be fixed exactly at the date of death (for example, most formula marital bequests must await the executor's determination of whether administration expenses will be deducted on the estate tax return or the estate's income tax return before they can be computed). Such gifts are nevertheless treated as bequests of "*a specific dollar amount*" for gain recognition purposes, regardless of whether they can be precisely computed at the date of death. As a result, gains or losses could be recognized by the estate if the formula gift describes a pecuniary amount to be satisfied with date-of-distribution values, as opposed to a fractional share of the residue of the estate.[[772]](#footnote-773)
      2. For fiscal years beginning on or before August 1, 1997, estates could recognize losses in transactions with beneficiaries. Although the Taxpayer Relief Act of 1997 repealed this rule for most purposes, an estate may still recognize a loss if it distributes an asset that has a basis in excess of its fair market value in satisfaction of a pecuniary bequest. IRC § 267(b)(13). Note, however, that loss recognition is denied to trusts used as estate surrogates by application of the related party rules of section 267(b)(6) of the Code, except for qualified revocable trusts electing to be treated as estates under section 645 of the Code.[[773]](#footnote-774)
    1. Pension and IRA Accounts Used to Fund Pecuniary Bequests
       1. Potential Issue
          1. Some commentators have argued that if a pension asset or IRA is used to satisfy a pecuniary legacy, the use of that asset will be treated as a taxable sale or exchange, and this treatment will accelerate the income tax due. This analysis is based upon section 1.661(a)-2(f) of the Treasury Regulations, which requires an estate to recognize gain when funding a pecuniary bequest with an asset whose fair market value exceeds its basis, as though the asset is sold for its fair market value at the date of funding.[[774]](#footnote-775)
          2. If an estate uses an asset constituting income in respect of a decedent to satisfy a pecuniary bequest, application of this principle would cause the gain to be accelerated. In our opinion, however, it can be persuasively argued that this acceleration will not occur if the beneficiary is not the estate, but the trustee named in the participant's will. Three lines of analysis support this conclusion.
       2. No Receipt by Estate
          1. The recognition rules under section 1.661(a)-2(f) of the Treasury Regulations apply only in the context of a distribution by the estate in satisfaction of a right to receive a specific dollar amount. When a "testamentary trustee" is named as the beneficiary of a pension plan or IRA, there is clearly no distribution by the estate, and no acceleration event should occur to the estate. The estate, after all, is subjected to taxation only on income received by the estate during the period of administration or settlement of the estate.[[775]](#footnote-776)
          2. Pension benefits payable directly to the trustee of the trust established under the Will of the plan participant are never "received by the estate." This fact remains true even if the Will contains instructions directing the testamentary trustee to use these funds in whole or in part to compute the amount of a pecuniary bequest. The fact that the executor takes these non-testamentary transfers into account in measuring the amount of other assets needed to fund the pecuniary bequest should not change this result. Since the non-probate pension assets are not subject to administration, the estate cannot properly be said to be the taxpayer with respect to any transaction involving these benefits.
       3. No IRD Transfer by Estate
          1. Separate and apart from the gain recognition rules of Treasury Regulation Section 1.661(a)-2(f) is the recognition rule of Section 691 of the Code that governs so-called "income in respect of a decedent" or "IRD" (discussed below). However, the recognition rules of section 691(a)(2) of the Code, by their terms, apply only if the right to receive income in respect of a decedent is transferred "by the estate of the decedent or a person who receives such right by reason of the death of the decedent . . ." (emphasis added). If the testamentary trustee is the beneficiary, there is simply no transfer by the estate. Moreover, there is no transfer by any "person" who receives such right by reason of the decedent's death.
          2. The Code expressly excludes from the definition of "transfer" requiring IRD acceleration any "transmission at death . . . to a person pursuant to the right of such person to receive such amount by reason of the death of the decedent."[[776]](#footnote-777) In that event, the recipient (here, the trust) includes these amounts in gross income not when the right to the payment is received, but only when the payments themselves (i.e., the distributions from the retirement plan) are actually received.[[777]](#footnote-778)
       4. Constructive Receipt Rules
          1. The general rules which describe the timing of recognition for income attributable to an IRD asset are reinforced by the statutes expressly governing pension distributions. Amounts held in qualified plans and IRAs are taxable to the recipient only when actually distributed.[[778]](#footnote-779)
          2. The mere fact that benefits under the plan or IRA are made available, or that the participant or beneficiary has access to them, is not determinative, since the constructive receipt rules do not apply to these assets.[[779]](#footnote-780)
       5. Proper Tax Treatment
          1. Therefore, if the testamentary trustee receives, whether by a spouse's disclaimer or by direct designation by the participant, the right to receive plan distributions, no income tax should be payable until such time as distributions are actually made from the plan or IRA to the trust, even if the assignment of the right to receive plan assets otherwise reduces (or eliminates) the amount that the estate needs to distribute in satisfaction of a pecuniary bequest.
          2. Instead, the testamentary trust should be able to defer taxation on pension and IRA proceeds until such time as those accounts are distributed (which may be until they are required to be distributed in accordance with the minimum required distribution rules).[[780]](#footnote-781)
    2. Section 643(e)(3) Election
       1. The executor may elect under section 643(e)(3) of the Code to recognize gain and loss on the distribution of appreciated and depreciated property. If this election is made, the amount of the distribution for income tax purposes will be the fair market value of the property at the time of the distribution. The election must be made on an "all or nothing" basis, so that the executor may not select certain assets and elect to recognize gain or loss on only those assets. Of course, if the executor wants to obtain the effect of having selected certain assets, he or she may actually "sell" the selected assets to the beneficiary for the fair market value of those assets, recognizing gain in the estate. The executor can thereafter distribute the sales proceeds received to the beneficiary who purchased the assets.
       2. Note that if an executor makes a gain-recognition election under section 643(e)(3) of the Code in a year that an IRD asset is distributed by the estate, gain would be accelerated, even if the distribution is otherwise subject to an exception under section 691(a)(2) of the Code, because the asset representing the IRD will be treated as having been sold by the estate in that year. For fiscal years beginning after August 1, 1997, the section 643(e)(3) election (or an actual sale to a beneficiary) can cause the estate to recognize gains, but not losses, since under the principles of section 267 of the Code, the estate and its beneficiary are now treated as related taxpayers.[[781]](#footnote-782)
  1. Beneficiaries May Recognize Income on Unauthorized Non Pro rata Distributions
     1. If an estate makes unauthorized non-pro rata distributions of property to its beneficiaries (meaning unauthorized under the terms of the governing instrument or local law), the IRS has ruled that the distributions are equivalent to a pro rata distribution of undivided interests in the property, followed by an exchange of interests by the beneficiaries to the extent the beneficiaries could compel a readjustment of distributions under applicable state law.
     2. This deemed exchange will presumably be taxable to both beneficiaries to the extent that values differ from basis.[[782]](#footnote-783)

Example 10: A decedent's estate passes equally to A and B, and contains two assets, stock and a farm. At the date of death, the stock was worth $100,000 and the farm was worth $110,000. At the date of distribution, each are worth $120,000. If the executor gives the stock to A and the farm to B *and if local law or the Will or revocable trust fails to authorize non-pro rata distributions*, the IRS takes the view that A and B each received one-half of each asset from the estate. A then "sold" her interest in the farm (with a basis of $55,000) for stock worth $60,000, resulting in a $5,000 gain to A. Likewise, B "sold" his interest in the stock (with a basis of $50,000) for a one-half interest in the farm worth $60,000, resulting in a $10,000 gain to B.[[783]](#footnote-784) To avoid this result, local law or the governing instrument should expressly authorize non-pro rata distributions.[[784]](#footnote-785)

* 1. Income in Respect of a Decedent is Taxed to the Recipient
     1. Generally
        1. A major exception to the rule that an inheritance is income-tax free applies to beneficiaries who receive payments that constitute income in respect of a decedent ("IRD").[[785]](#footnote-786)
        2. Not only is the receipt of IRD taxable to the recipient as income, the IRD asset is includible in the decedent's estate for estate tax purposes.[[786]](#footnote-787)
     2. IRD Defined
        1. IRD is not defined by statute, and the definition in the Treasury Regulations is not particularly helpful. Generally, IRD is comprised of items that would have been taxable income to the decedent if he or she had lived, but because of the decedent's death and income tax reporting method, are not reportable as income on the decedent's final income tax return.[[787]](#footnote-788)
        2. IRD may be included in the gross income of the decedent's estate or by one or more of the estate beneficiaries at the time the estate or beneficiary, respectively, collects the item of income. Because a beneficiary may include IRD in his or her income for income tax purposes, which means the beneficiary may pay income tax on that receipt, IRD is an exception to the rule of section 102(a) of the Code that inheritances are income-tax free.
        3. Examples of IRD include (1) accrued interest, (2) dividends declared but not payable, (3) unrecognized gain on installment obligations, (4) bonuses and other compensation or commissions paid or payable following the decedent's death, (5) interests in partnerships that hold unrealized receivables or inventory items, and notably, (6) amounts in IRAs and qualified benefit plans upon which the decedent has not been taxed (which would not include Roth IRAs and nonqualified retirement plan contributions, but pursuant to Revenue Ruling 75-125,[[788]](#footnote-789) would include net unrealized appreciation in employer securities distributed from a qualified retirement plan and for which no election was made to include the appreciation in income). Therefore, assets such as Roth IRAs and a decedent's after-tax investment in retirement plans are not IRD.
        4. A helpful test for determining whether an estate must treat an asset as IRD is set forth in *Estate of Peterson v. Commissioner*:[[789]](#footnote-790) (i) the decedent must have entered into a "legally significant transaction" – not just an expectancy; (ii) the decedent must have performed the substantive tasks required of him or her as a precondition to the transaction; (iii) there must not exist any economically material contingencies which might disrupt the transaction; and (iv) the decedent would have received the income resulting from the transaction if he or she had lived.
        5. The basis in an IRD asset is equal to its basis in the hands of the decedent; no basis adjustment occurs at death.[[790]](#footnote-791) This rule is necessary to prevent recipients of IRD from avoiding federal income tax with respect to items in which the income receivable by a decedent was being measured against his or her basis in the asset (such as gain being reported on the installment basis).
     3. Recognizing IRD
        1. If the executor distributes an IRD asset in a manner that will cause the estate to recognize gain on the distribution, or if a section 643(e)(3) election is made and the asset is distributed in the year of the election, the result will be to tax the income inherent in the item to the decedent's estate. Absent one of these recognition events, if the estate of the decedent transmits an IRD asset to another person who would be entitled to report that income when received, the transferee, and not the estate, will recognize the income. Thus, if a right to receive IRD is transferred by an estate to a specific or residuary legatee, only the legatee must include the amounts in income when received.[[791]](#footnote-792)
        2. If IRD is to be recognized by the estate, the tax costs may be substantial. In a setting where a substantial IRD asset is distributed from the estate in a manner causing recognition, a material decrease in the amount passing to other heirs might result.[[792]](#footnote-793)

Example: In 2021, X dies with a $14.7 million estate. The Will makes a formula marital gift of $3,000,000 to the spouse, leaving the rest of the estate (equal to the decedent's $11.7 million federal estate tax exclusion) to a bypass trust. If an IRD asset worth $3,000,000 but with a basis of $0 is used to fund the marital gift, the estate will report $3,000,000 of income. The spouse will receive the $3,000,000 worth of property, but the estate will owe income tax of some $1,108,000, presumably paid from the residue of the estate passing to the bypass trust. Payment of this tax would leave only $10,592,000 to fund the bypass trust.

Under these circumstances, the testator could consider making a specific bequest of the IRD asset to insure that the income will be taxed to the ultimate beneficiary as received, and will not be accelerated to the estate.

* + 1. Deductions in Respect of a Decedent
       1. A concept analogous to IRD is applied to certain deductible expenses accrued at the date of the decedent's death but paid after death. These "deductions in respect of a decedent" ("DRD") are allowable under section 2053(a)(3) of the Code for estate tax purposes as claims against the estate, and are also allowed as deductions in respect of a decedent for income tax purposes to the person or entity paying those expenses.[[793]](#footnote-794)
       2. The general rule disallowing both income and estate tax deductions for administration expenses, discussed below, does not apply to DRD. The theory behind allowing this "double" deduction is that had the decedent actually paid the accrued expense prior to death, he could have claimed an income tax deduction, and the cash on hand in his estate would be reduced, thereby effecting an estate tax savings as well. Of course, interest, administration expenses, and other items not accrued at the date of the decedent's death are subject to the normal election rules of section 642(g) of the Code discussed below.
  1. Executor Can Deduct Many Expenses for Either Income or Estate Tax Purposes
     1. Generally
        1. An executor is often confronted with a choice of deducting estate administration expenses on the estate tax return, or the estate's income tax return. In most instances, double deductions are disallowed.[[794]](#footnote-795)
        2. Between 1986 and 1992, the decision about where to deduct an expense was simplified by the fact that the lowest effective federal estate tax bracket (37%) was always higher than the highest marginal income tax bracket applied to estates (typically 31%). If estate tax was due, a greater tax benefit was always obtained by deducting expenses on the estate tax return.
        3. Between 1993 and 2001, the analysis was more difficult since income tax rates might or might not exceed effective estate tax rates in those years.
        4. For decedents dying between 2002 and 2009, the decision about where to deduct an expense was simplified by the fact that the lowest effective federal estate tax bracket (45%) was always higher than the highest marginal income tax bracket applied to estates (35%).
        5. Beginning in 2013, with a top income tax rate of 39.6% and a possible net investment income tax of 3.8%, executors were once again faced with deciding whether the deduction on the estate's income tax return (with a top combined tax bracket of 43.4%) would be of greater benefit than deducting expenses on the estate tax return, where the top bracket is effectively 40%.
        6. For tax years beginning after 2017 and before 2026, the combined top income tax rate of 40.8% and the top estate tax rate of 40% are virtually the same. Nevertheless, not all beneficiaries are in the top income tax bracket and ultimately, one must "run the numbers" on both returns to determine which offers the most tax savings.
     2. Section 642(g) Expenses
        1. The executor must make an election to take administration expenses as a deduction for income tax purposes by virtue of section 212 of the Code, or to deduct those same expenses as an estate tax deduction under section 2053 of the Code. No double deduction is permitted.
        2. Expenses to which this election applies include executors' fees, attorneys' fees, accountants' fees, appraisal fees, court costs, and other administration expenses, provided that they are ordinary and necessary in collection, preservation, and management of the estate. There is no requirement that the estate be engaged in a trade or business or that the expenses be applicable to the production of income.[[795]](#footnote-796)
        3. Note, however, that expenses attributable to the production of tax-exempt income are denied as an income tax deduction to estates, just as they are to individuals, under section 265(a)(1) of the Code. Interest on estate taxes deferred under section 6166 of the Code, which now accrues at only 45% of the regular rate for interest on underpayments, is no longer allowed as an estate tax or an income tax deduction.[[796]](#footnote-797)
     3. Method of Election
        1. There appears to be some confusion among tax return preparers about how the election under section 642(g) of the Code is made. Technically, the Code and Treasury Regulations require the executor to file with the estate's income tax return a statement, in duplicate, to the effect that the items have not been allowed as deductions from the gross estate of the decedent under section 2053 or 2054 of the Code and that all rights to have such items allowed at any time as deductions under section 2053 or 2054 of the Code are waived.[[797]](#footnote-798)
        2. Some executors protectively claim expenses on both returns, filing the income tax return waiver statement only after the estate has received a closing letter (or other confirmation that the estate tax has been finally determined) and deductions on the estate tax return have proven unnecessary. The election is not treated as made and final until a "fee waiver" (a sworn declaration) making the election is filed with a fiduciary income tax return. Therefore, the election need not be made until filing a final, amended fiduciary return for the year in which the expenses are paid.
        3. The only declaration regarding the election in the estate tax proceeding occurs when an agreed deficiency assessment is obtained in the estate tax audit process with the request by an agent for the fiduciary to sign an IRS Form 890, "Waiver of Restrictions on Assessment and Collection of Deficiency and Acceptance of Overassessment–Estate, Gift, and Generation-Skipping Transfer Tax." Pursuant to Form 890, the fiduciary waives notice and formal process on a deficiency assessment. The form contains a declaration regarding the fee waiver that binds the representative to the decision on where to claim these expenses.
        4. One might argue, however, that protective elections on both the income and estate tax return might be dangerous if the estate receives a closing letter (or other confirmation that the estate tax has been finally determined) without examination of or adjustment to the return. Under these circumstances, even though no IRS Form 890 would have been filed, presumably, the income tax waiver statement could not lawfully be filed, since the deductions in question will have been "allowed" as deductions from the gross estate.
     4. Payments from Income
        1. Increased attention has been focused on the interaction of state law and tax rules in determining whether estate administration expenses are chargeable to principal or income, particularly in estates seeking an estate tax marital or charitable deduction. The importance of this issue is illustrated by *Commissioner v. Estate of Hubert*,[[798]](#footnote-799) where the executor charged administration expenses to estate income for both state law and tax law purposes. The IRS held that such an allocation constituted a "material limitation" on the rights to income otherwise afforded recipients of marital and charitable gifts, and denied estate tax deductions for the gifts to which these expenses were allocated. The Supreme Court disagreed, holding that the Treasury regulations in place at the time justified the tax court's finding that the marital deduction was not jeopardized.
        2. In response to the *Hubert* decision, the IRS announced new regulations providing guidance on this issue, which apply to estates of decedents dying after December 3, 1999.[[799]](#footnote-800) Unlike the "material limitation" rules under the prior regulations, the new regulations permit deductions depending upon the nature of the expenses in question. The regulations provide that "estate management expenses" may be deducted as an income tax deduction (but not as an administrative expense for estate tax purposes) without reducing the marital or charitable deduction. Expenses that constitute "estate transmission expenses" require a dollar for dollar reduction in the amount of any marital or charitable deduction, regardless of whether the expenses are deducted on the estate's income tax return or on the estate tax return. Id. If an estate tax return is required and these expenses are taken on the estate's income tax return, the expenses are deemed to reduce any marital and charitable deduction taken on the estate tax return, thus causing an estate tax that might not otherwise be due.
        3. Estate management expenses are "expenses incurred in connection with the investment of the estate assets and their preservation and maintenance during a reasonable period of administration. Examples of these expenses include investment advisory fees, stock brokerage commissions, custodial fees and interest."[[800]](#footnote-801)
        4. Estate transmission expenses are all estate administration expenses that are not estate management expenses. These expenses are deemed to reduce the amount of the marital or charitable deduction if they are paid out of assets that would otherwise pass to the surviving spouse or to charity. Estate transmission expenses include expenses incurred as a result of the "consequent necessity of collecting the decedent's assets, paying the decedent's debts and death taxes, and distributing the decedent's property to those who are entitled to receive it." Examples of these expenses could include executor commissions and attorney fees (except to the extent of commissions or fees specifically related to investment, preservation, and maintenance of assets), probate fees, expenses incurred in construction proceedings and defending against will contests, and appraisal fees.[[801]](#footnote-802)
        5. In addition to reductions for estate transmission expenses, the final regulations require that the marital deduction be reduced by the amount of any estate management expenses that are "paid from the marital share but attributable to a property interest not included in the marital share."[[802]](#footnote-803)
        6. If estate management expenses are deducted on the estate tax return, the marital or charitable deduction must be reduced by the amount of any estate management expenses "that are deducted under Section 2053 on the decedent's Federal estate tax return."[[803]](#footnote-804) The justification for this position is the language in section 2056(b)(9) of the Code, which provides that nothing in section 2056 or any other estate tax provision shall allow the value of any interest in property to be deducted for federal estate tax purposes more than once with respect to the same decedent.

Example: $150,000 of life insurance proceeds pass to the decedent's child, and the balance of the estate passes to the surviving spouse. The decedent's applicable credit amount had been fully utilized prior to death. If estate management expenses of $150,000 were deducted for estate tax purposes, the marital deduction would have to be reduced by $150,000. Otherwise, the estate "would be taking a deduction for the same $150,000 in property under both sections 2053 and 2056." As a result, the deduction would have the effect of sheltering from estate tax $150,000 of the insurance proceeds passing to the decedent's child.[[804]](#footnote-805)

* + 1. Summary of Deductible Expenses
       1. ONLY on the Decedent's Final Income Tax Return
          1. Itemized deductions paid prior to date of death (other than miscellaneous itemized deductions for years 2018-2025).[[805]](#footnote-806)
          2. Capital loss carryforward of the decedent.[[806]](#footnote-807)
          3. Charitable contributions carryforward of the decedent.[[807]](#footnote-808)
          4. Net operating loss carryforward of the decedent.[[808]](#footnote-809)
          5. Disallowed investment interest carryforward of the decedent.[[809]](#footnote-810)
          6. Disallowed S corporation carryforward of the decedent.[[810]](#footnote-811)
          7. Investment tax credit carryforward of the decedent.[[811]](#footnote-812)
       2. EITHER Decedent’s Final Income Tax Return or Estate Tax Return
          1. Medical expenses of the decedent paid out of his estate within one year after date of death.[[812]](#footnote-813)
       3. ONLY on the Estate Tax Return
          1. Funeral expenses.[[813]](#footnote-814)
          2. Claims against the estate of a personal non-deductible nature (e.g., federal income and gift taxes unpaid at date of death).[[814]](#footnote-815)
          3. Administration expenses attributable to tax-exempt income.[[815]](#footnote-816)
       4. ONLY on the Estate's Income Tax Return
          1. State and local taxes on estate income (subject to a $10,000 aggregate limit for state and local taxes for years 2018-2025).[[816]](#footnote-817)
          2. Real estate taxes not accrued prior to death (subject to the $10,000 aggregate limit described above).[[817]](#footnote-818)
          3. Interest accruing after date of death on indebtedness incurred by the decedent or the estate that are not allowable as expenses of administration under local law.[[818]](#footnote-819)
       5. EITHER Estate’s Income Tax Return or Estate Tax Return
          1. Administration expenses, except administration expenses attributable to tax-exempt income, may be taken on the Form 1041 (U.S. Income Tax Return for Estates and Trusts) or the Form 706 (United States Estate (and Generation-Skipping Transfer) Tax Return). Any administration expenses, including those attributable to tax-exempt income, not claimed on the Form 1041 can be claimed on the Form 706.[[819]](#footnote-820)
          2. Casualty and theft losses.[[820]](#footnote-821)
       6. BOTH on Estate’s Income Tax Return and on the Estate Tax Return
          1. Business expenses accrued prior to death.[[821]](#footnote-822)
          2. Interest expenses accrued prior to death (subject to various limits).[[822]](#footnote-823)
          3. Taxes accrued prior to death (subject to various limits).[[823]](#footnote-824)
          4. Expenses incurred for the management, conservation, or maintenance of property held for the production of income, or in connection with the determination, collection, or refund of any tax accrued prior to death.[[824]](#footnote-825)
          5. For divorce or separation instrument entered into prior to January 1, 2019, alimony or separate maintenance payments accrued prior to death.[[825]](#footnote-826)

1. GRANTOR TRUSTS, IDGTs, CONVERSIONS, AND TOGGLING
   1. Generally
      1. A complete discussion of the grantor trust rules of Part E of Subchapter J (section 671-679 of the Code) is beyond the scope of these materials.[[826]](#footnote-827) From an income and estate planning perspective, based on the IRS’s position in Revenue Ruling 85-13 (discussed earlier), grantor trust status has two significant results: (i) the grantor is deemed to own all of the assets of the trust for all Federal income tax purposes; and (ii) any transaction between the grantor and the grantor trust will be ignored for all Federal income tax purposes. From a practical standpoint this means the grantor reports all of the trust’s tax items on his or her income tax return, and the grantor is responsible for paying any resulting income taxes. Furthermore, the grantor’s payment of the resulting income taxes is not considered a gift to the trust’s beneficiaries, and if the trustee has discretion to reimburse the grantor for the income tax liability, the mere existence of that discretion by itself (whether or not exercised) will not cause the trust’s assets to be included in the grantor’s gross estate.[[827]](#footnote-828) That being said, the most significant result is that the grantor and the grantor trust can participate in a myriad of transactions that otherwise would be taxable events had the parties been separate taxpayers. Instead, they are simply disregarded. All of this remains true as long as the grantor is still alive, and the powers or interests that trigger grantor trust treatment remain in effect.
      2. Importantly, the trust must also be 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.[[828]](#footnote-829) 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).[[829]](#footnote-830) 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.[[830]](#footnote-831)
      3. For purposes of this discussion, we assume grantor trust status is over the entire trust and over all income and corpus. Indeed, the most common power retained by grantors who intend on transacting with their grantor trusts is under section 675(4)(C) of the Code (the power, exercisable in a nonfiduciary capacity, to reacquire assets by substituting assets of equivalent value). If this power is, as often is the case, over all of the assets of the trust, the grantor is deemed the owner of the entire trust, including all of the income and corpus.
      4. To further complicate matters, grantor trust status can be conferred on taxpayers who are not grantors at all. Section 678 of the Code describes certain situations where a person other than a grantor will be treated as the owner of trust assets. Section 678(a) of the Code provides a person (other than the grantor) will be treated as the owner of any portion of a trust if (i) the person has a “power exercisable solely by himself to vest the corpus or the income therefrom in himself,”[[831]](#footnote-832) or (ii) the person “previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.”[[832]](#footnote-833) Under section 678(b) of the Code, traditional grantor trust status will trump this “third party” ownership status, if the actual grantor is regarded as the owner of the same portion of the trust, thereby avoiding taxation of the same items of taxable income to two different taxpayers.[[833]](#footnote-834) As mentioned earlier, section 678(a) of the Code is the linchpin of planning with BDOTs and BDITs.
      5. What is less known is what are the income tax consequences when grantor trust status is lost, either during the grantor’s lifetime or upon the grantor’s death. Are there instances when losing grantor trust status (whether intentionally or not) will be considered a taxable event? What is the resulting basis of any assets in an IDGT if grantor trust status is terminated during the lifetime of the grantor? Would it be different if grantor trust status is terminated due to the death of the grantor? What happens when a non-grantor trust becomes a grantor trust?
   2. Income Tax Consequences of Changes in Grantor Trust Status
      1. Introduction
         1. When grantor trust status is terminated or when a non-grantor trust becomes a grantor trust, the obvious end result is that the “owner” of the trust asset for Federal income tax purposes changes. When grantor trust is terminated, the trust becomes a separate taxable entity (non-grantor trust), and when a non-grantor trust becomes a grantor trust, the grantor (or someone other than the grantor under section 678 of the Code) becomes the owner of the trust’s assets for Federal income tax purposes. From an income tax perspective, how does that change in ownership occur?
         2. If the change in ownership is treated like a gift, then as previously discussed, the receipt of the trust property is not income to the recipient, and the property will have a carryover basis under section 1015 of the Code? If the change in ownership is caused by the death of the grantor, then like bequests or other transfers as death, do the trust assets get a basis adjustment under section 1014 of the Code? Could the change in ownership be considered a taxable sale or exchange, with gain and possibly loss recognition? Or could this transfer of ownership be akin to a tax free exchange? If the change in ownership is not a taxable event, if debt is in excess of basis, do the holdings in *Crane* and *Tuft* require a recognition gain?
      2. Grantor to Non-Grantor Trust During Grantor’s Lifetime
         1. In Revenue Ruling 77-402,[[834]](#footnote-835) the IRS held that when grantor trust is terminated during the grantor’s lifetime, the grantor is deemed to have transferred the trust property to a separate taxable entity. If the transferred property is subject to debt and the debt is in excess of basis, then the grantor, as the transferor, will recognize gain. In the ruling, A, an individual, created a T, an irrevocable trust (IDGT for the benefit of A’s descendants) which is a grantor trust as to the entire trust due to certain retained powers. A contributed some funds to T, and the trustee used those funds to purchase a partnership interest in P, a partnership with a principal activity of investing in real property, using both recourse and nonrecourse financing. P elected accelerated depreciation. The resulting deduction were allocated to the partners of P, including T and in turn, deducted on A’s income tax returns.
         2. When the adjusted basis of the partnership interest was nearly zero (deductions and other losses are limited to the amount basis in the partnership interests) and the real property had started generating net income, A, as grantor, renounced the powers that made T a grantor trust. The IRS ruled, “at the time A renounced the powers that gave rise to T's classification as a grantor trust, T no longer qualified as a grantor trust, with the result that A was no longer considered to be the owner of the trust and trust property for Federal income tax purposes. Consequently, at that time, A is considered to have transferred ownership of the interest in P to T, now a separate taxable entity, independent of its grantor, A.”[[835]](#footnote-836)
         3. When a partner transfers an interest in a partnership and the transferor’s share of partnership liabilities are reduced or eliminated, the transferor is treated as having sold the partnership interest for an amount equal to the amount of reduced or eliminated liabilities. The IRS thus concluded, “A realized an amount equal to the share of partnership liabilities that existed immediately before T converted from grantor to nongrantor status for Federal income tax purposes. The gain or loss realized by A is the difference between the amount realized from the reduction of the share of P's liabilities and the adjusted basis in the partnership interest … immediately prior to the change in T's tax status.”[[836]](#footnote-837) The ruling went on to say, the result would be the same if the termination of grantor trust status occurred due to the expiration or lapse of the powers or due to the exercise, release, renunciation, expiration or lapse of certain powers held by party other than the grantor.
         4. In 1980, the IRS issued section 1.1001-2 of the Treasury Regulations which addressed the discharge of liabilities in determining gain or loss on a sale, exchange, or other disposition. The Treasury Regulations provide, “the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.”[[837]](#footnote-838) In particular, the Treasury Regulations provide the following special rules:[[838]](#footnote-839)

--(i) The sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability;

--(ii) The sale or other disposition of property that secures a recourse liability discharges the transferor from the liability if another person agrees to pay the liability (whether or not the transferor is in fact released from liability);

--(iii) A disposition of property includes a gift of the property or a transfer of the property in satisfaction of liabilities to which it is subject;

--(iv) Contributions and distributions of property between a partner and a partnership are not sales or other dispositions of property; and

--(v) The liabilities from which a transferor is discharged as a result of the sale or disposition of a partnership interest include the transferor's share of the liabilities of the partnership.

* + - 1. These Treasury Regulations also include an example[[839]](#footnote-840) that is similar to Revenue Ruling 77-402. In the example, C, an individual, creates an irrevocable wholly owned grantor trust. The trustee bought an interest in a partnership. C deducted the distributive share of partnership losses attributable to the partnership interest held by the trust. When the adjusted basis of the partnership interest held by the trust was $1,200, C renounced the grantor trust powers, and the trust then ceased to be a grantor trust. At the time of the renunciation all of the partnership's liabilities are nonrecourse liabilities on which none of the partners have assumed any personal liability. The trust's proportionate share of the partnership liabilities was $11,000. The example concludes when C renounced the grantor trust powers, the trust no longer qualified as a grantor trust, with the result that C was no longer considered to be the owner of the trust and trust property for income tax purposes. Consequently, C was considered to have transferred ownership of the partnership interest to the trust, which was now a separate taxable entity, independent of C. On the transfer, C's share of partnership liabilities ($11,000) was treated as the amount realized by C. C's resulting gain was $9,800 ($11,000 - $1,200).
      2. The taxpayers in *Madorin v. Commissioner[[840]](#footnote-841)* challenged the validity of the foregoing example in the Treasury Regulations, essentially taking the position of the *Rothstein* court (discussed earlier). Bernard Madorin was the grantor of four trusts. The trustee of each of the four trusts had the power to sprinkle income and principal among a class of beneficiaries, and the power to add charitable beneficiaries. The four trusts were, therefore, grantor trusts pursuant to section 674(a) of the Code. The trusts bought limited partnership interests in a limited partnership, which in turn purchased a partnership interest in Saintly Associates. Bernard recognized losses generated by Saintly Associates. When Saintly Associates began generating income, the trustee renounced his power to add beneficiaries and the trusts ceased to be grantor trusts. The grantor argued that he should be treated as the owner of the trust only to attribute to him items of income, deductions, and credits (the *Rothstein* ruling). The IRS disagreed with the taxpayer and assessed a deficiency. Basing its position on the aforementioned example in the Treasury Regulations, the IRS contended that the grantor was the owner of the partnership interests and when the trusts ceased to be grantor trusts there was a disposition of the trusts’ assets (the partnership interests) on which gain would be recognized to the extent that the underlying debt from which the trust was released exceeded the taxpayer's basis in the partnership interests. The Tax Court ruled for the IRS. In coming to that conclusion, the court stated, “Absent a clear and unambiguous legislative directive in this matter, limiting the usage of the word "owner," we will apply the usual, ordinary, and everyday meaning of the word.”[[841]](#footnote-842)
      3. Given all of the foregoing precedents, the termination of grantor trust status during the grantor’s lifetime is treated as a transfer by the grantor of the trust’s assets to the trust (now a separate taxpayer) in exchange for any consideration the trust may give to the grantor. The foregoing consideration will include any discharge of liabilities of the grantor that results from such transfer. In particular, if nonrecourse debt encumbers the trust property and such debt exceeds basis, then grantor will recognize gain on the deemed transfer. 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.
    1. Grantor to Non-Grantor Trust Due to Grantor’s Death
       1. 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.[[842]](#footnote-843) Clearly, 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.
       2. 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.[[843]](#footnote-844) They cite *Crane*, *Diedrich*, section 1.1001-2 of the Treasury Regulations (all previously discussed) 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,”[[844]](#footnote-845) 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 recognition event, some commentators have pointed to Revenue Ruling 73-183.[[845]](#footnote-846) 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.
       3. 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.[[846]](#footnote-847) 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.[[847]](#footnote-848) It provided for certain modifications including the ability to increase the aggregate adjusted basis of estate property up to $1.3 million, [[848]](#footnote-849) with additional increases of up to $3.0 million for property passing to a surviving spouse, outright or to a QTIP trust.[[849]](#footnote-850) 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.”[[850]](#footnote-851) 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.
       4. In the mid-1970’s, with the 1976 Tax Reform Act, [[851]](#footnote-852) 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 between basis and liability.[[852]](#footnote-853) 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.”[[853]](#footnote-854) The carryover basis regime at death was repealed retroactively in 1980, so it never came into effect.[[854]](#footnote-855) One of the reasons for the repeal was likely the debt in excess of basis issue.
       5. 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.[[855]](#footnote-856) 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?
       6. Notwithstanding arguments to the contrary,[[856]](#footnote-857) the conventional view is that if the assets in the IDGT are not included in the grantor’s gross estate, the trust assets will not receive a “step-up” in basis under section 1014. In Chief Counsel Advice 200937028[[857]](#footnote-858) 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).”[[858]](#footnote-859)
       7. Most practitioners and commentators take the position that whatever assets owned by the IDGT at the time of the grantor’s death carry their historical tax basis. Hence, the reason swapping high basis assets with low basis assets in existing IDGTs will continue to be so important prior to the death of the grantor. 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). 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.”[[859]](#footnote-860) 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 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. [[860]](#footnote-861)
       8. One possible alternative view about what happens when grantor trust status is terminated (and an the installment note is still outstanding) is that the trustee of the IDGT is deemed to purchase the assets for the outstanding amount of the installment note at the time of the grantor’s death. The basis of the assets would thus be determined under section 1012 of the Code. However, this necessarily requires practitioners to take the position that an exchange occurs at the death of the grantor, which may give rise to adverse income tax consequences to the estate with respect to the note. That does not seem to be the position of the IRS. In a private letter ruling involving a sale from one grantor trust to another, the IRS provided, “when either Trust 1 or Trust 2 ceases to be treated as a trust owned by A under § 671 by reason of A’s death or the waiver or release of any power under § 675, no opinion is expressed or implied concerning whether the termination of such grantor trust treatment results in a sale or disposition of any property within the meaning of § 1001(a), a change in the basis of any property under § 1012 or § 1014, or any deductible administration expense under § 2053.”[[861]](#footnote-862)
       9. In 2015, the IRS added “Whether the assets in a grantor trust receive a section 1014 basis adjustment at the death of the deemed owner of the trust for income tax purposes when those assets are not includible in the gross estate of that owner under chapter 11 of subtitle B of the Internal Revenue Code” to the list of “areas under study in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a revenue ruling, a revenue procedure, regulations, or otherwise.”[[862]](#footnote-863) This continues to be an area of study to this day. The IRS recently released its 2020-2021 Priority Guidance Plan, and in the “General Guidance” section, it lists those projects “that will be the focus of efforts during the 12-month period from July 1, 2020, through June 30, 2021.” It specifically lists, “Guidance on basis of grantor trust assets at death under §1014,” in the Gifts and Estates and Trusts section.[[863]](#footnote-864)
       10. In the foreign trust context, there are some conflicting, possibly misleading, rulings. In PLR 201544002, husband and wife (both of whom are foreign citizens and non-residents of the United States) funded a joint foreign revocable trust with their community and separate property. Each spouse retained the right to revoke the trust with respect to his or her community property and separate property held in trust. Under the trust agreement, the surviving spouse has the power to appoint the trust assets to his or her estate by will. The IRS held that upon the first death of a spouse, the surviving spouse would receive a step-up (or step-down) in basis under section 1014(b)(2) of the Code with respect to the decedent’s spouse’s separate property and one-half share of the community property. The IRS further held that upon the death of the surviving spouse (who held a general power of appointment), to the extent the surviving spouse exercises the general power of appointment by will, the trust assets will receive a step-up (or step-down) in basis under section 1014(b)(4) of the Code. The ruling acknowledged the no-rule policy as mentioned above, but avoided it on the ground that the ruling request had been submitted before the no-rule policy was announced in 2015 and became effective.
       11. In PLR 201245006, the taxpayer asked the IRS how to determine the basis of property upon the death of the grantor for property owned by an irrevocable non-U.S. situs (foreign) trust. The taxpayer (“Taxpayer”) was a foreign citizen and non-resident of the United States. Taxpayer proposed to transfer assets to an irrevocable trust (“Trust”) established under the laws of Taxpayer's country (“Country”). The assets of Trust were to include cash and stock in two companies that are publicly traded in Country and on the New York Stock Exchange. The trustees of Trust are Taxpayer and X, an unrelated party (“Trustees”). Trustees were to pay all Trust income to Taxpayer during his lifetime and could distribute principal to Taxpayer in their absolute discretion. Upon Taxpayer's death, Taxpayer had a special testamentary power of appointment over the income and principal of Trust in favor of his issue. If Taxpayer did not exercise his special power of appointment, Trust property would be held in further trust for the benefit of Taxpayer's issue.
           1. The IRS ruled that the foreign trust was a grantor trust for U.S. income tax purposes. The IRS then ruled that the basis of the property held in trust would be the fair market value of the assets as provided under section 1014(a) of the Code.
           2. Significantly, the IRS ruled that section 1014(b)(9) of the Code (requiring the property to be included in determining the value of the decedent’s gross estate) was inapplicable. Rather, the assets received by the grantor’s issue would fall under section 1014(b)(1) of the Code (property acquired by bequest, devise, or inheritance). The IRS reasoned:

Taxpayer's issue will acquire, by bequest, devise, or inheritance, assets from Trust at Taxpayer's death. The assets acquired from Trust are within the description of property acquired from a decedent under § 1014(b)(1). Therefore, Trust will receive a step-up in basis in Trust assets under § 1014(a) determined by the fair market value of the property on the date of Taxpayer's death. See Rev. Rul. 84-139, 1984-2 C.B. 168 (holding that foreign real property that is inherited by a U.S. citizen from a nonresident alien will receive a step-up in basis under § 1014(a)(1) and 1014(b)(1)). This rule applies to property located outside the United States, as well as to property located inside the United States.

* + - * 1. In coming to the conclusion, the ruling points out that “Section 1014(b)(9)(C) provides that § 1014(b)(9) shall not apply to property described in any other paragraph of § 1014(b).” In other words, inclusion in the gross estate may not necessarily be the only avenue to receive a “step-up” in basis.
        2. While some practitioners may seek to interpret this ruling as allowing a “step-up” in basis for assets in an irrevocable grantor trust that are not otherwise included in the gross estate of the grantor, in actuality, it appears the drafters of the ruling at the Treasury Department may have mistakenly referred to section 1014(b)(1) of the Code (“Property acquired by bequest, devise, or inheritance, or by the decedent’s estate from the decedent.”) in the ruling. Based on conversations with the attorney that acquired the private letter ruling, the ruling should have referred to section 1014(b)(3), which provides for a “step-up” in basis for “property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust.”[[864]](#footnote-865) While not clear in the ruling, the grantor retained the power to alter beneficial enjoyment from and after his death, not during his lifetime.[[865]](#footnote-866) As such, this ruling may not stand for the proposition that assets in an IDGT can receive a “step-up” in basis, notwithstanding the fact the assets are not includible in the estate of the grantor.
    1. Non-Grantor to Grantor Trust
       1. A few private rulings have discussed the income tax consequences of a conversion of a non-grantor trust to a grantor trust.[[866]](#footnote-867) Chief Counsel Advice 200923024 involved trusts created by a parent and three adult children, all of whom held S corporation shares. The S corporation had filed with the SEC to do an initial public offering. Each taxpayer transferred their shares to a partnership, then formed an irrevocable non-grantor trust, funded with $100,000 in cash, and sold his or her partnership interest to his or her respective trust, in exchange for unsecured private annuities. The partnership had a section 754 election in place and, as a result, the partnership increased the basis of the partnership’s stock to fair market value (based on the purchase price of the partnership interests) under section 734 of the Code, and then the partnership sold all the shares of the corporation after the IPO for an amount roughly equal to the partnership’s basis in the shares (due to the inside basis adjustment). In other words, the partnership (and the trust) recognized little or no gain on the sale of the stock after the IPO. After the sale, the trust advisor removed the corporate trustee of the non-grantor trust and replaced by a person who would be considered a “subordinate party” under section 672(c) of the Code, thereby converting the trusts into grantor trusts under section 674(a) and (c) of the Code. After the trusts became grantor trusts, the taxpayers claimed to “own” all of the partnership interests and reported no gain or other taxable income attributable to any future payments on the private annuity sales.
       2. The IRS agent sought to treat the conversion from non-grantor to grantor trust as a transfer of the underlying assets (partnership interest) to the grantor trusts (the new owner) as a taxable exchange. The non-grantor trusts would recognize little or no gain on the transfer because the outside basis of the partnership interests were equal to their fair market value. On the other hand, the transferee (grantor trusts) would realize taxable income on the receipt of the partnership interests. To that end, the IRS agent cited Revenue Ruling 77-402, section 1.1002-(c) of the Code, example 5, of the Treasury Regulations, and *Madorin* (as discussed earlier, all of the foregoing cited authorities stand for the proposition that when converting from a grantor to a non-grantor trust, there is a deemed transfer from the grantor to the trust, and if debt is in excess of basis, there is recognition of gain to the extent of such excess). The IRS Chief Counsel rejected this argument because the authorities only deal with recognition of income to the transferor (not the transferee). In its discussion, the IRS stated the rule set forth in the foregoing authorities is narrow in that it only applies to inter vivos lapses of grantor trust status and then inexplicably and gratuitously adds “not that caused by the death of the owner which is generally not treated as an income tax event.”[[867]](#footnote-868) It’s the foregoing phrase that consistently gets quoted to stand for the proposition that the IRS does not believe termination of grantor trust caused by the death of the grantor is not a taxable event, despite the fact that the ruling itself does not involve the death of any taxpayer and the conversion in question is the opposite of the termination of grantor trust status. As to the first issue, whether the conversion of a non-grantor trust to a grantor trust is a transfer for income tax purposes of the property held by the non-grantor trusts to the owners of the grantor trusts requiring recognition of gain to the owners, the IRS Chief Counsel ruled that it is “not a transfer for income tax purposes of the property held by the nongrantor trusts to the owner of the grantor trust that requires recognition of gain to the owner.”[[868]](#footnote-869)
       3. According to the IRS Chief Counsel, asserting that a conversion like this results in taxable income to the grantor would have an impact on non-abusive situations. The IRS Chief Counsel then provides examples of how a non-grantor trust can become a grantor trust; “examples include the appointment of a related or subordinate trustee to replace an independent trustee as in the present case (§ 674); a borrowing of the trust corpus under § 675(3) (discussed below in ISSUE 2 with regard to the application of Rev. Rul. 85-13); or the payment of the grantor's legal support obligations under § 677(b).” The rule in Revenue Ruling 85-13 provided that the grantor could not engage in a taxable transaction with the grantor trust. Thus, while the IRS Chief Counsel agreed that the transaction at hand was abusive, the IRS should not take the position that it results in taxable income to the grantor.
       4. On the second issue, the IRS agent asserted that the private annuity transaction (the sale of the partnership interests to the trusts) should be treated as an indirect borrowing of the trust assets, causing the trusts to be grantor trusts under section 675(3) pf the Code. As a result, under Revenue Ruling 85-13, the IRS agent argued, the trusts did not get a cost basis upon purchase of the partnership interests and there would be no inside basis adjustment to the stock held by the partnership. The IRS Chief Counsel ruled that this private annuity transaction could not be recast as a loan under section 675(3) of the Code. Despite the positive results for the taxpayer, the memorandum concludes, “Please note that we are not opining on the possible applicability of the step transaction, the economic substance doctrine or other judicial doctrines to the transaction in the present case… Because the case presents an apparent abuse, however, we would like to explore with you further case development that may lead to other arguments to challenge the transaction.”[[869]](#footnote-870)
       5. It’s unclear what practitioners can take away, if anything, from Chief Counsel Advice 200923024. It could be interpreted to mean that a conversion from non-grantor trust to grantor trust is not a transfer for income tax purposes at all or, at the very least, not a transfer that will result in a recognition event to the grantor. In the one other ruling which, involved the conversion of a non-grantor charitable lead annuity to a grantor trust, the IRS wrote, “Given the lack of authority imposing such consequences, we conclude that the conversion of Trust from a non-grantor trust to a grantor trust will not be a transfer of property to Grantor from Trust under any income tax provision.”[[870]](#footnote-871) In any case, it’s hard to see how the Chief Counsel Advice 200923024 can be read to stand for the proposition “the death of the owner … is generally not treated as an income tax event,” as is so often quoted by commentators.
    2. Effective Date of Changes in Trust Status
       1. Many grantor trust powers can be drafted so the grantor or other power holder can release it at any time and terminating grantor trust status. In addition, the trust may give an independent third party, often acting in a non-fiduciary capacity, the power to re-grant the released power to the grantor, or a nonadverse party, and “toggle” grantor trust status back on. If a significant income tax event is anticipated, tax planners may choose to terminate grantor trust status or toggle it back on, depending on which taxpayer (grantor or non-grantor trust and its beneficiaries) should be responsible reporting the tax items on their respective income tax returns.[[871]](#footnote-872)
       2. Neither the Code or the Treasury Regulations provide any guidance on the effective date of a termination of grantor trust status, however, many believe that the release or elimination of the power that created grantor trust status will immediately make it a taxable non-grantor trust from that point forward. Support for this can be found in *Madorin* (discussed above). The power to add charitable beneficiaries was released on January 1 and was held effective from that day. As such, if a taxpayer wants to release a power and make the trust taxable for the next taxable year, the release should be made effective at midnight on December 31 of the current taxable year. The effective date of a conversion from non-grantor to grantor trust status would seem to be effective on the date on which the event[[872]](#footnote-873) that causes the conversion.[[873]](#footnote-874)
       3. An exception to the foregoing timing rule may exist if the operative grantor trust provision is section 675(3) of the Code which provides, “The grantor shall be treated as the owner of any portion of a trust in respect of which—The grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year.”[[874]](#footnote-875) The IRS has ruled that a trust is a grantor trust for any year (and for the entire taxable year) in which a loan under section 675(3) of the Code was outstanding.[[875]](#footnote-876)
  1. Section 678 Ownership by Beneficiaries or Other Entities
     1. As mentioned above, section 678(a) of the Code provides a person (other than the grantor) will be treated as the owner of any portion of a trust if (i) the person has a “power exercisable solely by himself to vest the corpus or the income therefrom in himself,”[[876]](#footnote-877) or (ii) the person “previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.”[[877]](#footnote-878)
     2. A trust where a person other than the grantor is conferred “grantor trust” by a “power exercisable solely by himself to vest the corpus or the income therefrom in himself” under section 678(a)(1) of the Code is more commonly referred to as a beneficiary deemed owner trust or BDOT.[[878]](#footnote-879) Common examples of this type of situation include section 2056(b)(5) marital trusts pursuant to which the spouse has a general power of appointment over the entire trust or trusts that permit withdrawal by a beneficiary as an alternative to mandatory termination or distribution when the beneficiary reaches a certain age. The foregoing examples involve the power to vest corpus. An example of a power to vest “the income therefrom” is described in Private Letter Ruling 201633021.[[879]](#footnote-880) The ruling involved Trust 1 and Trust 2 which were non-grantor trusts because the grantor had died. The assets of Trust 1 and Trust 2 are held for the benefit of the same beneficiaries. The governing document of Trust 2 provides that Trust 1 retains the power, solely exercisable by Trust 1, to revest the net income of Trust 2 in Trust 1; provided, however, that such power shall lapse on the last day of such calendar year. Trust 2 further provides that income includes (i) any dividends, interest, fees and other amounts characterized as income under section 643(b) of the Code, (ii) any net capital gains realized with respect to assets held less than twelve months, and (iii) any net capital gains realized with respect to assets held longer than twelve months. The ruling provides that the trustee “proposes to transfer funds from Trust 1 to Trust 2.”[[880]](#footnote-881) The IRS concluded, “Trust 1 will be treated as the owner of the portion of Trust 2 over which they have the power to withdraw under § 678(a). Accordingly, Trust 1 will take into account in computing their tax liability those items which would be included in computing the tax liability of a current income beneficiary, including expenses allocable to which enter into the computation of distributable net income. Additionally, Trust 1 will also take into account the net capital gains of Trust 2.”[[881]](#footnote-882)
     3. The ruling unfortunately does not provide any insight on what the income tax consequences would be when Trust 1 “transfers funds” to Trust 2. The language of the ruling implies the Trust 1 will be treated as a beneficiary of Trust 2 but also “as the owner of the portion of Trust 2 over which they have the power to withdraw under § 678(a).” The language doesn’t necessarily (but it could) mean that Trust 1 is the deemed owner entirely of Trust 2 and all of its assets. If Trust 1 is treated as the owner entirely of Trust 2, then theoretically Trust 1 could engage in a sale of the assets of Trust 1 to Trust 2 in exchange for an installment note, and the transaction would be disregarded for income tax purposes under Revenue Ruling 85-13. This would be the result if Trust one could withdraw all the assets of Trust 2 at any time. If, however, Trust 1 is merely an entity that must report the income, capital gain, expenses, and other items used to compute DNI, then such a transaction could, in part, be considered a taxable event. Even if the latter interpretation is correct, if Trust 1 is a non-GST exempt trust and Trust 2 is a GST exempt trust, the tax liability borne by Trust 1 from all of Trust 2’s income and capital gain could significantly increase Trust 2’s trust assets over time and decrease the assets in Trust 1.
     4. In a more recent ruling,[[882]](#footnote-883) the trust agreement of a Trust 1 prohibited the distribution of Shares (perhaps of a closely-held company) to the beneficiaries, but allowed for the distribution of the proceeds from the sale of Shares. Trust 1 contributed all of its Shares to LLC, a newly formed entity classified as partnership for Federal tax purposes, in exchange for membership interest in LLC. The same restrictions on the Shares were placed on the membership interests of LLC. Trust 1 then transferred a portion of its LLC interest to a Subtrust for the sole benefit of A. After A reached the age of 40, A exercised a withdrawal right to take all of the Subtrust’s assets, except the LLC interests. The Subtrust agreed to sell a portion of its LLC interests to Trust 2 in exchange for cash and a promissory note. Trust 2 is a grantor trust with respect to A. A also has the authority to withdraw the cash and promissory note from Subtrust after the sale. The IRS concluded, “because A has a power exercisable by herself to vest the proceeds of Subtrust’s LLC interest in herself and that those proceeds are Subtrust’s only asset, A will be treated as the owner of Subtrust under § 678. Consequently, the transfer of the LLC interests to Trust 2 is not recognized as a sale for federal income tax purposes because Trust 2 and Subtrust are both wholly owned by A.”[[883]](#footnote-884)

1. INSTALLMENT OBLIGATIONS AND PROMISSORY NOTES
   1. Introduction
      1. Two of the most common tools used in estate planning are promissory notes (i.e., intra-family loans) and installment obligations or notes (i.e., a sale of an asset to an IDGT in exchange for an installment note). In most cases, these transactions are between a grantor and a grantor trust (i.e., IDGT) so that there are no income tax consequences. However, as discussed above, grantor trust status is not permanent, and when grantor trust status is lost, income taxes come into play.
      2. As mentioned above, income tax planning often involves strategies that will defer a taxpayer’s tax liability. The most common method of deferring a tax liability is to take advantage of the installment method of accounting. Generally, under the installment method of accounting, gain on an installment sale is spread over the period during which the installment payments are received, rather than being taxed in the year of sale. The installment method does not apply to losses sustained on an installment sale.
      3. As we will see, installment notes utilized in a sale of property to an IDGT are treated very differently than installment notes from a taxable sale of property. The confusion that often arises when discussing the income tax consequences of promissory and installment notes is really a function of semantics. Installment obligations and promissory notes are essentially the same thing. Both involve a legal obligation by one party (the borrower or purchaser) to pay an amount (usually fixed in value) to another party (the lender or seller), and such amount can be satisfied with cash or property. Installment notes in an IDGT sale are not really “installment obligations” at all because there are no income tax consequences to the sale or the deferred payments of principal or income, provided grantor trust status is maintained. When grantor trust status is lost or when the grantor dies holding a promissory note or installment note (IDGT or taxable), the income tax consequences are very different for each type of transaction.
   2. Taxable Installment Sales
      1. Basic Rules
         1. Section 453(b) of the Code defines an “installment sale” as a “disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs.”[[884]](#footnote-885) Under the installment method, the seller will recognize gain as the seller receives each deferred payment, and each payment received is comprised of: (i) a nontaxable recovery of a portion of the adjusted basis of the sold property; (ii) a taxable portion of the realized gain; and (ii) taxable interest.[[885]](#footnote-886) The amount of each payment that the seller must report as taxable gain is determined by multiplying the total amount of payments that the seller received during the taxable year by the gross profit percentage, which is determined by dividing the gross profit by the total contract price.[[886]](#footnote-887)

Example: S sells property with an adjusted basis of $40 to B for $100, payable in 10 equal annual installments ($10 per year plus interest). The gross profit to S is $60. The gross profit percentage is 60% ($60 of gross profit divided by $100 total contract price). Each annual payment to S will be treated as $6 of gain (60% of $10 annual payment), $4 of nontaxable recovery of basis, and interest (ordinary income).

* + - 1. If the terms of the installment sale do not have a stated interest or the stated interest is too low, the seller is required to treat a portion of each installment as imputed interest under section 453 of the Code (original issue discount rules). The amount of unstated interest or inadequate interest is based upon the applicable federal rate under section 1274(d) of the Code.
      2. If the transaction otherwise qualifies as an installment sale, the installment method will by default apply unless the taxpayer elects out.[[887]](#footnote-888) The election must be made no later than the due date for filing the taxpayer's return (including extensions) for the year in which the sale occurs.[[888]](#footnote-889) There are a number reasons why a seller might choose to elect out of the installment method. The seller may have unused losses that can be used to offset the gain in the year of the transaction. In addition, if the transaction will result in capital gain and capital gain tax rates are expected to be higher in the future, the taxpayer is likely to benefit from recognizing the gain in the year of the transaction, notwithstanding the acceleration of the tax liability.
      3. As mentioned above, the installment method only applies if the transaction results in gain to the seller. If the disposition of property results in a loss, the installment method is not available, even if payments are made in installments. If the loss is deductible, it is only deductible in the year of the transaction.[[889]](#footnote-890)
      4. From the standpoint of the buyer, notwithstanding the deferred payment obligation, the buyer receives a cost basis in the property acquired. If the buyer is not a related person, the interest paid or deemed paid is deductible.
    1. Ineligibility for Installment Sale Treatment
       1. The installment method of accounting is not available with certain types of property and transactions. These nonqualifying situations include:
          1. Dealer dispositions[[890]](#footnote-891) (defined as any “disposition of personal property by a person who regularly sells or otherwise disposes of personal property of the same type on the installment plan”[[891]](#footnote-892) and “disposition of real property which is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business.”[[892]](#footnote-893));[[893]](#footnote-894)
          2. Sales of inventory;[[894]](#footnote-895)
          3. Sales of “stock or securities which are traded on an established securities market”[[895]](#footnote-896) or “property (other than stock or securities) of a kind regularly traded on an established market;”[[896]](#footnote-897)
          4. Sale of depreciable property[[897]](#footnote-898) to related persons;[[898]](#footnote-899) and
          5. Portion of gain attributable to depreciation recapture under section 1245 and 1250.[[899]](#footnote-900)
       2. Regarding the ineligibility to sell publicly traded stocks and securities, the Code gives Treasury authority to issue regulations disallowing the use of the installment method for transactions where the restrictions barring use of the installment method for sales of publicly traded property would be avoided by use of related parties, pass-through entities, or intermediaries.[[900]](#footnote-901) According to the legislative history, these Treasury Regulations would apply to sales of property where a substantial portion of the property's value is attributable to gain from publicly traded property.[[901]](#footnote-902) However, the installment method would available if the taxpayer cannot directly sell, or cause the direct sale of, publicly traded stocks or securities.[[902]](#footnote-903) To date, these Treasury Regulations have not been promulgated.
       3. If there is a sale of depreciable property to an unrelated person, the seller must recognize any income recaptured under these sections as ordinary income in the year of sale, but any portion attributable to capital gain would continue to be taxed under the installment method.[[903]](#footnote-904) If there is a sale of depreciable property to related persons, the installment method is unavailable for the entire transaction.[[904]](#footnote-905) In that case, all payments to be received pursuant to a sale of depreciable property are treated as received in the year of sale and are taxed as ordinary income.[[905]](#footnote-906) “Related persons” is defined in section 1239(b), except that it includes “2 or more partnerships having a relationship to each other described in section 707(b)(1)(B).” These related persons provisions were discussed earlier in these materials. This rule denying installment method reporting on the sale of depreciable property to related persons does not apply if it can be established to the satisfaction of the IRS that the sale did not have as one of its principal purposes the avoidance of Federal income taxes.[[906]](#footnote-907)
    2. Resales of Purchased Property by a Related Person
       1. If a person sells property under the installment method to a related party (the “first disposition”), and the related-party purchaser thereafter resells the property within two years after the first disposition (the “second disposition”) before the original seller has received all payments due with respect to the first disposition, the amount realized by the related party on the second disposition is treated as a payment received at that time by the original seller.[[907]](#footnote-908) In such case, the amount treated as received by the original seller for any taxable year as a result of the second disposition by the related party cannot exceed: (1) the lesser of the total amount realized by the related party on the second disposition before the close of the taxable year, or the total contract price for the first disposition, reduced by (2) the sum of the total payments received by the original seller on the first disposition before the close of such year, plus the amounts treated as received on the first disposition in prior taxable years as a result of this related-party resale rule.[[908]](#footnote-909)
       2. Two years following the first disposition, however, the related party who has an adjusted basis equal to cost basis from the first disposition can sell the property with little or no gain.

Example: S sells property with an adjusted basis of $40 to R for $100, payable in 10 equal annual installments ($10 per year plus interest). R is a non-grantor trust created by S for the benefit of S’s spouse and descendants. The gross profit percentage is 60%. Over the next two years, S receives two annual payments if $10 per year plus interest, recognizing in aggregate to S will be treated as $12 of gain (60% of $10 annual payment over 2 years), $8 of nontaxable recovery of basis, and interest (ordinary income). Soon thereafter, more than two years after the first disposition, R sells the property for $100 in cash to another non-grantor trust, recognizing no gain on the second disposition. After the second disposition, R holds $100 of cash with a remaining obligation to pay $80 to S. S has only recognized $12 of gain at that point.

* + - 1. The foregoing example assumes the property purchased in the first disposition did not depreciate in value over the two-year period. If taxpayers could be assured the property would not lose value during the two-year period, then it could be a powerful way for families to sell property under the installment method (deferring gain) but receive 100% of the consideration within two years. To that end, the Code provides, the “running of the 2-year period … shall be suspended with respect to any property for any period during which the related person's risk of loss with respect to the property is substantially diminished by:”[[909]](#footnote-910)
         1. The “holding of a put with respect to such property (or similar property),”[[910]](#footnote-911)
         2. The “holding by another person of a right to acquire the property,”[[911]](#footnote-912) or
         3. A “short sale or any other transaction”[[912]](#footnote-913) that effectively reduces the risk of loss (by the related party).
      2. For purposes of these related party resale rule, the term “related person” includes more relationships than “related persons” is used with depreciable property installment sales. “Related person” means: (i) “a person whose stock would be attributed under section 318(a) (other than paragraph (4) thereof) to the person first disposing of the property,”[[913]](#footnote-914) or (ii) “a person who bears a relationship described in section 267(b) to the person first disposing of the property.”[[914]](#footnote-915) These Code sections are discussed in more detail earlier in these materials. In pertinent part, the following relationships are “related persons” and people are deemed to be related to the first seller:
         1. Spouse (unless legally separated under a divorce decree or separate maintenance decree), children (including legally adopted children), grandchildren (and other lineal descendants), brothers and sisters (including half siblings), parents, and grandparents (and other ancestors);[[915]](#footnote-916)
         2. A partnership in which the original seller is a partner;[[916]](#footnote-917)
         3. An estate of which the original seller is a beneficiary;[[917]](#footnote-918)
         4. A trust of which the original seller is a beneficiary or treated as an owner (i.e., grantor trust);[[918]](#footnote-919) and
         5. A corporation in which the first seller owns, directly or indirectly, 50% or more of the value of the stock.

In addition to the foregoing, the relationships defined in sections 267(b)(3) through 267(b)(13) of the Code fall within the meaning of “related persons” for purposes of resales of purchased property. Those relationships are outlined earlier in these materials.

* + - 1. For purposes of the related person resale rules, a “second disposition” includes a sale, exchange, gift, or cancellation of the installment obligation. That being said certain types of “dispositions” are excluded from these rules. If the first disposition is a sale or exchange of stock to the issuing corporation (i.e., redemption), any subsequent disposition by the corporation is not treated as a second disposition.[[919]](#footnote-920) A compulsory or involuntary exchange within the meaning of section 1033 and any transfer thereafter will not be considered a second disposition if the first disposition occurred before the threat or imminence of the conversion.[[920]](#footnote-921) Importantly, any transfer after the earlier of the death of the seller in the first disposition, or the death of the related person who acquired the property, any transfer thereafter will not be considered a “second disposition.”[[921]](#footnote-922) Finally, the Code provides the resale rules will not apply to a second disposition (and any transfer thereafter) if “it is established to the satisfaction of the Secretary that neither the first disposition nor the second disposition had as one of its principal purposes the avoidance of Federal income tax.”[[922]](#footnote-923)
    1. Basis, Bequests, Gifts and Other Dispositions of Installment Obligations
       1. Section 453B(b) of the Code provides, “The basis of an installment obligation shall be the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full.”[[923]](#footnote-924)

Example: S sells property with an adjusted basis of $40 to B for $100, payable in 10 equal annual installments ($10 per year plus interest). The gross profit to S is $60. The gross profit percentage is 60% Each annual payment to S will be treated as $6 of gain, $4 of nontaxable recovery of basis, and interest. Prior to the first payment, S’s adjusted basis in the installment obligation is $40 (face value of $100 less $60, the income which would be returnable if the obligation is satisfied in full). After the first payment, S’s adjusted basis is $46 (face value of $100 less $54, the remaining unrealized gain).

* + - 1. The transfer of an installment obligation due to the death of the holder of the installment obligation (installment note) is not considered a taxable disposition.[[924]](#footnote-925) The installment obligation (the remaining unrealized gain of the obligation) is considered IRD.[[925]](#footnote-926) As a result, as discussed above, there is no step-up in basis under section 1014 of the Code, and the unrealized gain and interest will be taxable to the estate and the beneficiaries as payments are received by them.[[926]](#footnote-927) If the installment obligations is distributed by bequest, devise, inheritance, or other transfer after the death of the holder to the obligor (buyer), such transfer is considered a taxable disposition and gain must be reported by the holder’s estate.[[927]](#footnote-928) If the estate sells the installment obligation, the estate recognizes income to the extent of the fair market value of the obligation at the time of the transfer or the consideration received for the transfer, whichever is greater, reduced by the adjusted basis of the obligation.[[928]](#footnote-929) The income reportable by the estate upon such a sale or exchange retains the same character as that which would have been reported by the decedent had the obligation been disposed of by him.[[929]](#footnote-930) If, however, the estate distributes the obligation to a beneficiary in satisfaction of a specific bequest or as a part of a residuary bequest, it is not regarded as a (taxable) transfer for purposes of section 691 of the Code.[[930]](#footnote-931) If an installment obligation is held in joint tenancy with right of survivorship, the passage of ownership to the survivor upon the death of one of the joint tenants is not treated as a taxable disposition.[[931]](#footnote-932)
      2. Section 453B(a) of the Code provides if (i) an installment obligation is satisfied for other than its face value, or (ii) distributed, transmitted, sold, or otherwise dispose of, then gain or loss will be recognized. The amount of gain or loss is measured by the difference between the adjusted basis of the obligation and either (i) the “amount realized, in the case of satisfaction at other than face value or a sale or exchange,”[[932]](#footnote-933) or (ii) the “fair market value of the obligation at the time of distribution, transmission, or disposition, in the case of the distribution, transmission, or disposition otherwise than by sale or exchange.”[[933]](#footnote-934) The latter measure of gain and loss is applicable if if the seller cancelled the buyer's indebtedness[[934]](#footnote-935) or the seller gifted the obligation.[[935]](#footnote-936) If a partnership holds an installment obligation, a sale, exchange, or gift of an interest in the partnership is a taxable disposition of the installment obligation.
      3. The transfer of an installment obligation to a trust constitutes a taxable disposition if the seller (grantor) is not considered the owner of the trust under the grantor trust rules.[[936]](#footnote-937) A court has held that the fact that the grantor retained a life estate is immaterial where the transfer is to an irrevocable trust and the transferor is not regarded as the owner.[[937]](#footnote-938) The distribution of an installment obligation by a trust to a beneficiary, if the installment obligation arose from a sale of property by the trust, is also a taxable disposition. A distribution of an installment obligation in satisfaction of a specific dollar amount, or at the termination of a trust, is also a taxable disposition.[[938]](#footnote-939) A distribution from grantor trust to the grantor (beneficiary) is not a taxable disposition.[[939]](#footnote-940) A transfer of an installment obligation for the benefit of a spouse or a former spouse is not a taxable disposition if the transfer is incident to a divorce.[[940]](#footnote-941) In such instance, the transferee spouse recognizes the remaining unreported gain as the installment payments are received in the same manner as would have applied to the transferor.[[941]](#footnote-942)
      4. In 2014, the IRS issued proposed regulations[[942]](#footnote-943) that provide there is no gain or loss under section 453B of the Code on certain tax free exchanges, including (i) transfers to a corporation under sections 351 (tax free exchange of property for stock in a controlled corporation) and 361 of the Code (distributions pursuant toa tax free reorganization); (ii) contributions to a partnership[[943]](#footnote-944) under section 721 of the Code (tax free contribution in exchange for a partnership interest); and (iii) distributions from a partnership to a partner under section 731 of the Code (general rule that distributions of partnership property in-kind are tax free), except as provided by sections 704(c)(1)(B), 736, 737, and 751(b) of the Code (i.e., disguised sale and mixing bowl rules that are exceptions to general tax free distribution rule).[[944]](#footnote-945) The foregoing exception does not, however, apply to any disposition that results in a satisfaction of an installment obligation, even if there is no recognition of gain or loss on the disposition under the Code. Specifically, these transaction include, but are not limited to (i) the receipt of stock of a corporation from the corporation in satisfaction of an installment obligation of the corporation,[[945]](#footnote-946) and (ii) receipt of an interest in a partnership from the partnership in satisfaction of an installment obligation of the partnership.[[946]](#footnote-947) If an S corporation distributes an installment obligation in a complete liquidation, the distribution is not treated as a taxable disposition as long as receipt of the obligation is not treated as payment for the stock.[[947]](#footnote-948) Thus, except for tax imposed by subchapter S, the S corporation will not recognize gain or loss on the distribution.[[948]](#footnote-949) The character of gain or loss subsequently reported by the shareholder will be determined by reference to the character of the gain or loss that would have been reported by the S corporation.[[949]](#footnote-950)
  1. IDGT Installment Notes
     1. IRD or Step-Up?
        1. As noted above, while grantor trust status is maintained, nothing is deemed to have occurred between the grantor and the grantor trust for Federal income tax purposes. That includes any subsequent exchanges of other property of equivalent value, including an exchange of the originally sold property to the IDGT. As such, the grantor-seller holding an installment note pursuant to a sale property to an IDGT (IDGT installment note) effectively has no finally determined tax basis in the installment obligation. The concept of tax basis is moot until grantor trust status terminates, on death or otherwise.
        2. Upon the death of a grantor of owning an IDGT installment note, it is clear that the IDGT installment note will not be considered IRD like a taxable installment note and as such should be entitled to a step-up in basis under section 1014 of the Code. Despite the similarities between IDGT and taxable installment notes, they are fundamentally different. An IDGT installment note included in a holder’s estate can not be IRD as long as Revenue Ruling 85-13 remains effective. IRD can only include property that would have been taxable “in the hands of the decedent if the decedent had lived and received such amount.”[[950]](#footnote-951) As such, the basis adjustment at death under section 1014 of the Code makes the issue of the adjusted basis of the IDGT installment note of no consequence. IDGT installment notes likely satisfy the definition of the capital asset under section 1221(a) of the Code, but even if it doesn’t, capital asset status is irrelevant for purposes of section 1014 of the Code.[[951]](#footnote-952)
     2. Basis of IDGT Installment Notes
        1. The basis of an IDGT installment note becomes relevant if the grantor transfers the IDGT installment note or grantor trust status is terminated during the grantor’s lifetime. Unfortunately, there has been no guidance about whether the an IDGT installment note has tax basis and if so, what the basis might be. It seems that the only answer is the IDGT installment note can only have an adjusted basis equal to the property that was exchanged in the installment sale to the IDGT. An analogy to this treatment is a taxpayer who make a tax free exchange of property with the IDGT, receiving in the exchange an asset (IDGT installment note) that has a carryover basis of the exchanged property. This is explored in a series of examples below.
        2. Example 1: G sells to G’s IDGT property having an adjusted basis of $40 in exchange for an IDGT installment note having a face value of $100, payable in 10 equal annual installments ($10 per year plus interest at the appropriate AFR). Property collateralizes the $100 installment obligation to G. Immediately after the sale, G releases a power and terminates grantor trust status.
           1. As discussed above, the termination of grantor trust status is treated as a transfer of the property to the trust and because there is debt of $100 in excess of the basis ($40), G recognizes $60 of gain. What is G’s basis in G’s installment obligation prior to the exchange? It must be $40. This is because if G had sold the property to a non-grantor trust and it qualified for installment sale treatment, then G’s installment obligation, as discussed above, would have a basis under section 453B(b) of the Code equal to $40. Selling to an IDGT and immediately terminating grantor trust status is effectively the same thing as a taxable installment sale with a non-grantor trust. However, the tax result, in this instance is considerably worse because G recognized $60 of gain, leaving G with an installment obligation with a basis of $100, and the trust has property of basis equal to $100. Because basis is effectively a measure of the total after-tax investment of a taxpayer in property, this make sense. If G purchased the property for $40 and recognized gain of $60, for a total amount after-tax investment of $100. The trust also carries the same after-tax investment of G upon the deemed transfer of the property.
           2. The only other possible options are the IDGT installment obligation, prior to the termination of grantor trust status, has a basis of zero or a basis equal to the trust’s obligation to G of $100. Neither of those make any sense. If it had zero basis, then after the conversion, G’s resulting basis is $60, leaving G with an additional $40 of unrealized gain. G invested $40 and recognized an additional $60 of gain. If G continues to hold an installment obligation with a basis of $60, then if G sells the installment obligation for its face value of $100, G would recognize an additional $40 for a total of $140 of after-tax investment in this transaction for a transferred property that only has $100 of adjusted basis. If it had a basis of $100 before the conversion, then G would have $160 of basis, and G would be able to sell the installment obligation for $100 and possibly generate a $60 loss, netting G with a total $40 of after tax investment ($40 cost basis plus $60 of gain less $60 of loss).
        3. Example 2 : G sells to G’s IDGT property having an adjusted basis of $40 in exchange for an IDGT installment note having a face value of $100, payable in 10 equal annual installments ($10 per year plus interest at the appropriate AFR). Immediately after the sale, G gifts the IDGT installment note (having fair market value of $100) to G’s child, C. What is C’s adjusted basis in the installment obligation?
           1. Assuming G’s has a basis in installment obligation of $40 at the time of the gift, then C would get carryover basis on the note. With a taxable installment note, under section 453B(a) of the Code, a gift of an installment obligation is considered a taxable disposition, which would cause the transferor to recognize gain.[[952]](#footnote-953) However, if G had continued to hold and receive payments on the IDGT installment obligation, G would not have recognized any gain at all. Imposing $60 of gain on G due to the gift would give C adjusted basis in the installment note of $100, but G’s trust would theoretically still be at $40. There doesn’t seem to be any mechanism to “true-up” basis in the IDGT because there has been a taxable disposition (like a taxable sale of a partnership interest would entitle the partnership to make an inside basis adjustment under section 734 of the Code). The trust would get an increase in basis to $100 if G terminates grantor trust status after the gift, in this example, but that would be at the cost of an additional recognition of gain of $60 by the G because of the deemed transfer of the property with debt in excess of basis.
           2. If the gift is not a taxable disposition under section 453B(a) of the Code then C has a carryover basis in the installment obligation. Both C and the IDGT hold assets having a basis of $40 respectively, which provides parity, but that doesn’t necessarily resolve other issues. For example, if after the gift to C, G terminates grantor trust status, then, as discussed above, G will recognize $60 of gain, the trust will have $100 of basis in the property, but C will only have $40 of basis in C’s installment obligation. That would mean that as the trust makes installment payments, C might be required to recognize gain with each payment under the installment method. That seems inequitable. The correct result would be to interpret “gross profit” in the definition of “installment method” under section 453(c) of the Code to incorporate G’s recognized gain. In other words, the phrase “gross profit (realized or to be realized when payment is completed)”[[953]](#footnote-954) would take into account that gross profit does not include recognized gain. Under that interpretation, each annual payment to C would be $10 of nontaxable recovery of basis and interest. If G does not terminate grantor trust status, and the trust makes all of its payments to C in satisfaction of its obligation, then over the 10 annual installments, C will have, in aggregate, recognized $60 in gain (plus interest). A subsequent termination of grantor trust status by G would not result in any more gain because debt no longer exists at the trust level. However, the trust will still have $40 in basis on the property, and a subsequent sale of the trust property would cause G to recognize $60 in gain. Between C and G, $120 of gain is recognized, but the property (which had $40 of cost basis) is sold for $100 in total. That doesn’t seem correct. G could terminate grantor trust status after the installment obligation is fully paid. No gain would result on the termination, but it would leave the trust with $60 of unrealized gain. Again, that doesn’t seem correct.
           3. The only seemingly equitable way to treat a gift of an IDGT installment note is to treat the transfer like an open transaction. The initial transfer to C would not be considered a taxable disposition under section 453B(a) of the Code. As an open transaction, if G recognizes gain (due to a termination of grantor trust status or a sale by the trust of the property), then the “gross profit” ratio would be adjusted to reflect the recognition of gain by G, and the taxable portion of C’s installments would be adjusted. Unfortunately, there does not seem to be any mechanism in the Code or the Treasury Regulations to accomplish this.
        4. Example 3: G sells to G’s IDGT property 1 having an adjusted basis of $40 in exchange for an IDGT installment note having a face value of $100, payable in 10 equal annual installments ($10 per year plus interest at the appropriate AFR). Immediately after the sale, G swaps property 2, which has an adjusted basis of $80 and a fair market value of $100. Property 2 collateralizes the $100 obligation to G. At the same time, G terminates grantor trust status.
           1. Upon termination, G’s basis in the installment obligation seems to be $80, and the termination of grantor trust status will cause G to recognize $20 of gain (rather than $40 of gain in the example 1 above).
           2. This does bring up an interesting planning opportunity. What if the IDGT held other assets having an aggregate basis in excess of $100? The IDGT could agree to collateralize those assets and release the lien on property 2 (or even property 1, if the swap did not occur). Upon termination of grantor status, the deemed transfer would not result in a discharge of liability that is in excess of the basis of the assets.
  2. Planning with Intra-Family Promissory Notes
     1. Interest and Income Taxation Treatment of Interest
        1. Intra-family loans are common ways for families to not only to transfer wealth for estate planning purposes but to provide easy and hopefully in expensive liquidity and capital to family members. In order to avoid adverse gift tax consequences, it is commonly understood that the loan (and the evidence of the indebtedness, the promissory note) must bear at least interest at the appropriate AFR.[[954]](#footnote-955) If the loan does not bear sufficient interest, it is treated as a below-market loan under section 7872 of the Code and the “forgone interest” is treated as “transferred from the lender to the borrower,” and “retransferred by the borrower to the lender as interest.”[[955]](#footnote-956) The foregone interest is treated as a gift by the lender to the borrower for transfer tax purposes,[[956]](#footnote-957) and for income tax purposes, interest is deemed paid by the borrower and received by the lender.
        2. Unless the loan is made between a grantor and a grantor trust, the lender’s receipt of interest will be ordinary income to the lender,[[957]](#footnote-958) and the borrower will not be able to deduct the interest for income tax purposes. Section 163(h)(1) of the Code provides, “In the case of a taxpayer other than a corporation, no deduction shall be allowed under this chapter for personal interest paid or accrued during the taxable year.”[[958]](#footnote-959) “Personal interest” is, in turn, defined by exception is “any interest allowable as a deduction”[[959]](#footnote-960) other than: (i) interest paid on debt property allocable to a trade or business (other the performance of services),[[960]](#footnote-961) (ii) investment interest,[[961]](#footnote-962) (iii) interest used to compute income or loss from the passive activity of the taxpayer under section 469 of the Code,[[962]](#footnote-963) (iv) qualified residence interest,[[963]](#footnote-964) (v) interest on deferred estate tax liabilities,[[964]](#footnote-965) and (vi) interest on qualified education loans deductible under section 221 of the Code. [[965]](#footnote-966)
     2. Exchange or Substitution of Notes
        1. When interest rates decline, it is common for estate planners to seek to exchange or substitute the notes with those that have lower interest rates. It is commonly believed that such an exchange, as long as the substitution note bears interest at the appropriate AFR at the time of the exchange, will not be considered at taxable gift, particularly if the terms of the original loan contain a no prepayment penalty clause.[[966]](#footnote-967) From an income tax perspective, if the exchange is between a grantor and a grantor trust, no gain or loss will be recognized under Revenue Ruling 85-13. The same would also apply to an exchange or substitution between spouses under section 1041 of the Code.
        2. If the substitution is with another taxpayer other than those mentioned above, substitution of a note could be considered a taxable event for both parties. As discussed above, *Cottage Savings* and the Treasury Regulations provide, “the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.”[[967]](#footnote-968) The Treasury Regulations also provide that a modification of the debt could be a taxable event.[[968]](#footnote-969) The Treasury Regulations provide an exception for interest rate changes that are set out in the terms of the debt instrument or at the exercise of unilateral option in one party,[[969]](#footnote-970) but do not provide an exception for a reduction in the interest rate exercised without a legal right to do so under the debt instrument.
        3. If the substitution of a note is deemed a taxable exchange (or significant modification), then the borrower (now obligated to pay interest at a lower rate) may have COD income. The Code provides, “For purposes of determining income of a debtor from discharge of indebtedness, if a debtor issues a debt instrument in satisfaction of indebtedness, such debtor shall be treated as having satisfied the indebtedness with an amount of money equal to the issue price of such debt instrument.”[[970]](#footnote-971) The issue price is determined under sections 1273 and 1274 of the Code (although only section 1274 applies under these circumstances).[[971]](#footnote-972) The Treasury Regulations further provide, “An issuer realizes income from the discharge of indebtedness upon the repurchase of a debt instrument for an amount less than its adjusted issue price (within the meaning of Section 1.1275-1(b)).”[[972]](#footnote-973) Thus, the amount of COD is the difference between the “issue price” of the new promissory note and the “adjusted issue price” of the original promissory note.
        4. Section 1274 of the Code provides when the new promissory note bears “adequate stated interest” (AFR), the “issue price” is the “stated principal amount” (face amount of the note).[[973]](#footnote-974) The “adjusted issue price” is the “issue price of the debt instrument” increased by original issue discount (OID) includible in the gross income of the holder, and decreased by any payment previously made on the debt instrument, other than qualified stated interest. It is generally safe to assume under most family arrangements, the original promissory will not be an OID. If (i) the original note was issued with the appropriate AFR, (ii) the new promissory note is also issued at the appropriate AFR, even if the AFR is lower than the interest rate on the original note, and (iii) the face value of the new note equals the remaining amount of debt on the original note, there should be no COD. Importantly, if there is a deemed cancellation of indebtedness between family members, then it could be treated as a gift from the lender to the borrower, which would not be income to the borrower under section 102 of the Code.
  3. Promissory Notes: Basis and Capital Asset
     1. When a creditor loans cash to a borrower and receives a promissory note in return, the creditor’s adjusted basis in the promissory note is equal to the cash loaned. The promissory note meets the definition of a capital asset under section 1221(a) of the Code, and if the note is included in the gross estate of the holder of the note, then the note will get a basis adjustment under section 1014 of the Code, much like IDGT installment notes (but unlike taxable installment notes, which are IRD). If a creditor “loaned” property to a borrower, the “note” (or whatever evidence of the obligation to return the property) would have an adjusted basis equal to the basis of the loaned property, much like the lending of securities in a “short sale.”[[974]](#footnote-975)
     2. As discussed above, sometimes, under the swap power, a grantor exchanges his or her own promissory note for assets in an IDGT, the exchange and all payments on the promissory note will be ignored for Federal income tax purposes, as long as grantor trust status remains. If, however, grantor trust status is terminated (by death or during the lifetime of the grantor), it is unclear what tax basis the IDGT has in the promissory note. As discussed above, the promissory note, this obligation to pay, will have the same basis that the grantor had in the note at the time of the exchange. Unlike a traditional loan where funds are actually transferred, the issue at hand is whether a grantor has basis in his or her own promise to pay as evidenced by the promissory note held by the IDGT. If not, then the basis is likely to be zero. If the grantor does have basis, then the basis is likely to be the amount of the indebtedness.
     3. If the basis in the promissory note is zero, then when grantor trust is terminated, the trust will have a zero basis in the note, such that when the note is ultimately satisfied by the debtor (the estate or beneficiaries of the estate), capital gain will be recognized by the trust.
        1. The IRS position is that a debtor has no basis in his or her own promissory note.[[975]](#footnote-976) The Tax Court has consistently held when partners have contributed promissory notes to a partnership, the contributing partner does not get increased adjusted basis in his or her partnership interest because the partner has no basis in the note.[[976]](#footnote-977) In *Gemini Twin Fund III v. Commissioner*, the Tax Court wrote, “Even assuming, as petitioner argues, that a note is property under State law and for other purposes, a taxpayer has no adjusted basis in his or her own note. Until the note is paid, it is only a contractual obligation to the partnership. The existence of collateral does not change this result.”[[977]](#footnote-978)
        2. However, in other contexts, the courts have held that an unsecured promissory note does, in fact, create basis, as long as the note represents a genuine indebtedness. In *Peracchi v. Commissioner*,[[978]](#footnote-979) the taxpayer contributed real property to a corporation. The real property was encumbered by debt in excess of basis. Under section 357(c) of the Code, any liabilities in excess of basis will be considered gain upon contribution to a corporation (in this case, NAC) controlled by the taxpayer under section 351 of the Code. To avoid this gain, the taxpayer also contributed a promissory note in an amount equal to the excess liabilities, claiming the note had a basis equal to its face amount. The IRS argued that the note has a zero basis. The Ninth Circuit agreed with the taxpayer. The opinion provides:[[979]](#footnote-980)

We are aware of the mischief that can result when taxpayers are permitted to calculate basis in excess of their true economic investment. *See* Commissioner v. Tufts, 461 U.S. 300 (1983). For two reasons, however, we do not believe our holding will have such pernicious effects. First, and most significantly, by increasing the taxpayer's personal exposure, the contribution of a valid, unconditional promissory note has substantial economic effects which reflect his true economic investment in the enterprise. The main problem with attributing basis to nonrecourse debt financing is that the tax benefits enjoyed as a result of increased basis do not reflect the true economic risk. Here Peracchi will have to pay the full amount of the note with after-tax dollars if NAC's economic situation heads south. Second, the tax treatment of nonrecourse debt primarily creates problems in the partnership context, where the entity's loss deductions (resulting from depreciation based on basis inflated above and beyond the taxpayer's true economic investment) can be passed through to the taxpayer. It is the pass-through of losses that makes artificial increases in equity interests of particular concern. *See*, *e.g.*, Levy v. Commissioner, 732 F.2d 1435, 1437 (9th Cir. 1984). We don't have to tread quite so lightly in the C Corp context, since a C Corp doesn't funnel losses to the shareholder.

The court then goes on to point out that if the note has a zero basis, then the corporation also will have a zero basis in the note,[[980]](#footnote-981) which would create a subsequent gain if the note then was sold to a third party:[[981]](#footnote-982)

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

The dissenting judge in the *Perrachi* opinion remarked, “The taxpayer has created something -- basis -- out of nothing.”[[982]](#footnote-983)

* + 1. It is unclear what this means for swap transactions with an IDGT and the tax ramifications upon repayment of the debt when the IDGT becomes a non-grantor trust. What is clear is that the IRS will claim that the grantor’s note has no tax basis. There are sound arguments on both sides of the debate, although most believe these self-created promissory notes, where no funds or assets have been transferred, should have a basis of zero.[[983]](#footnote-984)
  1. Valuation and Inclusion of IDGT Installment and Promissory Notes
     1. IDGT installment notes and promissory notes are very similar. They evidence the obligation of one party to pay the principal and stated interest. As mentioned, both are entitled to a basis adjustment to fair market value under section 1014 of the Code, and as to that valuation, the Treasury Regulations provide:

The fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus interest accrued to the date of death, unless the executor establishes that the value is lower or that the notes are worthless. However, items of interest shall be separately stated on the estate tax return. If not returned at face value, plus accrued interest, satisfactory evidence must be submitted that the note is worth less than the unpaid amount (because of the interest rate, date of maturity, or other cause), or that the note is uncollectible, either in whole or in part (by reason of the insolvency of the party or parties liable, or for other cause), and that any property pledged or mortgaged as security is insufficient to satisfy the obligation.[[984]](#footnote-985)

* + 1. The IRS has agreed that “all available data and all relevant factors affecting the fair market value must be considered”[[985]](#footnote-986) in determining the value of a promissory note, and face value is not necessarily the value to be included in the gross estate. Many practitioners have, in the past, claimed valuation discounts on installment note obligations included in the estate due to a number of factors including a low interest rate, lack of security, and the obligor’s inability to pay the note as it becomes due.[[986]](#footnote-987) Practitioners may want to consider whether a valuation discount should be claimed today if the obligation will be entitled to a “step-up” in basis to fair market value at little or no transfer tax cost (assuming there is sufficient applicable exemption amount available at the time of the grantor’s death). Note that valuation is an issue for gift tax purposes too. If a note has an interest rate in excess of the applicable rate on the date of a gift, the value of the note could exceed the stated principal value.

1. TRUST MODIFICATIONS, SALES, DECANTINGS, AND TERMINATIONS
   1. Uniform Basis Rules
      1. As discussed above, when property is acquired by gift or from a decedent, the property has a basis determined either sections 1015 or 1014 of the Code, as the case may be. That basis can be shared among different owners of the property if, for example, the property is jointly owned by the recipients. The same holds true if the property is held in trust for the benefit of multiple beneficiaries, with varying interests in the trust property. The Treasury Regulations explain, “The principle of uniform basis means that the basis of the property (to which proper adjustments must, of course, be made) will be the same, or uniform, whether the property is possessed or enjoyed by the executor or administrator, the heir, the legatee or devisee, or the trustee or beneficiary of a trust created by a will or an inter vivos trust.”[[987]](#footnote-988) In one sense, the uniform basis rules is the historical amount of basis that is transferred from the donor or the decedent to the recipient.[[988]](#footnote-989) Indeed, from the moment of the transfer, the recipient becomes the owner of the property and is responsible for all tax items associated with the property. In the context of a trust, a beneficiary will generally not receive all of the interests in the trust, and the beneficiary’s partial interest in the trust property is reflected in the beneficiary’s partial interest in the uniform basis. As such, when an interest in a trust (e.g., income, remainder, life, or term) is commuted, sold, or otherwise disposed of for consideration, the uniform basis rules determine the gain or loss on such disposition.[[989]](#footnote-990)
      2. Initially, uniform basis starts with the basis of the property transferred in trust either under sections 1015 (gift) or 1014 (testamentary transfer) of the Code. Except for certain allowable adjustments allowable under section 1016 (capital expenditures and cost recovery reductions) and 1017 (changes to basis due to discharge of indebtedness) of the Code (arriving at the “adjusted uniform basis”),[[990]](#footnote-991) uniform basis remains the same, regardless of whether the originally contributed property is sold at a gain or a loss. Uniform basis, as properly adjusted for basis adjustments, is used for computing depreciation, depletion, and amortization deductions.[[991]](#footnote-992) The sale, exchange, or other disposition by a life tenant or remainderman of the life interest or remainder has no effect on the property's uniform basis in the hands of those who acquired it from the decedent or donor. As a result, gain or loss on a sale of trust assets by the trustee is determined without regard to any prior sale of any interest in the property, and adjustments for cost recovery deductions at the trust level are likewise unaffected by such prior sale.[[992]](#footnote-993) Depreciation, depletion, and amortization deductions allowed or allowable to a trustee and to the trust beneficiaries constitute adjustments to the basis of the property not only in the hands of the trustee, but also in the hands of the trust beneficiaries and every other person to whom the uniform basis applies.[[993]](#footnote-994) Similarly, adjustments for capital expenditures or losses, tax-free distributions, or other distributions that reduce basis, and other items for which the basis must be adjusted are made without regard to which one of the persons to whom the same uniform basis applies makes the capital expenditures or sustains the capital losses, or to whom the tax-free or other distributions are made, or to whom the deductions are allowed or allowable.[[994]](#footnote-995) Thus, if a some trust property is distributed to a beneficiary, carrying with it a some of the basis, the uniform basis will be reduced. Furthermore, the uniform basis rules do not apply when a trust or estate sells property to a beneficiary. The beneficiary’s basis is determined under the usual basis rules applicable between unrelated persons.[[995]](#footnote-996)
      3. The Treasury Regulations provide that the actuarial factors contained in section 20.2031-7(d)(7) will determine the amount of total basis allocated to a life interest, term interest, or remainder interest in property on the date such interest is sold,[[996]](#footnote-997) and those actuarial factors are contained in the Treasury Regulations under section 7520 of the Code.[[997]](#footnote-998) Thus, the “uniform basis” is the total basis of all interest in the property, and the sum of the parts equals the basis of the underlying assets (i.e., in trust). However, the allocation of that uniform basis among the interests will be based upon the relative values attributed to such interests. As a result, as a life tenant grows older and the remaining time left on a term of years gets shorter, the value of those interests decrease and its share of the uniform basis gets smaller. The decrease is offset by increases in the value (and share of basis attributable to) the remainder interest. The relative values between life, term, or remainder interests will also change with the section 7520 rate each month. Higher section 7520 rates generally increase the value of life and term interests (decrease to the remainder interest), and lower interest rates will increase the value of the remainder interest. Finally, when life expectancy factors under section 7520 are updated, the relative values of the interests will also change.[[998]](#footnote-999)
      4. Section 1001(e) of the Code provides, “In determining gain or loss from the sale or other disposition of a term interest in property, that portion of the adjusted basis of such interest which is determined pursuant to section 1014, 1015, or 1041 (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded.”[[999]](#footnote-1000) Thus, if there is a sale or other taxable disposition of a “term interest,” any basis that would have been attributed to such “term interest” shall be ignored. A “term interest” in property means a “life interest in property,” an interest in property for a term of years,” or an “income interest in a trust.”[[1000]](#footnote-1001) The foregoing “zero basis” rule “shall not apply to a sale or other disposition which is a part of a transaction in which the entire interest in property is transferred to any person or persons.”[[1001]](#footnote-1002)
      5. Example 1 (FMV Equals Basis): Decedent funds a testamentary trust with $1 million of property, the basis of which is determined under section 1014 of the Code. The trust provides for a life estate for the decedent’s spouse who is 55 years of age and remainder to their child. At the time of the decedent’s death the section 7520 rate is 2.0%.
         1. On the date of death, the spouse’s life estate is worth $383,650 or 38.365% of the fair market value of the trust property, and the child’s remainder interest is worth $616,350 (61.635% of the value).[[1002]](#footnote-1003)
         2. Spouse’s share of the $1 million of uniform basis is $383,650, and child’s share of the uniform basis is $616,350.
      6. Example 2 (FMV Increases, Time Passes, and 7520 Rate Changes): Same facts as above, except 5 years have passed, and the spouse is 60 years of age. The property in the trust has appreciated to $1.4 million, and the section 7520 rate is 4.0%.
         1. Spouse’s life estate is worth $751,660 or 53.690% of the fair market value of the trust property, and the child’s remainder interest is worth $648,340 (46.310% of the value).
         2. Spouse’s share of the $1 million of uniform basis is $536,900, and child’s share of the uniform basis is $463,100.

Notice, despite the fact that spouse is 5 years older, the combination of a higher section7520 rate and an increase in value causes spouse’s share of the uniform basis, which does not change, to significantly increase. It’s also important to note that the property in the trust may have a basis that is higher than $1 million.

* 1. Sales of Partial Interests
     1. Sale of Term Interest or Other Transfer
        1. Section 1001(e)(1) of the Code provides, “In determining gain or loss from the sale or other disposition of a term interest in property, that portion of the adjusted basis of such interest which is determined pursuant to section 1014, 1015, or 1041 (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded.”[[1003]](#footnote-1004) Thus, if there is a sale or other taxable disposition of a “term interest,” any basis that would have been attributed to such “term interest” shall be ignored. A “term interest” in property means a “life interest in property,” an interest in property for a term of years,” or an “income interest in a trust.”[[1004]](#footnote-1005) This effectively provides that a term interest will effectively have zero basis in a sale or taxable exchange of just a term interest.
        2. Transferring a term interest to a controlled corporation in a tax-free exchange under section 351 of the Code, followed by a sale of the corporation’s stock, will not provide the term holder with basis. Even worse, the corporation will not have any basis in the term interest.[[1005]](#footnote-1006) Assuming the corporation is a C corporation, this would eventually mean double taxation of the property. When the shareholder sells the stock of the corporation, gain will be recognized. When the corporation sells the term interest, the corporation will recognize gain at the entity level with no benefit of basis.
     2. Sale of Remainder Interest or Other Transfer
        1. There is no corresponding rule for remainder interests. Thus, the basis used in computing gain or loss realized from a sale or other disposition of a remainder interest in property acquired through a decedent or from a donor equals the portion of the adjusted uniform basis assignable to the remainder interest.[[1006]](#footnote-1007) Thus, a remainder interest can be sold, and the seller of the remainder interest will be entitled to use its portion of the adjusted uniform basis to calculate gain or loss in the transaction.
        2. If the holder of a remainder interest predeceases the life tenant, the interest’s uniform basis is not adjusted because of the death of the remainder owner.[[1007]](#footnote-1008) However, the basis of the remainder in the hands of the successor to the remainder owner equals the portion of the uniform basis assigned to the remainder: (i) increased by any excess of the value of the remainder interest included in the remainder owner's gross estate over the basis in the remainder interest immediately before the remainder owner's death, or (ii) decreased by any excess of the basis in the remainder interest immediately before the remainder owner's death over the value of the remainder interest included in the remainder owner's gross estate.[[1008]](#footnote-1009) The Treasury Regulations include the following helpful example:[[1009]](#footnote-1010)

Example (1)

Assume that, under the will of a decedent, property consisting of common stock with a value of $1,000 at the time of the decedent's death is transferred in trust, to pay the income to A for life, remainder to B or to B's estate. B predeceases A and bequeaths the remainder interest to C. Assume that B dies on January 1, 1956, and that the value of the stock originally transferred is $1,600 at B's death. A's age at that time is 37. The value of the remainder interest included in B's estate is $547 (0.34185, remainder factor age 37, x $1,600), and hence $547 is C's basis for the remainder interest immediately after B's death. Assume that C sells the remainder interest on January 1, 1961, when A's age is 42. C's basis for the remainder interest at the time of such sale is $596, computed as follows:

Basis of remainder interest computed

with respect to uniform basis of

entire property (0.39131, remainder

factor age 42, x $1,000, uniform

basis of entire property) .......................... $391

plus

Value of remainder interest included

in B's estate ............................ $547

less

Basis of remainder interest immediately

prior to B's death (0.34185, remainder

factor age 37, x $1,000) ................ 342 205

---- ----

Basis of C's remainder interest at the

time of sale ....................................... $596

* + - 1. The basis of any property distributed to the heir, legatee, or devisee upon termination of a trust or legal life estate, or at any other time, equals the distributed property's adjusted uniform basis: (i) increased by any excess of the value of the remainder interest included in the remainder owner's gross estate over the basis in the remainder interest immediately before the remainder owner's death, or (ii) decreased by any excess of the basis in the remainder interest immediately before the remainder owner's death over the value of the remainder interest included in the remainder owner's gross estate.[[1010]](#footnote-1011) The Treasury Regulations include the following additional example:[[1011]](#footnote-1012)

Example (2)

Assume the same facts as in example (1), except that C does not sell the remainder interest. Upon A's death terminating the trust, C's basis for the stock distributed to him is computed as follows:

Uniform basis of the property,

adjusted to date of termination

of the trust ....................................... $1,000

plus

Value of remainder interests in

the property at the time of B's

death .................................... $547

less

B's share of uniform basis of the

property at the time of his death ........ 342 205

----- -----

C's basis for the stock distributed

to him upon the termination of the

trust .............................................. $1,205

* + 1. Sale of Entire Interest
       1. Section 1001(e)(2) of the Code provides that the foregoing “zero basis” rule with respect to term interests “shall not apply to a sale or other disposition which is a part of a transaction in which the entire interest in property is transferred to any person or persons.”[[1012]](#footnote-1013) As a result, if both the term and remainder interests in the trust are sold in the same transaction, the seller of the term interest will be entitled to use its portion of the adjusted uniform basis to calculate gain or loss in the transaction.
       2. The Treasury Regulations provide an example pursuant to which the life tenant and the remainder owner jointly sold their respective interests to an unrelated purchaser.[[1013]](#footnote-1014) Both the life tenant and the remainder were able to use their respective portions of the adjusted uniform basis. In the example, the life tenant recognized a loss, and the remainder holder recognized gain.
  1. Commutations or Early Terminations
     1. The IRS has held,[[1014]](#footnote-1015) as recently as 2019 in a series of related private letter rulings,[[1015]](#footnote-1016) that the commutation or early termination of a trust pursuant to which the term interest holder and the remainder holder receive their respective actuarial shares of the underlying trust assets is a taxable exchange between the term and remainder holders. It is, according to the IRS, a transaction in which the term holder sells the term interest to the remainder holder. As such, because it is not a sale of the entire interest in the trust to a third party purchaser, the “zero basis” rule of section 1001(e) of the Code applies, resulting in the term holder recognizing gain with the no benefit of basis.
     2. The 2019 private letter rulings involved the early termination of generation-skipping trusts. The settlor created an irrevocable trust for the benefit of his son for his lifetime, providing for distributions of all net income, but no distributions of corpus were authorized. The trust provided upon son’s death, the remainder would be distributed to his then living issue, per stirpes. Pursuant to a non-judicial agreement among the trust beneficiaries, the trust would terminate, and the assets of the trust would be distributed to the various beneficiaries based on the actuarial values of their respective interests, on a pro-rata or in-kind basis. The early termination and distribution were contingent upon local court approval. The court approved finding the trust was “"is no longer necessary to achieve any clear material purpose of such trust because [Son]'s net worth has grown significantly, such that he does not need income from [Trust] for his support."[[1016]](#footnote-1017)
     3. The IRS ruled, “Although the proposed transaction takes the form of a distribution of the present values of the respective interests of Son, the Current Remaindermen, and the Successor Remaindermen, in substance it is a sale of Son's and the Successor Remaindermen's interests to the Current Remaindermen.”[[1017]](#footnote-1018) The current remaindermen are son’s children, and the successor remaindermen are the issue of the son’s children. In support of the foregoing, the IRS cited Revenue Ruling 69-486,[[1018]](#footnote-1019) which involved a trustee’s non-pro rata distribution of two different assets to two beneficiaries (one of which was a charitable organization). The trust did not authorize the trustee to make non-pro rata distributions of property. As such, the IRS treated the foregoing as a pro rata distribution of the two assets to each of the beneficiaries, following by a taxable exchange of half of the assets received by each of them.
     4. The IRS ruled the sale of son’s lifetime interest in the trust was the sale of a capital asset, citing Revenue Ruling 72-243.[[1019]](#footnote-1020) However, son’s term interest is “not part of a transaction in which the entire interest in Trust is transferred to a third party,”[[1020]](#footnote-1021) and as such, son’s portion of the adjusted uniform basis is disregarded under section 1001(e)(1) of the Code and the entire amount realized by the son will be considered long-term capital gain.
     5. In addition, the IRS held, the amounts received by the successor remainder holders (the issue of the son’s children) as a result of the termination are amounts received from the sale or exchange of a capital asset. Because this would be a sale of a remainder interest, each remainder holder would be entitled to get the benefit of their respective share of the adjusted uniform basis in determining the net long-term capital gain recognized. Interestingly, the ruling does not take the position that the current remainderman (the children) sold their interest in the trust. Rather, the IRS ruled, “to the extent that a Current Remainderman exchanges property, including property deemed received from Trust, for the interests of Son and the Successor Remaindermen, the Current Remainderman will recognize gain or loss on the property exchanged.”[[1021]](#footnote-1022) In other words, trust property that had been distributed tax free to the children would be considered part of a subsequent taxable exchange to the extent used to purchase the trust interests held by the son and successor remaindermen. In essence, the IRS concluded that the children (current remaindermen) purchased the son’s lifetime term interest and the contingent remainder interest.
     6. While the position taken by the IRS may seem harsh, consider that, after the termination of the trusts, each of the beneficiaries have materially different property rights and assets.[[1022]](#footnote-1023) Prior to the termination, son had an income interest for life, his children had a remainder interest in the trust property if they survived the death of son, and the issue of the children had an even more remote interest in the trust. After the termination, son, children, and the issue of the children directly owned their respective actuarial portions of the trust assets, without any contingencies and without any limitations to control or benefit from such assets. As discussed above, the principle set out in *Cottage Savings* led to the Treasury Regulations which says, “the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.”[[1023]](#footnote-1024) Quite obviously, amending the trust to allow distributions of income and principal to these various beneficiaries might have been a better course to follow.
  2. Tax Implications of Decanting and Trust Modifications
     1. Changes in circumstances that arise subsequent to the time that a trust becomes irrevocable may give rise to a modification of an otherwise irrevocable trust, either by the agreement of the parties (where permitted by local law) or through an action for a judicial modification. Under the traditional equitable deviation doctrine, if circumstances unanticipated by the settlor occur, a court may modify the administrative terms of a trust, but only to prevent the unanticipated circumstances from defeating or substantially impairing the accomplishment of the purposes of the trust.[[1024]](#footnote-1025) State statutes often permit modification of trusts under a broader variety of circumstances, permitting the modification of both administrative and dispositive provisions, if the changes have the effect of furthering the purposes of the trust.[[1025]](#footnote-1026) Modifications may also be effected by the action of a trustee who, acting under its authority to make distributions to or for the benefit of one or more beneficiaries, exercises that discretion to place property into a new and different trust, an action that has come to be referred to as "decanting."
     2. Decanting involves the distribution of assets of one trust (the old trust) to another trust (the new trust) to be held for the benefit of one or more of the beneficiaries of the original trust but on different terms than the old trust. Depending on how different the terms of the new trust are from the old trust, a decanting may be treated as a taxable exchange of trust interest by and among the beneficiaries. The IRS issued Notice 2011-101 requesting comments on trust decanting,[[1026]](#footnote-1027) and it has added a number of tax consequences of a decanting to its “areas under study” no ruling list:[[1027]](#footnote-1028)

Whether the distribution of property by a trustee from an irrevocable trust to another irrevocable trust (sometimes referred to as a "decanting") resulting in a change in beneficial interests is a distribution for which a deduction is allowable under § 661 or which requires an amount to be included in the gross income of any person under § 662.[[1028]](#footnote-1029)

Whether the distribution of property by a trustee from an irrevocable trust to another irrevocable trust (sometimes referred to as a "decanting") resulting in a change in beneficial interests is a gift under § 2501.[[1029]](#footnote-1030)

Whether the distribution of property by a trustee from an irrevocable generation-skipping transfer tax (GST) exempt trust to another irrevocable trust (sometimes referred to as a "decanting") resulting in a change in beneficial interests is the loss of GST exempt status or constitutes a taxable termination or taxable distribution under § 2612 .[[1030]](#footnote-1031)

* + 1. Notwithstanding the foregoing, in most cases, decanting from one trust to another, trust modifications, and trust combinations should present minimal, if any, unexpected income tax consequences to the trust or the trust beneficiaries. If trust assets are decanted from one trust to another trust, one possibility is that the decanting will be treated as simply a trust modification rather than a termination of the initial trust; consequently, both trusts will be treated as the same trust for income tax purposes. No income tax consequences would be recognized to either trust because of the decanting. Instead, the result would be that the surviving trust will report all income, expenses, and distributions for the entire year.[[1031]](#footnote-1032)
    2. A second possibility in the case of decanting follows the general rule that any distribution from a trust will carry with it a portion of the DNI, as discussed earlier in these material.[[1032]](#footnote-1033) Trust distributions are generally treated as coming first from the trust's current income, with tax-free distributions of "corpus" arising only if distributions exceed DNI.[[1033]](#footnote-1034) If distributions are made to multiple beneficiaries, DNI is allocated to them pro rata.[[1034]](#footnote-1035) If a trust terminates, current income is carried out, as are any unused capital losses, net operating losses, and expenses incurred in excess of income.[[1035]](#footnote-1036) Thus, when two trusts combine or "merge," no provision of the Code provides that the combination of trusts is tax-free. Therefore, the treatment may be that the terminating trust will be treated as making a terminating distribution, carrying out its DNI, unused losses, and excess deductions, to the surviving (new) trust.[[1036]](#footnote-1037) In other words, the result would be that the new trust would receive taxable income to the extent of the old trust's DNI, and the old trust would receive a corresponding distribution deduction.
    3. If the old trust does not terminate but instead a partial decanting occurs with the old trust retaining a right to withdraw a portion of the second trust, the first trust may be treated as the owner of the retained portion of the second trust. The new trust is possibly treated as a “grantor trust” of the old trust.[[1037]](#footnote-1038) In that case, section 678 of the Code would treat new trust as a “grantor trust” and the old trust will report DNI as defined in new trust.
    4. If the old trust is a grantor trust, it would seem the act of transferring, “merging,” or decanting the assets of a grantor trust to the new grantor trust should have no tax effect, under Revenue Ruling 85-13, even if there is debt in excess of basis. If the old trust is a grantor trust and the new trust is a non-grantor trust, then, like a termination of grantor trust status, the distribution of assets would generally not be a taxable event, unless there is debt in excess of basis. If old trust is a non-grantor trust and the new trust is a grantor trust, then based on the two rulings discussed earlier in the conversion from non-grantor to grantor trust, there would not be any transfer for any income tax purpose.
    5. If a proposed decanting or modification results in a significant change in property rights, however, the IRS may argue the decanting or trust modification may be treated as a distribution followed by an exchange of interests among the beneficiaries, resulting in recognized gain for income tax purposes. In Private Letter Ruling 200231011,[[1038]](#footnote-1039) the taxpayer asked the IRS to rule on the tax consequences of a proposed trust modification. Under the terms of a testamentary trust, the testator's grandson was to receive a fixed dollar amount each year during his life, with the remainder interest passing to various charities. The trust was later restructured to provide for annual income distributions in accordance with a performance chart. Subsequently, disputes arose regarding the administration of the trust. Under the terms of a settlement, the charities would receive an immediate distribution of corpus in termination of their interest. The remaining amount would continue in trust for the grandson, providing him a 7% unitrust amount plus distributions of principal as needed for his reasonable support. On his death, the remaining corpus would be distributed in accordance with the grandson's general testamentary power of appointment. Citing *Cottage Savings*, the IRS ruled that an exchange of property results in the realization of gain or loss under section 1001 of the Code if the properties exchanged are materially different. The IRS then compared the proposed modification to the modifications in two other cases. The first case, *Evans v. Commissioner*,[[1039]](#footnote-1040) involved the exchange of an income interest in a trust for an annuity which the court concluded was a realization event. The second case, *Silverstein v. United States*,[[1040]](#footnote-1041) found that the exchange of an interest in a trust for a right to specified annual payments from the remainder beneficiary did not result in a realization event because the taxpayer was to receive the same annual payments from the remainderman as she had been receiving from the trust. The IRS determined that the proposed settlement at issue more closely resembled the situation in *Evans* than in *Silverstein* because the grandson was currently entitled to trust income subject to a floor and ceiling, but under the proposed settlement he would receive annual unitrust payments and could receive additional discretionary distributions. The IRS stated, "[e]ven assuming that the projected payments under the proposed order approximate those that would be made under the current terms of the trust, under the proposed order Grandson would lose the protection of the guaranteed minimum annual payments required"[[1041]](#footnote-1042) under the current terms of the trust. He also would not be limited by the maximum annual payment ceiling, and payments would be determined without regard to trust income. Therefore, the grandson's interest in the modified trust would entail legal entitlements different from those under the current trust agreement, and as a result, the modification would be treated as a realization event for federal income tax purposes.[[1042]](#footnote-1043)
    6. In Private Letter Ruling 200743022,[[1043]](#footnote-1044) the IRS considered whether decanting assets from old trusts to new trusts and the merger of the trusts' assets would cause gain or loss recognition in a situation where both state law and the trust agreement authorized the decanting. Because the decanting was to occur as a result of the discretionary authority of the trustees based on state law and the trust agreement, and not as a result of the beneficiaries' exchange of trust property, the IRS ruled that no gain or loss would be recognized by any of the trusts or the beneficiaries. The exercise of the trustees' discretionary authority and the lack of involvement by the beneficiaries prevented an analysis pursuant to section 1001 of the Code.
    7. Under the Treasury Regulations, the severance of a trust occurring on or after August 2, 2007 will not be treated as an exchange of property for other property differing materially either in kind or in extent if (i) an applicable state statute or the governing instrument authorizes or directs the trustee to sever the trust; and (ii) any non-pro rata funding of the separate trusts resulting from the severance, whether mandatory or in the discretion of the trustee, is authorized by an applicable state statute or the governing instrument.[[1044]](#footnote-1045)

1. COMMON PARTNERSHIP PITFALLS, MISCONCEPTIONS & OPPORTUNITIES
   1. Introduction
      1. It is beyond the scope of these materials to write a full and comprehensive discussion of the fundamentals of partnership taxation. However, entities tax as partnerships (i.e., limited liability companies and limited partnerships) are the most common vehicles utilized to transfer assets in estate planning. There are many reasons why that is the case. One of those reasons is the flexibility that subchapter K gives to taxpayers to allocate tax items and to manage tax basis.
      2. The partnership rules provide sufficient planning flexibility to shift and change the basis of property through distributions (both non-liquidating and liquidating distributions) and the use of certain elections like the section 754 election. For example, a partnership could distribute a high basis asset into the hands of a partner with zero outside basis. The basis of the property in the hands of the partner generally would become a zero basis asset eligible for a “step-up” in basis on the subsequent death of the partner.[[1045]](#footnote-1046) With a section 754 election, the “stripped” basis (i.e., the partnership’s basis in the asset immediately prior to the distribution) would allow an upward basis adjustment to the other assets remaining inside the partnership.[[1046]](#footnote-1047) Furthermore, because partnership debt can create tax basis to certain partners, the careful management of each partner’s allocable share of that debt can increase or decrease basis.[[1047]](#footnote-1048) Notwithstanding the general rules above, other provisions of subchapter K must be considered, including the “mixing bowl” transaction and disguised sale rules.[[1048]](#footnote-1049)
      3. Flexibility unfortunately also means complexity and the risk of unintended tax consequences. This section of the materials will attempt to highlight common misconceptions, pitfalls, and planning opportunities in partnership taxation with a focus on the estate planning techniques and transactions that have become so popular. Our hope is that these materials will give estate planners a working knowledge of the following subjects pertaining to subchapter K and the income tax treatment of partners in a partnerships:
         1. Allocation of tax items among partners;
         2. Capital accounts;
         3. Unitary basis rule;
         4. Calculating inside and outside basis;
         5. Non-liquidating “current” distributions of partnership property;
         6. Liquidating distributions of partnership property;
         7. “Mixing Bowl” transactions and “Disguised Sale” rules;
         8. Treatment of partnership liabilities and their effect on basis;
         9. Section 754 election and inside basis adjustments;
         10. Partnership divisions; and
         11. Anti-abuse rules.
   2. Not All LLCs and LPs are Partnerships
      1. These materials focus on income tax planning opportunities with entities classified as partnerships (and to a certain extent, disregarded entities) for Federal tax purposes. However, just because an entity is, under state law, a partnership (general or limited) or a limited liability company, it may not be classified as partnership for Federal tax purposes. Estate planners must not assume that these entities are treated as partnerships for tax purposes.
      2. An unincorporated entity (e.g., limited liability company or limited partnership) with two or more owners may elect to be classified as an association (taxed as a corporation) [[1049]](#footnote-1050) or, by default, as a partnership. An unincorporated entity with a single owner (only limited liability companies because partnerships must have two or more partners) may elect to be treated as an association (taxed as a corporation) or disregarded as an entity separate from its owner (disregarded entity).[[1050]](#footnote-1051) Unless the unincorporated entity elects otherwise, a domestic eligible entity is a partnership if it has two or more owners or is a disregarded entity if it has (or deemed to have) a single owner.[[1051]](#footnote-1052)
      3. As noted above, an entity whose default classification is a partnership or a disregarded entity may elect to be classified as an S corporation.[[1052]](#footnote-1053) An eligible entity that makes a timely and valid election to be classified as an S corporation will be deemed to have elected to be classified as an association taxable as a corporation.[[1053]](#footnote-1054)
   3. Partnership Anti-Abuse Rules Could Apply to Estate Planning Transactions
      1. In 1995, the IRS issued “anti-abuse” Treasury Regulations[[1054]](#footnote-1055) 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.[[1055]](#footnote-1056) The breadth of these provisions are potentially infinite, but generally apply to artificial arrangements.
      2. The Treasury Regulations provide that the following requirements are implicit in the “intent” of subchapter K:
         1. 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;[[1056]](#footnote-1057)
         2. The form of each partnership transaction must be respected under substance over form principles;[[1057]](#footnote-1058) and
         3. 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.”[[1058]](#footnote-1059)
      3. The Treasury Regulations provide that certain of the factors that may be taken into account in determining whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate Federal tax liability in a manner inconsistent with the intent of subchapter K. Some of those factors are:
         1. The fact that substantially all of the partners (measured by number or interests in the partnership) are related (directly or indirectly) to one another;
         2. 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;
         3. The benefits and burdens of ownership of contributed property are retained by the contributing partner, or the benefits and burdens of ownership of partnership property are shifted to the distributee partner, before and after the property actually distributed;
         4. 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
         5. 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.[[1059]](#footnote-1060)
      4. Pertinent to the concept of changing the tax basis of property, the Treasury Regulations provide 2 examples of situations that generally indicate that basis shifts resulting from property distributions are allowable under the anti-abuse provisions:
         1. 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.[[1060]](#footnote-1061)
         2. 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.[[1061]](#footnote-1062)
      5. The Treasury Regulations do provide an example of an abusive situation. In that example, a partner contributes property with inherent loss to a partnership formed for the purpose by related parties, who contribute cash, used to purchase a nonmarketable security with a value and inside basis equal to the value of the contributed property. The contributor will have a section 704(c) allocation of the inherent loss and an outside basis equal to the value of the contributed loss property. The property is leased for three years to a prospective purchaser, who has an option to purchase at the value at the time of the contribution. Three years later, but before the sale under the option, the contributor receives a liquidating distribution of the other property with an inside basis equal to the value of the contributed property,[[1062]](#footnote-1063) 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.[[1063]](#footnote-1064)
      6. Notwithstanding the existence of these anti-abuse rules, the IRS may also rely on non-statutory principles like substance-over-form, step-transaction, and sham-transaction doctrines to recast certain partnership transactions.[[1064]](#footnote-1065) Further, as mentioned at the beginning of these materials, the economic substance doctrine under section 7701(o) of the Code[[1065]](#footnote-1066) could be invoked.

* 1. Grantors and Grantor Trusts Share Basis under the Unitary Basis Rules
     1. Unitary Basis Rule
        1. Estate planners are often surprised to learn that each partner in a partnership has a “unitary basis” in his or her partnership interest, even if the partner has different classes of partnership interest (general and limited, preferred and common, etc.) and even if the partner acquired the partnership interests in different transactions.[[1066]](#footnote-1067) This is in stark contrast to the “separate lot” rules applicable to shares of corporate stock when such separate lots can be “adequately identified.”[[1067]](#footnote-1068)
        2. The unitary basis rule is based and explained in Revenue Ruling 84-53,[[1068]](#footnote-1069) which described four different situations involving the sale of a partnership interest, three of which involve liability shifts. The underlying authority for the position taken in the ruling is section 1.61-6(a) of the Treasury Regulations, which provides:

When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part. The sale of each part is treated as a separate transaction and gain or loss shall be computed separately on each part. Thus, gain or loss shall be determined at the time of sale of each part and not deferred until the entire property has been disposed of.

* + - 1. The four situations described in the ruling are based on the following common facts:
         1. In 1978, Partnership Y was for the purpose of investing and trading in stocks and securities. Y has a calendar taxable year.
         2. A contributed $50x to Y in exchange for a general partner interest, entitling A to a 50 percent interest in all partnership distributions and in partnership income, gain, loss, and deduction. B contributed $50x to Y in exchange for a limited partner interest, entitling B to a 50 percent interest in all partnership distributions and in partnership income, gain, loss, and deduction.
         3. Since formation, the partnership has made cash distributions in amounts equal to its total income (including tax-exempt income).
      2. Situation 1
         1. In situation 1, on January 1, 1980, when the stock and securities of Y had decreased in value from $100x to $64x, B sold to A one half of B's limited partner interest for $16x, which interest A holds as a limited partner. On January 1, 1982, when the stock and securities of Y has risen in value from $64x (its 1980 value) to $120x, A sold to C one-half of A's general partner interest for $30x. Immediately prior to the sale, A's entire partnership interest had a fair market value of $90x and the transferred portion of the interest had a fair market value of $30x.
         2. The IRS concluded, prior to the sale of one-half of B's limited partner interest to A, the adjusted basis of B's entire partnership interest was $50x. Because the fair market value of the transferred portion of B's interest ($16x) is one-half of the fair market value of B's entire partnership interest ($32x), $25x (1/2 of $50x) of adjusted basis must be allocated to the interest transferred by B. B sustained a $9 loss ($16x - $25x) on the sale to A. The adjusted basis of the remainder of B's partnership interest is $25x.
         3. In addition, the IRS concluded, prior to the sale of one-half of A's general partner interest to C, the adjusted basis of A's entire partnership interest was $66x. Because the fair market value of the transferred portion of A's interest ($30x) is one-third of the fair market value of A's entire partnership interest ($90x), $22x (1/3 of $66x) of the adjusted basis must be allocated to the portion of the interest transferred by A. A realizes an $8x gain ($30x - $22x) on the sale to C. The basis of the remainder of A's partnership interest is $44x.
         4. Significantly, the IRS also stated the results would be the same to A if A, instead, sold to C the limited partner interest acquired earlier from B.
      3. Situation 2
         1. The facts are the same as in situation 1, except that, in 1981, Y borrowed $80x recourse which was invested in securities that became worthless on December 31, 1981. Furthermore, immediately prior to A's sale to C, A's entire partnership interest had a fair market value of $30x and the transferred portion of A's interest had a fair market value of $10x.
         2. The tax consequences of B’s sale of B’s limited partnership interest to A are the same as situation 1.
         3. As to the sale to C, in 1981, A's basis in A's entire partnership interest was increased from $66x to $146x as a result of the $80x recourse borrowing (which increases only the basis of A, the sole general partner, under sections 752(a) and 722 of the Code, and was decreased to $86x as a result of the $60x loss allocated to A that year when the securities became worthless). Thus, prior to the sale of one-half of A's general partner interest to C, the adjusted basis of A's entire partnership interest was $86x. To take into account the effect of the partnership liability sharing rules, $80x (A's share of all partnership liabilities) is subtracted from $86x, leaving $6x. Because the fair market value of the transferred portion of A's interest ($10x) is one-third of the fair market value of the entire interest ($30x), $2x (1/3 of $6x) of the remaining adjusted basis must be allocated to the transferred portion of A's general partner interest. The sum of that amount ($2x) plus the amount of partnership liabilities from which A is discharged on the disposition of the transferred portion of A's general partner interest ($40), or $42x, equals the adjusted basis of the transferred portion of the interest. A realizes an $8x gain ($10x + $40x - $42x) on the sale to C.
         4. The basis of the remainder of A's partnership interest is $44x ($86x - $42x).
      4. Situation 3
         1. The facts are the same as in situation 2 except that, on January 1, 1982, A sold A's entire limited partner interest to C for its fair market value of $10x (rather than one-half of A's general partner interest).
         2. The tax consequences of B’s sale of B’s limited partnership interest to A are the same as situation 1.
         3. As to the sale to C, prior to the sale of A's limited partner interest to C, the adjusted basis of A's entire partnership interest was $86x. To take into account the effect of the partnership liability sharing rules, $80x (A's share of all partnership liabilities) is subtracted from $86x, leaving $6x. Because of the fair market value of the transferred portion of A's limited partner interest ($10x) is one-third of the fair market value of A's entire interest ($30x), $2x (1/3 of $6x) of the remaining adjusted basis must be allocated to the transferred limited partner interest. The sum of that amount ($2x) plus the amount of partnership liabilities from which A is discharged on the disposition of the transferred limited partner interest ($0x), or $2x, equals the adjusted basis of the transferred portion of the interest. A realizes an $8x gain ($10x - $2x) on the sale to C.
         4. The basis of the remainder of A's partnership interest is $84x ($86x - $2x).
      5. Situation 4
         1. The facts are the same as in situation 1 except that, in 1981, Y borrowed $96x recourse which is invested in securities that became worthless on December 31, 1981. Furthermore, immediately prior to A's sale to C, A's entire partnership interest had a fair market value of $18x and the transferred portion of A's interest had a fair market value of $6x.
         2. The tax consequences of B’s sale of B’s limited partnership interest to A are the same as situation 1.
         3. As to the sale to C, in 1981, A's basis in A's entire partnership interest was increased from $66x to $162x as a result of the $96x recourse borrowing and was decreased to $90x as a result of the $72x loss allocated to A that year when the securities became worthless. Thus, prior to the sale of one-half of A's general partner interest to C, the adjusted basis of A's entire partnership interest was $90x. In this situation, A's share of all partnership liabilities ($96x) exceeds the adjusted basis of A's entire interest ($90x). Thus, the adjusted basis of the transferred portion of A's general partner interest equals $45x, the amount which bears the same relation to A's adjusted basis in the entire interest ($90x) as the amount of partnership liabilities from which A is discharged on the disposition of the transferred portion of the general partner interest ($48x) bears to A's share of all partnership liabilities ($96x). A realizes a $9x gain ($48x + $6x - $45x) on the sale of C.
         4. The basis of the remainder of A's partnership interest is $45x ($90x - $45x).
      6. As an explanation for its holdings, the IRS explains a two-step process for determining the total amount of basis allocated to the sold partnership interst.

In cases where the partner's share of all partnership liabilities does not exceed the adjusted basis of such partner's entire interest (including basis attributable to liabilities), the transferor partner shall first exclude from the adjusted basis of such partner's entire interest an amount equal to such partner's share of all partnership liabilities, as determined under section 1.752-1(e) of the regulations. A part of the remaining adjusted basis (if any) shall be allocated to the transferred portion of the interest according to the ratio of the fair market value of the transferred portion of the interest to the fair market value of the entire interest. The sum of the amount so allocated plus the amount of the partner's share of liabilities that is considered discharged on the disposition of the transferred portion of the interest (under section 752(d) of the Code and section 1.1001-2 of the regulations) equals the adjusted basis of the transferred portion of the interest.

On the other hand, if the partner's share of all partnership liabilities exceeds the adjusted basis of such partner's entire interest (including basis attributable to liabilities), the adjusted basis of the transferred portion of the interest equals an amount that bears the same relation to the partner's adjusted basis in the entire interest as the partner's share of liabilities that is considered discharged on the disposition of the transferred portion of the interest bears to the partner's share of all partnership liabilities, as determined under section 1.752-1(e).

* + - 1. Unitary basis is determined on a partnership-by-partnership basis even, so it seems, if a partner has an interest in 2 or more partnerships that are identical in all respects (including the interests of other partners), except perhaps the assets in the partnership, there does not seem to be a statutory rule that the unitary basis of the partner must be aggregated. This may have important planning implications in estate planning as it bears to reason that it might make sense for taxpayers to segregate low basis and high basis assets into different partnerships.
    1. Unitary Basis with Grantor and Grantor Trusts
       1. In estate planning, it is common for grantors to simultaneously own interests in FLPs individually and deem to own, for income tax purposes, FLP interests in an IDGT due to grantor trust status. As discussed earlier, Revenue Ruling 85-13 provides that a “defective grantor trust” will be “ignored” for all Federal income tax purposes.
       2. As such, because of the unitary basis rule, subsequent contributions of high basis property by the grantor will result in proportional increases (in a pro rata FLP) to the outside basis of the IDGT partnership interests. Given that the FLP interests held by the IDGT will generally not benefit from a “step-up” in basis at the death of the grantor, this can have the advantage of increasing the basis of the FLP interests without requiring an additional transfer to the trust or estate tax inclusion. Of course, if the grantor has a power to swap assets of equivalent value, exchanging high basis assets for the FLP interests is likely to be more advantageous from a basis increase standpoint.
       3. Another apparent effect of the unitary basis rule is that distributions of cash or property (as discussed later in these materials) must take into account the aggregate outside basis of a grantor and his or her grantor trusts regardless of who actually receives the distribution. For example, if a grantor and IDGT are equal partners in a partnership and collectively they share $100x of outside basis, then the IDGT could receive $100x of cash distribution without recognizing any gain.
       4. The ramifications of the unitary basis rule are seemingly unlimited.[[1069]](#footnote-1070) For example, if a grantor redeems his or her entire interest in a partnership for property but an IDGT continues to have an interest in the partnership, it seemingly means that the distribution is considered a current distribution, rather than a liquidating distribution (because the grantor is deemed to still have an interest in the partnership). This could mean the grantor would not be able to take a capital loss upon exiting the partnership and it might affect the basis that the grantor has in the distributed property. What then are the tax consequences if grantor trust status is terminated?
  1. Contributions of Property to a Partnership
     1. Contributions Are Usually Not Taxable Events
        1. Generally, a contribution of property[[1070]](#footnote-1071) to a partnership is a non-recognition event for tax purposes. As such, there is typically no gain or loss at the time of contribution.[[1071]](#footnote-1072)
        2. Under section 723 of the Code, upon a contribution of property, the partnership has a transferred basis (inside basis) in the property received, increased by any gain recognized under section 721(b) (discussed below).[[1072]](#footnote-1073) Accordingly, under section 722 of the Code, the contributing partner receives an exchanged basis (outside basis) in his or her partnership interest equal to the adjusted basis of the contributed property plus any contributed money.[[1073]](#footnote-1074)
        3. Furthermore, under section 1223(2) of the Code, the partnership “tacks” or continues the contributing partner’s holding period for any assets received in a nonrecognition contribution with a transferred basis.[[1074]](#footnote-1075) A contributing partner tacks the holding period of the contributed property to the holding period of the partnership interest received in the exchange.[[1075]](#footnote-1076) A partner will have a split holding period in his or her partnership interest if the partner acquires his or her partnership interest by contributing assets with different holding periods or by subsequent contributions. The split holding periods are allocated generally in proportion to the fair market value of the property in question.[[1076]](#footnote-1077) Under the unitary basis principle, the holding period of the interest will not be affected by subsequent adjustments for allocations of partnership tax items.[[1077]](#footnote-1078)
        4. Under section 704(c) of the Code, the contributing partner remains responsible for the tax consequences when the unrecognized gains or losses from the contributed property are realized by the partnership after contribution. As such, the contributing partner is taxed on any inherent gain (difference between the adjusted basis in the property and the fair market value of the property at the time of contribution) when the gain is realized, and the contributing partner is entitled to any deductions or losses inherent in any obligations transferred.[[1078]](#footnote-1079) Section 704(c) of the Code is discussed in some detail later in these materials, but a complete discussion is beyond the scope of this outline.
     2. Exception: Contributions to an “Investment Company”
        1. Under section 721(b) of the Code, gain is realized on the contribution of property to a partnership if the partnership would be treated as an “investment company” under section 351(e) of the Code. Section 351(e) of the Code and the Treasury Regulations provide that any contributions will be deemed to be a transfer to an investment company if the transfer results, directly or indirectly, in diversification of the transferor’s interests, and the transferee is, in pertinent part, a corporation (partnership, in this case) more than 80 percent of the value of whose assets are held for investment and are stocks or securities, or interests in regulated investment companies, or real estate investment trusts.
        2. Said another way, a contribution (e.g., stocks and securities) to partnership would not result in taxable gain if (i) the portfolio constitutes a "diversified portfolio” at the time of the transfer, and (ii) such contribution is not part of a plan whereby another person contributes an "undiversified" portfolio of stock and securities to the same investment partnership.[[1079]](#footnote-1080) There is an exception for contributions of assets which, in the aggregate, are an insignificant part of the total value of assets transferred. There have been a number of rulings on the issue of whether the contribution is insignificant. The rulings have generally held that if the contribution makes less than 5% of the total value, then it will be considered insignificant and thus will not trigger a taxable event.[[1080]](#footnote-1081)

Example: Partner A contributes Assets A and Partner B contributes Asset B to the AB Partnership in exchange for partnership interests. Whether gain is recognized on the contribution under section 721(b) is set out in the following chart:

|  |  |  |
| --- | --- | --- |
| Asset A | Asset B | Result |
| Stock X | Stock Y | Gain |
| Stock X | Stock X | No Gain |
| Diversified Portfolio | Diversified Portfolio | No Gain |
| Diversified Portfolio | Stock Y | Gain to Partner B |
| Stock X | Stock Y + Real Property (value is 20% of AB Partnership) | No Gain |
| Stock X (value less than 5% of AB Partnership) | Diversified Portfolio | No Gain |

* + - 1. If the contributing partners are spouses, one of the easiest ways of avoiding gain under section 721(b) is to have the spouses swap ½ of their respective securities with each other prior to their contribution to the partnership. Section 1041 of the Code provides no gain or loss is recognized by either spouse, and each spouse receives carryover basis in the securities. Section 2523 of the Code ensures that the spousal transfers qualify for the gift tax marital deduction.
    1. Exception: Contributions of Property Encumbered by Recourse Debt
       1. Gain or loss may be recognized upon certain contributions of encumbered property[[1081]](#footnote-1082) and contributions of property that are treated as disguised sales (discussed later in these materials).[[1082]](#footnote-1083)
       2. When property encumbered by a recourse liability is contributed to a partnership, generally, the liability is transferred to the partnership (to the extent of the fair market value of the property).[[1083]](#footnote-1084) The contribution is treated as two separate transactions, a contribution of property and contribution of the liability. The contribution of the liability will decrease the contributing partner’s outside basis in his or her partnership interest (due to a deemed distribution to the partner) by the share of liability shifted to other partners.[[1084]](#footnote-1085) A contributing partner will recognize gain under these circumstances when the deemed distribution exceeds the adjusted basis of the property contributed (or the pre-existing outside basis of the partner).[[1085]](#footnote-1086)
       3. It’s important to understand that even if the contributed property has debt in excess of basis, it does not necessarily mean that gain will be recognized. As mentioned above, the Treasury Regulations provide an exception to the *Crane* rule, “Contributions… of property between a partner and a partnership are not sales or other dispositions.”[[1086]](#footnote-1087) Because the partnership liability sharing rules control, recognition of gain generally only occurs when the following are true: (i) contributed property has a very low basis; (ii) the property is highly mortgaged; (iii) the contributing partner has a relatively small interest in the partnership; and (iv) the debt is recourse. Consider the following examples:

Example 1: In exchange for a 20% interest in a partnership, P contributes property having a fair market value of $100x and an adjusted basis of $40x. The property is subject to recourse debt of $60x. P will recognize $8 of gain on the contribution. P’s initial outside basis under section 722 of the Code is $40x. As a 20% partner, P’s share of the partnership’s nonrecourse is reduced from $60x to $12x. Under section 752(b) of the Code, P’s outside basis is reduced by the reduction of P’s share in liabilities of $48x (80% of the debt is deemed discharged), which is considered a distribution of money to the partner. Because P’s outside basis is only $40x, under section 731(a)(1) of the Code, P recognizes $8x of gain. P’s resulting outside basis is $0.

Example 2: Same facts as example 1, except P has a 40% interest in the partnership. P will not recognize gain on the contribution. P’s initial outside basis under section 722 of the Code will be $40x. As a 40% partner, P’s share of the partnership’s nonrecourse is reduced from $60x to $24x (only 60% of the debt is deemed discharged). Under section 752(b) of the Code, P’s outside basis is reduced by the reduction of P’s share in liabilities of $36x, which is considered a distribution of money to the partner. P’s initial outside basis of $40x is reduced by $36x, and P’s resulting outside basis is $4.

Example 3: Same facts as example 1, except P personally guarantees (with no right of reimbursement from the other partners) $10x of the $60x of total debt. P will not recognize gain on the contribution. P’s initial outside basis under section 722 of the Code is $40x. P is personally responsible for $10x, so only 80% of the remaining $50x of debt is discharged P’s net discharge is $40x, which is which is considered a distribution of money to the partner. P’s initial outside basis of $40x is reduced by $40x, and P’s resulting outside basis is $0.

* + 1. As discussed in more detail later in these materials, if the partnership has a section 754 election in place, the partner’s gain upon contribution of encumbered property will provide an upward inside basis adjustment to the partnership property.[[1087]](#footnote-1088) The inside basis adjustment, however, will not necessarily be allocated to the contributed property because of how section 755(b) allocates the basis adjustment (essentially to all partnership property). The gain should decrease the amount of built-in gain to be allocated under section 704(c).[[1088]](#footnote-1089) If there is no section 754 election in place, the partnership’s basis in the contributed asset is not increased, and the contributing partner may experience a temporary “doubling” of gain, the tax on the deemed distribution and an eventual tax on the allocation under section 704(c).[[1089]](#footnote-1090)
    2. Not an Exception: Contributions of Property Encumbered by Nonrecourse Debt
       1. All of the foregoing examples related to recourse debt. What if the debt was nonrecourse? It turns out that if a partner contributes property encumbered by a nonrecourse liability, the partner will not receive a deemed distribution under section 752(b) that exceeds the basis of the partnership interest. It’s not immediately obvious why that is the case, but it has to do with how nonrecourse liabilities are shared and with section 704(c) “minimum gain.” The Treasury Regulations provide, “A partner’s share of nonrecourse liabilities of a partnership”[[1090]](#footnote-1091) equals the sum of:
          1. “The partner's share of partnership minimum gain determined in accordance with the rules of section 704(b) and the regulations thereunder;”[[1091]](#footnote-1092)
          2. “The amount of any taxable gain that would be allocated to the partner under section 704(c) (or in the same manner as section 704(c) in connection with a revaluation of partnership property) if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities and for no other consideration;”[[1092]](#footnote-1093) and
          3. “The partner's share of the excess nonrecourse liabilities… of the partnership as determined in accordance with the partner's share of partnership profits.”[[1093]](#footnote-1094)
       2. As discussed above, section 704(c) of the Code ensures that a contributing partner remains responsible for any unrecognized gains or losses inherent in contributed property. Partnership “minimum gain” is the sum of the gains the partnership would realize, under *Crane* and *Tufts*, if the partnership disposed of all assets that are subject to nonrecourse liabilities, solely in satisfaction of those liabilities.[[1094]](#footnote-1095) In the sum above, the second addend is referred to as the “second tier” allocation of nonrecourse liabilities. Under the foregoing “second tier” allocation, nonrecourse liabilities are allocated in accordance with section 704(c) minimum gain. Section 704(c) minimum gain represents a partner's share of gain allocated under section 704(c) to the partner contributing appreciated property computed based on the hypothetical sale of the property subject to the nonrecourse loan in satisfaction of the nonrecourse liability for no consideration other than relief from the nonrecourse liability. Thus, the section 704(c) minimum gain allocated to the contributing partner is the excess amount of the nonrecourse debt over the adjusted basis of the property. The result is that the excess of the nonrecourse debt over the basis is allocated to the contributing partner’s outside basis,[[1095]](#footnote-1096) which in turn reduces the liability shift.[[1096]](#footnote-1097) If the nonrecourse debt is in excess of the fair market value of the contribute property, there is no liability shift because, under the Treasury Regulations,[[1097]](#footnote-1098) the liability shift is only to the extent of the fair market value.

Example: In exchange for a 20% interest in a partnership, P contributes property having a fair market value of $100x and an adjusted basis of $40x. The property is subject to nonrecourse debt of $60x. The section 704(c) minimum gain allocated to P is $20x (amount of debt in excess of basis). The remaining $40x of nonrecourse debt is allocated amount the partners according to the allocation partnership profits (the third addend of the sum above). As a result, as a 20% partner, P’s residual allocation of nonrecourse debt is $8x (20% of remaining $40x of nonrecourse debt). P’s resulting share of nonrecourse liability is $28x and the net decrease in P’s share of liabilities is $32x ($60x of total nonrecourse debt less $28x of P’s share of debt after the contribution). P’s resulting outside basis is $8x ($40x minus deemed distribution of $32x under section 752(b) of the Code).

* + - 1. When the basis of the contributed property exceeds the nonrecourse liability encumbering the property, there is no section 704(c) minimum gain and the entire nonrecourse liability is allocated according to the profit-sharing ratios or, if the partnership agreement so provides, in accordance with one of the safe harbors in the regulations.[[1098]](#footnote-1099) In all such cases, the portion of the liability shifted to other partners as a result of the contribution will never exceed the contributing partner’s outside basis, which initially is equal to the basis of the contributed property.
  1. Distributions to Partners: The Rules and the Exceptions
     1. Non-Liquidating “Current” Distributions
        1. Cash Distributions May Result in Gain and Sometimes 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.[[1099]](#footnote-1100) Since most FLPs are structured as “pro rata” partnerships,[[1100]](#footnote-1101) it is important to recognize that, generally, there is no gain or loss on pro rata current distributions regardless of the type of asset being distributed,[[1101]](#footnote-1102) unless cash distributed exceeds the outside basis of the partnership interest of any of the partners.[[1102]](#footnote-1103)
           2. Distributions of cash (including a reduction in a partner’s share of liabilities and distributions of marketable securities) [[1103]](#footnote-1104) to a partner reduces the partner’s outside basis, with gain recognized to the extent the cash distributed exceeds outside basis.[[1104]](#footnote-1105) No loss is ever recognized on a current distribution.[[1105]](#footnote-1106) Any gain resulting from a current distribution of cash is considered capital gain that would result from a sale of the partner’s interest.[[1106]](#footnote-1107)
           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).[[1107]](#footnote-1108) The definitions of these types of assets (sometimes referred to as “hot assets”) include more things than might be obvious. Unrealized receivables include rights to payment for goods or services not previously included in income,[[1108]](#footnote-1109) and recapture property, but only to the extent unrealized gain is ordinary income (as discussed above). “Inventory items” include any property described in section 1221(a)(1) (inventory or other property held for sale to customers in the ordinary course of business and any other property that would not result in capital gain or gain under section 1231 (accounts receivables).
           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.[[1109]](#footnote-1110) If the partner acquired his or her partnership interest by contributing property to the partnership (typically in a nonrecognition[[1110]](#footnote-1111) transaction), the holding period of the property transferred is added to the partnership interest’s holding period.[[1111]](#footnote-1112) If the partner acquires the partnership interest at different times, the partnership interest will have different holding periods, allocated in proportion to the fair market value of the contributed property.[[1112]](#footnote-1113)
           5. It should be noted that if a partner transferred his or her partnership interest in exchange for cash (or other property), the tax rate on capital gain may be different than if the partner received cash from the partnership in liquidation/redemption of the partnership interest. The planning opportunities that might arise as a result of this anomaly is discussed in more detail later in this outline.

Upon a sale or exchange, the transferor recognizes gain under rules similar to section 1001.[[1113]](#footnote-1114) The transferee of the partnership interest takes a cost basis in the partnership interest equal to the consideration paid,[[1114]](#footnote-1115) and carries over the transferor’s capital account and share of forward and reverse section 704(c) gain in the partnership assets, if any.[[1115]](#footnote-1116)

The character of the gain is capital subject to recharacterization under section 751(a). The transferor partner recognizes ordinary income or loss in an amount equal the income or loss that would be allocated to the partner if the partnership sold all of the partnership assets at fair market value.[[1116]](#footnote-1117) Capital gain or loss is recognized in an amount equal to the gain or loss that would be calculated under section 1001 minus the ordinary income (or plus the ordinary loss) computed under section 751(a).[[1117]](#footnote-1118)

All of the foregoing provides for similar results to a cash distribution to a partner. For determining the rate of tax on the capital gain, on the other hand, one looks through to the underlying partnership assets.[[1118]](#footnote-1119) Thus, depending on the assets held by the partnership, the transferor partner may recognize capital gain at a 20%, 25%, and 28% federal rate.

* + - 1. Property Distributions Are Generally Non-Taxable
         1. Neither the partner nor the partnership will recognize any gain or loss upon a distribution of property,[[1119]](#footnote-1120) unless the property is a marketable security (treated as cash)[[1120]](#footnote-1121) 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.[[1121]](#footnote-1122)
         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”).[[1122]](#footnote-1123) 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.[[1123]](#footnote-1124) 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.[[1124]](#footnote-1125) 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.[[1125]](#footnote-1126) 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.[[1126]](#footnote-1127)
      2. Partnership Inside Basis
         1. When gain is recognized on a distribution (cash in excess of outside basis) or when the basis of the distributed property is reduced because outside basis is less than the basis of the property prior to the distribution, absent a section 754 election, there is no adjustment to the partnership’s inside basis. This gives may give rise to a temporary duplication of gain or to a loss of basis to the partnership (and to the partners).
         2. If a section 754 election is made, an adjustment of basis under section 734(b) occurs when a partner recognizes gain due to a distribution (or deemed distribution) of cash in excess of outside basis, or property is distributed that results in a reduction of basis on the distributed property.[[1127]](#footnote-1128) The adjustment results in an increase to the inside basis of the partnership assets. The basis increase is allocated among two different classes of assets: (i) capital and section 1231 assets, and (ii) ordinary income property.[[1128]](#footnote-1129) Any basis adjustment due to gain from a distribution of cash must be allocated to capital assets.[[1129]](#footnote-1130) As discussed in more detail in these materials, under section 755 of the Code, any increased basis adjustment is allocated first to appreciated property in proportion to the amount of unrealized appreciation, with any remaining increase allocated to all of the properties within the same class in proportion to fair market values.[[1130]](#footnote-1131) Thus, there is a possibility of allocating basis to an asset above its fair market value, creating the possibility of a recognizable loss to the partners. Adjustments under section 734(b) are discussed in more detail later in this outline.
    1. Liquidating 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.[[1131]](#footnote-1132) Liquidating distributions are treated the same as current distributions except a loss may be recognized,[[1132]](#footnote-1133) and the basis of property distributed to a partner may be increased (discussed below).[[1133]](#footnote-1134) The only way to recognize a loss upon a liquidating transfer is if the distribution consists only of cash (but not including marketable securities[[1134]](#footnote-1135)) and section 751 assets (hot assets).[[1135]](#footnote-1136)
       2. In the estate planning context, most partnerships are structured as “pro rata” or single class share partnerships because of the “same class” exception under section 2701(a)(2)(B). With respect to this exception, the Treasury Regulations provides, “[a] class is the same class as is (or is proportional to the class of) the transferred interest if the rights are identical (or proportional) to the rights of the transferred interest, except for non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to management and limitations on liability).”[[1136]](#footnote-1137) In order to qualify for this exception, it generally requires that distributions must be made proportionately and at the same time (and perhaps with the same assets). In order to effectuate a disproportionate distribution of property to, for example, an older partner with limited outside basis (trying to maximize the benefit of the “step-up”), one would need to redeem a portion of the partner’s interest (lower the percentage ownership), which would be considered a current distribution, or liquidate the partner.
       3. 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.[[1137]](#footnote-1138) 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.[[1138]](#footnote-1139) If the transferred basis is in excess of the fair market value of the distributed asset, then a loss can be recognized on a subsequent sale or, if the property is depreciable, depletable or amortizable, the added basis can provide tax benefits in the form of ongoing deductions.
       4. The basis adjustments to the partnership are the same as discussed with current distributions, in particular, if there is a section 754 election in place. With respect to liquidating distributions, the inside basis adjustments may be increased or decreased (rather than only increased in a current distribution). This is because a liquidating distribution may result in a loss to the withdrawing partner,[[1139]](#footnote-1140) and a property distribution may result an increased tax basis.[[1140]](#footnote-1141) 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,”[[1141]](#footnote-1142) which will exist if the amount exceeds $250,000.[[1142]](#footnote-1143) 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. [[1143]](#footnote-1144)
       5. 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.[[1144]](#footnote-1145) 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.[[1145]](#footnote-1146) 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.[[1146]](#footnote-1147)
       6. As discussed earlier, the unitary basis rule means that a grantor and his or her IDGT would share a the combined basis of each of their respective interests. The Tax Court has held that for purposes of determining the amount of gain or loss recognized upon a distribution under section 731 of the Code a partner having multiple classes or types of interests is treated as owning a single partnership interest with a unitary basis. In *Chase v. Commissioner*,[[1147]](#footnote-1148) the Tax Court confirmed that section 731(a)(2) of the Code requires that all the taxpayer's direct ownership interest in the partnership be liquidated to recognize a loss on the liquidation. Consequently, the liquidation of a limited partnership interest at a time that the same person holds a general partnership interest in the partnership prevents the recognition of the loss incurred with respect to the liquidation of the investment in the limited partnership interest.[[1148]](#footnote-1149)
    2. Exception: Distributions and “Hot Assets”
       1. Section 751 was enacted to prevent partners from converting ordinary income to capital gain through sales or exchanges of their partnership interests or through distributions of partnership property. Generally, the Code provides that any consideration received by a partnership in exchange for his or her partnership interest that is attributable to unrealized receivables or inventory items (“hot assets”) shall be treated as an amount realized in exchange for property other than a capital asset.[[1149]](#footnote-1150) In other words, to the extent applicable, it converts what otherwise would be considered capital gain (sale of a partnership interest) to ordinary income.
       2. Section 751(b) provides that if a partner receives a distribution of hot assets (sometimes referred to as “section 751(b) property”) in exchange for all or part of his or her partnership interest,[[1150]](#footnote-1151) or receives other partnership property (not hot assets) in exchange for all or part of his or her interest in such hot assets,[[1151]](#footnote-1152) then the transaction will be considered a sale or exchange between the distributee partner and the partnership (as constituted after the distribution). Section 751(b) applies to both non-liquidating distributions as well as liquidating distributions.[[1152]](#footnote-1153) In effect, section 751(b) only applies to distributions involving an exchange of interests in one class of property for another class of property (ordinary for capital/capital for ordinary). As such, section 751(b) does not apply to distributions of one partner’s share of both section 751(b) property and other property.[[1153]](#footnote-1154) Furthermore, if a partnership has only one class of property (e.g., no hot assets), then section 751(b) will never apply. Thus, any disproportionate distribution of partnership property that results in any partner receiving more or less than his or her proportionate share of the hot assets will trigger section 751(b).
       3. If section 751(b) applies to a distribution, then income inclusion is required. If, by way of example, a partner receives a disproportionate distribution of section 751(b) (hot assets), then the partner will realize capital gain. If, on the other hand, the partner a disproportionate distribution of other property, then the partner will realize ordinary income.
       4. In determining whether there has been a disproportionate shift of hot assets or other property, the Treasury Regulations provide for a hypothetical transaction involving:
          1. Current distribution of partnership property relinquished by the distributee partner (the partner’s decreased interest in section 751(b) property or other property) in order to determine the partner’s tax basis in the relinquished property;[[1154]](#footnote-1155) and
          2. Partnership sale of the increased share in the other section 751(b) property in exchange for the property relinquished by the partner.[[1155]](#footnote-1156)
       5. The Code provides two specific exceptions to section 751(b). It does not apply to distributions of property to a partner who contributed the property to the partnership.[[1156]](#footnote-1157) Section 751(b) also does not apply to section 736(a) payments made to a retiring partner or a successor in interest of a deceased partner.[[1157]](#footnote-1158)
       6. Originally, the definition of “unrealized receivables” under section 751(c) only included rights to payments for services and rights to payments for goods. Since its enactment, 751(c) property has been expanded to include many additional types of property, the sale of which would result in the realization of ordinary income.[[1158]](#footnote-1159) In particular, the following types of assets have been added as “unrealized receivables” for purposes of section 751:
          1. Section 1245 property, but only to the extent that ordinary income would be recognized under section 1245(a) if a partnership were to sell the property at its fair market value.[[1159]](#footnote-1160) The amount is treated as an unrealized receivable with a zero basis. Section 1245 property includes property which allows for depreciation other than buildings or their structural components.[[1160]](#footnote-1161)
          2. Section 1250 property but only to the extent that ordinary income would be recognized under section 1240(a) if a partnership were to sell the property at its fair market value.[[1161]](#footnote-1162) Section 1250 property is any depreciable property other than section 1245 property.[[1162]](#footnote-1163) Generally, gain which is treated as ordinary income under section 1250(a) is the lower of: (a)” additional depreciation” taken after 1975, and (b) the gain realized on the disposition of the property.[[1163]](#footnote-1164) “Additional depreciation” generally refers to section 1250 property held for one year or less, all depreciation taken (in that one year or less), and for section 1250 property held for more than one year, the excess of the depreciation taken over the amount of depreciation which would have been taken if the straight-line method of depreciation had been used. Since TRA 1986, the “applicable recovery period” for most commercial real property assets are placed in 27.5 or 39-year recovery periods, while land improvements fall within 15 or 20-year recovery periods.[[1164]](#footnote-1165) Most importantly, the depreciation method for nonresidential and residential real property is straight line.[[1165]](#footnote-1166) Thus, most commercial real property assets would fall out of the definition of “unrealized receivables” and would not be considered a “hot” section 751(b) asset.
          3. Amortizable section 197 intangibles (patents, copyrights, goodwill, going concern value, etc.), which by definition are held in connection with a trade or business or an activity described in section 212.[[1166]](#footnote-1167) Amortizable section 197 intangibles are treated as property which is of the character subject to the allowance for depreciation,[[1167]](#footnote-1168) and these assets are subject to section 1245 recapture.[[1168]](#footnote-1169) Generally, this does not include self-created intangibles,[[1169]](#footnote-1170) so intangible assets in the hands of the creator (or held by a donee of such intangible) would fall out of the definition of “unrealized receivables” and would not be considered a “hot” section 751(b) asset.
          4. Section 1248 stock of a controlled foreign corporation (CFC) to the extent that ordinary income would be recognized under section 1248(a) if a partnership were to sell the CFC stock at its fair market value.[[1170]](#footnote-1171) The amount is treated as an unrealized receivable with a zero basis. The ordinary income under these circumstances is generally the “dividend,” which is determined, in part, by the additional corporate income tax that would have been paid by the CFC if it had been taxed as a domestic corporation plus the tax which would have been paid by the taxpayer by including in gross income (as long-term capital gain).[[1171]](#footnote-1172)
          5. Section 1254 property, which includes oil, gas, geothermal, or other mineral property, to the extent that ordinary income would be recognized under section 1254(a) if a partnership were to sell the property at its fair market value.[[1172]](#footnote-1173) The amount is treated as an unrealized receivable with a zero basis. Section 1254 recaptures certain previously expensed amounts as ordinary income to the extent of gain realized on the disposition of section 1254 property. Amounts deducted under sections 263 (capital expenditures), 616 (development expenditures with respect to a mine or other natural deposit other than an oil or gas well), and 617 (mining exploration expenditures), which otherwise would have been included in the property's adjusted tax basis, must be recaptured as ordinary income.[[1173]](#footnote-1174) In addition, any amount deducted under section 611 (deduction for depletion) must be recaptured to the extent it reduced the tax basis (e.g., cost depletion) of the section 1254 property.[[1174]](#footnote-1175) The calculation for section 1254 property is determined at the partner level, not at the partnership.[[1175]](#footnote-1176)
          6. Section 617(f)(2) mining property to the extent of the amount that would be treated as ordinary income under section 617(d)(1) if a partnership were to sell the mining property at its fair market value.[[1176]](#footnote-1177) The amount is treated as an unrealized receivable with a zero basis. Pursuant to section 617(a), a taxpayer can elect to deduct, as ordinary and necessary business expenses, expenditures paid or incurred during the taxable year and prior to the beginning of the development stage of the mine, for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral. In general, under section 617(d)(1), a portion of the gain recognized on the sale or other disposition of mining property is treated as ordinary income (the deducted exploration expenditures).
          7. Section 1252(a)(2) farm land to the extent that ordinary income would be recognized under section 1252(a)(1) if a partnership were to sell the property at its fair market value.[[1177]](#footnote-1178) The amount is treated as an unrealized receivable with a zero basis. Section 1252 generally provides that, if a taxpayer has held farm land for less than 10 years and has elected to deduct soil and water conservation expenditures under section 175, then upon disposition of the land, the taxpayer is required to treat a portion of the gain as ordinary income.[[1178]](#footnote-1179)
          8. Section 1253 property, to the extent that ordinary income would be recognized under section 1253(a) if the partnership were to sell the property at its fair market value. The amount is treated as an unrealized receivable with a zero basis. Under §1253(a), the transfer of a franchise, trademark, or trade name is not treated as a sale or exchange of a capital asset if the transferor retains any “significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark or trade name.”[[1179]](#footnote-1180)
          9. Partnership property subject to basis reduction under section 1017, relating to income from discharge of indebtedness that is excluded from income under section 108(a). These are reductions are treated as depreciation subject to section 1245 or section 1250 recapture.
          10. Market discount bonds to the extent that ordinary income would be recognized under section 1276(a) if a partnership were to sell the bonds at fair market value.[[1180]](#footnote-1181) The amount is treated as an unrealized receivable with a zero basis. Section 1276(a) provides that gain recognized upon the disposition of any market discount bond[[1181]](#footnote-1182) is treated as ordinary income to the extent of “accrued market discount” on the bond. The term “market discount bond” means any bond having “market discount.”[[1182]](#footnote-1183) The term “market discount” means the excess of the stated redemption price of the bond over the basis of the bond immediately after its acquisition by the taxpayer.[[1183]](#footnote-1184)
    3. Exception: Distributions in “Mixing Bowl” Transactions
       1. 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 “mixing bowl transaction” provisions of sections 704(c)(1)(B) and 737. These provisions can be triggered when contributed property is distributed to another partner or if other property is distributed to a contributing partner.
          2. Some of the techniques discussed in these materials require a distribution of partnership property to one partner (or less than all of the partners). If such property had been contributed by a partner (rather than purchased by the partnership), then these “mixing bowl” rules could be implicated, possibly triggering gain to one or more of the partners. As discussed, if seven years have elapsed from contribution to distribution, then that gain can be avoided.
       2. 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. [[1184]](#footnote-1185)
          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.[[1185]](#footnote-1186) 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.[[1186]](#footnote-1187)
          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).[[1187]](#footnote-1188)
          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.[[1188]](#footnote-1189)
          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.”[[1189]](#footnote-1190) Specifically to contributed property distributions to another partner, the Treasury Regulations provide, “The transferee of all or a portion of the partnership interest of a contributing partner is treated as the contributing partner for purposes of section 704(c)(1)(B) and this section to the extent of the share of built-in gain or loss allocated to the transferee partner.”[[1190]](#footnote-1191)
          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),”[[1191]](#footnote-1192) 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.[[1192]](#footnote-1193)
       3. Other Property Distributed to Contributing Partner- Section 737
          1. If a partner contributes appreciated property to the partnership and, within seven years of the date of contribution, that partner receives a distribution of any property other than the contributed property, such partner generally will be required to recognize gain upon the receipt of such other property.[[1193]](#footnote-1194) 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.[[1194]](#footnote-1195)
          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:

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”);[[1195]](#footnote-1196) or

The “net precontribution gain,”[[1196]](#footnote-1197) 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.[[1197]](#footnote-1198)

* + - * 1. 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.[[1198]](#footnote-1199) 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.[[1199]](#footnote-1200) If the distributed property is subject to a liability, it is the gross value of the property that is used in the calculation.[[1200]](#footnote-1201)
        2. 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.”[[1201]](#footnote-1202) 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.”[[1202]](#footnote-1203)
        3. 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.”[[1203]](#footnote-1204) 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).[[1204]](#footnote-1205) It seems, however, the consensus view is that a transferee steps in the shoes of the transferor as the contributing partner. One partnership treatise provides, “Any transferee of all or part of a contributing partner’s partnership interest steps into the shoes of the contributing partner under § 737 to the extent of a proportionate part of the net precontribution gain.”[[1205]](#footnote-1206) 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.”[[1206]](#footnote-1207) 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.”[[1207]](#footnote-1208)
        4. The character of the gain is determined by reference to the “proportionate character of the net precontribution gain,”[[1208]](#footnote-1209) which is to say, it is generally determined by its character in the hands of the partnership.
        5. 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.[[1209]](#footnote-1210) Further, the basis of the distributed property is adjusted to reflect the recognized gain on the partner’s outside basis.[[1210]](#footnote-1211)
        6. Marketable securities are generally treated as money for purposes of section 737.[[1211]](#footnote-1212) In determining “net precontribution gain” under section 737, however, marketable securities contributed to the partnership are treated as contributed property.[[1212]](#footnote-1213)
        7. 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.”[[1213]](#footnote-1214) 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).[[1214]](#footnote-1215)
    1. Exception: Distributions and the “Disguised Sale” Rules
       1. If a partner who has contributed appreciated property to a partnership receives a distribution of any other property or cash generally within two years of the contribution, based on the applicable facts and circumstances, the distribution may cause the partner to recognize gain as of the original date of contribution with respect to his or her contributed property under the "disguised sale" rules. [[1215]](#footnote-1216)
       2. 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,”[[1216]](#footnote-1217)
          2. “there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner),”[[1217]](#footnote-1218) and
          3. The two transfers, “when viewed together, are properly characterized as a sale or exchange of property.”[[1218]](#footnote-1219)
       3. Distributions in a transaction determined to be a disguised sale are treated as payments by the partnership to the disguised seller-partner, acting in an independent capacity, and not as a partner.[[1219]](#footnote-1220)
       4. 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.”[[1220]](#footnote-1221) For non-simultaneous transfers and distributions, a disguised sale occurs if the “subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.”[[1221]](#footnote-1222) The Treasury Regulations provide two rebuttable presumption 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;”[[1222]](#footnote-1223) 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.” [[1223]](#footnote-1224)
       5. The Treasury Regulations provide a list of 10 factors that would tend to prove the existence of a disguised sale. Notably, the Treasury Regulations provide, “Generally, the facts and circumstances existing on the date of the earliest of such transfers are the ones considered in determining whether a sale exists.”[[1224]](#footnote-1225) 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.
       6. The definition of a disguised sale is written broadly enough to include transactions that would include a deemed sale of property by the partnership to one or more partners. To that end, the Treasury Regulations provide, “Rules similar to those provided in section 1.707-3 apply in determining whether a transfer of property by a partnership to a partner and one or more transfers of money or other consideration by that partner to the partnership are treated as a sale of property, in whole or in part, to the partner.”[[1225]](#footnote-1226) 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.”[[1226]](#footnote-1227)
       7. 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).
       8. 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.[[1227]](#footnote-1228)
    2. Leveraged Distributions and Disguised Sales
       1. The Treasury Regulations provide that if a partnership incurs a liability and distributes the loan proceeds to a partner, the distribution will be treated as part of a disguised sale only to the extent that the amount of the distribution exceeds the distributee partner’s allocable share of the partnership liability.[[1228]](#footnote-1229) This “leveraged partnership distribution” exception allows a partnership to borrow money and distribute the entire amount to a single partner, even if the partner just contributed property to the partnership, provided that the entire liability is properly allocated to the distributee partner under section 752 of the Code (as discussed later in these materials).
       2. Generally, the assumption of liabilities encumbering transferred property is not alone considered indicative of a disguised sale unless the liabilities are incurred or in contemplation of the transfer. The Treasury Regulations generally presume liabilities incurred within two years of the contribution of the property are incurred in contemplation of the transfer.[[1229]](#footnote-1230) Under section 1.707-5(a)(5) of the Treasury Regulations, a partnership's assumption of a “qualified liability,” or a partnership's taking property subject to a “qualified liability,” in connection with a transfer of property by a partner to the partnership is not treated as part of a disguised sale. Prior to 2014, the Treasury Regulations defined four types of qualified liabilities, which were liabilities that encumber the property[[1230]](#footnote-1231) and those that are:
          1. Incurred more than two years prior to the transfer;[[1231]](#footnote-1232)
          2. Not incurred in anticipation of the transfer;[[1232]](#footnote-1233)
          3. Incurred to finance capital expenditures (allocable under the rules of section 1.163-8T of the Treasury Regulations) on the property;[[1233]](#footnote-1234) or
          4. Incurred in the ordinary course of a trade or business transferred, but only if all of the assets that are material to that trade or business are transferred to the partnership.[[1234]](#footnote-1235)
       3. In 2016, the IRS issued proposed, temporary, and final Treasury Regulations[[1235]](#footnote-1236) addressing the use of leverage to circumvent the disguised sale rules and the allocation of liabilities. This multi-faceted issuance was in response to the public comments to proposed Treasury Regulations published in 2014 (the “2014 Proposed Regulations”). [[1236]](#footnote-1237) The 2014 Proposed Regulations were, in part, issued to address certain leveraged (debt-financed) partnership distributions and bottom end (bottom dollar) guarantees. Whether liabilities have been properly allocated to a partner under these types of transactions has been the subject of a number of court and IRS rulings that are instructive to review.
          1. The disguised sale rules generally provide that a contribution of property by a partner to a partnership followed by a transfer of money or other consideration from the partnership to the partner will be treated as a sale of property by the partner to the partnership if, based on all the facts and circumstances, the transfer of money or other consideration would not have been made but for the transfer of the property (and, for non-simultaneous contributions, the subsequent transfer is not dependent on the entrepreneurial risks of the partnership).[[1237]](#footnote-1238) Notwithstanding the foregoing rule, the Treasury Regulations provide an exception for distributions of money to a partner if the distribution is traceable to a partnership borrowing and if the amount of the distribution does not exceed the partner’s allocable share of the liability incurred to fund the distribution.[[1238]](#footnote-1239)
          2. A bottom end (bottom dollar) guarantee is a type of arrangement pursuant to which debt is allocated to a partner, but the risk of loss to the partner is very remote and the liability represents the last dollars to be paid to the lender. For example, a developer holds real estate with a fair market value of $10 million, an adjusted basis of zero, and subject to a recourse debt of $3 million. If the developer contributes the property to a partnership (e.g., UPREIT), then there would be a $3 million deemed distribution under sections 731(a) and 752(b) of the Code, unless the partnership allocated $3 million of the partnership’s liabilities. The partnership refinances the contributing partner’s $3 million liability into the partnership’s pre-existing $1 billion line-of-credit, and the contributing partner guarantees the “bottom” $3 million of the line-of-credit. At the time of the guarantee, the partnership owns $5 billion of assets. Under the Treasury Regulations under section 752 prior to the issuance of the 2014 Proposed Regulations, the contributing partner would have been allocated $3 million of liability. Thus, the contributing partner can contribute the real estate without recognizing gain and diversify the single real property holding with minimal economic exposure.
          3. The Tax Court in *Canal Corp v. Commissioner*[[1239]](#footnote-1240) held that an indemnity provided by a contributing partner would not be respected under the anti-abuse rule of section 752 of the Code.[[1240]](#footnote-1241) Thus, the court concluded that the contribution of property followed by a cash distribution triggered the disguised sale rules. The facts of the case are:

WISCO (a subsidiary of Canal Corp) and GP formed an LLC, to which WISCO contributed a business valued at $775 million, and GP contributed a business valued at $376 million. On the same day as the contributions, the LLC borrowed $755 million from a bank. The loan was guaranteed by GP, but WISCO agreed to indemnify GP for any principal payments (not interest) GP might have to pay under the guaranty. Under the indemnity agreement, the parties agreed that GP had to proceed first against the LLC assets before seeking indemnification from WISCO, and if WISCO made any payments under the indemnity, WISCO would receive a proportionately increased interest in the LLC. On the day the loan proceeds were received, the LLC distributed $755 million to WISCO.

WISCO paid $604 million of the loan proceeds to Canal in the form of repayment of intercompany loans and a dividend. WISCO then loaned the remaining $151 million to Canal. After all of the foregoing transactions, WISCO’s assets consisted of its interest in the LLC, the $151 million Canal note, and a corporate jet valued at $6 million.

After the distribution of the loan proceeds, the LLC had net equity value of $400 million (contributed businesses minus the loan). GP had a 95% interest in the LLC with a capital account of $376 million, and WISCO had a 5% interest in the LLC with a capital account of $20 million.

Within a month after closing, the LLC borrowed $491 million from GP Finance (a subsidiary of GP) to refinance a portion of the original loan. The following year, the LLC borrowed $264 million from GP Finance to repay the balance of the original loan. The terms of the GP Finance loans were similar to the original loan terms, and the parties executed similar guaranty and indemnity agreements with respect to the GP Finance loans.

The LLC operated with this structure for a year. GP desired to acquire another corporation and, for antitrust purposes, had to sell its LLC interest before making the new acquisition. GP found a buyer for the LLC, but the buyer insisted only on buying 100% of the LLC interests. As a result, GP purchased WISCO’s 5% interest for $41 million. GP also paid Canal $196 million to compensate Canal for the loss of the tax deferral Canal believed it had achieved under the leveraged partnership structure. WISCO then cancelled the $151 million note receivable from Canal.

* + - * 1. In ILM 201324013, the IRS relied on the anti-abuse provision to disregard a partner’s indemnity of a partnership liability. The IRS concluded that the leveraged distribution exception did not apply to a distribution to the indemnifying partner because the liability was not properly allocable to het distribute partner. In the ruling, the IRS offered 3 arguments for disregarding the indemnity:

The indemnity lacked important features that were typically used in a commercially-driven transaction. According to the IRS, a typical indemnity includes such features such as a net worth maintenance requirement, an arms-length fee, an obligation to provide annual financial statements, and evidence that the parties engaged in a genuine negotiation over the indemnity. In the ruling request, the IRS noted the indemnity allowed the partner to sell off assets, make distributions to shareholder, or shift assets to related entities to insulate its assets if the partner expected the indemnity to be enforced.

The indemnity provided no practical or commercial risk of being enforced. The partnership liability was guaranteed by affiliates of the non-distributee partner. The distribute partner agreed to indemnify those guarantors, but only to the extent the guarantors actually made payments on the guarantees. The distribute partner had no direct or indirect obligation to the lender under the indemnity. If the guarantors defaulted on their guarantees, the indemnifying partner had no obligation under the indemnity to pay the lender, even if the underlying partnership liability had not been paid.

The non-distributee partner, in the opinion of the IRS, merely used the partnership as a conduit to borrow from the bank to accommodate the distributee partner’s structure.

* + - * 1. In TAM 200436011,[[1241]](#footnote-1242) a partner contributed assets to the partnership. The partnership borrowed against the contributed assets and made a simultaneous distribution to the contributing partner. The partnership had three classes of ownership interests: Senior Preferred Interests, Junior Preferred Interests, and Junior Common Interests. The contributing partner owned 100% of the Senior Preferred Interests. The contributing partner, along with other partners, owned the other two junior interests. The partnership allocated 100% of the gross income every quarter to the contributing partner up the amount of the preferred return on the Senior Preferred Interests. The partnership agreement also specified that the contributing partner’s share of excess nonrecourse liabilities would be determined under the “significant item” method,[[1242]](#footnote-1243) the result being that 100% of the nonrecourse liabilities would be allocated to the contributing partner in respect of the preferred return on the Senior Preferred Interests treated as the significant partnership item. The IRS ruled that a preferred return (gross income allocation) is not a “significant item” for purposes of allocating partnership liabilities. Therefore, all of the liability could not be allocated to the distributee partner, and the distribution did not qualify for the leveraged partnership exception. The IRS explained, a “significant item of partnership income or gain” does not refer to a tranche of bottom-line gross or net income, but instead refers to partnership income of a certain character or type, such as gain from the sale of property or tax-exempt income.
      1. The 2014 Proposed Regulations sought to amend not only the disguised sale rules under section 707 but also made significant changes to the sharing of partnership recourse and nonrecourse liabilities under section 752 (this is discussed in more detail later in the “Partnership Liabilities and Basis” section of these materials). In response to commentary, in 2016, the IRS issued temporary regulations under section 707 (the “707 Temporary Regulations”) for disguised sale rule purposes and under section 752 (the “752 Temporary Regulations”) directly relating to bottom dollar payment obligations.[[1243]](#footnote-1244) At the same time, the IRS issued final regulations Treasury Regulations under section 707 of the Code (the “707 Final Regulations”) and section 752 of the Code, relating to allocations of excess nonrecourse liabilities for disguised sale rule purposes (the “752 Final Regulations”).[[1244]](#footnote-1245) The 752 Temporary Regulations, with some changes, were adopted in final form in 2019 and are discussed later in the “Partnership Liabilities Are Reflected in Outside Basis” section of these materials).
      2. As discussed below, on October 9, 2019, the 707 Temporary Regulations were withdrawn and replaced with Treasury Regulations that were in effect prior to their issuance. However, a discussion of the 707 Temporary Regulations may still be relevant because the IRS and the Treasury Department believe the approach set out therein has merit. The 707 Temporary Regulations require a partner to apply the same percentage used to determine the partner’s share of excess nonrecourse liabilities under section 1.752-3(a)(3) (with certain limits) in determining the partner’s share of partnership liabilities for disguised sale rule purposes only.
         1. The rationale stated in the preamble to the 707 Temporary Regulations is that this more accurately reflects the economic arrangement of the partners. The preamble states, “In most cases, a partnership will satisfy its liabilities with partnership profits, the partnership's assets do not become worthless, and the payment obligations of partners or related persons are not called upon. This is true whether: (1) a partner's liability is assumed by a partnership in connection with a transfer of property to the partnership or by a partner in connection with a transfer of property by the partnership to the partner; (2) a partnership takes property subject to a liability in connection with a transfer of property to the partnership or a partner takes property subject to a liability in connection with a transfer of property by the partnership to the partner; or (3) a liability is incurred by the partnership to make a distribution to a partner under the debt-financed distribution exception in §1.707-5(b).”
         2. As such, the 707 Temporary Regulations provide, “For purposes of § 1.707- 5, a partner's share of a liability of a partnership, as defined in § 1.752-1(a) (whether a recourse liability or a nonrecourse liability) is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability under § 1.752-3(a)(3)… but shall not exceed the partner's share of the partnership liability under section 752 and applicable regulations.”[[1245]](#footnote-1246)
         3. Thus, the 707 Temporary Regulations treat all partnership liabilities, whether recourse or nonrecourse, as nonrecourse liabilities solely for disguised sale purposes under section 707 of the Code. The 707 Final Regulations, however, provide limitations on the available allocation methods under section 1.752-3(a)(3) of the Treasury Regulations, applicable solely for disguised sale purposes under section 707, for determining a partner's share of excess nonrecourse liabilities. Under section 1.752-3(a)(3) of the 2014 Proposed Regulations, the “significant item method” and the “alternative method” (as discussed later in these materials) were removed and were replaced by a new approach based on a partner’s liquidation value percentage.[[1246]](#footnote-1247) In response to commentary, the 752 Final Regulations retain the significant item method and alternative method, but do not adopt the liquidation value percentage approach for determining a partner’s interest in profits. That being said, the IRS concluded that the allocation of excess nonrecourse liabilities in accordance with the significant item method and the alternative method has been abused by partnerships and their partners for disguised sale purposes. The pre-existing Treasury Regulations already provided that the “additional method” does not apply for disguised sale rule purposes. The 752 Final Regulations now provide, “The significant item method, alternative method, and additional method do not apply for purposes of § 1.707-5(a)(2).”[[1247]](#footnote-1248)
         4. Therefore, under the 707 Temporary Regulations, a partner's share of any partnership liability for disguised sale purposes is determined using the same percentage used to determine the partner's share of the partnership's excess nonrecourse liabilities under section 1.752-3(a)(3) of the Regulations based on the partner's share of partnership profits.
      3. The 707 Temporary Regulations were incorporated by cross reference in a notice of proposed rulemaking published on October 5, 2016 (the “707 Proposed Regulations”).[[1248]](#footnote-1249) That notice also incorporated by cross reference the 752 Temporary Regulations and included new proposed regulations under sections 704 and 752 (the “752 Proposed Regulations”).
      4. The 707 Final Regulations formally add a new type of “qualified liability” to the pre-existing four types. This new qualified liability is one that is not incurred in anticipation of a transfer of the property to a partnership but that was incurred in connection with a trade or business in which property transferred to the partnership was used or held, provided that all assets related to that trade or business are transferred other than assets not material to a continuation of the trade or business.[[1249]](#footnote-1250) The 707 Final Regulations also provide guidance on the treatment of preformation capital expenditures,[[1250]](#footnote-1251) tiered partnerships, and liabilities in assets-over mergers. These subjects are beyond the scope of these materials.
      5. 2019 Withdrawal and Reinstatement of Regulations
         1. On October 9, 2019, the IRS formally withdrew the 707 Temporary Regulations and reinstated section 1.707-5(a)(2) of the Treasury Regulations (the “Prior 707 Regulations”) in effect, prior to the 707 Temporary Regulations, as of April 1, 2016 (the “2019 Withdrawal and Reinstatement”).[[1251]](#footnote-1252) This 2019 Treasury decision adopted the approach set out in a 2018 notice of proposed notice of rulemaking (the “2018 Proposed Regulations”),[[1252]](#footnote-1253) essentially with no change other than the applicability date.
         2. Under section 1.707-5(a)(2) of the Prior 707 Regulations, a partner's share of a partnership's recourse liability equals the partner's share of the liability under section 752 and the Treasury Regulations thereunder. A partnership liability is a recourse liability to the extent that the obligation is a recourse liability.[[1253]](#footnote-1254)
         3. Under section 1.707–5(a)(2)(ii) of the Prior 707 Regulations, a partner's share of a partnership's nonrecourse liability is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability.[[1254]](#footnote-1255) A partnership liability is a nonrecourse liability of the partnership to the extent that the obligation is a nonrecourse liability.[[1255]](#footnote-1256)
         4. As mentioned above, the 707 Final Regulations limited the available methods for determining a partner's share of an excess nonrecourse liability for disguised sale purposes. Under the 707 Final Regulations, a partner's share of excess nonrecourse liability for disguised sale purposes is determined only in accordance with the partner's share of partnership profits and by taking into account all facts and circumstances relating to the economic arrangement of the partners. Therefore, the significant item method, the alternative method, and the additional method[[1256]](#footnote-1257) do not apply for purposes of determining a partner's share of a partnership's nonrecourse liability for disguised sale purposes.
         5. Section 1.707–5(a)(2)(i) and (ii) of the Prior 707 Regulations provided that a partnership liability is a recourse or nonrecourse liability if the liability was treated as a partnership liability for purposes of section 752, specifically dealing with contingent liabilities under section 1.752-7 of the Treasury Regulations. In the 2018 Proposed Regulations, the IRS requested additional guidance on this issue.
         6. Examples 2, 3, 7, and 8 under section 1.707–5(f) of the Prior 707 Regulations are reinstated with the exception of added language to Example 3 to reflect an amendment made by the 707 Final Regulations regarding an anticipated reduction in a partner's share of a liability that is not subject to the entrepreneurial risks of partnership operations.
         7. The Prior 707 Regulations apply to any transaction with respect to which all transfers occur on or after October 4, 2019.
         8. The 2019 Withdrawal and Reinstatement came about, ostensibly, as a result of the 2017 Executive Order 13789 (E.O. 13789), titled “Reducing Regulation and Controlling Regulatory Costs,” pursuant to which the President Trump ordered the Treasury to identify significant tax regulations issued on or after January 1, 2016, that (i) impose an undue financial burden on U.S. taxpayers, (ii) add undue complexity to the Federal tax laws, or (iii) exceed the statutory authority of the IRS. The 707 Temporary Regulations were identified as meeting the regulatory burdens specified by E.O. 13789 and thus were withdrawn.[[1257]](#footnote-1258) Notwithstanding the withdrawal, 2019 Withdrawal and Reinstatement provides “The Treasury Department and the IRS continue to study the merits of the approach in the 707 Temporary Regulations and other approaches, including these final regulations, to determine which results in the most appropriate treatment of liabilities in the context of disguised sales.”
    1. Exception: Distributions of Marketable Securities
       1. 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.[[1258]](#footnote-1259) 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.[[1259]](#footnote-1260) 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.”[[1260]](#footnote-1261) Further, the Code provides that a marketable security includes “any financial instrument the value of which is determined substantially by reference to marketable securities.”[[1261]](#footnote-1262)
       2. There are a number of applicable exceptions to the foregoing treatment of distributions of marketable securities, including: (1) distributions of contributed securities to the partner who contributed them;[[1262]](#footnote-1263) (2) distributions of securities that were not marketable when acquired by the partnership and are distributed within five years of becoming marketable;[[1263]](#footnote-1264) and (3) distributions of securities from an “investment partnership” to an “eligible partner.”[[1264]](#footnote-1265)
       3. 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.[[1265]](#footnote-1266) 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).[[1266]](#footnote-1267) 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.[[1267]](#footnote-1268)
       4. 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.[[1268]](#footnote-1269)
       5. 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.[[1269]](#footnote-1270) 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).[[1270]](#footnote-1271)

* + - 1. 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.

* + - 1. 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 to 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.”[[1271]](#footnote-1272)
      2. 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.

* + - 1. Any unrealized loss in the marketable securities is not recognized, either by the partnership or the partner.[[1272]](#footnote-1273)
      2. 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.[[1273]](#footnote-1274) 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.[[1274]](#footnote-1275) As a result, the distributee-partner’s outside basis is reduced only by the basis of the distributed securities determined under section 732 without regard to any basis increase under section 731(c)(4) (which is reflected in the securities). The foregoing rules and resulting outside basis of the distributee-partner and in the security can be complicated:

Example 1: 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).

Example 2: 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.

* + - 1. 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.[[1275]](#footnote-1276) 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).[[1276]](#footnote-1277) Therefore, for purposes of sections 733 and section 734 of the Code, a distribution of marketable securities is treated as a property distribution.
      2. 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. [[1277]](#footnote-1278)
      3. 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 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.”[[1278]](#footnote-1279) The provision goes on to provide three examples:[[1279]](#footnote-1280)
         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.
  1. Partnership Liabilities Are Reflected in Outside Basis
     1. Introduction
        1. Generally, as discussed in more detail below, a partner’s basis in his or her partnership interest (outside basis) includes the partner’s share of the partnership’s liabilities. As such, any increase in a partner’s share of partnership liabilities will increase the partner’s outside basis. Conversely, any decrease in a partner’s share of partnership liabilities will decrease the partner’s outside basis and could also cause the partner to recognize income.
        2. Outside basis determines, among other things, the amount of money a partnership can distribute to a partner without triggering gain. Section 731(a) of the Code provides that a partnership does not recognize gain on a distribution of money expect to the extent that the amount of money distributed exceeds the partner’s basis in his or her interest.
        3. In addition, section 704(d) of the Code provides that a partner’s distributive share of partnership losses is allowed only to the extent of the partner’s outside basis at the end of the partnership taxable year in which the loss occurred. Any loss in excess of the partner’s outside basis is disallowed. The excess loss is allowed as a deduction at the end of the first succeeding partnership taxable year (and any subsequent years) but only to the extent, if any, of the partner’s outside basis at the end of that year.
        4. Importantly, in the context of tax basis management, outside basis determines (in whole or in part) the adjusted basis of property distributed to a partner. As discussed in more detail above, the basis of distributed property to a partner in a current distribution is the *lesser* of the inside basis of the property and the outside basis of the distributee partner.[[1280]](#footnote-1281) With respect to liquidating distributions of property, the basis of the distributed property is simply the outside basis of the distributee partner (as reduced by any money distributed in the same transaction).[[1281]](#footnote-1282)
        5. An extension of the unitary basis rule is that a partner (i.e., grantor and a grantor trust) will have one unitary liability allocation amount under section 752 of the Code. In a technical advice memorandum,[[1282]](#footnote-1283) the IRS concluded that the deemed distribution under section 752(b) of the Code from a reduction in a partner's share of nonrecourse liabilities should be applied against the partner's entire basis in both its limited and general partnership interests. The limited partnership interests of two partners, A and B, each having both a general partner and a limited partnership interest, were liquidated. As a result of the liquidation of the limited partnership interests, the nonrecourse liability allocation of A and B decreased. The IRS agent argued that A and B each had a separate basis as a limited partner and as a general partner and that to the extent the decrease in liability allocation exceeded their basis in the limited partnership interests, they would recognize gain under section 731 of the Code. The IRS National Office disagreed with the agent, specifically stating that A and B had a single adjusted basis with respect to their interests in the partnership. Because each of A and B had a basis in the partnership exceeding the amount of money deemed to be distributed under section 752(b) of the Code, the liquidation of their limited partnership interests did not result in gain recognition to either A or B under section 731 of the Code.
     2. Treasury Regulations on Economic Risk of Loss
        1. The partnership rules make an important distinction between recourse and nonrecourse liabilities. In this context, generally, recourse liabilities increase basis only as to the partner who bears economic risk of loss, whereas nonrecourse liabilities increase basis proportionately among all of the partners. A partnership liability is considered recourse if any partner or “related person” bear the economic risk of loss for the liability.[[1283]](#footnote-1284) Conversely, a liability is considered nonrecourse to the extent no person or “related person” bears such risk of loss.[[1284]](#footnote-1285)
        2. Under the Treasury Regulations, a partner is deemed to have the economic risk of loss if the partner would be required to pay the liability in the event all of the partnership assets are worthless,[[1285]](#footnote-1286) even if the economic reality is that the chance the partner will be required to pay or have the ability to pay the liability is very small. Under section 1.752-2(b)(1) of the Treasury Regulations, a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated:
           1. The partner or related person would be obligated to make a payment to any person or a contribution to the partnership because that liability becomes due and payable; and
           2. The partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner.
        3. Whether the partner’s or related person’s payment or contribution obligation exists (and the extent of such obligation) depends on all the facts and circumstances, like the existence of the following:
           1. Contractual obligations like “guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors or to other partners, or to the partnership;”[[1286]](#footnote-1287)
           2. Partnership obligations including “obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership;”[[1287]](#footnote-1288)
           3. Payment obligations “imposed by state law, including the governing state partnership statute;”[[1288]](#footnote-1289) and
           4. Reimbursement rights a partner or related person may have from another partner or a person who is related to such other partner.[[1289]](#footnote-1290)
        4. In making a determination of whether a partner or related person has a payment obligation on a partnership liability and bears the economic risk of loss, it is assumed the partner or related person will be able to pay the obligations “irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.”[[1290]](#footnote-1291) This presumption is sometimes referred to as the “deemed satisfaction rule.” Notwithstanding the deemed satisfaction rule, a payment obligation is disregarded if, taking into account all of the facts and circumstances, the obligation is subject to contingencies that make it unlikely that the obligation will be discharged. If a payment would arise in the future after the occurrence of an event that is not determinable with reasonable certainty, the obligation is ignored, but only until the triggering event occurs.[[1291]](#footnote-1292) In addition, the satisfaction presumption is subject to an anti-abuse rule in section 1.752-2(j) of the Treasury Regulations pursuant to which a payment obligation of a partner or related person may be disregarded or treated as an obligation of another person if facts and circumstances indicate that a principal purpose of the arrangement is to eliminate the partner's economic risk of loss with respect to that obligation (or create the appearance of the partner or related person bearing the economic risk of loss when the substance is otherwise).
        5. Any increase in a partner’s share of liabilities (including any assumption by a partner of any partnership liabilities) is treated as contribution of cash by the partner in the partnership, thereby increasing basis.[[1292]](#footnote-1293) Any decrease is treated as a distribution of cash to the partner, thereby reducing basis and possibly resulting in the recognition of gain if the amount of the deemed distribution exceeds available outside basis.[[1293]](#footnote-1294) If property that is subject to a liability is contributed to or distributed from a partnership, the transferee is deemed to assume the liability but only to the extent the liability is not in excess of the fair market value.[[1294]](#footnote-1295)
        6. The Treasury Regulations state that a person will be a “related person” to a partner if they have a relationship that is specified in sections 267(b) and 707(b)(1) but with a few modifications.[[1295]](#footnote-1296) Including those modifications, a person is related to a partner if they are (in part):
           1. Members of the same family (spouse, ancestors and lineal descendants);
           2. An individual and a corporation if more than 80% of the value of the outstanding stock of the corporation is owned, directly or indirectly, by or for such individual;
           3. A grantor and a fiduciary of any trust;
           4. A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;
           5. A fiduciary of a trust and a beneficiary of such trust;
           6. A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;
           7. A fiduciary of a trust and a corporation if more than 80% of the value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;
           8. A person and a charitable organization if the organization is controlled directly or indirectly by such person or, if the person is an individual, by members of the individual's family;
           9. A corporation and a partnership if the same persons own more than 80% in value of the outstanding stock of the corporation and more than 80% of the capital interest or the profits interest in the partnership;
           10. An S corporation and another S corporation (or C corporation) if the same persons own more than 80% in value of the outstanding stock of each corporation;
           11. Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of that estate;
           12. A partnership and a person owning, directly or indirectly, more than 80% of the capital interest, or the profits interest, in such partnership; or
           13. Two partnerships in which the same persons own, directly or indirectly, more than 80% of the capital interests or profits interests.
        7. To avoid double counting, the Treasury Regulations provide that persons owning interests (directly or indirectly) in the same partnership are not treated as related persons for purposes of determining their share of partnership loss.[[1296]](#footnote-1297)
        8. The Treasury Regulations further provide that if (i) a partnership liability is held or guaranteed by another entity that is a partnership, S corporation, C corporation, or trust; (ii) a partner or related person (directly or indirectly) owns 20% or more in such other entity, and (iii) a principal purpose of having such other entity act as a lender or guarantor is to avoid having the partner bears the risk of loss for all or part of the liability, then the partner is treated as holding the other entity’s interest as a creditor or guarantor to the extent of that partner’s or related person’s ownership interest in such other entity.[[1297]](#footnote-1298) The ownership interest of the partner and related person are determined according to each entity in the following manner:
           1. Partnership: highest percentage interest in any partnership loss or deduction for any taxable year;[[1298]](#footnote-1299)
           2. S corporation: percentage of outstanding stock owned by the shareholder;[[1299]](#footnote-1300)
           3. C corporation: percentage of the issued and outstanding stock owned by the shareholder based upon fair market value;[[1300]](#footnote-1301) and
           4. Trust: actuarial percentage interest owned beneficially.[[1301]](#footnote-1302)
        9. An otherwise nonrecourse partnership liability is treated as a recourse liability to the extent that a partner or a related person holds an interest in the liability, referred to as “partner nonrecourse debt” in the Treasury Regulations.[[1302]](#footnote-1303) In such case, the economic risk of loss is allocated to such partner (or related person) to the extent not otherwise allocated to another partner. [[1303]](#footnote-1304)
        10. If a partner (or related person) pledges property outside the partnership (a direct pledge) as security for a partnership liability, the partner is deemed to bear the risk of loss to the extent of the “net fair market value” of the pledged property.[[1304]](#footnote-1305) If a partner contributes property to a partnership solely for the purpose of securing a partnership liability (an indirect pledge), the partner is deemed to bear the risk of loss to the extent of the “net fair market value” of the pledged property.[[1305]](#footnote-1306) Contributed property will not be deemed indirectly pledged unless “substantially all of the items of income, gain, loss, and deduction attributable to the contributed property are allocated to the contributing partner, and this allocation is generally greater than the partner's share of other significant items of partnership income, gain, loss, or deduction.”[[1306]](#footnote-1307)
        11. As with other partnership provisions, the Treasury Regulations contain anti-abuse rules that would disregard the form of the situation “if facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's economic risk of loss with respect to that obligation or create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise.”[[1307]](#footnote-1308) The Treasury Regulations discuss 2 situations:
            1. Arrangements tantamount to a guarantee:[[1308]](#footnote-1309)

Partner or related person undertakes one or more contractual obligations so the partnership may obtain a loan;

Contractual obligations of the partner or related person eliminate substantially all the risk to the lender that the partnership will not satisfy its obligations under the loan; and

One of the principal purposes is to attempt to permit partners (other than those who are directly or indirectly liable for the obligation) to include a portion of the loan in the basis of their partnership interests.

* + - * 1. A plan to circumvent or avoid the obligation, based on the facts and circumstances, of a partner (or related person).[[1309]](#footnote-1310)
      1. A complete discussion of how nonrecourse liabilities are shared by partners is beyond the scope of this outline, but the Treasury Regulations generally provide that a partner’s share of such liabilities are the sum of:[[1310]](#footnote-1311)
         1. The partner’s share of “partnership minimum gain”[[1311]](#footnote-1312) (gain that would be realized if all property subject to nonrecourse liability is sold in full satisfaction of the liabilities and for no other consideration);[[1312]](#footnote-1313)
         2. Amount of taxable gain that would be allocated to the partner under section 704(c) (arising because the partner contributed property to the partnership and the partnership still holds the property) if the partnership disposed of all partnership property subject to nonrecourse liabilities in a taxable transaction in full satisfaction of the liabilities and for no other consideration;[[1313]](#footnote-1314) and
         3. The partner’s share of “excess nonrecourse liabilities” (liabilities not allocated above).[[1314]](#footnote-1315)
      2. Section 1.752-3(a)(3) of the Treasury Regulations provides a number of methods to determine a partner's share of “excess nonrecourse liabilities.” Under one method, a partner’s share of “excess nonrecourse liabilities” is generally “determined in accordance with the partner's share of partnership profits” under all of the “facts and circumstances relating to the economic arrangement of the partners.”[[1315]](#footnote-1316) As a result, if an FLP has pro rata shares (as is common), and no partner has made a contribution of property to the partnership, then nonrecourse debt will also be shared pro rata. The partnership agreement may specify the partners' interests in partnership profits so long as the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain (often referred to as the “significant item” method). Alternatively, excess nonrecourse liabilities may be allocated among partners in a manner that deductions attributable to those liabilities are reasonably expected to be allocated (often referred to as the “alternative” method). Additionally, the partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on section 704(c) property[[1316]](#footnote-1317) or property for which reverse section 704(c) allocations are applicable[[1317]](#footnote-1318) where such property is subject to the nonrecourse liability, to the extent that such built-in gain exceeds the gain described in section 1.752-3(a)(2) of the Treasury Regulations with respect to such property (often referred to as the “additional” method).
      3. As discussed earlier in these materials, for disguised sale rule purposes only, a partner’s share of partnership liabilities, whether recourse as to that partner or nonrecourse,[[1318]](#footnote-1319) is determined solely under the profit share provision.[[1319]](#footnote-1320) The significant item method, alternative method, and additional method are unavailable for this purpose.[[1320]](#footnote-1321)
    1. Withdrawal and Replacement of 2014 Proposed Regulations
       1. As mentioned in the “Leveraged Distributions and Disguised Sales” portion of these materials, the 2014 Proposed Regulations sought to amend not only the disguised sale rules under section 707 but also made significant changes to the sharing of partnership recourse and nonrecourse liabilities under section 752. The 2014 Proposed Regulations took a much more fact-specific approach providing that a partner will be treated as having the economic risk of loss only if there is a significant possibility that the partner will have to a pay a partnership liability and that the partner will have enough net worth to pay the liability with his or her own assets. If both of those conditions do not exist, then the partnership liability will be allocated to all of the partners as a nonrecourse liability. As with the previous regulations, the determination of the extent to which a partner or related person has an obligation to make a payment is based on the facts and circumstances, except that under the 2014 Proposed Regulations, the obligation will not be recognized if it fails any of the “recognition requirements.”[[1321]](#footnote-1322)
       2. The recognition requirements were:[[1322]](#footnote-1323)
          1. The partner or related person is:

Required to maintain a commercially reasonable net worth throughout the term of the payment obligation; or

Subject to commercially reasonable contractual restrictions on transfers of assets for inadequate consideration.

* + - * 1. The partner or related person is required periodically to provide commercially reasonable documentation regarding the partner’s or related person’s financial condition.
        2. The term of the payment obligation does not end prior to the term of the partnership liability.
        3. The payment obligation does not require that the primary obligor or any other obligor with respect to the partnership liability directly or indirectly hold money or other liquid assets in an amount that exceeds the reasonable needs of such obligor.
        4. The partner or related person received arm’s length consideration for assuming the payment obligation.
        5. In the case of a guarantee or similar arrangement, the partner or related person is or would be liable up to the full amount of such partner’s or related person’s payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied.
        6. In the case of an indemnity, reimbursement agreement, or similar arrangement, the partner or related person is or would be liable up to the full amount of such partner’s or related person’s payment obligation if, and to the extent that, any amount of the indemnitee’s or other benefitted party’s payment obligation is satisfied.
      1. In addition to the recognition factors, the 2014 Proposed Regulations would have effectively eliminated the deemed satisfaction rule for partners (other than individuals and estates of decedents). While it is still assumed that all partners and related persons who have obligations to make payments actually preform those obligations, a payment obligation is recognized only to the extent of the net value of the partner or related person.[[1323]](#footnote-1324) A partner or related person’s net value is determined under section 1.752-2(k) of the Treasury Regulations that determine the net value of disregarded entities.
      2. In response to comments to the 2014 Proposed Regulations, the IRS withdrew the proposed regulations under section 1.752-2 in 2016 and propose to move the recognition factors (other than those concerning bottom end/bottom dollar arrangements) to an anti-abuse rule under section 1.752-2(j) of the Treasury Regulations (the “752 Proposed Regulations). [[1324]](#footnote-1325) On October 9, 2019, the IRS adopted in final form, with certain changes, the 752 Temporary Regulations (dealing with: (i) bottom dollar payment obligations, and (ii) capital contributions and deficit restoration obligations) and the 752 Proposed Regulations (rules regarding when certain liabilities will be treated as recourse obligations under the anti-abuse rule of section 1.72-2(j) of the Treasury Regulations).[[1325]](#footnote-1326)
    1. Bottom Dollar Payment Obligations
       1. The Treasury Regulations provide generally that the extent to which a partner (or related party) has an obligation to make a payment is based on the facts and circumstances, taking into account obligations inside and outside the partnership agreement and imposed by law, and if the obligation is not recognized, then section 752 will be applied as if the obligation did not exist.[[1326]](#footnote-1327) Specifically, “bottom dollar payment obligation” will not be recognized as a payment obligation under of the Treasury Regulations. [[1327]](#footnote-1328)
          1. The Treasury Regulations broadly define a “bottom dollar payment obligation” as:[[1328]](#footnote-1329)

With respect to a guarantee (or similar arrangement), any obligation other than one in which the partner (or related person) is or would be liable up to the full amount of such partner’s (or related person’s) payment obligation if any amount of the partnership liability is not otherwise satisfied;

With respect to an indemnity (or similar arrangement), any obligation other than one in which the partner (or related person) is or would be liable up to the full amount of such partner’s (or related person’s) payment obligation if any amount of the indemnitee’s or benefited party’s payment obligation is satisfied;

With respect to an obligation to make a capital contribution or to restore a deficit capital account upon liquidation of the partnership,[[1329]](#footnote-1330) as any payment obligation other than one in which the partner is or would be required to make the full amount of the partner's capital contribution or to restore the full amount of the partner's deficit capital account; and

An arrangement with respect to a partnership liability that uses tiered partnerships, intermediaries, senior and subordinate liabilities, or similar arrangements to convert what would otherwise be a single liability into multiple liabilities if, based on the facts and circumstances, the liabilities were incurred pursuant to a common plan, and with a principal purpose of avoiding having at least one of such liabilities or payment obligations being treated as a bottom dollar payment obligation (as described above).

* + - * 1. An obligation will not be considered a bottom dollar payment obligation merely because:[[1330]](#footnote-1331)

A maximum amount is placed on the partner's (or related) person's payment obligation;

A partner's (or related person's) payment obligation is stated as a fixed percentage of every dollar of the partnership liability to which such obligation relates (a vertical slice obligation); or

There exists a right of proportionate contribution running between partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable.

* + - * 1. The Treasury Regulations include a simple, but instructive, example, pursuant to which ABC limited liability company (taxed as a partnership for tax purposes) borrows $1,000 from a bank. The LLC has 3 equal members. A guarantees up to $300 of the ABC liability if any amount of full liability is not recovered. B guarantees up to $200, but only if the bank recovers less than $200. A and B waive their rights of contribution from each other. Based on these facts, the Treasury Regulations conclude:[[1331]](#footnote-1332)

A’s $300 guarantee obligation is not a bottom dollar payment obligation. As a result, A’s payment obligation is recognized under section 1.752-2(b)(3) of the Treasury Regulations, and A’s economic risk of loss under section 1.752-2(b)(1) of the Treasury Regulations is $300.

B’s guarantee is a bottom dollar payment obligation. As a result, B’s payment obligation is not recognized under section 1.752-2(b)(3)(ii)(A) of the Treasury Regulations, and B bears no economic risk of loss under section 1.752-2(b)(1) of the Treasury Regulations for ABC’s liability.

The result is that $300 of ABC’s liability is allocated to A under section 1.752-2(a) of the Treasury Regulations (relating to a partner’s share of recourse liabilities), and $700 is allocated to A, B, and C under section 1.752-3 of the Treasury Regulations (relating to a partner’s share of nonrecourse liabilities).

* + - * 1. The Treasury Regulations further provide if a partner (or related person) has a payment obligation that would be recognized section 1.752-2(b)(3) of the Treasury Regulations (referred to as the “initial payment obligation”) but for a right of indemnification or reimbursement, then such bottom dollar payment obligation will nevertheless be recognized provided the partner (or related person) is liable for at least 90% of the initial payment obligation.[[1332]](#footnote-1333)
        2. The Treasury Regulations impose a requirement that a partnership must disclose a bottom dollar payment obligation (including those obligations that would be recognized under the 90% threshold exception described above) on Form 8275, Disclosure Statement, attached to the return of the partnership for the taxable year in which the bottom dollar payment obligation is undertaken or modified.[[1333]](#footnote-1334)
    1. New Anti-Abuse Treasury Regulations
       1. Pursuant to the Treasury Regulations, an obligation of a partner (or related person) to make a payment will not be recognized if “the facts and circumstances evidence a plan to circumvent or avoid the obligation.”[[1334]](#footnote-1335) The list of non-exclusive list of factors that may indicate a plan to circumvent or avoid the payment obligation (other than an obligation to restore a deficit capital account upon liquidation of a partnership) include:[[1335]](#footnote-1336)
          1. The partner (or related person) is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment, including, restrictions on transfers for inadequate consideration or on distributions by the partner (or related person) to equity owners in the partner (or related person).
          2. The partner or related person is not required to provide (either at the time the payment obligation is made or periodically) commercially reasonable documentation regarding the partner's (or related person's) financial condition.
          3. The term of the payment obligation ends prior to the term of the partnership liability, or the partner (or related person) has a right to terminate its payment obligation, if the purpose of limiting the duration of the payment obligation is to terminate such payment obligation prior to the occurrence of an event or events that increase the risk of economic loss to the guarantor or benefited party.[[1336]](#footnote-1337)
          4. There exists a plan or arrangement in which the primary obligor or any other obligor (or a person related to the obligor) with respect to the partnership liability directly or indirectly holds money or other liquid assets in an amount that exceeds the reasonable foreseeable needs of such obligor.
          5. The payment obligation does not permit the creditor to promptly pursue payment following a payment default on the partnership liability, or other arrangements with respect to the partnership liability or payment obligation otherwise indicate a plan to delay collection.
          6. In the case of a guarantee or similar arrangement, the terms of the partnership liability would be substantially the same had the partner or related person not agreed to provide the guarantee.
          7. The creditor or other party benefiting from the obligation did not receive executed documents with respect to the payment obligation from the partner or related person before, or within a commercially reasonable period of time after, the creation of the obligation.
       2. The Treasury Regulations include an example of a gratuitous guarantee by a partner that would be disregarded, thereby causing the partnership liability to be nonrecourse debt (not recourse as to the guarantor partner):[[1337]](#footnote-1338)

In 2020, A, B, and C form a domestic limited liability company (LLC) that is classified as a partnership for federal tax purposes. Also in 2020, LLC receives a loan from a bank. A, B, and C do not bear the economic risk of loss with respect to that partnership liability, and, as a result, the liability is treated as nonrecourse under § 1.752-1(a)(2) in 2020. In 2022, A guarantees the entire amount of the liability. The bank did not request the guarantee and the terms of the loan did not change as a result of the guarantee. A did not provide any executed documents with respect to A's guarantee to the bank. The bank also did not require any restrictions on asset transfers by A and no such restrictions exist.

The example concludes the facts and circumstances evidence a plan to circumvent or avoid the payment obligation pointing to the following factors: (i) the partner is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment; (ii) the partner is not required to provide (either at the time the payment obligation is made or periodically) commercially reasonable documentation regarding the partner's or related person's financial condition to the benefited party; (iii) in the case of the guarantee, the terms of the liability are the same as they would have been without the guarantee; and (iv) the creditor did not receive executed documents with respect to the payment obligation from the partner at the time the obligation was created.

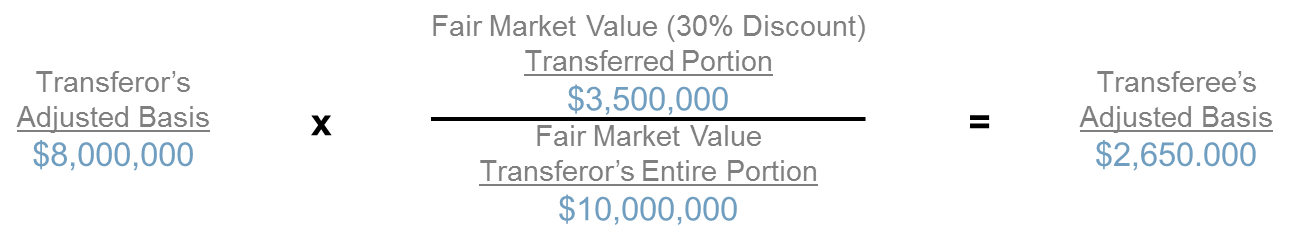
* + - 1. In addition to the foregoing, the Treasury Regulations provide an “obligation of any partner or related person to make a payment is not recognized … if the facts and circumstances indicate that at the time the partnership must determine a partner's share of partnership liabilities … there is not a commercially reasonable expectation that the payment obligor will have the ability to make the required payments under the terms of the obligation if the obligation becomes due and payable.”[[1338]](#footnote-1339) “Commercially reasonable expectation” facts and circumstances include factors that a third party creditor would take into account when determining to grant the loan.[[1339]](#footnote-1340) For this purpose, payment obligors include grantor trusts and disregarded entities (including wholly-owned limited liability companies, qualified subchapter S subsidiaries, and qualified REIT subsidiaries).[[1340]](#footnote-1341)
      2. The Treasury Regulations provide an example of an undercapitalized limited liability company (LLC) that is a disregarded entity for Federal income tax purposes and owned by A. In the example, LLC has no assets and is the general partner of a limited partnership (LP) that has two other partners (B and C) and that has $300,000 of debt. The partnership agreement provides that only the LLC is required to restore its any deficit in its capital account. The example concludes that A is treated as the partner in the limited partnership but only the LLC has an obligation with respect to the debt of the LP. As such the “commercially reasonable expectation” test is applied to the LLC, not A. As a result, because LLC has no assets, its deficit capital account restoration obligation is not recognized and, the $300,000 debt is characterized as nonrecourse, allocated among all three partners under section 1.752-3 of the Treasury Regulations.
  1. Termination of Grantor Trust Status May Cause Gain Because of Partnership Liabilities
     1. Because grantor trust status will be terminated on the death of the grantor or “turned off” by the release of the power causing grantor trust status, [[1341]](#footnote-1342) changing trustees,[[1342]](#footnote-1343) or repayment of borrowed trust assets,[[1343]](#footnote-1344) taxpayers must deal with having a trust that will ultimately be considered a separate taxable entity, a non-grantor trust. In the context of partnerships, this normally does not cause adverse tax consequences, but if there is partnership debt, it can, under certain circumstances, trigger gain.
     2. As mentioned above, if grantor trust status is terminated during the lifetime of the grantor, a transfer is deemed to occur, and the grantor may recognize gain to the extent the amount the IDGT may owe to the grantor (installment obligation) exceeds the grantor’s basis in the assets. For this reason, practitioners advise against terminating grantor trust status while the debt is still outstanding and advise clients to pay off the debt prior to the death of the grantor if at all possible.
     3. Gain can also result if grantor trust status is renounced and, due to the creation of a new taxpayer (the trust), it results in a reduction of partnership liabilities of the grantor or the IDGT. Outside basis of the partnership would no longer be calculated across all of the partnership interests and would thus be determined separately. If all of the partnership liabilities are nonrecourse, then no net reduction should occur to either the grantor or the trust. However, if the grantor had guaranteed some partnership debt thereby making such debt recourse as to the grantor, then the loss of grantor trust status would result in a net reduction of partnership liabilities with respect to the trust partner and a deemed distribution on the partnership shares owned by the trust. If there is insufficient outside basis in the trust shares, capital gain would be recognized by the trust.
     4. The IRS has ruled that when the grantor of a grantor trust that holds a partnership interest that is subject to liabilities renounces grantor trust status, the grantor is treated as transferring the partnership interest to the trust. When the interest transferred is a partnership interest and the grantor’s share of the partnership liabilities is reduced, the grantor is treated as having sold the partnership interest for an amount equal to the grantor’s share of the reduced liabilities.[[1344]](#footnote-1345)
     5. The Treasury Regulations also provide that if a taxpayer creates a grantor trust which purchases a partnership interest and the grantor later renounces grantor trust status, then the taxpayer is considered to have transferred the partnership interest to the trust. The taxpayer’s share of liabilities that are eliminated as a result of the transfer are considered part of the amount realized for income tax purposes.[[1345]](#footnote-1346)
     6. The loss of grantor trust status due to the death of the grantor should not result in a reduction of partnership liabilities with respect to the IDGT. If anything, it may result in an increase of such liabilities and an increase in basis if the partnership had recourse debt as to the grantor.
  2. Outside Basis of Gifted Partnership Interests May Not Be Proportionate
     1. Generally
        1. When a donor makes a gratuitous transfer of a partnership interest to a donee, even if the donee is not a deemed to be the donor for income tax purposes (e.g., a grantor trust of the donee), generally no gain or loss is recognized on the transfer.[[1346]](#footnote-1347) The donee has the donor’s basis in the interest received, increased by any gift tax paid.[[1347]](#footnote-1348) The transferred basis is, however, limited to fair market value of the partnership interest, for purposes of determining a loss.[[1348]](#footnote-1349) Given the foregoing limitation with respect to losses, valuation discounts could, in fact, limit the ability of the donee to recognize a portion of a subsequent loss. In such cases, the partner might be better off having received distributions of partnership assets in-kind and selling such assets, rather than selling the partnership interest itself. The tax difference between selling a partnership interest and selling distributed assets is discussed in more detail later in this outline.
        2. If the donor transfers only a portion of his or her partnership interest, only a portion of the donor’s unitary outside basis is transferred. One would assume that a pro rata portion of the donor’s outside basis would also be transferred to the donee. In other words, if a donor owns a partnership interest having an outside basis of $100 and the donor gifts 55% to a donee (who is not a grantor trust), then the donee will now own a partnership interest with an outside basis of $55. Surprisingly, that may not be the case.
        3. As mentioned above, Revenue Ruling 84-53,[[1349]](#footnote-1350) the IRS ruled in the context of calculating outside basis of a transferred partnership interest, “the basis of the transferred portion of the interest generally equals an amount which bears the same relation to the partner's basis in the partner's entire interest as the fair market value of the transferred portion of the interest bears to the fair market value of the entire interest.”[[1350]](#footnote-1351) Under this calculation, if the gift of the 55% partnership interest carries a valuation discount (which it should since that reflects fair market value), then the 55% interest would actually transfer less than $55 of basis.
        4. For example, assume a donor has a partnership interest that has a fair market value of $200 (the value represents a controlling interest in the partnership but reflects some discounts for lack of marketability) and an outside basis of $100. The donor gifts 45% of his or her partnership interest to a donee. Assume further that 45% transfer carries a valuation discount of 30%. As a result the gift tax value (fair market value) of the transfer is $63 (reflecting a 30% discount on an interest which has a value before the discount of $90). Under the formula of Revenue Ruling 84-53, the transferred interest has a fair market value of $63, and the fair market value of the entire interest is $200, resulting in only 31.5% of the donor’s original basis having been transferred ($63/$200). After the transfer, the donee owns 45% of the partnership interest with an outside basis of $31.50, and the donor retains 55% of the partnership interest but has an outside basis of $68.50.



It should be noted, that had the valuation of the donor’s interests prior to the transfer included the same valuation discount (30%), then the foregoing formula would have resulted in $45 of basis apportioned to the transferred interests (a proportionate percentage). It’s the fact that the value of the transferor’s entire portion has no (or less) valuation discount that causes the “distortion.”

* + - 1. Many practitioners are surprised by this result, and some have contended that Revenue Ruling 84-53 is not applicable to gratuitous transfers. [[1351]](#footnote-1352) It is true that Revenue Ruling 84-53 dealt exclusively with the taxable sale of a partnership interests. The ruling also assumed that there was no discount in value of limited versus general partnership interests.[[1352]](#footnote-1353) This fact may have been the reason why an “equitable apportionment” of basis was done on the basis of the fair market value of the interest conveyed to the transferor’s entire uniform basis. To the extent a discount is involved, transferring a lower amount of basis increases gain. In addition, in the case of gifts, allowing discounts to affect the amount of basis conveyed allows manipulation, as later described in this outline. There are some reasons why the basis apportionment rule may be different for gratuitous transfers, including sales to grantor trusts that can be interpreted as gifts for income tax purposes.
      2. On the other hand, sales to grantor trusts are structured to be bona fide sale transactions that are nonetheless ignored for income tax purposes. The Code defines the amount of gain as “the excess of the amount realized therefrom over the adjusted basis.”[[1353]](#footnote-1354) The amount realized is “the sum of any money received plus the fair market value of the property (other than money) received.”[[1354]](#footnote-1355) Since the amount realized is based on fair market value, it makes perfect sense that the basis of the transferred property (the partnership interest) would also be apportioned based on the fair market value of the property. Similarly, estate, gift, and generation-skipping transfer taxes are based on the “value” of the property transferred, sometimes defining the same in terms of “money or money’s worth.”[[1355]](#footnote-1356) Value, for these purposes, is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. Most would agree that this valuation standard for transfer tax purposes is the same as it would be in determining the amount realized for income tax purposes. Thus, there may be some basis for apportioning tax basis of gifted property by referencing the fair market value (including applicable valuation discounts) of the property.
      3. Some commentators argue that Revenue Ruling 84-53 specifically refers to section 1.61-6(a) of the Treasury Regulations which provides, “When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts.” They argue that “equitably apportioned” should be interpreted to mean that when a partner transfers 45% of his or her partnership interest, then 45% of the partner’s outside basis should “equitably” pass to the transferee. [[1356]](#footnote-1357) This produces the same result as in Rev. Rul. 84-53 where it was assumed that general and limited partnership interests had the same value regardless of any differences in right to vote and right to liquidate the partnership. A question arises as to the correct result if (i) all of the partnership interests do not have identical voting rights and economic rights to profits, distributions, and partnership capital, and (ii) if there are limitations or restrictions on a partner’s ability to immediately receive his or her proportionate share of the fair market value of the partnership’s business and assets. What apportionment is equitable where there are differences in partners’ rights?
      4. To illustrate why fair market value may be an appropriate way of apportioning outside basis, consider a partnership that holds assets and other underlying business interests having a value of $10 million.
         1. Scenario 1: The partnership agreement provides for 2 classes of interests: 50 units of Class A-Voting and 50 units of Class B-Non-Voting. The partnership agreement provides that each unit, whether voting or non-voting, is entitled to a pro rata allocation of all profits and partnership distributions, and the partnership will be liquidated according to capital accounts upon the unanimous vote of all of the Class A holders. Donor owns 50 units of Class A, and 50 units of Class B. Assume, Donor’s spouse owns a small interest of Class B, but such interest and its share of partnership capital is ignored for purposes of simplicity (thus, the entity is a partnership for tax purposes, not a disregarded entity). Donor’s unitary capital account is $10 million, and the outside basis of the of the Donor’s units is $8.0 million. Assume that the Class B units are entitled to a 30% valuation discount. If Donor gifts 50 units of Class B (50% of Donor’s units, having a fair market value of $3.5 million), then the transferee will receive $5 million of capital account.

With regard to basis, if one follows Revenue Ruling 84-53, the transferee will succeed to $2.65 of basis (with donor retaining $5.35 million of basis), as follows:



If one ignores the ruling and apportions basis proportionately (the same way capital account is apportioned), then the transferee would succeed to $4.0 million of basis (50% of the Donor’s total basis):

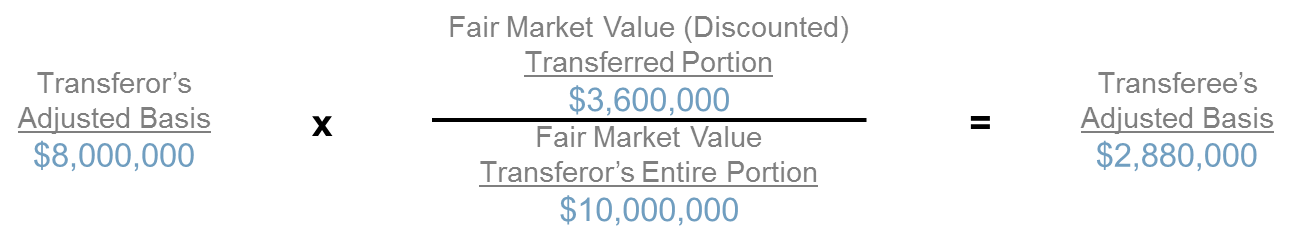


If an independent third party purchased the 50 Class B-Non-Voting units from the transferee for cash, the purchaser would not pay $5.0 million (because the units have no voting rights and are unmarketable). It would presumably pay $3.5 million for the Class B units. Under Revenue Ruling 84-53, the seller would recognize $850,000 of gain. On the other hand, if the proportionate rule for basis is used then the seller would actually recognize a $500,000 of loss, which does not seem reasonable since the transferor held appreciated partnership interest before the gift.[[1357]](#footnote-1358) However, as shown in the example below discussing the possible use of incomplete gift non-grantor trusts, if the sequence of transfers is changed, the same artificial loss is possible. Similarly, there could be an “artificial” loss if basis was allocated based on relative fair market values and shortly thereafter the partnership was liquidated and distributions were made in accordance with capital accounts. The transferee who had a basis in her interest that was higher than her share of capital accounts might realize a loss, assuming that cash or assets treated as cash were distributed so that the substituted basis rules did not apply to the liquidation.

* + - * 1. Scenario 2: The partnership agreement provides for 2 classes of interests: 100 units of Class A Preferred-Voting and 100 units of Class B Common-Non-Voting. The partnership agreement provides the Class A Preferred units have a liquidation preference of $4.0 million and an annual cumulative preferred yield of 12%, and the Class B Common units are entitled to any excess profits or return on the partnership assets after taking into account the economic rights of Class A. Donor owns 100 units of Class A, and 100 units of Class B. Assume, Donor’s spouse owns a small interest of Class B, but such interest and its share of partnership capital is ignored for purposes of simplicity (thus, the entity is a partnership for tax purposes, not a disregarded entity). Donor’s unitary capital account is $10 million, and the outside basis of the of the Donor’s units is $8.0 million. Assume that the Class B units are entitled to a 40% valuation discount. If Donor gifts 100 units of Class B (fair market value of $3.6 million), then the transferee will receive $6.0 million of capital account (because a liquidation of the partnership at the time of the transfer would limit the Class A units to $4.0 million of partnership property). How should the outside basis be “equitably” apportioned to the transferred Class B units? The Class A and Class B do not have identical economic rights to partnership property, profits, and distributions (not to mention Class A has voting rights and Class B does not).

One option is to apportion the basis according to capital accounts, so $4.8 million (60% of the $8 million of outside basis) will pass to the transferee of the Class B units. However, that again presumes that Class A and Class B have identical economic rights under the partnership agreement. They do not. While the holders of Class B may have $6.0 million of capital account, they do not have the right to liquidate the partnership. Further, consider that the 12% cumulative preferential distribution might have been gifted when preferred rates are much lower. Said another way, given how high the Class A preferential rate is, there is a chance that all partnership profits (and perhaps partnership property) will be needed to satisfy the 10% preferred distribution. Based on these facts, apportioning according to capital account balances does not seem reasonable.

The only methodology that takes into account the different economic rights of the Class A and Class B holders and the market conditions at the time of the transfer is to apportion according to fair market values. As mentioned above, the gifted Class B shares are valued at $3.6 million. Prior to the transfer, the Donor had the right to liquidate the partnership, so the Donor’s Class A and Class B units are worth $10 million (all of the assets in the partnership) prior to the transfer. It should be noted that this doesn’t necessarily mean that the Class A units are worth $6.4 million (a 60% premium over the $4.0 million liquidation preference) but $10 million is the value that a third-party purchaser would pay for all of Donor’s units prior to the gift. Pursuant to Revenue Ruling 84-53, the transferred basis allocated to Class B is $2.88 million:



* + 1. Estate Planning Implications
       1. The income and estate planning implications are significant. In the example above, the result is the donor retains a disproportionate amount of the basis, and the donee receives less. If the donee is in a lower income tax bracket or resides in a state (or is a resident non-grantor trust of such state) that has no state income tax and if the donor is in a higher income tax situation, a taxable event like the sale of the partnership interests (or the sale of the assets of the partnership followed by a distribution of the assets) would generally result in less taxes to be paid when compared to having the donor be the sole taxpayer. In addition, if the donee is near death, then holding a lower basis asset provides more potential for a “step-up” in basis.
       2. Often, however, the donor is in the senior generation and is wealthier than the donee. Under those circumstances, how can this distortion in basis be used, assuming it would be preferred that the donor retain less basis (for a potential “step-up” in basis) and the donee receive more basis. Consider the following:
          1. As in the first example in the previous section, donor owns a partnership interest that has a fair market value of $200 and an outside basis of $100. Transfers of minority interest in the partnership are entitled to a 30% valuation discount.
          2. The donor transfers a 45% interest to a DING, NING, or other incomplete gift non-grantor trust.[[1358]](#footnote-1359) A properly structured incomplete gift non-grantor trust has the following features:

The trust not a grantor trust (although the grantor is a permissible beneficiary of the trust);

Contributions to the trust by the grantor are not completed gifts for Federal gif tax purposes; and

The assets of the trust are includible in the grantor’s gross estate upon the grantor’s death, although the corpus is subject to a testamentary special power of appointment held by the grantor.

* + - * 1. After the initial transfer to the incomplete gift non-grantor trust, the donor gifts the remainder of his or her partnership interests (55% interest) to an IDGT.
        2. For basis purposes, based on Revenue Ruling 84-53, the non-grantor trust (the assets of which will be includible in the estate of the donor at death) has a partnership interest with an outside basis of $31.50 (although representing 45% of the donor’s interest). The IDGT (the assets of which are not includible in the donor’s estate), on the other hand, has a partnership interest with an outside basis of $68.50 (representing 55% of the donor’s interest). Thus, a disproportionate amount of basis ends up passing with the partnership interest that is out of the donor’s estate, while the partnership interest that remains in the estate is poised to get a disproportionately large “step-up” in basis (particularly, if as discussed above, certain measures are taken to reduce or eliminate the valuation discounts attributable to the partnership interest in the non-grantor trust).
  1. Allocation of Tax Items and the Varying Interest Rule
     1. Pass-Through Taxation
        1. The pass-through nature of partnerships is established by section 701 of the Code which provides, “A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.”[[1359]](#footnote-1360) The allocated income (or loss) is credited to the individual partner's capital account (discussed in more detail later), and is taxed to the partner without regard to when or whether the income is ever distributed to the partner.[[1360]](#footnote-1361)
        2. Section 702 of the Code establishes the concept of distributive share, mandating, “In determining his income tax, each partner shall take into account separately his distributive share of the partnership's”[[1361]](#footnote-1362) tax items including capital gains and losses, gains and losses from section 1231 property, taxes, and other taxable income. While section 702(a) of the Code specifically lists specific tax items that must be separately stated and reported the partners, the Code permits the Treasury Regulations to require the separate statement of other tax items,[[1362]](#footnote-1363) and there is a long list of such items.[[1363]](#footnote-1364) The partnership provides each partner with a Schedule K-1 listing the share of each separately stated item and the share of partnership profits and losses that are not separately stated.
     2. Allocation of Tax Items among Partners
        1. Section 704(a) of the Code provides that a “partner’s distributive share of income, gain, loss, deduction, or credit shall … be determined by the partnership agreement.”[[1364]](#footnote-1365) Section 704(b) of the Code then provides that the allocation is determined by the “interest in the partnership,”[[1365]](#footnote-1366) under all the facts and circumstances, if the partnership agreement does not provide for the allocation,[[1366]](#footnote-1367) or if the allocation does not have “substantial economic effect.”[[1367]](#footnote-1368)
        2. In order to ensure the validity of a partnership’s allocation of tax items, many family partnership agreements are written to satisfy the “substantial economic effect” test,[[1368]](#footnote-1369) which requires (i) that the allocations must have economic effect, and (ii) the economic effect must be substantial. In order for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. According to the Treasury Regulations, this means “in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden.”[[1369]](#footnote-1370) The economic effect of an allocation will be deemed substantial if there is a reasonable probability that the allocation will affect substantially the dollar amount to be received by the partners from the partnership, independent of the tax consequences.[[1370]](#footnote-1371)
        3. The “safe harbor” Treasury Regulations provide that allocations will have economic effect if:[[1371]](#footnote-1372)
           1. The partnership maintains capital accounts (discussed in more detail below) under section 1.704-1(b)(2)(iv) of the Treasury Regulations;
           2. Upon liquidation of the partnership (or any partner’s interest in the partnership), liquidating distributions are required to be made in accordance with the positive capital account balances of the partners; and
           3. Either:

Each partner is unconditionally obligated to restore any deficit in such partner’s capital account on liquidation of the partnership; or

The partnership agreement has a “qualified income offset” provision.[[1372]](#footnote-1373)

* + - 1. If allocations do not fall under the foregoing safe harbor provisions, they will be deemed to have economic effect provided that as of the end of each partnership taxable year, a liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic results to the partners as would occur if the foregoing requirements above had been satisfied. This is referred to as the economic effect equivalence.[[1373]](#footnote-1374) This would be similar to an approach that some partnerships employ called “targeted allocations.” Targeted allocations assume a hypothetical liquidation at the end of each accounting period where it is determined what each partner would receive if all of the partnership assets are sold for cash as each asset is valued under section 704(b) of the Code. The hypothetical cash proceeds are distributed in liquidation of the partnership under the distribution provisions of the partnership agreement. Once that amount is determined, each partner is allocated section 704(b) profits and losses so that the partner’s capital account balance at the end of the period is equal to the amount of cash the partner would have received in the hypothetical liquidation. The IRS has not formally blessed targeted capital account allocations as qualifying under the economic effect equivalence rule.[[1374]](#footnote-1375)
      2. If the partnership agreement does not address allocations or the allocations do not have substantial economic effect, allocations will be made according to each partner’s economic interest in the item of income or deduction, based on the facts and circumstances (referred to as the “partner’s interest in the partnership” or “PIP”).[[1375]](#footnote-1376) In determining the PIP, the Treasury Regulations point to the partner’s capital contributions to the partnership and the partner’s interest in the economic profits and losses (if different from his or her interest in the taxable income and losses), cash flow, non-liquidating distributions, and liquidating distributions of capital.[[1376]](#footnote-1377) Generally, a PIP (and thus allocations hereunder) will be based on the amount the partner would receive if the partnership liquidated and distributed all of its assets.
      3. For a variety of reasons, very few family partnership agreements provide for allocations based on targeted allocations or allocations based on PIP. Further, while there are some instances (i.e., preferred partnership structures) pursuant to which family partnerships can allocate profits disproportionately to some partners than others or allocate losses differently than profits, in the estate planning context, most partnerships are structured as “pro rata” or single class share partnerships because of the “same class” exception under section 2701(a)(2)(B) 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-lapsing differences with respect to management and limitations on liability).”[[1377]](#footnote-1378) As such, most family partnerships will provide for allocations of profit and loss based upon each partner’s capital account balance, which is essentially each partner’s net equity in the partnership. The capital account rules are discussed in the next section of these materials.
    1. Sales of Partnership Interests, Gifts, and the Varying Interest Rule
       1. Varying Interest Rule
          1. Section 706(d)(1) of the Code provides, “if during any taxable year of the partnership there is a change in any partner's interest in the partnership, each partner's distributive share of any item of income, gain, loss, deduction, or credit of the partnership for such taxable year shall be determined by the use of any method prescribed by the Secretary by regulations which takes into account the varying interests of the partners in the partnership during such taxable year.”[[1378]](#footnote-1379) This is commonly referred to as the “varying interest rule.” This rule prohibits a partnership from making retroactive allocations of a full share of partnership items for a tax year to persons who were partners in the partnership for only a portion of the tax year.
          2. Notwithstanding the prohibition against making retroactive allocations if partnership interests vary during the year, the Treasury Regulations permit amendments to the partnership agreement after the close of the tax year to make changes among contemporaneous partners for the entire taxable year (or among contemporaneous partners for a segment if the item is entirely attributable to a segment).[[1379]](#footnote-1380) That being said, if the partnership agreement is amended to reflect a non-pro rata contribution of additional capital to the partnership by one or more existing partners, the interests of noncontributing partners are considered “otherwise” reduced within the meaning of section 706(c)(2)(B) of the Code, and the varying interest rule applies.
          3. The varying interest rule does not apply to gifts of partnership interests and sales of partnership interests to certain family members (or trusts for the same). Allocations of partnership income, in those instances, are governed by the family partnership rules (discussed below).
          4. Section 706(c)(2)(A) of the Code provides that if a partner sells its entire interest in its partnership, the taxable year of the partnership closes with respect to the partner. On the other hand, section 706(c)(2)(B) of the Code provides if a partner sells less than his entire interest, the taxable year of the partnership does not close.
          5. For tax years in which there is a variation in a partner's interest (either because the partner has disposed of a partial or entire interest in the partnership or because the partner's interest has been reduced), the regulations provide the following ten-step process for determining the partners’ distributive shares of items subject to allocation under the varying interest rule.[[1380]](#footnote-1381) A complete discussion of the steps is beyond the scope of these materials, but some discussion about the methodology is warranted:

The partnership can apply either an interim closing method or proration method with respect to each variation in interest. The interim closing method is the default method, but proration can be applied if there is an agreement of the partners.[[1381]](#footnote-1382)

“Extraordinary items” cannot be prorated, but must be allocated among the partners in proportion to their interests in the partnership item at the time of day on which the extraordinary item occurred. Extraordinary items include, in pertinent part:[[1382]](#footnote-1383)

Any item from the disposition or abandonment (other than in the ordinary course of business) of a capital asset;

Any item from the disposition or abandonment (other than in the ordinary course of business) of section 1231(b) property;

Any item from the discharge or retirement of debt, except certain instances that are subject to special allocation rules as provided in sections 108(e)(8) or 108(i) of the Code; and

Any other item if there is an “agreement of the partners” to treat the item as an extraordinary item for the tax year, provided it does not result in a substantial distortion of income in any partner's return.[[1383]](#footnote-1384)

Absent an agreement of the partners to perform regular monthly or semi-monthly interim closings, the only interim closings during the partnership's tax year will be at the deemed time of the occurrence of variations for which the partnership uses the interim closing method. If there is an interim closing during the year, the partnership tax year is delineated into “segments” of the tax year. The partnership tax items are allocated among the segments and in which the items can be further prorated.

A special rule applies to allocable cash items. Under section 706(d)(2) of the Code, allocable cash basis items (interest, taxes, rents, payments for services, and other items specified Treasury Regulations)[[1384]](#footnote-1385) are allocated among the partners on essentially an accrual basis. Section 706(d)(2)(A) of the Code provides these cash basis items are allocated to each day in the tax period in which the item was accrued.

* + - 1. Gifts, Sales, and Allocations under the Family Partnership Rules
         1. The Treasury Regulations provide that a transfer of a partnership interest by gift does not close the partnership year with respect to the donor, and that income up to the date of the gift attributable to the donor's interest should be allocated to the donor in accordance with section 704(e)(1) of the Code.[[1385]](#footnote-1386) Section 704(e) of the Code, in turn, provides that the donee will include in gross income his or her distributive share under the partnership agreement, “except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital.”[[1386]](#footnote-1387)
         2. Pursuant to the foregoing, if capital income is a material income-producing factor and the donee’s ownership is real, the partnership’s income may be allocated among the partners by first, providing reasonable compensation for services rendered by the donor and ensuring that the donee’s income attributable to capital is proportionate to the donor’s capital. To the extent the distributive share of the donee is not so allocated, the Treasury Regulations provide, “the distributive shares of the partnership income of the donor and donee shall be reallocated by making a reasonable allowance for the services of the donor and by attributing the balance of such income (other than a reasonable allowance for the services, if any, rendered by the donee) to the partnership capital of the donor and donee. The portion of income, if any, thus attributable to partnership capital for the taxable year shall be allocated between the donor and donee in accordance with their respective interests in partnership capital.”[[1387]](#footnote-1388) As such, pro rata allocations according to capital account balances (equal to the amount of capital that would be distributed to the partner upon liquidation of the partnership) should be respected. It is unknown how this provision might be applied to preferred partnership structure, which generally provide that a preferred return must be matched by a corresponding allocation of income or gain. The Treasury Regulations provide, in the context of the disguised sale rules, 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 income or gain.”[[1388]](#footnote-1389)
         3. In addition, the Code goes on to provide that an interest purchased by a family member will, for this rule, be considered transferred by gift from the seller, and “the fair market value of the purchased interest shall be considered to be donated capital.”[[1389]](#footnote-1390) Family of an individual includes his or her “spouse, ancestors, and lineal descendants, and any trusts for the primary benefit of such persons.”[[1390]](#footnote-1391) Thus, a taxable purchase of a partnership interest by a family member (or trust for the benefit of such family member) will be treated as a gift for purposes of section 704(e) of the Code. This would include, in all circumstances, a transfer due to the termination of grantor trust status which would likely be considered a transfer by gift or a taxable sale to the extent there is debt in excess of basis.
         4. The Treasury Regulation provide, “Whether an alleged partner who is a donee of a capital interest in a partnership is the real owner of such capital interest, and whether the donee has dominion and control over such interest, must be ascertained from all the facts and circumstances of the particular case.”[[1391]](#footnote-1392) Control by the donee has been held to mean the donee’s participation in the partnership activities and with respect to the partnership interest as a property right.[[1392]](#footnote-1393) Further, actual distribution to a donee partner of the “entire amount or a major portion of his distributive share of the business income… is substantial evidence of the reality of donee’s interest.” The Treasury Regulations provide that when a donor has retained certain controls over the gifted interest and the donee has little control over the gifted interest, then for distributive share purposes, the donor will be treated as remaining the owner of the interest.[[1393]](#footnote-1394) These retained powers include the control over distributions, liquidations, assets outside the partnership that are essential to the business of the partnership, and management inconsistent with normal relationships among partners.[[1394]](#footnote-1395)
         5. Notwithstanding the foregoing, the vast majority of family partnerships are limited partnership or limited liability companies. Non-managing members and limited partners generally do not have unlimited rights and powers. To that end, the Treasury Regulations provide:

To be recognized for Federal income tax purposes, a limited partnership must be organized and conducted in accordance with the requirements of the applicable State limited-partnership law. The absence of services and participation in management by a donee in a limited partnership is immaterial if the limited partnership meets all the other requirements prescribed in this paragraph. If the limited partner's right to transfer or liquidate his interest is subject to substantial restrictions (for example, where the interest of the limited partner is not assignable in a real sense or where such interest may be required to be left in the business for a long term of years), or if the general partner retains any other control which substantially limits any of the rights which would ordinarily be exercisable by unrelated limited partners in normal business relationships, such restrictions on the right to transfer or liquidate, or retention of other control, will be considered strong evidence as to the lack of reality of ownership by the donee.

* + - * 1. Section 761(b) of the Code provides, “In the case of a capital interest in a partnership in which capital is a material income-producing factor, whether a person is a partner with respect to such interest shall be determined without regard to whether such interest was derived by gift from any other person.”[[1395]](#footnote-1396) The Treasury Regulations provide: [[1396]](#footnote-1397)

Capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business conducted by the partnership. In general, capital is not a material income-producing factor where the income of the business consists principally of fees, commissions, or other compensation for personal services performed by members or employees of the partnership. On the other hand, capital is ordinarily a material income-producing factor if the operation of the business requires substantial inventories or a substantial investment in plant, machinery, or other equipment.

* + - * 1. For purposes of section 704(e), a “capital interest in a partnership means an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership. The mere right to participate in the earnings and profits of a partnership is not a capital interest in the partnership.”[[1397]](#footnote-1398)
        2. If the partnership interest is gifted to a trust (or sold to a trust for the benefit of a family member) and if the trustee is unrelated to and independent of the grantor, then the trust will likely be recognized as the legal owner of the partnership interest, “unless the grantor has retained controls inconsistent with such ownership.”[[1398]](#footnote-1399) If the grantor (or a person amenable to the grantor’s will) is the trustee, “the trust may be recognized as a partner only if the grantor (or such other person) in his participation in the affairs of the partnership actively represents and protects the interests of the beneficiaries in accordance with the obligations of a fiduciary and does not subordinate such interests to the interests of the grantor.”[[1399]](#footnote-1400) In addition, other factors will be considered including whether the trust is recognized as a partner in business dealings with customers and creditors, and whether the trust's share of the partnership income not retained for the businesses’ reasonable needs is distributed to the trust annually and used or reinvested solely for the beneficiaries’ interests.[[1400]](#footnote-1401) In one case,[[1401]](#footnote-1402) the court held when a donor conveyed a partnership interest to a trust for which he served as trustee, the trust did not become a partner for federal tax purposes because there was no evidence that: (i) the donor actively represented the trust as an independent factor in the management and operation of the business (metal parts manufacturer), and (ii) the trust was held out as a partner to customers or creditors. In addition the partnership agreement did not provide any right to sell its partnership, and although trust could withdraw from the partnership, it could do so without allowance for goodwill, trade names, patents or other tangible assets.
  1. Capital Accounts and Estate Planning
     1. Generally
        1. As noted above, one of the central concepts in partnership taxation is each partner’s “capital account.” The capital account maintenance rules are not based on generally accepted account principles but are based on the Treasury Regulations under section 704(b) of the Code, relating to allocations of partnership tax items.
        2. In effect, the Treasury Regulations use a partner’s capital account as a yardstick to measure the partner’s economic interest in the partnership property at any given point and time. Stated simplistically, a partner’s capital account reflects the amount of equity invested in the partners and is adjusted to reflect the ongoing profits and losses of the partnership. Thus, if the partnership is liquidated at some point, it reflects the amount the partner would receive upon liquidation of the partnership, assuming all partnership assets were disposed of at their book value.
        3. A full discussion of the capital account maintenance rules is beyond the scope of this outline, but some discussion is warranted.
           1. Each partner’s capital account is increased by:[[1402]](#footnote-1403)

The amount of money contributed to the partnership by the partner;

The fair market value of property contributed to the partnership by the partner, net of any liabilities that the partnership assumes or takes subject to; and

Allocations to the partner of items of partnership income and gain, including tax-exempt income.

* + - * 1. Each partner’s capital account is decreased by:[[1403]](#footnote-1404)

the amount of money distributed by the partnership to the partner;

the fair market value of property distributed by the partnership to the partner, net of any liabilities that the distributee partner assumes or takes the distributed property subject to; and

allocations to the partner of items of partnership loss and deduction and partnership expenditures that are neither deductible by the partnership in computing its taxable income nor properly chargeable to capital account.

* + - * 1. Partnership agreements may provide that the partner’s capital accounts will be adjusted to reflect a revaluation of partnership property, but such adjustments must be based on the fair market value of the partnership’s properties (assuming for these purposes that the value of the property is not less than any indebtedness on the property) and must reflect the manner in which gain or loss (not previously reflected in capital account balances) would be allocated to the partnership if each partnership property were sold at its fair market value in a taxable transaction.[[1404]](#footnote-1405) The adjustments are deemed to be made principally for a substantial non-tax business purpose under the following circumstances:[[1405]](#footnote-1406)

in connection with a contribution of money or property to the partnership by a new or existing partner in exchange for an interest in the partnership;

in connection with the liquidation of the partnership or a distribution of money or other property by the partnership to a retiring or continuing partner as consideration for an interest in the partnership;

in connection with the grant of an interest in the partnership, as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner;

in connection with the issuance by the partnership of a non-compensatory option; or

under generally accepted industry accounting practices, provided substantially all of the partnership's property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market.

* + - 1. The Treasury Regulations provide, “a partner who has more than one interest in a partnership shall have a single capital account that reflects all such interests, regardless of the class of interests owned by such partner (e.g., general or limited) and regardless of the time or manner in which such interests were acquired.” [[1406]](#footnote-1407) This one capital account rule presumably would apply if the partner held preferred and common interests in a partnership and would apply if the partner is deemed to own interests held by an IDGT pursuant to Revenue Ruling 85-13.[[1407]](#footnote-1408)
    1. Capital Accounts and Transfers of Partnership Interests
       1. The Treasury Regulations provide that “upon the transfer of all or a part of an interest in the partnership, the capital account of the transferor that is attributable to the transferred interest carries over to the transferee partner.”[[1408]](#footnote-1409) The Treasury Regulations contain a simple example[[1409]](#footnote-1410) pursuant to which a partner sells half of the partner’s interest in a general partnership (representing a 25% interest in the partnership) for $10,000. At the time of the transfer, the general partnership held $40,000 in cash and securities, and the transferring partner’s capital account prior to the transfer was $11,000. The example provides, in accordance with the Treasury Regulations “the partnership agreement provides” the transferee “inherits 50 percent of”[[1410]](#footnote-1411) the transferor’s capital account balance. Thus, the transferee inherits a capital account of $5,500. In other words, the Treasury Regulations seem to take the position that the portion of the transferor’s capital account that carries over to the transferee equals the percentage of the transferor’s total interest that is sold. In other words, when only a portion of a partner’s interest is transferred and the partnership is a pro rata partnership, then the amount of capital account carried over to the transferee is in direct proportion to the amount transferred and retained. Thus, for example, if the transferor’s capital account was $200 prior to the transfer and the transferor transferred (by gift or sale) 45% of his or her interest, then $90 of capital account carries over to the transferee:



* + - 1. As mentioned in the above, however, this is not how the calculation of transferred outside basis is calculated under Revenue Ruling 84-53.[[1411]](#footnote-1412) In this example, assume the donor’s partnership interest has a fair market value of $200 (for simplicity’s sake, assume the fair market value is equal to the transferor’s capital account) and an outside basis of $100. When the transferor transfers 45% of his or her partnership interest and if the transfer carries a valuation discount of 30% (discounted value of $63.00), then only $31.50 of outside basis is deemed to have been transferred (not $45.00), as follows:



Clearly, this will have a direct impact on the gain recognized by the transferor if the transfer is a taxable sale and if the transfer is a gift, the amount of basis carried over to the donee.

* + - 1. The calculation of transferred capital account is straightforward when dealing with a partnership that has only one class of partnership interest (each partner holds a static percentage of the profits, losses, and capital of the partnership). However, it becomes more complicated when dealing with partnerships that have multiple classes of interests (e.g., preferred and common interests or profits and capital interests). For example, if a partner contributes $100 to a partnership, in exchange for 10% of the future profits of the partnership and 10% of the capital of the partnership, how much capital account would be transferred if the partner then made a gift of the profits interest but retained the right to receive a return of the capital upon liquidation of the partnership. It would seem in this situation that no capital account should pass to the donee and the donor would retain $100 of the capital account, notwithstanding the profits interest transferred might have significant value for gift tax purposes.[[1412]](#footnote-1413) As the Treasury Regulations provide in the context of the family partnership provisions of section 704(e) of the Code, “a capital interest in a partnership means an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership. The mere right to participate in the earnings and profits of a partnership is not a capital interest in the partnership.”[[1413]](#footnote-1414) If no capital account is allocated to a transferred profits interest, should outside basis be allocated to it under Revenue Ruling 84-53 because it has some value?[[1414]](#footnote-1415)
    1. Capital Accounts, Liquidations, and Redemptions
       1. It’s clear that capital accounts, when properly maintained, determine how much partnership property will be received by the partner upon liquidation of the partnership. However, it’s not as clear how much property a partner should receive upon a complete or partial redemption of such partner’s interest, particularly in the family and estate planning context.
       2. If a partnership completely redeems a partner’s interest, must the partner receive property equal in value to the partner’s entire capital account balance or must the partnership distribute property equal in value to the fair market value of the interest, which might include significant discounts in value? What value should be distributed if it is a partial redemption, fair market value (including valuation discounts) or capital account balance (not including discounts)? The answer significantly affects the economics of many estate planning transfers. For example, assume a partnership owns property with a fair market value of $1,000,000. After a series of estate planning transfers, the partnership is owned 40% by the grantor and 60% by non-grantor trusts for the benefit of the grantor’s children. If the partnership makes a full redemption of the grantor’s interest at a discounted value (assume a 45% discount), then the grantor will receive $220,000, rather than $400,000. This redemption at discounted value creates a shift in value of $180,000 for the benefit of the non-grantor trusts.
       3. Is this a taxable gift? How are the capital accounts of the remaining partners affected? If capital accounts are properly maintained, does a “capital shift” occur and what are the tax ramifications of that shift? As Sheldon Banoff writes, “a ‘capital shift’ occurs when one or more partners directly or indirectly give up their right to a portion of their capital interest to one or more other existing partners. As a result, the transferor partner’s right to repayment of capital is reduced, while the transferee partner’s right to capital increases. The meaning, relevance and impact of ‘capital shifts in the analysis of partnership ownership realignments is far from clear.”[[1415]](#footnote-1416)
       4. On the gift tax issue, the Treasury Regulations provide that a bona fide sale, exchange, or other transfer of property, in the ordinary course of business will not constitute a gift:

Transfers reached by the gift tax are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefor. However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth.[[1416]](#footnote-1417)

The courts have, however, held that if the transaction is between family members, special scrutiny is required, and the presumption is that the transfer is a gift.[[1417]](#footnote-1418) The Treasury Regulations provide that if a corporation makes a transfer to shareholder B for less than full and adequate consideration, the other shareholders are deemed to have made a gift to B (but only to the extent it exceeds B’s own interest in such amount as a shareholder). Further, a transfer by B to a corporation for less than full and adequate consideration will be treated as a gift by B to the other shareholders to the extent of their proportionate interests in the corporation.[[1418]](#footnote-1419)

* + - 1. In this context, the courts have consistently held that fair market value is based on the willing buyer/willing seller standard, which necessarily requires consideration of valuation discounts and premiums when warranted by the facts and circumstances. For example, in *Estate of Mary D. Maggos v. Commissioner*,[[1419]](#footnote-1420) the Tax Court held that a complete redemption of one of the shareholders of a closely held corporation for less than less than the fair market value of the stock was a gift by the redeemed shareholder to the sole remaining shareholder (the son of the redeemed shareholder). The Tax Court determined that the fair market value, after taking into account a control premium and a discount for lack of marketability (which were deemed to offset each other), of the redeemed stock was $4.9 million. Because the redeemed shareholder only received $3.0 million (in the form of a promissory note), the Tax Court held that the redeemed shareholder made a gift of $1.9 million to her son at the time of the redemption.
      2. As noted above, the “safe harbor” rule for economic effect provides that all distributions must be made according to positive capital account balances upon a “liquidation of the partnership (or any partner’s interest in the partnership).”[[1420]](#footnote-1421) This would seem to imply that a complete redemption of a partner’s interests requires a distribution of partnership property equal in value to the partner’s capital account. However, the Treasury Regulations explain that the foregoing requirement is “not violated if all or part of the partnership interest of one or more partners is purchased (other than in connection with the liquidation of the partnership) by the partnership or by one or more partners … pursuant to an agreement negotiated at arm's length by persons who at the time such agreement is entered into have materially adverse interests and if a principal purpose of such purchase and sale is not to avoid the principles of”[[1421]](#footnote-1422) the economic benefit principles (allocations must correspond with economic benefit or burden). The Treasury Regulations do not elaborate on what would be considered “materially adverse interests,” though the phrase “sufficiently adverse interests” is used in the context of distributions of section 704(c) property, which requires valuation at “the price at which the property would change hands between a willing buyer and a willing seller at the time of the distribution” but which will be deemed correct if the “value is reasonably agreed to among the partners in an arm's-length negotiation and the partners have sufficiently adverse interests.”[[1422]](#footnote-1423)
      3. Taken together, the foregoing would seem to imply that as long as the value distributed upon full (or partial) redemption is appropriately determined under the willing buyer/willing seller standard (which necessarily might include valuation discounts and premiums), then “arm’s-length negotiation” and “materially adverse interests” can be deemed to exist. Thus, the value paid upon full redemption would necessarily be fair market value, not capital account value. If the value is greater or less than fair market value, the courts have consistently held that a taxable gift will result.
    1. Example
       1. The following example will provide an illustration of how tax basis and capital account would be calculated if a taxpayer gifted interests in a FLP and then later had his or her interest in the FLP fully redeemed (liquidated).
       2. D formed Family, LLC by contributing $3 million of cash and an asset worth $7 million with zero basis. Assume for purpose of this example, Family, LLC is taxed as a partnership because a non-grantor trust contributed a nominal amount of property to the Family, LLC, but for purposes of this example the trust’s ownership interest (and any interest it may have in any partnership property and any allocations relating to the same) is ignored. A qualified business appraiser has determined that D’s interest has a fair market value of $10 million because it represents a controlling interest in the LLC and the resulting control premium negates any valuation discount due to lack of marketability. The adjusted tax bases and capital accounts are:

|  |  |  |
| --- | --- | --- |
| Partnership | Inside Basis | Book Value |
| Cash | $3,000,000 | $3,000,000 |
| Appreciated Asset | $0 | $7,000,000 |
| *TOTAL* | ***$3,000,000*** | ***$10,000,000*** |
|  |  |  |
| Partners (Ownership %) | **Outside Basis** | **Book Capital Account** |
| D (100%) | $3,000,000 | $10,000,000 |
| *TOTAL* | ***$3,000,000*** | ***$10,000,000*** |

* + - 1. D subsequently gifts 60% of the units to his two children, C1 and C2, in equal shares. At the time of the gift, the LLC owns the same $10 million in assets. A qualified business appraiser has determined that D’s interest, after the transfer, has a fair market value of $2.2 million, and each child’s interest is worth $1.65 million (45% valuation discount). The resulting tax bases and capital accounts are:

|  |  |  |
| --- | --- | --- |
| Partnership Assets | Inside Basis | Book Value |
| Cash | $3,000,000 | $3,000,000 |
| Appreciated Asset | $0 | $7,000,000 |
| *TOTAL* | ***$3,000,000*** | ***$10,000,000*** |
|  |  |  |
| Partners (Ownership %) | **Outside Basis** | **Book Capital Account** |
| D (40%) | $2,010,000 | $4,000,000 |
| C1 (30%) | $495,000 | $3,000,000 |
| C2 (30%) | $495,000 | $3,000,000 |
| *TOTAL* | ***$3,000,000*** | ***$10,000,000*** |

Note how, after the gift, capital accounts are in proportion to the ownership interests of the partners, but the outside bases are not. D’s ownership interest retains 67% of the $3,000,000 of tax basis, and C1 and C2 each hold 16.5% of the original basis (33% in the aggregate). This is because the value of D’s interest prior to the transfer was $10 million and the gift to the children was valued, in aggregate, at $3.3 million due to valuation discounts.

* + - 1. Assuming the same values, Family, LLC distributes $2.2 million (fair market value) to D in complete redemption of D’s interest. Assuming this is the only transaction affecting basis and capital accounts since formation and gift, and also assuming the LLC has a section 754 election in place, the result of the redemption is as follows:

|  |  |  |
| --- | --- | --- |
| Partnership Assets | Inside Basis | Book Value |
| Cash | $800,000 | $800,000 |
| Appreciated Asset | $190,000 | $7,000,000 |
| *TOTAL* | ***$990,000*** | ***$7,800,000*** |
|  |  |  |
| Partners (Ownership %) | **Outside Basis** | **Book Capital Account** |
| C1 (50%) | $495,000 | $3,900,000 |
| C2 (50%) | $495,000 | $3,900,000 |
| *TOTAL* | ***$990,000*** | ***$7,800,000*** |

* + - 1. D recognizes $190,000 of gain on the redemption because the cash distributed is in excess of D’s outside basis of $2,010,000 prior to the distribution.[[1423]](#footnote-1424) As discussed later in these materials, the section 754 election provides an increase in the inside basis of partnership property in an amount equal to the amount of gain recognized to D under section 734(b)(1) of the Code. The basis increase is allocated under section 755 of the Code to the zero basis partnership asset (the only asset capable of receiving the basis increase since cash always has a basis equal to face value). Had there been no section 754 election in place, the basis of the appreciated asset would have remained at zero and the inside basis of all of the partnership property would be $800,000 but the outside bases of the partners would have been $990,000. The inside basis adjustment eliminates this discrepancy. Importantly, note how the capital account balances of C1 and C2 have been increased by $900,000 each. The cumulative effect of the redemption at fair market value creates an aggregate “capital shift” of $1.8 million in favor of the children.
  1. Section 754 Election and Inside Basis Adjustments

* + 1. Generally
       1. As discussed above, whether a partnership has a section 754 election in place has a direct bearing on the inside basis of the assets held by a partnership. Those adjustments to basis are made pursuant to section 743, when there is a sale or exchange of a partnership interest or a death of a partner occurs, and section 734, when there is a distribution to a partner.
       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 partners. These transactions can create discrepancies between inside and outside basis, which in turn can create distortions in the amount of income recognized and the timing of the income. For example, if a partner dies or a partner sells his or her partnership interest, the transferee partner will have a basis in the partnership interest equal to fair market value or the cost of the sale. If that basis is greater than the inside basis of the assets, when the partnership sells those assets, additional gain will be allocated to the transferee partner. Similarly, if a partnership makes a liquidating distribution to a partner for cash, and the partner recognizes gain as a result of that distribution because the partner’s outside basis is less than the cash distributed, that gain essentially represents the liquidated partner’s share of appreciation in the partnership. Absent an adjustment to inside basis, a subsequent sale of the partnership assets will result in that gain being allocated to the remaining partners. The adjustments under sections 743 and 734 attempt to adjust for those types of discrepancies. Adjustments can increase or decrease the inside basis of partnership property.
       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 in question (sale, exchange, death or distribution) occurs.[[1424]](#footnote-1425) 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.[[1425]](#footnote-1426)
    2. Adjustments under Section 743(b) Are Hypothetical Basis Adjustments
       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:
          1. An increase in the transferee’s share of partnership inside basis “by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property”[[1426]](#footnote-1427) or
          2. A decrease in the transferee’s share of partnership inside basis “by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership.”[[1427]](#footnote-1428)
       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.[[1428]](#footnote-1429) The partner’s previously taxed capital is:[[1429]](#footnote-1430)
          1. The amount of cash the partner would receive upon a hypothetical sale of all of the partnership assets (immediately after the transfer or death, as the case may be) in a fully taxable transaction for cash equal to the fair market value of the assets;[[1430]](#footnote-1431) increased by
          2. The amount of tax loss that would be allocated to the partner on the hypothetical transaction; and decreased by
          3. The amount of tax gain that would be allocated to the partner on the hypothetical transaction.
       3. Inside basis adjustments under section 743(b) do not change or affect capital accounts,[[1431]](#footnote-1432) and because the adjustments only apply to the transferee, they are not made to the common basis of the partnership.[[1432]](#footnote-1433) 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.[[1433]](#footnote-1434) 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.[[1434]](#footnote-1435)
    3. Adjustments under Section 734(b) Are Actual Basis Adjustments to Property
       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.”[[1435]](#footnote-1436) In contrast, adjustments under section 743(b) “shall constitute an adjustment to the basis of partnership property with respect to the transferee partner only.”[[1436]](#footnote-1437)
       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.[[1437]](#footnote-1438) On the other hand, adjustments under section 734(b) result in corresponding adjustments to capital accounts.[[1438]](#footnote-1439)
       4. When evaluating inside basis adjustments under section 734(b) of the Code, one must make a distinction between current and liquidating distributions.
          1. With a current distribution, only gain (not loss) can be recognized to a distributee partner. As such, an adjustment under section 734(b) is triggered when a distributee partner recognizes a gain on distribution of money in excess of outside basis. The amount of gain results in a corresponding increase in the inside basis of partnership property.[[1439]](#footnote-1440)
          2. With a current distribution, when partnership property (other than money) is distributed, the basis of the property in the hands of the partner is the *lesser* of the inside basis of the property or the distributee partner’s outside basis (after reducing outside basis by any money distributed).[[1440]](#footnote-1441) 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.[[1441]](#footnote-1442)
          3. Unlike current distributions, a distributee partner can recognize a loss on a liquidating distribution. Thus, on a liquidating distribution, the inside basis adjustment can increase the basis of partnership (for a gain) or decrease the basis of partnership property (for a loss).[[1442]](#footnote-1443)
          4. Further, unlike a current distribution, when partnership property (other than money) is distributed in a liquidating distribution, the basis of the property can be increased if the liquidated partner’s outside (after reducing outside basis by any money distributed) is greater than the inside basis of the asset distributed.[[1443]](#footnote-1444) The inside basis of the property has its basis replaced by the outside basis of the liquidated partnership interest.[[1444]](#footnote-1445) If liquidated property has its basis increased, then the inside basis adjustment would correspond to a reduction of inside basis of remaining partnership property under section 734(b)(2)(B) of the Code.
          5. For liquidating distributions, unlike current distributions, there is a mandatory inside basis adjustment when there is a substantial basis reduction with respect to a distribution of partnership property.[[1445]](#footnote-1446) This would occur if the partner recognized a loss of more than $250,000 upon liquidation, or the basis of liquidated property is increased by more than $250,000. Either of these events would require the partnership to reduce the basis of its remaining assets under section 734(b) of the Code by the total amount of the loss or basis increase even if a section 754 election was not in place.
    4. Allocating Inside Basis Adjustments under Section 755
       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.”[[1446]](#footnote-1447) For these purposes, capital gain property includes capital assets and section 1231(b) property, and all other property (including unrealized receivables and recapture items under section 751(c) of the Code) is considered ordinary income property.[[1447]](#footnote-1448) Next the portion of the adjustment allocated to each class of assets is then further divided among the assets in each class. The mechanism for making the allocation in this second step is different depending on whether the inside basis adjustment is under section 734(b) (e.g., distributions) or section 743(b) (e.g., transfers or death of a partner) of the Code.
       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 with a class, the Treasury Regulations employ a hypothetical transaction pursuant to which you can calculate the transferee’s allocable share of gain or loss from each asset if immediately after the transfer the partnership made a cash sale of all of the partnership assets for fair market value.[[1448]](#footnote-1449)

* + - 1. If the purchaser of a partnership interest or the fair market value of the asset upon the death of a partner is equal to the selling partner’s or deceased partner’s share of the partnership assets, then the general result will be that the inside basis adjustments under section 743(b) will exactly offset the buyer’s gain or loss inherent in each asset. However, that is not always the case. If the buyer pays a premium over asset value, then under the residual method utilized under section 1060 of the Code, the excess will be allocated to goodwill or other section 197 intangibles. If the buyer purchases at a discount below fair market value (or more likely in the estate planning context, the deceased partner’s partnership interest is valued at a discount for purposes of section 1014 of the Code), the Treasury Regulations first allocate the adjustment to ordinary income property to the extent possible, and then provide a mechanism to allocate the shortfall based upon two factors: (i) unrealized appreciation in each asset, and (ii) each asset’s relative fair market value.[[1449]](#footnote-1450)
      2. 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.[[1450]](#footnote-1451) 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.[[1451]](#footnote-1452) If the partnership has no assets in the appropriate class, the adjustment is deferred until the partnership acquires an asset in that class.[[1452]](#footnote-1453)
      3. 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.[[1453]](#footnote-1454) Negative basis adjustments are allocated first to assets within the relevant class which have unrealized depreciation in proportion to their relative unrealized depreciation. Once all of the unrealized depreciation has been eliminated, then the adjustment is allocated among all assets in the class in proportion to their adjusted basis (not fair market value).[[1454]](#footnote-1455) The inside basis of property cannot be reduced below zero.[[1455]](#footnote-1456)

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

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| ABC Partnership Balance Sheet | | | | | |
| Assets | | | **Capital Accounts** | | |
|  | Tax Basis | Book Value |  | Outside Basis | Capital Account |
| Asset A | $40x | $100x | Partner A | $40x | $100x |
| Asset B | $60x | $100x | Partner B | $60x | $100x |
| Asset C | $20x | $100x | Partner C | $20x | $100x |
| Total | **$120x** | **$300x** | **Total** | **$120x** | **$300x** |

The partnership liquidates C’s interest by distributing Asset B to C. Because C’s outside basis is $20x, Asset B has its basis reduced by $40x to $20x. The causes the partnership to have $40x less in basis than it had before the liquidation. If Asset A, B, and C are all capital assets, the section 734(b) adjustment would be as follows:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| ABC Partnership Balance Sheet | | | | | |
| Assets | | | **Capital Accounts** | | |
|  | Tax Basis | Book Value |  | Outside Basis | Capital Account |
| Asset A | $57x | $100x | Partner A | $40x | $100x |
| Asset C | $43x | $100x | Partner B | $60x | $100x |
| Total | **$100x** | **$200x** | **Total** | **$100x** | **$200x** |

If Assets A and B are capital assets but Asset C is an ordinary asset, then the section 734(b) basis adjustment is allocated only to Asset A, as follows:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| ABC Partnership Balance Sheet | | | | | |
| Assets | | | **Capital Accounts** | | |
|  | Tax Basis | Book Value |  | Outside Basis | Capital Account |
| Asset A | $80x | $100x | Partner A | $40x | $100x |
| Asset C | $20x | $100x | Partner B | $60x | $100x |
| Total | **$100x** | **$200x** | **Total** | **$100x** | **$200x** |

If Asset B is an ordinary asset and Assets A and C are capital assets, the basis adjustment would be suspended until ABC Partnership acquires an ordinary asset to which the section 734(b) adjustment can be applied.

* + 1. Mandatory Inside Basis Adjustments
       1. Even in the absence of a section 754, the Code provides that a partnership must make mandatory inside basis adjustments under the following circumstances:
          1. There is a distribution of property that results in a “substantial basis reduction” with respect to the distribution (requiring a mandatory basis adjustment under section 734(b) of the Code).[[1456]](#footnote-1457)
          2. There is a transfer of a partnership interest when the partnership has a “substantial built-in loss” immediately after the transfer (requiring a mandatory basis adjustment under section 743(b) of the Code).
       2. 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.[[1457]](#footnote-1458) 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).
       3. Since the enactment of TCJA, a partnership is deemed to have “substantial built-in loss” if:
          1. The partnership’s adjusted basis in the partnership property exceeds the fair market value of such property by more than $250,000.[[1458]](#footnote-1459)
          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.”[[1459]](#footnote-1460)
  1. Partnership Divisions Are an Important Tool in Estate Planning
     1. Generally
        1. 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.”[[1460]](#footnote-1461)
           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.
        2. 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.[[1461]](#footnote-1462) “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.”[[1462]](#footnote-1463)
           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.”[[1463]](#footnote-1464) 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.”[[1464]](#footnote-1465) This exception is often referred to as the “vertical slice exception.”
           3. In addition, section 2701 does not apply to any right with respect to an applicable retained interest if such interest is the same class as the transferred interest,[[1465]](#footnote-1466) 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).[[1466]](#footnote-1467)
           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
        1. Partnership divisions are governed by section 708(b)(2)(B). The Treasury Regulations issued in 2001,[[1467]](#footnote-1468) 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.[[1468]](#footnote-1469)
        2. 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.[[1469]](#footnote-1470) Parity of ownership interests will likely exist between the divided partnership and the recipient partnership because of the Chapter 14 considerations mentioned above. As such, the distribution of the recipient partnership interest to the partners will be current distributions rather than liquidating distribution because no partner is terminating his or her interest in the divided partnership. Because of this parity of ownership, it is unlikely that the “mixing bowl” transaction (as discussed above) will trigger any gain or loss.[[1470]](#footnote-1471) Furthermore the preamble to the Treasury Regulations point out that when a division results in a pro rata division, there are no section 704(c) implications.[[1471]](#footnote-1472) Similarly, given the parity of ownership before and after the division, there should be no gain resulting from a deemed distribution of cash under section 752 because the division will not result in a change in the share of the liabilities of the partners.
        3. 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.
        4. In a division, the Treasury Regulations provide that a “resulting partnership”[[1472]](#footnote-1473) (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.[[1473]](#footnote-1474) 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.[[1474]](#footnote-1475) 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.[[1475]](#footnote-1476)
        5. 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”[[1476]](#footnote-1477) with the form, the IRS may recast the larger series of transactions in accordance with their substance.
     3. Partnership Divisions in Tax Basis Management
        1. 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).
        2. 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.
  2. Death of a Partner
     1. Generally
        1. The transfer of a deceased partner’s interest in a partnership will not result in gain or loss, even if the deceased partner’s share of liabilities exceeds outside basis.[[1477]](#footnote-1478)
        2. The estate’s outside basis in the partnership will equal the fair market value of the partnership interest for estate tax purposes (which is net of partnership liabilities), plus the estate’s share of partnership liabilities, minus any value attributed to items of IRD owned by the partnership. The Treasury Regulations provide, “The basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of his death or at the alternate valuation date, increased by his estate's or other successor's share of partnership liabilities, if any, on that date, and reduced to the extent that such value is attributable to items constituting income in respect of a decedent (see section 753 and paragraph (c)(3)(v) of § 1.706-1 and paragraph (b) of § 1.753-1) under section 691.”[[1478]](#footnote-1479)
        3. Because only the net equity value (after taking into account partnership liabilities) is included in the gross estate for estate tax purpose but the “step-up” in basis is grossed up to include the estate’s share of partnership liabilities, one of the ways to leverage the “step-up” in basis prior to the death of a partner is to borrow at the partnership level and distribute the proceeds of the loan to the partners (often referred to as a “refinancing” in the commercial real property business). The procurement of the loan and the subsequent distribution of the proceeds should (assuming the partnership liability is nonrecourse and the distributions are made proportionately to the partners) be a tax free distribution. As mentioned above in the upside of debt portion of these materials, in order to take advantage of this “step-up” in basis on the partnership interest, the partner must engage in another step to transfer the loan proceeds out of the gross estate. This second step would not necessarily be needed in the context of nonresident alien partners because, as discussed earlier in these materials, often a basis adjustment under section 1014 is available without any U.S. estate tax inclusion.
        4. Unless a section 754 election applies, no adjustment is made to the tax basis of the partnership property as a result of the partner’s death. The lack of an inside basis adjustment puts the estate (or the successor in interest) at risk of being taxed on unrealized gain in the partnership at the time of the decedent’s death.
     2. Inside Basis Adjustments at Death
        1. If a section 754 election is timely made or in place at the time of a partner’s death, the estate or successor to the partnership interest gets the benefit of an inside basis adjustment over the partnership’s assets under section 743.
           1. The inside basis adjustment will not, however, “step-up” the basis of partnership assets that would be considered IRD if held by the deceased partner individually and unrealized receivables of the partnership.[[1479]](#footnote-1480)
           2. The IRS has affirmatively ruled that the inside basis adjustment applies to the entire partnership interest that is considered community property upon the death of the deceased spouse/partner (even if the estate of the deceased partner is admitted as a partner and the surviving spouse is not admitted as a partner).[[1480]](#footnote-1481) The rule applies regardless of which spouse predeceases the other.
           3. The inside basis adjustment is limited by the fair market value of the deceased partner’s interest in the partnership. As such, to the extent that valuation discounts are applicable to the partnership interest, the inside basis adjustment will be limited to the extent of such discounts. To the extent little or no transfer taxes would be payable upon the death of a partner, practitioners may want to reduce or eliminate such valuation discounts, thereby maximizing the inside basis adjustment with a section 754 election. Further, because the inside basis adjustment under section 743 is applied to all of the assets in the partnership at the time of the death of the partner, the adjustment does not allow tax practitioner to proactively choose which asset will get the benefit of the “step-up” in basis. For this reason, practitioners may want to consider distributing certain property in-kind to the partner prior to the partner’s death and allowing the partner to own the property outside the partnership at the time of death. Valuation discounts will not apply, and if the partner’s outside basis is very low, the distributed property will have a very low basis in the hands of the partner. In this manner, practitioners can maximize the size of the “step-up” in basis and also choose the asset that they wish to receive the basis adjustment at death.
           4. As mentioned above, the adjustment under section 743(b) is the difference between the successor partner’s tax basis in partnership interest (generally, fair market value at the date of death under section 1014(a), increased by the partner’s share of partnership liabilities and reduced by items of IRD) and the successor partner’s proportionate share of the basis of the partnership property. In calculating the partner’s proportionate share of the partnership’s tax basis, the Treasury Regulations assume a fully taxable hypothetical sale of the partnership’s assets. This taxable sale is deemed to occur immediately after the transfer that triggers the inside basis adjustment. The IRS has ruled that the transfer in question, for purposes of section 743(b), is the date of the decedent partner’s death.[[1481]](#footnote-1482) As such, practitioners should consider what effect the death of the partner might have on the value of the partnership assets in determining the inside basis adjustment.
        2. Even in the absence of a section 754 election, there is a mandatory downward inside basis adjustment if, at the time of death, the partnership has a substantial built-in loss (more than $250,000).[[1482]](#footnote-1483) For example, if A owns 90% of a partnership. At the time of A’s death, if the partnership owns property worth $9 million but with a tax basis of $10 million, then the partnership will be required to make a mandatory downward basis adjustment of $900,000 (assuming A’s share the partnership’s basis is 90% of the total basis). [[1483]](#footnote-1484)
     3. Section 732(d) Election: Avoiding the Section 754 Election
        1. As mentioned above, even with no section 754 election, the estate or successor in interest can achieve the same benefits of an inside basis adjustment if the partnership makes a liquidating distribution of property within two years of the date of death and if the successor partner makes an election under section 732(d).[[1484]](#footnote-1485) The election must be made in the year of the distribution if the distribution includes property that is depreciable, depletable, or amortizable. If it does not include such property, the election can wait until the first year basis has tax significance. [[1485]](#footnote-1486)
        2. The basis adjustment is computed under section 743(b), which relates the basis adjustments due to sales or transfer of partnership interest (during lifetime, or more notably for this discussion, at death). The inside basis adjustment is made artificially to all of the partnership property owned on the date of death (for purposes of determining the transferred inside basis to the distributee with respect to the property distributed). In other words, it is allocated to all of the partnership property whether actually distributed or not.[[1486]](#footnote-1487) If any property for which the distributee/transferee would have had an inside basis adjustment is distributed to another partner, the adjustment for such distributed property is reallocated to remaining partnership property.[[1487]](#footnote-1488)
        3. The election under section 732(d) can be a significant planning opportunity especially when planners would like to avoid having a section 754 election in place. As mentioned above, once the section 754 election is made, it is irrevocable unless the IRS gives permission to revoke the election. Because the inside basis adjustments under section 743(b) only apply to the transferees of the partnership interests (not to the partnership as a whole), having a section 754 election in place requires having a different set of basis calculations for the transferees of the interest. The book keeping requirements become quite onerous as partnership interests are often distributed at death to multiple trusts or beneficiaries and become even more so as additional partners pass away.
        4. If the distribution of property is made pursuant to provision in the partnership agreement that requires a mandatory in-kind liquidation of the deceased partner’s interest based on the partner’s positive capital account balance, then the estate would have a good argument to say that the value of the partner’s interest for purposes of section 1014(a) should not entail valuation discounts. This would, in turn, increase the inside basis adjustment on the assets claimed with the section 732(d) election. Giving the manager of the LLC or general partner of the partnership the discretion to determine what assets to distribute in liquidation of the partnership interest could give considerable planning opportunities to pick and choose which assets to receive the inside basis adjustment based on the needs of the distributee partner. While the assets received would likely not receive full fair market value (because, as mentioned above, the inside basis adjustment is artificially allocated across all of the partnership assets whether distributed or not), some planning opportunities could exist by distributing assets to other partners prior to the liquidation because the nominal inside basis adjustment that would have been allocated to those assets would be adjusted to the remaining partnership property.
  3. Partnership Terminations
     1. Prior to the enactment of TCJA, a partnership was treated as terminated for tax purposes if:
        1. No part of any “business, financial operation, or venture of the partnership continues to be carried on by any of its partners,”[[1488]](#footnote-1489) or
        2. Within a twelve month period there is a “sale or exchange of 50 percent or more of the “total interest in partnership capital and profits.”[[1489]](#footnote-1490)
     2. The latter termination event is often referred to as a “technical termination” because the termination often did not necessarily end the partnership’s existence. However, a technical termination closes the partnership’s taxable year, terminates certain partnership elections, and can restart the depreciation recovery periods for certain types of property.[[1490]](#footnote-1491)
     3. With the enactment of TCJA, effective for partnership taxable years beginning after December 31, 2017, the technical termination rule under section 708(b)(1)(B) of the Code is repealed.[[1491]](#footnote-1492) As a result, a partnership is considered terminated only if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners.
     4. Any partnership activity will suffice to continue a partnership and keep it from terminating.[[1492]](#footnote-1493) For example, it’s been held that the mere collection of promissory notes is sufficient to keep a partnership from terminating.[[1493]](#footnote-1494)
  4. Maximizing the “Step-Up” and Shifting Basis
     1. Given the limitations of the basis adjustment at death, practitioners may want to consider distributing certain property in-kind to the partner prior to the partner’s death and allowing the partner to own the property outside the partnership at the time of death. Valuation discounts will not apply, and if the partner’s outside basis is very low, the distributed property will have a very low basis in the hands of the partner. In this manner, practitioners can maximize the size of the “step-up” in basis and also choose the asset that they wish to receive the basis adjustment at death.
     2. Consider the following scenario: FLP owns 2 assets, one with very high basis and one with very low basis, neither of which is a marketable security. The assets have been in the FLP for more than seven years. The partners consist of younger family members and a parent. Assume that the parent’s outside basis in the FLP is zero. As discussed above, the traditional advice of allowing the parent to die with the FLP interest and making a section 754 election after death will likely create an inside basis adjustment that is limited by a significant valuation discount under section 743. Assume further that the partnership intends on selling the very low basis asset relatively soon. What might be a way to maximize the “step-up” in basis that will occur at the parent’s death and also create tax basis for the low basis asset that will be sold? The partnership should make a section 754 election and distribute the high basis asset, in-kind, to the parent in full or partial liquidation/redemption of the parent’s interest in the partnership. What is the result of this distribution?
     3. Because the distribution is not cash or marketable securities, neither the partner nor the partnership will recognize any gain or loss upon a distribution of the property.[[1494]](#footnote-1495) In addition, because the assets have been in the partnership for more than seven years, there are no concerns about triggering any gain to another partner under the “mixing bowl” or the “disguised sale” rules. The basis of the distributed property in the hands of the parent is based on the tax basis that the partnership had in the property prior to the distribution. The basis of the distributed property will, however, be limited to the outside basis of the partner’s partnership interest, as adjusted for cash distributions (reduction in basis) and changes in liabilities because the distributed property is encumbered with debt. This limitation, effectively, transfers the inherent gain in the partnership interest (outside basis) to the distributed property. In other words, the basis of the asset now held by the parent is zero. Because the parent now owns the property individually and outside of the partnership, upon the parent’s death, the property will get a full “step-up” in basis to fair market value, free of any valuation discounts.
     4. Because a section 754 election was made, an adjustment of inside basis under section 734(b) occurs. The adjustment results in an increase to the inside basis of the partnership assets. The increased basis adjustment is allocated first to appreciated property in proportion to the amount of unrealized appreciation, with any remaining increase allocated to all of the properties within the same class (capital gain or ordinary) in proportion to fair market values. Thus, there is a possibility of allocating basis to an asset above its fair market value, creating the possibility of a recognizable loss to the partners. The result, in this case, is the tax basis that was “stripped” from the high basis asset when it was distributed to the parent (and became a zero basis asset) is allocated to the only other remaining asset in the partnership (the low basis asset that will be sold). Thus, the low basis asset becomes a high basis asset, reducing or eliminating the gain to be recognized when it is sold. Unlike adjustments under section 743(b), adjustments under section 734(b) (upon a distribution of partnership property to a partner) are made to the common inside basis of the partnership assets, so the basis adjustment is made in favor of all of the partners in the partnership (not just for the benefit of a transferee).
     5. The type of basis management discussed above is predicated upon a number of factors that must be that must orchestrated well in advance of the actual transaction. In particular, the movement of tax basis and the maximization of the “step-up” is predicated upon: (i) the selective use of the section 754 election (not necessarily at death but certainly upon distribution of assets in-kind); (ii) the isolation of the assets to be used in the basis shift; (iii) the avoidance of the triggering gain under the “mixing bowl” and “disguised sale” rules; and (iv) the manipulation of outside basis, so that the partner to receive the property has zero or very low basis in his or her partnership interest. As such, planners should consider evolving the partnership over time to put the taxpayers in the best position to take advantage of the type of flexibility that the partnership rules allow.
     6. By way of example, practitioners should consider setting up a partnership that is funded with all manner of assets that might be used in this type of planning (high and low basis assets, depreciable and non-depreciable assets, closely held company interests, cash, etc.). The more assets the taxpayers contribute, the more options will be available in the future. The only type of asset planners should consider avoiding is marketable securities. This is because, generally, a distribution consisting of marketable securities generally is treated as a distribution of cash (rather than property).[[1495]](#footnote-1496) Thus, regardless of the basis in the marketable securities, a distribution may cause the distributee partner to recognize gain because of insufficient outside basis. However, as discussed later, there is an important exception to this rule that might allow practitioners to create a separate partnership holding only marketable securities and still allow the types of tax basis management discussed herein. Once the assets have been contributed, it is critical that the assets remain in the partnership for at least seven years to avoid the “mixing bowl” and “disguised sale rule” problems.
     7. As discussed in more detail above, distributions of marketable securities are generally treated as cash. There is, however, an important exception to this rule for distributions of securities from an “investment partnership” to an “eligible partner.”[[1496]](#footnote-1497) 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.[[1497]](#footnote-1498) 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).[[1498]](#footnote-1499) 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.[[1499]](#footnote-1500) As such, if taxpayers wish to proactively manage the basis of marketable securities in the manner discussed in this article, taxpayers must have a partnership that *from inception* has essentially only held marketable securities and has never engaged in a trade or business. Hence, practitioners should consider having taxpayers create partnerships that only hold marketable securities and having it hold the securities for at least seven years.
     8. During the seven year period, if at all possible, the partnership should avoid making a section 754 election because of the limitations of the inside basis adjustment at death and the onerous record keeping requirements discussed above. Once the seven year period has expired, then the assets of the partnership (that is hopefully free of a section 754 election) are ripe for proactive tax basis management. Once an opportunity arises for the type of planning discussed above (e.g., a potential sale of a low basis asset or the failing health of a partner), then the partnership can then proceed to isolate the appropriate assets in tax free “vertical slice” division. The assets to be carved out of the larger partnership into a smaller partnership would be those assets selected to receive the basis and those that would have their basis reduced upon distribution. Careful consideration should be given to reducing the outside basis of the distributee partner through disproportionate distributions of cash or shifting basis to other partners by changing the allocable share of partnership debt under section 752 (e.g., by converting nonrecourse debt to recourse debt through a guarantee by the other partners).[[1500]](#footnote-1501)
     9. Upon distribution of the higher basis assets to the distributee partner, the inside basis adjustment would be applied across all of the remaining assets in the partnership, but only those assets that have been spun off the larger partnership are in this partnership. Thus, allowing for a larger basis increase to those assets (rather than having the basis increase apply to all of the assets of the larger partnership and never creating an asset fully flush with tax basis). A section 754 election is required to effectuate the inside basis shift under section 734, but the election would only apply to the smaller, isolated partnership. As such, the record keeping requirements are kept to a minimum and are totally eliminated when and if the smaller partnership is dissolved and liquidated. Remember, in a vertical slice division, the isolated partnership is considered a continuation of the larger partnership, and the elections of the previous partnership follow to the new partnership. By keeping the larger partnership free of a section 754 election, it allows practitioners to selectively choose when and over what assets it would apply to in the future.
  5. Basis Shifts to Diversify a Concentrated Stock Position
     1. Introduction
        1. 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.
        2. All of the strategies discussed in this section assume that (i) the partnership entity is an “investment partnership” under section 731(c)(3)(C) of the Code, and (ii) all of the assets in the partnership have been contributed more than seven years ago or have been purchased by the partnership. As such, distributions of marketable securities are not treated as distributions of cash under section 731(c) of the Code, and the “mixing bowl” rules do not apply. Further, assume the disguised sale rules do not apply, and the relevant anti-abuse rules would not apply to recharacterize the partnership transactions.
     2. Shifting Basis from a Diversified Position to a Concentrated Position
        1. 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,[[1501]](#footnote-1502) and recently one-half of the Stock A position was sold for cash and a diversified portfolio of marketable securities. The G1 and G2 Partners each recognized $25 million of capital gain. As a result, the adjusted tax bases and capital accounts are:



* + - 1. 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:



* + - 1. Instead of selling Stock A, assume the FLP makes a 754 election or has one in effect at such time, and the FLP could makes an in-kind distribution of the diversified portfolio to the G1 Partners in a liquidating distribution (G1’s capital account balance and the diversified portfolio each have a value of $50 million). Under section 732(b) of the Code, the diversified portfolio in the hands of the G1 partners has a basis of $25 million (having been reduced from $50 million). Under section 734(b) of the Code, the partnership’s assets (Stock A) are increased by “the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution… over the basis of the distributed property to the distributee.”[[1502]](#footnote-1503) 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:



* + - 1. If the FLP subsequently sells the Stock A position for its fair market value and then purchases a diversified portfolio, then only $25 million of gain will be recognized. The overall result is that all of Stock A will have been diversified, but only $25 million (rather than $50 million) was recognized. Of course, the G1 Partners continue to have an unrealized $25 million capital gain, but that gain can be deferred indefinitely and possibly eliminated with a “step-up” in basis upon the death of the G2 Partners, as illustrated below:



* + 1. Using Debt to Exchange a Concentrated Position for a Diversified Position
       1. Assume a FLP that has one asset, $100 million of a publicly traded security, Stock A, that has zero basis. The FLP is owned by family members, 10% by first generation (G1 Partners) and 90% by the younger generations (G2 Partners). The two generational groups of partners will be referred to collectively (and separately) as the G1 and G2 Partners. The adjusted tax bases and capital accounts are:



* + - 1. The family is considering winding up the affairs of the FLP and liquidating the partnership. They are also looking for ways to tax efficiently diversify the concentrated position in Stock A. Instead of selling Stock A and recognizing $100 million of gain, the FLP borrows $90 million from a third party lender. The third party lender, as a condition for the loan, requires a pledge of the $100 million of the Stock A held by the partnership, and (given the size of the loan against a concentrated stock position) it also requires the G1 Partners (who have significantly more net worth than the G2 Partners) to personally guarantee the loan and post additional personal assets as collateral for the loan, in case the FLP is unable to pay any portion of the loan. The G1 Partners agree with the G2 Partners to be solely responsible for the repayment of any partnership liabilities with respect to this loan and give up any right of reimbursement from the G2 Partners. Assume, under the current and proposed Treasury Regulations, the partnership liabilities under section 752 of the Code are properly allocated to the G1 Partners because they bear the economic risk of loss. When the $90 million loan is procured, the adjusted tax bases, capital accounts, and books of the partnership are:



* + - 1. 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:



* + - 1. Later, assuming the FLP makes a 754 election or has one in effect, the FLP distributes the ETF to the G2 Partners in liquidation of their interest in the FLP. The capital account balance of the G2 Partners and the fair market value of the ETF are $90 million. Under section 732(b) of the Code, the ETF in the hands of the G2 partners has a basis of zero.[[1503]](#footnote-1504) Under section 734(b) of the Code, the partnership’s assets (Stock A) are increased by the $90 million of excess basis that was stripped from the ETF. The results are:



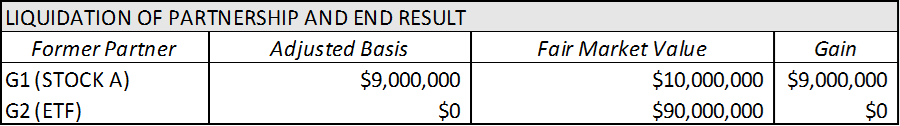
* + - 1. Assuming no changes in value and ignoring interest and other costs, when the FLP then sells $90 million of Stock A (90% of the partnership’s holdings) to repay the loan, the FLP will recognize $9 million of gain. The gain will be reflected in the outside basis of the G1 Partners, as follows:



* + - 1. 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:



* + - 1. If the FLP subsequently liquidates and winds up its affairs, assuming no changes in values, the end result is exactly the same as it would have been if G2 had contributed its allocable share of Stock A to a third party exchange fund and then liquidated its share of the fund seven years later. In this strategy, however, there is no need to wait seven years (the “mixing bowl” period was tolled in the FLP), the diversified portfolio is chosen by the family (rather than what may be held by the exchange fund including non-equity assets [e.g., real estate investments] that are typically held by exchange funds to avoid investment company status), and there is minimal gain:



* 1. Basis Shifts with Grantors and Grantor Trusts
     1. Generally
        1. When reduced down to its simplest form, basis shifting transactions involve a partnership holding a low and a high basis asset, a partner having a low outside basis in his or her partnership interest, and a distribution of the high basis asset to the low outside basis partner. Often, however, a partnership may not have any assets with sufficient basis in order to effectuate the basis shift.
        2. In the previous example dealing with marketable securities, the partnership used leverage to purchase an asset, thereby acquiring a high basis asset. If, however, partnership debt is not an option, a contribution of a high basis asset to the partnership should be considered. The difficulty with using contributed property in this type of planning is that the distribution of the high basis asset may trigger a taxable gain under the disguised sale and mixing bowl transaction rules.
        3. Contributions by a grantor to a partnership that has a grantor trust (IDGT) as a partner may be a way to reduce the risk of triggering gain because of the unitary basis rules. As mentioned earlier in these materials, the unitary basis rules require that a grantor and an IDGT will share outside basis (and capital account), and as a result, contributions of high basis assets by one or the other will result in a proportional increase in the outside basis that is shared by both partners.
     2. Basis Shift Example
        1. A limited partnership (LP) has an S corporation as general partner, with 100% of the limited partnership interests owned by an IDGT. Assume that the S corporation owns a sufficient interest in the LP to be recognized as partner for tax and state law purposes (e.g., 1% ), but for purposes of this illustration, its interest in the partnership will be ignored. The LP owns Asset A with an inside basis of zero and a fair market value of $100x. The IDGT owns 100% of the limited partnership interests which have an outside basis of zero and a capital account of $100x. For tax reasons, the partnership would like Asset A to have tax basis.
        2. Grantor contributes Asset B, which has an adjusted basis of $100x and a fair market value of $100x, to the LP in exchange for 50% of the limited partnership interests. After the contribution, grantor and IDGT are equal partners, each owning an equal share of all of the limited partnership interests. Due to unitary basis and capital account rules, grantor and IDGT share an outside basis of $100x and a capital account of $200x. LP owns Asset A ($0 basis/$100x in value) and Asset B ($100x basis/$100x in value).
        3. So long as grantor and IDGT are considered the same taxpayer, they will continue to share an outside basis of $100x such that if Asset B (high basis asset) is distributed to either of them, it’s unlikely that a basis reduction would occur because the basis that is shared by both of them is equal to the tax basis of Asset B. However, what if grantor trust status is relinquished with respect to the IDGT?
        4. When grantor trust status is lost, the grantor is deemed to make a transfer of the partnership interest held by the trust, which is now a separate taxpayer, as a non-grantor trust. In this example, grantor is deemed to make a transfer of 50% of the limited partnership interests to the trust, which requires an allocation of outside basis and capital account to the transfer. Prior to the transfer, the unitary basis of all of the limited partnership interests was $100x and the capital account was $200x. 50% of the capital account or $100x will go to the trust upon the deemed transfer. As discussed above, according to Revenue Ruling 84-53, the amount of basis that is allocated to the transfer depends on the relative fair market values of the transferred interest and the entire interest prior to the transfer.
        5. Let’s assume in “Version 1” of this example, the fair market value of 100% of the limited partnership is equal to the capital account balance of $200x (liquidation value) because the sole shareholder of the S corporation is the grantor who is the transferor in this deemed transfer. The grantor has the power to compel liquidation of the LP. If the deemed transfer of the 50% limited partnership interest to the trust carries a 30% valuation discount, then $35x of basis will pass to the trust ($65x will remain with the grantor), as follows:



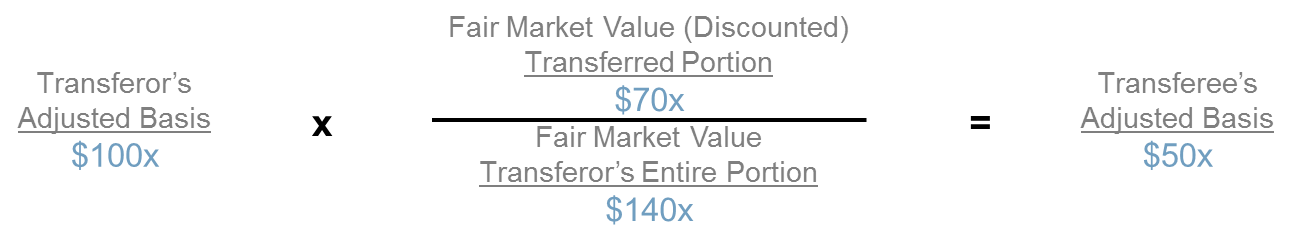
* + - 1. The resulting partnership books after the deemed transfer are as follows:



* + - 1. Assuming a section 754 election is in place, if Asset B is distributed to the trust in liquidation of its interest in the LP, the resulting partnership books and position of the trust are as follows:



* + - 1. Version 1 of this example results in a shift of $65x of basis to Asset A with $35x remaining with Asset B now owned by the trust outside of the partnership.
      2. In “Version 2” of this example, everything is the same except the fair market value of 100% of the limited partnership is not equal to a liquidation value of $200x. Rather, the fair market value of the limited partnership interests held by the grantor have a 30% valuation discount associated with them (because in Version 2, perhaps, the grantor is not have control of the S corporation general partner of LP). The value of the grantor’s interests prior to the deemed transfer is $140x. If the deemed transfer of the 50% limited partnership interest to the trust carries a 30% valuation discount, then $50x of basis will pass to the trust ($50x will remain with the grantor), as follows:



* + - 1. The resulting partnership books after the deemed transfer are as follows:



* + - 1. Assuming a section 754 election is in place, if Asset B is distributed to the trust in liquidation of its interest in the LP, the resulting partnership books and position of the trust are as follows:



* + - 1. Version 2 of this example results in a shift of $50x of basis to Asset A with $50x remaining with Asset B now owned by the trust outside of the partnership, which may seem less effective, but as discussed below, it may solve a taxable gain issue under the mixing bowls transaction rules.
    1. Possible Income Tax Implications of the Basis Shifts
       1. Generally
          1. As mentioned above, whenever property is contributed to a partnership and, within a certain period of time, partnership property is distributed to a partner, there is the potential to trigger gain under the disguised sale and mixing bowl transaction rules.
          2. In the example above, the LP held Asset A that had an inside basis of zero and a fair market value of $100x. Assume that the LP was formed by contribution of Asset A to LP in exchange for 100% of the limited partnership interests, and assume that there has been no change in the value of Asset A since contribution.
          3. The tax implication of Version 1 and Version 2 in the example above depend, in large part, on how long the asset has been held by the partnership.
       2. Disguised Sale
          1. As discussed above, if a partner who has contributed appreciated property to a partnership receives a distribution of any other property or cash generally within two years of the contribution, based on the applicable facts and circumstances, the distribution may cause the partner to recognize gain as of the original date of contribution with respect to his or her contributed property under the "disguised sale" rules. Thus, assuming no facts or circumstances that would properly characterize the transaction as a sale, the operating holding period for Asset A is two years.
          2. If Asset A has been held by the partnership for less than two years at the time of the distribution of Asset B, then the disguised sale will be presumed to have occurred. Interestingly, it likely would have not have made a difference whether the grantor originally contributed Asset A to LP (and subsequently transferred 100% of the limited partnership interests to the IDGT) or if the IDGT originally contributed Asset A to the LP because they would be considered the same taxpayer under the grantor trust rules. As such, both the grantor trust and the IDGT would be considered the contributing partner. Also note that the Code provides that the elements of a disguised sale can occur if (i) there is a contribution to the partnership by a partner, (ii) there is a “transfer of money or other property by the partnership to such partner (or another partner),”[[1504]](#footnote-1505) and (iii) the transfers “when viewed together, are properly characterized as a sale or exchange of property.”[[1505]](#footnote-1506)
          3. In either Version 1 or Version 2 in the example above, if Asset A has been held by the partnership for two years or less, a disguised sale is deemed to occur, resulting in a deemed sale of Asset A for $100x and resulting in $100x of gain. The basis that could have been shifted to Asset A in the basis shifts above would not reduce the amount of gain because a disguised sale is calculated as of the original date of contribution.
       3. Mixing Bowl Transaction
          1. As discussed above, the mixing bowls transaction provisions of sections 704(c)(1)(B) and 737 of the Code have a seven year time limit. Both operative sections of the mixing bowl transaction rules are operative in this example. If Asset A has been in the partnership for more than two years but seven years or less at the time of the distribution of Asset B, then the mixing bowl transaction rules will be triggered and a taxable event will be deemed to have occurred, but the gain differs in Version 1 and Version 2.
          2. Section 704(c)(1)(B) provides if contributed property is distributed within seven years of the date of contribution to any partner other than the partner who contributed such property, the contributing partner must generally recognize a taxable gain or loss in the year of distribution. [[1506]](#footnote-1507) Further, with respect transfers of partnership interests, the Treasury Regulations provide, for section 704(c) purposes, “If a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. If the contributing partner transfers a portion of the partnership interest, the share of built- in gain or loss proportionate to the interest transferred must be allocated to the transferee partner.”[[1507]](#footnote-1508) Specifically to contributed property distributions to another partner, the Treasury Regulations provide, “The transferee of all or a portion of the partnership interest of a contributing partner is treated as the contributing partner for purposes of section 704(c)(1)(B) and this section to the extent of the share of built-in gain or loss allocated to the transferee partner.”[[1508]](#footnote-1509)
          3. Section 737 provides if a partner contributes appreciated property to the partnership and, within seven years of the date of contribution, that partner receives a distribution of any property other than the contributed property, such partner generally will be required to recognize gain upon the receipt of such other property.[[1509]](#footnote-1510) Thus, section 737 only applies to property received that was not otherwise contributed by such partner.
          4. Under section 737(a), a partner who has contributed section 704(c) property and who receives a distribution of property within seven years thereafter is required to recognize gain in an amount equal to the *lesser* of:

The excess (if any) of the fair market value (other than money) received in the distribution over the adjusted basis of such partner’s outside basis immediately before the distribution reduced (but not below zero) by the amount of money received in the distribution (the “excess distribution”);[[1510]](#footnote-1511) or

The “net precontribution gain,”[[1511]](#footnote-1512) which is the net gain (if any) which would have been recognized by the distributee partner under section 704(c)(1)(B) if, at the time of the distribution, all section 704(c) property contributed by the distributee partner within 7-years of the distribution that is still held by the partnership were distributed to another partner.[[1512]](#footnote-1513)

* + - * 1. As discussed in more detail in the mixing bowl transaction section in these materials, although there is some debate as to whether a transferee under section 737 is treated as a contributing partner, the consensus view is that a transferee steps into the shoes of the transferor as the contributing partner.
        2. In the example above, grantor and IDGT are essentially both contributors of the appreciated Asset A (section 704(c) property) and of the high basis asset, Asset B (as far as the unitary basis rules are concerned). When the IDGT converts to a non-grantor trust, there is a deemed transfer of 50% of the limited partnership interests to the trust. Prior to the deemed transfer, grantor (as the taxpayer) was the contributor of both assets. After the transfer, the trust, as transferee (now a separate taxpayer), steps into the grantor’s shoes but only with respect to ½ of each of Asset A and Asset B. It is similar to how they would be treated under the mixing bowl transaction rules if grantor and the trust had formed LP by each contributing an undivided ½ interest in Asset A and Asset B in exchange for 50% each of the limited partnership interests.
        3. When Asset B is distributed to the trust in both versions of the example above, one-half of Asset B is being returned to the trust. That portion that is being “returned” to the trust does not trigger section 704(c)(1)(B) because that one-half portion of Asset B was deemed to have been contributed by the trust (transferee steps into the shoes of the grantor as contributor). Section 737 applies to other property distributed to the contributing partner. The trust is deemed to be the contributor of one-half of Asset A. In the example, the distribution of the *other* one-half of Asset B (the one-half that was contributed by the grantor and retained by the grantor because only 50% is transferred to the trust) to the trust will trigger section 737.
        4. The amount of gain under section 737 is a lesser of the excess distribution, and the net precontribution gain.

In Version 1, the outside basis of the trust is $35x, and the inside basis of Asset A is $65 after the distribution but zero at the time of the distribution. The excess distribution is $15x (fair market value of the *other* one-half of Asset B [$50x] over the trust’s outside basis [$35x]). The net precontribution gain under section 704(c)(1)(B) is $25x. It is limited to 25x because the trust is the deemed contributor of one-half of Asset A. The *other* one-half of Asset A has $50x of gain, but the trust’s portion of that gain is 50% of that. In all, because section 737 uses a lesser of rule, Version 1 would result in $15x of gain.

In Version 2, the outside basis of the trust is $50x, and the inside basis of Asset A is $50 after the distribution but zero at the time of the distribution. The excess distribution is zero (fair market value of the *other* one-half of Asset B [$50x] over the trust’s outside basis [$50x]). The net precontribution gain under section 704(c)(1)(B) is $25x, as explained above. Version 2 would result in *no gain*.

* + - * 1. As illustrated, in this type of basis shift, when the appreciated contributed asset has been in the partnership for more than two years but for seven years or less, the amount of gain that might result is a function of how much outside basis is allocated to the distributee partner, the trust. That, in turn, is often a function of the valuation discounts that might be applicable to the partnership interests at the time of the deemed transfer when the grantor trust converts to a non-grantor trust.
        2. If, in the example above, Asset A has been held by LP for more than seven years, the mixing bowl transactions rules would not be applicable, and both Version 1 and Version 2 would result in *no gain*.
    1. Section 678, BDOTs, and Basis
       1. As discussed earlier, section 678(a) of the Code provides that a person or entity, other than the grantor, will be treated as the owner of any portion of a trust if the person or entity has the power to “vest the corpus or the income therefrom” or the person or entity “released” the power. It’s unclear whether the power to vest the income and capital gain from a trust makes the holder of that power (beneficiary of that trust or another trust) the owner of the entire trust, so that transactions between the power holder and the trust would be disregarded for Federal income tax purposes.
       2. Even if the power holder would not deemed to be the other of the entire, the power holder would be required to “take into account in computing their tax liability those items which would be included in computing the tax liability of a current income beneficiary.”[[1513]](#footnote-1514) It seems that if the power holder has that requirement, then for unitary basis and capital account purposes, the power holder (beneficiary or other trust) would be considered the same taxpayer. In that case, then, the types of basis shifting transactions between a grantor and a grantor trust discussed above might be available to the power holder and the trust.
  1. Planning with Charitable Entities
     1. Generally
        1. One of the tax benefits of having a partner that is a charitable entity is its tax-exempt status. When a charitable entity holds a partnership interest, however, due regard should be given to unrelated business taxable income[[1514]](#footnote-1515) and excess benefit transactions.[[1515]](#footnote-1516) Further, if the charitable entity is a private foundation, planners should consider the rules relating to self-dealing transactions[[1516]](#footnote-1517) and excess business holdings.[[1517]](#footnote-1518) A full discussion of these and other related rules is beyond the scope of these materials. For purposes of these materials, it is assumed that the charitable partner is a public charity, and the assets in the partnership do not give rise to unrelated business taxable income, excess benefit transactions, or private inurement issues.
        2. If a donor makes a charitable contribution of a partnership interest to charity, the donor may be entitled to a charitable deduction (for income and transfer tax purposes). If the partnership interest is appreciated (outside basis is less than the fair market value), then the amount of the charitable deduction may be reduced under section 170(e) of the Code. If a partnership interest is sold in a taxable transaction, the character of the gain recognized by the selling partner is capital subject to recharacterization as ordinary income under section 751(a) of the Code for gain attributable to “hot assets” (ordinary income items like unrealized receivables, inventory items, etc.) held by the partnership.[[1518]](#footnote-1519)
        3. The Code provides that all contributions of “ordinary income property,” regardless of the type of charitable done, must be reduced by the amount of ordinary income that would have resulted if the donor had sold the contributed property at its fair market value at the time of the contribution.[[1519]](#footnote-1520) For these purposes, ordinary income includes any gain attributable to “hot assets” of the partnership, and any short-term capital gain attributable with respect to the partnership interest. The capital gain attributable to a partnership interest will be short-term or long-term depending on the transferor partner’s holding period in the partnership interest. Notwithstanding the unitary basis requirement for partnership interests, the Treasury Regulations provide that a partner can have multiple holding periods for a single partnership interest.[[1520]](#footnote-1521)
        4. The Code further provides that a donor’s contribution of capital gain property will be further reduced by “the amount of gain which would have been long-term capital gain”[[1521]](#footnote-1522) if the donor contributes the property to a private foundation (other than private operating foundations, distributing foundations, and foundations with a common fund).[[1522]](#footnote-1523) If the donor contributes the partnership interest to a public charity, the donor will be entitled to a charitable deduction equal to the fair market value of the interest (assuming there is no reduction for ordinary income due to “hot assets” in the partnership). However, the income tax deduction will be limited to 30%[[1523]](#footnote-1524) (not 50%[[1524]](#footnote-1525)) of the donor’s contribution base for the taxable year.[[1525]](#footnote-1526) A donor may avoid limiting the deduction to 30% if the donor elects to be subject to section 170(e)(1)(B) of the Code.[[1526]](#footnote-1527) Pursuant to the election, the amount of the contribution is reduced by the amount that would have been long-term capital gain (if the contributed property had been sold for its fair market value at the time of contribution). If the election is made, then the contribution is subject to the 50% limitation, rather than the 30% limitation.
        5. A charitable contribution of a partnership interest generally will not cause the donor to recognize gain or loss. However, there may be gain if, as a result of the transfer, there is a deemed reduction in partnership liabilities under section 752(d) of the Code or if the partnership interest is subject to a liability in excess of outside basis, so that the transfer is considered a part sale/part gift. In such circumstances, the donor will recognize gain (but not loss) for the excess of any liability over the outside basis in the partnership interest.[[1527]](#footnote-1528) In addition, ordinary income may be triggered under section 751(a) of the Code if the partnership owns hot assets if there is a deemed transfer of partnership liabilities,[[1528]](#footnote-1529) and the contribution may also accelerate inherent gain in an installment obligation owned by the partnership.[[1529]](#footnote-1530)
     2. Basis Shifting with Charitable Entities
        1. As discussed above, Revenue Ruling 84-53 provides that when a partner transfers (gratuitous or taxable) a partnership interest and the interest carries a valuation discount, a disproportionately smaller amount of basis is transferred to the transferee. Further, as discussed in these materials, a tax basis “shift” is predicated upon the partnership distributing a higher inside basis asset (in-kind) to a partner whose outside basis in the partnership is lower than the distributed asset. With these rules in mind, a gift of a non-controlling partnership interest to a charitable entity may provide significant tax basis planning opportunities.
        2. Consider the following highly simplified hypothetical:
           1. Taxpayer creates a limited partnership and contributes to the partnership the following assets:

Asset A with a zero basis and fair market value of $100; and

Asset B with $100 basis and fair market value of $100.

* + - * 1. As a result of the contribution, the taxpayer takes back a 1% general partnership interest and 99% limited partnership interest. Assume another person contributes and owns a nominal interest in the partnership to ensure that the entity is a partnership for income tax purposes, rather than a disregarded entity (see the discussion later in these materials). For purposes of this hypothetical, ignore the existence of this nominal partner. Outside basis in the taxpayer’s partnership interest is $100 and his capital account is $200. Assume for purposes of this example that the taxpayer’s interest (prior to any transfer) in the partnership remains at $200 (no valuation discounts).
        2. Taxpayer donates 50% of the limited partnership interest to charity (retaining the 1% general partnership interest and a 49% limited partnership interest). Assume the value of the limited partnership interest carries a 50% valuation discount. In other words, the value for income and gift tax purposes is $50.[[1530]](#footnote-1531)
        3. Under Revenue Ruling 84-53, the basis of charity’s partnership interest is only $25, and taxpayer’s outside basis is $75:



* + - * 1. Notwithstanding the foregoing, charity’s capital account, under the Treasury Regulations,[[1531]](#footnote-1532) is $100.



* + - * 1. At least seven years after the contribution of the assets, assuming the assets remain in the partnership and there has been no change in the values, the partnership liquidates charity’s interest (according to its capital account balance) and distributes Asset B ($100 basis and fair market value of $100) to charity. Assume the LLC has a section 754 election in place at the time of the distribution of Asset B.
        2. The basis of Asset B owned by charity has its basis replaced by charity’s outside basis in the partnership. As a result, Asset B’s basis is $25. Charity can then sell the Asset B and recognize the gain in a tax-exempt environment.
        3. With the section 754 election, the $75 of basis reduction (basis strip) results in an increase in the basis to Asset A under section 734(b) of the Code. Asset A’s basis goes from zero to $75. As discussed in in more detail above, the basis adjustment under section 734(b) is to partnership property, so if the partnership sells Asset A, the basis increase will benefit all of the remaining partners (the taxpayer and any transferees of the taxpayer’s retained interest).
    1. Charitable Family Limited Partnership
       1. Purpose and Mechanics
          1. The purpose of a charitable partnership is to enable a donor to:

Make a larger charitable gift than the donor would feel comfortable making otherwise;

Make a charitable gift when the donor is making substantial gifts to the donor’s descendants; and

Sell appreciated assets without incurring gain. In the discussion below a transaction with the donor’s children is generally assumed. However, the transaction may also be undertaken with grandchildren or other descendants, or with trusts for the benefit of descendants.

* + - * 1. The donor creates a limited partnership. The other initial partner may be the donor’s spouse or children. Generally, forming a limited partnership between a donor and spouse is better than involving children because it reduces the opportunity for the IRS to claim that the donor made a gift upon the formation of the partnership. The partnership may have 10,000 units of which 100 would be general partnership units and 9900 would be limited partnership units. Thus, 99% of the “equity” in the partnership is represented by the limited partnership units while 1% of the partnership controls it.
        2. The partnership can be funded with whatever assets the donor desires. Ideally appreciated assets would be used and care must be taken to avoid the investment company rules.[[1532]](#footnote-1533) The effects on valuation of funding options should be considered as well. For example, if real property is contributed, more different parcels usually create lower values, e.g. a partnership that contains some undeveloped land and rental properties of various types may be discounted more than a partnership that owns only one kind of real estate.
        3. The donor would contribute the 9900 limited partnership units to a charity. A community foundation is often a good choice because through the foundation the donor is able to benefit multiple charitable beneficiaries. Private foundations are not a good choice because of the self-dealing limitations nor are public charities that are controlled or substantially influenced by the donor.
        4. Section 170 of the Code allows the donor to receive and income tax deduction for the contribution of limited partnership units so long as the contribution is not viewed as being of a partial interest. That is, in order for an income tax deduction to be available the partnership must be respected so that the charity is viewed as receiving partnership units rather than a partial interest in the assets of the partnership. For that reason, the charity should receive the full benefits of the units it receives including income distributions, and the partnership formalities should be followed completely. In general, the same considerations as a donor would follow to minimize or avoid the application of section 2036(a)(1) of the Code (transfers with retained enjoyment or control) in the FLP context are applicable here. The amount of the donor’s income tax deduction depends on the fair market value of the units which must be determined by appraisal.[[1533]](#footnote-1534)
        5. Most charities do not desire to retain limited partnership interests and thus will want to sell the units. Experience suggests that the most likely purchasers will be one or more members of the donor’s family. That may be the children, grandchildren, or trusts for their benefit. The charity should be willing to sell the units for their fair market value which is appraised value. The net effect is that the charity receives appraised value and the children, or other purchasers of the units, receive the value of the partnership above the appraised value.
      1. Economics of the Basic Transaction
         1. With Children

Is the transaction beneficial to the family and to the charity? Stated differently, is it a good deal? To illustrate, let us begin with a donor with $1,000,000 in cash. The donor, who has used her gift tax exemption, intends to give $700,000 of that to charity and $300,000 to her children. Of the $300,000 for the donor’s children, gift tax of about $86,000 will be owed netting to the children about $214,000.

The $700,000 given to charity will remove $700,000 from the donor’s estate but will save the donor about $280,000 in income tax (assuming a combined 40% federal and state rate). If the donor took that $280,000 and paid gift tax of $80,000 (assuming a 40% tax rate) the donor’s children would receive about $200,000. So, the donor’s children would receive $214,000 plus $200,000 for about $414,000 in this transaction. Charity would have $700,000.

The same transaction with the partnership would have the following results. First, assume that the partnership is funded with $1,000,000 and that the 9900 limited partnership units are valued at $700,000 (approximately a 30% discount). The donor receives a $700,000 income tax deduction upon making the gift to charity which is same as above. If the donor takes the income tax savings and gives them to the children, they will net $200,000.

If the children purchase the partnership units from the charity for $700,000, the units would have $990,000 of underlying value. If (when) the donor transfers the 100 general partnership units to the children that value may be unlocked. If it is unlocked, the children will have paid $700,000 for something worth $990,000.

The total benefit to the children is, therefore, $200,000 from the charitable deduction and $290,000 from the unlocking of partnership value for a total of $490,000. The children are ahead by $76,000. Of course, consideration should be given to the children’s adjusted basis.

* + - * 1. With Grandchildren or Trusts for Descendants

The transaction becomes more favorable when assets are moved down more than one generation. To illustrate, a donor with $300,000 of cash will pay $86,000 in gift tax and $61,000 in generation-skipping tax (at the 40% rate, tax exclusive because a direct skip), leaving the children with $153,000. Similarly, the donor who makes a charitable gift of $700,000 and receives and income tax deduction of $280,000 may give only $143,000 to the grandchildren after payment of gift and generation-skipping transfer tax. Thus the grandchildren would receive $153,000 plus $143,000, which is $296,000.

Recall that the yield of the charitable partnership transaction does not vary regardless of the purchaser of the limited units; if grandchildren or a trust for descendants is the purchaser, the benefit remains at $217,500 net of capital gains tax. The value of income tax deduction to the grandchildren remains $143,000. So the grandchildren receive if the partnership is used a total of $360,500. The increase to the grandchildren from using the partnership is $360,500 minus $296,000, which is $64,500. If the donor must sell assets to pay gift tax and generation-skipping transfer tax, the benefits are likewise substantially increased.

* + - * 1. Enhancement of the Transaction

If appreciated assets are used to fund the partnership, the transaction may be enhanced. If the assets are sold while the charity owns the limited units, the 99% of the gain realized by the partnership would be allocated to the charity and thus escape income tax. Under the disguised sale rules, a partner who contributes assets to a partnership must recognize gain from the sale of the assets within two-years; however, that rule causes the owner of the limited units to be taxed, in effect, rather than the donor/contributor.

In almost every situation the assets inside the partnership should be sold while the charity is the substantial partner. Otherwise, the donee’s lack of basis tends to reduce the overall tax benefits.

* + - * 1. Role of the Charity

The charity’s role is that of an independent charity looking out for its own best interest. To that end, it will require an appraisal, at a minimum, before selling the limited partnership units. The appraisal may be the same as the donor’s appraisal, although the better practice would be to have an independent review. In addition, the charity may have other procedures it follows, such as review of acceptance and disposition of partnership units by special committees; requirements that it be indemnified against liability and unrelated business income tax before it accepts the units; and “shopping” the units to potentially interested purchasers (e.g. “advertising” the availability of units to the financial community through private communications, notification to the charity’s board, etc.).

Charities are required to disclose the disposition of contributed nonmarketable assets sold within three years of receipt by filing a Form 8282 (Donee Information Return) within 125 days after the disposition. In many instances charities have as policy the retention of nonmarketable assets during the three-year period. If the partnership units are to be retained, then another appraisal will be required at the time of the sale and should be procured by the charity.

An independent charity is best to ensure that the IRS does not conclude that the sale of the units was conducted in other than an arms-length manner. Although private foundations should not be used for this purpose – because of concerns about self-dealing arising not only from the sale of the units but also from the acquisition and retention of the units – supporting organizations may be. Special care should be taken to ensure that all decisions about the retention and sale of the units are made by persons other than the donor or the donor’s family.

* + - * 1. Poor Children

A common concern about the charitable partnership is that the children do not have sufficient assets to purchase the limited partnership units. Generally, it is a concern raised by the charity. Experience suggests that it is not a concern in most family situations. The reason would appear to be that most persons who are ready to contribute significant amounts to charity have already given significant amounts to their descendants or at least in trust for their descendants. However, if that is not the case, or if the costs of generating the funds is prohibitive (e.g., the basis of the purchaser in the assets to be sold to raise cash to purchase the units is zero or very low), then a variation may be used.

The partnership may sell the assets it owns and generate cash. With that cash it may redeem partnership units from the charity, at the appropriately discounted value, thereby, indirectly, increasing the value of the remaining units. To illustrate, suppose donor creates a partnership with 100 general partnership units and 9900 limited partnership units and gives the 100 general partnership units to a trust for the benefit of the donor’s descendants (value is 1% of the amount in the partnership; a $1,000,000 partnership produces a $10,000 gift). The trustee, as general partner, orders all of the assets of the partnership to be sold and then negotiates to redeem the charity’s units at appraised value. If the charity’s 9900 limited units are redeemed for $700,000 the partnership has only 100 general partnership units remaining and owns $300,000 in assets. As before, gain will be triggered if the partnership is liquidated. In many instances it may be desirable to retain the form of a general partnership interest in which case a few limited units may be given to the trust or to the donor’s descendants.

Transactions structured in this manner have been advocated across the country by a number of different entities and planners. In certain versions the redemption occurs at deeply discounted values, supported, in some instances, by giving the charity the rights to put the units to the partnership for specified amounts. To illustrate, the partnership might provide for a 50-year term during the first year of which the charity would have the right to put the units for 2% of the partnership’s book value, during the second year for 4%, and so forth. Planners will need to evaluate such arrangements carefully, particularly given the IRS position with respect to such transactions, discussed below.

* + - 1. IRS Position
         1. As might be expected, the IRS has identified some potential areas of abuse with charitable family limited partnerships. In 2001, the IRS Exempt Organizations Continuing Professional Education (hereinafter, 2001 EO CPE) identified the “CHAR-FLIP” (an extreme version of the charitable family limited partnership transaction described above) as the “years favorite charity scam.”[[1534]](#footnote-1535) As provided in 2001 EO CPE, “The charitable family limited partnership technique is touted as avoiding the capital gain tax on the sale of the donor's appreciated assets, allowing the donor to continue to control the assets until some subsequent sale date, often many years in the future, and still provide the donor with a current charitable deduction on his or her income tax return. Another ‘benefit’ is reducing estate taxes.”
         2. 2001 EO CPE describes the CHAR-FLIP as follows:[[1535]](#footnote-1536)

A typical charitable family limited partnership works as follows: Donor “D”, having substantially appreciated assets, which are often not readily marketable, such as real estate or proprietary interest in a closely held business, sets up a donor family limited partnership (“DFLP”). D transfers highly appreciated assets to DFLP in exchange for both a general and limited partnership interest with the general partnership interest comprising a very modest 1 or 2 percent of the total partnership interests. The DFLP agreement usually provides for a term of 40 to 50 years.

D contributes a large percentage of the DFLP interest to charity “Z”, usually as much as 95 to 98 percent, in the form of a limited partnership interest. D will usually retain the general partnership interest. D may also retain a modest limited partnership interest or transfer such an interest to D’s children. D obtains an independent appraisal of the value of the partnership interests in order to establish the fair market value of the IRC 170(c) charitable contribution deduction. Z receives whatever assets are held by DFLP at the end of the partnership term, assuming the partnership interest was not sold prior to the expiration of the partnership term.

D claims an IRC 170(c) tax deduction based on the value of the gift of the partnership interest to Z. The value likely has been discounted to take into account the lack of Z control and management of partnership operations as well as the lack of marketability of the limited partnership interest in the context of a closely held business.

The key point is control. Control remains with D as the general partner. Z holds a limited partnership interest with no voice in the day to day management or operations of the partnership.

If appreciated property held by DFLP is sold by DFLP, most of the gain escapes taxation by virtue of the IRC 501(c)(3) exempt status of Z. Only the modest limited or general partnership interests held by D and his family are subject to capital gain taxation.

D generally receives a management fee as compensation for operating and managing the partnership.

Z holds a DFLP interest that may produce current income (although many charitable family limited partnerships produce little or no income) as well as an interest in a (hopefully) appreciating asset which will be sold or exchanged no later than the expiration of the partnership term, usually 40 years or even 50 years.

One of the aspects of the “CHAR-FLIP” is a feature which gives a DFLP the right to sell the property to D or his family at a price specified in the partnership agreement. This right is essentially a put option. While such option may serve to benefit Z, the option is often viewed by critics of this technique as working more for the benefit of D or his family than for Z.

* + - * 1. Among the identified issues with the foregoing described transaction were private inurement and benefit, unrelated business income under section 511 of the Code, and excess benefit transaction under section 4958 of the Code. If the charity is a private foundation, then some additions issues were self-dealing under section 4941 of the Code and excess business holdings under section 4943 of the Code.
      1. Given the issues identified by the IRS, practitioners should consider one or all of the following with charitable family limited partnership planning:
         1. Transfer the GP interest to a family trust contemporaneously or soon after contribution to charity in order to avoid the argument of donor control;
         2. Distribute the net income of the partnership annually;
         3. Allow charity to sell its limited partnership units, if the charity can find a buyer;
         4. Do not grant an option;
         5. Do not sell the partnership property to donor or donor’s family (or trust); and
         6. Do not provide any compensation to or for the benefit of the general partner.
  1. Sale of a Partnership Interests Is Likely Worse Than a Property Distribution
     1. Taxable Sale of Partnership Interests
        1. If a partner sells his or her partnership interest in a taxable transaction, the transferor recognizes gain or loss in accordance with the rules of section 1001.[[1536]](#footnote-1537) The transferee takes a cost basis in the acquired partnership interest,[[1537]](#footnote-1538) but the transferee’s capital account is not based on the consideration tendered. The capital account of the transferee carries over from the transferor partner.[[1538]](#footnote-1539) The purchased partnership interest carries with it the transferor’s share of section 704(c) gain (both forward and reverse) in the partnership’s assets.[[1539]](#footnote-1540)
        2. The character of the gain recognized by the selling partner is capital subject to recharacterization under section 751(a) for “hot assets,” as discussed in more detail above.[[1540]](#footnote-1541) Capital gain or loss is recognized as it would be under section 1001 less the amount of ordinary income (or plus the amount of ordinary loss) recharacterized under section 751(a).[[1541]](#footnote-1542)
        3. Section 1(h) provides that the tax rate on the capital gain portion of the sale is determined by looking through to the partnership assets at the time of the sale.[[1542]](#footnote-1543) As a result, the transferor partner may recognize capital gain at a 20%, 25%, and 28% rate (along with the 3.8% Net Investment Income Tax, if applicable to the taxpayer) depending on the nature of the assets in the partnership. The capital gain will be short-term or long-term depending on the transferor partner’s holding period in the partnership interest. Notwithstanding the unitary basis requirement for partnership interests, as discussed above, the Treasury Regulations provide that a partner can have multiple holding periods for a single partnership interest.[[1543]](#footnote-1544) As a result, the sale of a partnership interest can result in ordinary income, short-term capital gain, and long-term capital gain at a multitude of different rates.
        4. As discussed below, a distribution of assets, rather than a sale of the partnership interest (particularly when the partner is exiting the partnership) may result in much better results for the exiting partner. The distribution is not subject to the look-through rule of section 1(h).
        5. As discussed above, if the partnership has a section 754 election in place, the inside basis of the partnership’s assets will be adjusted based upon the value of the consideration furnished by the purchasing partner. This will essentially give the income purchasing partner a fair market value basis in each of the partnership assets (assuming no valuation discount), so that if the partnership were to sell the assets at that time, no additional gain or loss would be borne by the incoming partner.[[1544]](#footnote-1545)
     2. Liquidating Distributions
        1. As mentioned above, if the liquidating distribution includes cash, then gain or loss is recognized based on the amount of outside basis on the partnership interest prior to the distribution. Ordinary income will be generated under section 751(b) to the extent that certain “hot assets” are in the partnership.[[1545]](#footnote-1546) To the extent the distributee partner recognizes capital gain, the gain will be taxed at 20% (never 25% or 28%) because there is no look-through rule under section 1(h).[[1546]](#footnote-1547) As one author points out, “While there is no obvious reason why the higher capital gain rates can apply to dispositions of partnership interests but not to distributions, that is the way the statute is written.”[[1547]](#footnote-1548) If a section 754 election is in place, any gain recognized by a distributee will not be also be allocated to the remaining partners (thereby avoiding the higher capital gain tax rates in the future for the remaining partners). If the liquidating distribution does not include cash in excess of outside basis, no gain will be recognized but ordinary income may be generated under section 751(b).
        2. If property in-kind is distributed, the outside basis of the partnership interest replaces the basis of the distributed assets.[[1548]](#footnote-1549) Ordinary income assets take a carryover basis, with any outside basis remaining going to the capital gain and section 1231 assets distributed.[[1549]](#footnote-1550) Assuming a section 754 election, if the distributed capital assets receive additional basis after the distribution (or if there is a substantial basis reduction with respect to such distribution exceeding $250,000), then the partnership must adjust the inside basis of the remaining assets downward by that amount.[[1550]](#footnote-1551) If the distributed capital asset results in a basis reduction, the partnership will receive an upward inside basis adjustment if a section 754 election is in place.[[1551]](#footnote-1552) All of these adjustments are made pursuant to section 734(b) and are therefore for the benefit of the partnership and the remaining partners. If the distribution in-kind is not in liquidation of the distributee partner’s interest, the inside basis adjustment shifts results in a basis shift from the distributee partner to the non-distributee partners.[[1552]](#footnote-1553)
     3. Planning for FLPs: Sales vs. Distributions
        1. Given the disparate treatment of taxable sales of partnership interests and distributions of partnership property, families in FLPs will often find distributions of assets in-kind more advantageous than a taxable sale of a partnership interest.
        2. A number of strategies can be devised to take advantage of lower income tax bracket partners (including individuals or non-grantor trusts residing in no income tax states or private foundations). By way of example, one strategy might be distributing appreciated property to the lower income tax rate partner (not in liquidation of the partnership) prior to a taxable sale of the assets. This puts the appreciated property in hands of the lower income tax bracket partner
     4. Another strategy might include a non-liquidating distribution of cash[[1553]](#footnote-1554) in partial redemption of most of the departing partner’s interest in the partnership (triggering gain), followed then by a taxable sale of the remaining partnership interest to another family taxpayer. This takes advantage of the no look-through feature of distributions, and with a section 754 election in place, a common inside basis adjustment in favor of the partnership under section 734(b) for the cash distribution, and then an inside basis adjustment in favor of the purchasing partner under section 743.
  2. Section 704(c) Elections Can Shift Income Tax
     1. A full discussion of section 704(c) is beyond the scope of this outline, but estate planners should be aware of certain elections under section 704(c) that can be used under the correct circumstances that could shift income tax liabilities among different taxpayers.[[1554]](#footnote-1555)
     2. When a partner contributes property to a partnership that has a fair market value different (more or less) than its tax basis, section 704(c)(1)(A) ensures that the inherent tax characteristics associated with such difference will ultimately be allocated to the contributing partner. Upon contribution, the contributing partner’s capital account is credited with an amount equal to the fair market value of the property, and when the contributed property is sold by the partnership, any inherent gain or loss (as calculated at the time of contribution) will be allocated to the contributing partner.[[1555]](#footnote-1556) In that manner, section 704(c) ensures that the inherent gain or loss is not allocated to the non-contributing partners. As the Treasury Regulations provide, “The purpose of section 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss. Under section 704(c), a partnership must allocate income, gain, loss, and deduction with respect to property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution.”[[1556]](#footnote-1557)
     3. When the contributed property is depreciable property (e.g., commercial real estate or equipment), section 704(c) attempts to put the non-contributing partners in the same position they would be if the depreciable property had been contributed when the tax basis was equal to the fair market value.
        1. By way of example, partner A contributes depreciable property worth $1,000,000 and with a tax basis equal to $400,000. Assume, the property has a remaining depreciable life of 5 years. Partner B contributes $1,000,000 of cash. Partner A and B are equal 50% partners.
           1. For book purposes, the depreciable property is depreciated over the remaining 5 years based on the $1,000,000 book value. Assuming straight line depreciation that would be $200,000 per year.[[1557]](#footnote-1558) For tax purposes, because the property only has $400,000 of tax basis, the partnership only has $80,000 of depreciation per year.
           2. Absent section 704(c), A and B would be allocated $40,000 each of depreciation per year. This would be $60,000 less depreciation than B would have been allocated had the property actually had a tax basis of $1 million (as assumed for book purposes). Said another way, for the same equal contribution to become an equal partner, B will have $60,000 more taxable income per year. In theory, A is effectively shifting taxable income to B because A has already enjoyed more of the depreciation previously.
           3. Section 704(c) attempts to cure this anomaly. The Treasury Regulations provide, “For section 704(c) property subject to amortization, depletion, depreciation, or other cost recovery, the allocation of deductions attributable to these items takes into account built-in gain or loss on the property. For example, tax allocations to the noncontributing partners of cost recovery deductions with respect to section 704(c) property generally must, to the extent possible, equal book allocations to those partners.”[[1558]](#footnote-1559) As such, all of the tax depreciation must be allocated to B until B has received tax depreciation equal to his share of the book depreciation. In other words, all $80,000 of depreciation will be allocated to B each year.[[1559]](#footnote-1560) As a result, A has more taxable income and is effectively “recapturing” the depreciation taken prior to the contribution.
           4. This method of allocation is sometimes referred to as the “traditional method.”
        2. As a result, in the family context, when dealing with depreciable property, under the “traditional method,” section 704(c) serves to disproportionately allocate depreciation deductions to the non-contributing partner. Thus, families could form a partnership and use the traditional method of allocations under section 704(c) to their advantage particularly if the non-contributing partner is:
           1. A high income taxpayer (including a non-grantor taxable trust),
           2. Holding property that has basis and that is not depreciable (e.g., cash or marketable securities); or
           3. Has an investment that generates significant passive income each year.
     4. You will note, in the previous example, B will be allocated $80,000 of tax depreciation per year, not the $100,000 that B would have received if the depreciable property had a tax basis of $1 million at the time of the contribution. Over the remaining 5 years, B will be allocated, in aggregate, $400,000 of depreciation deductions (which is $100,000 less than the $500,000 B would have received if the property had $1 million of tax basis). This result is due to what is referred to as the “ceiling rule.” [[1560]](#footnote-1561) The ceiling rule mandates that the partnership cannot allocate more depreciation than it actually has for tax purposes. The Treasury Regulations provide that partnerships can override the effect of the ceiling rule by making “curative” allocations or, alternatively, “remedial” allocations, as discussed in more detail below.
     5. A partnership may elect to make “reasonable” [[1561]](#footnote-1562) curative allocations to correct distortions created by the ceiling rule. This is often referred to as the “traditional method with curative allocations.”
        1. Pursuant to this election, the partnership may allocate other tax items (not related to the contributed property) of income, gain, or deduction.[[1562]](#footnote-1563) Thus, because B in the traditional method above will be allocated $20,000 less depreciation each year, if the partnership has other depreciable property, it could allocate $20,000 of other depreciation to B.
        2. Alternatively, if the partnership does not have other depreciable property, it could allocate $20,000 of ordinary income to A, which has the same effect as an allocation of depreciation to B.[[1563]](#footnote-1564)
        3. Note, however, in the family context, whether an allocation of depreciation to B or ordinary income to A is economically holistically better to the family is dependent upon their individual circumstances of the taxpayers. What if A has significant net operating losses? What if B is a non-grantor trust subject to very high state income taxes?
        4. 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.[[1564]](#footnote-1565)

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* + - 1. Generally, curative allocations must be made over the remaining depreciation life of the asset, [[1565]](#footnote-1566) but if the remaining depreciation life is very short in comparison to its actual economic life, under certain circumstances, the IRS could invoke the anti-abuse rule and invalidate the curative allocation.
    1. The Treasury Regulations allow a third allocation method, often referred to as the “remedial allocation.”[[1566]](#footnote-1567)
       1. Unlike curative allocations which are made from actual partnership tax items, remedial allocations involve the creation of notional tax items by the partnership (not dependent upon the actual tax items recognized by the partnership).[[1567]](#footnote-1568) Furthermore, unlike curative allocations, remedial allocations must fully offset the disparity created by the ceiling rule.[[1568]](#footnote-1569)
       2. Under the remedial allocation method, if the ceiling rule results in a book allocation to a non-contributing partner different from the corresponding tax allocation, the partnership makes a remedial allocation of tax items to the non-contributing partner equal to the full amount of the limitation caused by the ceiling rule, and a simultaneous, offsetting remedial allocation of tax items to the contributing partner.[[1569]](#footnote-1570)
       3. From the partner’s standpoint, remedial allocations have the same effect as other tax items actually recognized by the partnership from both a tax liability and outside basis standpoint.[[1570]](#footnote-1571)
       4. Unlike curative allocation, when it comes to depreciable property, the time period is different for remedial allocations. As discussed above, curative allocations are generally made over the remaining depreciable life of the property.[[1571]](#footnote-1572) Under the remedial allocation method, a partnership must bifurcate its book basis in the contributed property for purposes of calculating depreciation.
       5. 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).[[1572]](#footnote-1573) 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.[[1573]](#footnote-1574) As discussed above, for residential real property that would generally be 27.5 years. However, for certain types of qualified property (e.g., certain leasehold improvements), it could mean 50% bonus depreciation under section 168(k) in the first year.[[1574]](#footnote-1575)
    2. 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.
    3. Anti-Abuse Rule for Allocation Methods
       1. Echoing the general anti-abuse provisions discussed above, the Treasury Regulations provide that any “allocation method (or combination of methods) is not reasonable if the contribution of property (or event that results in reverse section 704(c) allocations) and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.”[[1575]](#footnote-1576) It also provides that any reference to partners above includes both “direct and indirect” partners, and an “indirect partner” is “any direct or indirect owner of a partnership, S corporation, or controlled foreign corporation … or direct or indirect beneficiary of a trust or estate, that is a partner in the partnership.”[[1576]](#footnote-1577)
       2. Example 3 in the Treasury Regulations describes a situation where the contributed property only has one year remaining in its depreciable life (although the economic life is 10 years) and the contributing partner has an expiring net operating loss.[[1577]](#footnote-1578) The proposed curative allocation is to offset the entire disparity between book value and tax basis in the first year. The example concludes that the curative allocation is unreasonable because income would be allocated to a partner with a low marginal tax rate from a partner with a high marginal tax rate “within a period of time significantly shorter than the economic life of the property.” However, the example goes on, if the partnership makes curative allocations over the economic life of the property (10 years) then the allocation would be deemed reasonable.[[1578]](#footnote-1579)
       3. It should be noted that the anti-abuse rules do not necessarily apply for state income tax purposes (although most state income tax regimes are tied to the Federal tax liability). When the anti-abuse rules refer to the present value of aggregate tax liability, it refers only to the Federal income tax. Therefore, there are likely allocations that would not result in any Federal income tax savings that would be deemed reasonable, but could result in significant state income tax savings (e.g., partners in high and low income tax states).
       4. The Treasury Regulations do not require a particular election to apply curative or remedial allocations. However, the partnership agreement needs to reflect the allocation chosen by the partnership.

1. PLANNING WITH DISREGARDED ENTITIES
   1. 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).[[1579]](#footnote-1580) 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.” [[1580]](#footnote-1581) Effectively, the entity is “disregarded as an entity separate from its owner if it has a single owner,” [[1581]](#footnote-1582) and this applies for “federal tax purposes.”[[1582]](#footnote-1583)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.[[1583]](#footnote-1584) 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.”[[1584]](#footnote-1585)
      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.[[1585]](#footnote-1586)
   2. May Discounts Be Used When Valuing Interests in Disregarded Entities?
      1. The critical issue for estate planning purposes is whether valuation discounts must be disregarded when valuing transfers (gifts, bequests, sales, and exchanges) of interests in disregarded entities to and among the grantor and grantor trusts. Does the “willing buyer/willing seller” standard[[1586]](#footnote-1587) apply to transfers of interests in disregarded entities? In other words, just as transfers between a grantor and grantor trust are ignored for Federal income tax purposes, are they also ignored for Federal transfer tax purposes?
      2. In *Pierre v. Commissioner*,[[1587]](#footnote-1588) the Tax Court held the transfers of interests in a disregarded entity should be valued for gift tax purposes as transfers of interests in the entity, rather than transfers of the underlying assets of the entity. The Tax Court pointed out, “[s]tate law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed.” As such, the transferred interests in the disregarded entity would qualify for marketability and minority interest discounts. In the case at issue, however, the court concluded that the step transaction applied, in part, because the entity was funded (cash and marketable securities) by the taxpayer less than two weeks prior to the transfers of the entity interests. The taxpayer transferred her entire interest in the wholly-owned LLC to two trusts (9.5% gift and 40.5% sale to each trust).
      3. Importantly, the Tax Court in *Pierre* wrote:[[1588]](#footnote-1589)

While we accept that the check-the-box regulations govern how a *single-member LLC* will be taxed for Federal tax purposes, i.e., as an association taxed as a corporation or as a disregarded entity, we do not agree that the check-the-box regulations apply to disregard the LLC in determining how a *donor* must be taxed under the Federal gift tax provisions on a transfer of an ownership interest in the LLC. If the check-the-box regulations are interpreted and applied as respondent contends, they go far beyond *classifying* the LLC for tax purposes. The regulations would require that Federal law, not State law, apply to define the property rights and interests transferred by a donor for valuation purposes under the Federal gift tax regime. We do not accept that the check-the-box regulations apply to define the property interest that is transferred for such purposes. The question before us (i.e., how a transfer of an ownership interest in a validly formed LLC should be valued under the Federal gift tax provisions) is not the question addressed by the check-the-box regulations (i.e., whether an LLC should be taxed as a separate entity or disregarded so that the tax on its operations is borne by its owner). To conclude that because an entity elected the *classification* rules set forth in the check-the-box regulations, the long-established Federal gift tax valuation regime is overturned as to single-member LLCs would be “manifestly incompatible” with the Federal estate and gift tax statutes as interpreted by the Supreme Court.

* + 1. In other cases, courts have generally supported the position that transfers of interests in disregarded entities are entitled to valuation discounts based on the rights of the transferee under applicable state law and under the LLC operating agreement.[[1589]](#footnote-1590)
  1. 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,[[1590]](#footnote-1591) 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.
        1. In situation 1, B purchases 50% of A’s ownership in the LLC for $5,000. The ruling concludes that the LLC is converted to a partnership when B purchases the interest in the LLC from A. The purchase of the LLC interest is treated for tax purposes as if B purchased 50% of each of the LLC’s assets (which are, in turn, treated as if held by A for tax purposes). Immediately thereafter, A and B are deemed to contribute their respective interests in those assets to a newly formed partnership. Under such treatment, the ruling further provides:
           1. Member A recognizes gain or loss on the deemed sale under section 1001 of the Code. However, there is no further gain or loss under section 721(a) of the Code for the contribution of asset to the partnership in exchange for partnership interests in the newly formed entity.
           2. Under section 722 of the Code, B’s outside basis in the partnership is $5,000, and A’s outside basis is equal to A’s basis in A’s 50% share of the assets in the LLC. Under section 723 of the Code, the partnership’s tax basis in the assets is the adjusted basis of the property in A and B’s hands immediately after the deemed sale.
           3. Under section 1223(1) of the Code, A’s holding period for the partnership interest includes his or her holding period in the assets held by the LLC, and B’s holding period for the partnership interests begins on the day following the date of B’s purchase of the LLC interest from A.[[1591]](#footnote-1592) 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.
        2. In situation 2, B contributes $10,000 in the LLC for a 50% ownership interest in the LLC. In this instance, as in the previous situation, the ruling concludes that the LLC is converted to a partnership when B contributes the cash to the LLC in exchange for an ownership interest in the partnership. A is treated as contributing all of the assets of the LLC to a newly formed partnership. Under such treatment and facts, the ruling provides:
           1. There is no gain or loss to A or B under section 721(a) of the Code.
           2. Under section 722 of the Code, B’s outside basis is equal to $10,000, and A’s outside basis is his or her basis in the assets of the LLC which A is treated as contributing to the new partnership. Under section 723 of the Code, the basis of the property contributed to the partnership by A is the adjusted basis of that property in A‘s hands. The basis of the property contributed to the partnership by B is $10,000, the amount of cash contributed to the partnership.
           3. Under section 1223(1) of the Code, A‘s holding period for the partnership interest includes A‘s holding period in the LLC assets deemed contributed when the disregarded entity converted to a partnership. B‘s holding period for the partnership interest begins on the day following the date of B‘s contribution of money to the LLC. Under section 1223(2), the partnership's holding period for the assets transferred to it includes A ‘s holding period.
     3. Unfortunately, the foregoing ruling does not address (i) non-taxable transactions like sales or exchanges of a disregarded entity interests between a grantor and his or her grantor trust (situation 1 is a taxable sale) or (ii) contributions of assets to a disregarded entity by a grantor or grantor trust. Under those circumstances, how should the tax basis be allocated among the grantor and the grantor trust? It seems that given the IRS’s position in Revenue Ruling 85-13 that grantor trusts are “ignored” or also disregarded, that the unitary basis rules would apply in such a way that if B was a grantor trust in the situations described in Revenue Ruling 99-5, B’s outside would not be $5,000/$10,000 respectively. Rather, the aggregate basis of A (the grantor) and B (the grantor trust) would be allocated pursuant to the unitary basis rules, as discussed in more detail above (essentially B would receive a portion of A’s basis in the transferred asset).
     4. Further, the ruling does not address the conversion of a disregarded entity to a partnership when grantor trust status is lost and the trust holds only a portion of the entities interest.
  2. Conversion of Partnership to Disregarded Entity
     1. In Revenue Ruling 99-6,[[1592]](#footnote-1593) the IRS provided guidance on the tax issues involved in a conversion of partnership to a disregarded entity. The ruling addresses 2 situations with respect to an LLC that is classified as a partnership but becomes a disregarded entity when a transaction consolidates all of the ownership with a single member. The ruling provides that the LLC has no liabilities, and the assets are not subject to any indebtedness.
        1. In situation 1, A and B are equal partners in an LLC taxed as a partnership. A sell’s his or her entire interest in the LLC to B for $10,000. The ruling concludes the partnership terminates under section 708(b)(1)(A) when B purchases A’s entire interest. A must treat the transaction as a sale of A’s partnership interests, and with respect to the treatment of B, there is a deemed liquidating distribution of all of the assets to A and B, followed by B treated as acquiring the assets deemed to have been distributed to A in liquidation of A’s interests. Under such treatment:
           1. A has gain or loss resulting from the sale of the partnership interest under section 741 of the Code. As discussed above, section 741 of the Code provides that gain or loss resulting from the sale or exchange of an interest in a partnership shall be recognized by the transferor partner, and that the gain or loss shall be considered as gain or loss from a capital asset, except as provided in section 751 of Code (relating to “hot assets,” unrealized receivables and inventory items).
           2. B’s basis in the assets attributable to A’s one-half interest in the partnership is $10,000 under section 1012 of the Code. B does not get to retain the holding period of the partnership on such assets deemed liquidated and distributed to A under section 735(b) of the Code. Rather, these are newly acquired assets, and B’s holding period for these assets begins on the day immediately following the date of the sale.
           3. With respect to B’s portion of the deemed liquidation, B will recognize gain or loss (if any) under section 731(a) of the Code (generally, no gain or loss except to the extent that any money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution, assuming there are no “hot assets” in the partnership). B‘s basis in the assets received in the deemed liquidation of B‘s interest is determined under section 732(b) of the Code (generally, the adjusted basis of B’s interest in the partnership, reduced by any money distributed in the same transaction). Under section 735(b) of the Code, B‘s holding period for the assets includes the partnership's holding period for such assets.[[1593]](#footnote-1594)
        2. In situation 2, C and D are equal partners in an LLC taxed as a partnership. C and D sell their entire interests in the LLC to E, an unrelated person, for $20,000 ($10,000 each). As under the previous situation, the ruling concludes the partnership terminates under section 708(b)(1)(A) when E purchases all of the LLC interests. C and D must treat the transaction as a sale of their respective partnership interests, and with respect to E, there is a deemed liquidating distribution of all of the assets to C and D, followed by E treated as acquiring all of the former assets of the partnership from C and D.
           1. C and D have gain or loss under section 741 of the Code.
           2. E’s basis in the assets in the partnership is $20,000 under section 1012 of the Code, and E’s holding period begins on the day immediately following the date of the sale.
     2. In typical estate planning transactions, a conversion from a partnership to a disregarded entity could occur in a taxable transaction (e.g., sale of a partnership interest from a non-grantor trust to another partner) or in a non-taxable transfer (e.g., the distribution of a partnership interest from a non-grantor trust to a beneficiary that is the only other partner or in a gratuitous transfer of the partnership interest (subject to gift or estate tax) to the only other partner. Presumably, the Revenue Ruling 99-6 would apply to the taxable transactions, but it is unclear how they might apply to the non-taxable transactions.
  3. Disregarded Entities: Subchapter K and Capital Accounts
     1. One of the practical benefits of utilizing disregarded entities with grantor trusts is that the income tax consequences of every transaction (transfers of partnership interests, contributions of capital, distributions, etc.) can be essentially ignored until there is a conversion event, whether that occurs because of the death of the grantor, relinquishing grantor trust status, or admitting a partner that is not the grantor for tax purposes. As long as 100% of the ownership interest is held by the grantor or grantor trusts, there are no complications relating to the allocation of built-in gains and losses under section 704(c) of the Code (or “reverse 704(c)” due to the admission of new partners), no recognition events due to the sale or exchange of a partnership interest, and no need to account for inside or outside basis.
     2. Even if a partner has more than one interest in a partnership (held individually or through grantor trusts, presumably) that partner is deemed to have a single capital account. Maintaining capital accounts only becomes important when the disregarded entity is converted to a partnership or if there is a liquidation of the disregarded entity among the members. As discussed in more detail above, the “safe harbor” Treasury Regulations provide that an allocation will have “economic effect” if, in part, the partnership maintains capital accounts under the Treasury Regulations,[[1594]](#footnote-1595) and the partnership makes liquidating distributions in accordance with the partners’ positive capital account balances.[[1595]](#footnote-1596)
     3. The Treasury Regulations provide that upon a transfer of all or a part of a partnership interest, the transferor’s capital account “that is attributable to the transferred interest carries over to the transferee partner.”[[1596]](#footnote-1597) The Treasury Regulations take the position that the portion of the transferor’s capital account that carries over to the transferee equals the percentage of the transferor’s total interest that is sold or transferred. This methodology is not how tax basis is allocated. As discussed above, in Revenue Ruling 84-53,[[1597]](#footnote-1598) the IRS ruled in the context of calculating outside basis of a transferred partnership interest, “the basis of the transferred portion of the interest generally equals an amount which bears the same relation to the partner's basis in the partner's entire interest as the fair market value of the transferred portion of the interest bears to the fair market value of the entire interest.”[[1598]](#footnote-1599)
     4. As discussed in more detail above, each partner is deemed to have a single unitary basis for all interests held in a partnership. Similarly, each partner has a single capital account for all interests in the same partnership. The Treasury Regulations provide, “a partner who has more than one interest in a partnership shall have a single capital account that reflects all such interests, regardless of the class of interests owned by such partner (e.g., general or limited) and regardless of the time or manner in which such interests were acquired.” [[1599]](#footnote-1600)
     5. In the disregarded entity context, B owns a wholly-owned LLC that is recapitalized into preferred and common shares. B transfers the preferred shares to grantor trust C and the common shares to grantor trust D. The allocation of tax basis and capital account has no meaning in this context because it remains a disregarded entity. What if C becomes a non-grantor trust? The IRS has taken the position that when grantor trust status is lost, it will be treated as if the grantor transferred the interest to trust C at that time. If that is the case, what value is used for determining the allocation of outside basis? Certainly, Chapter 14 value under section 2701 of the Code can’t be the answer because what if the preferred shares are deemed to have a zero value under section 2701 of the Code because they do not fall under the qualified payment interest exception? Revenue Ruling 99-5 would treat the loss of grantor trust status as a conversion from a disregarded entity to a partnership (deemed transfer) which would treat C as having purchased a portion of the LLC’s assets and then contributed them to a new partnership. What portion of the assets is C deemed to have purchased and how does one value that? For capital account purposes, should the common shares get any balance if the preferred liquidation preference is equal to the section 704(b) book value at that time?
  4. Planning Opportunities with Disregarded Entities[[1600]](#footnote-1601)
     1. Inherent Leverage with No Income Tax Consequences
        1. Because transfers of less than 100% of a disregarded entity to a grantor trust (another disregarded entity) will likely carry valuation discounts (see the discussion above), but liquidations must occur according to positive capital accounts, there is inherent wealth transfer leverage in any zeroed-out transfer to an IDGT or GRAT (if and when the disregarded entity or converted entity is finally liquidated). This assumes that the contribution or transfer to the trust carries a valuation discount, but the liquidation will occur on basis that does not include the discount. It further assumes the transfer and the ultimate liquidation is not subject to recharacterization under the economic substance doctrine under section 7701(o) of the Code or non-statutory doctrines like substance-over-form, step-transaction, or sham-transaction.
        2. While grantor trust status is retained, the grantor will continue to be treated as if the grantor owned all of the assets for income tax purposes. This allows the assets in the IDGT or GRAT to grow without the burden of paying income tax, which is borne by the grantor. If the grantor also has a power to exchange assets of equivalent value under section 675(4)(C) of the Code, assets that carry a valuation discount can be exchanged to further increase the wealth transfer. For example, if the IDGT directly holds assets that have been liquidated from a disregarded entity, then those assets could be reacquired with shares in another disregarded entity but the value of which carries a discount. All of these transactions can be consummated without recognizing any gain or loss.
     2. Disregarded Entities and S Corporations
        1. S corporations cannot have more than one class of stock, which generally requires that all of the outstanding stock must have identical rights to distributions and liquidation proceeds, but the S corporation may have voting and non-voting shares.[[1601]](#footnote-1602) In addition, partnerships are not eligible S corporation shareholders.[[1602]](#footnote-1603) Because of the single class of stock requirement, S corporation shareholders are not able bifurcate their economic interests into preferred and common interests and effectuate transactions similar to a preferred partnership freeze or reverse freeze.
        2. S corporation shareholders may be able to create preferred and commons interests through a disregarded entity. Pursuant to this idea, S corporation shareholder would create a wholly-owned LLC that is treated as a disregarded entity and contribute his or her S corporation shares to the entity. The disregarded entity would then recapitalize its shares into preferred and common shares, thereby allowing the taxpayer to do a forward or reverse freeze transaction with his or her IDGT. While the taxpayer is alive and the trust remains a grantor trust, the individual taxpayer should continue to be deemed the eligible S corporation shareholder.[[1603]](#footnote-1604) The IRS has ruled that an S corporation may be owned by a partnership or a limited liability company (or a combination of them) as long as the partnership and limited liability company are disregarded for income tax purposes.[[1604]](#footnote-1605) If the disregarded entity is liquidated during the life of the grantor, then the S corporation shares will be distributed among the grantor and the trust, which will either remain a grantor trust or become either an electing small business trust[[1605]](#footnote-1606) or a qualified subchapter S trust.[[1606]](#footnote-1607)
        3. If, however, the grantor dies prior to the liquidation of the disregarded entity, then an issue arises as to whether the entity will be deemed to have converted to a partnership (as an entity owned by a non-grantor trust and the estate of the taxpayer), thereby terminating the S corporation status of the corporation. This termination might be avoided, as follows:
        4. If the operating agreement of the disregarded entity requires an immediate termination and liquidation upon the death of the grantor, then the LLC would, in theory, cease to exist and the assets (the S corporation shares) would immediately be divided among the estate of the decedent and the trust (that must also qualify as an ESBT or QSST).[[1607]](#footnote-1608) In most forward freeze transactions, the grantor would hold a preferred interest that had a fixed liquidation amount, and the trust would hold any excess value. The value of the S corporation shares would need to be determined in allocating the fixed liquidation amount to the estate, with any excess shares passing to the trust.
        5. Another possible way of avoiding S corporation termination is to ensure that upon the death of the taxpayer, the LLC shares held by the decedent would pass directly to the trust, thereby unifying 100% of the LLC ownership in the trust (which is either an ESBT or QSST). It appears that bequeathing the shares under the decedent’s Will may still cause termination of S status. The IRS has ruled that if a corporation’s stock is subject to the possession of the executor or administrator of the decedent’s estate, the estate is considered a shareholder as of the date of death, notwithstanding the fact that applicable state law provides that legal title to the stock passes directly to the heirs under the Will.[[1608]](#footnote-1609) However, termination might still nonetheless be avoided by providing that the LLC interests pass directly to the trust outside of probate. The operating agreement could provide an immediate transfer of the grantor’s interest in the LLC to the trust, similar to a transfer on death provision or beneficiary designation. Whether a transfer on death provision in a revocable living trust (as opposed to under the Will) would also be effective is unclear.
        6. Even if there is a deemed termination of S corporation status, The IRS has granted relief in circumstances where the S corporation stock was held by disregarded entities and the death of the grantor caused the termination. In PLRs 201730002 and 200841007, the IRS concluded that a termination of S corporation status caused by the death of the grantor—during life the taxpayer had created grantor trusts that held shares in a disregarded entity that, in turn, owned S corporation shares—was inadvertent within the meaning of section 1362(f) of the Code. In both rulings, the taxpayer was granted relief and S corporation status was maintained after the death of the taxpayer.[[1609]](#footnote-1610) Of course, private letter rulings have no precedential value, so practitioners are advised to obtain a ruling in advance to ensure that S corporation status will not be terminated.
     3. Eliminating Outstanding Installment Notes
        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.[[1610]](#footnote-1611)
        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.
        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.

1. CONCLUSION
   1. Estate planners tailor tax strategies to the client’s non-tax objectives. Traditionally, the primary taxes were those involved in wealth transfer taxation – the estate, gift, and generation-skipping transfer taxes. As the amount insulated from those taxes by ever increasing applicable exclusion amounts (the temporary doubling of the applicable exclusion amounts under TCJA) strategies to minimize the income tax consequences of the client’s planning become increasingly necessary. Just as there are many estate, gift and, generation-skipping tax planning strategies, so too are there multiple income tax planning strategies and pitfalls.
   2. These materials are meant to be a resource to understand the fundamentals of income taxation, with a focus on the consequences of the estate planning transfers, transactions, and techniques often utilized when our clients are alive and after their deaths. As discussed, there are many unclear and unknown income tax consequences to certain estate planning structures. Many of the unintended and unanticipated income tax consequences can be avoided by having a stronger understanding of the fundamentals of income taxation.

1. § 691 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. [↑](#footnote-ref-2)
2. § 102(a). One exception would be if appreciated assets are used to satisfy or fund a pecuniary bequest. *See* *Kenan v. Commissioner*, 114 F.2d 217 (2d Cir. 1940), Treas. Reg. § 1.661(a)-2(f), Rev. Rul. 82-4, 1982-1 C.B. 99 (equalizing distribution is in satisfaction of a right to receive a specific dollar amount), and Rev. Rul. 67-74. *Cf.* PLRs 200405001–200405004. [↑](#footnote-ref-3)
3. § 1202(a). [↑](#footnote-ref-4)
4. § 1400Z-2(c). [↑](#footnote-ref-5)
5. § 453. [↑](#footnote-ref-6)
6. Rev. Proc. 2020-45, 2020-46 I.R.B. 1016. [↑](#footnote-ref-7)
7. *See* § 1041 and Austin W. Bramwell and Carlyn S. McCaffrey*, Select Unconventional Uses of Grantor and Nongrantor Trusts*, 54th Annual Heckerling Institute on Estate Planning (2020), published by LexisNexis Matthew Bender, Ch. 11, ¶ 1104, p. 11-33. [↑](#footnote-ref-8)
8. *See* CCA 200515019. [↑](#footnote-ref-9)
9. *Cottage Savings Ass’n v. Commissioner*, 499 U.S. 554 (1991). [↑](#footnote-ref-10)
10. § 1001(a). [↑](#footnote-ref-11)
11. Treas. Reg. § 1.1001-1(a). [↑](#footnote-ref-12)
12. *Cottage Savings Ass’n v. Commissioner*, 499 U.S. 554 (1991) , at 565. [↑](#footnote-ref-13)
13. *Id.* [↑](#footnote-ref-14)
14. *See* Treas. Reg. § 1.1001-3. *See also* Rev. Proc. 2001-21, 2001-9 I.R.B. 742 (election to treat a substitution of debt instruments as a realization event even when it does not result in a significant modification). [↑](#footnote-ref-15)
15. *See, e.g.*, PLRs 201722007 (the modifications and future divisions of trusts with assets allocated on a pro rata basis, but if appreciated assets are used to fund an equalization distribution between the two trusts, then a gain will result under § 1001), 200209007 and 200209008 (no gain or loss to beneficiaries of a generation skipping trust on trust's partition because materially different properties will not be exchanged in the transaction), 200539008 (division of trust into two trusts pursuant to divorce agreement will not cause gain or loss to be recognized by trusts), and 200552009 (no gain or loss recognized on merger and division of family trusts into new trusts that contained substantially the same terms and held interests equal to those before the merger and division). *See also* Treas. Reg. 1.1001-1(h). [↑](#footnote-ref-16)
16. *Crane v. Commissioner*, 331 U.S. 1 (1947). [↑](#footnote-ref-17)
17. *Commissioner v. Tufts*, 461 U.S. 300 (1983). [↑](#footnote-ref-18)
18. *Crane v. Commissioner*, 331 U.S. 1 (1947), at 14. [↑](#footnote-ref-19)
19. *Id.*, fn. 37. [↑](#footnote-ref-20)
20. § 752(d). [↑](#footnote-ref-21)
21. § 1001(a). [↑](#footnote-ref-22)
22. § 1001(b). [↑](#footnote-ref-23)
23. The opinion provides, “We are disinclined to overrule *Crane*, and we conclude that the same rule applies when the unpaid amount of the nonrecourse mortgage exceeds the value of the property transferred. *Crane* ultimately does not rest on its limited theory of economic benefit; instead, we read *Crane* to have approved the Commissioner's decision to treat a nonrecourse mortgage in this context as a true loan. This approval underlies *Crane*'s holdings that the amount of the nonrecourse liability is to be included in calculating both the basis and the amount realized on disposition. That the amount of the loan exceeds the fair market value of the property thus becomes irrelevant. *Commissioner v. Tufts*, 461 U.S. 300 (1983), at 307. [↑](#footnote-ref-24)
24. *Id.* at 309-310. [↑](#footnote-ref-25)
25. Treas. Reg § 1.1001-2(a)(1). [↑](#footnote-ref-26)
26. Treas. Reg § 1.1001-2(a)(4)(i). [↑](#footnote-ref-27)
27. Treas. Reg § 1.1001-2(a)(4)(iii). [↑](#footnote-ref-28)
28. Treas. Reg § 1.1001-2(a)(4)(iv). [↑](#footnote-ref-29)
29. *See* § 357(c) (“If the sum of the amount of the liabilities assumed exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.”). [↑](#footnote-ref-30)
30. *See* 752(c) (“For purposes of this section, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property.”). [↑](#footnote-ref-31)
31. *Rothstein v. U.S.*, 735 F.2d 704 (2nd Cir. 1984). [↑](#footnote-ref-32)
32. Amount realized by the taxpayer is fair market value of the liquidated property of $1,054,580, reduced by assumed corporate liabilities of $267,751 (net $785,829), with a cost basis in the stock of $820,000 ($500,000 from the stock purchased from the other shareholder, and $320,000 on the stock purchased from the trust). *Id.* at 705. [↑](#footnote-ref-33)
33. § 675(3). [↑](#footnote-ref-34)
34. § 671. [↑](#footnote-ref-35)
35. *Rothstein v. U.S.*, 735 F.2d 704 (2nd Cir. 1984), at 709. [↑](#footnote-ref-36)
36. *Jeffrey N. Pennell*, (Mis)Conceptions about Grantor Trusts, 50th Annual Southern Federal Tax Institute, Outline V, p. 1-2 (Oct. 2015). [↑](#footnote-ref-37)
37. Rev. Rul. 85-13, 1985-1 C.B. 184. [↑](#footnote-ref-38)
38. *Id.* *See also* Rev. Rul. 2007-13, 2007-1 C.B. 684 (sale of a life insurance policy from one grantor trust to another grantor trust is not a transfer for income tax purposes because the grantor is treated as the owner of the assets of both trusts)), Rev. Rul. 88-103, 1988-2 C.B. 304 and PLR 8729023 (grantor and grantor trust will be treated as a single taxpayer for purposes of qualifying for involuntary conversion treatment under section 1033 of the Code), and Rev. Rul. 2004-86, 2004-33 I.R.B. 191 (a taxpayer may exchange interests in a grantor trust—a Delaware statutory trust—for real property and qualify for like-kind treatment under section 1031 of the Code). *But see* Prop. Treas. Reg. § 1.108-9(c)(1), (2) (cancellation of indebtedness rules only apply if the grantor, not the grantor trust, is bankrupt or insolvent). [↑](#footnote-ref-39)
39. *See, e.g.,* Stuart M. Horwitz & Jason S. Damicone, *Creative Uses of Intentionally Defective Irrevocable Trusts*, 35 Est. Plan. 35 (2008) and Michael D. Mulligan, *Sale to Defective Grantor Trusts: An Alternative to a GRAT*, 23 Est. Plan. 3 (1996). [↑](#footnote-ref-40)
40. § 1274. [↑](#footnote-ref-41)
41. *See* Edwin P. Morrow, *IRC Section 678 and the Beneficiary Deemed Owner Trust (BDOT)* (April 19, 2018). Available at SSRN: <https://ssrn.com/abstract=3165592> and Jonathan G. Blattmachr, Mitchell M. Gans, and Alvina H. Lo, *A Beneficiary as Trust Owner: Decoding Section 678*, 35 ACTEC J. 106 (2009). [↑](#footnote-ref-42)
42. *See* Jerome M. Hesch, Lawrence Brody, Richard A. Oshins & Susan P. Rounds, *A Gift From Above: Estate Planning on a Higher Plane — The Unique Design of a BDIT Minimizes — Even Eliminates — Many Tax and Non-Tax Problems*, 150 Tr. & Est. 17 (Nov. 2011). [↑](#footnote-ref-43)
43. The IRS has section 678 beneficiary owned trust on its list of areas in which rulings will not ordinarily be issued and list of areas under study in which rulings will not be issued until the service resolves the issue through the publication of a revenue ruling, revenue procedure, regulation, or otherwise. Rev. Proc. 2021-3, 2021-1 I.R.B. 140, sections 4.01(42) and 5.01(10). [↑](#footnote-ref-44)
44. *See* *Rauenhorst v. Commissioner*, 119 T.C. 157 (2002). [↑](#footnote-ref-45)
45. § 1222. [↑](#footnote-ref-46)
46. § 1(h). [↑](#footnote-ref-47)
47. § 1(j). [↑](#footnote-ref-48)
48. § 1(h)(1)(F). [↑](#footnote-ref-49)
49. *See Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988). [↑](#footnote-ref-50)
50. See 1222(5) through (11). [↑](#footnote-ref-51)
51. § 1221(a)(1). [↑](#footnote-ref-52)
52. § 1221(a)(2). [↑](#footnote-ref-53)
53. § 1221(a)(3). [↑](#footnote-ref-54)
54. § 1221(a)(4). [↑](#footnote-ref-55)
55. *See Byram v. United States*, 705 F.2d 1418 (5th Cir. 1983). [↑](#footnote-ref-56)
56. *See, e.g., Reidel v. Commissioner*, 261 F.2d 371 (5th Cir. 1958) (sale of real property). The sale of inherited inventory may also qualify as capital gain. *See Maley v. Commissioner*, 17 T.C. 260, *acq.*, 1952-1 C.B. 3. *But see Commissioner v. Linde*, 213 F.2d (9th Cir. 1954), *cert. denied*, 348 U.S. 871 (1954). [↑](#footnote-ref-57)
57. *See Lloyd v. Commissioner*, 29 T.C.M. 453 (1970) and *Erhman v. Commissioner*, 120 F. 2d 607 (9th Cir 1941). [↑](#footnote-ref-58)
58. *See* § 1231(a)(1) and (2). [↑](#footnote-ref-59)
59. § 1231(a)(3)(A)(i) [↑](#footnote-ref-60)
60. § 1231(b)(1)(A) through (D). [↑](#footnote-ref-61)
61. *See* § 1231(b)(2), (3), and (4). There are different holding requirements for each of these assets. [↑](#footnote-ref-62)
62. *See* Rev. Rul. 72-111, 1972-1 C.B. 56. [↑](#footnote-ref-63)
63. *See* § 1231(a)(3)(A). [↑](#footnote-ref-64)
64. *See McBride v. Commissioner*, 50 T.C. 1 (1968), *Carnick v. Commissioner*, 9 T.C. 756 (1947), *Marx v. Commissioner*, 5 T.C. 173 (1945), and *Campbell v. Commissioner*, 5 T.C. 272 (1945). [↑](#footnote-ref-65)
65. *See Carnick v. Commissioner*, 9 T.C. 756 (1947) and *Campbell v. Commissioner*, 5 T.C. 272 (1945). [↑](#footnote-ref-66)
66. § 1231(b)(1). *See also* Treas. Reg. §§ 1.1231-1(c)(1), 1.167(a)-2, §1.167(a)-3(a), and §1.197-2(g)(8). [↑](#footnote-ref-67)
67. *See* § 167 and Treas. Reg. §§ 1.167(a)-1, 1.167(a)-2, and 1.167(a)-3(a). [↑](#footnote-ref-68)
68. § 167(a) and Treas. Reg. §§ 1.167(a)-1(a) and 1.167(a)-2. [↑](#footnote-ref-69)
69. Rev. Proc. 87-56, 1978-2 C.B. 674, *modified by* Rev. Proc 88-22, 1988-2 C.B. 785. *See also* IRS Publication 946 (How to Depreciate). [↑](#footnote-ref-70)
70. § 197(a). [↑](#footnote-ref-71)
71. IRS Publication 535 (Business Expenses). *See also* § 197(c)(1) and (d). [↑](#footnote-ref-72)
72. § 1222(3) and (4). [↑](#footnote-ref-73)
73. § 1222(1) and (2). [↑](#footnote-ref-74)
74. § 1(h). [↑](#footnote-ref-75)
75. § 1223(2). [↑](#footnote-ref-76)
76. § 1231(1). [↑](#footnote-ref-77)
77. § 1223(9). [↑](#footnote-ref-78)
78. Treas. Reg. § 1.701-2(i). [↑](#footnote-ref-79)
79. Health Care and Education Reconciliation Act of 2010, P.L. 111-152, § 1409 (Mar. 30, 2010). [↑](#footnote-ref-80)
80. § 7701(o)(1). [↑](#footnote-ref-81)
81. § 7701(o)(5)(B). [↑](#footnote-ref-82)
82. § 267(a). [↑](#footnote-ref-83)
83. *See Reddington v. Commissioner*, 131 F.2d 1014 (2d Cir. 1942), *Lakeside IRR. Co., Inc. v. Commissioner*, 128 F.2d 418 (5th Cir. 1942), and *Kaplan v. Commissioner*, 21 T.C. 134 (1953). [↑](#footnote-ref-84)
84. § 267(d)(1). This netting rule does not apply if the loss if the wash sale rules of section 1091 of the Code apply. § 267(d)(2). [↑](#footnote-ref-85)
85. § 1041(a). [↑](#footnote-ref-86)
86. § 267(d) and Treas. Reg. § 1.267(d)-1(c)(2). [↑](#footnote-ref-87)
87. § 267(d) and Treas. Reg. § 1.267(d)-1(a)(2). [↑](#footnote-ref-88)
88. § 267(d)(3). [↑](#footnote-ref-89)
89. Treas. Reg. § 1.267(d)-1(a)(3). [↑](#footnote-ref-90)
90. Treas. Reg. § 1.267(d)-1(a)(4). [↑](#footnote-ref-91)
91. *See McWilliams v. Commissioner*,331 U.S. 694 (1947). [↑](#footnote-ref-92)
92. *See Estate of Estroff v. Commissioner*, T.C. Memo 1983-666. [↑](#footnote-ref-93)
93. *See Merritt v. Commissioner*, 400 F.2d 417 (5th Cir. 1968), and *Zacek v. Commissioner*, 8 T.C. 1056 (1947). [↑](#footnote-ref-94)
94. *See Hassen v. Commissioner*, 599 F.2d 305 (9th Cir. 1979). *But see McNeill v. Commissioner*, 251 F.2d 863 (4th Cir. 1958). [↑](#footnote-ref-95)
95. § 267(b)(1) through (13). [↑](#footnote-ref-96)
96. *See* 267(c)(4). [↑](#footnote-ref-97)
97. *See* 267(f). There is also constructive ownership and attribution from partnerships (partner having an interest of 5% or more in either capital or profits of the partnerships), estates and non-grantor trusts (beneficiary with an actuarial interest of 5% or more, assuming maximum exercise of discretion by trustee for the benefit of the beneficiary), grantor trusts, other corporations (5% or more in value), spouses, minor children and certain adult children, grandchildren, parents, and grandparents. *See* § 1563(e). [↑](#footnote-ref-98)
98. § 267(b)(2). [↑](#footnote-ref-99)
99. § 267(c)(1) through (5). [↑](#footnote-ref-100)
100. § 707(b)(1). [↑](#footnote-ref-101)
101. § 707(b)(1)(A). [↑](#footnote-ref-102)
102. § 707(b)(1)(B). [↑](#footnote-ref-103)
103. § 707(b)(1), flush language, and Treas. Reg. § 1.707-1(b)(1). [↑](#footnote-ref-104)
104. § 707(b)(2)(A). [↑](#footnote-ref-105)
105. § 707(b)(2)(B). [↑](#footnote-ref-106)
106. § 707(b)(2). [↑](#footnote-ref-107)
107. § 707(b)(3). [↑](#footnote-ref-108)
108. *See* 267(c)(5). [↑](#footnote-ref-109)
109. *See* Treas. Reg. § 1.267(b)-1(b)(1). [↑](#footnote-ref-110)
110. § 61(a)(11). [↑](#footnote-ref-111)
111. § 108(e)(4)(A). [↑](#footnote-ref-112)
112. § 108(e)(4)(B). [↑](#footnote-ref-113)
113. § 108(e)(4)(C). [↑](#footnote-ref-114)
114. *See* Treas. Reg § 1.414(c)-2(b), (c), and (d). [↑](#footnote-ref-115)
115. *See, e.g.*, Treas. Reg. § 1.414(c)-2(b)(2)(i)(A) through (D). [↑](#footnote-ref-116)
116. *Cf.* Treas. Reg § 1.414(c)-2(b) [parent-subsidiary group], (c) [brother-sister group], and (d) [combined group]. [↑](#footnote-ref-117)
117. See Treas. Reg. § 1.414(c)-4(b)(1) through (6). [↑](#footnote-ref-118)
118. *See* Treas. Reg. § 1.108-2(d)(1). [↑](#footnote-ref-119)
119. Treas. Reg. § 1.108-2(b). [↑](#footnote-ref-120)
120. Treas. Reg. § 1.108-2(c)(1). [↑](#footnote-ref-121)
121. Treas. Reg. § 1.108-2(c)(3). [↑](#footnote-ref-122)
122. § 336(a). In addition to the exception noted above, there is another exception in section 337 of the Code for distributions of property to a parent (owning at least 80%) upon a complete liquidation of a subsidiary. [↑](#footnote-ref-123)
123. § 336(d)(1)(A)(i) and (ii). [↑](#footnote-ref-124)
124. § 336(d)(1)(B0/ [↑](#footnote-ref-125)
125. *See* § 1033(a)(2)(E)(ii). [↑](#footnote-ref-126)
126. § 1033(i)(3). [↑](#footnote-ref-127)
127. § 1033(i). [↑](#footnote-ref-128)
128. *See* § 1033(a)(2)(B). [↑](#footnote-ref-129)
129. § 1033(i)(1). [↑](#footnote-ref-130)
130. *See* § 1031(f)(1)(A) and (B). [↑](#footnote-ref-131)
131. *See* § 1031(f)(1)(C). Gain or loss is determined as of the date of the later disposition. § 1031(f)(1) [flush language]. [↑](#footnote-ref-132)
132. § 1031(f)(f)(2) [↑](#footnote-ref-133)
133. § 1239(a). The IRS has ruled that the sale or exchange of property constituting oil and gas reserves is not subject to section 1239(a) of the Code because the reserves are subject to depletion allowances under section 611(a), not depreciation under section 167 of the Code. However, section 1239(a) of the Codes does apply to any improvements which are subject to the allowance for depreciation under sections 611(a) and 167 of the Code. PLR 200602018. [↑](#footnote-ref-134)
134. *See* § 318(a)(3)(B)(i) of the Code. [↑](#footnote-ref-135)
135. § 1239(b). [↑](#footnote-ref-136)
136. § 1239(c). [↑](#footnote-ref-137)
137. 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.” [↑](#footnote-ref-138)
138. Section 313 of the Congressional Budget Act of 1974, as amended (2 U.S.C. § 644). [↑](#footnote-ref-139)
139. § 1(j). [↑](#footnote-ref-140)
140. § 63(c)(7)(A) and Rev. Proc. 2020-45, 2020-46 I.R.B. 1016. [↑](#footnote-ref-141)
141. § 164(b)(6). [↑](#footnote-ref-142)
142. § 67(g). [↑](#footnote-ref-143)
143. Rev. Proc. 2020-45, 2020-46 I.R.B. 1016. [↑](#footnote-ref-144)
144. *See* § 2631(c). [↑](#footnote-ref-145)
145. § 2001(g)(2). [↑](#footnote-ref-146)
146. § 2001(b)(1). [↑](#footnote-ref-147)
147. § 2001(b)(2). [↑](#footnote-ref-148)
148. The Form 706 instruction for “Line 7 Worksheet” provides that the basic exclusion amount available in each year using a Table of Basic Exclusion Amounts for each year in which gifts were made, from 1977 to date, (plus any applicable deceased spousal unused exclusion amount) is used in calculating the gift tax that would have been payable in that year (but using date of death tax rates). The effect is that the tentative tax on the taxable estate plus adjusted taxable gifts would NOT be reduced by any gift tax payable on those gifts if the gifts were covered by the Applicable Exclusion Amount at such time. Thus, the tentative estate tax would include a tax on the prior gifts that were sheltered by the Applicable Exclusion Amount. [↑](#footnote-ref-149)
149. T.D. 9884, 84 Fed. Reg. 64,995 (11/26/19) (the “Anti-Clawback Regulations”). [↑](#footnote-ref-150)
150. REG-106706-18 (the “Proposed Anti-Clawback Regulations”) [↑](#footnote-ref-151)
151. Treas. Reg. § 20.2010-1(c). [↑](#footnote-ref-152)
152. The adjustment would be made to Step 4 in the calculation described in the preamble. Preamble to the Proposed Anti-Clawback Regulations. [↑](#footnote-ref-153)
153. Applicable Exclusion Amount. [↑](#footnote-ref-154)
154. Basic Exclusion Amount. [↑](#footnote-ref-155)
155. The preamble also explains, “Some commenters suggested a BEA ordering rule, similar to that for DSUE, under which the increase in the BEA during the increased BEA period over the BEA in effect in 2017 (base BEA) is deemed to be allowable against gifts before the base BEA. They posited that this would allow donors to utilize the increase in the BEA without being deemed to have utilized the base BEA, so that the base BEA would remain available for transfers made after 2025. Specifically, a $5 million gift made during the increased BEA period would use the temporary increase in the BEA and preserve or “bank” the base BEA of $5 million so as to be available after 2025 for either gift or estate tax purposes. This suggestion was not adopted for several reasons.” Preamble to the Proposed Anti-Clawback Regulations. [↑](#footnote-ref-156)
156. IR-2018-229 (Nov. 11, 2018). [↑](#footnote-ref-157)
157. Preamble to the Anti-Clawback Regulations. [↑](#footnote-ref-158)
158. Basic Exclusion Amount, which includes the temporary increase under TCJA. [↑](#footnote-ref-159)
159. Treas. Reg. 25.2513-1(b). [↑](#footnote-ref-160)
160. Preamble to the Anti-Clawback Regulations. [↑](#footnote-ref-161)
161. *Id.* [↑](#footnote-ref-162)
162. *Id.* [↑](#footnote-ref-163)
163. *See* Melissa J. Willms*, Getting the 411 on IRC 199A: Just the Facts Ma’am*, 53rd Annual Heckerling Institute on Estate Planning (2019), published by LexisNexis Matthew Bender, Ch. 2, for a more comprehensive and complete discussion of section 199A. [↑](#footnote-ref-164)
164. § 199A(a). [↑](#footnote-ref-165)
165. § 199A(i). [↑](#footnote-ref-166)
166. § 199A(c)(3)(A). [↑](#footnote-ref-167)
167. § 199A(c)(4). [↑](#footnote-ref-168)
168. As described in section 707(c) of the Code. [↑](#footnote-ref-169)
169. As described in section 707(a) of the Code. [↑](#footnote-ref-170)
170. § 199A(c)(3)(A)(i). [↑](#footnote-ref-171)
171. § 199A(c)(3)(B). [↑](#footnote-ref-172)
172. § 199A(d)(1). [↑](#footnote-ref-173)
173. § 199A(d)(2)(A). [↑](#footnote-ref-174)
174. § 199A(d)(2)(B). [↑](#footnote-ref-175)
175. § 199A(d)(3). [↑](#footnote-ref-176)
176. § 199A(e)(2)(A). [↑](#footnote-ref-177)
177. § 199A(e)(2)(B). [↑](#footnote-ref-178)
178. Rev. Proc. 2020-45, 2020-46 I.R.B. 1016. [↑](#footnote-ref-179)
179. § 199A(a)(1)(A). [↑](#footnote-ref-180)
180. § 199A(a)(1)(B). [↑](#footnote-ref-181)
181. § 199A(a)(2)(A). [↑](#footnote-ref-182)
182. § 199A(a)(2)(B). [↑](#footnote-ref-183)
183. § 199A(a) [flush language]. [↑](#footnote-ref-184)
184. §§ 199A(b) [title to the subsection] and 199A(b)(1)(A). [↑](#footnote-ref-185)
185. § 199A(b)(1)(B). [↑](#footnote-ref-186)
186. § 199A(b)(2)(A). [↑](#footnote-ref-187)
187. § 199A(b)(2)(B). [↑](#footnote-ref-188)
188. § 199A(b)(6)(A). [↑](#footnote-ref-189)
189. § 199A(b)(6)(B). [↑](#footnote-ref-190)
190. § 199A(f)(1)(A). [↑](#footnote-ref-191)
191. *Id.* [flush language]. [↑](#footnote-ref-192)
192. § 199A(f)(1)(B), [↑](#footnote-ref-193)
193. T.D. 9847, 84 Fed. Reg. 2952 (2-8-19) (collectively referred to as the “199A Final Regulations”). [↑](#footnote-ref-194)
194. Treas. Reg. § 1.199A-1(b)(14). [↑](#footnote-ref-195)
195. *Id.* [↑](#footnote-ref-196)
196. Each trade or business must itself be a trade or business as defined in section 1.199A-1(b)(14) of the Treasury Regulations. [↑](#footnote-ref-197)
197. *See* Treas. Reg. § 1.199A-1(a)(2). [↑](#footnote-ref-198)
198. Treas. Reg. § 1.199A-4(b)(1)(i). [↑](#footnote-ref-199)
199. Treas. Reg. § 1.199A-4(b)(1)(ii). [↑](#footnote-ref-200)
200. Treas. Reg. § 1.199A-4(b)(1)(iii). [↑](#footnote-ref-201)
201. Treas. Reg. §§ 1.199A-4(b)(1)(iv) and 1.199A-5 (for definition of a specified service trade or business). [↑](#footnote-ref-202)
202. Treas. Reg. § 1.199A-4(b)(1)(v). [↑](#footnote-ref-203)
203. Treas. Reg. § 1.199A-4(c)(1). [↑](#footnote-ref-204)
204. *Id.* [↑](#footnote-ref-205)
205. *Id.* [↑](#footnote-ref-206)
206. A partnership (other than a publicly traded partnership) or an S-corporation that is owned, directly or indirectly by at least one individual, estate, or trust. *See* Treas. Reg. § 1.199A-1(b)(10). [↑](#footnote-ref-207)
207. Treas. Reg. § 1.199A-3(b)(5). [↑](#footnote-ref-208)
208. Treas. Reg. § 1.199A-6(d)(3)(vii). [↑](#footnote-ref-209)
209. Treas. Reg. § 1.199A-6(e)(2)(i). [↑](#footnote-ref-210)
210. § 643(f). [↑](#footnote-ref-211)
211. *Id.* (flush language). [↑](#footnote-ref-212)
212. Treas. Reg. § 1.643(f)-1(a). [↑](#footnote-ref-213)
213. REG-107892-18 (the “643(f) Proposed Regulations”). [↑](#footnote-ref-214)
214. Prop. Treas. Reg. § 1.643(f)-1(b). [↑](#footnote-ref-215)
215. Prop. Treas. Reg. § 1.643(f)-(1)(c), *Ex. 1*. [↑](#footnote-ref-216)
216. Prop. Treas. Reg. § 1.643(f)-(1)(c), *Ex. 2*. [↑](#footnote-ref-217)
217. Prop. Treas. Reg. § 1.643(f)-(1)(b). [↑](#footnote-ref-218)
218. Preamble to 643(f) Proposed Regulations (Explanation of Provisions, VII. Proposed §1.643(f)-1: Anti-avoidance Rules for Multiple Trusts). [↑](#footnote-ref-219)
219. *Id.* [↑](#footnote-ref-220)
220. Redesignating the current section 1061 to section 1062 of the Code. [↑](#footnote-ref-221)
221. § 1061(a)(1) and (2). [↑](#footnote-ref-222)
222. § 1061(a). [↑](#footnote-ref-223)
223. § 1061(c)(1). [↑](#footnote-ref-224)
224. § 1061(c)(4)(B). [↑](#footnote-ref-225)
225. § 1061(c)(1). [↑](#footnote-ref-226)
226. § 1061(c)(4)(A). [↑](#footnote-ref-227)
227. Conf. Rep. on P.L. 115-97, ¶ 10,611.99 (12/22/2017). [↑](#footnote-ref-228)
228. T.D. 9945. [↑](#footnote-ref-229)
229. 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. [↑](#footnote-ref-230)
230. § 1061(c)(2). [↑](#footnote-ref-231)
231. § 1061(c)(2)(A). [↑](#footnote-ref-232)
232. § 1061(c)(2)(B). [↑](#footnote-ref-233)
233. § 1061(c)(3). [↑](#footnote-ref-234)
234. *See* § 475(c)(2). [↑](#footnote-ref-235)
235. § 1061(d)(1). [↑](#footnote-ref-236)
236. § 1061(d)(1)(A). [↑](#footnote-ref-237)
237. § 1061(d)(1)(B). [↑](#footnote-ref-238)
238. § 1061(d)(2)(A). [↑](#footnote-ref-239)
239. § 1061(d)(2)(B). [↑](#footnote-ref-240)
240. Treas. Reg. § 1.1061-5(b). [↑](#footnote-ref-241)
241. P.L. 112-240, 126 Stat. 2313, enacted January 2, 2013. [↑](#footnote-ref-242)
242. § 1411. [↑](#footnote-ref-243)
243. P.L. 111–152, 124 Stat. 1029, enacted March 30, 2010. [↑](#footnote-ref-244)
244. P.L. 111-148, 124 Stat. 119, enacted on March 23, 2010. [↑](#footnote-ref-245)
245. Consisting of maximum Federal long-term capital gain tax rate of 28% and ordinary income tax rate of 39.1%, New York State income tax rate of 6.85%, and a New York City income tax rate of 3.59%. The effective combined tax rate depends, in part, on whether the taxpayer is in the alternative minimum tax, and the marginal tax bracket of the taxpayer. [↑](#footnote-ref-246)
246. *See, e.g.,* Stuart M. Horwitz & Jason S. Damicone, *Creative Uses of Intentionally Defective Irrevocable Trusts*, 35 Est. Plan. 35 (2008) and Michael D. Mulligan, *Sale to Defective Grantor Trusts: An Alternative to a GRAT*, 23 Est. Plan. 3 (1996). [↑](#footnote-ref-247)
247. For example, the California enactment in 2012 of the Temporary Taxes to Fund Education, commonly known as Proposition 30 that raised the highest marginal income tax bracket to 13.3%. [↑](#footnote-ref-248)
248. For example, (i) effective January 1, 2018, the New Jersey estate tax was repealed but the inheritance tax remained; (ii) effective April 1, 2014, New York modified its state estate tax to immediately increase the state estate tax exemption from $1,000,000 to $2,062,500 per person to then have the exemption equal the Federal basic exclusion amount by 2019; (iii) on July 23, 2013, North Carolina repealed its estate tax (effective date of January 1, 2013); and (iv) on May 8, 2013, Indiana repealed its inheritance tax (effective date of January 1, 2013). [↑](#footnote-ref-249)
249. § 2001(c) (for transfers above $1 million) and § 2641(a)(1). [↑](#footnote-ref-250)
250. § 2010(c)(3)(A). [↑](#footnote-ref-251)
251. § 2010(c)(3)(B). [↑](#footnote-ref-252)
252. Rev. Proc. 2020-45, 2020-46 I.R.B. 1016. [↑](#footnote-ref-253)
253. § 2010(c)(2). [↑](#footnote-ref-254)
254. § 2010(c)(4). Enacted as part of the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010, Pub. L. 111-312, 124 Stat. 3296 (“TRA 2010”). Section 101(a)(2) of ATRA struck the “sunset” provisions of TRA 2010 by striking section 304 of TRA 2010. [↑](#footnote-ref-255)
255. § 2631(c). [↑](#footnote-ref-256)
256. § 101(a)(1) of ATRA provides for a repeal of the “sunset” provision in the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107-16, 115 Stat. 38, (“EGTRRA”). The “sunset” provision of EGTRRA is contained in § 901 (“All provisions of, and amendments made by, this Act [EGTRRA] shall not apply… to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010,” and the “Internal Revenue Code of 1986 … shall be applied and administered to years, estates, gifts, and transfers … as if the provisions and amendments described [in EGTRRA] had never been enacted.”). [↑](#footnote-ref-257)
257. Temp. Treas. Reg. § 20.2010-1T(d)(3)(ii). [↑](#footnote-ref-258)
258. Determined and published by the Bureau of Labor Statistics. [↑](#footnote-ref-259)
259. § 1. [↑](#footnote-ref-260)
260. § 1(h)(1)(D). [↑](#footnote-ref-261)
261. § 1(h)(11) (allowing such income to be considered “net capital gain”). [↑](#footnote-ref-262)
262. *See* Richard L. Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax, Part 1 & Part 2*, Tax Notes, Aug. 12. 2013, p. 683 and Aug. 19, 2013, p. 785, and Jonathan G. Blattmachr, Mitchell M. Gans, and Diana S.C. Zeydel, *Imposition of the 3.8% Medicare Tax on Estates and Trusts*, 40 Est. Plan. 3 (Apr. 2013). [↑](#footnote-ref-263)
263. § 1411(c). [↑](#footnote-ref-264)
264. § 1411(c)(1)(A). [↑](#footnote-ref-265)
265. *Id.* [↑](#footnote-ref-266)
266. § 1411(c)(2)(A). [↑](#footnote-ref-267)
267. § 1411(c)(2)(B). [↑](#footnote-ref-268)
268. § 1411(c)(2)(C). [↑](#footnote-ref-269)
269. § 1411(c)(3), referencing § 469(e)(1)(B), which provides “any income, gain, or loss which is attributable to an investment of working capital shall be treated as not derived in the ordinary course of a trade or business.” *See* Prop. Reg. § 1.1411-6(a). [↑](#footnote-ref-270)
270. § 1411(c)(1)(B). [↑](#footnote-ref-271)
271. § 1411(a)(1)(A). [↑](#footnote-ref-272)
272. § 1411(a)(1)(B)(i). Modified adjusted gross income is “adjusted gross income” as adjusted for certain foreign earned income. § 1411(d). [↑](#footnote-ref-273)
273. § 1411(a)(1)(B)(i). [↑](#footnote-ref-274)
274. § 1411(b). [↑](#footnote-ref-275)
275. § 1411(a)(2). [↑](#footnote-ref-276)
276. § 1411(a)(2)(B)(i). [↑](#footnote-ref-277)
277. § 1411(a)(2)(B)(ii). [↑](#footnote-ref-278)
278. *See* Rev. Proc. 2020-45, 2020-46 I.R.B. 1016. [↑](#footnote-ref-279)
279. § 1411(c)(4)(A). [↑](#footnote-ref-280)
280. § 1411(c)(5). [↑](#footnote-ref-281)
281. § 1411(c)(5) and Treas. Reg. §1.1411-8(a). *See also* REG-130507-11, Preamble and Proposed Regulations under Section 1411 (December 5, 2012), Fed. Reg. Vol. 77, No. 234, p. 72612-33 (hereinafter, “Preamble to § 1411 Proposed Regulations”). [↑](#footnote-ref-282)
282. *See* Preamble to § 1411 Proposed Regulations. [↑](#footnote-ref-283)
283. Treas. Reg. § 1.1411-4(b)(1). [↑](#footnote-ref-284)
284. Treas. Reg. § 1.1411-4(b)(2)(i). [↑](#footnote-ref-285)
285. Treas. Reg. § 1.1411-4(b)(2)(ii). [↑](#footnote-ref-286)
286. Treas. Reg. § 1.1411-3(b)(1)(v). [↑](#footnote-ref-287)
287. 256 F. Supp. 2d 536 (N.D. Tex. 2003) [↑](#footnote-ref-288)
288. 142 T.C. 165 (2014). [↑](#footnote-ref-289)
289. TAM 201317010. *See also* TAM 200733023 and PLR 201029014. [↑](#footnote-ref-290)
290. *Id.* [↑](#footnote-ref-291)
291. REG-130843-13. Generally, effective for taxable years beginning after December 31, 2013. [↑](#footnote-ref-292)
292. Prop. Treas. Reg. § 1.1411-7(a)(2)(i) [↑](#footnote-ref-293)
293. Prop. Treas. Reg. § 1.1411-7(a)(3). [↑](#footnote-ref-294)
294. Prop. Treas. Reg. § 1.1411-7(c)(2)(ii) (all dispositions that occur during the taxable year are presumed to be part of a plan). [↑](#footnote-ref-295)
295. Prop. Treas. Reg. § 1.1411-7(c)(2)(i). [↑](#footnote-ref-296)
296. Prop. Treas. Reg. § 1.1411-7(c)(4). [↑](#footnote-ref-297)
297. The 2013 Proposed Regulations provide certain exceptions for situations when a transferor will be ineligible to use the optional simplified reporting method, notwithstanding qualifying for such. Situations of exception would include if the transferor held the interest for less than 12 months or if the transferor transferred Section 1411 Property to the Pass-Through Entity or received a distribution of property that is not Section 1411 property during the Section 1411 Holding Period. *See* Prop. Treas. Reg. § 1.1411-7(c)(3). [↑](#footnote-ref-298)
298. Prop. Treas. Reg. § 1.1411-7(a)(1). [↑](#footnote-ref-299)
299. Prop. Treas. Reg. §§ 1.1411-7(a)(2)(iv), 1.1411-7(b), 1.469-2T. [↑](#footnote-ref-300)
300. § 1361(d)(1)(A) treating such QSSTs as grantor trusts of U.S. citizens or residents under § 1361(c)(2)(A)(i). [↑](#footnote-ref-301)
301. § 1361(d)(3)(A). [↑](#footnote-ref-302)
302. Fiduciary accounting income, not taxable income. Treas. Reg. § 1.1361-1(j)(1)(i). [↑](#footnote-ref-303)
303. § 1361(d)(3)(B). [↑](#footnote-ref-304)
304. §§ 1361(d)(3) and 663(c). [↑](#footnote-ref-305)
305. *See* PLR 9603007 [↑](#footnote-ref-306)
306. § 1361(d)(1)(B) and Treas. Reg. § 1.1361-1(j)(7)(i). [↑](#footnote-ref-307)
307. Treas. Reg. § 1.1361-1(j)(8). [↑](#footnote-ref-308)
308. Preamble to REG-130843-13. [↑](#footnote-ref-309)
309. § 1361(c)(2)(A)(v). [↑](#footnote-ref-310)
310. Must be individuals, estates, or charitable organizations described in § 170(c)(2) through (c)(5). § 1361(e)(1)(A)(i) and Treas. Reg. § 1.1361-1(m)(1). [↑](#footnote-ref-311)
311. *See* §§ 1361(e)(1) and 1361(c)(2). [↑](#footnote-ref-312)
312. § 641(c) and Treas. Reg. § 1.1641(c)-1(a). [↑](#footnote-ref-313)
313. Treas. Reg. § 1.641(c)-1(a). [↑](#footnote-ref-314)
314. § 641(c)(1), (c)(2)(A), and Treas. Reg. § 1.641(c)-1(e). [↑](#footnote-ref-315)
315. Treas. Reg. § 1.1411-3(c). [↑](#footnote-ref-316)
316. § 664. [↑](#footnote-ref-317)
317. § 1(h)(6)(A) (Defined as the amount of long-term capital gain that would be treated as ordinary income if Section 1250(b)(1) included all depreciation and the applicable percentage under Section 1250(a) were 100%. This convoluted definition essentially provides that the aggregate straight-line depreciation taken on the property will be considered unrecaptured Section 1250 gain. Under the current depreciation system, straight-line depreciation is required for all residential rental and nonresidential real property. § 168(b)(3)(A), (B). [↑](#footnote-ref-318)
318. § 1(h)(1)(E). [↑](#footnote-ref-319)
319. The Treasury Department did not issue formal guidance on how the material participation will be determined in the final Treasury Regulations issued in 2013. It is unclear whether material participation will be determined at the trustee, donor, or recipient level. [↑](#footnote-ref-320)
320. The Treasury Regulations provide the taxpayer’s activities conducted through C corporations, partnerships, and S corporations can be grouped for passive activity (and 3.8% Medicare Tax purposes). Trusts are excluded. *See* Treas. Reg. § 1.496-4(a). [↑](#footnote-ref-321)
321. §§ 531 and 532 of EGTRRA provided for a reduction of and eventual repeal of the Federal estate tax credit for state death taxes under § 2011, replacing the foregoing with a deduction under § 2058. [↑](#footnote-ref-322)
322. Connecticut, District of Columbia, Hawaii, Illinois, Maine, Maryland, Massachusetts, Minnesota, Nebraska (imposed by counties), New York, Oregon, Pennsylvania, Rhode Island, Vermont, and Washington. Iowa, New Jersey, and Kentucky have an inheritance tax, but the exemption to lineal heirs is unlimited. [↑](#footnote-ref-323)
323. New York has a maximum estate tax rate of 16%, when added to the maximum Federal tax rate of 40% and deducted pursuant to § 2058, the combined maximum transfer tax rate is 49.6%, compared to a maximum long-term capital gain tax rate of 36.5% for New York City taxpayers in the alternative minimum tax (20% Federal, 3.8% Net Investment Income Tax, 8.82% state, and 3.876% local). [↑](#footnote-ref-324)
324. Combined long-term capital gain tax rate of 36.1% for California taxpayers in the alternative minimum tax (20% Federal, 3.8% Medicare Tax, and 12.3% state). [↑](#footnote-ref-325)
325. Washington does not have a state income tax. [↑](#footnote-ref-326)
326. Trust that provides the grantor with a “qualified annuity interest” under Treas. Reg. § 25.2702-3(b). [↑](#footnote-ref-327)
327. § 1274. [↑](#footnote-ref-328)
328. § 7520. [↑](#footnote-ref-329)
329. *See* Franklin, Law and Karibjanian*, Portability – The Game Changer*, ABA-RPTE Section (January 2013) (<http://meetings.abanet.org/webupload/commupload/RP512500/otherlinks_files/TheGameChanger-3-12-13v11.pdf>). [↑](#footnote-ref-330)
330. *See* Rev. Proc. 2020-45, 2020-46 I.R.B. 1016. [↑](#footnote-ref-331)
331. Treas. Reg. § 25.2505-2(b). [↑](#footnote-ref-332)
332. *See* Rev. Rul. 2004-64, 2004-27 I.R.B. 7. [↑](#footnote-ref-333)
333. § 675(4)(C). [↑](#footnote-ref-334)
334. Rev. Rul. 85-13, 1985-1 C.B. 184 and PLR 9535026. [↑](#footnote-ref-335)
335. § 691. [↑](#footnote-ref-336)
336. *See e.g.*, § 1016(a)(2). [↑](#footnote-ref-337)
337. *See e.g.,* §§ 731(a)(1) and 1368(b). [↑](#footnote-ref-338)
338. *Estate of Graegin v. Commissioner*, T.C. Memo. 1988-477, 56 T.C.M. (CCH) 387 (1988). [↑](#footnote-ref-339)
339. *See* Stephanie Loomis-Price, Paul S. Lee, Charles E. Hodges, *Asset Rich, Cash Poor: Addressing Illiquidity with Graegin Loans, as Well as Sections 6166 and 6161*, 36 Tax Mgmt. Est. Gifts & Tr. J No. 4 (July 14, 2011). [↑](#footnote-ref-340)
340. Another free-base situation could arise with a testamentary transfer to a zeroed-out charitable lead annuity trust. The creation of basis would significantly lower the ongoing income tax liability of the non-grantor charitable lead trust. However, increasing the value would also increase the payments to charity that are required to zero-out the testamentary transfer to the trust. [↑](#footnote-ref-341)
341. 133 S. Ct. 2675 (2013). [↑](#footnote-ref-342)
342. 135 S. Ct. 2584 (2015). [↑](#footnote-ref-343)
343. Rev. Rul. 2013-17, 2013-38 I.R.B. 201. [↑](#footnote-ref-344)
344. Definition of Terms Relating to Marital Status, 80 Fed. Reg. 64378 (proposed Oct. 23, 2015). [↑](#footnote-ref-345)
345. § 1001(a). [↑](#footnote-ref-346)
346. *See* § 731(a)(1). [↑](#footnote-ref-347)
347. *See* § 704(d)(1) [↑](#footnote-ref-348)
348. *See* § 465. [↑](#footnote-ref-349)
349. *See, e.g.*, § 167 [↑](#footnote-ref-350)
350. § 1012(a). [↑](#footnote-ref-351)
351. §§ 1011(a) and 1016. [↑](#footnote-ref-352)
352. § 1016(a)(1) and Treas. Reg. §§ 1.1016-2(a) and 1.1016-2(b). [↑](#footnote-ref-353)
353. §§ 1016(a)(1) and 263. [↑](#footnote-ref-354)
354. *See Woodward v. Commissioner*, 397 U.S. 572 (1970). The courts have held that there is a presumption that expenses should be capitalized. *See Indopco, Inc. v. Commissioner*, 503 U.S. 79 (1992). [↑](#footnote-ref-355)
355. § 266. [↑](#footnote-ref-356)
356. *See Commissioner v. Superior Yarn Mills*, 228 F.2d 736 (4th Cir. 1955) and *Schrader v. U.S.*, 582 f.2d 1374 (6th Cir. 1978). [↑](#footnote-ref-357)
357. § 168. [↑](#footnote-ref-358)
358. *See* §§ 168(g) and 197. [↑](#footnote-ref-359)
359. § 611. [↑](#footnote-ref-360)
360. § 1250(c). [↑](#footnote-ref-361)
361. Accelerated Cost Recovery System (“ACRS”) was enacted in 1981 under the Economic Recovery Tax Act of 1982 (“ERTA”), P.L. 97-34. ACRS was later modified by the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”), P.L. 97-248, and the Tax Reform Act of 1984, P.L. 98-369, when the recovery period for most real property was extended from 15 to 18 years. In 1985, the real property recovery period was extended from 18 to 19 years, P.L. 99-121, § 103. ACRS generally applies to property placed in service after December 31, 1980, and before December 31, 1986. Prop. Treas. Reg. § 1.168-4(a). [↑](#footnote-ref-362)
362. §§ 1245(a)(3) and 1250(c). [↑](#footnote-ref-363)
363. § 1(h)(E). [↑](#footnote-ref-364)
364. § 1245(a)(1). [↑](#footnote-ref-365)
365. § 102(a). [↑](#footnote-ref-366)
366. § 1015(a). [↑](#footnote-ref-367)
367. *See* § 453B. [↑](#footnote-ref-368)
368. *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. [↑](#footnote-ref-369)
369. § 1015(d)(6). [↑](#footnote-ref-370)
370. § 1015(d)(6)(A) and (B). [↑](#footnote-ref-371)
371. § 1015(e). [↑](#footnote-ref-372)
372. § 1041(b)(2). [↑](#footnote-ref-373)
373. *See* Treas. Reg. § 1.1041-1T(d), A-11. [↑](#footnote-ref-374)
374. *But see* § 1014(e) for transfers in trust for a spouse when liabilities exceed basis. [↑](#footnote-ref-375)
375. *Diedrich v. Commissioner*, 643 F.2d 499 (8th Cir. 1981). [↑](#footnote-ref-376)
376. *See also* *Guest v. Commissioner*, 77 T.C. 9 (1981). [↑](#footnote-ref-377)
377. Treas. Reg. § 1.1001-2(a). [↑](#footnote-ref-378)
378. § 469(j)(6). [↑](#footnote-ref-379)
379. *See* §§ 61(a)(11) and 102(a). [↑](#footnote-ref-380)
380. *Helvering v. American Dental*, 318 U.S. 322 (1943). [↑](#footnote-ref-381)
381. § 102(a). [↑](#footnote-ref-382)
382. § 1014(a)(1). [↑](#footnote-ref-383)
383. §§ 1014(a)(2) and (a)(3). [↑](#footnote-ref-384)
384. § 1014(a)(4). [↑](#footnote-ref-385)
385. § 1015. [↑](#footnote-ref-386)
386. Treas. Reg. § 1.1014-1(a). [↑](#footnote-ref-387)
387. § 1014(b)(1). *See also,* Treas. Reg. § 1.1014-2(a)(1). [↑](#footnote-ref-388)
388. § 1014(b) [introductory language]. [↑](#footnote-ref-389)
389. Rev. Rul. 84-139, 1984-2 C.B. 168 (real property owned by a nonresident alien and not subject to U.S. estate tax will take a basis equal to its fair market value) and PLR 201245006 (assets held in a foreign revocable trust will receive a basis adjustment at death under section 1014(b)(1) of the Code even though the assets are not subject to U.S. estate tax). However, as discussed later in these materials, it is likely the IRS mistakenly cited (b)(1) in PLR 201245006 as the operative subsection for the basis adjustment at death. [↑](#footnote-ref-390)
390. § 1014(b)(2). *See also,* Treas. Reg. § 1.1014-2(a)(1) and Rev. Rul. 57-287, 1957-1 C.B. 517, *modifying* Rev. Rul. 55-502, 1955-2 C.B. 560. [↑](#footnote-ref-391)
391. § 1014(b)(9). [↑](#footnote-ref-392)
392. § 1014(b)(4). *See also,* Treas. Reg. § 1.1014-2(a)(4). [↑](#footnote-ref-393)
393. § 1014(b)(6). *See also,* Treas. Reg. § 1.1014-2(a)(5), Rev. Rul. 87-98, 1987-2 C.B. 206, Rev. Rul. 66-283, 1966-2 C.B. 297, Rev. Rul. 59-220, 1959-1 C.B. 210, and Rev. Rul. 55-605, 1955-2 C.B. 382. [↑](#footnote-ref-394)
394. § 1014(b)(9). *See also,* Treas. Reg. § 1.1014-2(a)(4). [↑](#footnote-ref-395)
395. S. Rep. No. 1622, 83d Cong., 2d Sess. 107 (1954). [↑](#footnote-ref-396)
396. § 1014(b)(9). [↑](#footnote-ref-397)
397. *See* Treas. Reg. § 1.1014-6(a)(3), Ex. 1. [↑](#footnote-ref-398)
398. *See* Treas. Reg. § 1.1014-6(a)(2). [↑](#footnote-ref-399)
399. Rev. Rul. 58-130, 1958-1 CB 121. [↑](#footnote-ref-400)
400. *See* Treas. Reg. § 1.1014-6(c). [↑](#footnote-ref-401)
401. § 1014(b)(10). [↑](#footnote-ref-402)
402. P.L. 114-41 (the “Highway Bill”). [↑](#footnote-ref-403)
403. § 2004 of the Highway Bill. [↑](#footnote-ref-404)
404. §§ 6721, 6724(d)(1)(D), and 6724(d)(2)(II). The penalty under section 6721 if the Code for failing to file an information return was increased from $100 to $250 by the Trade Preferences Extension Act of 2015 (P.L. 114-27) on June 29, 2015. The penalty under section 6723 of the Code for failing to comply with a “specified information reporting requirement” does not apply, because “specified information reporting requirement” is a defined term limited under sections 6724(d)(3) of the Code, applying to circumstances which do not apply here. [↑](#footnote-ref-405)
405. § 6662(a) (accuracy-related penalties on underpayments). [↑](#footnote-ref-406)
406. § 6662(b)(8) and 6662(k). [↑](#footnote-ref-407)
407. § 2005 of the Highway Bill and re-designated § 6502(e)(1)(B)(ii). [↑](#footnote-ref-408)
408. § 1014(f)(2). [↑](#footnote-ref-409)
409. §§ 2004(d) and 2005(b) of the Highway Bill. [↑](#footnote-ref-410)
410. The following discussion comes from materials entitled, “Basis Bonanza: A Few Creative Ways to Generate Basis Step-Up,” prepared by Charles A. Redd of Stinson Leonard Street LLP who graciously gave the authors consent to reproduce them as part of these materials. [↑](#footnote-ref-411)
411. Prop. Treas. Reg. § 1.6035-1(g)(2). [↑](#footnote-ref-412)
412. Prop. Treas. Reg. § 1.1014-10(b)(1). [↑](#footnote-ref-413)
413. Prop. Treas. Reg. § 1.1014-10(b)(3). [↑](#footnote-ref-414)
414. Prop. Treas. Reg. § 1.1014-10(b)(2). [↑](#footnote-ref-415)
415. Prop. Treas. Reg. § 1.6035-1(b)(2), *Ex.1*. [↑](#footnote-ref-416)
416. Prop. Treas. Reg. § 1.6035-1(a)(1). [↑](#footnote-ref-417)
417. Prop. Treas. Reg. § 1.6035-1(a)(2). [↑](#footnote-ref-418)
418. Prop. Treas. Reg. § 1.6035-1(d)(1). [↑](#footnote-ref-419)
419. Prop. Treas. Reg. § 1.6035-1(b)(1). [↑](#footnote-ref-420)
420. *Id.* [↑](#footnote-ref-421)
421. *Id.* [↑](#footnote-ref-422)
422. Prop. Treas. Reg. § 1.6035-(b)(1)(i)-(iv). [↑](#footnote-ref-423)
423. Prop. Treas. Reg. § 1.1014-10(a)(2). [↑](#footnote-ref-424)
424. *Id.* [↑](#footnote-ref-425)
425. *Id.* [↑](#footnote-ref-426)
426. Prop. Treas. Reg. § 1.6035-1(c)(1). [↑](#footnote-ref-427)
427. Prop. Treas. Reg. § 1.6035-1(c)(2). [↑](#footnote-ref-428)
428. Prop. Treas. Reg. §§ 1.6035-1(c)(3) and 1.6035-1(e)(3)(ii), *Ex. 2*. [↑](#footnote-ref-429)
429. Prop. Treas. Reg. § 1.6035-1(c)(3). [↑](#footnote-ref-430)
430. Prop. Treas. Reg. § 1.6035-1(c)(1). [↑](#footnote-ref-431)
431. Prop. Treas. Reg. § 1.6035-1(e)(2). [↑](#footnote-ref-432)
432. Prop. Treas. Reg. § 1.6035-1(e)(3). [↑](#footnote-ref-433)
433. Prop. Treas. Reg. § 1.6035-1(e)(4)(i). [↑](#footnote-ref-434)
434. Prop. Treas. Reg. § 1.1014-10(c)(3)(i)(A). [↑](#footnote-ref-435)
435. Prop. Treas. Reg. § 1.1014-10(c)(3)(i)(B). [↑](#footnote-ref-436)
436. Prop. Treas. Reg. § 1.6035-1(f). [↑](#footnote-ref-437)
437. *Id.* [↑](#footnote-ref-438)
438. *Id.* [↑](#footnote-ref-439)
439. § 1014(e)(1)(A). [↑](#footnote-ref-440)
440. § 1014(e)(1)(B). [↑](#footnote-ref-441)
441. § 1014(e)(1) (flush language). [↑](#footnote-ref-442)
442. § 1014(e)(2)(B). [↑](#footnote-ref-443)
443. *See* PLRs 200210051, 200101021, 9026036, and TAM 9302002. [↑](#footnote-ref-444)
444. T.C. Memo 2013-43. [↑](#footnote-ref-445)
445. “All of the underlying trust assets, including the OG&E stock transferred to Mr. Kite in 1995, received a step-up in basis under sec. 1014.” *Estate of Kite v. Commissioner*, T.C. Memo 2013-43, footnote 9. [↑](#footnote-ref-446)
446. *See* Jeffrey N. Pennell, *Jeff Pennell on Estate of Kite: Will it Fly?*, LISI Estate Planning Newsletter #2062 (Feb. 11, 2013) and John J. Scroggin, *Understanding Section 1014(e)*, LISI Estate Planning Newsletter #2192 (Feb. 6, 2014). [↑](#footnote-ref-447)
447. § 1014(b)(6). [↑](#footnote-ref-448)
448. Alaska Stat. 34.77.010 et al. (Alaska Community Property Act). [↑](#footnote-ref-449)
449. KRS 386.620 et. seq. (2020 Kentucky Community Property Trust Act). [↑](#footnote-ref-450)
450. S. D. C. L. ch. 55-17 (2016 South Dakota Special Spousal Trust) [↑](#footnote-ref-451)
451. Tenn. Code Ann. § 35-17-101 et al. (Tennessee Community Property Trust Act of 2010). [↑](#footnote-ref-452)
452. Jonathan G. Blattmachr, Howard M. Zaritsky and Mark L. Ascher. *Tax Planning with Consensual Community Property: Alaska’s New Community Property Law*, 33 Real Prop. Probate and Tr. J. 615 (Winter 1999). *See also* *Commissioner v. Harmon*, 323 U. S. 44 (1944) (an Oklahoma income tax case involving elective community property), *McCollum v. U.S.*, 58-2 USTC § 9957, 2 A.F.T.R.2d 6170 (N. D. Okla. 1958) (explaining what *Harmon* meant, and distinguishing it in the context of basis), and Rev. Rul. 77-359, 1977-2 C.B. 24. [↑](#footnote-ref-453)
453. Simply moving to a community property state will typically not automatically cause separate property to be considered community property. [↑](#footnote-ref-454)
454. Cal. Fam. Code § 850. [↑](#footnote-ref-455)
455. It is limited to real property, located in the enacting state, and personal property of a person domiciled in the enacting state. [↑](#footnote-ref-456)
456. *Estate of Graegin v. Commissioner*, 56 T.C.M. (CCH) 387 (1988). [↑](#footnote-ref-457)
457. *See* Stephanie Loomis-Price, Paul S. Lee, Charles E. Hodges, *Asset Rich, Cash Poor: Addressing Illiquidity with Graegin Loans, as Well as Sections 6166 and 6161*, 36 Tax Mgmt. Est. Gifts & Tr. J No. 4 (July 14, 2011). [↑](#footnote-ref-458)
458. Another free-base situation could arise with a testamentary transfer to a zeroed-out charitable lead annuity trust. The creation of basis would significantly lower the on-going income tax liability of the non-grantor charitable lead trust. However, increasing the value would also increase the payments to charity that are required to zero-out the testamentary transfer to the trust. [↑](#footnote-ref-459)
459. §§ 1(h)(4) and 408(m). [↑](#footnote-ref-460)
460. *See,* *Milton H. Greene Archives Inc. v. Marilyn Monroe LLC*, No. 08-056471 (9th Cir. 8/30/12), *aff’g* 568 F. Supp. 2d 1152 (C.D. Cal. 2008). *See* <http://rightofpublicity.com> for a good discussion of statues, cases, and current controversies, maintained by Jonathan Faber of the Indiana University McKinney School of Law. [↑](#footnote-ref-461)
461. Ca. Civ. Code § 3344. [↑](#footnote-ref-462)
462. 17 U.S.C. § 102(a)(1)-(8). [↑](#footnote-ref-463)
463. *See*, *e.g.*, *Apple Computer, Inc. v. Franklin Computer Corp.*, 714 F.2d 1243 (3rd Cir. 1983). [↑](#footnote-ref-464)
464. 17 U.S.C. § 302(a). [↑](#footnote-ref-465)
465. 17 U.S.C. § 304. [↑](#footnote-ref-466)
466. 17 U.S.C. § 203(a). [↑](#footnote-ref-467)
467. *Id.* [↑](#footnote-ref-468)
468. § 61(a)(6). *See also* Treas. Reg. § 1.61-8. Rev. Proc. 2004-34, 2004-22 I.R.B. 964, allows certain taxpayers to defer to the next taxable year, certain payments advance royalty payments. [↑](#footnote-ref-469)
469. § 1221(a)(3). § 1221(b)(3) provides a limited exception for copyrights in musical works, pursuant to which the taxpayer may elect to have § 1221(a)(3) not apply to a sale or exchange. [↑](#footnote-ref-470)
470. It could also be afforded § 1231 treatment (asset primarily held for sale to customers in the ordinary course of a trade or business). [↑](#footnote-ref-471)
471. § 1221(a)(3)(C). [↑](#footnote-ref-472)
472. § 1223(9). [↑](#footnote-ref-473)
473. 35 U.S.C. § 154(a)(1). [↑](#footnote-ref-474)
474. 35 U.S.C. § 154(a)(2). [↑](#footnote-ref-475)
475. 35 U.S.C. § 173. [↑](#footnote-ref-476)
476. § 61(a)(6). *See also* Treas. Reg. § 1.61-8. [↑](#footnote-ref-477)
477. “For purposes of this subparagraph, the phrase “similar property” includes for example, such property as a theatrical production, a radio program, a newspaper cartoon strip, or any other property eligible for copyright protection (whether under statute or common law), but does not include a patent or an invention, or a design which may be protected only under the patent law and not under the copyright law.” Treas. Reg. § 1.1221-1(c)(1). [↑](#footnote-ref-478)
478. Even with the exclusion from “similar property,” the individual generally had to be considered a non-professional inventor (otherwise the patent would be considered stock in trade or inventory in the hands of a professional inventor). [↑](#footnote-ref-479)
479. § 1231(a)(3)(A)(i). The holding period is deemed to start when the patent is reduced to practice. *Kuzmick v. Commissioner,* 11 T.C. 288 (1948). [↑](#footnote-ref-480)
480. § 1221(a)(3). [↑](#footnote-ref-481)
481. § 1231(b)(1)(C). [↑](#footnote-ref-482)
482. § 1235(a). [↑](#footnote-ref-483)
483. § 1235(a)(2) and Treas. Reg. § 1.1235-2(d)(3). [↑](#footnote-ref-484)
484. § 1235(b)(1). [↑](#footnote-ref-485)
485. § 1235(b)(2). [↑](#footnote-ref-486)
486. § 1235(b)(2)(A)-(B). [↑](#footnote-ref-487)
487. *See* Treas. Reg. § 1.671-2(c). If a holder sells his or her interest in a transfer qualifying under section 1235 and later dies before all payments are received, the estate and/or beneficiary of the deceased reports the payments as long-term capital gain as income in respect of a decedent. [↑](#footnote-ref-488)
488. Treas. Reg. § 1.1235-2(d)(2). *See also*, PLRs 200135015, 200219017, 200219019, 200219020, 200219021, 200219026, 200506008, 200506009, and 200506019. [↑](#footnote-ref-489)
489. § 1235(d). [↑](#footnote-ref-490)
490. § 1235(d)(2) [↑](#footnote-ref-491)
491. § 1235(d)(1). [↑](#footnote-ref-492)
492. § 691 and Treas. Reg. § 1.691(a)(3). [↑](#footnote-ref-493)
493. §§ 1221(a)(3) and 61(a)(6). Section 1221(b)(3) of the Code provides a limited exception for copyrights in musical works, pursuant to which the taxpayer may elect to have section 1221(a)(3) not apply to a sale or exchange. [↑](#footnote-ref-494)
494. § 1221(a)(1). [↑](#footnote-ref-495)
495. §§ 1221(a)(5)(B) and 1015. [↑](#footnote-ref-496)
496. § 1(h)(4). [↑](#footnote-ref-497)
497. §§ 1(h)(5)(A) and 408(m)(2). [↑](#footnote-ref-498)
498. § 1014(a). [↑](#footnote-ref-499)
499. *See* §§ 1221(a)(3) and 1223(9). [↑](#footnote-ref-500)
500. §§ 1016(a)(2), 168(a), and Treas. Reg. § 1.1016-3(a)(1)(i). [↑](#footnote-ref-501)
501. Accelerated Cost Recovery System (“ACRS”) was enacted in 1981 under the Economic Recovery Tax Act of 1982 (“ERTA”), P.L. 97-34. ACRS was later modified by the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”), P.L. 97-248, and the Tax Reform Act of 1984, P.L. 98-369, when the recovery period for most real property was extended from 15 to 18 years. In 1985, the real property recover period was extended from 18 to 19 years, P.L. 99-121, § 103. ACRS generally applies to property placed in service after December 31, 1980, and before December 31, 1986. Prop. Treas. Reg. § 1.168-4(a). The Tax Reform Act of 1986, P.L. 99-514, (“TRA 1986”) dramatically changed the applicability of ACRS to real property investments and instituted the modified ACRS (“MACRS”). Notably, the “applicable recovery period” for most real property assets like buildings are placed in 27.5 or 39-year recovery periods, while land improvements fall within 15 or 20-year recovery periods. § 168(c). In this example, because it was placed in service before 1984, the building would be considered 15-year real property, pursuant to which the applicable percentage of depreciation was 12% in the first year, reducing to 5% in from 11 to 15 years. [↑](#footnote-ref-502)
502. § 1245(a)(5) before being amended by TRA 1986, defines “§1245 recovery property” to include all recovery property under ACRS, real or personal, other than certain types of 19-year (18-year for property placed in service after March 15, 1984, and before May 9, 1985; and 15-year for property placed in service before March 16, 1984) real property and low-income housing: residential rental property, property used “predominantly” outside the United States, property as to which an election to use straight-line recovery is in effect, and certain low-income and Federally insured residential property. The foregoing types of property are subject to recapture under Section 1250. In this example, the office building does not fall within the listed categories, and as such is subject to recapture under Section 1245. [↑](#footnote-ref-503)
503. *See* § 1245(a)(1). [↑](#footnote-ref-504)
504. § 1245(a)(3). [↑](#footnote-ref-505)
505. § 1250(c). [↑](#footnote-ref-506)
506. § 1250(b)(1), (3), (5). [↑](#footnote-ref-507)
507. § 168(b)(3)(A)-(B). [↑](#footnote-ref-508)
508. § 1(h)(6). [↑](#footnote-ref-509)
509. § 1250(d)(1) and (2). [↑](#footnote-ref-510)
510. §§ 752(a) and 722. Treas. Reg. § 1.752-1(b). [↑](#footnote-ref-511)
511. §§ 752(b) and 733. Treas. Reg. § 1.752-1(c). [↑](#footnote-ref-512)
512. § 731(a) or 751. [↑](#footnote-ref-513)
513. [↑](#footnote-ref-514)
514. Treas. Reg. §§ 1.704-2(b)(1) and 1.704-2(c). [↑](#footnote-ref-515)
515. Treas. Reg. § 10.74-1(b)(3). [↑](#footnote-ref-516)
516. § 752(a). [↑](#footnote-ref-517)
517. *See* § 705(a)(2). [↑](#footnote-ref-518)
518. *See* Treas. Reg. § 1.704-1(b)(2)*(iv)(b)*. [↑](#footnote-ref-519)
519. *Id.* [↑](#footnote-ref-520)
520. § 731(a). [↑](#footnote-ref-521)
521. Partnership borrowings and payments of liabilities do not affect the capital accounts, because the asset and liability changes offset each other on the partnership balance sheet. *See* Treas. Reg. § 1.704-1(b)(2)(iv)*(c)*. [↑](#footnote-ref-522)
522. §§ 751 and 453(i)(2). Under § 751, unrealized receivables are deemed to include recapture property, but only to the extent the unrealized gain is ordinary income. Treas. Reg. § 1.751-1(e) and (g). [↑](#footnote-ref-523)
523. Rev. Rul. 84-53, 1984-1 C.B. 159, Situation 4. [↑](#footnote-ref-524)
524. *See* Steve Breitstone and Jerome M. Hesch, *Income Tax Planning and Estate Planning for Negative Capital Accounts: The Entity Freeze Solution*, 53 Tax Mgmt. Memo. 311 (August 13, 2012). [↑](#footnote-ref-525)
525. *See* Elliott Manning and Jerome M. Hesch, *Sale or Exchange of Business Assets: Economic Performance, Contingent Liabilities and Nonrecourse Liabilities (Part Four)*, 11 Tax Mgmt. Real Est. J. 263, 272 (1995), and Louis A. del Cotto and Kenneth A. Joyce, *Inherited Excess Mortgage Property: Death and the Inherited Tax Shelter*, 34 Tax L. Rev. 569 (1979). [↑](#footnote-ref-526)
526. §§ 1014(a), 1014(b), 742; Treas. Reg. §§ 1.1014-1(a), (b), and 1.742-1. The election is made by the distributee partner's attaching a schedule to the income tax return setting out (i) the election to adjust the basis of distributed property under Section 732(d), and (ii) the computation of the basis adjustment to the distributed properties. Treas. Reg. § 1.732-1(d)(3). [↑](#footnote-ref-527)
527. § 743(a). [↑](#footnote-ref-528)
528. § 732(d) and Treas. Reg. §1.732-1(d)(1)(i)-(iii). The election is made by the distributee partner's attaching a schedule to the income tax return setting out (i) the election to adjust the basis of distributed property under Section 732(d), and (ii) the computation of the basis adjustment to the distributed properties. Treas. Reg. § 1.732-1(d)(3). [↑](#footnote-ref-529)
529. Treas. Reg. § 1.732-1(d)(2). [↑](#footnote-ref-530)
530. Investment Company Institute, *Release: Quarterly Retirement Market Data, Third Quarter 2017*, <https://www.ici.org/research/stats/retirement/ret_20_q3>, as of September 30, 2020. [↑](#footnote-ref-531)
531. *See* the anti-alienation provision in § 401(a)(13)(A). [↑](#footnote-ref-532)
532. § 2039(a). [↑](#footnote-ref-533)
533. The IRS has taken the position that qualified retirement assets used to fund a pecuniary bequest to a charitable organization will be considered an income recognition event, triggering ordinary income. CCA 200644020. [↑](#footnote-ref-534)
534. *See e.g.*, *Ballard v. Commissioner*, T.C. Memo 1992-217, *Hess v. Commissioner*, 271 F.2d 104 (3d Cir. 1959), Rev. Rul. 92-47, 1992-1 C.B. 198, Rev. Rul. 69-297, 1969-1 C.B. 131, PLR 9132021, and GCM 39858 (9/9/91). [↑](#footnote-ref-535)
535. § 1014(c). [↑](#footnote-ref-536)
536. §§ 61(a)(14), 72, 402(a) and 408(d)(1), assuming the decedent owner had no nondeductible contributions. *See* § 72(b)(1) and (e)(8). [↑](#footnote-ref-537)
537. § 691(c)(1). [↑](#footnote-ref-538)
538. § 402(c)(9). [↑](#footnote-ref-539)
539. Treas. Reg. § 1.408-8, Q&A-5(a). [↑](#footnote-ref-540)
540. *See* Paul S. Lee and Stephen S. Schilling, *CRTs Are Back (in Four Delicious Flavors)*, Trusts & Estates (Oct. 2014), p. 40-43. [↑](#footnote-ref-541)
541. § 408A. [↑](#footnote-ref-542)
542. Treas. Reg. § 1.408A-1, Q&A-1(b). [↑](#footnote-ref-543)
543. Treas. Reg. § 1.408A-6, Q&A-14. One specific exception is the “at-least-as-rapidly” rule under § 401(a)(9)(B)(i). [↑](#footnote-ref-544)
544. Treas. Reg. § 1.408A-2, Q&A-4. [↑](#footnote-ref-545)
545. § 408A(d)(1). [↑](#footnote-ref-546)
546. § 1411(c)(5). [↑](#footnote-ref-547)
547. Tax Increase Prevention and Reconciliation Act of 2005, P.L. 109-222, effective for tax years beginning after December 31, 2009. [↑](#footnote-ref-548)
548. Prior to this change, only taxpayers having less than $100,000 in modified adjusted gross income could convert a Traditional IRA to a Roth IRA. Former § 408A(c)(3)(B). [↑](#footnote-ref-549)
549. § 408A(d)(3)(A)(i). [↑](#footnote-ref-550)
550. *See* Notice 2008-30, 2008-12 I.R.B. 638 (3/24/2008) and Notice 2009-75, 2009-39 I.R.B. 436 (9/28/2009). § 408A(d)(3)(A). [↑](#footnote-ref-551)
551. § 1297(a)(1). Generally, “passive income” is foreign personal holding company income, as provided in § 954(c). § 1297(b). [↑](#footnote-ref-552)
552. § 1297(a)(2). [↑](#footnote-ref-553)
553. § 1297(e). [↑](#footnote-ref-554)
554. § 1291(b)(2)(A). [↑](#footnote-ref-555)
555. Prop. Treas. Reg. § 1.1291-2(e)(1). [↑](#footnote-ref-556)
556. *See* § 1(h)(11)(C)(iii). [↑](#footnote-ref-557)
557. § 1291(a)(1)(A). [↑](#footnote-ref-558)
558. § 1291(a)(1)(B). [↑](#footnote-ref-559)
559. § 1291(c). [↑](#footnote-ref-560)
560. § 1291(c)(1). [↑](#footnote-ref-561)
561. § 1291(c)(1) through (c)(3). [↑](#footnote-ref-562)
562. § 1291(a)(1)(C). [↑](#footnote-ref-563)
563. § 1291(a)(2). [↑](#footnote-ref-564)
564. § 1293(a). [↑](#footnote-ref-565)
565. Prop. Treas. Reg. § 1.1291-6(c)(2)(iii)(A). [↑](#footnote-ref-566)
566. Prop. Treas. Reg. § 1.1291-6(c)(2)(iii)(B). [↑](#footnote-ref-567)
567. Prop. Treas. Reg. § 1.1291-6(d)(2). [↑](#footnote-ref-568)
568. Prop. Treas. Reg. § 1.1291-6(c)(3)(iv). [↑](#footnote-ref-569)
569. § 1291(e)(1). [↑](#footnote-ref-570)
570. § 1291(e)(2). [↑](#footnote-ref-571)
571. For a more complete discussion of QSBS, *see* Paul S. Lee, L. Joseph Comeau, Julie Miraglia Kwon, and Syida C. Long, *Qualified Small Business Stock: Quest For Quantum Exclusions, Part 1*, Tax Notes Federal (Jul. 6, 2020), p. 15, *Part 2*, Tax Notes Federal (Jul. 13, 2020), p. 217, and *Part 3*, Tax Notes Federal (Jul. 20, 2020), p. 410. [↑](#footnote-ref-572)
572. *See* §§ 1(h)(1)(F) and 1(h)(4)(A)(ii). [↑](#footnote-ref-573)
573. § 1(h)(7). [↑](#footnote-ref-574)
574. The chart excludes the 60% exclusion with respect to QSBS of certain empowerment zone businesses acquired after December 21, 2000 since the enactment of the 75% and 100% exclusions have made the 60% exclusion of no value to taxpayers. *See* §§ 1202(a)(2) and 1397C(b). [↑](#footnote-ref-575)
575. For taxpayers who acquired their stock on or before September 27, 2010, 7% of the excluded gain is a preference item. *See* §§ 57(a)(7) and 1202(a)(4)(C), which is only applicable to QSBS acquired after September 27, 2010. The taxable portion of the gain is subject to the maximum AMT rate of 28% plus the 3.8% excise tax on net investment income, but the 7% preference item is subject only to the AMT tax, not the excise tax. As a result, the 50% exclusion results in a maximum AMT rate of 16.88%, as follows: {[50% taxable gain + (7% x 50% of excluded gain)] x 28% AMT rate} + (50% taxable gain x 3.8% excise tax). The 75% exclusion results in a maximum AMT rate of 9.42%, as follows: {[25% taxable gain + (7% x 75% of excluded gain)] x 28% AMT rate} + (25% taxable gain x 3.8% excise tax). [↑](#footnote-ref-576)
576. § 1202(a)(1). [↑](#footnote-ref-577)
577. § 1202(a)(3). [↑](#footnote-ref-578)
578. § 1202(a)(4). [↑](#footnote-ref-579)
579. § 1202(b)(1). [↑](#footnote-ref-580)
580. § 1202(b)(1)(A). [↑](#footnote-ref-581)
581. § 1202(b)(1)(B). [↑](#footnote-ref-582)
582. §§ 1202(h)(1), (2)(A) and (B). [↑](#footnote-ref-583)
583. § 1202(b)(3). [↑](#footnote-ref-584)
584. § 1202(b)(1) [flush language]. [↑](#footnote-ref-585)
585. § 1202(d)(2)(A). [↑](#footnote-ref-586)
586. § 1202(d)(2)(B). [↑](#footnote-ref-587)
587. *See* Rev. Rul. 84-111, 1984 C.B. 88. [↑](#footnote-ref-588)
588. § 1202(i)(1). [↑](#footnote-ref-589)
589. § 1202(i)(2). [↑](#footnote-ref-590)
590. *Id.* [↑](#footnote-ref-591)
591. § 1400Z-2(a)(1). [↑](#footnote-ref-592)
592. The QOZ investment has an initial basis of zero, but there is an increase in basis equal to 10% of the deferred gain if the QOZ investment is held for five years, and an additional 5% after seven years. § 1400Z-2(b)(2)(B). [↑](#footnote-ref-593)
593. § 1400Z-2(b)(1)(B). [↑](#footnote-ref-594)
594. § 1400Z-2(c). [↑](#footnote-ref-595)
595. § 1400Z-2(b)(1). [↑](#footnote-ref-596)
596. Treas. Reg. § 1.1400Z2(b)-1(c). [↑](#footnote-ref-597)
597. Treas. Reg. § 1.1400Z2(b)-1(c)(3). [↑](#footnote-ref-598)
598. Treas. Reg. § 1.1400Z2(b)-1(c)(5)(i). [↑](#footnote-ref-599)
599. *Id.* [↑](#footnote-ref-600)
600. Treas. Reg. § 1.1400Z2(b)-1(c)(5)(ii). [↑](#footnote-ref-601)
601. *See* Treas. Reg. § 1.1400Z2(b)-1(c)(5)(ii) and -1(c)(4). [↑](#footnote-ref-602)
602. § 1400Z-2(e)(3). [↑](#footnote-ref-603)
603. *See* Preamble to T.D. 9889, 85 Fed. Reg. 1866 (01-13-20). [↑](#footnote-ref-604)
604. Treas. Reg. § 1.1400Z2(b)-1(d)(1)(iii). [↑](#footnote-ref-605)
605. Treas. Reg. § 1.1400Z2(b)-1(g)(6)(i). [↑](#footnote-ref-606)
606. Treas. Reg. § 1.1400Z2(b)-1(g)(6)(ii). [↑](#footnote-ref-607)
607. § 675(4)(C) and Rev. Rul. 2008-22, 2008-16 I.R.B. 796. [↑](#footnote-ref-608)
608. *See* Rev. Rul. 85-13, 1985-1 C.B. 184 and PLR 9535026. [↑](#footnote-ref-609)
609. Arkansas, the District of Columbia, Louisiana, and Montana tax the grantor only in a limited set of circumstances. *See* Ark. Inc. Tax Reg. § 4.26-51-102, D.C. Code §§ 47-1809.08 to 47-1809.09, La. Rev. Stat. Ann. § 47:187, and Mont. Code Ann. § 15-30-2151(5). Tennessee recently clarified an issue regarding grantor trusts, so effective for tax returns filed on or after May 20, 2013, a grantor, instead of a the trustee, of a grantor trust may file the Hall income tax (on interest and dividends) return and pay the tax if the grantor reports the trust income on his or her own individual Federal tax return. *See* Public Chapter 480 and T.C.A. § 67-2-102. [↑](#footnote-ref-610)
610. New York State Department of Taxation and Finance Advisory Opinion (TSB-A-14(6)S) (Jan. 29, 2014). [↑](#footnote-ref-611)
611. 140 T.C. 86 (2013), *rev’d*, *Estate of James A. Elkins, Jr. v. Commissioner*, 767 F.3d 443 (5th Cir. 2014). [↑](#footnote-ref-612)
612. § 2704(b)(3)(B). [↑](#footnote-ref-613)
613. *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.). [↑](#footnote-ref-614)
614. 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>]. [↑](#footnote-ref-615)
615. FR Doc. 2017-22776, 82 Fed. Reg. 48779. [↑](#footnote-ref-616)
616. Uniform Partnership Act, as adopted in 2007 and last amended in 2013, by the National Conference of Commissioners on Uniform State Laws (hereinafter, UPA). [↑](#footnote-ref-617)
617. The comment to section 701(b) of the UPA provides, “Liquidation value is not intended to mean distress sale value. Under general principles of valuation, the hypothetical selling price in either case should be the price that a willing and informed buyer would pay a willing and informed seller, with neither being under any compulsion to deal. The notion of a minority discount in determining the buyout price is negated by valuing the business as a going concern. Other discounts, such as for a lack of marketability or the loss of a key partner, maybe appropriate, however. For a case applying the concept, see *Fotouhi v. Mansdorf*, 427 B.R. 798, 803–05 (Bankr. N.D. Cal. 2010).” [↑](#footnote-ref-618)
618. 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). [↑](#footnote-ref-619)
619. *See* § 1141(a)(1) of the UPA [↑](#footnote-ref-620)
620. *See* § 1131(a) of the UPA. [↑](#footnote-ref-621)
621. *See* Treas. Reg. § 25.2701-1(c)(4). [↑](#footnote-ref-622)
622. *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017). [↑](#footnote-ref-623)
623. *See* *Estate of Strangi v. Commissioner*, T.C. Memo. 2003-15, *aff’d*, 417 F.3d 468 (5th Cir. 2005) and *Estate of Turner v. Commissioner*, T.C. Memo. 2011-209 (both cases involved a decedent owning a general partnership interest). *But see* *Kimball v. U.S.*, 371F.3d 257 (5th Cir. 2004), *rev’g*, 244 F. Supp 2d 700 (N.D. Tx. 2003) and *Estate of Mirowski v. Commissioner*, T.C. Memo. 2008-74. [↑](#footnote-ref-624)
624. § 2043(a). [↑](#footnote-ref-625)
625. *Id.* [↑](#footnote-ref-626)
626. *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017), footnote 7. [↑](#footnote-ref-627)
627. *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017), concurring opinion. [↑](#footnote-ref-628)
628. *See* *Hurford Investments No. 2, Ltd. v. Commissioner*, No. 23017-11, 2017 BL 138848 (T.C. Apr. 27, 2017) and PLR 200626003. [↑](#footnote-ref-629)
629. §§ 2041(b)(1) and 2514(c). [↑](#footnote-ref-630)
630. § 2041(a)(2) and Treas. Reg. § 20.2041-3(b). [↑](#footnote-ref-631)
631. *Freeman Estate v. Commissioner*, 67 T.C. 202 (1976). [↑](#footnote-ref-632)
632. Treas. Reg. § 1.1014-2(a)(4). [↑](#footnote-ref-633)
633. Treas. Reg. § 1.1014-2(b)(2). [↑](#footnote-ref-634)
634. Treas. Reg. § 20.2041-3(c)(2). [↑](#footnote-ref-635)
635. *Univ. Nat’l Bank v. Rhoadarmer*, 877 P.2d 561 (Colo. App. 1991). [↑](#footnote-ref-636)
636. *See*, *e.g.*, *Clapp v. Ingraham*, 126 Mass. 200 (1879). [↑](#footnote-ref-637)
637. *See*, *e.g.*, *State Street Trust Co. v. Kissel*, 19 N.E.2d 25 (Mass. 1939). [↑](#footnote-ref-638)
638. *See*, *e.g.*, *Estate of Breault*, 211 N.E.2d 424 (Ill. App. Ct. 1965). [↑](#footnote-ref-639)
639. *See*, *e.g.*, *St. Matthews Bank v. DeCharette*, 83 S.W.2d 471 (Ky. 1935). [↑](#footnote-ref-640)
640. *See* Mich. Comp. Laws § 556.123. [↑](#footnote-ref-641)
641. *See* N.Y. Est. Powers & Trusts Law §§ 10-7.1, *et seq.* [↑](#footnote-ref-642)
642. *See* Uniform of Powers of Appointment Act § 502. [↑](#footnote-ref-643)
643. *See* Uniform of Powers of Appointment Act § 504(a). [↑](#footnote-ref-644)
644. The IRS has ruled favorably on other formula general powers of appointment dealing with estate inclusion in lieu of a generation-skipping transfer. *See*, *e.g.*, PLRs 9527024 and 911054. [↑](#footnote-ref-645)
645. Similar to the basis adjustment under section 743 upon the death of a partner when the partnership makes or has a section 754 election. *See also* Rev. Proc. 64-19, 1964-1 C.B. 682 , in the marital funding area, which requires that the assets selected for distribution be fairly representative of the appreciation and depreciation between the decedent’s death and the funding. [↑](#footnote-ref-646)
646. Pennsylvania provides that mere existence of a general power of appointment does not cause inclusion of the assets subject to the power for inheritance tax purposes. Under § 9111(k) of Title 72 of the Pennsylvania Consolidated Statutes, property subject to a power of appointment is exempt from Pennsylvania inheritance tax in the estate of the donee of the power of appointment. [↑](#footnote-ref-647)
647. § 2056(b)(7)(B)(v). [↑](#footnote-ref-648)
648. § 2518(b)(2). [↑](#footnote-ref-649)
649. 976 F.2d 1486 (5th Cir. 1992), *rev'g* 97 T.C. 327 (1991). [↑](#footnote-ref-650)
650. *See* § 2518(a) and Treas. Reg. § 25.2518-1(b). [↑](#footnote-ref-651)
651. *See* TAM 8551001 and *Kurz Estate v. Commissioner*, 101 T.C. 44 (1993), aff’d, 68 F.3d 1027 (7th Cir. 1995). [↑](#footnote-ref-652)
652. *See, e.g.*, Alaska Stat. § 13.36.370(b)(4) (“modify the terms of a power of appointment granted by the trust”); Idaho Code §15-7-501(6)(c) (“To modify the terms of any power of appointment granted by the trust. However, a modification or amendment may not grant a beneficial interest to any individual or class of individuals not specifically provided for under the trust instrument.”); S.D. Codified Law § 55-1B-6(3) (“Modify the terms of any power of appointment granted by the trust. However, a modification or amendment may not grant a beneficial interest to any individual or class of individuals not specifically provided for under the trust instrument.”); Wyo. Stat. § 4-10-710(a)(xi) (“to grant a power of appointment to one (1) or more trust beneficiaries or to terminate or amend any power of appointment granted by the trust; however… of a power of appointment may not grant a beneficial interest to any person or class of persons not specifically provided for under the trust instrument or to the trust protector, the trust protector's estate or for the benefit of the creditors of the trust protector.”). [↑](#footnote-ref-653)
653. § 2642(f). [↑](#footnote-ref-654)
654. *Estate of Goodwyn*, T. C. Memo. 1973-153, nor a power for the grantor trust provisions of sections 671, *et seq.*, of the Code, *Estate of Goodwyn v. Commissioner*, T.C. Memo. 1976-238. [↑](#footnote-ref-655)
655. *Securities and Exchange Commission v. Wyly*, 2014 WL 4792229 (S.D.N.Y. Sept. 25, 2014). [↑](#footnote-ref-656)
656. Because I conclude that both the Bulldog and Bessie Trusts were grantor trusts under Section 674, I need not reach the issue of whether they were also grantor trusts under Section 679. Although the SEC contends that the trading profits on sales of Issuer securities should be taxed at the ordinary income rate, I decline to do so. Rather, I will approximate unpaid taxes by applying the rate the Wylys would have had to pay if they owned the shares personally, which requires applying the ordinary income or capital gains rate for the taxable year. Thus, the “reasonable approximation” of disgorgement is $111,988,622.76 for Sam Wyly and $58,896,281.97 for Charles Wyly when using the lower capital gains rate. *See* JX 9904A and JX 9904B (“Calculations Using the Ordinary and Capital Gains Tax Rates for All Transactions in Registered Securities Attributable to Sam and Charles Wyly ”). [↑](#footnote-ref-657)
657. Treas. Reg. § 25.2702-6. [↑](#footnote-ref-658)
658. *See* *Crummey v. Commisioner*., 397 F.2d 82 (9th Cir. 1968). [↑](#footnote-ref-659)
659. § 1014(e). [↑](#footnote-ref-660)
660. Treas. Reg. § 20.2053-7. [↑](#footnote-ref-661)
661. 331 U.S. 1 (1947) (holding that the proper tax basis of the property acquired by bequest subject to a mortgage “is the value of the property, undiminished by mortgages thereon.”) [↑](#footnote-ref-662)
662. Treas. Reg. §1.671-2(e)(1). [↑](#footnote-ref-663)
663. Treas. Reg. §1.671-2(e)(6). [↑](#footnote-ref-664)
664. *See* Mitchell M. Gans, Jonathan G. Blattmachr & Diana S.C. Zeydel, *Supercharged Credit Shelter Trust*, 21 Prob. & Prop. 52 (July/Aug. 2007). [↑](#footnote-ref-665)
665. For an excellent discussion of this technique, see Mickey R. Davis & Melissa J. Willms, *Trust and Estate Planning in a High-Exemption World and the 3.8% “Medicare” Tax: What Estate and Trust Professionals Need to Know*, The Univ. of Tex. School of Law 61st Ann. Tax Conf. – Est. Pl. Workshop (2013). [↑](#footnote-ref-666)
666. *But see* PLR 200101021 on the applicability of Section 1014(e). [↑](#footnote-ref-667)
667. Treas. Reg. § 1.671-2(e)(5). [↑](#footnote-ref-668)
668. PLRs 200102021, 200210051, 200604028, 200413011, 200403094 and TAM 9308002 [↑](#footnote-ref-669)
669. Alan S. Gassman, Christopher J. Denicolo, and Kacie Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses-Part 1*, 40 Est. Plan. 3 (Oct. 2013), Alan S. Gassman, Christopher J. Denicolo, and Kacie Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses-Part 2*, 40 Est. Plan. \_\_\_ (Nov. 2013), and Gassman, Ellwanger & Hohnadell, *It’s Just a JEST, the Joint Exempt Step-Up Trust*, Steve Leimberg’s Estate Planning Email Newsletter-Archive Message #2086 (4/3/13). [↑](#footnote-ref-670)
670. *See* §§ 2056(b)(5), 2056(b)(7)(B)(ii)(I), Treas. Reg. § 20.2056(b)-7(d)(2), Rev. Rul. 72-333, 1972-2 C.B. 530, and Rev. Rul. 68-554, 1968-2 C.B. 412. [↑](#footnote-ref-671)
671. *See* Treas. Reg. §§ 20.2056(b)-5(f)(4) and 20.2056(b)-5(f)(5). [↑](#footnote-ref-672)
672. *See* Treas. Reg. §§ 25.2523(a)-1(b)(3), 25.2523(b)-1 and 20.2056(c)-2(b)(1)(iii). [↑](#footnote-ref-673)
673. *See* Treas. Reg. § 25.2511-2(d). [↑](#footnote-ref-674)
674. § 677(a)(1). [↑](#footnote-ref-675)
675. § 677(a)(2). [↑](#footnote-ref-676)
676. See Treas. Reg. § 1.677(a)-1(g). [↑](#footnote-ref-677)
677. § 675(4)(C) and Rev. Rul. 2008-22, 2008-16 I.R.B. 796. [↑](#footnote-ref-678)
678. § 2038(a)(1). [↑](#footnote-ref-679)
679. *See* *Crane v. Commissioner*, 331 U.S. 1 (1947). [↑](#footnote-ref-680)
680. § 2053(a)(4). [↑](#footnote-ref-681)
681. Treas. Reg. § 20.2053-7. [↑](#footnote-ref-682)
682. Rev. Rul. 83-81, 1983-1 C.B. 230. [↑](#footnote-ref-683)
683. *See* *Feiberg Estate v. Commissioner*, 35 T.C.M. 1794 (1976), *Bowers Estate v. Commissioner*, 23 T.C. 911 (1955), *acq.*, 1955-2 C.B. 4, and *Hartshorne v. Commissioner*, 48 T.C. 882 (1967), *acq.*, 1968-2 C.B. 2. [↑](#footnote-ref-684)
684. *See* *Courtney Estate v. Commissioner*, 62, T.C. 317 (1974) and *Fawcett Estate v. Commissioner*, 64 T.C. 889 (1975). [↑](#footnote-ref-685)
685. Treas. Reg. § 20.2053-7 [↑](#footnote-ref-686)
686. *Id.* [↑](#footnote-ref-687)
687. *See* § 2044(b). [↑](#footnote-ref-688)
688. § 2044(a). [↑](#footnote-ref-689)
689. § 2044(c). [↑](#footnote-ref-690)
690. Treas. Reg. § 20.2053-7. [↑](#footnote-ref-691)
691. § 1014(b)(10). [↑](#footnote-ref-692)
692. § 1014(b)(9). [↑](#footnote-ref-693)
693. *Id.* [↑](#footnote-ref-694)
694. It applies to “Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will.” § 1014(b)(4). [↑](#footnote-ref-695)
695. § 1014(a)(1). [↑](#footnote-ref-696)
696. S*ee* Peter Melcher and Steven J. Oshins, *New Private Letter Ruling Breathes Life into Nevada Incomplete Gift Non-Grantor Trusts*, Wealthmanagement.com, the digital resource of REP. and Trusts & Estates (Apr. 16, 2013), and Steven J. Oshins, *NING Trusts Provide Tax and Asset Protection Benefits*, CCH Estate Planning Review - The Journal, Page 150 (Aug. 20, 2013). [↑](#footnote-ref-697)
697. § 164(b)(6). [↑](#footnote-ref-698)
698. PLRs 200148028, 200247013, 200502014, 200612002, 200637025, 200647001, 200715005, and 200731019. Other rulings and jurisdictions, *see* PLRs 200647001, 200715005, 200731019, 201310002-20131000, 201410001-201410010, 201426014, 201430003-201430007, 201436012-201436032, 201636027-201636032, 201650005, 201729009, 201742006, 201836006, 201848002, 201848009, 201908003-201908005, and 201925005-201925010. [↑](#footnote-ref-699)
699. *See* Treas. Reg. §§ 25.2511-2(b) and 25.2511-2(c). [↑](#footnote-ref-700)
700. IR-2007-127. [↑](#footnote-ref-701)
701. CCA 201208026. [↑](#footnote-ref-702)
702. *See* PLRs 200647001, 200715005, 200731019, 201310002-20131000, 201410001-201410010, 201426014, 201430003-201430007, 201436012-201436032, 201636027-201636032, 201650005, 201729009, 201742006, 201836006, 201848002, 201848009, 201908003-201908005, and 201925005-201925010. [↑](#footnote-ref-703)
703. Rev. Proc. 2021-3, 2021-1 I.R.B. 140, Section 5.01(9) and (17). [↑](#footnote-ref-704)
704. N.Y. Tax Law § 612(b)(41). The provision does not apply to income of such trusts that were liquidated before June 1, 2014. 2014 N.Y. Laws 59, Part I, § 9 (Mar. 31, 2014). [↑](#footnote-ref-705)
705. *Id.* [↑](#footnote-ref-706)
706. In a different context, contractual rights tied to or deriving value to the return of endowment funds have been used with charitable remainder trusts to avoid unrelated business taxable income. *See*, *e.g.*, PLRs 200922061, 200703037, 200733032, 200733033, 201022022, 201016082, 201016085, 201016086, 201011035, 201007063, 201003023, 201003024, 200952059, 200951037, 200913063, 200913065, and 200824021. [↑](#footnote-ref-707)
707. *See* Elliott Manning and Jerome M. Hesch, *Sale or Exchange of Business Assets: Economic Performance, Contingent Liabilities and Nonrecourse Liabilities (Part Four)*, 11 Tax Mgmt. Real Est. J. 263, 272 (1995), and Louis A. del Cotto and Kenneth A. Joyce, *Inherited Excess Mortgage Property: Death and the Inherited Tax Shelter*, 34 Tax L. Rev. 569 (1979). [↑](#footnote-ref-708)
708. For example, Proposition 13, California Constitution Article XIII(A). [↑](#footnote-ref-709)
709. *But see* CCA 2014442053. *See also* Richard L. Dees, *Is Chief Counsel Resurrecting the Chapter 14 ‘Monster’?*, 145 Tax Notes 11, p. 1279 (Dec. 15, 2014). [↑](#footnote-ref-710)
710. *See* PLRs 9350016, 9616035, 9722022, 199952012, 199927002 and 200913065. [↑](#footnote-ref-711)
711. § 2703 and Treas. Reg. § 25.2703-1(a). [↑](#footnote-ref-712)
712. Treas. Reg. § 25.2703-1(a)(2). [↑](#footnote-ref-713)
713. § 2703(b). [↑](#footnote-ref-714)
714. Rev. Rul. 80-162, 1980-2 C.B. 280. *See also* Rev. Rul. 84-25, 1984-1 C.B. 191. The IRS held that, “In the case of a legally enforceable promise for less than an adequate and full consideration in money or money’s worth, the promisor makes a completed gift under section 2511 of the Code on the date when the promise is binding and determinable in value rather than when the promised payment is actually made.” [↑](#footnote-ref-715)
715. § 651(a) and Treas. Reg. § 1.651(a)-1. [↑](#footnote-ref-716)
716. § 651. [↑](#footnote-ref-717)
717. § 652(a). [↑](#footnote-ref-718)
718. § 652(b). [↑](#footnote-ref-719)
719. § 661(a). [↑](#footnote-ref-720)
720. *Id.* [↑](#footnote-ref-721)
721. §§ 661(b) and 662(b). [↑](#footnote-ref-722)
722. § 662(a). [↑](#footnote-ref-723)
723. § 663(b). [↑](#footnote-ref-724)
724. Although individual taxpayers are entitled to a personal exemption, Code Section 151(d)(5) provides that for tax years beginning after December 31, 2017 and before January 1, 2026, the personal exemption is zero. [↑](#footnote-ref-725)
725. § 642(b)(3). [↑](#footnote-ref-726)
726. § 642(b)(1). [↑](#footnote-ref-727)
727. § 642(b)(2). [↑](#footnote-ref-728)
728. *See* IRC § 663(a)(1). [↑](#footnote-ref-729)
729. § 643(a). [↑](#footnote-ref-730)
730. § 644. [↑](#footnote-ref-731)
731. § 662(c). [↑](#footnote-ref-732)
732. Treas. Reg. § 1.663(a)-1(b)(1) and Rev. Rul. 60-87, 1960-1 C.B. 286. [↑](#footnote-ref-733)
733. Treas. Reg. § 1.663(a)-1(b)(2)(i). [↑](#footnote-ref-734)
734. Treas. Reg. § 1.661(a)-2(e) and Rev. Rul. 68-49, 1968-1 C.B. 304. [↑](#footnote-ref-735)
735. *See, e.g.*, UNIF. PROB. CODE § 3-101. [↑](#footnote-ref-736)
736. Rev. Rul. 68-49, 1968-1 C.B. 304. [↑](#footnote-ref-737)
737. IRS Office of the Chief Counsel, Service Center Advice Memorandum 1998-012 (5-12-98). [↑](#footnote-ref-738)
738. §§ 661(a)(1) and 662(a)(1). [↑](#footnote-ref-739)
739. §§ 661(a)(2) and 662(a)(2). [↑](#footnote-ref-740)
740. § 662(a)(1). [↑](#footnote-ref-741)
741. § 663(c). [↑](#footnote-ref-742)
742. Treas. Reg. § 1.663(c)-4. [↑](#footnote-ref-743)
743. Treas. Reg. § 1.663(c)-5, Exs. 3-11. [↑](#footnote-ref-744)
744. Treas. Reg. § 1.663(c)-4(c). [↑](#footnote-ref-745)
745. *Id.* [↑](#footnote-ref-746)
746. Treas. Reg. § 1.663(c)-4(a). For a good discussion of some of the complexities associated with the application of the separate share rule to estates, *see* Charles F. Newlin, *Coping with the Complexity of the Separate Shares under the Final Regs*., 27 Est. Plan. J. 243 (July 2000). [↑](#footnote-ref-747)
747. *See, e.g.*, UNIF. PRIN. & INC. ACT § 201(1). [↑](#footnote-ref-748)
748. UNIF. PRIN. & INC. ACT § 201(3) (1997). [↑](#footnote-ref-749)
749. Rev. Rul. 73-322, 1973-2 CB 44. [↑](#footnote-ref-750)
750. § 663(a)(3). [↑](#footnote-ref-751)
751. § 642(c). [↑](#footnote-ref-752)
752. § 642(c)(1). [↑](#footnote-ref-753)
753. *See* Treas. Reg. § 1.662(c)-4. [↑](#footnote-ref-754)
754. Treas. Reg. § 1.663(a)-2. [↑](#footnote-ref-755)
755. UNIF. PRIN. & INC. ACT § 201(3) (2000). [↑](#footnote-ref-756)
756. Rev. Rul. 73-322, 1973-2 C.B. 44. [↑](#footnote-ref-757)
757. IRS Notice 89-35, 1989-13 I.R.B. 4. [↑](#footnote-ref-758)
758. Treas. Reg. § 1.663(c)-5, Ex. 7. [↑](#footnote-ref-759)
759. *Schwan v. United States*, 264 F. Supp. 2d 887 (D. S.D. 2003). [↑](#footnote-ref-760)
760. Rev. Rul. 57-31, 1957-1 CB 201. [↑](#footnote-ref-761)
761. Treas. Reg. § 1.642(h)-1(b). *But see Dorfman v. Commissioner*, 394 F.2d 651 (2d Cir. 1968) (holding this portion of the regulation invalid). [↑](#footnote-ref-762)
762. Treas. Reg. § 1.642(h)-2(b). [↑](#footnote-ref-763)
763. Treas. Reg. § 1.642(h)-2(a). [↑](#footnote-ref-764)
764. §§ 67(g) and 642(a), (b), (g). [↑](#footnote-ref-765)
765. Treas. Reg. § 1.642(h)-2(b). [↑](#footnote-ref-766)
766. *Id.* [↑](#footnote-ref-767)
767. Treas. Reg. § 1.642(h)-3(a). [↑](#footnote-ref-768)
768. Treas. Reg. § 1.642(h)-4. [↑](#footnote-ref-769)
769. Treas. Reg. § 1.642(h)-2(b)(2). Section 1.652(b)-3(a) of the Treasury Regulations provides that deductions directly attributable to one class of income are allocated to that income. Any remaining deductions that are not directly attributable to a specific class of income, as well as any deductions that exceed the amount of directly attributable income, may be allocated to any item of income (including capital gains), but a portion must be allocated to tax-exempt income, if any. *See* Treas. Reg. § 1.652(b)-3(b) and (d). The new regulations provide that the character and amount of each deduction remaining after application of section 1.652(b)-3 of the Treasury Regulation comprises the excess deductions available to the beneficiaries succeeding to the property as provided under section 642(h)(2) of the Code. [↑](#footnote-ref-770)
770. § 643(e). [↑](#footnote-ref-771)
771. Rev. Rul. 74-178, 1974-1 C.B. 196. [↑](#footnote-ref-772)
772. *Compare* Treas. Reg. § 1.663(a)-1(b) (to qualify as bequest of specific sum of money or specific bequest of property, and thereby avoid DNI carry-out, the amount of money or the identity of property must be ascertainable under the will as of the date of death) with Treas. Reg. § 1.661(a)-2(f) (gain or loss is recognized if distribution is in satisfaction of a right to receive a specific dollar amount or specific property other than that distributed). *See also* Treas. Reg. § 1.1014-4(a)(3), Rev. Rul. 60-87, 1960-1 C.B. 286, and *Kenan v. Commissioner*, 114 F.2d 217 (2d Cir. 1940). [↑](#footnote-ref-773)
773. For decedents dying in 2010 whose executors elected out of the federal estate tax and into the modified carry-over basis rules of Section 1022, recognition of gain on the funding of a pecuniary bequest was limited to post-death appreciation. IRC § 1040. Note, however, that if the modified carryover basis rules were applicable, any transfer of property by a United States person (including a trust or estate) to a non-resident alien resulted in the recognition of all built-in gains. IRC § 684(a). [↑](#footnote-ref-774)
774. *See* Rev. Rul. 60-87, 1960-1 C.B. 286. [↑](#footnote-ref-775)
775. § 641(a)(3). [↑](#footnote-ref-776)
776. § 691(a)(2). [↑](#footnote-ref-777)
777. § 691(a)(1)(B). [↑](#footnote-ref-778)
778. §§ 72 and 402(a). [↑](#footnote-ref-779)
779. §§ 402(a) and 408. [↑](#footnote-ref-780)
780. *See* PLR 9630034 (pecuniary disclaimer by spouse of one-half interest in decedent's IRA does not cause recognition to spouse or estate). [↑](#footnote-ref-781)
781. § 267(b)(13). [↑](#footnote-ref-782)
782. Rev. Rul. 69 486, 1969-2 CB 159. [↑](#footnote-ref-783)
783. *See* PLR 9429012. [↑](#footnote-ref-784)
784. *See* PLRs 9422052 and 9523029 (no gain recognized). [↑](#footnote-ref-785)
785. §§ 102(a), 691 and Treas. Reg. § 1.691(a)-1(b). [↑](#footnote-ref-786)
786. § 2033. [↑](#footnote-ref-787)
787. *See* Treas. Reg. § 1.691(a)-1(b). [↑](#footnote-ref-788)
788. Rev. Rul. 75-125, 1975-1 CB 254. [↑](#footnote-ref-789)
789. *Est. of Peterson v. Commissioner*, 667 F.2d 675 (8th Cir. 1981). [↑](#footnote-ref-790)
790. § 1014(c). [↑](#footnote-ref-791)
791. Treas. Reg. § 1.691(a)-4(b)(2). [↑](#footnote-ref-792)
792. See PLR 9507008. [↑](#footnote-ref-793)
793. § 691(b). [↑](#footnote-ref-794)
794. § 642(g). [↑](#footnote-ref-795)
795. Treas. Reg. § 1.212-1(i). [↑](#footnote-ref-796)
796. §§ 163(k), 2053(c)(1)(D), and 6601(j). [↑](#footnote-ref-797)
797. Treas. Reg. § 1.642(g)-1. [↑](#footnote-ref-798)
798. *Commissioner v. Est. of Hubert*, 117 S. Ct. 1124 (1997). [↑](#footnote-ref-799)
799. Treas. Reg. §§ 20.2013-4(b)(3), 20.2055-3, and 20.2056(b)-4(d). [↑](#footnote-ref-800)
800. Treas. Reg. §§ 20.2055-3(b)(1)(i) and 20.2056(b)-4(d)(1)(i). [↑](#footnote-ref-801)
801. Treas. Reg. §§ 20.2055-3(b)(1)(ii) and 20.2056(b)-4(d)(1)(ii). *See also Brown v. U.S.*, 329 F.3d 664 (9th Cir. 2003) (discussing *Hubert* and the procedures for properly determining the deduction for administration expenses). [↑](#footnote-ref-802)
802. Treas. Reg. § 20.2056(b)-4(d)(1)(iii)(4). Similar language is applied to charitable gifts. Treas. Reg. § 20.2055-3(b)(4). [↑](#footnote-ref-803)
803. Treas. Reg. §§ 20.2055-3(b)(3) and 20.2056(b)-4(d)(3). [↑](#footnote-ref-804)
804. Treas. Reg. § 20.2056(b)-4(d)(5), Ex. 4. [↑](#footnote-ref-805)
805. § 67(g) and §§161-223. [↑](#footnote-ref-806)
806. § 1212(b). [↑](#footnote-ref-807)
807. § 170(d)(1). [↑](#footnote-ref-808)
808. § 172(b). [↑](#footnote-ref-809)
809. § 163(d)(2). [↑](#footnote-ref-810)
810. § 1366(d)(2). [↑](#footnote-ref-811)
811. § 46. [↑](#footnote-ref-812)
812. § 213(c). [↑](#footnote-ref-813)
813. § 2053(a)(1) and Treas. Reg. § 20.2053-2. [↑](#footnote-ref-814)
814. § 2053(a)(3). [↑](#footnote-ref-815)
815. Rev. Rul. 59-32, 1959-1 C.B. 245. [↑](#footnote-ref-816)
816. §§ 164(a), 164(b)(6), and 2053(c)(1)(B). [↑](#footnote-ref-817)
817. *Id.* [↑](#footnote-ref-818)
818. §§ 163(a) and 2053(c)(1)(B). [↑](#footnote-ref-819)
819. §§ 212, 642(g), and 2053(a). *See* Rev. Rul. 59-32, 1959-1 C.B. 245. [↑](#footnote-ref-820)
820. §§ 165, 642(g), and 2054. [↑](#footnote-ref-821)
821. §§ 163 and 2053(a). [↑](#footnote-ref-822)
822. §§ 163 and 2053(a). [↑](#footnote-ref-823)
823. §§ 164, 2053(a), and 2053(c)(1)(B). [↑](#footnote-ref-824)
824. §§ 212 and 2053(a). [↑](#footnote-ref-825)
825. §§ 215 and 2053(a). *See* Rev. Rul. 67-304, 1967-2 C.B. 224. [↑](#footnote-ref-826)
826. For an excellent article on the grantor trust rules, *see* Stephen R. Akers, Jonathan G. Blattmachr, and F. Ladson Boyle, *Creating Intentional Grantor Trusts*, 44 Real Prop., Tr. and Est. Law J. 207 (Summer 2009). [↑](#footnote-ref-827)
827. Rev. Rul. 2004-64, 2004-27 I.R.B. 7. [↑](#footnote-ref-828)
828. *See* Treas. Reg. § 1.671-3. [↑](#footnote-ref-829)
829. *See* § 677(a) and Treas. Reg. § 1.677(a)-1(g), Ex. 1. [↑](#footnote-ref-830)
830. *See* *Bennett v. Commissioner*, 119 T.C. 157 (2002) with *Benson v. Commissioner*, 76 T.C. 1041 (1981). [↑](#footnote-ref-831)
831. § 678(a)(1). [↑](#footnote-ref-832)
832. § 678(a)(2). [↑](#footnote-ref-833)
833. By its terms, section 678(b) of the Code only refers to grantor powers over income, commentators have stated that limiting this to just income (and not items of corpus) is nonsensical and akin to a drafting error. Ferguson, Freeland, & Ascher, *Federal Income Taxation of Estates, Trusts, and Beneficiaries*, § 10.16[C] (3d ed. 2011). *See also* PLRs 201235006, 200730011, 200606006, and 200603040. [↑](#footnote-ref-834)
834. Rev. Rul. 77-402, 1977-2 C.B. 222. [↑](#footnote-ref-835)
835. *Id.* [↑](#footnote-ref-836)
836. *Id.* *See also* G.C.M. 37228 for a more detailed discussion of the reasoning supporting the revenue ruling. [↑](#footnote-ref-837)
837. Treas. Reg. § 1.1001-2(a)(1). [↑](#footnote-ref-838)
838. Treas. Reg. § 1.1001-2(a)(4)(i) through (v). [↑](#footnote-ref-839)
839. Treas. Reg. § 1.1001-2(c), Ex. 5 [↑](#footnote-ref-840)
840. *Madorin v. Commissioner*, 84 T.C. 667 (1985). [↑](#footnote-ref-841)
841. *Id.* at 673. [↑](#footnote-ref-842)
842. Rev. Rul. 57-51, 1957-1 C.B. 171. *See also* 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.”). [↑](#footnote-ref-843)
843. *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). [↑](#footnote-ref-844)
844. CCA 200923024 (Dealing with a conversion from non-grantor to grantor trust status, discussed later in these materials). [↑](#footnote-ref-845)
845. Rev. Rul. 73-183, 1973-1 C.B. 364. [↑](#footnote-ref-846)
846. 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. [↑](#footnote-ref-847)
847. § 1022(a)(2). [↑](#footnote-ref-848)
848. § 1022(b)(2)(B) [↑](#footnote-ref-849)
849. § 1022(c)(1). [↑](#footnote-ref-850)
850. § 1022(g)(1). [↑](#footnote-ref-851)
851. P.L. 94-455 (Oct. 4, 1976). *See also* P.L. 95-600 (Nov. 6, 1978). [↑](#footnote-ref-852)
852. Louis A. DelCotto and Kenneth F. Joyce, *Inherited Excess Mortgage Property: Death and the Inherited Tax Shelter*, 34 Tax L. Rev. 569 (1979). [↑](#footnote-ref-853)
853. *Id.* at 569. [↑](#footnote-ref-854)
854. P.L. 96-223 (Apr. 2, 1980). [↑](#footnote-ref-855)
855. 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? [↑](#footnote-ref-856)
856. *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. [↑](#footnote-ref-857)
857. CCA 200937028. [↑](#footnote-ref-858)
858. *Id.* [↑](#footnote-ref-859)
859. § 1015(b) [↑](#footnote-ref-860)
860. Rev. Rul. 72-406, 1972-2 C.B. 462. *See also* *Pierre S. Du Pont v. Commissioner*, 18 B.T.A. 1028 (1930). [↑](#footnote-ref-861)
861. PLR 200434012. [↑](#footnote-ref-862)
862. Rev. Proc. 2015-37, 2015-26 I.R.B. 1196 (effective for all requests received after June 15, 2015). Continued in section 5.01(12) of Rev. Proc. 2016-3, 2016-1 I.R.B. 126. [↑](#footnote-ref-863)
863. 2020-2021 Priority Guidance Plan which can be obtained at <http://www.irs.gov/uac/Priority-Guidance-Plan>. [↑](#footnote-ref-864)
864. § 1014(b)(3). [↑](#footnote-ref-865)
865. The drafters of the trust could not provide for a lifetime power to change beneficial enjoyment without losing foreign grantor trust status. The Code provides grantor trust status with respect to a foreign person for a portion of any trust if “the only amounts distributable from such portion (whether income or corpus) during the lifetime of the grantor are amounts distributable to the grantor or the spouse of the grantor.” § 672(f)(2)(A)(ii). [↑](#footnote-ref-866)
866. CCA 200923024 and PLR 201730018 [↑](#footnote-ref-867)
867. *Id.* [↑](#footnote-ref-868)
868. *Id.* [↑](#footnote-ref-869)
869. *Id.* [↑](#footnote-ref-870)
870. PLR 201730018. [↑](#footnote-ref-871)
871. *See* Laura H. Peebles, *Mysteries of the Blinking Trust*, 147 Tr. & Est. 16 (Sept. 2008). For an excellent discussion on terminating grantor trust status and certain tax attributes that would transfer to the non-grantor trust (e.g., section 465 at-risk deduction limitations and section 469 passive activity loss and credit limitations) and those that would be retained by the grantor (e.g., section 1212 capital loss carrybacks and carryovers) see David Kirk, Nickolas Davidson, and Paul Schuh, [↑](#footnote-ref-872)
872. For example, (i) if the trust allows distributions without a reasonably definite standard, changing trustees so that more than half of the trustees are related or subordinate parties will result in grantor trust status under sections 674(a) and 674(c) of the Code if those trustees are, in fact, subservient to the wishes of the grantor or if the grantor’s spouse is the trustee; (ii) converting a domestic trust into a foreign trust under section 679 of the Code by adding a foreign trustee or co-trustee or replacing the trustee with a foreign trustee; and (iii) decanting the assets of the non-grantor trust over to a grantor trust pursuant to a power or state statute. [↑](#footnote-ref-873)
873. *See* CCA 200923024 and PLR 200848017. [↑](#footnote-ref-874)
874. § 675(3). It does not apply to “a loan which provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor.” *Id.* [↑](#footnote-ref-875)
875. Rev. Rul. 86-82. 1986-1 C.B. 253. [↑](#footnote-ref-876)
876. § 678(a)(1). [↑](#footnote-ref-877)
877. § 678(a)(2). [↑](#footnote-ref-878)
878. For an in-depth discussion of the BDOT, *see* Edwin P. Morrow*, IRC § 678 and the Beneficiary Deemed Owner Trust (BDOT)* (2020) available at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3165592> and a large portion of which was published previously as LISI Estate Planning Newsletter #2587 (Sept 5, 2017). [↑](#footnote-ref-879)
879. PLR 201633021. [↑](#footnote-ref-880)
880. *Id.* [↑](#footnote-ref-881)
881. *Id.* [↑](#footnote-ref-882)
882. PLR 202022002. [↑](#footnote-ref-883)
883. *Id.* [↑](#footnote-ref-884)
884. § 453(f)(1). [↑](#footnote-ref-885)
885. §§ 453(c) and 61(a)(4). [↑](#footnote-ref-886)
886. *Id.* [↑](#footnote-ref-887)
887. § 453(d)(1). [↑](#footnote-ref-888)
888. § 453(d)(2). *See also* Treas. Reg. § 301.9100-1 through § 301.9100-3. [↑](#footnote-ref-889)
889. Rev. Rul. 70-430, 1970-2 C.B. 51. [↑](#footnote-ref-890)
890. § 453(b)(2)(A). [↑](#footnote-ref-891)
891. § 453(l)(1)(A). [↑](#footnote-ref-892)
892. § 453(l)(1)(B). [↑](#footnote-ref-893)
893. There are certain exceptions for farm property, timeshares, and residential lots. *See* §§ 453(l)(2)(A) and 453(l)(2)(B). [↑](#footnote-ref-894)
894. § 453(b)(2)(B). The Code gives the Treasury Department the authority to issue Treasury Regulations disallowing the use of the installment method, in whole or in part, for transactions where the restrictions barring use of the installment method for sales of publicly traded property would be avoided by use of related parties, pass-through entities, or intermediaries [↑](#footnote-ref-895)
895. § 453(k)(2)(A). [↑](#footnote-ref-896)
896. § 453(k)(2)(B). [↑](#footnote-ref-897)
897. Property that, in the hands of the transferee, is subject to the allowance for depreciation under section 167 of the Code. § 453(f)(7). [↑](#footnote-ref-898)
898. § 453(g). [↑](#footnote-ref-899)
899. § 453(i). [↑](#footnote-ref-900)
900. § 453(k), flush language. [↑](#footnote-ref-901)
901. S. Rep. No. 99-313, at 131 (1986). [↑](#footnote-ref-902)
902. *Id.* [↑](#footnote-ref-903)
903. § 453(i). [↑](#footnote-ref-904)
904. § 453(g)(1)(A). [↑](#footnote-ref-905)
905. §453(g)(1)(B)(i). [↑](#footnote-ref-906)
906. § 453(g)(2) [↑](#footnote-ref-907)
907. § 453(e). [↑](#footnote-ref-908)
908. § 453(e)(3)(A) and (B). [↑](#footnote-ref-909)
909. § 453(e)(2)(B). [↑](#footnote-ref-910)
910. § 453(e)(2)(B)(i). [↑](#footnote-ref-911)
911. § 453(e)(2)(B)(ii). [↑](#footnote-ref-912)
912. § 453(e)(2)(B)(iii). [↑](#footnote-ref-913)
913. § 453(f)(1)(A). [↑](#footnote-ref-914)
914. § 453(f)(1)(B). [↑](#footnote-ref-915)
915. §§ 453(f)(1)(A), 318(a)(1), 267(b)(1) and §267(c)(4). [↑](#footnote-ref-916)
916. § 318(a)(2)(A). [↑](#footnote-ref-917)
917. *Id.* [↑](#footnote-ref-918)
918. § 318(a)(2)(B). [↑](#footnote-ref-919)
919. § 453(e)(6)(A). [↑](#footnote-ref-920)
920. § 453(e)(6)(B). [↑](#footnote-ref-921)
921. § 453(e)(6)(C). [↑](#footnote-ref-922)
922. § 453(e)(7). [↑](#footnote-ref-923)
923. § 453B(b). [↑](#footnote-ref-924)
924. § 453B(c). [↑](#footnote-ref-925)
925. *See* § 691(a), [↑](#footnote-ref-926)
926. § 691(a)(4) and Treas. Reg. § 1.691(a)-5(a). [↑](#footnote-ref-927)
927. § 691(a)(5). [↑](#footnote-ref-928)
928. Treas. Reg. § 1.691(a)-5(b). [↑](#footnote-ref-929)
929. § 691(a)(3). [↑](#footnote-ref-930)
930. § 691(a)(2). [↑](#footnote-ref-931)
931. Rev. Rul. 76-100, 1976-1 C.B. 123. [↑](#footnote-ref-932)
932. § 453B(a)(1). [↑](#footnote-ref-933)
933. § 453B(a)(2). [↑](#footnote-ref-934)
934. § 453B(f). [↑](#footnote-ref-935)
935. Rev. Rul. 79-371, 1979-2 C.B. 294. [↑](#footnote-ref-936)
936. Rev. Rul. 67-167, 1967-1 C.B. 107, and Rev. Rul. 74-613, 1974-2 C.B. 153. *See also* PLR 9149026. [↑](#footnote-ref-937)
937. *Marshall v. U.S.*, 26 F.Supp. 580 (S.D. Cal. 1939). [↑](#footnote-ref-938)
938. Treas. Reg. § 1.661(a)-2(f)(1) and Rev. Rul. 55-159, 1955-1 C.B. 391. [↑](#footnote-ref-939)
939. PLR 8001045. [↑](#footnote-ref-940)
940. § 453B(g). [↑](#footnote-ref-941)
941. § 453B(g)(2). [↑](#footnote-ref-942)
942. REG-109187-11 (Dec. 23, 2014). [↑](#footnote-ref-943)
943. The Treasury Regulation provides that if a partnership disposes of section 704(c) property in an installment sale, the installment obligation received by the partnership is treated as the new section 704(c) property with the same amount of built-in gain as the section 704(c) property disposed of by the partnership. Treas. Reg. § 1.704-3(a)(8)(ii). The amount of remaining built-in gain is calculated taking into account any gain recognized on the installment sale. *Id.* The installment obligation received by the partnership in exchange for the section 704(c) property is considered section 704(c) property for purposes of both sections 704(c)(1)(B) and 737. Treas. Reg. § 1.737-2(d)(3)(ii). [↑](#footnote-ref-944)
944. Prop. Treas. Reg. 1.453B-1(c)(1)(i). [↑](#footnote-ref-945)
945. Prop. Treas. Reg. 1.453B-1(c)(1)(ii)(A). [↑](#footnote-ref-946)
946. Prop. Treas. Reg. 1.453B-1(c)(1)(ii)(B). [↑](#footnote-ref-947)
947. §§ 453B(h)(1) and 453B(h)(2). Section 453(h)(1) of the Code provides rules on when the receipt of an installment obligation is not treated as payment for stock. [↑](#footnote-ref-948)
948. § 453B(h), flush language. [↑](#footnote-ref-949)
949. *Id.*  [↑](#footnote-ref-950)
950. As discussed earlier, intellectual property in the hands of the creator is specifically excluded from the definition of capital asset. § 1221(a)(3). However, it is entitled to a step-up in basis under section 1014 and becomes a capital asset in the hands of the recipient. [↑](#footnote-ref-951)
951. See e.g., § 1014(a)(3) [↑](#footnote-ref-952)
952. *See* Rev. Rul. 67-167, 1967-1 C.B. 107, and Rev. Rul. 74-613, 1974-2 C.B. 153. *See also* PLR 9149026. [↑](#footnote-ref-953)
953. § 453(c). [↑](#footnote-ref-954)
954. § 7872(g)(3) (The term “gift loan” means any below-market loan where the forgoing of interest is in the nature of a gift.). A “below-market loan” means a demand or term loan where the “interest is payable on the loan at a rate less than the applicable Federal rate” or the “amount loaned exceeds the present value of all payments due under the loan” (with present value determined with a discount rate equal to the applicable Federal rate). *See* 7872(e)(1), (f)(1), and (f)(3). [↑](#footnote-ref-955)
955. §§ 7872(a) and 1274(d). [↑](#footnote-ref-956)
956. Treas. Reg. § 25-2512-8. [↑](#footnote-ref-957)
957. § 61(a)(4). [↑](#footnote-ref-958)
958. § 163(h)(1). [↑](#footnote-ref-959)
959. § 163(h)(2). [↑](#footnote-ref-960)
960. § 163(h)(2)(A). *See also* Treas. Reg. 1.163(d)-8T for meaning of a trade or business. [↑](#footnote-ref-961)
961. §§ 163(h)(2)(B) and 163(d)(3). [↑](#footnote-ref-962)
962. § 163(h)(2)(C). [↑](#footnote-ref-963)
963. §§ 163(h)(2)(D) and 163(h)(3). [↑](#footnote-ref-964)
964. § 163(h)(2)(E). [↑](#footnote-ref-965)
965. § 163(h)(2)(F). [↑](#footnote-ref-966)
966. For an excellent discussion on the transfer and income tax consequences of not substitutions, *see* Jonathan G. Blattmachr, Bridget J. Crawford, and Elisabeth O. Madden, *How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note*, 109 J. Tax’n. 22 (July 2008). Consideration of how the obligor justifies the substitution of a new note with a lower interest rate is warranted under state law. [↑](#footnote-ref-967)
967. Treas. Reg. § 1.1001-1(a). [↑](#footnote-ref-968)
968. Treas. Reg. § 1.1001-3(a). *See* Rev. Rul. 89-122, 1989-2 C.B. 200, Rev. Rul. 87-19, 1987-1 C.B. 249, and PLR 9127003. [↑](#footnote-ref-969)
969. *See* Treas. Reg. §§ 1.1001-3(c)(1)(ii) and 1.1001-3(c)(2)(ii). [↑](#footnote-ref-970)
970. § 108(e)(10)(A). [↑](#footnote-ref-971)
971. § 108(e)(10)(B). [↑](#footnote-ref-972)
972. Treas. Reg. § 1.61-12(c)(2)(ii). [↑](#footnote-ref-973)
973. § 1274(a)(1). [↑](#footnote-ref-974)
974. *See* § 1058(c). [↑](#footnote-ref-975)
975. *See, e.g.,* Rev. Rul. 80-235, 1980-2 C.B. 229 (liability created by the written obligation of a limited partner does not create basis in the limited partnership interest), and Rev. Rul. 68-629, 1968-2 C.B. 154 (contribution of promissory notes to a corporation did not create tax basis, resulting in gain under section 357(c) of the Code because the taxpayer contributed other assets with liabilities in excess of tax basis). [↑](#footnote-ref-976)
976. *VisionMonitor Software, LLC v. Commissioner*, T.C. Memo. 2014-182, *Dakotah Hills Offices Ltd. Part. v. Commissioner*, T.C. Memo. 1998-134, *Gemini Twin Fund III v. Commissioner*, T.C. Memo 1991-315, aff’d without published opinion, 8 F.3d 26 (9th Cir. 1993), *Bussing v. Commissioner*, 88 T.C. 449 (1987), *Oden v. Commissioner*, T.C. 1981-184, *aff’d* without published opinion, 678 F.2d 885 (4th Cir. 1982). [↑](#footnote-ref-977)
977. *Gemini Twin Fund III v. Commissioner*, T.C. Memo 1991-315. [↑](#footnote-ref-978)
978. *Peracchi v. Commissioner*, 143 F.3d 487 (9th Cir. 1997). *But see Seggerman Farms Inc. v. Commissioner*, 308 F.3d 803 (7th Cir. 2002) and *Alderman v. Commissioner*, 55 T.C. 662 (1971). [↑](#footnote-ref-979)
979. *Peracchi v. Commissioner*, 143 F.3d 487 (9th Cir. 1997) at 494. [↑](#footnote-ref-980)
980. *See* *Lessinger v. Commissioner*, 872 F.2d 519 (2d Cir. 189). The court agreed with the IRS’s argument that the note had a zero basis, but then concluded the note had a basis in the corporation’s hands equal to its face value. [↑](#footnote-ref-981)
981. *Peracchi v. Commissioner*, 143 F.3d 487 (9th Cir. 1997) at 494. [↑](#footnote-ref-982)
982. *Id.* at 497. [↑](#footnote-ref-983)
983. *See* Stuart Lazar, *Lessinger, Peracchi, and the Emperor’s New Clothes: Covering a Section 357(c) Deficit with Invisible (or Nonexistent) Property*, 58 Tax Lawyer No. 1, 41 (Fall 2004); Elliott Manning, *The Issuer’s Paper: Property or What? Zero Basis and Other Income Tax Mysteries*, 39 Tax L. Rev. 159 (1984); and Jerred G. Blanchard Jr., *Zero Basis in the Taxpayer’s Own Stock or Debt Obligations: Do Those Instruments Constitute ‘Property’?*, 2005 Tax Notes 1431 (March 21, 2005). [↑](#footnote-ref-984)
984. *See* Treas. Reg. § 20.2031-4 [↑](#footnote-ref-985)
985. TAM 8229001. [↑](#footnote-ref-986)
986. *See* M. Read Moore, *Valuation Discounts for Private Debt in Estate Administration*, 25 Est. Plan. 195 (1998) and Jerry M. Hesch, Alan S. Gassman, and Christopher J. Donicolo, *Interesting Interest Questions: Interest Rates ,for Intra-Family Transactions*, 36 Est. Gifts & Tr. J. 128 (2011). [↑](#footnote-ref-987)
987. Treas. Reg. § 1.1014-4(a)(1). *See also* Treas. Reg. § 1.1015-1(b). [↑](#footnote-ref-988)
988. *See* Treas. Reg. § 1.1015-5(a)(1) (The uniform basis is the unadjusted basis of the entire property determined immediately after the decedent's death under the applicable sections of Part II of Subchapter O of Chapter 1 of the Code). [↑](#footnote-ref-989)
989. Treas. Reg. §§ 1.1014-5(a)(1) and 1015-1(b). [↑](#footnote-ref-990)
990. *See* Treas. Reg. § 1.1014-5(a)(1). [↑](#footnote-ref-991)
991. Treas. Reg. § 1.1014-4(a)(1). [↑](#footnote-ref-992)
992. *Id.* [↑](#footnote-ref-993)
993. Treas. Reg. § 1.1014-4(b). [↑](#footnote-ref-994)
994. *Id.* [↑](#footnote-ref-995)
995. Treas. Reg. § 1.1014-4(a)(3). [↑](#footnote-ref-996)
996. *See* Treas. Reg. § 1.1014-5(a)(3). [↑](#footnote-ref-997)
997. *See* Treas. Reg. §§ 20.2031-(d)(1), 25.7520-1, 1001-1(f)(e), and 1.1015-1(b). [↑](#footnote-ref-998)
998. On August 7, 2020, the National Center for Health Statistics at the Centers for Disease Control and Prevention issued the decennial life table for 2009-2011. This is the source for the actuarial tables under section 7520. [↑](#footnote-ref-999)
999. § 1001(e)(1). [↑](#footnote-ref-1000)
1000. § 1001(e)(2). [↑](#footnote-ref-1001)
1001. § 1001(e)(3). [↑](#footnote-ref-1002)
1002. *See* Table S which can be found at <https://www.irs.gov/retirement-plans/actuarial-tables>. [↑](#footnote-ref-1003)
1003. § 1001(e)(1). *See also* Treas. Reg. § 1.1001-1(f). [↑](#footnote-ref-1004)
1004. § 1001(e)(2). [↑](#footnote-ref-1005)
1005. *See* Treas. Reg. §§ 1.1014-5, Ex. 6, and 1.1001-1(f)(2). [↑](#footnote-ref-1006)
1006. Treas. Reg. §§ 1.1014-5(a)(1) and 1015-1(b). [↑](#footnote-ref-1007)
1007. Treas. Reg. § 1.1014-8(a)(1). [↑](#footnote-ref-1008)
1008. *Id.* [↑](#footnote-ref-1009)
1009. Treas. Reg. § 1.1014-8(b), Ex. 1. [↑](#footnote-ref-1010)
1010. Treas. Reg. § 1.1014-8(a)(2). [↑](#footnote-ref-1011)
1011. Treas. Reg. § 1.1014-8(b), Ex. 2. [↑](#footnote-ref-1012)
1012. § 1001(e)(3). [↑](#footnote-ref-1013)
1013. Treas. Reg. § 1.1014-5, Ex. 5. [↑](#footnote-ref-1014)
1014. *See* PLRs 200210018, 200231011, 200648016, and 200648017. [↑](#footnote-ref-1015)
1015. PLRs 201932001 through 201932010. [↑](#footnote-ref-1016)
1016. PLR 201932001. [↑](#footnote-ref-1017)
1017. *Id.* [↑](#footnote-ref-1018)
1018. Rev. Rul. 69-486, 1969-2 C.B. 159. [↑](#footnote-ref-1019)
1019. Revenue Ruling 72-243, 1972-1 C.B. 233. [↑](#footnote-ref-1020)
1020. *Id.* [↑](#footnote-ref-1021)
1021. *Id.* [↑](#footnote-ref-1022)
1022. *See* F. Ladson Boyle, Howard M. Zaritsky, and D. Ryan Wallace, *The Uniform Basis Rule and Terminating Interests in Trusts Early*, Real Prop., Tr. & Est. L.J. 1 (Spring 2020) and Douglas A. Kahn, *Gain from the Sale of an Income Interest in a Trust*, 30 Va. Tax Rev. 445 (2010), for excellent discussions on the tax implications of sales of income interests and commutations. [↑](#footnote-ref-1023)
1023. § 1.1001-1(a). [↑](#footnote-ref-1024)
1024. *See* Restatement of Trusts 2d § 167(1) (1959). [↑](#footnote-ref-1025)
1025. *See, e.g.*, Unif. Trust Code §§ 410-417 (2004). [↑](#footnote-ref-1026)
1026. Notice 2011-101, 2011-52 I.R.B. 932. [↑](#footnote-ref-1027)
1027. Rev. Proc. 2021-3, 2021-1 I.R.B. 140, sections 5.01(8) . [↑](#footnote-ref-1028)
1028. *Id.* at section 5.01(8) [↑](#footnote-ref-1029)
1029. *Id.* at section 5.01(16). [↑](#footnote-ref-1030)
1030. *Id.* at section 5.01(18). [↑](#footnote-ref-1031)
1031. *See* PLRs 200736002, 200723014, 200607015. [↑](#footnote-ref-1032)
1032. *See* §§ 651 and 661. [↑](#footnote-ref-1033)
1033. § 661. [↑](#footnote-ref-1034)
1034. *Id.* [↑](#footnote-ref-1035)
1035. § 642(h). [↑](#footnote-ref-1036)
1036. *Id.* [↑](#footnote-ref-1037)
1037. *See* PLR 201633021. [↑](#footnote-ref-1038)
1038. PLR 200231011. [↑](#footnote-ref-1039)
1039. *Evans v. Commissioner*, 30 TC 798 (1958). [↑](#footnote-ref-1040)
1040. *Silverstein v. U.S.*, 419 F.2d. 999 (7th Cir. 1969). [↑](#footnote-ref-1041)
1041. PLR 200231011. [↑](#footnote-ref-1042)
1042. Cf. PLRs 201647001 (because Grantors' status as owners of trust for federal income tax purposes did not change beneficial interests, modification to grant additional trustee powers did not result in transfer); 201528024; 201419001; 200736002 (finding division of trust into three separate trusts on a pro rata basis did not result in gain or loss because new trusts were not materially different, even though trustees would be different in the new trusts); 200615006 (court-approved settlement clarifying ambiguous trust terms to provide that stated distribution amounts were minimums and that trustee should also distribute all trust income to beneficiaries, were not materially different). [↑](#footnote-ref-1043)
1043. PLR200743022, [↑](#footnote-ref-1044)
1044. Treas. Reg. § 1.1001-1(h). [↑](#footnote-ref-1045)
1045. §§ 732(a)(2) and 1014(a). [↑](#footnote-ref-1046)
1046. § 734(b). [↑](#footnote-ref-1047)
1047. § 752. [↑](#footnote-ref-1048)
1048. §§ 704(c)(1)(B), 707(a)(2)(B), 731(c), 737, and 751(b). [↑](#footnote-ref-1049)
1049. *See* Treas. Reg. § 301.7701-2(b)(2). [↑](#footnote-ref-1050)
1050. *See* Treas. Reg. § 301.7701-3(a). [↑](#footnote-ref-1051)
1051. Treas. Reg. § 301.7701-3(b). Form 8832 and an election to be an S corporation under section 1362(a) of the Code (Form 2553, Election by a Small Business Corporation) [↑](#footnote-ref-1052)
1052. Treas. Reg. § 301.7701-3(c)(1)(i). [↑](#footnote-ref-1053)
1053. *Id.* [↑](#footnote-ref-1054)
1054. Treas. Reg. § 1.701-2. [↑](#footnote-ref-1055)
1055. Treas. Reg. § 1.701-2(b). [↑](#footnote-ref-1056)
1056. Treas. Reg. § 1.701-2(a)(1). [↑](#footnote-ref-1057)
1057. Treas. Reg. § 1.701-2(a)(2). [↑](#footnote-ref-1058)
1058. Treas. Reg. § 1.701-2(a)(3). [↑](#footnote-ref-1059)
1059. Treas. Reg. § 1.701-2(c). [↑](#footnote-ref-1060)
1060. Treas. Reg. § 1.701-2(d), Ex. 9. [↑](#footnote-ref-1061)
1061. Treas. Reg. § 1.701-2(d), Ex. 10. [↑](#footnote-ref-1062)
1062. 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. [↑](#footnote-ref-1063)
1063. 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). [↑](#footnote-ref-1064)
1064. Treas. Reg. § 1.701-2(i). [↑](#footnote-ref-1065)
1065. Health Care and Education Reconciliation Act of 2010, P.L. 111-152, § 1409 (Mar. 30, 2010). [↑](#footnote-ref-1066)
1066. Rev. Rul. 84-53, 1984-1 C.B. 159. *Cf.* PLR 200909001 (the unitary basis rule does not apply to publicly-traded partnership interests). [↑](#footnote-ref-1067)
1067. *See* Treas. Reg. § 1.1012-1(c). Even if lots cannot be identified, then a first-in, first-out accounting convention is used to determine gain or loss. [↑](#footnote-ref-1068)
1068. Rev. Rul. 84-53, 1984-1 C.B. 159. *See also* Rev. Rul. 84-52, 1984-1 C.B. 157, endorses the unitary basis concept and which involved a general partnership converted to a limited partnership. Two of the general partners in the general partnership converted their interest into a general partner interest and a limited partner interest in the limited partnership. [↑](#footnote-ref-1069)
1069. *See* H. Grace Kim, *Application of Unitary Basis in Partnership Interests*, 54 Tax Mgmt. Memo. 103 (2013) for an excellent discussion of the complications caused by the unitary basis rule in conjunction with other provisions of subchapter K including allocations of income under section 704(d) of the Code, distributions of cash and property to partners under sections 731 and 732 of the Code, and other situations involving transfers of partnerships. [↑](#footnote-ref-1070)
1070. A partner may also contribute services to the partnership in exchange for an interest in the partnership, but a discussion of those rules is beyond the scope of this outline. [↑](#footnote-ref-1071)
1071. § 721(a). [↑](#footnote-ref-1072)
1072. *See also* § 7701(a)(42) and (43) (definition of “substituted basis property” and “transferred basis property”). [↑](#footnote-ref-1073)
1073. *See also* § 7701(a)(44) (definition of “exchanged basis property”). [↑](#footnote-ref-1074)
1074. *See* Rev. Rul. 68-79, 1968-1 C.B. 310 (new partner contributing cash for an interest in a continuing partnership is entitled to long-term capital gain on allocable share of gain on partnership long-term capital asset sold one month after admission). *But see* *Citizens Nat’l Bank of Waco v. U.S.*, 417 F.2d 675 (5th Cir. 1969) (tacking permitted in part gift, part sale transfer to trust even though liability transferred exceeded transferor's basis, and transferee's basis was determined by amount of liability, not transferor's basis). [↑](#footnote-ref-1075)
1075. *See Commissioner v. Lehman*, 165 F.2d 383 (2d Cir. 1948) (holding period of partnership interest is not determined by partnership's holding period of assets; partners do not split holding period for increase in percentage interest on withdrawal of a partner), *aff'g* 7 T.C. 1088 (1946). [↑](#footnote-ref-1076)
1076. *See* Treas. Reg. § 1.1223-3. [↑](#footnote-ref-1077)
1077. *See Commissioner v. Lehman*, 165 F.2d 383 (2d Cir. 1948) ), *aff'g* 7 T.C. 1088 (1946). [↑](#footnote-ref-1078)
1078. *See* § 704(c)(1)(A) and Treas. Reg. §§ 1.704-1(b)(4)(i) and 1.704-3(a)(4). [↑](#footnote-ref-1079)
1079. A contribution of stocks and securities will be considered diversified if, taken in the aggregate, (a) the stock or securities of any one issuer do not constitute more than 25% of the value of the contributed assets and (b) the stock and securities of 5 or fewer issuers do not constitute more than 50% of the value of the transferred assets. *See* Treas. Reg. 1.351-1(c)(6)(i). [↑](#footnote-ref-1080)
1080. *See* Rev. Rul. 87-9, 1987-1 C.B. 133 (contribution of cash representing 11% the total contribution was held to be significant, resulting in diversification), PLR 9451035 (cash in excess of 5% of the aggregate assets are considered significant, resulting in diversification) and PLR 9504025 (cash equal to 1% of the value of assets contributed is insignificant) and PLR 200006008 (contributions of stock portfolios to an LLC are insignificant because the assets constitute less than 5% of the company’s total value after the transfer). [↑](#footnote-ref-1081)
1081. § 731(a) (gain is recognized when a partner receives actual or constructive cash distribution from the partnership in excess of the adjusted basis in the partnership interest) and § 752(b) (gain may be recognized upon contribution when there is a decrease in a partner’s share of partnership liabilities, causing a deemed distribution of money and reducing the outside basis below zero). *See also* Treas. Reg. § 1.752-1(g), *Ex. 1*. [↑](#footnote-ref-1082)
1082. *See* § 707(a)(2) and Treas. Reg. § 1.707-3. [↑](#footnote-ref-1083)
1083. § 752(c) and Treas. Reg. § 1.752-1(e). [↑](#footnote-ref-1084)
1084. §§ 705(a)(2), 752(b), 733(1), and Treas. Reg. §§ 1.722-1, *Ex. 1*, 1.733-1, and 1.752-1(f). [↑](#footnote-ref-1085)
1085. §§ 752(b), 731(a), 705(a)(2), and Treas. Reg. § 1.722-1, *Ex. 2*. [↑](#footnote-ref-1086)
1086. § 1.1002-2(a)(4)(iv). [↑](#footnote-ref-1087)
1087. § 734(b). [↑](#footnote-ref-1088)
1088. § 704(c)(1)(A) and Treas. Reg. § 1.704-3(a). [↑](#footnote-ref-1089)
1089. *See* §§ 723, 734, 754 and Rev. Rul. 84-15, 1984-1 C.B. 158. [↑](#footnote-ref-1090)
1090. Treas. Reg. § 1.752-3(a). [↑](#footnote-ref-1091)
1091. Treas. Reg. § 1.752-3(a)(1). [↑](#footnote-ref-1092)
1092. Treas. Reg. § 1.752-3(a)(2). [↑](#footnote-ref-1093)
1093. Treas. Reg. § 1.752-3(a)(3). [↑](#footnote-ref-1094)
1094. Treas. Reg. § 1.704-2(d)(1). *See* Rev. Rul. 95-41, 1995-1 C.B. 132, and PLR 9507023. [↑](#footnote-ref-1095)
1095. *Id.* [↑](#footnote-ref-1096)
1096. *See* Treas. Reg. § 1.752-3(a)(2). The lower the basis of the contributed property relative to encumbrance, the less the liability shift is because the section 704(c) minimum gain is more. [↑](#footnote-ref-1097)
1097. Treas. Reg. § 1.752-1(e). [↑](#footnote-ref-1098)
1098. *See* Treas. Reg. 1.752-3(a)(3). [↑](#footnote-ref-1099)
1099. Treas. Reg. § 1.761-1(d). [↑](#footnote-ref-1100)
1100. This is generally due to the “same class” exception under § 2701(a)(2)(B). With respect to this exception, the Treasury Regulations provides, “A class is the same class as is (or is proportional to the class of) the transferred interest if the rights are identical (or proportional) to the rights of the transferred interest, except for non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to management and limitations on liability).” Treas. Reg. § 25.2701-1(c)(3). [↑](#footnote-ref-1101)
1101. § 731(a)(1) and Treas. Reg. §§ 1.731-1 and 1.732-1(b). [↑](#footnote-ref-1102)
1102. § 731(a)(1) and Treas. Reg. § 1.731-1(a). [↑](#footnote-ref-1103)
1103. § 731(c) and Treas. Reg. § 1.731-2. [↑](#footnote-ref-1104)
1104. § 733(a) and Treas. Reg. § 1.733-1. [↑](#footnote-ref-1105)
1105. §§ 731(a)(2) and 731(b). A loss may only occur with a liquidating distribution. Treas. Reg. §1.731-1(a)(2). [↑](#footnote-ref-1106)
1106. § 731(a). [↑](#footnote-ref-1107)
1107. § 751. [↑](#footnote-ref-1108)
1108. § 751(b) and Treas. Reg. § 1.751-1(b)(2), (d)(1). [↑](#footnote-ref-1109)
1109. *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). [↑](#footnote-ref-1110)
1110. § 721. [↑](#footnote-ref-1111)
1111. §§ 1223(1), 1223(2), and 723; Treas. Reg. §§ 1.1223-1(b) and 1.723-1. [↑](#footnote-ref-1112)
1112. 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). [↑](#footnote-ref-1113)
1113. *See* § 741. [↑](#footnote-ref-1114)
1114. Treas. Reg. § 1.704-1(b)(2)(iv)(b). [↑](#footnote-ref-1115)
1115. Treas. Reg. § 1.704-3(a)(7). [↑](#footnote-ref-1116)
1116. Treas. Reg. § 1.751-1(a)(2). [↑](#footnote-ref-1117)
1117. *Id.* [↑](#footnote-ref-1118)
1118. *See* § 1(h)(5)(B), (h)(9), and (h)(10). Treas. Reg. § 1.1(h)-1(a). [↑](#footnote-ref-1119)
1119. § 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. [↑](#footnote-ref-1120)
1120. § 731(c) and Treas. Reg. § 1.731-2. [↑](#footnote-ref-1121)
1121. Treas. Reg. § 1.752-1(e) and (g). [↑](#footnote-ref-1122)
1122. § 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). [↑](#footnote-ref-1123)
1123. *See* Treas. Reg. §§ 1.732-1, 1.736-1(b)(1), and 1.743-1(d)(1). [↑](#footnote-ref-1124)
1124. § 732(c)(1)(A)(i) and Treas. Reg. §1.732-1(c)(1)(i). [↑](#footnote-ref-1125)
1125. § 735(a). [↑](#footnote-ref-1126)
1126. § 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. [↑](#footnote-ref-1127)
1127. § 734(b)(1). [↑](#footnote-ref-1128)
1128. Treas. Reg. §§ 1.755-1(a)(1) and 1.755-1(c)(1). [↑](#footnote-ref-1129)
1129. Treas. Reg. § 1.755-1(c)(1)(ii). [↑](#footnote-ref-1130)
1130. Treas. Reg. § 1.755-1(c)(1)(i). [↑](#footnote-ref-1131)
1131. § 761(d). [↑](#footnote-ref-1132)
1132. § 731(a)(2) and Treas. Reg. § 1.731-1(a)(2). [↑](#footnote-ref-1133)
1133. § 732(b), 732(c), and Treas. Reg. § 1.732-1(b). [↑](#footnote-ref-1134)
1134. § 731(c)(1) refers to § 731(a)(1), the gain provision, not § 731(a)(2), the loss provision. [↑](#footnote-ref-1135)
1135. § 731(a)(2). Treas. Reg. §§ 1.731-1(a)(2) and 1.732-1(c)(3). [↑](#footnote-ref-1136)
1136. Treas. Reg. § 25.2701-1(c)(3). [↑](#footnote-ref-1137)
1137. § 732(c)(1)(A) and Treas. Reg. § 1.732-1(c)(1)(i). [↑](#footnote-ref-1138)
1138. § 732(b) and Treas. Reg. § 1.732-1(b). [↑](#footnote-ref-1139)
1139. § 734(b)(2)(A) and Treas. Reg. §1.734-1(b). [↑](#footnote-ref-1140)
1140. § 734(b)(2)(B) and Treas. Reg. §1.734-1(b). [↑](#footnote-ref-1141)
1141. § 734(a). [↑](#footnote-ref-1142)
1142. § 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. [↑](#footnote-ref-1143)
1143. *See* IRS Notice 2005-32, 2005-1 C.B. 895. [↑](#footnote-ref-1144)
1144. Treas. Reg. § 1.755-1(c)(2). [↑](#footnote-ref-1145)
1145. Treas. Reg. § 1.755-1(c)(2)(i). [↑](#footnote-ref-1146)
1146. Treas. Reg. § 1.755-1(c)(2)(ii). [↑](#footnote-ref-1147)
1147. *Chase v. Commissioner*, 92 T.C. 874 (1989). [↑](#footnote-ref-1148)
1148. It is significant to note that the court allowed the wife of the general partner to recognize a loss upon a distribution of cash to her in liquidation of her interest. [↑](#footnote-ref-1149)
1149. § 751(a). [↑](#footnote-ref-1150)
1150. § 751(b)(1)(A). [↑](#footnote-ref-1151)
1151. § 751(b)(1)(B). [↑](#footnote-ref-1152)
1152. *See* Treas. Reg. § 1.751-1(b)(1). [↑](#footnote-ref-1153)
1153. *See* Rev. Rul. 57-68, 1957-1 C.B. 207. [↑](#footnote-ref-1154)
1154. *See* Treas. Reg. §§ 1.751-1(b)(1)(iii), 2(iii), and 3(iii). [↑](#footnote-ref-1155)
1155. *See* Treas. Reg. §§ 1.751-1(b)(1)(iii), 2(ii), and 3(ii). [↑](#footnote-ref-1156)
1156. § 751(b)(2)(A). [↑](#footnote-ref-1157)
1157. § 751(b)(2)(B). [↑](#footnote-ref-1158)
1158. One court ruled that section 751(c) “invites a liberal construction by stating that the phrase ‘unrealized receivables’ *includes* certain specified rights, thereby implying that the statutory definition of term is not necessarily self-limiting.” *Logan v. Commissioner*, 51 T.C. 482, 486 (1968). [↑](#footnote-ref-1159)
1159. § 704(c) and Treas. Reg. §§ 1.751-1(c)(4)(iii), -1(c)(5). [↑](#footnote-ref-1160)
1160. § 1245(a)(3). [↑](#footnote-ref-1161)
1161. Treas. Reg. §§ 1.751-1(c)(4)(v), -1(c)(5), -1(a)(1)(i) and -1(a)(2)(ii). [↑](#footnote-ref-1162)
1162. § 1250(c). [↑](#footnote-ref-1163)
1163. § 1250(a)(1)(A). [↑](#footnote-ref-1164)
1164. § 168(c). [↑](#footnote-ref-1165)
1165. § 168(b). [↑](#footnote-ref-1166)
1166. *See* §§ 197(c) and (d)(1). [↑](#footnote-ref-1167)
1167. § 197(f)(7) and Treas. Reg. § 1.197-2(g)(8). [↑](#footnote-ref-1168)
1168. *See* Treas. Reg. § 1.197-2(g)(8). [↑](#footnote-ref-1169)
1169. § 197(c)(2). [↑](#footnote-ref-1170)
1170. *See* § 751(c) and Treas. Reg. §§ 1.751-1(c)(4)(iv), -1(c)(5). [↑](#footnote-ref-1171)
1171. § 1248(b) and Treas. Reg. § 1.1248-4. [↑](#footnote-ref-1172)
1172. § 751(c) and Treas. Reg. §§ 1.751-1(c)(4)(ix), -1(c)(5). [↑](#footnote-ref-1173)
1173. *See* § 1254(a)(1)(A)(i) and Treas. Reg. § 1.1254-1(b)(1)(i)(A). [↑](#footnote-ref-1174)
1174. *See* § 1254(a)(1)(A)(ii) and Treas. Reg. § 1.1254-1(b)(1)(i)(B). [↑](#footnote-ref-1175)
1175. *See* Treas. Reg. § 1.1254-5(b)(1). [↑](#footnote-ref-1176)
1176. *See* Treas. Reg. §§ 1.751-1(c)(4)(i) and -1(c)(5). [↑](#footnote-ref-1177)
1177. *See* Treas. Reg. §§ 1.1252-1(a), 1.751-1(c)(4)(vii), and -1(c)(5). [↑](#footnote-ref-1178)
1178. § 1252(a). [↑](#footnote-ref-1179)
1179. § 751(c) and Treas. Reg. §§ 1.751-1(c)(4)(viii), -1(c)(5). [↑](#footnote-ref-1180)
1180. § 751(c) and Treas. Reg. § 1.751-1(c)(5). [↑](#footnote-ref-1181)
1181. *See* § 1278(a)(1). [↑](#footnote-ref-1182)
1182. § 1278(a)(1)(A). [↑](#footnote-ref-1183)
1183. § 1278(a)(2). [↑](#footnote-ref-1184)
1184. § 704(c)(1)(B). [↑](#footnote-ref-1185)
1185. § 704(c)(2)(B)(i) and Treas. Reg. § 1.704-4(a). [↑](#footnote-ref-1186)
1186. Treas. Reg. § 1.704-4(b). [↑](#footnote-ref-1187)
1187. Treas. Reg. § 1.704-4(d)(1)(i). [↑](#footnote-ref-1188)
1188. § 704(c)(1)(B)(iii) and Treas. Reg. § 1.704-4(e). [↑](#footnote-ref-1189)
1189. Treas. Reg. § 1.704-3(a)(7). [↑](#footnote-ref-1190)
1190. Treas. Reg. § 1.704-4(d)(2). [↑](#footnote-ref-1191)
1191. Treas. Reg. § 1.704-4(f)(1). [↑](#footnote-ref-1192)
1192. Treas. Reg. § 1.704-4(f)(2), Ex. 2. [↑](#footnote-ref-1193)
1193. §§ 704(c)(1)(B) and 737. [↑](#footnote-ref-1194)
1194. § 737(d)(1) and Treas. Reg. § 1.737-3(d). [↑](#footnote-ref-1195)
1195. § 737(a)(1). [↑](#footnote-ref-1196)
1196. § 737(a)(2). [↑](#footnote-ref-1197)
1197. § 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). [↑](#footnote-ref-1198)
1198. Treas. Reg. § 1.737-1(b)(2). [↑](#footnote-ref-1199)
1199. *Id.* [↑](#footnote-ref-1200)
1200. Treas. Reg. § 1.737-1(e), Ex. 2. [↑](#footnote-ref-1201)
1201. § 737(d)(1) and Treas. Reg. § 1.737-2(d)(1). [↑](#footnote-ref-1202)
1202. Treas. Reg. § 1.737-3(b)(2). [↑](#footnote-ref-1203)
1203. Treas. Reg. § 1.737-1(c)(2)(iii). [↑](#footnote-ref-1204)
1204. *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). [↑](#footnote-ref-1205)
1205. 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 [↑](#footnote-ref-1206)
1206. Id. at ¶ 19.08[2][e], fn. 167. [↑](#footnote-ref-1207)
1207. Willis, Pennell, Postlewaite & Lipton, *Partnership Taxation*, Sixth Edition (Thompson Reuters, 2017), ¶ 13.02[1][a][v]. [↑](#footnote-ref-1208)
1208. § 737(a) [flush language] and Treas. Reg. § 1.737-1(d). [↑](#footnote-ref-1209)
1209. § 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. [↑](#footnote-ref-1210)
1210. § 737(c)(1) and Treas. Reg. § 1.737-3(b)(1). [↑](#footnote-ref-1211)
1211. §§ 737(c)(1), 737(e), and Treas. Reg. § 1.731-2(a). [↑](#footnote-ref-1212)
1212. Treas. Reg. § 1.731-2(g)(i)-(iii). [↑](#footnote-ref-1213)
1213. Treas. Reg. § 1.731-4(a). [↑](#footnote-ref-1214)
1214. Treas. Reg. § 1.731-4(b), Ex. 1. [↑](#footnote-ref-1215)
1215. § 707(a)(2)(B). [↑](#footnote-ref-1216)
1216. § 707(a)(2)(B)(i). [↑](#footnote-ref-1217)
1217. § 707(a)(2)(B)(ii). [↑](#footnote-ref-1218)
1218. § 707(a)(2)(B)(iii). [↑](#footnote-ref-1219)
1219. § 707(a)(2) and Treas. Reg. § 1.707-3. [↑](#footnote-ref-1220)
1220. Treas. Reg. § 1.707-3(b)(1)(i). [↑](#footnote-ref-1221)
1221. Treas. Reg. § 1.707-3(b)(1)(ii). [↑](#footnote-ref-1222)
1222. Treas. Reg. § 1.707-3(c)(1). [↑](#footnote-ref-1223)
1223. Treas. Reg. § 1.707-3(d). [↑](#footnote-ref-1224)
1224. Treas. Reg. § 1.707-3(b)(2). [↑](#footnote-ref-1225)
1225. Treas. Reg. § 1.707-6(a). [↑](#footnote-ref-1226)
1226. Treas. Reg. § 1.707-6(b)(1). [↑](#footnote-ref-1227)
1227. Treas. Reg. §§ 1.707-3(c) and 1.707-8 (requiring the filing of Form 8275). [↑](#footnote-ref-1228)
1228. Treas. Reg. § 1.707-5(b)(1). [↑](#footnote-ref-1229)
1229. *See* Treas. Reg. §§ 1.707-5(a)(7) (disguised sale to partnership) and 1.707-6(b)(1) (disguised sale by partnership). [↑](#footnote-ref-1230)
1230. The disguised sale by partnership rules treat all partnership liabilities incurred by the partnership more than two years before the transfer as qualified, even if they do not encumber partnership property. Treas. Reg. § 1.707-6(b)(2)(iii)(B). [↑](#footnote-ref-1231)
1231. Treas. Reg. § 1.707-5(a)(6)(i)(A). [↑](#footnote-ref-1232)
1232. Treas. Reg. § 1.707-5(a)(6)(i)(B). [↑](#footnote-ref-1233)
1233. Treas. Reg. § 1.707-5(a)(6)(i)(C). [↑](#footnote-ref-1234)
1234. Treas. Reg. § 1.707-5(a)(6)(i)(D). [↑](#footnote-ref-1235)
1235. T.D. 9787, T.D. 9788, and REG-122855-15 (Oct. 5, 2016). [↑](#footnote-ref-1236)
1236. REG-119305-11 (January 30, 2014). [↑](#footnote-ref-1237)
1237. *See* Treas. Reg. § 1.707-3. [↑](#footnote-ref-1238)
1238. Treas. Reg. § 1.707-5(b). [↑](#footnote-ref-1239)
1239. *Canal Corp v. Commissioner*, 135 T.C. 199 (2010). [↑](#footnote-ref-1240)
1240. Treas. Reg. § 1.752-2(j). [↑](#footnote-ref-1241)
1241. *See also* ILM 200513022. [↑](#footnote-ref-1242)
1242. Treas. Reg. § 1.752-3(a)(3). [↑](#footnote-ref-1243)
1243. T.D. 9788 (including two correcting amendments, 81 Fed. Reg. 80993 and 81 Fed. Reg. 80994). [↑](#footnote-ref-1244)
1244. T.D. 9787 (including a correction, 81 Fed. Reg. 80587). [↑](#footnote-ref-1245)
1245. Treas. Reg. § 1.707-5T(a)(2). [↑](#footnote-ref-1246)
1246. *See* § 1.752-3(a)(3) of the 2014 Proposed Regulations. [↑](#footnote-ref-1247)
1247. Treas. Reg. § 1.752-3(a)(3). [↑](#footnote-ref-1248)
1248. REG-12855-15. [↑](#footnote-ref-1249)
1249. Treas. Reg. § 1.707-5(a)(6)(i)(E). [↑](#footnote-ref-1250)
1250. *See* Treas. Reg. § 1.707-4(d). [↑](#footnote-ref-1251)
1251. T.D. 9876, 84 Fed. Reg. 54027 (Oct. 9, 2019). [↑](#footnote-ref-1252)
1252. REG-131186-17, 83 Fed. Reg. 28397 (Jun. 19, 2018). [↑](#footnote-ref-1253)
1253. As determined under Treas. Reg. § 1.752–1(a)(1). [↑](#footnote-ref-1254)
1254. As determined under Treas. Reg. § 1.752–3(a)(3). [↑](#footnote-ref-1255)
1255. As determined under Treas. Reg. § 1.752–1(a)(2). [↑](#footnote-ref-1256)
1256. *See* Treas. Reg. § 1.752–3(a)(3). [↑](#footnote-ref-1257)
1257. *See* Notice 2017-18, 2017-31 I.R.B. 147 (Jul 24, 2017) and Second Report to the President on Identifying and Reducing Tax Regulatory Burdens, 82 Fed. Reg. 48013 (Oct. 16, 2017). [↑](#footnote-ref-1258)
1258. § 731(c). [↑](#footnote-ref-1259)
1259. § 731(c)(2)(A) and (C). [↑](#footnote-ref-1260)
1260. § 731(c)(2)(B)(ii). [↑](#footnote-ref-1261)
1261. § 731(c)(2)(B)(iii). [↑](#footnote-ref-1262)
1262. § 731(c)(3)(A) and Treas. Reg. § 1.731-2(d)(1). [↑](#footnote-ref-1263)
1263. § 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. [↑](#footnote-ref-1264)
1264. §§ 731(c)(3)(C)(i) and 731(c)(3)(A)(iii). [↑](#footnote-ref-1265)
1265. § 731(c)(3)(C)(i). [↑](#footnote-ref-1266)
1266. § 731(c)(3)(C)(i)(I) through (VIII). [↑](#footnote-ref-1267)
1267. § 731(c)(3)(C)(ii)(I) and Treas. Reg. § 1.731-2(e)(3)(i). [↑](#footnote-ref-1268)
1268. § 731(c)(3)(C)(iii)(I). [↑](#footnote-ref-1269)
1269. § 731(c)(3)(B) and Treas. Reg. § 1.731-2(a) and (j), Ex. 1. [↑](#footnote-ref-1270)
1270. § 731(c)(3)(B)(i) and (ii). [↑](#footnote-ref-1271)
1271. PS-2-95, 61 Fed. Reg. 28 (Jan. 2, 1996). [↑](#footnote-ref-1272)
1272. § 731(b). [↑](#footnote-ref-1273)
1273. § 731(c)(4)(A) and Treas. Reg. § 1.731-2(f)(1)(i). [↑](#footnote-ref-1274)
1274. § 731(c)(5) and Treas. Reg. § 1.731-2(f)(1)(ii). [↑](#footnote-ref-1275)
1275. § 731(c)(5) and Treas. Reg. § 1.731-2(f)(2). [↑](#footnote-ref-1276)
1276. Treas. Reg. § 1.731-2(j), Ex. 6(iv). [↑](#footnote-ref-1277)
1277. § 731(a)(1) and Treas. Reg. § 1.731-2(f)(1)(ii), (j), Ex. 5. [↑](#footnote-ref-1278)
1278. Treas. Reg. § 1.731-2(h). [↑](#footnote-ref-1279)
1279. *Id.* [↑](#footnote-ref-1280)
1280. § 732(a). [↑](#footnote-ref-1281)
1281. § 732(b). [↑](#footnote-ref-1282)
1282. TAM 8350006. [↑](#footnote-ref-1283)
1283. Treas. Reg. § 1.752-1(a)(1). [↑](#footnote-ref-1284)
1284. Treas. Reg. § 1.752-1(a)(2). [↑](#footnote-ref-1285)
1285. Treas. Reg. § 1.752-2(b). [↑](#footnote-ref-1286)
1286. Treas. Reg. § 1.752-2(b)(3)(i). [↑](#footnote-ref-1287)
1287. Treas. Reg. § 1.752-2(b)(3)(ii). [↑](#footnote-ref-1288)
1288. Treas. Reg. § 1.752-2(b)(3)(iii). [↑](#footnote-ref-1289)
1289. Treas. Reg. § 1.752-2(b)(5). [↑](#footnote-ref-1290)
1290. Treas. Reg. § 1.752-2(b)(6). [↑](#footnote-ref-1291)
1291. Treas. Reg. § 1.752-2(b)(4). [↑](#footnote-ref-1292)
1292. § 722 and Treas. Reg. § 1.752-1(b). [↑](#footnote-ref-1293)
1293. §§ 733, 731(a), 751 and Treas. Reg. § 1.752-1(c). [↑](#footnote-ref-1294)
1294. Treas. Reg. § 1.752-1(e). [↑](#footnote-ref-1295)
1295. Treas. Reg. § 1.752-4(b)(1). [↑](#footnote-ref-1296)
1296. Treas. Reg. § 1.752-4(b)(2)(iii). [↑](#footnote-ref-1297)
1297. Treas. Reg. § 1.752-4(b)(2)(iv)(A). [↑](#footnote-ref-1298)
1298. Treas. Reg. § 1.752-4(b)(2)(iv)(B)(1) [↑](#footnote-ref-1299)
1299. Treas. Reg. § 1.752-4(b)(2)(iv)(B)(2). [↑](#footnote-ref-1300)
1300. Treas. Reg. § 1.752-4(b)(2)(iv)(B)(3). [↑](#footnote-ref-1301)
1301. Treas. Reg. § 1.752-4(b)(2)(iv)(B)(4). [↑](#footnote-ref-1302)
1302. *See* Treas. Reg. § 1.704-2(b)(4). [↑](#footnote-ref-1303)
1303. Treas. Reg. § 1.752-2(c)(1). [↑](#footnote-ref-1304)
1304. Treas. Reg. § 1.752-2(h)(1). [↑](#footnote-ref-1305)
1305. Treas. Reg. § 1.752-2(h)(2). [↑](#footnote-ref-1306)
1306. *Id.* [↑](#footnote-ref-1307)
1307. Treas. Reg. § 1.752-2(j)(1). [↑](#footnote-ref-1308)
1308. Treas. Reg. § 1.752-2(j)(2). *See* CCA 200246014 (a guarantee was disregarded due to a number of facts including sever undercapitalization and the provisions of the guarantee set forth many waivers and defenses for the benefit of the purported guarantor). [↑](#footnote-ref-1309)
1309. Treas. Reg. § 1.752-2(j)(3). An example is provided that involved a general partnership, minimally capitalized corporation as a partner and a deficit capital account restoration obligation. The obligations of the corporate partner and the capital account restoration obligation are ignored for purposes of Section 752. [↑](#footnote-ref-1310)
1310. Sometimes referred to as the sum of tier one, tier two, and tier three allocations. [↑](#footnote-ref-1311)
1311. Treas. Reg. § 1.752-2(d)(1). [↑](#footnote-ref-1312)
1312. Treas. Reg. § 1.752-3(a)(1). [↑](#footnote-ref-1313)
1313. Treas. Reg. § 1.752-3(a)(2). [↑](#footnote-ref-1314)
1314. Treas. Reg. § 1.752-3(a)(3). [↑](#footnote-ref-1315)
1315. *Id.* [↑](#footnote-ref-1316)
1316. As defined under section 1.704-3(a)(3)(ii) of the Treasury Regulations. [↑](#footnote-ref-1317)
1317. As described in section 1.704-3(a)(6)(i) of the Treasury Regulations. [↑](#footnote-ref-1318)
1318. Treas. Reg. § 1.707-5T(a)(2)(i) and (f), *Ex. 2*, and T.D. 9788. [↑](#footnote-ref-1319)
1319. Treas. Reg. § 1.707-5T(a)(2)(ii) and T.D. 9788. [↑](#footnote-ref-1320)
1320. Treas. Reg. § 1.752-3(a)(3) and T.D. 9787. [↑](#footnote-ref-1321)
1321. § 1.752-2(b)(3) of the 2014 Proposed Regulations. [↑](#footnote-ref-1322)
1322. Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(A)-(G) of the 2014 Proposed Regulations. [↑](#footnote-ref-1323)
1323. § 1.752-2(b)(3)(iii) of the 2014 Proposed Regulations. [↑](#footnote-ref-1324)
1324. REG-122855-15 (October 5, 2016). [↑](#footnote-ref-1325)
1325. T.D. 9877, 85 Fed. Reg. 54014 (Oct. 9, 2019). [↑](#footnote-ref-1326)
1326. Treas. Reg. § 1.752-2(b)(3)(i). [↑](#footnote-ref-1327)
1327. Treas. Reg. § 1.752-2(b)(3)(ii)(A). [↑](#footnote-ref-1328)
1328. Treas. Reg. § 1.752-2(b)(3)(ii)(C)(1). [↑](#footnote-ref-1329)
1329. As described in, and taking into account, Treas. Reg. §§ 1.704-1(b)(2)(ii)(b)(3) and 1.704-1(b)(2)(ii)(c). [↑](#footnote-ref-1330)
1330. Treas. Reg. § 1.752-2(b)(3)(ii)(C)(2). [↑](#footnote-ref-1331)
1331. Treas. Reg. § 1.752-2 (f)(10), Ex. 10. [↑](#footnote-ref-1332)
1332. Treas. Reg. § 1.752-2(b)(3)(ii)(B). [↑](#footnote-ref-1333)
1333. Treas. Reg. § 1.752-2(b)(3)(ii)(D). [↑](#footnote-ref-1334)
1334. Treas. Reg. § 1.752-2(j)(3)(i). [↑](#footnote-ref-1335)
1335. Treas. Reg. § 1.752-2(j)(3)(ii). [↑](#footnote-ref-1336)
1336. For example, termination prior to the due date of a balloon payment or a right to terminate that can be exercised because the value of loan collateral decreases. Treas. Reg. § 1.752-2(j)(3)(ii)(C). [↑](#footnote-ref-1337)
1337. Treas. Reg. § 1.752-2(j)(4). [↑](#footnote-ref-1338)
1338. Treas. Reg. § 1.752-2(k)(1). [↑](#footnote-ref-1339)
1339. *Id.* [↑](#footnote-ref-1340)
1340. *Id.* [↑](#footnote-ref-1341)
1341. *E.g.*, § 675(4)(C) power. [↑](#footnote-ref-1342)
1342. *E.g.*, § 674(c) power. [↑](#footnote-ref-1343)
1343. *See* § 675(c). [↑](#footnote-ref-1344)
1344. Rev. Rul. 77-401, 1977-2 C.B. 215. [↑](#footnote-ref-1345)
1345. Treas. Reg. § 1.1007-2(c), Ex. 5. *See also* TAM 200011005. [↑](#footnote-ref-1346)
1346. This assumes that the transfer is not considered a part sale/part gift transfer. Gain, possibly ordinary income under section 751(a) of the Code, but not loss, may be recognized with a part sale/part gift, but only when the sale price exceeds the outside basis of the partnership interest. *See* § 751(a) and Rev. Rul. 60-351, 1960-2 C.B. 169 (gift accelerated gain on an installment obligation). The sale price would be deemed to include any partnership liabilities deemed to have been transferred. *See* § 752(d), Rev. Rul. 77-402, 1977-2 C.B. 222 (grantor trust converting to a taxable trust), and *Madorin v. Commissioner*, 84 T.C. 667 (1985). [↑](#footnote-ref-1347)
1347. § 1015(d). [↑](#footnote-ref-1348)
1348. § 1015(a). [↑](#footnote-ref-1349)
1349. Rev. Rul. 84-53, 1984-1 C.B. 159. [↑](#footnote-ref-1350)
1350. *Id.* The ruling relies on Treasury Regulation § 1.61-6(a) which provides that when a part of a larger property is sold, the basis of the entire property shall be equitably apportioned among the several parts for purposes of determining gain or loss on the part sold. [↑](#footnote-ref-1351)
1351. *See* Ellen K. Harrison and Brian M. Blum, *Another View: A Response to Richard Robinson’s “’Don’t Nothing Last Forever’--Unwinding the FLP to the Haunting Melodies of Subchapter K,”* 28 ACTEC J. 313 (2003). In support of their assertion, the authors cite Treasury Regulation section 1.743-1(f) that states, “in the case of the gift of an interest in a partnership, the donor is treated as transferring and the donee is treated as receiving, that portion of the [section 743] basis adjustment attributable to the gifted partnership interest.” *But see* Richard B. Robinson, *Comments on Blum’s and Harrison’s “Another View,”* 28 ACTEC J. 318 (2003). [↑](#footnote-ref-1352)
1352. Situation 2 in the ruling involved a transfer by A of one half of A’s general partnership interest and Situation 3 in the ruling involved a transfer by A of A’s limited partner interest. Both transfers involved a sale of 1/3 of A’s economic interest in the partnership and both were valued at $10x. Moreover, the ruling misquotes Treas. Reg. § 1.61-6(a) on which it relies. The regulation does not provide that “the basis of the transferred portion of the interest generally equals an amount which bears the same relation to the partner’s basis in the partner’s entire interest as the fair market value of the transferred portion of the interest bears to the fair market of the entire interest.” The regulation says that “when a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts…” [↑](#footnote-ref-1353)
1353. § 1001(a). [↑](#footnote-ref-1354)
1354. § 1001(b). [↑](#footnote-ref-1355)
1355. *See* §§ 2031, 2512 and 2642 [↑](#footnote-ref-1356)
1356. *See* Richard B. Robinson, *Comments on Blum’s and Harrison’s “Another View,”* 28 ACTEC J. 318 (2003) where he correctly points out that “The term ‘equitably apportioned’ has been consistently interpreted to mean ‘divided according to the fair market value of the separate parts.’” [↑](#footnote-ref-1357)
1357. While not applicable under these facts, if the purchaser had to make a purchase price allocation under section 1060 of the Code (to determine tax liability of the seller and to determine the new basis of the purchased business assets), the Code mandates that the price allocated to an asset may not be more than the fair market value (willing buyer/willing seller) of such asset. [↑](#footnote-ref-1358)
1358. The same result could be achieved if the donor transfers the interest to the donor’s spouse although in that case the basis adjustment would occur, of course, on the spouse’s death rather than the death of the grantor. *See* § 1041(b). [↑](#footnote-ref-1359)
1359. § 701. *See also* Treas. Reg. § 1.701-1. [↑](#footnote-ref-1360)
1360. *See U.S. v. Basye*, 410 U.S. 441 (1973). [↑](#footnote-ref-1361)
1361. § 702(a). [↑](#footnote-ref-1362)
1362. § 702(a)(7). [↑](#footnote-ref-1363)
1363. See Treas. Reg. 1.702-1(a)(8). [↑](#footnote-ref-1364)
1364. § 704(a). [↑](#footnote-ref-1365)
1365. § 704(b). [↑](#footnote-ref-1366)
1366. § 704(b)(1). [↑](#footnote-ref-1367)
1367. § 704(b)(2). [↑](#footnote-ref-1368)
1368. Treas. Reg. § 1.704-1(b)(2)(i). [↑](#footnote-ref-1369)
1369. Treas. Reg. § 1.704-1(b)(2)(ii)(*a*). [↑](#footnote-ref-1370)
1370. Treas. Reg. § 1.704-1(b)(2)(iii). [↑](#footnote-ref-1371)
1371. Treas. Reg. § 1.704-1(b)(2)(ii)(*b*). In addition, allocations that are attributable to property secured by nonrecourse debt required to comply with additional requirements. [↑](#footnote-ref-1372)
1372. *See* Treas. Reg. § 1.704-1(b)(2)(ii)(*d*). Generally, if a partner unexpectedly receives certain adjustments, allocations, or distributions (relating to depletion allowances, changes in the partner’s interest in the partnership, a partnership loss related to section 751(b) property, or adjustments under the family partnership rules of section 704(e)(2) of the Code) and it causes a deficit capital account balance for the partnership, a qualified income offset provision will allocate as quickly as possible items of income and gain in an amount and manner sufficient to eliminate that deficit capital account balance. [↑](#footnote-ref-1373)
1373. *See* Treas. Reg. § 1.704-1(b)(2)(ii)(*i*). [↑](#footnote-ref-1374)
1374. *See* Treas. Reg. § 1.704-1(b)(2)(ii)(h)*(i)* and Proposed Treasury Regulations under section 707(a)(2)(A) of the Code, REG-11452-14, 80 Fed. Reg. 43,652 (July 23, 2015). The preamble requests comments on the impact of targeted allocations on certain allocations but then provides “[n]o inference is intended as to whether and when targeted capital account agreements could satisfy the economic effect equivalence rule.” [↑](#footnote-ref-1375)
1375. Treas. Reg. § 1.704-1(b)(3)(i). [↑](#footnote-ref-1376)
1376. Treas. Reg. § 1.704-1(b)(3)(ii). [↑](#footnote-ref-1377)
1377. Treas. Reg. § 25.2701-1(c)(3). [↑](#footnote-ref-1378)
1378. § 706(d)(1). [↑](#footnote-ref-1379)
1379. Treas. Reg. 1.706-4(b)(1). See § 761(c) allowing amendments to a partnership agreement after the close of the taxable year. [↑](#footnote-ref-1380)
1380. *See* Treas. Reg. §§ 1.706-4(a)(3) and (a)(4). [↑](#footnote-ref-1381)
1381. *See* Treas. Reg. § 1.706-4(f). [↑](#footnote-ref-1382)
1382. Treas. Reg. § 1.706-4(e)(2). [↑](#footnote-ref-1383)
1383. *See* Treas. Reg. § 1.706-4(e)(2)(ix). [↑](#footnote-ref-1384)
1384. *See* REG-109370-10, 80 Fed. Reg. 45,905 (Aug. 3, 2015) [↑](#footnote-ref-1385)
1385. Treas. Reg. § 1.706-1(c)(5). [↑](#footnote-ref-1386)
1386. § 704(e)(1). [↑](#footnote-ref-1387)
1387. Treas. Reg. § 1.704-1(e)(3)(i)(b). [↑](#footnote-ref-1388)
1388. Treas. Reg. § 1.707-4(a)(2). [↑](#footnote-ref-1389)
1389. § 704(e)(2). [↑](#footnote-ref-1390)
1390. *Id.* [↑](#footnote-ref-1391)
1391. Treas. Reg. § 1.704-1(e)(2)(i). [↑](#footnote-ref-1392)
1392. *Pflugradt v. U.S.*, 310 F.2d 412 (7th Cir. 1962). [↑](#footnote-ref-1393)
1393. Treas. Reg. § 1.704-1(e)(2)(ii). [↑](#footnote-ref-1394)
1394. Treas. Reg. § 1.704-1(e)(2)(ii)(a) through (d). [↑](#footnote-ref-1395)
1395. § 761(b). [↑](#footnote-ref-1396)
1396. Treas. Reg. 1.704-1(e)(1)(iv). *See also* Ketter v. Commissioner, 70 T.C. 637 (1978). [↑](#footnote-ref-1397)
1397. Treas. Reg. 1.704-1(e)(1)(v). [↑](#footnote-ref-1398)
1398. Treas. Reg. 1.704-1(e)(2)(vii). [↑](#footnote-ref-1399)
1399. *Id.* [↑](#footnote-ref-1400)
1400. *Id.* [↑](#footnote-ref-1401)
1401. *Ginsberg v. Commissioner*, 502 F.2d 965, 966 (6th Cir. 1974). [↑](#footnote-ref-1402)
1402. Treas. Reg. § 1.704-1(b)(2)(iv)(*b*). [↑](#footnote-ref-1403)
1403. *Id.* [↑](#footnote-ref-1404)
1404. Treas. Reg. § 1.704-1(b)(2)(iv)(*f*)(*1*) and (*2*). [↑](#footnote-ref-1405)
1405. Treas. Reg. § 1.704-1(b)(2)(iv)(*f*)(*5*). [↑](#footnote-ref-1406)
1406. Treas. Reg. § 1.704-1(b)(2)(iv)(*b*). [↑](#footnote-ref-1407)
1407. *See* Rev. Rul. 85-13, 1985-1 C.B. 184. [↑](#footnote-ref-1408)
1408. Treas. Reg. §§ 1.704-1(b)(2)(iv)(*l*) and 1.704-1(b)(5), ex. 13. [↑](#footnote-ref-1409)
1409. Treas. Reg. § 1.704-1(b)(5), Ex. 13. [↑](#footnote-ref-1410)
1410. *Id.* [↑](#footnote-ref-1411)
1411. Rev. Rul. 84-53, 1984-1 C.B. 159. [↑](#footnote-ref-1412)
1412. *See* CCA 201442053. *See also*, Richard Dees, *Is Chief Counsel Resurrecting the Chapter 14 “Monster,”* 145 Tax Notes 1279 (Dec. 15, 2014). [↑](#footnote-ref-1413)
1413. Treas. Reg. § 1.704-1(e)(1)(v). [↑](#footnote-ref-1414)
1414. For an excellent discussion of the complexities of identifying a partner’s interest in profits and capital, *see* Sheldon I. Banoff, *Identifying Partners’ Interests in Profits and Capital: Uncertainties, Opportunities and Traps*, 85 Taxes-The Tax Magazine 197 (March 2007). [↑](#footnote-ref-1415)
1415. Sheldon I. Banoff, *Partnership Ownership Realignments via Partnership Reallocations, Legal Status Changes, Recapitalization and Conversions: What Are the Tax Consequences?*, 83 Taxes-The Tax Magazine 105 (March 2005). [↑](#footnote-ref-1416)
1416. Treas. Reg. § 25.2512.8. [↑](#footnote-ref-1417)
1417. *See* *Cavallaro v. Commissioner*, T.C. Memo 2014-189, *Harwood v. Commissioner*, 82 T.C. 238 (1984), *aff’d*, 786 F.2d 1174 (9th Cir. 1986) and *Estate of Reynolds v. Commissioner*, 55 T.C. 172 (1970). [↑](#footnote-ref-1418)
1418. Treas. Reg. § 25.2511-1(h)(1). Also, if a shareholder makes a transfer to a corporation for less than full and adequate consideration, then the contributing shareholder is treated as having made a gift to the other shareholders. [↑](#footnote-ref-1419)
1419. *Estate of Mary D. Maggos v. Commissioner*, T.C. Memo 2000-129. *See also*, *Kincaid v. U.S.*, 682 F.2d 1220 (1982) (deemed gift upon contribution of ranchland to a corporation for less valuable non-voting stock when there was no business reason for such contribution), *Senda v. Commissioner*, T.C. Memo 2004-160 (contribution of stock to family limited partnership and transfers of the interests were deemed gifts of the underlying stock), and *Trenchard v. Commissioner*, T.C. Memo 1995-121 (taxpayer’s excess contributions to a corporation, not in the ordinary course of business, deemed a gift). [↑](#footnote-ref-1420)
1420. Treas. Reg. § 1.704-1(b)(2)(ii)(*b*)(*2*). [↑](#footnote-ref-1421)
1421. Treas. Reg. § 1.704-1(b)(2)(ii)(*b*) [last paragraph]. [↑](#footnote-ref-1422)
1422. “The fair market value of the distributed section 704(c) property is the price at which the property would change hands between a willing buyer and a willing seller at the time of the distribution, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. The fair market value that a partnership assigns to distributed section 704(c) property will be regarded as correct, provided that the value is reasonably agreed to among the partners in an arm's-length negotiation and the partners have sufficiently adverse interests.” Treas. Reg. § 1.704-4(a)(3). [↑](#footnote-ref-1423)
1423. § 731(a)(1). [↑](#footnote-ref-1424)
1424. 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. [↑](#footnote-ref-1425)
1425. § 754 and Treas. Reg. § 1.754-1(a). An election may be revoked if there exists: (i) a change in the nature of the partnership business; (ii) a substantial increase in or a change in the character of the partnership's assets; and (iii) an increase in the frequency of partner retirements or shifts in partnership interests (resulting in increased administrative costs attributable to the § 754 election). Treas. Reg. § 1.754-1(c)(1). [↑](#footnote-ref-1426)
1426. § 734(b)(1). [↑](#footnote-ref-1427)
1427. § 734(b)(2). [↑](#footnote-ref-1428)
1428. Treas. Reg. § 1.743-1(d)(1). [↑](#footnote-ref-1429)
1429. Treas. Reg. § 1.743-1(d)(1)(i)-(iii). [↑](#footnote-ref-1430)
1430. Treas. Reg. § 1.743-1(d)(2). [↑](#footnote-ref-1431)
1431. Treas. Reg. § 1.704-1(b)(2)(iv)(m). [↑](#footnote-ref-1432)
1432. 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). [↑](#footnote-ref-1433)
1433. Treas. Reg. § 1.743-1(j)(3). [↑](#footnote-ref-1434)
1434. Treas. Reg. § 1.743-1(j)(4). [↑](#footnote-ref-1435)
1435. § 734(b)(1) and (2). [↑](#footnote-ref-1436)
1436. § 743(b) (flush language). [↑](#footnote-ref-1437)
1437. Treas. Reg. § 1.704-1(b)(2)(iv)(*m*)(*2*). [↑](#footnote-ref-1438)
1438. Treas. Reg. § 1.704-1(b)(2)(iv)(*m*)(*4*) and (*5*). [↑](#footnote-ref-1439)
1439. § 734(b)(1)(A). [↑](#footnote-ref-1440)
1440. § 732(a)(1) and (2). [↑](#footnote-ref-1441)
1441. § 734(b)(1)(B) [↑](#footnote-ref-1442)
1442. § 734(b)(1)(A) and (2)(A). [↑](#footnote-ref-1443)
1443. § 732(b) and Treas. Reg. § 1.732-1(b). [↑](#footnote-ref-1444)
1444. Certain limitations apply to section 751 assets. *See* § 732(c)(1)(A) and § Treas. Reg. 1.732(c)(1)(i). [↑](#footnote-ref-1445)
1445. § 734(a), (b), and (d). [↑](#footnote-ref-1446)
1446. Treas. Reg. § 1.755-1(a). [↑](#footnote-ref-1447)
1447. *Id.* [↑](#footnote-ref-1448)
1448. Treas. Reg. §1.755-1(b)(1)(ii). [↑](#footnote-ref-1449)
1449. *See* Treas. Reg. § 1.755-1(b)(3)(ii). [↑](#footnote-ref-1450)
1450. Treas. Reg. § 1.755-1(c)(1)(ii). [↑](#footnote-ref-1451)
1451. Treas. Reg. § 1.755-1(c)(1)(i). [↑](#footnote-ref-1452)
1452. Treas. Reg. § 1.755-1(c)(4). [↑](#footnote-ref-1453)
1453. Treas. Reg. § 1.755-1(c)(2)(i). [↑](#footnote-ref-1454)
1454. Treas. Reg. § 1.755-1(c)(2)(ii). [↑](#footnote-ref-1455)
1455. Treas. Reg. § 1.755-1(c)(3). [↑](#footnote-ref-1456)
1456. § 734(a)(1). [↑](#footnote-ref-1457)
1457. §§ 734(d) and 734(b)(2). [↑](#footnote-ref-1458)
1458. § 743(d)(1)(A). [↑](#footnote-ref-1459)
1459. § 743(d)(1)(B). [↑](#footnote-ref-1460)
1460. Cassady V. Brewer, *Coming Together and Breaking Apart: Planning and Pitfalls in Partnership Mergers and Divisions*, 43rd Annual Southern Federal Tax Institute (2008), Outline F, F-13. [↑](#footnote-ref-1461)
1461. § 2701. [↑](#footnote-ref-1462)
1462. § 2701(e)(5). [↑](#footnote-ref-1463)
1463. Treas. Reg. § 25.2701-1(c)(4). [↑](#footnote-ref-1464)
1464. *Id.* [↑](#footnote-ref-1465)
1465. § 2701(a)(2)(B). [↑](#footnote-ref-1466)
1466. § 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). [↑](#footnote-ref-1467)
1467. T.D. 8925, 66 Fed. Reg. 715 (Jan. 4, 2001). [↑](#footnote-ref-1468)
1468. *See* Treas. Reg. § 1.708-1(d)(3). [↑](#footnote-ref-1469)
1469. 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. [↑](#footnote-ref-1470)
1470. §§ 704(c)(1)(B), 737 and Treas. Reg. §§ 1.704-4(c)(4), 1.737-2(b)(2). [↑](#footnote-ref-1471)
1471. T.D. 8925, 66 Fed. Reg. 715 (1/4/01). Non-pro rata divisions are still being reviewed. [↑](#footnote-ref-1472)
1472. Treas. Reg. § 1.708-1(d)(4)(iv) [↑](#footnote-ref-1473)
1473. Treas. Reg. § 1.708-1(d)(1). [↑](#footnote-ref-1474)
1474. Treas. Reg. § 1.708-1(d)(2)(ii). [↑](#footnote-ref-1475)
1475. *See* PLR 9015016 (seven continuing partnerships with same owners in the same proportions). [↑](#footnote-ref-1476)
1476. 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. [↑](#footnote-ref-1477)
1477. *See* Elliott Manning and Jerome M. Hesch, *Sale or Exchange of Business Assets: Economic Performance, Contingent Liabilities and Nonrecourse Liabilities (Part Four)*, 11 Tax Mgmt. Real Est. J. 263, 272 (1995). [↑](#footnote-ref-1478)
1478. Treas. Reg. § 1.742-1. [↑](#footnote-ref-1479)
1479. §§ 1014(c), 691(a)(1), Treas. Reg. § 1.691(a)(1)-1(b), and *Woodhall v. Commissioner*, 454 F.2d 226 (9th Cir. 1972). [↑](#footnote-ref-1480)
1480. Rev. Rul. 79-124, 1979-1 C.B. 224. [↑](#footnote-ref-1481)
1481. Rev. Rul. 79-84, 1979-1 C.B. 223 (partnership interest owned by grantor trust). [↑](#footnote-ref-1482)
1482. § 743(b). [↑](#footnote-ref-1483)
1483. *See* IRS Notice 2005-32, 2005-1 C.B. 895. [↑](#footnote-ref-1484)
1484. Treas. Reg. § 1.732-1(d)(1)(iii). [↑](#footnote-ref-1485)
1485. Treas. Reg. § 1.732-1(d)(2). [↑](#footnote-ref-1486)
1486. Treas. Reg. §§ 1.732-1(d)(1)(vi), 1.743-1(g)(1) and (5), Ex. (ii). [↑](#footnote-ref-1487)
1487. Treas. Reg. §§ 1.743-1(g)(2) and (5), Ex. (iv). [↑](#footnote-ref-1488)
1488. § 708(b)(1)(A). [↑](#footnote-ref-1489)
1489. § 708(b)(1)(B). [↑](#footnote-ref-1490)
1490. *See e.g.,* §§ 708(a), 706(c)(1), 168(i)(7), and Treas. Reg. § 1.708-1(b)(3). [↑](#footnote-ref-1491)
1491. § 13504 of TCJA. [↑](#footnote-ref-1492)
1492. *See* § 708(a). [↑](#footnote-ref-1493)
1493. *See* *Baker Commodities v. Commissioner*, 415 F.2d 519 (9th Cir. 1969), and *Foxman v. Commissioner*, 41 T.C. 535 (1964), *aff’d*, 392 F.2d 466 (3rd Cir. 1965). [↑](#footnote-ref-1494)
1494. § 731(a)-(b) and Treas. Reg. § 1.731-1(a)-(b). This assumes the property distributed is not a “hot asset” under section 751 of the Code. [↑](#footnote-ref-1495)
1495. § 731(c). [↑](#footnote-ref-1496)
1496. §§ 731(c)(3)(C)(i) and 731(c)(3)(A)(iii). [↑](#footnote-ref-1497)
1497. § 731(c)(3)(C)(i). [↑](#footnote-ref-1498)
1498. § 731(c)(3)(C)(i)(I) through (VIII). [↑](#footnote-ref-1499)
1499. § 731(c)(3)(C)(iii)(I). [↑](#footnote-ref-1500)
1500. *See* Treas. Reg. § 1.752-2(b). [↑](#footnote-ref-1501)
1501. The contribution would have been a non-taxable event under section 721(a) of the Code even though the FLP would have constituted an investment company under sections 721(b) and 351(e) of the Code. The contributions of Stock A did not result in any diversification. Treas. Reg. §§ 1.351-1(c)(1)(i) and 1.351(1)(c)(5). [↑](#footnote-ref-1502)
1502. § 734(b)(1)(B). [↑](#footnote-ref-1503)
1503. In this example, the G1 partners bear the economic risk of loss and the partnership liability is recourse to the G1 partners. As a result, the outside bases of the G1 partners are increased by the total liability under section 752(a) of the Code. If, in contrast, the partnership liabilities were considered nonrecourse liabilities and all of the partners had their outside bases increased by a proportionate amount of the liability, you would get the same result (the ETF in the hands of the G2 partners has a basis of zero) because the interests of the partners are fully liquidated. As a result, when the G2 partners exit the partnership and they are no longer share any of the partnership liabilities, there is a deemed distribution of money under section 752(b) of the Code, reducing their outside bases to zero, which is then followed by a distribution of the ETF with an inside basis of $90 million. [↑](#footnote-ref-1504)
1504. § 707(a)(2)(B)(ii). [↑](#footnote-ref-1505)
1505. § 707(a)(2)(B)(iii). [↑](#footnote-ref-1506)
1506. § 704(c)(1)(B). [↑](#footnote-ref-1507)
1507. Treas. Reg. § 1.704-3(a)(7). [↑](#footnote-ref-1508)
1508. Treas. Reg. § 1.704-4(d)(2). [↑](#footnote-ref-1509)
1509. §§ 704(c)(1)(B) and 737. [↑](#footnote-ref-1510)
1510. § 737(a)(1). [↑](#footnote-ref-1511)
1511. § 737(a)(2). [↑](#footnote-ref-1512)
1512. § 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). [↑](#footnote-ref-1513)
1513. PLR 201633021. [↑](#footnote-ref-1514)
1514. § 511. [↑](#footnote-ref-1515)
1515. § 4958. [↑](#footnote-ref-1516)
1516. § 4941 [↑](#footnote-ref-1517)
1517. § 4943. [↑](#footnote-ref-1518)
1518. § 741. [↑](#footnote-ref-1519)
1519. § 170(e)(1)(A). [↑](#footnote-ref-1520)
1520. Treas. Reg. § 1.1223-3. [↑](#footnote-ref-1521)
1521. § 170(e)(1)(B). [↑](#footnote-ref-1522)
1522. § 170(e)(1)(B)(ii) [↑](#footnote-ref-1523)
1523. *See* § 170(b)(1)(C). [↑](#footnote-ref-1524)
1524. *See* § 170(b)(1)(A). [↑](#footnote-ref-1525)
1525. § 170(b)(1)(C)(i). [↑](#footnote-ref-1526)
1526. § 170(b(1)(C)(iii). [↑](#footnote-ref-1527)
1527. Treas. Reg. § 1.1001-1(e), *Diedrich v. Commissioner*, 457 U.S. 191 (1982), *aff’d* 643 F.2d 499 (8th Cir. 1981), *rev’g* T.C. Memo 1979-441, 29 T.C.M 433 (gain recognized with a net gift where gift tax paid by the donees exceeded the basis of property transferred), *Estate of Levine v. Commissioner*, 72 T.C. 780 (1979), *aff’d*, 634 F.2d 12 (2d Cir. 1980) (gain realized on net gift of encumbered property). [↑](#footnote-ref-1528)
1528. *See* Rev. Rul. 64-102, 1984-2 C.B. 119 (shift of liability upon the admission of a new partner resulting in income to the partners under Section 751(b) of the Code). [↑](#footnote-ref-1529)
1529. *See* Tennyson v. United States, 76-1 USTC ¶9264 (W.D. Ark. 1976) and Rev. Rul. 60-352, 1960-2 C.B. 208 (gift of interest in partnership holding an installment receivable is a disposition of the receivable accelerating the gain). [↑](#footnote-ref-1530)
1530. Assuming the charitable entity is a public charity and the partnership does not have any “hot asset” under section 751 of the Code, the taxpayer will receive a $50 income tax deduction. *See* § 170(e)(1)(A). [↑](#footnote-ref-1531)
1531. Treas. Reg. §§ 1.704-1(b)(2)(iv)(l) and 1.704-1(b)(5), Ex. 13. [↑](#footnote-ref-1532)
1532. § 721(b) provides gain is realized on the contribution of property to a partnership if the partnership would be treated as an “investment company” under § 351(e). Section 351(e) of the Code and the Treasury Regulations provide that any contributions will be deemed to be a transfer to an investment company if the transfer results, directly or indirectly, in diversification of the transferor’s interests, and the transferee is, in pertinent part, a corporation more than 80 percent of the value of whose assets are held for investment and are stocks or securities, or interests in regulated investment companies, or real estate investment trusts. [↑](#footnote-ref-1533)
1533. *See* Treas. Reg. § 1.170A-13. [↑](#footnote-ref-1534)
1534. 2001 Exempt Organizations Continuing Professional Education, Chapter G: Control and Power: Issues Involving Supporting Organizations, Donor Advised Funds and Disqualified Person Financial Institutions, p. 128 (hereinafter, 2001 EO CPE). [↑](#footnote-ref-1535)
1535. 2001 EO CPE, p. 128. [↑](#footnote-ref-1536)
1536. § 741. [↑](#footnote-ref-1537)
1537. § 742. [↑](#footnote-ref-1538)
1538. Treas. Reg. § 1.704-1(b)(2)(iv). [↑](#footnote-ref-1539)
1539. Treas. Reg. § 1.704-3(a)(7). [↑](#footnote-ref-1540)
1540. § 741. [↑](#footnote-ref-1541)
1541. Treas. Reg. § 1.751-1(a)(2). [↑](#footnote-ref-1542)
1542. § 1(h)(5)(B), (h)(9), (h)(10) and Treas. Reg. § 1.1(h)-1(a). [↑](#footnote-ref-1543)
1543. Treas. Reg. § 1.1223-3. [↑](#footnote-ref-1544)
1544. In fact, in this instance, the gain or loss would be allocated to the purchasing partner in an amount equal to the gain or loss that would have been allocated to the transferor partner had there been no taxable sale of the interest, and then the inside basis adjustment under section 743(b) then offsets the gain or loss allocated. The effect is the same. *See* Treas. Reg. § 1.743-1(j)(3)(ii), Ex. 2. [↑](#footnote-ref-1545)
1545. One thing to note, however, section 751(b) only applies to “substantially appreciated” inventory. *See* §§ 751(b)(1)(A)(ii) and 751(a)(2). To the extent that inventory exists but is not substantially appreciated, a distribution of cash in liquidation of a partnership interest will be considered capital gain, but a taxable sale of such interest would generate ordinary income under section 751(a). “Substantial appreciation” is defined in section 751(b)(3). [↑](#footnote-ref-1546)
1546. The rule only applies to the sale or exchange of an interest. *See* § 1(h)(9) and Treas. Reg. § 1.1(h)-1(a). [↑](#footnote-ref-1547)
1547. Howard E. Abrams, *Now You See It; Now You Don’t: Exiting a Partnership and Making Gain Disappear*, 50 Tax Mgmt. Mem. No. 4 (Feb. 16, 2009). [↑](#footnote-ref-1548)
1548. § 732(b). [↑](#footnote-ref-1549)
1549. § 732(c). [↑](#footnote-ref-1550)
1550. § 734(b)(2)(B). [↑](#footnote-ref-1551)
1551. § 734(b)(1)(B). [↑](#footnote-ref-1552)
1552. *See* Howard E. Abrams, *The Section 734(b) Basis Adjustment Needs Repair*, 57 Tax Law. 343 (2004). [↑](#footnote-ref-1553)
1553. The partnership could borrow the proceeds to effectuate the cash distribution. Care should be given to ensure that undesirable partnership liability shifts do not occur in the transaction. Thus, taxpayers should consider borrowing on a nonrecourse basis but having certain remaining partners guarantee the debt. [↑](#footnote-ref-1554)
1554. For an excellent article on using section 704(c) allocation in the family partnership context, see Thomas N. Lawson, *Using Curative and Remedial Allocations to Enhance the Tax Benefits of FLPs*, 9 Est. Plan. No. 8, pg. 12 (Aug. 2009). [↑](#footnote-ref-1555)
1555. *See* Treas. Reg. § 1.704-1(b)(2)(iv)(d)(1). [↑](#footnote-ref-1556)
1556. Treas. Reg. § 1.704-3(a)(1). [↑](#footnote-ref-1557)
1557. Treas. Reg. § 1.704-1(b)(2)(iv)(g)(3) provides that book depreciation must bear the same relationship to book value that tax depreciation bears to adjusted tax basis. If adjusted tax basis is zero, book depreciation can be any reasonable method. [↑](#footnote-ref-1558)
1558. Treas. Reg. § 1.704-1(b)(1). [↑](#footnote-ref-1559)
1559. *See* Treas. Reg. § 1.704-3(b)(2), Ex. 1. [↑](#footnote-ref-1560)
1560. 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).” [↑](#footnote-ref-1561)
1561. *See* Treas. Reg. § 1.704-3(c)(3). [↑](#footnote-ref-1562)
1562. Treas. Reg. § 1.704-3(c)(1). [↑](#footnote-ref-1563)
1563. *Id.* [↑](#footnote-ref-1564)
1564. *Id.* [↑](#footnote-ref-1565)
1565. *See* Treas. Reg. § 1.704-3(c)(4), Ex. 2. [↑](#footnote-ref-1566)
1566. *See* Treas. Reg. § 1.704-3(d). [↑](#footnote-ref-1567)
1567. *See* Treas. Reg. § 1.704-3(d)(4). [↑](#footnote-ref-1568)
1568. Treas. Reg. § 1.704-3(d). [↑](#footnote-ref-1569)
1569. Treas. Reg. § 1.704-3(d)(1). [↑](#footnote-ref-1570)
1570. Treas. Reg. § 1.704-3(d)(4)(ii). [↑](#footnote-ref-1571)
1571. *See* Treas. Reg. § 1.704-1(b)(2)(iv)(g)(3). [↑](#footnote-ref-1572)
1572. Treas. Reg. § 1.704-3(d)(2). [↑](#footnote-ref-1573)
1573. *Id.* [↑](#footnote-ref-1574)
1574. This provision currently requires extension each year and was recently extended by the Tax Increase Prevention Act of 2014, P.L. 113-295 (December 19, 2014) to include certain property placed in service through 2014. [↑](#footnote-ref-1575)
1575. Treas. Reg. § 1.704-3(a)(10)(i). [↑](#footnote-ref-1576)
1576. Treas. Reg. § 1.704-3(a)(10)(ii). [↑](#footnote-ref-1577)
1577. Treas. Reg. § 1.704-3(c)(4), Ex. 3. [↑](#footnote-ref-1578)
1578. *See also* Treas. Reg. § 1.704-3(b)(2), Ex. 2 for an example of an unreasonable use of the traditional method involving the contribution of property having on year of remaining depreciable life. [↑](#footnote-ref-1579)
1579. 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). [↑](#footnote-ref-1580)
1580. Treas. Reg. § 301.7701-2(a). [↑](#footnote-ref-1581)
1581. Treas. Reg. § 301.7701-3(b)(1)(ii). [↑](#footnote-ref-1582)
1582. Treas. Reg. §§ 301.7701-1(a) and -2(c)(2). [↑](#footnote-ref-1583)
1583. Rev. Proc. 2002-69, 2002-45 I.R.B. 831. [↑](#footnote-ref-1584)
1584. *Id.* [↑](#footnote-ref-1585)
1585. Rev. Rul. 2004-77, 2004-31 I.R.B. 119. [↑](#footnote-ref-1586)
1586. *See generally* Treas. Reg. §§ 20.2031-1(b) and 25.2512-1 and Rev. Rul. 59-60, 1959-1 C.B. 237. [↑](#footnote-ref-1587)
1587. *Pierre v Commissioner*, 133 T.C. 24 (2009). [↑](#footnote-ref-1588)
1588. *Id.* [↑](#footnote-ref-1589)
1589. *See e.g.*, *Estate of Mirowski v. Commissioner*, T.C. Memo. 2008-74 (Mar. 26, 2008). *But see* *Pope & Talbot Inc., et al. v. Commissioner*, 105 T.C. 574 (1995) (The court ignored the existence of a newly created partnership in valuing the tax paid upon a distribution of the interests to its shareholders under section 311 of the Code). [↑](#footnote-ref-1590)
1590. Rev. Rul. 99-5, 1999-1 C.B. 434. [↑](#footnote-ref-1591)
1591. The ruling cites Rev. Rul. 66-7, 1966-1 C.B. 188. [↑](#footnote-ref-1592)
1592. Rev. Rul. 99-6, 1999-6 I.R.B. 6. [↑](#footnote-ref-1593)
1593. Except for inventory items. *See* §735(a)(2). [↑](#footnote-ref-1594)
1594. Treas. Reg. § 1.704-1(b)(2)(iv). [↑](#footnote-ref-1595)
1595. Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2). [↑](#footnote-ref-1596)
1596. Treas. Reg. § 1.704-1(b)(2)(iv)(l). [↑](#footnote-ref-1597)
1597. Rev. Rul. 84-53, 1984-1 C.B. 159. [↑](#footnote-ref-1598)
1598. *Id.* The ruling relies Treasury Regulation § 1.61-6(a) which provides that when a part of a larger property is sold, the basis of the entire property shall be equitably apportioned among the several parts for purposes of determining gain or loss on the part sold. [↑](#footnote-ref-1599)
1599. Treas. Reg. § 1.704-1(b)(2)(iv)(b). [↑](#footnote-ref-1600)
1600. *See* Richard A. Oshins and David A. Handler, *Estate Planning with Disregarded Entities*, presented at the Society of Trust and Estates Practitioners Institute on Tax Estate Planning and the Economy (Jan. 2014) for an excellent discussion of the topic and additional planning opportunities including using a disregarded entity with a residence in lieu of a qualified personal residence trust and a tiered LLC strategy to maximize the leverage of an installment sale. [↑](#footnote-ref-1601)
1601. *See* § 1361(b)(1)(D), Treas. Reg. § 1.1361-1(l)(1). [↑](#footnote-ref-1602)
1602. *See* § 1361(b)(1)(B). [↑](#footnote-ref-1603)
1603. *See* § 1361(c)(2)(A)(i) allowing grantor trusts of U.S. citizens and residents to be S corporation shareholders. [↑](#footnote-ref-1604)
1604. PLR 200513001. [↑](#footnote-ref-1605)
1605. § 1361(c)(2)(A)(v). [↑](#footnote-ref-1606)
1606. § 1361(d)(1)(A) treating such qualified subchapter S trusts as grantor trusts of U.S. citizens or residents under § 1361(c)(2)(A)(i). [↑](#footnote-ref-1607)
1607. *See* *Guzowski v. Commissioner*, T.C. Memo 1967-145. A partnership that ceased to exist based on the stated term in the partnership agreement was not deemed to be the shareholder. The partners were deemed to be the shareholders. [↑](#footnote-ref-1608)
1608. Rev. Rul. 62-116, 1982-2 C.B. 207. [↑](#footnote-ref-1609)
1609. *See also* PLRs 200237014, 200237011, 9010042, and 8934020 where the IRS ignored momentary ownership of a newly formed corporation’s stock by a partnership during the process of incorporating the partnership or taking remedial measures. [↑](#footnote-ref-1610)
1610. *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. [↑](#footnote-ref-1611)