POST 2012 FLP UPDATE:
WHEN THE ESTATE OR TRUST IS A PARTNER

By

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I. INTRODUCTION

Executors and trustees face many income tax issues when they own partnership interests. They must not only be familiar with the income tax rules for estates and trusts, but they must also be familiar with partnership income tax rules. Failure to understand the interaction between trust income taxes and partnership income taxes can lead to costly mistakes. Therefore, it is critical that fiduciaries and their advisors address the income tax matters of these flow-through entities early in the estate administration.

II. INVENTORY ON DATE OF DEATH

One of the first things an executor should do is size up the basis and market value of assets owned by the partnership. The estate is entitled to adjust the basis of a decedent's partnership interest to the date of death value and the holding period of the partnership interest automatically becomes long-term.[1] However, the basis of partnership assets is not adjusted unless the partnership makes a Section 754 election.[2] Nor do the partnership assets receive a new holding period because of the decedent's death. Therefore, the partnership must hold the assets for more than one year before sale to obtain long-term capital gain treatment, even for assets on hand on the partner's date of death.

A. Inside Basis and Value of Partnership Assets

The executor needs to know the basis and value of the partnership assets on the date of death for several purposes. The basis of the assets on the partnership books is known as the "inside basis." The difference between the inside basis and the market value of the partnership assets helps the general partner decide whether to make a Section 754 election.[3] It also helps him determine whether the partnership is subject to the mandatory basis adjustment rules for substantial built-in losses.[4] And finally it helps him determine whether there is any income in respect of a decedent in the partnership. Therefore, the partnership should provide the executor the basis and market value of each partnership asset on the date of death. In addition, the executor should obtain an appraisal of the partnership interest, which considers discounts if the decedent had a minority interest or restrictions on the transfer of his partnership interest.

B. Valuation Discounts

Family partnership interests are often discounted from 15 to 60 percent in the estate inventory due to restrictions on the partnership interests that make them worth less than the underlying assets.[5] As a general rule, the allowable discounts are related to the risks of the

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[1] IRC § 1223(11).

[2] See discussion at III.

[3] See discussion at III.

[4] IRC § 743(b).

[5] Strangi v. Comm'r, 115 TC 478, *affd on this issue sub nom* Gulig v. Comm'r, 293 F3d 279 (5th Cir 2002); McCord v. Comm'r , 120 TC 358; Lappo v. Comm'r TC Memo 2003-258, Peracchio v. Comm'r, TC Memo 2003-280; Kelley v. Comm'r, TC Memo 2005-235; Temple v. United States, 423 F Supp 2d 605 (DC TX 2006); Astleford v. Comm'r, TC Memo 2008-128, Holman v. Comm'r., 130 TC 170; Pierre v. Comm'r, TC Memo 2010-

underlying investments held by the entity.[6] Discounts are popular because they reduce the size of the taxable estate and allow more value to pass to the beneficiaries. But with fewer estates being taxable because of an increased estate tax exemption, the unused exemption of the predeceased spouse, and significant prior gifts, the question arises whether discounts should still be claimed when they won't reduce the estate taxes. This decision affects not only the value reported on the decedent's Form 706, but the inventory value reported to the local probate court and the value reported on the partnership's Form 1065 if it makes a § 754 election.

The downside of claiming a discount is that the partnership basis is reduced (whether outside or inside), which may ultimately cause more income tax to be paid on sale of the partnership assets. An estate can save estate taxes equal to 40 percent of the discount. However, the discount also reduces the basis of the partnership interest, and the inside basis of the partnership assets if a 754 election is made. Therefore, the discount will *cost* the estate additional income taxes when the assets are sold equal to 20 percent of the discount. If the estate is taxable, it comes out ahead with the discount, despite the additional income tax on sale of the assets. However, if the estate is not taxable, discounts can cost the estate money by reducing the basis of the assets with no offsetting estate tax savings. Thus the question arises whether the executor can simply choose to ignore the discounts.

Case law generally holds that discounts on family investment partnerships are warranted when there are bona fide non-tax reasons for forming the partnership, there are enforceable restrictions on transferring the partnership interest, and the partner has no control over the partnership.[7] Even where the partnership's assets consist mostly of cash, the IRS and Tax Court have upheld a 7.5 percent discount simply because the partnership interest is not worth as much as the underlying assets.[8] In *Koons v. Commissioner*, the Tax Court held that where a partner had control over the partnership and could force a distribution or liquidation, the value of his interest should be no less than liquidation value.[9]

However, the IRS and the courts will disallow the discounts entirely when there was no bona fide non-tax reason to form the partnership and the donor or decedent exercised control over the partnership assets. They do this by invoking IRC § 2036(a), which includes the partnership assets in the decedent's estate rather than the partnership interest. But absent a § 2036 challenge, there is little justification to ignore discounts altogether, regardless of whether they are needed to reduce the estate taxes. Moreover, it would be hard to claim no discount if the donor or decedent claimed discounts on prior gift tax returns or on the estate of a predeceased spouse. Consequently, some discount should be claimed on family partnerships, regardless of whether a Form 706 is required. But they may be less aggressive, say 15 to 20 percent.

If discounts are not needed and will increase the income tax on sale of the assets, the family should consider dissolving the partnership. If the decedent has already died, the executor might be justified in claiming no discount on the basis that IRC § 2036 would apply because the

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106; Keller v. Comm'r, 697 F.3d 238 (5th Cir. 2012); Murphy v. United States, 104 AFTR 2d 2009-7703 (DC AR); Gallagher v. Comm'r, 101 T.C. Memo 1702 (2011).

6 IRS Appeals Coordinated Issues Settlement Guidelines (Oct. 20, 2006).

7 *Supra* note 5.

8 Koons v. Comm'r, TC Memo 2013-94.

9 *Id.*

decedent had no non-tax motive for forming the partnership and exercised control over the partnership assets. Section 2036 is not just a tool for the IRS. It may be asserted by the taxpayer.

C. Pre-Contribution Gains and Losses under Sec. 704(c)

1. The General Rule

Each time a partner contributes property to a partnership, IRC § 704(c)(1)(A) requires the partnership to measure the difference between the property's cost basis and its market value. The difference is hereafter referred to as "pre-contribution gains and losses" or "built-in gains and losses." Built-in gains and losses must be tracked on a property by property and a partner by partner basis.[10] When the partnership disposes of any property that contains built-in gain or loss, the gain or loss must be specially allocated to the contributing partner before any remaining gain or loss is allocated to all partners according to their partnership interests. The purpose of this rule is to prevent artificial shifting of tax consequences among the partners.[11]

EXAMPLE

> Dad contributes his Dell Computer stock with a tax basis of $1 and a market value of $10,000 in return for a 50 percent interest in the DS Family Limited Partnership. Son contributes land worth $10,000 with a basis of $10,000. Dad's built-in gain on the date of contribution is $9,999 ($10,000 - $1). If the partnership sells the stock for $12,000, the pre-contribution gain of $9,999 is allocated to Dad. The remaining $2,000 post-contribution gain is allocated 50-50 between Dad and Son.[12]

To ameliorate some of the recordkeeping with multiple partners, properties, and transactions, the regulations allow certain types of property to be aggregated. These include depreciable property other than real estate, zero basis property, inventory, and other property designated by the Service in rulings from time to time.[13] The regulations also allow the partnership to ignore "small disparities" between value and basis.[14] A small disparity exists when the difference between the basis and market value of all property contributed by a single partner in a tax year is no more than 15 percent of the tax basis of all such property and that difference for all properties is no more than $20,000. These exceptions are little help to the typical family partnership with investment assets where the disparity is nearly always greater than 15 percent or $20,000.

If the partnership has or will make a § 754 election when a partner dies, it may seem pointless to keep track of pre-contribution gains and losses for the decedent. Upon a partner's death, the § 754 election adjusts the decedent's basis in partnership assets to the date of death value, effectively eliminating any difference between the deceased partner's inside and outside basis and any resulting gain or loss. In effect, the § 754 election "wipes out" any allocation of pre-contribution gain or loss under § 704(c) with respect to the deceased partner.[15] However, the

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10 Reg. § 1.704-3(a)(2).

11 Reg. § 1.704-3(a)(1).

12 Reg. § 1.704-1(b)(5), Example 13(i).

13 Reg. § 1.704-3(e)(2).

14 Reg. § 1.704-3(e)(1).

15 Reg. § 1.743-1(j).

§ 754 election has no effect on the other partners.[16] Therefore, it is important to keep track of their pre-contribution gains and losses. Distributions and other transactions with the partnership continue to have direct tax consequences for them.

2. Partnership Interests Acquired by Gift

When a partner gifts a partnership interest to a family member, the donee succeeds to the donor's outside and inside basis, including any pre-contribution gains and losses.

a. Pre-Contribution Gains

When a partner transfers a partnership interest, by gift or otherwise, the transferor's built-in gain under § 704(c) attributable to that interest also transfers to the transferee partner.[17] Built-in losses are transferred to the transferee under this same rule, but only for contributions of built-in loss property that were made on or before October 22, 2004.[18] Depending on how a partner acquires his partnership interest, his regular profit and loss sharing ratio may differ from his allocation of built-in gains and losses. This occurs in family limited partnerships when a partner acquires his interest partly by gift and partly by his own contributions.

EXAMPLE

Dad contributes Dell Computer stock with a basis of $1 and a fair market value of $10,000 and Son contributes $10,000 land to a family limited partnership. Shortly thereafter, Dad gifts half of his 50 percent interest to Son. The partners' capital accounts immediately afterward are:

	Market Value	Tax Basis
Dad – 25%	$ 5,000	$ .50
Son – 75%	15,000	10,000.50
Total	$ 20,000	$ 10,001.00

Dad's gift also transfers half of his § 704(c) built-in gain as follows:

	704(c) Gain Before the Gift	Net Change	704(c) Gain After the Gift	%
Dad	9,999.00	-4,999.50	4,999.50	50
Son	-0-	4,999.50	4,999.50	50
Total	9,999.00	-0-	9,999.00	100

If the Dell Computer stock is sold immediately after the gift, the § 704(c) gain is allocated 50-50 between Dad and Son. However, any post-contribution gain would have been allocated 25-

[16] Reg. § 1.743-1(j)(1).

[17] Reg. § 1.704-3(a)(7).

[18] IRC § 704(c)(1)(C), added by the American Jobs Creation Act § 833; *see* discussion at Section II.C.3. *infra*.

75 between Dad and Son. Next, assume instead of acquiring his partnership interest by contribution to the partnership, Son acquires his interest by gift from Dad and Mom.

EXAMPLE

Assume Dad and Mom form the partnership with jointly owned property consisting of $10,000 in cash and Dell stock worth $10,000 and with a basis of $1. Then they gift a 50 percent interest to son. The partners' capital accounts after the gift are:

	Market Value	Tax Basis	§ 704(c) Gain
Dad & Mom	$10,000	5,000.50	4,999.50
Son	$10,000	5,000.50	4,999.50
Total	$20,000	$10,001	9,999.00

In this case, Son's basis in his interest is the same as Dad and Mom's.[19] He also acquires the § 704(c) built-in gain allocable to the gifted interest. In essence, he steps into Dad and Mom's shoes as the contributing partner with respect to their pre-contribution gain under § 704(c).

b. Pre-Contribution Losses on Property Contributed Before October 22, 2004

Section 704(c) also applies to built-in losses, but only for assets contributed on or before October 22, 2004. Built-in losses on assets contributed after October 22, 2004 are subject to special rules and need to be tracked separately.[20]

EXAMPLE

Dad bought Coca-Cola stock for $70,000. In 2003 Dad contributed the stock to a partnership when it was worth only $40,000. He has a built-in loss under § 704(c) of $30,000. Shortly afterward, he gave Son a 50 % partnership interest. The partnership then sells the stock for $50,000 resulting in a $20,000 tax loss for the partnership.

	704(c) Loss Before the Gift	Gift of 704(c) Loss	704(c) Loss After the Gift	%
Dad	(30,000)	15,000	(15,000)	50
Son	-0-	(15,000)	(15,000)	50
Total	(30,000)	-0-	(30,000)	

The $20,000 tax loss is shared according to the partners' § 704(c) built in losses, or $10,000 to Dad and $10,000 to Son. Dad has shifted a capital loss to his Son by making the gift in the form of a partnership interest.

19 IRC § 1015(a).

20 IRC § 704(c)(1)(C) (added by the American Jobs Creation Act of 2004, P.L. No. 108-457, § 833); *see* discussion at Section II.C.3. *infra.*

3. Contributions of Built-in Loss Property

The American Jobs Creation Act of 2004 enacted new § 704(c)(l)(C), which allows only the contributing partner to use pre-contribution losses on property contributed after October 22, 2004.[21] Therefore, the partnership needs to track built-in loss property contributed after this date separately. There is no de minimis exception for small built-in losses. Note that contributing an appreciated mutual fund avoids this problem, assuming it is treated as a single property. The new statute does not, however, appear to prohibit the transfer of built-in losses after October 22, 2004 for property that was contributed to the partnership on or before that date.[22] Therefore, partners may continue to transfer built-in losses after October 22, 2004 as long as the property was contributed before the new statute's effective date.

The House Committee Report elaborates further that "…if the contributing partner's partnership interest is transferred or liquidated…the built-in loss is eliminated (emphasis added)."[23] This is a stark contrast to the "step-in-the-shoes" rule under § 704(c) for transfers of built-in loss property before October 22, 2004 discussed above. Thus, the current regulations are invalid for contributions of built-in loss property after October 22, 2004 to the extent they allow a contributing partner's built-in losses to be allocated to the transferee partner.[24]

To carry out its purpose, the new statute provides a special basis rule for the transferee partner.[25] To compute the transferee's gain or loss, the basis of contributed property in the hands of the partnership is deemed to be its fair market value on the date of its contribution. When one considers that pre-contribution gains and losses are tracked on partner by partner, property by property basis, this new requirement adds another layer of complexity to partnership bookkeeping.[26] It can also have a draconian effect for gifts of partnership interests with built-in loss property contributed after October 22, 2004.

EXAMPLE 1

Dad bought several different stocks between 1999 and 2004 for $1,000,000. In 2005 he contributed them to a partnership when they were worth $1,000,000. However, half the stocks had a built-in gain of $200,000 and the other half had a built-in loss of $200,000. Shortly afterward, he gave Son a 50 percent partnership interest. Son acquires Dad's built-in gains of $100,000 [50% X $200,000], but not Dad's built-in losses of $100,000. They are eliminated.

EXAMPLE 2

Assume that one of the built-in loss stocks in the above example above was Coca-Cola, which Dad bought for $70,000 and was worth $40,000 when he contributed it to the partnership. Thus, he had a built-in loss of $30,000. But after the transfer to

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[21] IRC § 704(c)(1)(C)(i).
[22] P.L. No. 108-457, § 833(a).
[23] H.R. Rep. No. 108-548, pt.1.
[24] Reg. § 1.704-3(a)(7).
[25] IRC § 704(c)(1)(C)(ii).
[26] Reg. § 1.704-3(a)(2).

Son, Dad only has a \$15,000 loss. The partnership then sells the stock for \$50,000 resulting in a tax loss of \$20,000.

Son's new basis for calculating gain or loss in the Coca-Cola stock is his share of its market value on the date of contribution by Dad. If the partnership sells Coca-Cola for \$50,000, Son reports half of the \$10,000 gain, or \$5,000.

However, Dad's share of the gain or loss is not as clear. The statute provides that built-in losses may only be used by the contributing partner and the House Committee Report adds that built-in losses on transferred or liquidated interests are eliminated.[27] But, the unused losses on the transferred interest are not really eliminated. They remain in the form of outside basis in the partnership interest. If the contributing partner sells or liquidates his interest, his basis can reduce his gain or loss.[28] In the case of a gifted interest, the transferee partner inherits the contributing partner's basis in the gifted interest.[29] Thus, eventually the donee can use the basis in determining the gain or loss on liquidation or sale of the partnership interest, subject to the special rule that applies if the value of gifted property exceeds its basis on the date of the gift.[30]

Thus, in our example, Dad only reports half the built-in losses, plus his share of the post-contribution gain, for a total loss of only \$10,000 [50% X -\$30,000 + 50% X \$10,000]. Dad and Son recognize a combined loss of only \$5,000 (Son reporting a \$5,000 gain and Dad reporting a \$10,000 loss), rather than the partnership's \$20,000 actual loss incurred. Thus, \$15,000 of the actual tax loss has disappeared. Presumably the partnership shows the \$15,000 nondeductible loss as a Schedule M-1 adjustment. Hopefully the IRS will address these uncertainties soon under the broad regulatory authority granted them in § 704(c)(1). However, they chose not to do so in their first round of guidance in Notice 2005-32.[31]

4. Disproportionate Capital Contributions

A partner's basis also changes when partners make disproportionate capital contributions after the partnership is formed. Disproportionate contributions generally require all the partners' interests to change and capital accounts to be restated. In this event, the regulations require the partnership to make a "reverse § 704(c)" allocations.[32] In a reverse allocation, all partnership property is revalued and the appreciation or depreciation accruing since the last restatement becomes a separate "layer" of built-in gain or loss. This new layer is thereafter tracked on a property by property, and a partner by partner basis just like the first layer.

A reverse § 704(c) allocation is a special allocation of each partner's built-in gain or loss on partnership property accruing since the date of the last capital account restatement. However, if it did not arise from a partner's contribution of built-in gain or loss property, it is not subject to the new prohibition on transferring built-in losses for property contributed after October 22, 2004[33]

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[27] H.R. Rep. No. 108-548, pt. 1.
[28] IRC § 731(a).
[29] IRC § 1015(a).
[30] *Id.*
[31] Notice 2005-32, 2005-16 I.R.B. 895 (Apr.1, 2005).
[32] Regs. §§ 1.704-1(b)(2)(iv)(f), 1.704-3(a)(6).
[33] *See* discussion at Section II.C.3. *infra.*

or the mixing bowl rules.[34] Nonetheless, it still impacts the partners when partnership interests change because of disproportionate capital contributions. However, a detail discussion of reverse 704(c) allocations is beyond the scope of this paper.

D. Income in Respect of a Decedent (IRD)

The Code provides special treatment for items constituting income in respect of a decedent (IRD) under § 691. In general, IRD is any item of gross income not yet properly reported by the decedent under his method of accounting before he died.[35] This includes accrued interest and dividends, unreported interest on US Treasury savings bonds, the decedent's interest in an IRA, pension income, annuities, nonqualified employee stock options, unrecognized gain on installment notes, litigation settlement income, lottery winnings, and cash basis accounts receivable, just to name a few. Section 691 also covers deductions in respect of a decedent (DRD).[36] These include expenses incurred before death, but unpaid on the date of death related to business expenses (§ 162), interest expense (§ 163), taxes (§ 164), investment expenses (§ 212), and depletion (§ 611).

Items of IRD do not receive a stepped-up basis on the decedent's death under IRC § 1014, unlike other assets.[37] Thus, an estate or beneficiary that receives IRD must include it in gross income when he or she collects it. But the recipient may claim a deduction for the portion of the estate tax, if any, attributable to IRD that was included in the decedent's taxable estate.[38] Nor does IRD attributable to a partnership interest receive a stepped-up basis.[39] This holds whether or not the partnership made a § 754 election.[40] Therefore, when a partner dies, the estate should determine whether some or all payments from the partnership constitute IRD.

1. Statutory IRD of a Deceased Partner

IRD attributable to a partnership interest is not the same as IRD owned directly by a decedent. For IRD attributable to a partnership interest, § 691(e) refers exclusively to § 753, which provides that "the amount includible in income of a successor in interest of a deceased partner under section 736(a) shall be considered income in respect of a decedent under section 691."[41] Section 736(a) payments are those made *by a partnership* in liquidation of a retired partner's interest, *other than* payments for an interest in partnership property. Payments for unrealized receivables and unstated goodwill to a general partner of a service partnership are specifically excluded from treatment as property, and thus are § 736(a) payments.[42]

Because § 736(a) payments are defined by exclusion, they generally include all payments in excess of those for an interest in partnership property. If the partnership agreement expressly provides for a payment of goodwill, such payments are for an interest in partnership property

34 *See* discussion at Section IV.C. *infra.*
35 IRC § 691(a)(1).
36 IRC § 691(b).
37 IRC § 1014(c).
38 IRC § 691(c).
39 Reg. § 1.742-1.
40 Reg. § 1.755-1(b)(4)(ii), Example (as amended Dec. 14, 1999 by T.D. 8847).
41 IRC § 753.
42 IRC § 736(b)(2).

under § 736(b) and do not constitute IRD.[43]

Note that § 736 does not apply when the continuing partners, rather than the partnership, purchase the interest of the retiring or deceased partner. Nor does § 736 apply to payments received in complete liquidation of the partnership. Thus, even though the economic consequences may be the same to a deceased partner whether the partners buy him out, the partnership buys him out, or the partnership liquidates, the tax consequences may vary.[44]

Because § 753 refers exclusively to § 736(a) payments, which are payments of income (not property) and payments for unrealized receivables and unstated goodwill made to a general partner of an ongoing service partnership, no other partnership item should constitute IRD. That is, the Code does not require us to "look through" the partnership for other types of income that would constitute IRD if owned outright by the decedent, such as accrued dividends, interest, installment sale gain, annuities, etc. There is no statutory basis for parity between IRD inside and outside of a partnership. Contrast the rule for Subchapter S corporations under which § 1367(b)(4) expressly provides that "If any person acquires stock in an S corporation by reason of the death of a decedent or by bequest, devise, or inheritance, section 691 shall be applied with respect to any item of the S corporation in the same manner as if the decedent had held directly his pro rata share of such item."[45]

2. Judicially Created IRD

Despite the plain reading of the statute, the IRS, the Tax Court, and two Circuit Courts of Appeal have disagreed and held that IRD of a deceased partner is not limited to § 736(a) payments.[46] In *Quick v. Commissioner*, the Eight Circuit affirmed the Tax Court's position that payments received by a deceased partner in liquidation of a two-man service partnership representing his share of zero-basis accounts receivable were IRD. The Tax Court held that the specific cross-reference in § 691(e) to § 753 "has no legal effect."[47] And even if it did, it was not limited to payments described in § 753. It "merely states that certain distributions in liquidation under section 736(a) shall be treated as income in respect of a decedent. It does not state that no other amounts can be so treated."

Further, the Tax Court found that the legislative history indicates that Congress did not view a partnership interest as a "unitary res, incapable of further analysis," but "as a bundle of rights." Both the House and Senate committee reports to § 751 specifically state that income rights relating to unrealized receivables or fees are regarded "as severable from the partnership interest and as subject to the same tax consequences which would be accorded an individual entrepreneur."[48] The Senate committee report adds:

> The House bill provides that a decedent partner's share of unrealized receivables are [sic] to be treated as income in respect of a decedent. Such rights to income are to be

[43] IRC § 736(b)(2)(B).

[44] Reg. § 1.736-1(a)(1)(i).

[45] Reg. § 1.1367-1(j).

[46] PLR 9715008*;* Quick Trust v. Comm'r, 54 T.C. 1336, *aff'd* 444 F.2d 90 (8th Cir. 1971); Woodhall v. Comm'r, 28 T.C.M. 1438, *aff'd* 454 F.2d 226 (9th Cir. 1972); Rev. Rul. 66-325, 1966-2 C.B. 249.

[47] § 7806(a) provides that cross references in the Internal Revenue Code are made only for convenience, and shall be given no legal effect.

[48] See H. Rept. No. 1337, 83d Cong., 2d Sess., p. 71 (1954); S. Rept. No. 1622, 83d Cong., 2d Sess., p. 99 (1954).

> taxed to the estate or heirs when collected, with an appropriate adjustment for estate taxes. *** Your committee's bill agrees substantially with the House in the treatment described above but also provides that other income apart from unrealized receivables is to be treated as income in respect of a decedent. [S. Rept. No. 1622, 83d Cong., 2d Sess., p. 99 (1954)][49]

Less than seven months after *Quick* was decided, the Ninth Circuit also upheld the Tax Court in a case with facts nearly identical to those in *Quick*. In *Woodhall v. Commissioner*, the Ninth Circuit held that payments received by the estate of a general partner in a two-man partnership pursuant to a written buy-sell agreement providing that the partnership shall terminate upon the death of either partner and the survivor shall purchase the decedent's interest in the partnership were IRD.[50] Like *Quick*, it relied on the legislative history of §§ 741, 743, and 751 wherein the House Report specifically states that "A decedent partner's share of unrealized receivables and fees will be treated as income in respect of a decedent."[51]

Whether the courts will expand the scope of *Quick* and W*oodhall* to include more categories of IRD from a partnership than unrealized accounts receivable is unclear. These cases have neither been followed nor criticized by other Circuit Courts of Appeal. But they have generated considerable disagreement among commentators.[52] In the meantime, it is not altogether clear which payments, if any, other than those under § 736(a) should constitute IRD of a deceased partner. The regulations don't mention anything other than § 736(a) payments as IRD.[53] But the preamble to Reg. § 1.755-1(b)(4) suggests that Treasury and the IRS adopt the *Quick* and *Woodhall* holdings. Taxpayers may challenge these holdings in another circuit court someday.

3. Reporting Requirements

The estate is responsible for reporting IRD and the related estate tax deduction and allocating it between the estate and beneficiary based on the amount it retains or distributes.[54] The instructions to Form 1041, U.S. Income Tax Return for Estates and Trusts, require an estate or trust to attach a schedule showing how the IRD deduction was calculated. However, there is no requirement in the statute or instructions to Form 1065 for a partnership to report a partner's share of IRD. The partner is apparently on his own to determine if he has any share of partnership IRD.

E. Promissory Notes from Sales to Irrevocable Grantor Trusts

It would not be uncommon for an estate to own a promissory note from the sale of the decedent's partnership interest prior to his death. A popular estate planning technique is to sell a partnership interest to an intentionally defective grantor trust (IDGT) for an installment note. The sale is ignored for federal income tax purposes because transactions between a grantor and a trust all of which is deemed owned by the grantor are not recognized for income tax purposes.[55] But

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[49] Quick Trust v. Comm'r, 54 T.C. 1336, 1345, *aff'd* 444 F.2d 90 (8th Cir. 1971).

[50] Woodhall v. Comm'r, 28 T.C.M. 1438, *aff'd* 454 F.2d 226 (9th Cir. 1972).

[51] H.R. 1337, to accompany H.R. 8300 (P.L. 591), 83rd Cong., 2d Sess., pp. 70-71 (1954).

[52] McKee, Nelson, & Whitmire ¶ 23.02[2][b] (4th ed. 2007).

[53] Reg. § 1.753-1.

[54] Reg. § 1.691(c)-2.

[55] Rev. Rul. 85-13, 1985-1 CB 184.

the transfer is recognized for estate and gift tax purposes. Therefore, all future appreciation in the asset belongs to the trust and is excluded from the grantor's estate. However, when the trust converts to a nongrantor trust upon the partner's death, a host of income tax questions arise if the note is still outstanding.

The first question is whether gain is recognized upon the conversion from grantor to nongrantor trust status while the installment note is still outstanding. If so, is it recognized by the grantor or by his estate? Should there be a different treatment for conversions during the grantor's life than for conversions upon his death? And if the transaction is taxable, does the note qualify for installment sale reporting under IRC § 453 or otherwise constitute income in respect of a decedent (IRD) under § 691 to the extent of any unrecognized gain? And finally, what is the basis of the note in the hands of the decedent (or his successor) and what is the basis of the property in the hands of the trust?

No single authority answers all these questions. Some commentators maintain that the termination of grantor trust status upon the grantor's death is taxable to the extent that the unpaid note exceeds the grantor's basis in the property.[56] Consequently they advise paying off the note before the grantor dies to avoid gain recognition. Other commentators maintain that there is no income tax upon the conversion to a nongrantor trust while the note is outstanding primarily because testamentary and lifetime gifts are generally not taxable.[57] While they concede that the IRS and the courts have carved out an exception for conversions during the grantor's lifetime for consideration, they point out that no authority taxes such conversions on account of death.[58]

1. Gain at Death

The IRS consistently maintains that termination of grantor trust status during the grantor's life is a *deemed transfer* of property to the trust that may have income tax consequences to the extent of any consideration received.[59] For example, where a grantor has transferred a partnership interest to a grantor trust that later converts to a nongrantor trust, the grantor recognizes income to the extent that any relief from partnership debt exceeds his basis in the partnership.[60] Likewise, the IRS holds that a transfer for less than adequate consideration is a part-sale part-gift, which causes the grantor to recognize gain to the extent that the consideration exceeds the grantor's basis.[61] If we extend those holdings to the sale of property to a grantor trust for an installment note, the grantor is deemed to have transferred property in a part gift part

[56] Carol A. Cantrell, "Gain is Realized at Death," Trusts & Estates (February 2010), p. 20; Deborah V. Dunn & David A. Handler, "Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates," J. Tax'n. (July 2001), p. 49.

[57] Jonathan G. Blattmachr and Mitchell M. Gans, "No Gain at Death," Trusts & Estates (February 2010), p. 34; Jonathan G. Blattmachr, Mitchell M. Gans, & Hugh H. Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," J. Tax'n. (Sept. 2002).

[58] *Id.*

[59] Reg. § 1.1001-2(c), Ex. 5; Madorin v. Comm'r, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222, TAM 200011005; GCM 37228; Diedrich v. Comm'r, 457 U.S. 191 (1982).

[60] Reg. § 1.1001-2(c), Ex. 5; Madorin v. Comm'r, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222; GCM 37228 (Aug. 23, 1977).

[61] Reg. § 1.1001-1(e), Ex. 1 (income recognized on a part-sale-part-gift); TAM 200011005; Diedrich v. Comm'r, 457 U.S. 191 (1982) (grantor was taxable to the extent the donee paid the donor's gift tax liability in a net gift arrangement.)

sale transaction for consideration equal to the unpaid note when grantor status ends. Thus the IRS would maintain that gain should be recognized by the grantor equal to the amount by which the note exceeds the grantor's adjusted basis in the property transferred.[62]

So far, the rulings and cases have only addressed terminations of grantor status during the grantor's lifetime and not at his death. Some commentators argue that there is a general "no gain at death" rule for transfers of property at death, although no authority holds such. In fact, IRC § 1022(g) suggests just the opposite by providing that gain is not recognized on the acquisition by the estate of property from a decedent when liabilities exceed its basis for deaths in 2010. There would be no need for that exception if gain is never recognized on transfers from a decedent to his estate. While testamentary transfers from a decedent to his estate are generally tax free, there is no authority providing that nontestamentary transfers from a decedent are tax free.

Nor does tax policy in general weigh against acceleration of income at death. The cancellation of an installment note at the holder's death (SCIN) is treated as a satisfaction of the note at face value and taxable to the decedent's estate.[63] A Roth IRA owner who dies during the two or four year deferral period under Section 408A(d)(3)(A) must accelerate the remaining deferred income on his or her final income tax return.[64] A business owner who elected to defer income on advance payments for certain goods or services under Section 451 and dies before the end of the deferral period accelerates the remaining income on his or her final return.[65] Therefore, income acceleration at death is not against tax policy.

Questions also arise in the opposite situation where a nongrantor trust is converted to a grantor trust. In CCA 200923024, the IRS held that the conversion of a nongrantor trust to a grantor trust was not a deemed transfer of property from the trust to the grantor despite that the opposite situation - conversion of grantor to nongrantor status - was a deemed transfer of property from the grantor to the trust. In the CCA, the grantor had sold appreciated property to a nongrantor trust and recognized gain on annuity payments it received in connection with the sale. The nongrantor trust received a stepped up basis equal to its purchase price. However, when the corporate trustee was replaced with a related party, the trust became a grantor trust and thus the grantor was no longer required to recognize gain on the annuity payments.

While the IRS indicated that this may be a potentially abusive transaction, it simply held that the conversion from nongrantor to grantor status was not a deemed transfer of property from the trust to the grantor requiring income recognition. The CCA seems logical because eventually the grantor trust status will cease, and there will be income tax consequences at that time to the extent any consideration exceeds the grantor's basis.

2. Who Reports the Gain?

Whether the decedent or his successor should report the deferred gain on conversion of a grantor to a nongrantor trust will depend on whether the deemed transfer to the trust on death qualifies as an "installment sale" eligible for deferred gain reporting. If it does not qualify for installment reporting, the gain should be reported on the decedent's final income tax return

62 *Id.*
63 IRC §§ 691(a)(5), 453B(f).
64 IRC § 408A(d)(3)(E)(ii).
65 Reg. § 1.451-5(f).

because the deemed transfer occurs on death, and all income received on the date of death is taxable on the decedent's final income tax return.[66] If the deemed transfer qualifies for installment reporting, the estate or successor should report the gain as payments are collected.

Revenue Ruling 85-13 holds that the transfer of property to a grantor trust in exchange for a note is "not a *sale* for federal income tax purposes."[67] However, the conversion to a nongrantor trust may have income tax consequences to the extent that any consideration received exceeds the donor's basis in the property transferred as discussed above. If the consideration - the unpaid installment note - qualifies for installment sale reporting, the deferred gain is income in respect of a decedent (IRD) and taxed to the recipient as the note payments are collected.[68]

An installment sale is defined 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."[69] The regulations further provide that in order for no gain to be recognized on the transmission of an installment obligation at death, the obligation must have been "originally acquired in a transaction the income from which was properly reportable by the decedent on the installment method under section 453."[70] It is doubtful whether the note can meet this definition because the decedent was not reporting income under the installment method during his lifetime because the transaction was ignored for federal income tax purposes.

However, the IRS permits installment reporting where a note is received in other partial nonrecognition transactions, such as bargain sales to charity, tax-free exchanges, and transfers in exchange for stock under Section 351.[71] If these situations are analogous to a deemed transfer to trust for consideration, the note should qualify for installment reporting, the deferred gain should constitute IRD, and be reported by the estate or successor to the note.

3. Basis of Trust Property

And finally, there is the question of basis in the installment note and the trust property. The note should be entitled to a stepped up basis under IRC § 1014(a) because it was acquired by reason of the death of a decedent and required to be included in the decedent's estate tax return as a state law property interest.[72] However, to the extent the deferred gain constitutes IRD, the note is not entitled to a step up in basis.[73] Therefore, the basis of the note turns on whether it qualifies for installment reporting and who is required to report the deferred gain. If the decedent is required to report the deferred gain on his final income tax return, the gain is added to the basis of the note and there is no IRD because all the gain has been reported. In that case, the basis of

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[66] Reg. § 1.451-1.

[67] Rev. Rul. 85-13, 1985-1 CB 184.

[68] IRC § 453B(c) (death is not a disposition of an installment obligation that causes gain or loss to be recognized); Reg. § 1.451-1(b)(2) (If the decedent owned an installment obligation the income from which was taxable to him under section 453, no income is required to be reported in the return of the decedent by reason of the transmission at death of such obligation.)

[69] IRC § 453(b)(1).

[70] Reg. § 1.691(a)-5(a).

[71] Reg. § 1.453-1(f) (installment sale reporting allowed for nonpermitted property received in partial recognition exchanges such as tax-free exchanges under Section 1031, 351, etc; PLR 7933009 (bargain sale to charity with an installment note qualified for installment sale reporting).

[72] IRC § 1014(b)(9).

[73] IRC § 1014(c).

the note is its face value, which is presumably market value. On the other hand, if the deferred gain is properly reported by the estate or successor, and thus constitutes IRD, the basis of the note is not stepped up.[74]

But in no event is the property owned by the trust entitled to an adjusted basis under § 1014 because it was not included in the decedent's taxable estate.[75] Its basis is the greater of the amount paid by the trust (the note balance) or the grantor's adjusted basis at the time of the transfer.[76] If the note balance exceeds the grantor's basis, the trust's basis in the property is equal to the unpaid note and its holding period starts on the date the grantor trust status ceases.[77] On the other hand, if the unpaid note is less than the grantor's basis on termination of grantor status, the trust's basis in the property is equal to the grantor's basis and therefore it may tack the grantor's holding period.[78]

EXAMPLE

> Joe Brown sold a partnership interest on the installment basis to an IDGT for $60,000 in 2009. The sale is ignored for income tax purposes because the trust is a grantor trust. Joe died in 2013 when the unpaid note balance was $30,000 and the basis of the partnership interest was $20,000. Therefore, there is a $10,000 gain on the transfer – the excess of the consideration ($30,000) over the basis of the property ($20,000).[79] If the transfer qualifies for installment reporting, Joe's estate or successor reports the $10,000 as IRD. If it does not qualify for installment reporting, Joe recognizes $10,000 of gain on his final Form 1040. The trust's basis in the partnership interest is $30,000, which is the amount paid for the partnership. The estate's basis in the note is $30,000, its fair market value under § 1014.

Perhaps the IRS will someday clarify the income tax treatment of installment sales to a grantor trust when the grantor dies before the note is paid. The IRS is unlikely to hold that the unpaid note has no income tax consequences to the grantor or his estate. But Congress may beat the IRS to it if it adopts the administration's proposals to include the assets of the grantor trust in the grantor's estate, subjecting them to estate tax and stepping up the basis.[80] Nonetheless, based on the current authorities, any gain at death should be eligible for installment sale reporting and would increase the trust's basis in the property.

III. THE SECTION 754 ELECTION

When a partner dies, the basis of his partnership interest is adjusted to its fair market value on the partner's date of death or the alternate valuation date, if applicable, less any income in respect of a decedent attributable to the partnership interest.[81] In addition, the estate or

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[74] IRC § 453B(b); IRC § 1014(c).
[75] CCA200937028 (Sept. 11, 2009).
[76] Reg. § 1.1015-4(a).
[77] Ltr. Rul. 7752001; Reg. § 1.1015-4.
[78] *Id.*
[79] Reg. § 1.1001-1(e).
[80] General Explanation of the Administration's 2014 Revenue Proposals, p.231, *available at.* http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf
[81] IRC § 1014(a)(1); Reg. § 1.742-1; *see also* discussion at Section II.D. *infra.*

successor partner receives a long-term holding period in his partnership interest.[82] But this only affects the decedent's or his successor's partnership interest and has no effect on the underlying partnership property. Thus, if the partnership sells an asset immediately after a partner dies, the partner's estate or other successor will report gain as if no basis adjustment occurred as a result of the decedent partner's death.

However, if the partnership makes a § 754 election, the estate or successor partner adjusts his share of the *inside* basis of partnership assets to equal its outside basis. The successor partner acquires a basis in his share of the underlying partnership assets as if he had purchased an undivided interest in them at market value on the date of death. It has no effect on the holding period, however. Nor does it affect the basis of any other partner.[83]

Where the executor elects out of the estate tax in 2010, the outside basis of the decedent's partnership interest will be the carryover basis, plus any special basis increase that the executor allocates to it under § 1022(b) and (c). But the § 754 election may be ineffective to adjust the inside basis of the partnership assets. That is because Revenue Procedure 2011-41 reinforces the notion that property transferred by a decedent whose executor elected out of the estate tax under § 1022 is treated as a transfer by gift. A gift is not a transfer by sale or exchange or by death that would give rise to a § 743 basis adjustment. Therefore, it is doubtful that the inside basis of the partnership assets would be adjusted to the outside basis of the partnership interest for a decedent whose executor elected out of the estate tax.

The inside basis increase allows the successor partner to recognize a smaller share of gain or a larger share of loss than his fellow partners when the partnership sells the assets on hand at the decedent's date of death. He can also claim higher depreciation deductions than his partners based on his higher inside depreciable basis. The increase is treated as newly-purchased recovery property placed in service when the transfer (death) occurs.[84] Any applicable recovery period and method may be used. Therefore, conventional wisdom usually suggests making the § 754 election on the death of a partner.

However, the § 754 election can be a two-edged sword. First, the recordkeeping can be a burden. Second, it causes a step-down as well as a step-up in basis for the successor partner if the partnership assets are worth less than their tax basis on the date of the transfer. For example, a § 754 election is not desirable when discounts on the outside partnership interest would reduce the decedent's share of inside basis of partnership assets to below his share of their cost basis. Third, the election is irrevocable without the consent of the IRS. Thus it causes inside basis adjustments at each subsequent partner's death whether the partners desire it or not. And fourth, it requires the partnership to adjust the basis of its assets when it makes certain types of distributions.[85] In short, it affects every partner from that point forward.

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[82] IRC § 1223(9).
[83] Reg. § 1.743-1(j)(1).
[84] Reg. § 1.743-1(j)(4)(i)(B); On the other hand, any decrease in the basis of depreciable property under a § 754 election is recovered over the remaining useful life of the partnership's depreciable property under Reg. § 1.743-1(j)(4)(ii)(B).
[85] IRC 734(b).

A. Who Can Make the Election

A § 754 election can only be made if the partner dies, there is a distribution of property to a partner, or there is a transfer of a partnership interest by sale or exchange.[86] A distribution of a partnership interest is a sale or exchange for purposes of § 754.[87] Accordingly, a distribution of a partnership interest by an estate or trust should allow the partnership to make a § 754 election and step up the inside basis of the assets. The Senate Report to the 1986 Tax Reform Act explains that distributions of partnership interests are sales or exchanges for purposes of §§ 708, 743, and any other partnership provision specified in the regulations. [88] It further provides that the Secretary may provide exceptions to this rule, such as distributions of a partnership interest by an estate or testamentary trust by reason of the death of a partner. However, the IRS has not published any regulations excepting distributions from an estate or trust from sale or exchange treatment for purposes of § 743.

Another special issue arises when the decedent owned a partnership interest through a QTIP marital trust. Under pre-2010 law the QTIP assets are included in the decedent's gross estate under § 2044. The partnership interest is treated as passing from the decedent under § 2044. Thus there has been a transfer by death, which enables the partnership to make a § 754 election to step up the inside basis of the partnership assets to the decedent partner's outside basis.[89] However, if the partner dies in 2010, the QTIP assets are not included in the decedent's gross estate because there is no estate tax and § 2044 does not apply. This means there has been no transfer by death under § 743(a), and the partnership cannot adjust the inside basis of the partnership assets.

B. Mechanics: The Hypothetical Sale

The outside basis in the decedent's partnership interest is adjusted to the value on the partner's date of death, or the alternate valuation date, if applicable, regardless of whether a § 754 election is made.[90] The basis increase will eventually provide a tax savings for the successor when the partnership interest is sold or liquidated. However, wanting to reap the tax benefits of a basis step-up sooner, many partnerships make the § 754 election. This pushes the outside step-up or step-down to the inside basis of the partnership assets with respect to the decedent partner's interest. Thus, sales of property occurring fairly soon after death will result in little or no gain to the successor partner due to the § 754 basis adjustment.

The regulations provide how to allocate a transferee's basis in his partnership interest among his share of the underlying partnership assets when the partnership makes a § 754 election.[91] The goal of § 754 is to achieve uniformity between the inside and outside basis when there has been a transfer of a partnership interest by sale or exchange or upon the death of a partner. Stated another way, a transferee partner of a partnership that made a § 754 election should have the same basis in his share of the underlying partnership assets as if he had purchased an undivided interest in them. To achieve this goal, regulations provide a three-step process.

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[86] IRC §§ 734(a), 743(a).
[87] IRC § 761(e).
[88] S. Rep. 313, 99th Cong., 2nd Sess., 1986-3 C.B. Vol. 3 924.
[89] PLR 200442028.
[90] IRC § 1014(a).
[91] Regs. §§ 1.743-1, 1.755-1.

Step One - Determine the difference between the partner's basis of his partnership interest and his share of the adjusted basis of partnership property.[92] This difference is the § 743 adjustment. The basis of a purchased interest is its cost. The basis of an interest acquired from a decedent is the fair market value at the date of death or the alternate valuation date.[93]

Step Two – Separate the adjustment into two classes - ordinary income and capital gain property. [94]Apply the adjustment first to ordinary income property in an amount equal to the income that would be allocated on sale of that asset at fair market value. Apply the remaining balance of the adjustment to the capital gain class. One class may get a step-up in basis and another class may be allocated a step-down. [95]

Step Three - Allocate the step-up or down for each class among the assets within each class on an asset by asset basis based on the taxable gain or loss that would be allocated to the transferee from the "hypothetical sale" of each item. [96]

EXAMPLE

Joe died with an interest in partnership that has only marketable securities. His partnership interest is valued at $17,500 based on a hypothetical sale of his share of the underlying assets. His share of the basis in those assets is $11,200. The Section 743 adjustment is $6,300 ($17,500 – 11,200) and is allocated as follows:

	Basis before 743 Adj	FMV	§ 743 Adj.
Stock A	6,000	2,000	-4,000
Stock B	1,800	9,200	+7,400
Stock C	3,300	2,800	- 500
Stock D	100	3,500	+ 3,400
Total	$11,200	17,500	6,300

C. Applying Partnership Discounts

A "hypothetical sale" of the underlying partnership assets will always produce a higher value than a sale of a discounted minority interest in them. Thus the question arises how to allocate valuation discounts among the partnership assets. The regulations provide an example of a partner who sells his interest for less than fair market value, which would be similar to a discount based on restrictions in the partnership agreement.[97] In the example, the discount is allocated to the partnership's capital gain assets based on each property's relative fair market

92 Reg. § 1.743-1(b)-(d).
93 Reg. § 1.742-1.
94 Reg. § 1.755-1(a).
95 Reg. § 1.755-1(b)(2).
96 Reg. § 1.755-1(b)(3).
97 Reg. § 1.755-1(b)(3)(iii), Ex. 2.

value as a percentage of all the capital gain assets.[98]

EXAMPLE

Joe died with an interest in partnership that has only marketable securities. His share of the underlying assets is worth $17,500 based on a hypothetical sale of those assets. However, an appraiser values his interest at $14,000 based on discounts for lack of marketability and control. Joe's share of the basis in those assets is $11,200. The total gain that would be allocated from a hypothetical sale of those assets is $6,300 ($17,500 – 11,200). However, this exceeds the total basis adjustment required under § 743 by $3,500 ($17,500 - $14,000), which is the amount of the discount. Therefore, the $3,500 discount and is allocated as follows:[99]

	Basis before 743 Adj	FMV	§ 743 Adj.	Discount Allocated	Adjusted Basis
Stock A	6,000	2,000	-4,000	-400[100]	$ 1,600
Stock B	1,800	9,200	+7,400	-1,840	7,360
Stock C	3,300	2,800	- 500	-560	2,240
Stock D	100	3,500	+ 3,400	-700	2,800
Total	$11,200	17,500	6,300	-$ 3,500	$14,000

Stated more simply, each asset derives a new basis equal to a fraction of the total discounted value based on each asset's fair market value as it relates to the total fair market value. In the example above, Stock D comprises 20 percent of the total fair market value ($3,500/$17,500 = 20%). Therefore, Stock D has a new basis under § 743 of $2,800, or 20 percent of $14,000.

D. Community Property

A § 754 election permits an adjustment to be made under § 743(b) to the basis of partnership property "...in the case of a transfer of an interest in a partnership by sale or exchange or on the death of a partner." In community property states the surviving spouse's one-half community interest in the partnership is not "transferred" upon the decedent's death because the surviving spouse owns it to start with.[101] However, by statutory grace, the survivor obtains a basis adjustment under § 1014(b)(6). Despite that the § 754 election should not literally apply to the surviving spouse's community property interest in the partnership, the IRS has ruled that the § 754 optional basis adjustment applies to the entire partnership interest owned as community property, including the surviving spouse's share.[102] The same result applies if the nonpartner spouse predeceases the partner spouse.[103] While seemingly incorrect, the ruling is favorable to

98 Reg. § 1.755-1(b)(3)(iii), Ex. 2.
99 *Id.*
100 $2000/$17,500 X $3,500 = $400.
101 Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin are community property states.
102 Rev. Rul. 79-124, 1979-1 C.B. 224.
103 *Id.*

the taxpayers and solves the accounting problems that arise from a bifurcated basis attributable to the surviving spouse's partnership interest.

E. When Not to Make the Election

If the discounted value of the partnership interest is less than the partnership's cost basis in the underlying assets, the partnership should not make the § 754 election. If made, the election will reduce the decedent partner's share of the cost basis of the partnership assets to the discounted amount. However, for deaths occurring after October 22, 2004 the partnership will be forced to make a downward adjustment if the cost basis of all the partnership property exceeds its fair market value by more than $250,000.[104]

EXAMPLE

DMS partnership has marketable securities with a cost basis of $100,000 and a market value of $150,000. An appraisal applies a 50 percent discount, valuing the partnership at $75,000. D, a 20 percent partner, dies and DMS makes § 754 election. D's new basis on his date of death is $15,000, or 20 percent of $75,000. After his death, DMS sells the stock for $150,000. The tax consequences to D's successor are:

	With § 754 Election	Without § 754 Election
Sales Proceeds allocable to D (20% X $150,000)	30,000	30,000
D's Stock Basis		
(20% X $75,000)	-15,000	
(20% X $100,000)		-20,000
Gain Recognized	$15,000	10,000

In the above example, the § 754 election brings the discount inside the partnership causing D to report an extra $5,000 in gain. But this is only a timing difference. D's successor adds the $5,000 gain to his outside basis and reduces his gain when he later disposes of his interest.

	With § 754 Election	w/o § 754 Election
D's Basis in Pship	15,000	15,000
Gain recognized	15,000	10,000
Liquidation Distr.	-30,000	-30,000
Gain on Liquidation	-0-	5,000

However, timing differences matter, especially if the partnership does not plan to cash out the successor partner right away and the partnership will sell assets soon after the decedent's death.[105] The partnership should base its decision whether to make a § 754 election on how soon

[104] *See* discussion at Section III.F. *infra*.

[105] *See* Exhibit B, Section 754 Decision Tree *infra*.

after the decedent's death the assets will be sold. The more likely the partnership will sell them soon after the decedent's death, the more likely the § 754 election will be beneficial.

If the IRS is currently auditing or likely to audit the decedent's Form 706, it may be difficult to decide whether to make the § 754 election. Any reduction in the discount will affect the basis of partnership assets when a § 754 election is in effect. A partnership that did not make the election because the cost basis of its assets exceeded the discounted value may regret that decision if the IRS reduces the discount so that the discounted value exceeds the inside cost basis. In that case a § 754 election would have been desirable. However, taxpayers should evaluate the § 754 election independently of the potential consequences of an IRS audit.[106] First, it is impossible to predict whether the Form 706 will be audited and what the outcome will be. Second, the partnership and partners can amend their income tax returns if they are within the three-year statute of limitations. Third, the partners may be entitled to equitable relief if they are beyond the statute of limitations for amended returns.[107]

Unless the § 754 election will produce significant benefits, it should probably not be made because of its impact on the remaining partners. For example, if the partnership redeems the estate shortly after death, the estate will receive a new basis in the assets distributed equal to the estate's outside basis in the partnership interest. Thus there would be no need for a 754 election. If the partnership does not plan to sell any of its major assets anytime soon, a step-up on the inside basis produces no immediate tax savings. In both cases, if the partnership had made the election, it would achieve little or no income tax benefit, while causing significant impact on the remaining partners for the duration of the partnership. Thus, where the estate's interest is very small or assets will not be sold or depreciated, the partnership should probably not make the election. This decision can be one of the hardest decisions a partnership can make.[108]

F. Mandatory Basis Adjustments for "Substantial Built-in Loss Property"

Basis adjustments under § 743 are mandatory when a partner dies or transfers by sale or exchange an interest in the partnership that has a "substantial built-in loss." A substantial built-in loss exists if the adjusted basis of partnership property exceeds the property's market value by more than $250,000 on the date of the death or transfer.[109] If the partnership is required to make a mandatory basis adjustment because of a substantial built-in loss, it must check the box on new line 12c of Form 1065, Schedule B and attach a statement showing the computation and allocation of the basis adjustment.[110]

Note that the $250,000 is the difference between the cost and market value of the partnership *property,* not the partnership interest. But once this threshold is met, the required adjustment is the difference between the cost of the partnership property and the discounted value of the partnership interest, which could be significantly larger than the spread between the cost and market value of the partnership assets.

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106 *Id.*

107 Jorgensen v. Comm'r, T.C. Memo 2009-66 (Mar. 26, 2009), *aff'd* 107 AFTR 2d 2011-2069 (9th Cir 2011).

108 *See* Exhibit B, Section 754 Decision Tree *infra.*

109 IRC § 743(d).

110 2009 Form 1065, Schedule B, line 12c.

1. The $250,000 Threshold

The partnership measures the $250,000 on a "net" basis with respect to the entire partnership, rather than on a per asset basis. Thus, the partnership could have significant built-in losses and escape the rule as long as it has sufficient built-in gains to offset the losses to below $250,000. The statute applies the $250,000 test on a partnership by partnership basis. Thus, it may apply to a parent but not to its subsidiary partnership. Nonetheless, the value and basis of a subsidiary partnership is part of the gain or loss measured at the parent level. Anticipating potential abuse in this area, Congress authorized the IRS to write regulations aggregating related partnerships.[111] Congress anticipated that taxpayers might be tempted to transfer property to a partnership just before a death or sale of the interest to avoid these rules. Therefore, Congress also granted the IRS regulatory authority to disregard property acquired by the partnership in anticipation of a transfer or death.[112]

There are many unanswered questions about how to figure a partnership's basis in its property under IRC § 743(d). For example, do § 754 adjustments count as part of the basis of the partnership assets? Also, is the basis of built-in loss property contributed after October 22, 2004 its basis or market value on the contribution date?[113]

The estate's alternate valuation election does not affect the determination of whether a partnership has a substantial built-in loss. Section 743(d) measures the difference between the basis and the market value of the partnership assets on the date of death or transfer. It makes no reference to the alternate valuation date. Once the partnership determines that it has a substantial built-in loss on the date of death, the *amount* of its mandatory basis adjustment under § 743(b) depends upon whether the estate elects AVD. It is also important to note that the partnership calculates the built-in loss, but the estate makes the AVD election, and they have different compliance deadlines. Therefore, it might be impractical to make the partnership's determination of whether it has a substantial built-in loss depend on whether the executor elects AVD.

2. The Mechanics

Once the partnership determines that it has a substantial built-in loss on the date of a sale, exchange, or death of a partner, the size of the adjustment depends on the distributee's outside basis. The partnership must adjust, up or down, the basis of individual partnership assets with respect to the transferee to equal the transferee's outside basis in his partnership interest. The adjustment is allocated among the assets as if the transferee purchased an undivided interest in each one. A sale or exchange of any size, or the death of any partner, requires this adjustment with no de minimis rule. The adjustment affects only the transferee partner.

EXAMPLE

Dad died with a 25 percent interest in a family partnership with assets worth $4,000,000 and a basis of $4,300,000. The partnership has a substantial built-in loss because the property's basis exceeds its market value by more than $250,000.

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[111] IRC § 743(d)(2).

[112] *Id.*

[113] *See* discussion at Section II.C.3. *infra*.

	(a) FMV of Partnership Assets	(b) Cost of Partnership Assets	(a) – (b) Substantial Built-in Loss
Total	$ 4,000,000	$ 4,300,000	(300,000)

The partnership must reduce the decedent's share of the inside basis of partnership assets as if the partnership had made a § 754 election, even though the partnership would not have made the election voluntarily. In the example above, if the partnership sells its assets for $4,000,000 the other partners would report their share of the loss. However, the estate's basis has been reduced by its share of the built-in loss and thus is not entitled to report any share of the loss.

3. Partnership Discounts and the $250,000 Threshold

The question arises how valuation discounts impact the new mandatory basis rules. Section 734(d) asks us to measure the difference between the partnership's basis and fair market value of its property. For this purpose, it is irrelevant what the partner's basis in his partnership interest is. However, once the partnership determines that it has a substantial built-in loss, the transferee/decedent partner's basis in his partnership interest determines the amount of the mandatory basis adjustment made on the partnership books.[114]

EXAMPLE

Dad died with a 25 percent interest in a family partnership that has assets worth $4 million and a basis of $4.3 million. The partnership has a substantial built-in loss of $300,000.[115] Therefore, it must reduce the estate's share of the inside basis of the partnership assets to the value of the estate's partnership interest, which the executors valued at $700,000 using a 30 percent discount. The mandatory downward adjustment for the estate is therefore $375,000 [$1,075,000 - $700,000].

	(a) FMV of Pship Assets	(b) Basis of Pship Assets	(a) – (b) Difference	(c) Outside Basis of Pship Interest	(b) – (c) Mandatory Step Down
Total	$4,000,000	$4,300,000	(300,000)	$2,800,000	
Dad's 25%	$1,000,000	1,075,000	(75,000)	700,000	$ 375,000

Therefore, even though partnership discounts do not affect the $250,000 threshold, they may affect the size of the mandatory basis adjustments the partnership is required to make once it passes the threshold. Further, because discounts are apt to change upon an IRS audit, the partnership may not be sure how much of an adjustment to make. For example, assume the partnership sells property and reports gain or loss to the transferee partner based on the mandatory adjustments. If the mandatory adjustments subsequently change because the discounts change, the partnership and the transferee partner(s) would need to amend their income tax

[114] IRC § 743(b)(2).

[115] Adapted from Notice 2005-32, 2005-16 I.R.B. 895 (Apr. 1, 2005).

returns to report the correct gain or loss. They should be careful to do so before the statute of limitations expires, which is generally three years from the extended due date of their original returns.[116] These adjustments apply only to the transferee partner and his successors.[117]

If a partnership has a built-in loss exceeding $250,000, and the death of a major partner is imminent, the partnership might consider selling assets to recognize losses before the partner dies. Alternatively, the partner might consider gifting all or a portion of his partnership interest to a family member to transfer his built-in losses to the donee under § 704(c).[118] This applies to all built-in losses except on property contributed after October 22, 2004.

An estate that acquires an interest in a partnership that is subject to the new mandatory basis adjustment rues must notify the partnership in writing of its acquisition within one year of the partner's death.[119] A transferee by sale or exchange has only 30 days from the transfer to notify the partnership. The partnership must attach a statement to its return in the year of a death or transfer to which these rules apply showing the computation of the adjustments and the properties to which they have been allocated.[120]

G. Recordkeeping Responsibility

The regulations require a partnership to attach a statement to its return when it becomes aware that a transfer subject to the optional basis adjustment rules has occurred.[121] The statement must contain the partner's name, taxpayer ID number, and a computation of the partner's adjustment under § 743(b). Transferees (i.e. purchasers or successors in interest) must notify the partnership of the basis in their acquired interest.[122] Transferors have no obligation to report the transfer. When a partner dies, the successor partner must notify the partnership within one year of death.[123] Partnerships may rely on written representations of transferee partners concerning either the amount paid or the basis in the partnership interest acquired from a decedent.[124]

H. Impact of § 754 on Other Partners

The § 754 basis adjustments not only affect a transferee partner's basis, they also affect the basis of the partnership's assets under any of the following four situations:

(a) A partner receives money (or securities) in excess of his partnership basis;[125]
(b) A partner receives only money (or securities), unrealized receivables, and inventory in complete liquidation of his interest and the total of these items is less than his remaining basis in his partnership interest;[126]

116 IRC § 6511; *see also* Exhibit B, Section 754 Decision Tree *infra.*
117 Reg. §§ 1.743-1(f), (j)(1).
118 *See* discussion at Section II.C.2.
119 Notice 2005-32, 2005-16 I.R.B. 895 (Apr. 1, 2005); Reg. § 1.743-1(k)(2)(ii).
120 Notice 2005-32, 2005-16 I.R.B. 895 (Apr. 1, 2005); Reg. § 1.743-1(k)(l).
121 Reg. § 1.743-1(k)(1).
122 Reg. § 1.743-1(k)(2).
123 Reg. § 1.743-1(k)(2)(ii).
124 Reg. § 1.743-1(k)(3).
125 IRC §§ 731(a)(1), 734(b)(1)(A).
126 IRC §§ 731(a)(2), 734(b)(2)(A).

(c) A partner receives property that has an adjusted basis in excess of the partner's basis in his partnership interest;[127] and
(d) A partner receives property in a liquidating distribution and the property's basis is less than the partner's basis in his partnership interest;[128]

In situations (a) and (c) the partnership must increase the basis of assets remaining on its books. In situations (b) and (d), the partnership must reduce the basis of assets remaining on its books. Note that the American Jobs Creation Act of 2004 made these basis adjustments mandatory for deaths and transfers after October 22, 2004 where the partnership has a built-in loss greater than $250,000, despite the absence of a § 754 election.[129] The Jobs Act also made the negative adjustments mandatory for distributions after October 22, 2004 if the amount of the adjustment required if a § 754 election had been in effect would have exceeded $250,000.[130]

The following illustrates the adjustment to partnership property if a § 754 election is in effect when the partnership makes a liquidating distribution of property, the basis of which exceeds the partner's basis in his partnership interest (situation (c) above):

EXAMPLE 1

> D, M, and S form DMS, a family partnership with a § 754 election in effect. D and M each contribute Properties A and B for a one-third interest in the partnership. Properties A and B each have a basis of $40 and a FMV of $100. S contributes land with a basis and fair market value of $100 for a one-third interest. Seven years later the land, still worth $100, is distributed to D in liquidation of his interest.

The partnership's basis in the land is $100. However, upon distribution, its basis to D is limited to D's $40 basis in his partnership interest.[131] Without a Section 754 election, no adjustment is made to the partnership's remaining assets and $60 of the land's basis disappears into thin air. If, however, the partnership had a § 754 election in effect in the year of the distribution, the basis of DMS's remaining assets would be stepped-up by $60 to make up for the disappearing land basis.

Example 1 creates basis for the partnership. Contrast it with Example 2 below which eliminates partnership basis (situation (d) described above):

EXAMPLE 2

> Assume the same facts as Example 1 except that the partnership distributes Property A to S in liquidation of his interest (instead of D). Property A, worth $100, has a basis of $40 basis, but it assumes a new basis in the hands of S equal to S's basis in his partnership interest, or $100.[132]

[127] IRC §§ 732(a)(2), 734(b)(1)(B).
[128] IRC §§ 732(b), 734(b)(2)(B).
[129] P.L. 108-457, § 833.
[130] *Id.*
[131] IRC § 732(b).
[132] *Id.*

If the partnership had a § 754 election in effect in the year of the distribution, the basis of DMS's remaining assets would be stepped-up down by $60 to make up for the basis increase that S enjoyed. Absent a § 754 election in effect, no adjustment is made to the basis of the partnership's remaining property. In effect, $60 of basis has been created for Property A with respect to S. In addition, the partnership retains the high basis land. This is exactly the type of practice the American Jobs Creation Act sought to curtail after October 22, 2004.[133]

Keep in mind that these adjustments are only temporary. When the partnership interest is liquidated and the assets are distributed or sold, the proper amount of gains and losses will be recognized by the proper parties regardless of whether the partnership made a § 754 election. The only difference is the timing. The main point is to anticipate the impact a § 754 election will have on future transactions and weigh the current benefits to the deceased partner of a § 754 election against any potentially detrimental basis adjustments impacting the remaining partners.

I. Making the Election

To make the election the regulations require the partnership to attach a written statement, signed by one of the partners, to its timely filed return (including extensions) for the year in which the partner died or the transfer occurred.[134] The partnership should also check the box on line 12a of Form 1065, Schedule B, indicating that it is making the election. Checking the box is not a substitute for attaching a written election statement. Nor is it enough to reflect the adjustments to basis as if the election were in place. The election must actually be made.[135]

The IRS gives independent effect to each partnership's § 754 election (or lack thereof). Thus, a parent's § 754 election is not effective for the lower tier partnership. It must make a separate election.[136] However, where a lower tier partnership inadvertently fails to make a § 754 election, the IRS has granted it relief where the upper tier partnership made a timely election.[137] If both an upper and lower-tier partnership make a § 754 election, the upper-tier's election causes a basis adjustment of property for both tiers.[138] If only the lower-tier partnership makes a § 754 election, no basis adjustment is available at either level.[139] In other words, to adjust the basis of the lower tier partnership's assets, both tiers must make the election.

1. Late Elections

If the due date for a § 754 election has passed, the partnership can still make the election by filing an original or amended return within twelve months of the due date, including extensions, of the return year for which the election is sought. The partnership should print: "**FILED PURSUANT TO REG. 301.9100-2**" on the top of the election. No user fees apply.[140] Thus the partnership can make an election effective for 2013 as late as September 15, 2015, which is one

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[133] P.L. 108-457, § 833.
[134] Reg. § 1.754-1(b).
[135] Ltr. Ruls. 200901015, 200903068, 200901016.
[136] Rev. Rul. 87-115, 1987-2 C.B. 163.
[137] Ltr. Ruls. 9338004, 9338005, 9338006, 9327068.
[138] *Id.*
[139] Rev. Rul. 87-115, 1987-2 C.B. 163; *See also* McKee, Nelson, & Whitmire, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS, Third Edition (Warren, Gorham & Lamont, 2004) ¶24.09.
[140] Reg. § 301.9100-2(d).

year from the final extended due date of September 15, 2014.

Failure to qualify under the automatic extension provisions of Reg. § 301.9100-2 is not the last stop. But it's the last quick or cheap stop. Taxpayers ineligible for the automatic extension may still request a late § 754 election under Reg. § 301.9100-3. Permission is not automatically granted by the Commissioner and carries a $10,000 user fee.[141] The partnership must have acted reasonably and in good faith and the relief must not jeopardize the interest of the government.

The IRS has been generous in granting relief for late § 754 elections where the failure was due to complications of administering the estate, extended litigation,[142] reliance on accountants who made an error or failed to properly inform them,[143] preparation of the election statement, but failure to attach it to the return,[144] and simple inadvertence, where the taxpayer acted in good faith.[145] While the IRS has been lenient, a ruling requires a $10,000 user fee ($2,000-$4,000 for small users) and takes significant professional time to complete.[146]

If several years are closed under the statute of limitations, the IRS has denied relief.[147] It has also denied a late election where it was made after the IRS included partnership assets in the decedent's estate under § 2036. The LLC had not made the § 754 election on the original return because "the benefit it provided did not outweigh the complexity of creating multiple bases."[148]

2. Revoking the Election

Once made, the election is irrevocable without the approval of the district director for the district in which the partnership return is required to be filed.[149] A request for revocation must be filed within 30 days after the partnership year end for which the election is intended to be effective, usually the tax year within which the partner died.[150] The IRS will approve a request for reasons such as a change in the nature of the partnership business, a change in the character of the partnership assets, or an increased frequency of shifts of partnership interests where a 754 election would increase the administrative burden on the partnership. A revocation will not be approved if its primary purpose is to avoid stepping down the basis of partnership assets.

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141 Rev. Proc. 2013-1, 2013-1 I.R.B., Appendix A.

142 Ltr. Ruls. 200531016, 200530015.

143 Ltr. Ruls. 201102025-26, 201012031, 201011004, 201012032, 200906026, 200835007, 200827031, 200815008, 200808022, 200738009, 200530018, 200507007.

144 Ltr. Rul. 200802001.

145 Ltr. Rul. 201251004, 201222012, 201149006, 201141002, 201141001,201122015, 201122011, 201114011, 201119020, 201108023, 201102025, 201102026, 201017034, 200950031, 200941007, 200932037, 200929003, 200908018, 200903069, 200838019, 200837001, 200834018, 200832014, 200827020, 200826027, 200606004, 200546002, 200537016, 200537008.

146 Rev. Proc. 2013-1, 2013-1 I.R.B. 1 (for ruling requests received by IRS after Feb. 4, 2012) (Reduced user fees apply to individuals, estates, partnerships, corporations, and other entities whose adjusted gross income is less than $250,000 or $1,000,000.)

147 Ltr. Rul. 9452025.

148 Ltr. Rul. 200626003 (7/28/2006) (IRS denied relief under Reg. § 301.9100-3 for a partnership to make a late § 754 election after the decedent's Form 706 was audited and the IRS included assets contributed to the partnership in the decedent's estate under § 2036. The partnership did not make the § 754 election on the original return because at the time it did not seem that the benefits outweighed the complexity.).

149 Reg. § 1.754-1(c).

150 Reg. § 1.754-1(c)(1).

If the partnership is beyond the 30 day revocation period under Reg. § 1.754-1(c), it can seek relief for a late filed revocation under Reg. § 301.9100-1, which defines the standards for relief under Reg. § 301.9100-2.[151] The partnership will need to pay a $10,000 user fee and provide a detailed explanation of why additional time should be granted.[152]

On the other hand, if the partnership discovers that a § 754 election was made in error, it may be possible to rescind the election based on "mistake of fact." There are no published rulings on revoking a § 754 election, prospectively or retroactively, except for a few dealing with a special one-time revocation that was permitted for certain pre-2000 requests.[153] But note that a rescission is not the same as a revocation. A revocation must be requested within 30 days of the partnership year end for which it is to be effective. Because this deadline occurs well the initial election would have been made, the procedures for revoking an election could not have been intended for revoking an initial election. If the initial election was made in error, it may be possible to amend the return and void the election from inception based on a "mistake of fact, particularly if the taxpayer received no benefit from the election."[154]

3. Division or Constructive Termination

Another way to terminate a § 754 election is to constructively terminate the partnership under § 708. A constructive termination occurs if 50 percent or more of the total interest in partnership profits and capital are sold or exchanged within a 12 month period.[155] A constructive termination ends any partnership elections that were in effect prior to the termination, including a § 754 election, except with respect to the incoming partner.[156] The termination is effective on the date of the sale or exchange, which by itself or together with sales or exchanges occurring in the previous 12 months, transfers an interest of 50 percent or more in partnership profits and capital.[157] There are no attribution rules in determining the 50 percent ownership test.

Distributions of a partnership interest by an entity are sales or exchanges for purposes of § 708, 743, and any other provision that the Secretary prescribes in regulations.[158] The sale or exchange need not necessarily be a taxable sale or exchange. The legislative history to § 761(e) provides that the Secretary may provide exceptions to this rule and that: "It is intended that exceptions might include a distribution of a partnership interest by an estate or testamentary trust by reason of the death of a partner will not be treated as a sale or exchange for purposes of § 708(b)." [159] To date the IRS has excluded the following transactions from sale or exchange treatment under § 708:

[151] Ltr. Ruls. 9234022, 9228018.

[152] Rev. Proc. 2013-1, 2013-1 I.R.B. 1, Appendix A, category 3(c) (for requests received by IRS after Feb. 4, 2012).

[153] Reg. § 1.754-1(c)(2).

[154] Roy H. Park Broadcasting, Inc. v. Commissioner, 78 T.C. 1093, 1134 (1982) ("once a taxpayer makes an elective choice, he is stuck with it."); *but see* Grynberg v. Comm'r, 83 T.C. 255 (1984) (exceptions to the doctrine of election for material mistake of fact.)

[155] Reg. § 1.708-1(b)(2).

[156] Reg. § 1.708-1(b)(5).

[157] Reg. § 1.708-1(b)(1)(iii)(b).

[158] IRC § 761(e).

[159] S. Rep. No. 313, 99th Cong., 2d Sess. 924 (1986).

- A transfer by gift, bequest, or inheritance.[160]
- A liquidation of a partnership interest. [161]
- Contributions of property by new or existing partners causing a shift in partnership interests of more than 50 percent.[162]

Because these constructive termination rules serve as a "trap for the unwary or as an affirmative planning tool for the savvy taxpayer," the Administration's Fiscal Year 2014 Revenue Proposals would repeal § 708(b)(1) altogether.[163]

a. Distributions of a Greater Than 50 Percent Partnership Interest

The death of a 51 percent partner and consequent transfer to his estate is not a sale or exchange that constructively terminates the partnership.[164] Nor is the transfer of a partnership interest in satisfaction of a specific bequest, according to the regulations. However, a distribution by the estate of a 51 percent partnership interest in satisfaction of a pecuniary bequest is a taxable sale or exchange under § 661.[165] It would also cause a constructive termination of the partnership and terminate the partnership's § 754 election.

However, a distribution of the partnership interest by the estate as part of the residue would not be a sale or exchange that constructively terminates the partnership because it is a transfer by inheritance, which the regulations exclude from sales or exchanges under § 708.[166] Thus it would not terminate the partnership's § 754 election. A distribution by a trust other than by reason of the death of a partner would not be a "transfer by bequest or inheritance" and thus could cause a constructive termination under § 708, even though it is not a sale or exchange.[167]

In lieu of a deemed sale, a partnership could simply dissolve in order to substitute its outside basis for its inside basis.[168] The partnership could also divide as discussed below.

b. Dividing the Partnership

A partnership can also terminate, along with its elections, by dividing into two or more partnerships, at least one of which is owned by partners who had an interest of 50 percent or less in the capital and profits of the prior partnership.[169] In this case, a resulting partnership of 50 percent or less of the prior partnership is treated as a liquidation of the partners' interests and a contribution to a new partnership.[170] Any resulting partnership that consists of partners owning more than 50 percent of the prior partnership's capital and profits is considered a continuation of

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160 Reg. § 1.708-1(b)(1)(ii).
161 Reg. § 1.708-1(b)(2).
162 *Id.*
163 General Explanation of the Administration's 2014 Revenue Proposals, p.231, *available at.* http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf.
164 Reg. § 1.708-1(b)(1)(ii).
165 Reg. § 1.661(a)-2(f)(1).
166 Reg. § 1.761-1(e).
167 S. Rep. No. 313, 99th Cong., 2d Sess. 924 (1986).
168 IRC § 732(d).
169 IRC § 708(b)(2)(B).
170 Reg. § 1.708-1(d).

the prior partnership and its elections remain intact.[171]

EXAMPLE

> A, B, C, and D are each 25 percent partners in ABCD Partnership that has a § 754 election in effect. The partnership divides its assets equally into AB Partnership and CD Partnership. A and B each own a 50 percent interest in AB. C and D each own a 50 percent interest in CD. ABCD Partnership has terminated because 50 percent or more of its capital and profits has been exchanged within a 12 month period. Neither AB nor CD is owned by partners who owned more than 50 percent of ABCD Partnership. Therefore, neither AB nor CD has a valid § 754 election in effect.

A partnership wishing to terminate a § 754 election by dividing a partnership must do so before the death of the key partner. The assets for which the § 754 election is undesirable should be transferred to a new partnership that is not considered a continuation of the prior partnership under § 708. This is major surgery, but may be warranted in the right circumstances.

On the other hand, if the partnership has not already made a § 754 election and has both appreciated and depreciated assets, it should consider dividing in two. One partnership would own the appreciated assets and make a § 754 election. The other would own the depreciated assets and would not make the election. The post-division election by one partnership does not affect the other partnership.[172] One must be careful that the cost basis of the depreciated assets does not exceed their market value by more than $250,000, or else the mandatory basis adjustment rules require the basis to be stepped down.[173] In addition, it is important to complete the division and have the new partnership make a timely § 754 election. The partnership with assets having the greatest fair market value (net of liabilities) will continue to use the federal ID number of the old partnership. The other partnership must obtain a new ID number.[174]

J. The Duty of Consistency

Regardless of whether the partnership makes the § 754 election or not, the IRS and the Tax Court maintain that taxpayers have a "duty of consistency" to use the same basis for federal income tax purposes as the estate tax values finally determined. The taxpayer's duty of consistency is a judicial doctrine invoked where (1) the taxpayer made a representation of fact or reported an item for tax purposes in one tax year; (2) the Commissioner acquiesced in or relied on that fact for that year; and (3) the taxpayer desires to change the representation previously made in a later tax year after the earlier year has been closed by the statute of limitations.

The IRS Appeals Settlement Guidelines for Family Limited Partnerships discusses the duty of consistency in connection with partners using the undiscounted basis for federal income tax purposes, while benefiting from discounted values for estate tax purposes.[175] It refers to *Janis v. Commissioner* in which the trustee used the undiscounted basis for determining cost of goods

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[171] *Id.*
[172] Reg. § 1.708-1(d)(2)(ii).
[173] IRC § 743(d).
[174] Reg. § 1.708-1(d)(2)(i); Reg. § 1.708-1(d)(4)(i).
[175] APPEALS SETTLEMENT GUIDELINES, FAMILY LIMITED PARTNERSHIPS AND FAMILY LIMITED LIABILITY CORPORATIONS, Uniform Issue List (UIL) 2031.01-00 (Jan. 29, 2007).

sold in an art inventory, even though a heavily discounted basis was used when valuing the art inventory for estate tax purposes.[176] The Tax Court held that the trustee had a duty of consistency to use the same basis for estate and income tax reporting purposes. Although *Janis* did not involve a partnership § 754 election, the duty of consistency would apply whether or not a partnership makes a § 754 election. Thus, the partnership may not use a different basis for partnership assets than that finally determined for federal estate tax purposes.

For several years now, the Administration's Revenue Proposals have included a provision to require the basis of property to be equal to its date of death value for estate tax purposes or the donor's basis for gift tax purposes. The proposals have also contained reporting requirements that would be imposed on the executor or donor to provide the basis information to the recipient as well as the IRS.[177]

K. Consequences of Overstating the Basis

A critical question has been whether overstating the basis of an asset is an omission of gross income, which invokes the 6-year statute of limitations under § 6501(e). When a taxpayer omits an amount of gross income from a return that exceeds 25 percent of the gross income stated on the return, the IRS has 6 years from the time the return is filed to assess the tax, compared to the normal 3 year statute of limitations. The IRS regulations currently hold that a basis overstatement is an understatement of gross income for purposes of the 6 year statute of limitation.[178] However, the U.S. Supreme Court invalidated those regulations in April 2012 in *United States v. Home Concrete & Supply*. Thus, overstating the basis of an asset sold is not an omission of gross income that potentially extends the 3-year statute of limitations to 6 years.[179]

L. Valuation Discounts for the Election

Because mandatory basis adjustments have measurable negative consequences, a purchaser of a partnership interest would surely take them into consideration. For instance, higher discounts should apply during any seven year period in which the mixing bowl rules might apply. Additional discounts should also apply where the partnership agreement requires the partnership to make the § 754 election, or where the purchaser insists on it, because it requires extra recordkeeping. And finally, discounts should apply if the partnership has built-in loss property contributed on or after October 22, 2004 or that could be subject to mandatory basis adjustments on its distribution.[180] Even though it may be difficult to quantify the exact discount attributable to these basis adjustments, the accounting costs are real, despite their nature as timing differences. Congress thought these timing differences were significant when it enacted tough new laws to curb their abuses.

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[176] Janis v. Comm'r, TC Memo 2004-117, *aff'd* 461 F.3d 1080 (9th Cir. 2006), *aff'd on different grounds* 469 F.3d 256 (2nd Cir. 2006).

[177] General Explanation of the Administration's 2014 Revenue Proposals, *available at.* http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf.; General Explanation of the Administration's Fiscal Year 2013 Revenue Proposals, U.S. Dept. of the Treasury (Feb. 2012).

[178] Reg. § 301.6501(e)-1(a)(1)(iii).

[179] United States v. Home Concrete & Supply, 132 S.Ct. 1836 (2012).

[180] *See* discussion at Sections II.B.3. and IV.B. *infra*.

M. Partnerships Owned by a Marital Trust

When a surviving spouse dies with appreciated assets in a partnership interest owned by a QTIP trust that is included in his or her gross estate under § 2044(a), can the QTIP trust make a § 754 election to step up its share of the inside basis of the partnership assets? Some suggest that the answer is "no" because the partner (the QTIP trust) has neither sold, transferred, distributed its interest or died, which are prerequisites for the QTIP trust to adjust its share of the inside basis of partnership property under a § 754.[181] However, § 2044(c) treats property included under IRC § 2044(a) as property "passing from the decedent." Further § 1014(b)(10) treats property includible in the gross estate of the decedent under § 2044 as having "passed from the decedent" for purposes of acquiring a basis equal to the market value on the decedent's date of death.

Therefore, if the partnership interest is included in the surviving spouse's gross estate under § 2044 and is treated as "passing from the decedent" to the QTIP trust, the partnership should be eligible to make a § 754 election and adjust the QTIP trust's share of the inside basis of the partnership assets, assuming it makes a timely election. The election must be filed by the extended due date of the partnership return for the year in which the surviving spouse died,[182] or 12 months later under the automatic relief provision of Reg. § 301.9901-2.[183] Failing that, the partnership may request permission to make a late election pursuant to Reg. § 301.9901-3 if the partnership has acted reasonably and not on the basis of hindsight. By the same token, when a partnership interest is included in the decedent's estate under § 2044, it would also be subject to the mandatory basis adjustment rules if it has a substantial built-in loss under § 743(b).[184]

N. Partnerships Included under § 2036

Partnership interests included in a decedent's estate under § 2036 will achieve the benefits of a § 754 election whether the partnership makes an election for not. In Ltr. Rul. 200626003 the IRS denied an LLC permission to make a late § 754 after a partner died because the partnership did not act reasonably and in good faith and was acting in hindsight. [185] The partnership initially declined to make the election because the partners decided that the benefit "did not outweigh the complexity of creating multiple bases." But after the IRS audited the estate tax return and included the full value of the real estate in the father's gross estate under § 2036(a)(1), the partners changed their mind and asked for permission to make a late § 754 election.

Even though the IRS denied the late § 754 election, it allowed a stepped up basis for the partnership's asset under § 1014(b)(9) on the basis that it was 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).." Thus, the Service allowed the LLC to adjust the basis of the real estate, without a § 754 election.

The Tax Court also reached this same conclusion in *Jorgensen v. Commissioner* for partnership assets included in the decedent's estate under § 2036.[186] This is particularly

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181 Frank J. O'Connell and Sally E. Day, "Marital Trusts and the Sec. 754 Election," The Tax Adviser Magazine, Tax Clinic, 9-06 T.T.A. 514 (Sept. 2006).

182 Reg. § 1.754-1(b).

183 Reg. § 301.9901-2(a)(2)(vi).

184 *See* discussion at Section III.F. of this outline.

185 Ltr. Rul. 200626003 (July 28, 2006).

186 Jorgensen v. Comm'r, T.C. Memo 2009-66 (Mar. 26, 2009), *aff'd* 107 AFTR 2d 2011-2069 (9th Cir 2011).

significant because the assets in the Jorgensen's estate included partnership interests owned by other family members who had received their interests by gift many years before Jorgensen's death. Nonetheless, the Tax Court invoked the doctrine of equitable recoupment under § 6214(b) and allowed the other family members to amend their tax returns, which were otherwise barred by the statute of limitations, to reduce gains previously reported .

IV. TAXATION OF DISTRIBUTIONS

A. General Rules

The general rule is that partnership distributions are not taxable to the partner or the partnership, unless any money distributed exceeds the partner's basis in his partnership interest.[187] However, exceptions nearly swallow up this rule. For example, the IRS can treat distributions of property as money based on substance over form if the distribution has no business purpose.[188] Similarly, marketable securities can be treated like money under § 731(c). So can the transfer of partnership property to a partner in satisfaction of a guaranteed payment under § 707(c). It will constitute a taxable sale or exchange between the partner and the partnership.[189] Distributions of ordinary income property under § 751 can be taxable. Distributions can also be treated as "disguised sales" under § 707(a). And finally, distributions of proeprty within seven years of a contribution of property can be treated as a sale between partners under §§ 704(c)(1)(B) and 737. Therefore, it is more correct to say that taxable distributions are the norm and tax-free distributions the exception.

1. When Distributions are Deemed to Occur

Distributions are generally aggregated and treated as all occurring on the last day of the partnership's tax year.[190] However, certain distributions that are treated as "disguised sales" under § 707(a) are deemed to occur on the actual day of the transaction. [191] And distributions of pre-contribution gain or loss property within seven years of a contribution of property to the partnership are deemed to occur on the actual date of the transaction.[192]

2. Basis of Property Distributed

In a nonliquidating distribution of property, the partner takes a carryover basis equal to the basis of the property in the hands of the partnership, limited to the partner's basis in his partnership interest.[193] If the basis of the distributed property exceeds the partner's basis in his

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[187] IRC §§ 731(a), (b).

[188] CCA 200650014 (Sept. 7, 2006) (where the property was selected by the distributee, acquired by the partnership immediately before the distribution solely for the purpose of distribution, and was unrelated to the partnership's business.); see also Countrywide Limited Partnership et al v. Comm'r, T.C. Memo 2008-3 (Jan. 2, 2008) (The IRS alleged that note distributed in liquidation of a partner's interest had no legitimate business purpose and should therefore be treated as cash distributions resulting in a gain to the partners. However, the Tax Court held in favor of the taxpayer finding a legitimate business purpose because the economic interest of the partners had changed.)

[189] Rev. Rul. 2007-40, 2007-25 I.R.B. 1426 (June 1, 2007).

[190] Reg. § 1.731-1(a)(1)(ii).

[191] Reg. § 1.707-3(a)(2).

[192] Reg. §§ 1.704-4(b), 1.737-1(d).

[193] Reg. § 1.732-1(a).

partnership interest, the excess "disappears," unless the partnership has a § 754 election in effect.[194] With a § 754 election, the partnership steps up the basis of its remaining property.

The rules on liquidating distributions are different. The partner's basis in his partnership interest becomes the new basis for the property received in liquidation of his interest.[195] As in a nonliquidating distribution, if the basis of property distributed exceeds the partner's basis in his partnership interest, the excess "disappears," unless the partnership has a § 754 election in effect.[196] If a § 754 election is in place the excess increases the basis of the partnership's remaining property. However, if the basis of property distributed in liquidation is less than the partner's basis in his partnership interest, the partner steps up the basis in the property distributed. The partnership must also reduce the basis of its remaining property, but only if the partnership has a § 754 election in effect or the adjustment is more than $250,000.[197]

If multiple properties are distributed, the partner's basis is first reduced by any cash received. Then it is reduced by the basis of any inventory and unrealized receivables (i.e. ordinary income property). The remaining basis is allocated to property first in an amount equal to its unrealized appreciation and the remainder is allocated on relative fair market values.[198]

3. Holding Period

Where the partner receives a carryover basis in property distributed by the partnership, he also receives a carryover holding period in the asset.[199] Therefore, distributions of capital assets held by the partnership for more than a year will allow a partner to achieve long-term capital gain on a sale of the asset even if he has held his partnership interest less than a year. Likewise, if the partnership distributes property owned for less than a year to a partner who acquired his interest from a decedent (and thus has a long-term holding period in his partnership interest) the partner will have a short-term gain or loss upon immediate sale of the property. Thus, there is generally no interruption in the holding period of partnership assets, even where the partnership makes a § 754 election to adjust the inside basis of its assets.[200] There is simply no authority to tack the holding period of the partnership interest to the basis of the partnership assets.

B. Distributions that Require Mandatory Basis Adjustments

The American Jobs Creation Act added three new mandatory basis adjustment rules to prevent partners and partnerships from duplicating losses.[201] Although these rules were aimed at corporate tax shelters, many family partnerships are impacted by them. But Congress failed to offer any special exception for family partnerships. These new mandatory basis adjustment rules

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[194] *See* discussion at Section III.H. for adjustments to the basis of the partnership's remaining property where a § 754 election is in effect.
[195] Reg. § 1.732-1(b).
[196] *See* discussion at Section III.H. for adjustments to the basis of the partnership's remaining property where a § 754 election is in effect.
[197] *See* discussion at Section IV.B.
[198] Reg. § 1.732-1(c).
[199] IRC § 735(b).
[200] Rev. Rul. 68-79, 1968-1 C.B. 310 (the holding period of a partnership interest does not affect the holding period of the partnership assets.)
[201] IRC §§ 704(c)(1)(C), 734(a) and 743(a).

do not themselves trigger gain or loss recognition. They merely require the partnership to adjust the basis of its assets when it makes certain types of distributions. Note that basis adjustments only affect the timing of a partner's income or loss and not the amount. Treasury has not yet written regulations to resolve the many questions surrounding these new mandatory basis adjustments. However, the regulations are still on IRS and Treasury's Priority Guidance Plan.[202]

1. Mechanics

Two kinds of distributions made after October 22, 2004 require the partnership to adjust the basis of property on its books. The first is when a partner receives a liquidating distribution of cash that is less than the basis in his partnership interest by more than $250,000.[203] The second is when a partner receives a liquidating distribution of property, the basis of which is less than his basis in his partnership interest by more than $250,000.[204] In other words, after October 22, 2004, a partnership that cashes out a partner at a loss of more than $250,000 or redeems a partner with property the basis of which is less than the partner's basis in his partnership interest by more than $250,000 must reduce the basis of assets remaining on the partnership's books.

EXAMPLE

> Dad and Mom contribute $10,000,000 to a family partnership and gift Son 50 percent of the partnership over time. In the meantime, the partnership purchases Stock A for $3,000,000 and Stock B for $7,000,000. The stocks decline in value to $1,000,000 each. Now Son wants to cash out his 50 percent interest worth $1,000,000. The partnership borrows $1,000,000 to cash him out. Son reports a loss of $4,000,000 [$5,000,000 basis - $1,000,000]. Because this loss exceeds $250,000, the partnership must reduce the basis of its assets by the $4,000,000 loss.[205]

EXAMPLE

> Same facts as above, except that the partnership distributes Stock A worth $1,000,000 to Son in liquidation. Son increases the basis in Stock A from $3,000,000 in the hands of the partnership to his $5,000,000 basis in the partnership interest. This is a positive basis adjustment of more than $250,000 and therefore, the partnership must reduce the basis of Stock B by $2,000,000.[206]

The downward basis adjustment of $2,000,000 to Stock B has a detrimental effect on Mom and Dad because when the partnership sells Stock B for $1,000,000, they are only entitled to a $4,000,000 loss [$1,000,000 – ($7,000,000 - $2,000,000)] instead of a $6,000,000 loss [$1,000,000 - $7,000,000] as under the old rules where the partnership did not have a § 754 election in effect. In essence, the new rules mandate that the basis of partnership property be

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202 Department of the Treasury 2012-2013 Priority Guidance Plan, Third Quarter update, May 2, 2013, *available at* http://www.irs.gov/pub/irs-utl/2012-2013_pgp_3rd_quarter_update.pdf.
203 IRC §§ 734(d), 734(b)(2).
204 *Id.*
205 IRC §§ 734(b)(2)(A), (d)(1); see also H.R. Rep. No. 108-548, pt.1 (June 16, 2004).
206 IRC §§ 734(b)(2)(B),(d)(1); Example adapted from Notice 2005-32, 2005-16 I.R.B. 895 (Apr. 1, 2005).

reduced (but not increased) as if the partnership had a § 754 election in effect. Rather than being elective as under prior law, negative basis adjustments are now mandatory.

Positive adjustments to the partnership's property in the year it distributes high basis property to a low basis partner, however, are not mandatory. But they are highly desirable and can only be made if the partnership makes a § 754 election. Therefore, the partnership should consider making the § 754 election anytime it distributes high basis property to a low basis partner, especially when liquidating a deceased partner's interest.

2. Effect of a Section 754 Election

Section 734(b) is especially a trap when a partner receives a stepped up basis for his partnership interest because of a death or a purchase and the partnership subsequently distributes cash or low basis property to that partner. The distribution of low basis property to the high outside basis partner requires the partnership to reduce the basis of its other assets.

EXAMPLE

> Assume the same facts as above except that Son stays in the partnership and Dad dies when the stocks have increased to $8,000,000 each. The partnership redeems the estate's 25 percent interest by distributing half of Stock A worth $4,000,000 with a basis of $1,500,000. Dad had a basis in his partnership interest of $2,500,000, but under § 1014 his estate's new basis is his date of death value of $4,000,000. Under § 732(b), the estate increases the basis of Stock A from $1,500,000 to $4,000,000. However, this $2,500,000 positive adjustment requires the partnership to reduce the basis of Stock B by $2,500,000 under § 734(b).

In essence, the step-up under § 1014 gets incorporated into the new mandatory basis reduction rules. On the other hand, if the partnership had made a § 754 election in the above example, the estate would have been entitled to step up its share of the inside basis of partnership assets from $2,500,000 to $4,000,000. This new inside basis of $1,500,000 would have been added to the basis of half of Stock A received in the liquidation, giving it a new basis of $3,000,000 ($1,500,000 + $1,500,000). Now the estate only has a positive adjustment of $1,000,000 to increase the basis of Stock A to equal its outside basis of $4,000,000 under § 732(b). Thus the partnership only needs to reduce the basis of Stock B by $1,000,000 under the mandatory basis adjustment rules of § 734(b).

It may be tempting for the partnership to make a § 754 election as soon as it discovers the problem. Presumably there will still be time to make it for the distribution year. This not only avoids the extra basis reduction in the current year, but it allows the partnership to increase the basis of its property when it distributes high basis property to a low basis partner later on. However, it is not automatic that the partnership should make an election to cure this problem. The election will impact all future deaths, transfers, and distributions. The short-term benefit may not be worth the long-term cost. There are circumstances in which the election should not be made.[207] Moreover, these basis adjustments are merely timing differences. Regardless of their size or frequency, a partner will never report more income than he receives during the life of the partnership. Any basis remaining on liquidation of his interest will eventually be used.

[207] *See* Exhibit B, Section 754 Decision Tree *infra*.

C. Distributions Within Seven Years of Contribution

During the 1980s enterprising partners began to stretch the limits of the general rule that partnership distributions are tax-free. They simultaneously contributed appreciated property, while they or others withdrew property with no tax consequence. In effect, they achieved a tax-free exchange through the partnership without following the § 1031 rules. Such transactions are known as "mixing bowl" transactions. [208] This term is now enshrined in the IRS's audit training manual and defined as: "Transactions in which partners arrange to pool their assets in a partnership, and then make related allocations or distributions in order to shift the benefits and burdens of ownership."[209] To correct these perceived abuses, Congress created the anti-mixing bowl statutes contained in §§ 704(c)(1)(B), 737, and 731(c). Unfortunately, these rules also snare innocent family partnerships that were never intended to be the target.

1. Distributions of Contributed Property - § 704(c)(1)(B)

If a partnership distributes property with respect to which a contributing partner has built-in gain or loss, to another partner within seven years of the contribution, the contributing partner must recognize gain or loss.[210] Thus, § 704(c)(1)(B) requires the partnership to track all pre-contribution gains and losses, on a property by property basis, for seven years from its contribution date to its date of disposition. This is an ongoing process as each built-in gain or loss property is contributed or distributed. It is usually a complete surprise to all the partners that § 704(c)(1)(B) taxes the contributing partner instead of the partner who receives the distribution.

a. Computing Gain or Loss

If a contributing partner's built-in gain or loss property is distributed to another partner within seven years of its contribution, the contributing partner recognizes gain or loss as if the property were sold at its market value on the distribution date. However, the gain or loss is limited to the contributing partner's pre-contribution gain or loss on the property.[211] The partnership adjusts the basis of the property by the contributing partner's recognized gain or loss.[212] And the contributing partner adjusts his basis in the partnership interest accordingly.[213]

EXAMPLE

On July 1, 2010 Partner A contributed Property X with a basis of $10,000 and a market value of $20,000 to AB Partnership for a 50 percent interest. On July 1, 2012 AB Partnership distributes Property X to B when its value is $40,000. A recognizes pre-contribution gain as if the property were sold for $40,000 on July 1, 2012. The hypothetical gain of $30,000 ($40,000 FMV - $10,000 basis) is allocated $20,000 to A ($10,000 pre-contribution gain plus one-half the post-contribution gain of $20,000). However, the gain recognized under § 704(c)(1)(B) is limited to A's pre-contribution gain of $10,000. If, instead, Property X had declined in value to $15,000

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[208] 90 TNT 97-46.
[209] Glossary, IRS Market Segment Specialization Program Guideline, 2002 WL 32076538.
[210] IRC § 704(c)(1)(B).
[211] IRC § 704(c)(1)(B)(i).
[212] Reg. § 1.704-4(e)(2).
[213] IRC § 704(c)(1)(B)(iii); Reg. § 1.704-4(e)(1).

on the distribution date, A would only recognize $5,000 of pre-contribution gain ($10,000 pre-contribution gain limited to the actual gain of $5,000).

The *amount* of the gain or loss reported by the contributing partner under § 704(c)(1)(B)(i) is determined as if the property were sold at its market value on the distribution date to the distributee partner.[214] The *character* of the gain or loss is also determined as if the property had been sold to the distribute partner.[215] This raises the question whether a § 704(c) loss would be disallowed if the distribute partner owns more than 50 percent of the partnership under § 707(b)(1)(A). The Service would probably maintain that built-in losses under § 704(c)(1)(B) losses are disallowed to the contributing partner where the distributee partner owns more than a 50 interest.[216] However, there are no cases, regulations, or rulings on this point.

b. Character of Gain or Loss

The gain or loss recognized by the contributing partner under § 704(c)(1)(B) has the same character as if the partnership had sold the property to the distributee.[217] For example, assume A contributes land to the AB Partnership, which is a capital asset in the hands of the partnership. But if AB distributes the real estate to Partner B, who uses the property in his trade or business and holds more than a 50 percent interest in the partnership, the gain would be ordinary income under § 707(b)(2). Therefore, the character of the gain to Partner A would be ordinary income.[218]

c. Step-in-the-Shoes Rule

Section 704(c)(1)(B) applies to a transferee partner just as it would to the transferor partner with a § 704(c) gain for property contributed on or before October 22, 2004.[219] So, if a partner that contributes § 704(c) property transfers (sells, exchanges, or gifts) his partnership interest and the § 704(c) property is thereafter distributed to a partner other than the transferee partner within seven years of its contribution, the transferee partner is taxed as the original contributor of the § 704(c) property. In other words, he "steps into the shoes" of the transferor for purposes of § 704(c). The step-in-the-shoes rule does not apply, however, to property with a built-in loss contributed to the partnership after October 22, 2004.[220]

2. Distributions of Other Property to a Contributing Partner - § 737

Section 737(a) was enacted to assure that partners did not avoid recognizing § 704(c) gains by cashing in their partnership interest with other property while the partnership continued to own the § 704(c) property.[221] Therefore § 737 taxes a partner that receives a distribution of partnership property within seven years (five, for property contributed on or before June 8, 1997) of when the partner contributed any other appreciated property to the partnership.

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214 Reg. § 1.704-4(a)(1).

215 IRC § 704(c)(1)(B)(ii)

216 Preamble to Reg. § 1.704-4, T.D. 8642 (Dec. 22, 1995).

217 IRC § 704(c)(1)(B)(ii).

218 Reg. § 1.704-4(b)(2)(iii).

219 Reg. § 1.704-4(d)(2); *but see* IRC § 704(c)(l)(C) added by P.L. l08-457, § 833 (October 22, 2004).

220 IRC § 704(c)(l)(C) added by P.L. l08-457, § 833 (October 22, 2004); *see* discussion at Section IV.C.3. *infra.*

221 H. Rep't. No. 102-1018, 102nd Cong, 2d Sess., 1992 U.S.C.C.&A.N. 2472, 2519-2520 (10/5/92).

Section 737 taxes the partner who receives a distribution, whereas § 704(c)(1)(B) taxes the partner who contributes the § 704(c) property. Another key difference between § 704(c)(1)(B) and 737 is that gain under § 737 is limited to the excess of the property's market value over the partner's basis in his partnership interest. Contrast § 704(c)(1)(B), which determines the contributing partner's gain or loss as if the property were sold on the distribution date, ignoring his basis in the partnership interest. Finally, unlike § 704(c)(1)(B), § 737 never results in a loss.

a. Computing the Gain

Section 737 functions differently than § 704(c)(1)(B). Under § 737, the distributee recognizes gain (but not loss) equal to the lesser of (1) the excess of the market value of property (other than money) received over the adjusted basis of the partner's interest in the partnership immediately before the distribution; or (2) the partner's "net pre-contribution gain." Net pre-contribution gain means the gain that would be allocated to the distributee under § 704(c)(1)(B) if all the property that had been contributed to the partnership immediately before the distribution were distributed to another partner.[222] Distributions of a partner's own previously contributed property are not taken into account under § 737.[223] Note also that unlike § 704(c)(1)(B), the distributee's basis in his partnership interest limits the amount of gain recognized under § 737.

EXAMPLE

> Partner A contributes Property X with a basis of $10,000 and a market value of $20,000 to AB Partnership for a 50 percent interest. Partner B contributes Property Y with a basis of $20,000 and a market value of $20,000. Within seven years of A's contribution, Property Y is distributed to A when its value is $40,000. A recognizes pre-contribution gain of $10,000, which is the lesser of his § 704(c) gain of $10,000 or the excess of the property's value ($40,000) over A's basis in his partnership interest ($10,000). If, instead, Property X was worth $15,000 on the distribution date, A would only recognize $5,000 of pre-contribution gain, the lesser of his $10,000 § 704(c) gain, or the excess of the property's $15,000 market value over A's $10,000 basis in his partnership interest.

Any gain recognized under § 737 is added to the partner's basis in his partnership interest immediately before the distribution of the property to him.[224] The basis of the distributee's § 704(c) property remaining in the partnership is also increased.[225] But the increase only applies to the distributee partner's built-in gain (not loss) property of the same character if sold by the partnership as the character of the gain recognized by him in the § 737 distribution. The property distributed to him takes a carryover basis determined under the normal basis rules in § 732.

Section 737 does not apply to distributions of property that a partner previously contributed to the partnership.[226] Thus, in the above example, if Property X (instead of Y) had been distributed to Partner A, § 737 would not have applied. Similarly, if only half of Property X

[222] Reg. § 1.737-1(c)(1).
[223] IRC § 737(d)(1).
[224] IRC § 737(c)(1).
[225] IRC § 731(c)(2).
[226] IRC § 737(d)(1).

(worth \$20,000) and half of Property Y (worth \$10,000) had been distributed, § 737 would ignore the half of Property X distributed and apply only to distribution of Property Y. We would treat the portion of Property X as if it had been distributed to Partner A in a separate and independent distribution prior to the distribution of Property Y.[227] Thus, the fair market value, basis, and pre-contribution gain attributable to half of Property X are simply omitted from the § 737 calculation and gain on the distribution is only \$5,000 as follows:

	Distribution of ½ X and Y to Ptr. A	Less prev. contributed Property X	Rest subject to §737
FMV of distribution	\$30,000	20,000	10,000
Basis in pship interest	\$10,000	5,000	5,000
Pre-contribution gain (net)	\$10,000	5,000	5,000

b. Character of Gain

The character of gain recognized by the distribute partner under § 737 is determined at the partnership level as if the partnership sold all the partner's § 704(c) property to an unrelated third party at the time of the distribution.[228] Most property contributed to a family partnership will be long-term capital gain character. However, if there are other character types, they are netted and separated into the same categories as would be required to be separately stated on the partner's schedule K-1. These include, for example, long-term capital gains and losses, short-term capital gains and losses, § 1231 gains and losses, and foreign source items.[229] In that case, the distributee partner recognizes gain in proportion to each character category.

c. Step-in-the-Shoes Rule

Like § 704(c)(1)(B), a transferee (donee) partner steps into the shoes of the transferor partner under § 737. Thus, the transferee is treated as the contributing partner both with respect to the transferor's § 704(c) gain or loss and also for purposes of whether the transferee receives his own property back on a distribution. However, some commentators believe that Reg. § 1.737-1(c)(2)(iii) may be interpreted as allowing a transferee partner to step into Shoe #1 with respect to inheriting the transferor's § 704(c) gain, but not Shoe #2 for determining whether he is the contributing partner of property distributed to him.[230] While Reg. § 1.737-1(c)(2)(iii) states clearly that a transferee succeeds to the transferor's § 704(c) account, it merely refers to Reg. §§ 1.704-3(a)(7) and 1.704-4(d)(2) "for similar provisions in the context of §§ 704(c)(1)(A) and 704(c)(1)(B)" for the treatment of transferee partners. This casual reference makes some people unsure about whether the transferee is treated as the contributing partner under § 737.

However, it makes little sense to treat a transferee partner as a contributing partner under § 737 to determine the extent of his potential gain under § 704(c)(1)(B), but not treat him as a

227 Reg. § 1.737-3(b)(2).
228 Reg. § 1.737-1(d).
229 Reg. § 1.702-1(a).
230 "Unwinding the Family Limited Partnership: Income Tax Impact of Scratching the Seven Year Itch," J. TAX'N, (March 2002); *see also* Sheldon I. Banoff & Richard M. Lipton, eds., "When is a Transferee Partner a Contributing Partner?" J. TAX'N (May 2003).

contributing partner for purposes of determining whether he gets his own property back. The regulations under both sections were designed to harmonize the two statutes. They were written at the same time, by the same people, as part of the same regulation project, and are liberally laced with cross-references to each other.[231]

There is no reason to believe that Congress or the IRS intended to tax a transferee partner more harshly than the contributing partner. Despite the inartful drafting, leading partnership treatises assume that the IRS meant to treat the transferee partner as the contributing partner both for determining the § 704(c) net pre-contribution gain and for purposes of whether he receives a distribution of his own property back – i.e. the transferee steps in both the transferor's shoes.[232] This author also assumes that the two statutes work in tandem as they were designed to, and that a transferee partner completely steps into the transferor partner's shoes under both §§ 704(c)(1)(B) and 737.

D. Distributions of Marketable Securities - § 731(c)

Because marketable securities are the virtual equivalent of cash, § 731(c) provides that a distribution of marketable securities will be treated as a distribution of money, unless an exception applies. To the extent marketable securities are treated as money, a partner may recognize gain under § 731(a) when he receives money in excess of his basis in the partnership interest. In addition, to the extent marketable securities are treated like money, it reduces the amount treated like property for purposes of § 737 (gain on distributions of property within 7 years of a contribution of appreciated property).[233] Any gain recognized on the distribution of marketable securities increases the basis of the distributed securities.[234]

1. Marketable Securities Defined

Marketable securities under § 731(c)(2) means financial instruments and foreign currencies that are actively traded. It includes stocks and other cash-like instruments including common trust funds, regulated investment companies, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, derivatives, foreign currencies, precious metals, and interests in entities containing such property.[235] Although the definition seems broad, it does not cover every type of security. For example, a flexible premium variable life insurance policy is not a security for purposes of § 731(c).[236] In addition, privately issued notes are not marketable securities.[237] Nor is § 731(c) as broad as the list of securities in § 351(e), which determines whether property contributed to an investment company is taxable under § 721(b). The primary difference is that § 731(c) focuses on cash equivalents, whereas § 351(e) targets all stocks and securities, including stock in closely held businesses and employee stock options.

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231 T.D. 8642, 60 Fed. Reg. 66,727 (Dec. 26, 1995).

232 Willis, Pennell, & Postlewaite, PARTNERSHIP TAXATION, Sixth Edition (Warren Gorham & Lamont, 2004) ¶13.02[1][a][v] at 13-21; and McKee, Nelson, & Whitmire, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS, Fourth Edition (Warren, Gorham & Lamont, 2007), ¶19.08[2][e], fn. 167.

233 *See* discussion at IV.C.2 of this outline.

234 Reg. § 1.731-2(f)(1).

235 IRC § 731(c)(2).

236 Ltr. Rul. 200651023 (Sept. 21, 2006).

237 Countryside Limited Partnership v. Comm'r, T.C. Memo 2008-3 (Jan. 2, 2008).

2. Reduction in the Amount Treated Like Money

If the value of marketable securities distributed to a partner exceeds his basis in his partnership interest, the amount treated like money may be reduced by his share of unrealized gain in those securities.[238] To determine his share of unrealized gain, all marketable securities held by the partnership are aggregated.[239] Regardless of which marketable securities the partnership distributes, the distributee partner's share of the gain is measured before and after the distribution. The difference reduces the amount of the distribution treated like money. Thus, the partner's share of unrealized gain on marketable securities acts is the most that can reduce the portion treated like money on a distribution. The regulations provide a good example.[240]

EXAMPLE

A and B are equal partners in AB partnership, which holds securities X, Y, and Z worth $100 each and with a basis of $70, 80, and $110 respectively. AB distributes X to A in a current distribution. His share of the gain before the distribution is $20 and his share after the distribution is $5. Thus, A may reduce the portion of Security X that is treated like cash by the $15 difference. So, only $85 of Security X is treated like cash and the balance is treated like property.

WITH X:	Value	Basis	Gain or Loss	A's Share
X	100	70	30	
Y	100	80	20	
Z	100	110	-10	
	300	260	40	$20
WITHOUT X:				
Y	100	80	20	
Z	100	110	-10	
	200	190	10	5
Difference				$15

All we have done up to this point is figure the amount of the distribution that is treated like cash to A. To the extent that the deemed cash portion does not exceed the basis in his partnership interest, A will not report any gain on the distribution and his basis in the partnership interest is not reduced. He simply takes a carryover basis in the distributed securities.

The partnership can select specific securities in such a combination as to minimize or maximize the partner's gain on distribution. If the partner's outside basis is large enough to absorb a cash distribution without recognizing gain and if a property distribution would have negative consequences for him under § 737, then it may be better to maximize the portion of the distribution treated like cash. In the above example, if the partnership had distributed Y instead

[238] IRC § 731(c)(3)(B); Reg. § 1.732-2(b)(2).
[239] IRC § 731(c)(3)(B); Reg. § 1.731-2(b)(1).
[240] Reg. § 1.731-2(j).

of X, the amount treated like cash would have been $90 instead of $85.[241] And if Z had been distributed, the entire $100 would be treated like cash because there is no gain in Security Z.

3. Impact of Valuation Discounts

Valuation discounts on a partnership interest can significantly increase the likelihood that distributions of marketable securities to an estate or successor partner will be taxable. The value of distributed securities is treated like money and to the extent it exceeds the partner's outside basis in the partnership, the partner recognizes gain on the distribution.[242] Although § 731(c)(3)(B) reduces the amount treated like money by the partner's share of gain on the securities, this reduction may not be sufficient to completely avoid gain recognition.

EXAMPLE

Mabel died with an 80 percent interest in XYZ partnership, which owned $2,000,000 of bonds with a basis of $1,500,000. An appraiser valued the partnership at $1,300,000 using a 35% discount. Thus, the estate's outside basis of the partnership interest is $1,040,000. The partnership redeemed Mabel's estate with $1,600,000 of bonds. Ordinarily the bonds would be treated like cash, resulting in a $560,000 gain to Mabel's estate. [$1,600,000-$1,040,000] But the amount treated like cash is reduced by the estate's share of gain in the bonds, or $400,000. Thus the amount treated like cash is only $1,200,000, resulting in a gain of only $160,000.[243]

	Total	**Mabel's 80%**
FMV of Securities	$ 2,000,000	$ 1,600,000
Tax Basis	1,500,000	1,200,000
Unrecognized Gain	500,000	400,000
FMV/Outside Basis under § 1014 (with a 35% discount)	$ 1,300,000	$ 1,040,000

Note that § 731(c) merely causes the estate or other successor partner to recognize gain it would eventually recognize when it sells the securities. This may not be a problem if the estate plans to sell the securities shortly after receipt. But it can be avoided.

Assume the partnership in the above example makes a § 754 election. The estate's basis in the bonds is now $1,040,000, exactly the same as its outside basis. Therefore, a distribution of the bonds will not cause the estate or successor partner to recognize gain under § 731(a).[244] Note that making a § 754 election in this case runs counter to intuition because it reduces the estate's

[241] $100 value of Y less A's $10 share of gain in Y.
[242] IRC § 731(a), (c).
[243] IRC § 731(c)(4)(A); The estate is also entitled to increase the basis of the distributed securities by $160,000.
[244] Reg. § 1.731-2(b)(3).

inside basis of the assets. However, under these circumstances it avoids a premature recognition of gain on a distribution of the securities.

Alternatively, if the partnership did not make a § 754 election, the estate or successor partner can make a § 732(d) election instead. This has the same effect as if the partnership had made a § 754 election, but without the consequences of a § 754 election on the other partners.[245] The basis adjustments under § 732(d) can be made to assets on hand at the date of death or to "like-kind" property if those assets no longer exist.[246] However, a § 732(d) election can only be made for property distributions made within two years of the decedent's death.

4. Statutory Exceptions

If the partner cannot avoid gain under the rule allowing him to reduce the amount treated like money by his share of the gain in the securities being distributed, he may qualify for one or more of three outright exceptions to the rule treating marketable securities like money.[247]

● First, marketable securities are not treated as money when distributed to the partner who contributed the security. This is because Congress did not intend to tax a partner who merely got his own property back. Instead the statute seeks to tax a partner who exchanges other property for an interest in marketable securities which Congress considered equivalent to a sale.

Under § 731(c) the transferee of a partnership interest is not treated as the contributor of the transferor's property. Thus, if Partner A transfers securities to a partnership and transfers his partnership interest to Partner B, Partner B is not treated as the contributing partner when he takes a distribution of those securities. Thus, Partner B treats the securities as money. This is in sharp contrast to the rules under §§ 704(c)(1)(B) and 737, which treat a transferee partner as the contributor of the transferor partner's property. However, the legislative history and purposes of § 731(c) differ from those of §§ 704(c)(1)(B) and 737. Section 731 treats marketable securities as cash because they are cash equivalents, not because partners are using them to avoid § 704(c) gain recognition, which is the focus of §§ 704(c)(1)(B) and 737. Thus, it appears that transferee partners, including estates, are not treated as contributing partners under § 731 with respect to distributions of marketable securities.

● Second, marketable securities are not treated like money if the property was not a marketable security when acquired by the partnership.

● Third, marketable securities are not treated like money when distributed by an "investment partnership" to an "eligible partner."[248] An investment partnership is one that has never been engaged in a trade or business (other than investing) and substantially all of the assets of which (by value) have always consisted of investment type assets listed under § 731(c)(3)(C)(i). Note that this list includes nonmarketable securities such as stock in a corporation. "Substantially all" means consisting of 90 percent or more marketable securities or

[245] *See* discussion at III.H. for impact of a § 754 election on the other partners.
[246] Reg. § 1.743-1(g)(2)(ii).
[247] IRC § 731(c)(3)(A).
[248] Reg. § 1.731-2(d).

money.[249] An eligible partner is one who has never contributed any non-investment type assets to the partnership

Partnerships that relied on the "less than 80% stocks and securities" test to avoid gain recognition on formation under §§ 721(b) and 351(e) will not meet this 90 percent test for an investment company under § 731(c). Thus, marketable securities will be treated like money distributions. However, it is not uncommon for a family partnership's assets to have always consisted of 90 percent investment securities. It may have relied on the diversified portfolio exception to the investment company rules to avoid gain.[250] Or there may have been no built-in gain on the assets contributed to form the partnership. In either case, if a partnership meets the "always more than 90%" test, distributions of marketable securities will not be treated like cash.

E. Liquidating Distributions

When a family partnership distributes cash or property, in complete termination or otherwise, it can easily invoke all three mixing bowl statutes at the same time. For example, distributing a marketable security that has pre-contribution gain or loss within seven years to a partner who has a pre-contribution gain or loss account under § 704(c) created within the last seven years will invoke all three statutes and likely be taxable to one of the partners. Section 704(c)(1)(B) taxes the contributing partner as if the property were sold at market value on the distribution date. Section 731(c) taxes the distributee partner to the extent that the money portion exceeds the partner's basis in his partnership interest. And finally, § 737 taxes the distributee partner to the extent that the fair market value of the property portion of the security exceeds the basis in his partnership interest.

When all three statutes are involved, the regulations require an ordering rule – first § 704(c)(1)(B), then § 731(c), and § 737.[251] The regulations do not, however, provide an example of all three mixing bowl statutes working together. In addition, if the partner also has a § 743(b) basis adjustment because the partnership made a § 754 election[252] or was subject to the mandatory basis adjustment rules,[253] this basis adjustment needs to be taken into account under all of the mixing bowl statutes.

But these problems can be avoided with a little forethought. Absent other non-tax considerations, partnerships attempting to minimize or avoid adverse tax consequences on termination or distribution of partnership assets should adhere to the following:

- Avoid terminating the partnership until seven years after the last contribution of built-in gain property
- Avoid distributing cash in excess of a partner's basis.
- Distribute property that the partnership has purchased.

[249] Reg. § 1.731-2(c)(3).
[250] *Id.*; *see also* Reg. § 35l-l(c)(6); IRC § 368(a)(2)(F)(ii).
[251] Reg. § 1.731-2(g)(1); *see* Exhibit A, Mixing Bowl Flowchart for Partnership Property Distributions *infra.*
[252] *See* discussion at Section III.B. *infra.*
[253] *See* discussion at Section III.F. *infra.*

● Distribute property in proportion to each partner's interest in the partnership if the distribution occurs within seven years of a contribution of built-in gain or loss property by one of the distributees.

● Avoid distributing previously contributed built-in gain or loss property to partners other than the partner (or transferee partner) who contributed the property within seven years of the contribution.

● Avoid distributing property to a partner who has previously contributed other built-in gain property or is a transferee of one who has contributed other built-in gain property.

● Distribute marketable securities pro rata based on their value, regardless of their different cost bases.

Following these general guidelines on termination can help avoid a taxable event.

V. DISTRIBUTING PARTNERSHIP INTERESTS TO BENEFICIARIES

An executor may decide to distribute partnership interests to the beneficiaries, rather than to redeem the estate's partnership interest. If so, he should be aware of the tax and other consequences of that decision, particularly if the interest is transferred to a trust. Trustees have the added burden of knowing how the Prudent Investor Act and the Uniform Principal and Income Act apply to partnership interests.

A. Closing the Partnership Books

The taxable year of a partnership closes "with respect to a partner whose entire interest….terminates (whether by reason of death, liquidation or otherwise.)"[254] Thus the partnership year closes with respect to a deceased partner and the partnership must allocate income or losses from the beginning of the partnership year to the date of death to the decedent. Income and losses incurred afterward are allocated to the estate or successor partner. The regulations also clarify other events that cause the books to close with respect to a partner.

1. Transfers By Gift

The regulations provide that gifts of a partnership interest require the partnership to allocate to the donor all income, deductions, and credits incurred under its method of accounting up to the date of the gift, and all items after that date to the donee.[255]

2. Bequests

Recently proposed regulation § 1.706-1(c)(2) clarifies that if the decedent partner's estate or other successor sells, exchanges, or liquidates its entire interest in the partnership, the partnership taxable year closes with respect to the estate or other successor on the date of the sale, exchange, or liquidation. However, "sale or exchange" of a partnership interest does not include the transfer of a partnership interest that occurs at death as a result of inheritance or any testamentary

[254] IRC § 706(c)(2)(A).
[255] Reg. § 1.706-1(c)(5).

disposition.[256] In a testamentary disposition, the partnership interest is deemed to have been transferred directly from the decedent to the legatee as if there were no intervening period of administration. The decedent reports income up to the date of his death and the legatee reports income from that point forward. The proposed regulations provide the following example:

EXAMPLE

> H is a partner in a partnership having a taxable year ending December 31. Both H and his wife W are on a calendar year and file jointly. H dies on March 31, 2010. Administration of the estate is completed and the estate, including the partnership interest, is distributed to W as legatee on November 30, 2010. The distribution by the estate is not a sale or exchange of H's partnership interest. The taxable year of the partnership closes with respect to H on March 31, 2010. He will include on his final income tax return his share of partnership items from January 1 through March 31, 2010. W will include on her income tax return for 2010, her share of partnership items from April 1 through December 31, 2010.

Note that in the example above, the distribution of the partnership interest occurred in the same year as the decedent died. Presumably, if the distribution had occurred in 2011 or later, the estate would have reported its share of partnership income during the intervening years. The regulations are not clear about this. Note also that it is not clear whether this disposition is pursuant to a pecuniary or residuary bequest.

However, long standing regulations under Subchapter J treat testamentary distributions in satisfaction of a pecuniary bequest as a sale or exchange by the estate.[257] Therefore, it seems that the distribution of a partnership interest in satisfaction of a pecuniary bequest would close the partnership taxable year with respect to the estate.[258] The partnership would allocate income or loss to the decedent up to the date of his death, to the estate from the date of death to the date of the distribution, and to the legatee from the date of the distribution forward.

However, distributions in satisfaction of a residuary bequest are not treated as a sale or exchange by the estate. Therefore, they would not close the partnership taxable year with respect to the estate, as the example above illustrates.[259]

2. Closing Methods

Partnerships use two basic methods to allocate items when a partner terminates his interest during the year.[260] The default method is the *interim closing* of the books, which separates the partnership into two or more segments during the year.[261] Items occurring in each segment are allocated to the partners who were partners during that segment. The other method is a *daily proration*, if the partners agree.[262] Neither the final not the proposed regulations are clear which

[256] Prop. Reg. § 706-1(c)(2)(i), REG-144689-04, Fed. Reg. Vol. 74, No. 70 p. 17119 (4/14/2009).
[257] Reg. § 1.661(a)-2(f); Reg. § 1.663(a)-1(b)(1).
[258] *Id.*
[259] Prop. Reg. § 1.706-1(c)(2)(i) (4/14/09); Reg. § 1.706-1(c)(3)(iv).
[260] Prop. Reg. §1.706-4 (4/14/09); Reg. § 1.706-1(c)(2)(ii); Richardson v. Comm'r., 693 F.2d 1189 (5th Cir. 1982).
[261] Prop. Reg. § 1.706-4(c) (4/14/09); Reg. § 1.706-1(c)(2)(ii).
[262] Prop. Reg. § 1.706-4(d) (4/14/09); Reg. § 1.706-1(c)(2)(ii).

partners must agree. Presumably only the *affected* partners must agree, similar to the rule for terminating an interest in a Subchapter S corporation.[263] The affected partners would include the decedent and his estate or successor in interest. The closing method is important because there could be a significant shift of taxable income between the affected partners. Therefore, the executor should determine which method produces the best result for the estate and ask the partnership to use that method.

Regardless of which method is chosen, cash basis partnerships must use the accrual method to allocate interest, taxes, payments for services or the use of property (other than guaranteed payments subject to Section 83), and any other item the regulations specify.[264] The partnership must assign a portion of these items to each day in the period to which it is attributable. The daily portion is then assigned to the partners in proportion to their partnership interest at the close of each day. This prevents partners from deliberately achieving significant misstatements among them by timing the payment of large cash basis items. The most common cash basis items likely to affect family partnerships under this rule are real estate taxes and payments for services.

EXAMPLE

> D, a 50 percent partner in DS Partnership, died on September 30, 2009. The Partnership incurred a long-term capital gain of $1,000,000 on June 1, 2009 and no other income or expenses during the year. Under a closing of the books method, D reports $500,000 [50% of $1,000,000] of capital gain on his final 1040 resulting in a tax liability of $75,000. D's estate may deduct this income tax liability as a debt on his federal estate tax return Form 706.[265] The estate or other successor in interest reports no income or loss.

The second method is the proration method, which apportions all items for the partnership year according to the portion of the year for which a partner was a partner. Under this method, a partner who dies during the year is allocated a fraction of partnership income for the entire partnership year, regardless of when the partnership incurred the items.

EXAMPLE

> D, a 50 percent partner in DS Partnership, died on September 30, 2009. The partnership incurred a long-term capital gain of $1,000,000 on June 1, 2009 and no other income or expenses during the year. Under a proration method, D reports $375,000 [50% X 9/12 X $1,000,000] of capital gain on his final 1040 resulting in a tax liability of $56,250, which is deductible as a debt on his federal estate tax return.[266] The estate reports the other $125,000 of capital gain allocable to 3/12 of 50 percent of the capital gain.

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[263] IRC § 1377(a)(2); Reg. § 1.1377-1(a).

[264] IRC § 706(d)(2); Prop. Reg. § 1.706-3(a) (2005); *See* Cantrell, *Partnership Interests for Services Regs. Offer Estate Planners a "Bona Fide" Solution*, The Tax Adviser, October 2005, at 636 (taxation of partnership interests granted for services rendered).

[265] Reg. § 20.2053-6(f).

[266] Reg. § 20.2053-6(f).

Depending on the particular facts, one method may be clearly superior to the other. Executors should work with the partnership to selecting the best method for the estate.

B. Constructive Termination on Change in Ownership

The distribution by an estate or trust of a more than 50 percent interest in a partnership can cause a constructive termination of the partnership. Under § 708(b)(1)(B) a partnership terminates within a 12-month period if there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.[267] The consequences of termination are that all the partnership's tax elections are cancelled and the partnership starts a new depreciable life on all its depreciable assets.[268] This can actually be beneficial if the partnership wants to terminate its elections. Moreover, a technical termination is not a deemed distribution of partnership assets, which could otherwise be taxable if the partnership owned property with pre-contribution built-in gain or marketable securities.[269]

However, distributions of a specific or residuary bequest by the estate do not cause a constructive termination of the partnership because the regulations exclude transfers by bequest or inheritance from causing a constructive termination.[270] But all other distributions from estates and trusts would cause a constructive distribution if they constituted more than a 50 percent interest in the partnership.[271]

C. Gain or Loss on Funding

The executor or trustee should exercise great care when distributing assets that have appreciated or depreciated significantly since the decedent's death, or that constitute or contain IRD under § 691. The simple act of transferring a partnership interest to satisfy a pecuniary bequest may cause the estate or trust to recognize gain or loss on any post-death change in value of the partnership interest. It may also trigger recognition of any income in respect of a decedent (IRD) in the partnership interest.

Distributions by the estate to fund specific bequests are *not* treated as taxable sales or exchanges by the estate.[272] Nor are residuary bequests.[273] On the other hand, if the executor uses a partnership interest to satisfy a gift of a specific dollar amount (i.e. a pecuniary bequest) or to satisfy a gift of specific property other than the partnership interest, then the estate or trust recognizes gain or loss based on the difference between the value of the partnership interest on the date of the distribution and its adjusted basis on the date of death.[274] For pecuniary bequests by decedents who died in 2010, gain is only recognized on the post death appreciation.[275] Pecuniary bequest means a gift of a fixed dollar amount or a formula pecuniary amount.[276] If a

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[267] See discussion at III.I.3. of this outline.
[268] Reg. § 1.708-1(b)(5); IRC § 168(i)(7).
[269] *See* discussion starting at IV.A. of this outline.
[270] Reg. § 1.708-1(b)(1)(ii).
[271] IRC § 761(e); See discussion at III.I.3. of this outline.
[272] IRC § 663(a)(1); Reg. § 1.663(a)-1(a),(b).
[273] Reg. § 1.661(a)-2(f).
[274] *Id.*
[275] IRC § 1040.
[276] Rev. Rul. 60-87, 1960-1 CB 286.

partnership interest has declined in value since the decedent's death, the estate may deduct the loss under § 267(b)(13). However, trusts may not recognize losses incurred in funding pecuniary bequests. In either case, unused losses in the final year of an estate or trust are passed to the beneficiaries.[277]

D. Triggering IRD Recognition

If an estate transfers an asset that constitutes income in respect of a decedent (IRD) to satisfy a pecuniary bequest, the estate recognizes income on the transfer.[278] On the other hand, if the estate transfers IRD assets pursuant to a specific or residuary bequest, only the legatee recognizes income when collected.[279] Note that a partnership has IRD only to the extent of payments due a retired or deceased partner in excess of those for his interest in property and payments due a general partner of a service partnership for unrealized receivables or unstated goodwill.[280] Therefore, there cannot be any IRD in an investment partnership.[281]

E. Carrying Out DNI When Funding with a Partnership Interest

An estate or trust is entitled to deduct cash or other amounts distributed in-kind to beneficiaries.[282] Further, it recognizes no gain or loss on the distribution of in-kind property unless it is in satisfaction of a right to receive a specific dollar amount or property other than the property distributed.[283] In determining the estate or trust's deduction, property distributions are taken into account at the lesser of their fair market value or basis in the hands of the estate or trust on the date of distribution.[284] The deduction, however, cannot exceed the fiduciary's DNI.[285]

The amount deducted by the estate carries out to the beneficiaries who include it in their gross income, limited to their share of the fiduciary's DNI.[286] Thus, DNI acts as a limit on both the fiduciary's deduction and the beneficiaries' reportable income. In the case of multiple beneficiaries, DNI is allocated among the beneficiaries based on actual distributions received by each and is deemed to include a pro rata share of each class of income included in DNI.[287]

Almost every distribution of cash or property carries out all or a part of the fiduciary's DNI to the recipient. Thus, any partnership interest used in funding a bequest under the will or trust carries out some part of the fiduciary's DNI to the beneficiary except for:

- specific bequests[288]
- bequests to charitable beneficiaries which are governed by § 642(c),[289] and

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[277] IRC § 642(h).
[278] Reg. § 1.691(a)-4(b)(2); Ltr. Ruls. 9123036, 9315016, 9507008.
[279] *Id.*
[280] IRC §§ 691(e), 736(a), and 753.
[281] *See* discussion at II.D.1 of this outline.
[282] IRC §§ 651(a), 661(a).
[283] Reg. § 1.661(a)-2(f).
[284] IRC § 643(e)(1) and (2).
[285] IRC §§ 651(b), 661(a).
[286] IRC §§ 652(a), 662(a).
[287] Reg. §§ 1.652(b)-2(a) and 1.662(b)-1.
[288] IRC § 663(a).
[289] *Id.*

- distributions to a "separate share" that is not entitled to the fiduciary's net income under the terms of the governing instrument or local law (except for its share of estate IRD)[290]

1. The Separate Share Rule

The separate share rule requires the fiduciary to maintain separate accountings of DNI within a single estate or trust where the entity has separate and independent shares for separate beneficiaries or groups of beneficiaries.[291] The separate share rule limits the DNI carryout to those shares based on the extent to which they share in the fiduciary's accounting income.[292] As such, distributions to one beneficiary (or group of beneficiaries) of the same estate or trust only carry out that beneficiary's share of the DNI and not that of the other beneficiaries. Without the separate share rule, DNI would be carried out based on relative distributions received by the beneficiaries during the tax year.[293]

A separate share exists if the economic interest of a beneficiary or class of beneficiaries neither affects nor is affected by the economic interest of another beneficiary or class of beneficiaries. For example, a pecuniary and residuary bequest are separate shares.[294] A qualified revocable trust for which an election is made under § 645 is always a separate share of the estate and may itself contain two or more separate shares. Conversely, a gift or bequest of a specific sum of money or of property as defined in IRC § 663(a)(1) is specifically excluded from separate share treatment.[295] The regulations contain 11 examples of separate shares.[296]

2. Pecuniary Bequests and DNI Carryout

Distributions in satisfaction of a pecuniary bequest that is not entitled to a share of fiduciary accounting income under the terms of the governing instrument or local law do not carry out DNI.[297] The regulations provide the following example:

EXAMPLE

> Testator's will provides for a pecuniary formula bequest to be paid to a trust for the benefit of his child of the largest amount that can pass free of estate tax and a bequest of the residuary to his surviving spouse. The will provides that the bequest to the child's trust is not entitled to any of the estate's income and does not participate in appreciation or depreciation in estate assets. During the estate's first tax year, it receives dividend income of $50,000. The executor partially funds the child's trust by distributing to it the family partnership interest, which has an adjusted basis to the estate of $350,000 and a fair market value of $380,000 on the date of distribution. As a result of this distribution, the estate realizes a $30,000 long-term capital gain.[298]

[290] Reg. § 1.663(c)-2(b)(2).
[291] Reg. § 1.663(c)-4(a).
[292] Reg. §§ 1.663(c)-4(a), 1.663(c)-2(b)(2).
[293] Reg. § 1.662(a)-2(b).
[294] Reg. § 1.663(c)-5, Example 4.
[295] Reg. § 1.663(c)-4(a).
[296] Reg. § 1.663(c)-5, T.D. 8849, Dec. 27, 1999.
[297] Reg. § 1.663(c)-2(b)(2).
[298] Reg. § 1.663(c)-5, at Example 4.

The estate has two separate shares consisting of a formula pecuniary bequest to the child's trust and a residuary bequest to the surviving spouse. Because the will provides that no income is allocated to the bequest to the child's trust, the DNI for that trust's share is zero. Therefore, with respect to the $380,000 distribution to the child's trust, the estate is allowed no deduction under § 661, and no amount is included in the trust's gross income under § 662. Because no distributions were made to the spouse, there is no need to compute the DNI allocable to the marital share.

3. Income from Pass-Through Entities

The second item of interest to estates that contain family partnerships is that income from partnerships, S corporations, and other noncash sources is allocated to separate shares in the same proportion that fiduciary accounting income from that entity would be apportioned to them under the governing instrument or local law.[299]

EXAMPLE

> The facts are the same as in the preceding example, except that the family partnership issues a Schedule K-1 to the estate showing $100,000 of interest income. Because, under the terms of the will, the child's trust is not entitled to a share of the estate's fiduciary income, no partnership K-1 income will be allocated to its separate share. Therefore, the estate is not entitled to deduct the $380,000 it distributes to the child's trust and the trust includes no amount in income.[300]

4. Special Rule for IRD Included in DNI

The last item of importance to estates with family limited partnership interests is the rule for allocating an estate's income in respect of a decedent. The regulations provide that IRD reported by the estate is allocated among separate shares based on the relative value of each share that could potentially be funded with it. This is an exception to the general rule that DNI is only allocated to shares that are entitled to receive income under the terms of the governing instrument or applicable local law.[301]

EXAMPLE

> The facts are the same as the previous example, except that the estate also receives $900,000 from the decedent's IRA, which is included in the estate's gross income. Because the $900,000 is corpus under local law, both the separate share for the child's trust and the separate share for the surviving spouse may potentially be funded with it. Therefore, the IRD must be allocated between the two shares based on their relative values using a reasonable and equitable method. Thus the estate must allocate a portion of the IRD to the child's trust when it funds it, despite that the trust received no portion of the IRD. The estate may not deduct any DNI when it funds the child's trust. But it may deduct the trust's ratable portion of IRD and the trust must include a corresponding amount in income.[302]

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[299] Reg. § 1.663(c)-2(b)(4).

[300] Reg. § 1.663(c)-5, Example 5.

[301] Reg. § 1.663(c)-2(b)(3).

[302] Reg. § 1.663(c)-5, Example 6.

Thus, DNI is allocated to the pecuniary share regardless of the fact that it is not entitled to any state law income.[303]

VI. HOLDING PARTNERSHIP INTERESTS IN TRUST

A. Prudent Investor Act

If the estate or trust's assets consist primarily or solely of an interest in a family partnership, the trust agreement must expressly allow it, or the fiduciary must justify that it does not violate the general standards of prudent investing or the specific duties of diversification, loyalty, and impartiality among the beneficiaries.[304] The prudent investor statutes impose a heightened burden on the fiduciary to invest the assets for maximum growth according to modern risk management theory, while balancing the interests of all the beneficiaries based on a laundry list of other considerations.[305] The trustee must also reduce costs and consider the tax consequences of his investments.

To enable the trustee to meet these duties, all state Prudent Investor Acts allow, in some cases mandate, the trustee to delegate these functions in order to be prudent.[306] Thus, many trustees rely on the expertise of investment advisors, whether hired by the trust or the partnership, to fulfill their prudent investor duties.

There may be some question about whether holding a large interest in a family partnership satisfies a trustee's duty to diversify, especially if the interest cannot be sold or it is not making distributions. However, if the partnership owns a diversified portfolio, the duty may be satisfied. Holding a diversified portfolio in a family partnership is not much different than owning a mutual fund, except that the mutual fund can be sold. The Uniform Prudent Investor Act approves mutual funds as trust investments, particularly for the smaller trust that may not be able to effectively diversify any other way.[307] However, the trustee should either monitor the partnership's diversification regularly, and ask the partnership to redeem the trust's interest if the partnership investment strategy is not appropriate for the trust.

There is an even greater question about whether a trustee can fulfill his duty of loyalty under Section 5 of the Uniform Prudent Investor Act by holding a family partnership interest. This is especially true if the trustee is also the general partner of the partnership. The duty of loyalty requires the trustee to invest solely in the interest of the trust beneficiaries. However, if the trustee is also the general partner, he must be loyal to the partners as well, despite that their goals, time horizons, and risk tolerances may differ from those of the trust beneficiaries. If the investment strategy of the partnership is not aligned with that of the trust beneficiaries, the trustee must divest himself of the partnership interest.

On the other hand, if the trustee determines that the partnership can invest in a manner that allows the trustee to meet his duties of loyalty and impartiality among the beneficiaries, the

[303] Reg. § 1.663(c)-2(b)(2).
[304] UNIF. PRUDENT INVESTOR ACT §§ 2, 3, 6 (1994).
[305] UNIF. PRUDENT INVESTOR ACT § 2.
[306] UNIF. PRUDENT INVESTOR ACT § 9.
[307] UNIF. PRUDENT INVESTOR ACT § 3, cmt.

details of the investment agreement should be carefully documented. In delegating his investment authority, the Act requires the trustee to select the agent, establish the scope of the delegation, and monitor the agent with reasonable care, skill, and caution.[308] The agent should accept the delegation cautiously because he assumes full liability as a fiduciary under the Uniform Prudent Investor Act.[309] To avoid the argument altogether, the trust agreement should expressly allow the trustee to invest in family investment partnerships.

B. Annual Gift Tax Exclusion

In 2013 each donor can make a gift to each donee of up to $14,000 per year without incurring any gift tax liability or using any of the donor's lifetime exclusion.[310] The donor can use the annual exclusion for as many donees as he wishes. Gifts can be made to a spouse for an unlimited amount, unless the spouse is a nonresident alien, in which case the annual exclusion is $143,000 in 2013.[311]

Despite the advantages of the annual exclusion, it has a substantial element of complexity. Only gifts that qualify as a "present interest" are eligible for the annual exclusion. Regulation § 25.2503-3(b) defines a present interest as "[a]n unrestricted right to the immediate use, possession, or enjoyment of property the income from property…" It must have one of those two elements to qualify. Whether a gift meets these qualifications has been highly litigated.

Prior to 2002, the IRS generally allowed gifts of a family partnership interest to qualify for the annual gift tax exclusion.[312] However, beginning with *Hackl v. Commissioner* in 2002, the IRS began to challenge such gifts as not meeting the present interest requirement where the donee does not have a right to freely transfer the partnership interest or have the immediate use, possession, or enjoyment of income from the partnership.[313] This attack makes little sense when the purpose of the present interest requirement is to easily identify the donees. It is clear who the partners in a partnership are, unlike a trust, which may have contingent beneficiaries. Nonetheless, the taxpayer is losing on this issue in court and did not appeal the last two cases.[314] An appeal in *Fisher v. United States* would have been to the Seventh Circuit where *Hackl* was adversely decided. And *Price v. Commissioner* probably involved too small a deficiency to appeal with $93,000 of annual exclusions disallowed for each of Mr. and Mrs. Price.

There are several strategies to avoid losing the annual exclusion on gifts of family partnership interests.[315] First, the partnership agreement could provide a minimum guaranteed rate of return. Although this may reduce the discount, it might be preferable to losing the annual exclusion. Second, the partnership agreement could give the partners annual withdrawal or

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[308] UNIF. PRUDENT INVESTOR ACT (1994) § 9(a).
[309] *Id*. at §§ (b),(d).
[310] IRC § 2503(b); Rev. Proc. 2012-41, 2012-45 I.R.B. 539 (Oct. 18, 2012).
[311] IRC §§ 2523(a), 2523(i)(2); Rev. Proc. 2012-41, 2012-45 I.R.B. 539 (Oct. 18, 2012).
[312] Ltr. Rul. 199944003, 199905010, 9131006, 8611004; TAM 9415007; but see TAM 9751003 (annual exclusion denied because the general partner could retain funds "for any reason whatsoever").
[313] Hackl v. Comm'r, 118 TC 279, *aff'd*. 92 AFTR 2d 2003-5254 (7th Cir 2003); Price v. Commissioner, T.C. Memo 2010-2 (January 4, 2010); Fisher v. United States, 105 AFTR 2d. 20101347 (S.D. Ind. March 11, 2010).
[314] *Id.*
[315] Robert W. Malone & Jon R. Stefanik, II, "Fisher and Price: The End of Annual Exclusion Gifts of FLP Interests, or Mere Child's Play?" TAXES-THE TAX MAGAZINE, Oct. 2011, p.17.

"Crummey" rights. However, this could complicate the accounting if the partners actually withdrew the amounts because it could cause disproportionate distributions. It could also cause estate tax inclusion under § 2036 for the donor who should also have a withdrawal right to avoid disproportionate distributions. Therefore, instead of drafting Crummey withdrawal powers into the partnership agreement, it would be better to give the partnership units to a trust with Crummey withdrawal rights and plenty of cash to satisfy the donees' demands.

In *Wimmer v. Commissioner* the Tax Court allowed the annual exclusion for gifts of partnership interests because the gifts were made in trust.[316] The general partner was also the trustee of the recipient trust. The trust's sole asset was the limited partnership interest. Thus it had no other source of funds to pay the tax on its share of partnership income. The Court held that the general partner had a duty to distribute sufficient cash to the trust to pay its income tax on partnership income. And because the partnership was required to make prorata distributions to all partners, all partners had an expectation of distributions. As such, all partners had the immediate use, possession or enjoyment of income from the partnership, passing the income prong of the two-part test, and were thus eligible for the annual exclusion. *Wimmer* suggests that gifts of partnership interest should be made in trust to qualify for the annual exclusion.

Perhaps the safest of all is to make gifts of cash along with gifts of partnership units so that at least the cash gifts qualify for the annual exclusion. Gifts in trust also generally qualify for the annual exclusion if all the income is required to be distributed or the beneficiary has a present right to withdraw the gifts immediately after they are made.[317] Such rights are known as Crummey powers after the 1968 case of *Crummey v. Commissioner*.[318]

But Crummey powers are far from a perfect solution. They are easy to overlook, a nuisance for the trustee to administer, can have unintended consequences if the beneficiary actually withdraws the money, and have complicated tax consequences. If the donee retains a cumulative right to withdraw funds from year to year (i.e. hanging powers), he is treated as having a power of appointment over the trust causing inclusion in his taxable estate under § 1041. If he lets his withdrawals powers lapse year to year, he is treated as having made a gift to the trust equal to the excess of the lapsed withdrawal right over the greater of $5,000 or 5 percent of the trust corpus. In either event, he is treated as the owner of that portion of the trust over which he has withdrawal powers under IRC § 678.

Donors may not need to rely as much on the annual exclusion and may instead use the enlarged lifetime gift exemption to avoid gift taxes on annual gifts. This was not always possible when the lifetime gift exclusion was $1 million. In addition, grantors may decide not to include Crummey powers in irrevocable trusts. And finally, donors of family partnership interests may decide that they would rather restrict distributions in order to obtain higher valuation discounts than provide for generous distributions just to qualify for the present interest exclusion.

C. 3.8 Percent Surtax on Unearned Income of Estates and Trusts

New § 1411 imposes a surtax of 3.8 percent on the unearned income of individuals, estates, and trusts for taxable years beginning after December 31, 2012. The surtax is in addition

[316] Wimmer v. Comm'r, TC Memo 2012-157 (June 4, 2012).
[317] Reg. § 25.2503-3(b), (c), example 3.
[318] Crummey v. Comm'r, 397 F2d 82 (9th Cir 1968).

to all other taxes imposed by Subtitle A (Income Taxes).[319] In the case of an estate or trust, the surtax applies to the *lesser* of a) adjusted gross income under § 67(e) in excess of the highest income tax bracket threshold ($11,950 in 2013) or b) undistributed net investment income.[320] The threshold for the highest bracket is indexed for inflation each year, unlike the threshold for individuals, which is fixed at $250,000 for married individuals, $125,000 for those married individuals filing separately, and $200,000 for other individuals.[321] A trust cannot take advantage of multiple thresholds by dividing into multiple trusts because multiple trusts are aggregated and treated as one if they have substantially the same trustees and beneficiaries.[322]

D. Passive Activities

Fiduciaries frequently own an interest in a trade or business such as a ranch, rental property, or other business enterprise. These activities can be owned directly or indirectly through passthrough entities. They are either acquired for investment purposes or simply inherited by virtue of the partner's death. In order to deduct their share of losses incurred by these activities, however, the trustee must materially participate in the activity.[323] The Treasury Department has issued regulations explaining how individuals can meet the material participation requirements, but it has not yet issued regulations addressing material participation by trusts and estates.[324]

Individuals (natural persons) can meet one of seven safe harbor tests in Reg. § 1.469-5T(a)(1)-(7) in order to materially participate in an activity for purposes of deducting passive losses.[325] These seven tests are:

1. The individual participates in the activity for more than 500 hours during such year.
2. The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year;
3. The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year;
4. The activity is a significant participation activity (within the meaning of paragraph (c) of this section) for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours;
5. The individual materially participated in the activity (determined without regard to this paragraph (a)(5)) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;

[319] IRC § 1411(a)(1).
[320] IRC § 1411(a)(2).
[321] IRC § 1(f); IRC § 1411(b).
[322] IRC § 643(f).
[323] IRC § 469(h)(1).
[324] Reg. § 1.469-8 [Reserved], T.D. 8417 (May 12, 1992).
[325] Temp. Reg. § 1.469-5T, T.D. 8175 (Feb. 19, 1988).

6. The activity is a personal service activity (within the meaning of paragraph (d) of this section), and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year; or
7. Based on all of the facts and circumstances (taking into account the rules in paragraph (b) of this section), the individual participates in the activity on a regular, continuous, and substantial basis during such year.

Individual limited partners, however, may only avail themselves of tests number 1, 5, and 6 in order to materially participate in the activity. Courts have held that LLC members are considered general rather than limited partners and may therefore rely on any of the seven tests for material participation.[326] However, the IRS recently published Prop. Reg. § 1.469-5, which defines limited partner as any interest holder in a partnership who does not have rights to manage the entity under the applicable state law, regardless of the partner's liability exposure.[327] Therefore, a LLC member who does not participate in management will be considered a limited partner under the proposed regulations.

Estates and trusts are apparently not considered 'individuals" for purposes of the safe harbor tests or the special rules for limited partners. In addition, it is unclear whose participation counts for purposes of material participation - the trustee, the beneficiaries, or agents. Until regulations are issued for estates and trusts, the IRS maintains that § 469(h)(1) is the sole standard for determining whether a trust or estate satisfies the material participation test. Section 469(h)(1) provides that a taxpayer materially participates only if he is involved in the operations of the activity on a regular, continuous, and substantial basis. But who is the taxpayer?

The District Court for the Northern District of Texas addressed this issue for a trust the first time in *Carter v. United States*. [328] The Carter Trust owned a working cattle ranch with mineral interests. The trustee had extensive business, managerial and financial experience and maintained regular office hours on trust business. However, he delegated the ranch operations to a full-time manager and several employees who performed all of the activities for the ranch. The trust claimed losses from the ranch, which the IRS disallowed as passive under § 469. The IRS maintained that the "material participation" of a trust is based on only the activities of the trustee in his capacity as such. Because he delegated so much of his responsibility, the IRS argued that he did not materially participate. The Carter Trust, however, argued that because the trust (not the trustee) is the taxpayer, "material participation" should be determined by assessing the activities of the trust through all its fiduciaries, employees, and agents.

Agreeing with the Carter Trust, the district court held that the material participation in the ranch operations should be determined by reference to all the persons who conducted the business of the ranch on Carter Trust's behalf, including the trustee. The evidence was clear that the collective activities of those persons with relation to the ranch operations during relevant times were regular, continuous, and substantial so as to constitute material participation.

Notwithstanding the *Carter* decision, the IRS held in TAM 200733023 that losses flowing from an LLC to a trust were passive because the trustee himself was not involved in the LLC's

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[326] Hegarty v. Comm'r, T.C. Summ. Op. 2009-153 (October 6, 2009); Garnett v. Comm'r, 132 T.C. No. 19 (June 30, 2009); Thompson v. United States, 87 Fed. Cl. 728 (July 20, 2009).
[327] REG-109369-10, Prop. Reg. § 1.469-5 (Nov. 28, 2011).
[328] Carter v. United States, 256 F. Supp. 2d 536 (N.D. Tex. 2003).

operations on a regular, continuous, and substantial basis as required by § 469(h)(1). The TAM justified its position on the basis that individual business owners cannot rely on the activities of their employees to satisfy the material participation requirement.[329] Businesses generally involve employees or agents and therefore allowing an owner to be treated as materially participating in a business because his employees materially participated would gut the test altogether.

However, TAM 200733023 may provide a roadmap for trustees wishing to establish material participation. The trust in the TAM employed "Special Trustees" who ran the business, but could not legally bind or commit the trust to any course of action and had no discretionary powers. Therefore, they were not fiduciaries for purposes of the material participation test. But even if they were, their duties of negotiating tax matters, handling the entry of new partners, and reviewing operating budgets had a questionable nexus to the conduct of the business. Therefore trusts wishing to meet the material participation test should make sure that their trustees participate on a regular, continuous, and substantial basis in the operations of the business activity and that any special trustees have discretionary powers and the power to bind the trust.

A similar result was reached in Letter Ruling 201029014, which held that the sole means for a trust to materially participate in a trade or business activity is for the fiduciary to be involved in the operations of the activity on a regular, continuous, and substantial basis.[330] The trust in the ruling was a complex trust whose trustee was also a beneficiary. The IRS concluded that the trustee materially participate in the partnership's activities if he was involved in them on a regular, continuous, and substantial basis. It expressed no opinion about whether the trustee in fact materially participated in the activities.

Most recently, TAM 201317010 held that a special trustee did not materially participate in the activities of a highly profitable S corporation, even though he was President of the S corporation and materially participated in its activities on a regular, continuous and substantial basis.[331] Material participation was important to the trust in order to allow it to deduct its share of the S corporation's research and development expenses rather than amortize them over 10 years under IRC § 56(b)(2), which cross-references IRC §469(h). The IRS held that because the President was unable to differentiate the time he spent in his capacity as President from the time he spent in his capacity as trustee, the trustee was not involved in the operations of the business on a regular, continuous and substantial basis.

In addition, the IRS noted that his special powers were restricted and did not give him the power to commit the trust to any course of action or control trust property beyond selling or voting the stock. Although these functions could be counted in determining material participation, it did not rise to the level of "regular, continuous and substantial." Although the TAM does not specify, it appears that the trust was a defective grantor trust.

E. Determining "Trust Income" From a Partnership

In addition to the prudent investor and tax issues, the trustee must also determine whether distributions from a partnership are income or principal. Most wills and trust agreements default to the state law rules for determining income and principal. The Uniform Principal and Income

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329 Tax Reform Act of 1986, Sen. Rep. No. 99-313, at 735 ("the activities of [employees]… are not attributed to the taxpayer.")
330 TAM 2007 33023 (Aug. 17, 2007).
331 TAM 201317010 (Apr. 26, 2013).

Act treats money distributions from "entities" as income and property distributions as principal.[332] Entities include corporations, partnerships, limited liability companies, regulated investment companies, real estate investment trusts, common trust funds, and any other organization in which a trustee has an interest (except a trust or estate, a business activity, or an asset-backed security to which other sections of the Act apply.)

However, any money distributed in complete or partial liquidation of the entity is principal. A partial liquidation is one that the entity "indicates" as a partial liquidating distribution regardless of the size of the distribution.[333] A trustee may rely on a statement made by an entity about the source or character of a distribution if the statement is made at or near the time of distribution by the entity's board of directors or other person or group authorized to exercise powers similar to a board of directors.[334]

If the entity is silent about whether the distribution is a partial liquidating distribution, the trustee can rely on the 20-percent rule. A distribution or a series of related distributions that exceeds 20 percent of the entity's gross assets is considered a partial liquidation.[335] However, the portion of the distribution that equals the income tax due on the entity's taxable income is ignored in calculating the 20 percent.[336] Although the Act resolved some of the issues regarding income from entities, it leaves several more unanswered questions.

1. QTIP Trusts

Trustees of marital trusts should be especially careful that the surviving spouse is entitled to all the "income" from the entity so that the trust qualifies for the estate tax marital deduction under § 2056(b)(7). The IRS has shown willingness to accept reasonable allocations between income and principal where a marital trust owns a partnership interest.[337]

Most recently, Revenue Ruling 2006-26 held that a QTIP trust qualifies for the marital deduction where its income is determined under a state law unitrust of 3 to 5 percent or based on traditional income, with or without an exercise of the power to adjust by the trustee.[338] In addition, the spouse must be able to compel the trustee to make the property productive.[339] Although this Revenue Ruling dealt with income from an IRA paid to a QTIP trust, its reasoning can apply to income from a partnership interest.

Where a QTIP trust owns a partnership interest that does not distribute sufficient income, the IRS could find that the trust does not qualify as a QTIP trust under § 2056(b)(7). Thus,

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332 UNIF. PRINCIPAL & INCOME ACT §§ 401(b), (c).
333 *Id.* at § 401(d)(1).
334 *Id.* at § 401(f).
335 *Id.* at § (d)(2).
336 *Id.* at § (e).
337 FSA 199920016 (contribution of assets of a QTIP trust to a family limited partnership didn't result in a gift because the beneficiary still received the same amount of income that she received from the QTIP trust before); (P.L.R. 9739017 (IRS allows a will formula allocating a portion of partnership liquidation payments to marital trust income to meet the marital deduction requirements).
338 Rev. Rul. 2006-26, 2006-22 I.R.B. 939.
339 Reg. §§ 20.2056(b)-5(f)(4) and (5).

QTIP trusts owning partnerships should be careful that the partnership is distributing enough income to avoid potential disqualification of the marital trust.

2. The 20-Percent Rule

In determining whether a distribution, or series of distributions, is in partial liquidation because it exceeds 20 percent of the entity's gross assets, the trustee needs the entity's financial statements for the year ended immediately before the distribution (or first distribution of a series). The entity may prepare its financial statements on GAAP, fair market value, or any other method it deems appropriate. For example, in 2004 when Microsoft declared a dividend that exceeded 30 percent of its book value, trustees could use Microsoft's December 31, 2003 audited financial statements included in its Form 10-K filing with the SEC.

If the entity prepares its financial statements using historical cost and its assets have appreciated substantially, the 20-percent rule favors the principal beneficiary because distributions are more likely to exceed 20 percent of gross assets and be treated as principal. Note also the control that the entity has over the trust's income or principal. The entity can specify that a distribution is either a partial liquidating distribution or not by merely stating so. In addition, the entity can simply pay more than 20 percent of its gross assets if it wants to create a principal distribution for the trust beneficiaries.

The trustee can also manipulate income and principal under the 20-percent rule. For example, if the trustee transfers trust assets to an entity that makes no distributions or that distributes more than 20 percent of its gross assets, the trust has no income from that entity. Alternatively, if the entity distributes less than 20 percent of its gross assets, the trust can have a steady stream of income even if the entity is selling off corpus to support the distributions. Of course these maneuvers are tempered by the fiduciary's duty of loyalty to all the beneficiaries.

Another criticism of the 20-percent rule is its rigidity. If a distribution exceeds 20 percent of the entity's gross assets, it is per se principal. Although UPIA 401(d)(1) allows a payment of less that 20 percent of an entity's gross assets to be classified as principal if the entity indicates it is principal at or near the time of a distribution, there is no corresponding rule that allows payments in excess of 20 percent to be classified as income. This is so despite that the distribution may actually represent many years of accumulated income that is no longer needed by the entity in its operations. This was probably the case with Microsoft. Some trustees treated the 2004 extraordinary distribution as income and some treated it as principal.

In addition a recent California Court of Appeal found the 20 percent rule susceptible of two different interpretations. In *Thomas v. Elder*, the beneficiary interpreted the statute as classifying distributions to income when a *single owner* receives less than 20 percent of the entity's gross assets, regardless of the owner's percentage interest.[340] The Court of Appeal agreed that the statute was capable of that interpretation and held for the beneficiary. In reaction to *Thomas*, the California state legislature enacted as an emergency measure an amendment to their UPIA statute to clarify that distributions are income only when the total amount distributions to *all* shareholders collectively exceeds 20 percent of the entity's gross assets.

But the problems didn't stop there. In *Hasso v. Hasso*, the trustee claimed that distributions from an S corporation to a trust were principal because they exceeded 20 percent of the S

[340] Thomas v. Elder, 21 Cal. Rptr. 3d 741 (Dec. 2, 2004)

corporation's $133 million of "special purpose" assets. The company had prepared its financial statements on the "equity" method of accounting at the special request of a lender rather than on a GAAP consolidated basis. A footnote to the financial statements disclosed that the company actually had $630 million of assets under a GAAP consolidated basis.[341] The company's chief financial officer also confirmed this in deposition testimony. Both the court and the parties struggled to interpret the complex financial statements. The court ultimately found that the true assets were $630 million and classified the distributions as income.

The most recent case addressing the 20-percent rule is *Manson v. Shepherd*.[342] The California Appeal Court determined that a $3 million distribution to a trust from its closely held corporation was a distribution in partial liquidation of the company and therefore principal because the corporation's board minutes stated that the proceeds arose from the sale of a significant asset and were distributed to the trust so that the trust could repay its debt to the company. From those minutes, the court inferred that the corporation made it known, or "indicated," at the time of the board meeting that the $3 million distribution was a liquidating distribution and properly allocated to principal.

F. Taxes on Undistributed Partnership Taxable Income

When a trust owns an interest in a partnership or S corporation, it must report its share of the entity's taxable income, regardless of how much the entity distributes to the trust. The entity may distribute nothing. Or it may distribute an amount less than the trust's tax on the entity's taxable income. Or it may distribute more than enough for the trustee to pay its tax on the entity's taxable income, but less than all of the entity's taxable income. In each case, the trustee must allocate the taxes on its share of the entity's taxable income between income and principal.

UPIA § 505(c) and (d) require a trust to pay taxes on its share of an entity's taxable income from trust income to the extent that receipts from the entity are income and from principal to the extent that receipts from the entity are principal. In determining the amount due to a beneficiary, UPIA § 505(d) requires the trustee to consider that distributions may be tax deductible to the trust.[343] Before amendment in October 2008, UPIA § 505 was unclear what this meant. To remove the ambiguity, NCCUSL amended § 505 to read as follows:

UPIA § 505 INCOME TAXES

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(c) A tax required to be paid by a trustee on the trust's share of an entity's taxable income must be paid:

(1) from income to the extent that receipts from the entity are allocated only to income;
(2) from principal to the extent that receipts from the entity are allocated only to principal;

[341] Hasso v. Hasso, 55 Cal. Rptr. 3d 667 (Mar. 6, 2007), pet. for review denied, No. S1511873 (May 16, 2007).

[342] Manson v. Shepherd, 188 Cal. App. 4th 1244 (Cal. App. 6th Dist. 2010).

[343] Generally amounts paid by a trust to a beneficiary are tax deductible. However, in the case of an Electing Small Business Trust (ESBT), the trust is not entitled to deduct payments to beneficiaries. The comments to UPIA § 505 explain that 505(d) was intended to address both situations.

(3) proportionately from principal and income to the extent that receipts from the entity are allocated to both income and principal; and
(4) from principal to the extent that the tax exceeds the total receipts from the entity.

(d) After applying subsections (a) through (c), the trustee shall adjust income or principal receipts to the extent that the trust's taxes are reduced because the trust receives a deduction for payments made to a beneficiary.

Thirty-five states have adopted the 2008 amendments to UPIA § 505.[344] The states that still use the pre-2008 version of UPIA § 505 potentially face two different interpretations of their statute, which produce vastly different results. It is possible that any disputes will be resolved in favor of the 2008 amendment because that expresses NCCUSL's intent.

As amended, UPIA § 505 requires the trustee to *first* calculate the trust's tax on an entity's taxable income and then reduce income or principal receipts *before* making a payment to the beneficiary. If necessary, the trustee must use the entire distribution from an entity to pay its taxes on the entity's taxable income. If the distribution from the entity exceeds the trust's taxes on its share of the entity's taxable income, the trustee allocates the rest to income or principal depending on whether the receipt was income or principal. Because the trust's taxes and the amount paid or payable to the beneficiary are interdependent, it requires an algebraic formula to determine the proper amount due the beneficiary from the entity.

Entity Distributes Less Than Enough to Pay the Trust's Taxes

In many situations the entity distributes little or nothing to its owners. Regardless, the trustee must report its full share of the entity's taxable income and pay the tax thereon. This can create cash flow problems for the trustee if the entity does not distribute enough to pay the trust's share of taxes on the entity's income. Consider the following example:

EXAMPLE 1

ABC Trust receives a K-1 from Partnership reflecting taxable income of $ 1 million and a $100,000 distribution from the partnership, which is allocated to income. The trust is in the 35 percent tax bracket.

The trust's tax liability on $1,000,000 is $350,000. But the trust only received $100,000 from the entity, which is not enough to pay its tax obligation. The trustee must use the $100,000 to satisfy its tax obligation and the income beneficiary receives nothing.[345]

Under a pre-amendment interpretation, however, no taxes would be allocated to the $100,000 of income receipts because they are fully deductible by the trust when distributed to the beneficiary. That is, they do not contribute to the trust's tax. Although the income beneficiary

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[344] States adopting the 2008 amendments to UPIA § 505 include Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, District of Columbia, Idaho, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Michigan, Mississippi, Missouri, ontana, Nebraska, Nevada, New Mexico, North Carolina, North Dakota, Oklahoma, Oregon, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia http://www.uniformlaws.org/LegislativeFactSheet.aspx?title=Principal and Income Amendments (2008).
[345] UPIA § 505, cmt. Example 1.

will pay tax on the $100,000 received from the trust, the trust, on the other hand, has a $315,000 tax obligation to satisfy [35% X ($1,000,000 – 100,000)], regardless of its ability to pay the tax.

Entity Distributes More Than Enough to Pay the Trust's Taxes

Assume, however, that the entity distributes more than enough to pay taxes on its K-1 income. The trustee has income receipts left over to pay the beneficiary. But how much? Under the 2008 amendments, the trustee must first determine its tax on the K-1 taxable income before paying the beneficiary. But the trust's tax depends on the amount paid to a beneficiary.[346] Thus, the calculation is circular, either solved by trial and error, or by algebraic equation:

$$D = (C-R*K)/(1-R)$$

D = Distribution to income beneficiary
C = Cash paid by the entity to the trust
R = tax rate on income
K = entity's K-1 taxable income

This equation is needed only when the entity distributes more than enough to pay the tax on its taxable income, but less than its total taxable income. When the entity distributes more than its taxable income, the trust's tax attributable to that entity's taxable income is zero, because payments to the income beneficiary theoretically reduce the trust's taxable income to zero.

EXAMPLE 2

Trust receives a K-1 from Partnership reflecting taxable income of $1 million. Partnership distributes $500,000 to the Trust, which is in the 35 percent tax bracket.

In the example above, the partnership distribution exceeds the trust's $350,000 tax on the K-1 income by $150,000. Because the trust can deduct the $150,000 paid to the beneficiary, it must apply the formula to determine the amount owed the beneficiary so that after deducting the payment, there is exactly enough to pay its tax on the remaining taxable income from the entity.

Taxable Income per K-1		1,000,000
Payment to beneficiary		230,769[347]
Trust Taxable Income		$ 769,231
35 percent tax	269,231	

Partnership Distribution	$ 500,000
Fiduciary's Tax Liability	(269,231)
Payable to the Beneficiary	$ 230,769

[346] UPIA § 505(d) and comments.

[347] D = (C-R*K)/(1-R) = (500,000 – 350,000)/(1 - .35) = $230,769. (D is the amount payable to the income beneficiary, K is the entity's K-1 taxable income, R is the trust ordinary tax rate, and C is the cash distributed by the entity).

The trustee allocates $269,231 of the entity's income receipts to pay the trustee's taxes. The income beneficiary also pays $80,769 [35% X $230,769] of personal income taxes when he reports the $230,769 on his individual income tax return, assuming he is in the 35 percent tax bracket. Thus the income beneficiary bore total taxes of $350,000 [$269,321 + $80,769], or the entire tax liability on the entity's $1,000,000 of Schedule K-1 income.[348]

Critics fault this result as being unfair to the income beneficiary. Drafting attorneys should anticipate that a trust might own a significant interest in a partnership that fails to distribute all its taxable income and draft the trust instrument to clarify how the taxes should be allocated.

G. Distributing Capital Gains

One way to reduce the fiduciary's exposure to the two-percent floor *and* the Medicare is by making distributions to the beneficiaries. However, it can be difficult to reduce the fiduciary's AGI to zero if capital gains are not able to be distributed and thus keep the estate or trust's AGI high for purposes of the two-percent floor and the Medicare tax.

Capital gains are significant for estates and trusts, accounting for about 50 percent of an estate or trust's gross income.[349] If these gains are not "income" under the governing instrument or local law, they cannot be distributed to the beneficiary.[350] Hence the gains are trapped in the fiduciary causing the fiduciary's adjusted gross income to be high for purposes of the two-percent floor and the Medicare tax. If they could be distributed, the trustee may be able to significantly reduce its tax. While the capital gains would then be included in the beneficiary's income, much of it might be below the beneficiary's Medicare tax threshold, particularly if the distribution is spread among several beneficiaries.

The Code defines distributable net income (DNI) as taxable income less certain items, including:

> "gains from the sale or exchange of capital assets…..to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year or (B) paid permanently set aside or to be used for the purposes specified in section 642(c) [charity]."[351]

Because the trustee has no authority to allocate partnership capital gains to corpus, it stands to reason that such partnership gains are not excluded from DNI by the statute. The regulations further elaborate on when capital gains may be excluded from DNI. But they do not expressly address capital gains of a passthrough entity.

1. Capital Gain Distributions Under the Regulations

IRS regulations provide that a trustee may include capital gains of the trust in DNI and distribute it to the beneficiaries only when:[352]

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[348] UPIA § 505, cmt. Example 2.

[349] http://www.irs.gov/uac/SOI-Tax-Stats---Fiduciary-Returns---Sources-of-Income,-Deductions,-and-Tax-Liability---Type-of-Entity.

[350] IRC § 643(a)(3).

[351] *Id.*

[352] Reg. § 1.643(a)-3.

a) capital gains are allocated to income by the governing instrument or local law;[353]

b) the fiduciary has discretion to allocate capital gains to income under the governing instrument or local law;[354]

c) the fiduciary *consistently* distributes capital gains to the beneficiary;[355]

d) the fiduciary actually distributes the capital gains to the beneficiary or utilizes the capital gains to determine an amount distributed or required to be distributed to a beneficiary.[356]

Nearly all state unitrust statutes provide the needed authority to distribute capital gains by providing an ordering rule. These ordering rules generally carry out ordinary and tax-exempt income first, then short-term capital gains, then long term capital gains, and then principal. This order follows the examples in the regulations.[357] However, these examples in the regulations are safe harbors only.[358] They do not preclude other means of distributing capital gains in a unitrust, especially if the trust instrument provides a different method.

For example, the trust instrument could direct that a unitrust distribution consist of the same proportion of capital gains as the trust's total capital gains bear to its total taxable income for the year. Thus, the distributions would carryout a cross section of the trust's capital gains and other classes of income. It is unclear whether the IRS would respect this means of allocating capital gains. Regardless, it should not adversely affect the trust's qualification as a marital trust because the § 2056 regulations address only the *amount* and not the character of the income distributed.[359]

However, only Texas and South Dakota grant the trustee with a power to adjust the discretion to characterize all or part of the adjustment as capital gain.[360] The drafters in these states believe that the regulations require the fiduciary to have express authority over capital gains in the governing instrument or local law in order to distribute those gains as part of a power to adjust. A plain reading of the regulations suggests that this is correct. If that is the case, the power to adjust alone does not provide the trustee authority to include capital gains in that adjustment. Consequently, drafters of new trust instruments should consider granting express authority to allocate capital gains as part of a power to adjust in the governing instrument. If the governing instrument grants the trustee discretion to determine what is income and principal, it should state that the power includes the discretion over capital gains.

2. Including Partnership Capital Gains in DNI

The question often arises whether capital gains from a partnership are includible in DNI. The regulations do not address this issue, despite that the AICPA asked the IRS to address it in

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353 Reg. § 1.643(a)-3(b)(1).
354 *Id.*
355 Reg. § 1.643(a)-3(b)(2).
356 Reg. § 1.643(a)-3(b)(3).
357 Reg. § 1.643(a)-3(e), Examples 11 and 13.
358 Reg. § 1.643(a)-3(e), Examples 11 and 13.
359 Reg. § 1.2056(b)-7(d)(1).
360 Tex. Prop. Code § 116.005(a); S.D. CODIFIED LAWS § 55-13A-104.

comments on the proposed regulations under IRC § 643 in 2001.[361] In response, the Preamble to the final regulations simply states:

> "One commentator requested examples of the effect on DNI of capital gains from a passthrough entity and income from a passthrough entity that is more or less than the trust accounting income from that entity. These issues are beyond the scope of this project."[362]

Despite the IRS's silence on the issue, it seems relatively clear that partnership capital gains should be included in DNI based on a plain reading of IRC § 643(a). The statute defines DNI as taxable income minus "gains from the sale or exchange of capital assets…to the extent that such gains are allocated to corpus and are not …paid, credited, or required to be distributed to any beneficiary during the taxable year" or permanently set aside for charity. Partnership capital gains are not "gains from the sale or exchange of capital assets…allocated to corpus," but rather capital gains of a separate legal entity over which the trustee has no power to allocate to corpus. The trustee can only allocate *receipts* from the entity to corpus if they meet the definition of principal under the governing instrument or local law.[363]

The United States Court of Federal Claims addressed this very issue in *Crisp v. United States*.[364] In *Crisp*, the Hunt Trust invested $5 million for a 2/3 limited partnership interest in ZH Associates, a Texas limited partnership. ZH generated a large amount of capital gains from sophisticated trading activities such as arbitrage and hedging. The trustee, Don Crisp, included the trust's share of the partnership capital gains in DNI and carried them out to the income beneficiary, Caroline Hunt. The IRS challenged the inclusion of the partnership's capital gains in the trust's DNI as contrary to the Texas Trust Code, the trust instrument, and IRC § 643(a).

First the IRS argued that partnerships are not separate taxpayers under the tax code, but mere conduits through which tax items flow to their partners. Accordingly, the partnership capital gains are corpus and should not be included in DNI. However, the Court noted that the tax treatment does not control the allocation between income and principal. Second, the IRS analogized the situation to capital gains from regulated investment companies (RICs) and mutual funds, which the Texas Trust Code allocates to corpus even though the trust does not own the underlying securities. However, the Court was not persuaded by this argument either because ZH was neither a RIC nor a mutual fund.

Third, the IRS pointed out that the partnership capital gains fit squarely the definition of capital gains in the tax code and therefore they should be excluded from DNI under IRC § 643(a)(3). However, the Court reminded the IRS again that although the Internal Revenue Code affects the rate of tax on capital gains, it does not control whether they are income or principal. Finally, the IRS argued that allowing the trustee to treat partnership capital gains as income permitted him to use the partnership form to convert corpus into income. However, the Court pointed out that trustees can do this anyway simply by choosing whether to invest in income or growth assets. Further, the trustee was merely exercising the discretion granted him in the trust

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[361] Tax Notes Today, 2001 TNT 97-26 (May 17, 2001) (Comments by the AICPA to Treasury regarding the proposed regulations to revise the definition of trust income under Section 643(b)).
[362] T.D. 9102.
[363] *See also* E. James Gamble, Trust Accounting and Income Taxes, AICPA Conference (June 2005).
[364] Crisp v. United States, 34 Fed. Cl. 112 (1995).

instrument to choose among various business structures.

In sum, the Court held that the partnership profits are not corpus under either the trust agreement or state law because the trust did not acquire the securities. Rather, the partnership, a distinct legal entity acquired the securities.[365] It also gave weight to the fact that the trustee hired a national accounting firm to audit the trust and they determined that its partnership profits were income. The Court also found that allocating partnership capital gains to income did not jeopardize the interests of the remaindermen. But even if it favored the income beneficiary, the facts indicated that the settlors intended that result. Based on all these facts, the Court found that capital gains from the partnership constituted trust income.

Even though *Crisp* was decided before the final § 643 regulations and the adoption of the Uniform Principal and Income Act (1997), its holding is still sound because partnership capital gains are not "gains from the sale or exchange of capital assets…allocated to corpus" under either state law, the governing instrument, or IRC § 643(a).

3. Carrying Out Capital Gains from a Unitrust

Capital gains can also be carried out with a unitrust payment. Most state unitrust statutes provide an ordering rule under which ordinary and tax-exempt income flow out first, then short term capital gains, then long term capital gains, and then principal. This order follows the examples in the regulations.[366] The ordering rules in the regulations are safe harbors. As such, they do not preclude other means of distributing capital gains, especially if the trust instrument requires a particular method. The regulations do, however, require that if the trustee has discretion, he exercise that discretion *consistently* in allocating capital gains to income.[367] Presumably this means that once the trustee picks an allocation method, he stick with it.

However, the trustee may wish to allocate taxable income under a different ordering rule than the regulations illustrate. For example, he may wish to allocate capital gains in the same proportion as the trust's capital gains bears to its total taxable income for the year. So if 80 percent of a unitrust's taxable income consists of capital gains, the trustee might allocate 80 percent of the unitrust payment to capital gains. It is uncertain whether the IRS will respect this allocation under § 643. But regardless, it should not adversely affect the trust's qualification as a marital trust be because the regulations under § 2056 require address only the amount and not the character of trust income.[368]

VII. CONCLUSION

The executor or trustee with partnership interests has a challenge. He or she must have a working knowledge of the income tax rules as well as the estate tax rules for both trusts and partnerships. The job also demands active communication with the partnership management and recognizing when the fiduciary needs to delegate duties he is not qualified to perform himself. Successes in the administration often go unnoticed, but the fiduciary's errors will be magnified.

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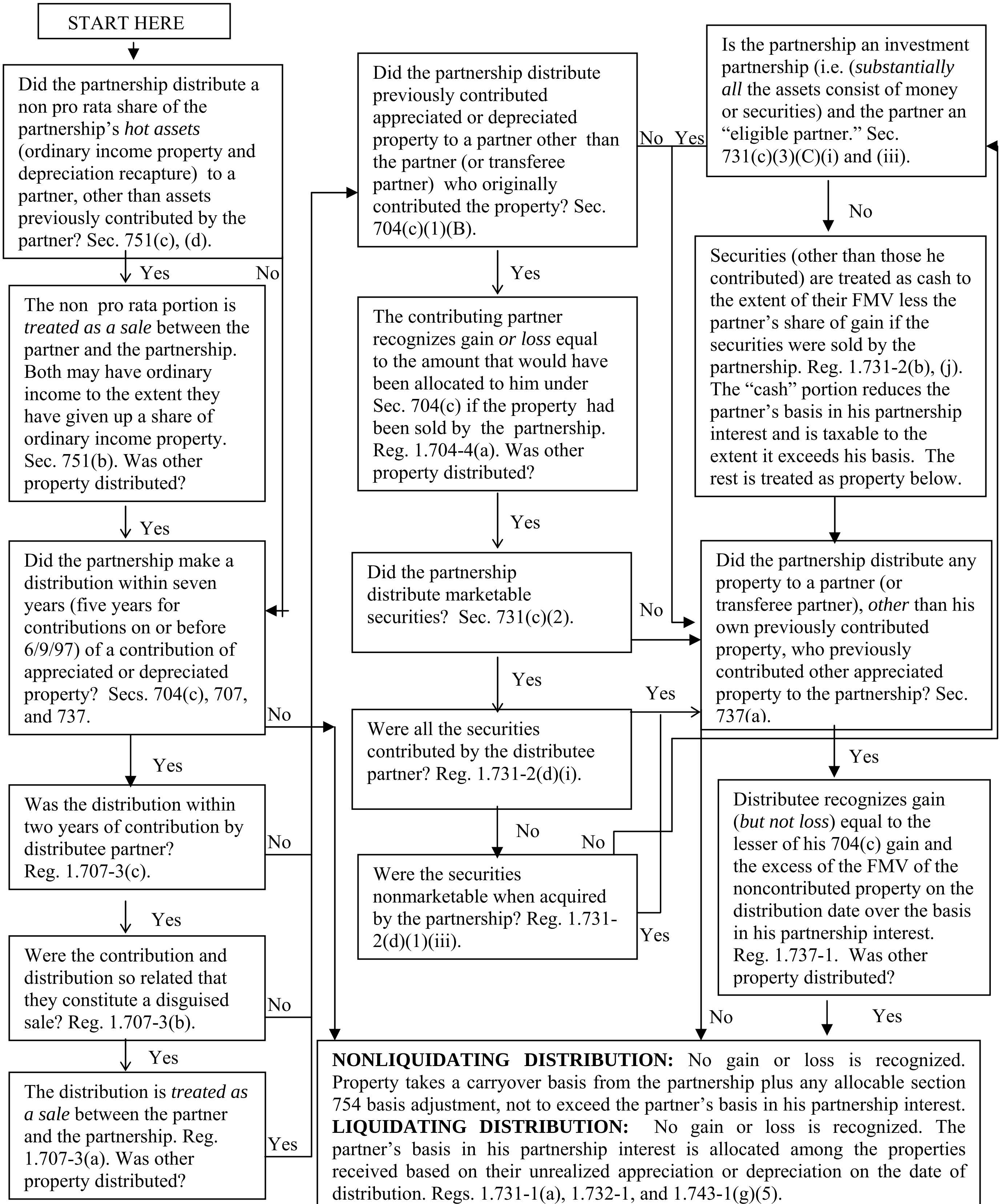
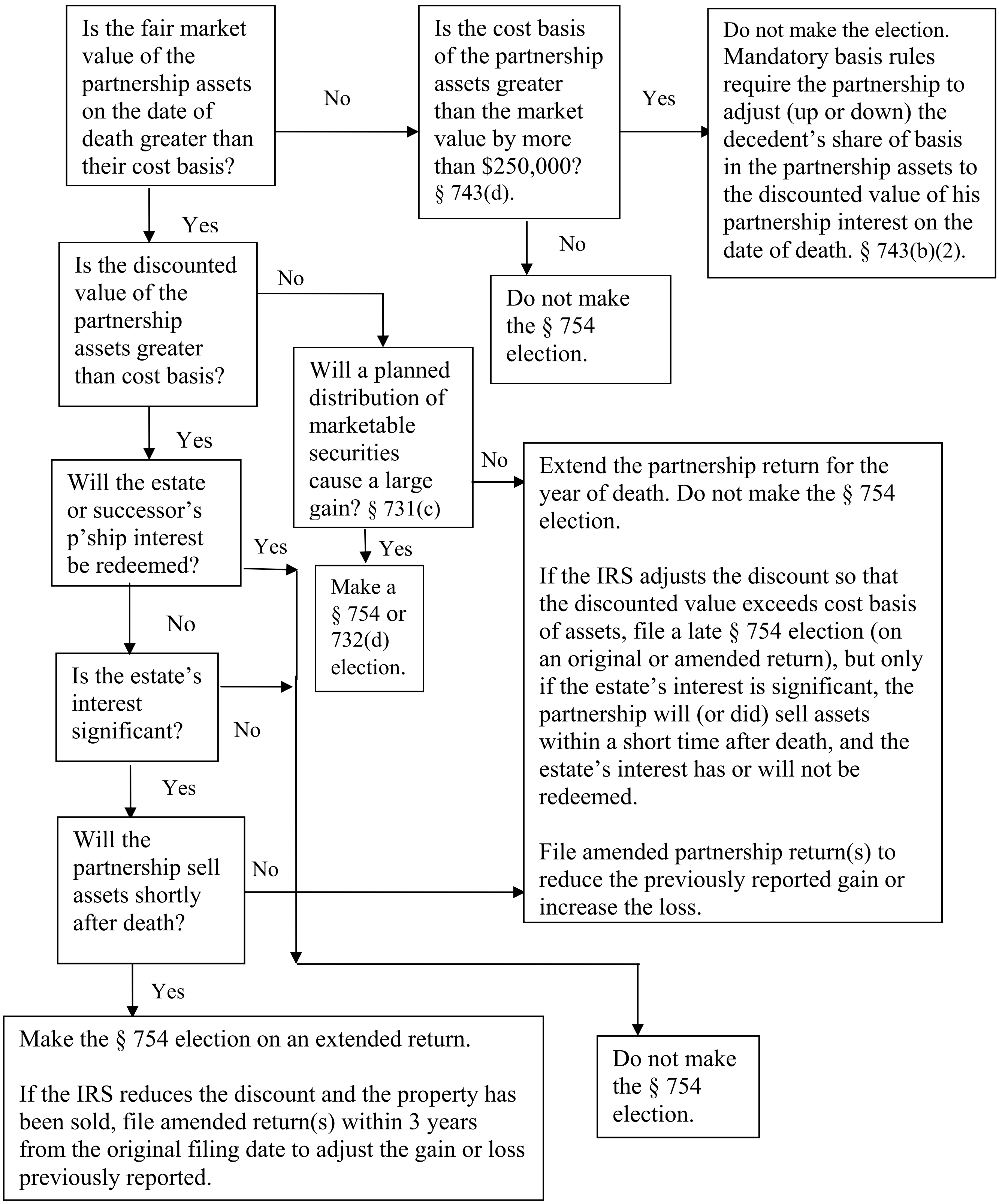
365 Crisp v. United States, 34 Fed. Cl. 112 at 118-120.
366 Reg. § 1.643(a)-3(e), Examples 11 and 13.
367 Reg. § 1.643(a)-3(b)(1).
368 Reg. § 1.2056(b)-7(d)(1).

Mixing Bowl Flowchart for Partnership Property Distributions
IRC §§ 704(c)(1)(B), 707, 731, 737, and 751
EXHIBIT A



Section 754 Decision Tree
Decedent's Estate with a Discounted Family Limited Partnership
EXHIBIT B



When Capital Gains Are Included in DNI under Reg. § 1.643(a)-3
EXHIBIT C