

**INCOME TAX PROBLEMS WHEN
THE ESTATE OR TRUST IS A PARTNER**

By

Carol A. Cantrell

Cantrell & Cowan, PLLC
3700 Buffalo Speedway, Suite 520
Houston, TX 77098
713-333-0555
ccantrell@cctaxlaw.com

For

ALI-ABA Planning Techniques for Large Estates
Scottsdale, AZ
April 19, 2013

INCOME TAX PROBLEMS WHEN THE ESTATE OR TRUST IS A PARTNER

I. INTRODUCTION	1
II. INVENTORY ON DATE OF DEATH	1
A. Inside Basis and Value of Partnership Assets.....	1
B. Pre-Contribution Gains and Losses under Sec. 704(c).....	1
1. The General Rule	1
2. Partnership Interests Acquired by Gift	2
3. Contributions of Built-in Loss Property	4
4. Disproportionate Capital Contributions.....	6
C. Income in Respect of a Decedent (IRD).....	6
1. Statutory IRD of a Deceased Partner.....	7
2. Judicially Created IRD.....	8
3. Reporting Requirements	9
D. Promissory Notes from Irrevocable Grantor Trusts.....	9
1. Gain at Death	10
2. Who Reports the Gain?.....	11
3. Basis of Trust Property	12
E. Valuation Discounts When There's No Estate Tax	13
III. THE SECTION 754 ELECTION	14
A. Who Can Make the Election.....	15
B. Mechanics: The Hypothetical Sale	16
C. Applying Partnership Discounts	17
D. Community Property.....	18
E. When Not to Make the Election.....	18
F. Mandatory Basis Adjustments for "Substantial Built-in Loss Property"	20
1. The \$250,000 Threshold	20
2. The Mechanics	21
3. Partnership Discounts and the \$250,000 Threshold	22
G. Recordkeeping Responsibility	23
H. Impact of § 754 on Other Partners.....	23
I. Making the Election.....	25
1. Late Elections.....	25
2. Revoking the Election.....	26
3. Division or Constructive Termination	27
J. The Duty of Consistency	29
K. Consequences of Overstating the Basis	30
L. Valuation Discounts for the Election	30
M. Partnerships Owned by a Marital Trust	31
N. Partnerships Included under § 2036.....	31
IV. TAXATION OF DISTRIBUTIONS.....	32
A. General Rules.....	32
1. When Distributions are Deemed to Occur	33
2. Basis of Property Distributed.....	33
3. Holding Period.....	34

B. Distributions that Require Mandatory Basis Adjustments.....	34
1. Mechanics	34
2. Effect of a Section 754 Election	35
C. Distributions Within Seven Years of Contribution.....	36
1. Distributions of Contributed Property - § 704(c)(1)(B).....	36
2. Distributions of Other Property to a Contributing Partner - § 737	38
D. Distributions of Marketable Securities - § 731(c).....	41
1. Marketable Securities Defined.....	41
2. Reduction in the Amount Treated Like Money	41
3. Impact of Valuation Discounts	42
4. Statutory Exceptions	44
E. Liquidating Distributions.....	45
V. DISTRIBUTING PARTNERSHIP INTERESTS TO BENEFICIARIES	46
A. Closing the Partnership Books.....	46
1. Transfers By Gift	46
2. Closing Methods	47
B. Constructive Termination on Change in Ownership	48
C. Gain or Loss on Funding.....	49
D. Triggering IRD Recognition.....	50
E. Carrying Out DNI When Funding with a Partnership Interest	50
1. The Separate Share Rule.....	51
2. Pecuniary Bequests and DNI Carryout.....	51
3. Income from Pass-Through Entities	52
4. Special Rule for IRD Included in DNI	52
VI. HOLDING PARTNERSHIP INTERESTS IN TRUST	53
A. Prudent Investor Act	53
B. Annual Gift Tax Exclusion	54
C. 3.8 Percent Surtax on Unearned Income of Estates and Trusts	55
D. Passive Activities	58
E. Determining “Trust Income” From a Partnership.....	61
1. QTIP Trusts.....	61
2. The 20-Percent Rule	62
F. Taxes on Undistributed Partnership Taxable Income.....	63
G. Distributing Capital Gains	66
1. Capital Gain Distributions Under the Regulations	67
2. Including Partnership Capital Gains in DNI.....	68
3. Carrying Out Capital Gains from a Unitrust.....	69
H. The 2-Percent Floor	70
1. The AMT Impact	71
2. Medicare Tax Impact	71
3. Revised Proposed Regulations.....	72
VII. CONCLUSION.....	75

Exhibit A – Mixing Bowl Flowchart for Partnership Property Distributions

Exhibit B – Section 754 Decision Tree

Exhibit C– When Trust Capital Gains are Included in Distributable Net Income

INCOME TAX PROBLEMS WHEN THE ESTATE OR TRUST IS A PARTNER

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 still meet the one-year holding period in order to achieve long-term capital gain treatment, even for assets on hand on the date of the decedent partner's death.

A. Inside Basis and Value of Partnership Assets

Despite the general rule that a partnership does not adjust the basis of its assets to fair market value upon a partner's death, the executor still needs this information for several other purposes. It helps him know whether it is desirable for the partnership to make a Section 754 election to adjust the basis of the partnership assets to date of death value with respect to the decedent.³ It also helps him determine whether the partnership is subject to the new mandatory basis adjustment rules enacted by the American Jobs Creation Act of 2004.⁴ Therefore, the partnership should provide the executor information about the basis and fair market value of each partnership asset on the date of death. In addition, the partnership will need to allocate discounts for minority and lack of marketability among the various partnership assets.

B. 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 fair market value. The difference is hereafter referred to as "pre-contribution gains and losses" or interchangeably, "built-in gains and losses." Pre-contribution gains and losses must be tracked on a property by property and a partner by partner basis.⁵ When the partnership disposes of any property that

¹ IRC § 1223(11).

² See discussion at III.

³ See discussion at III.

⁴ P.L. 108-457, § 833, Treatment of Partnership Loss Transfers and Partnership Basis Adjustments.

⁵ Reg. § 1.704-3(a)(2).

contains pre-contribution gain or loss, such pre-contribution 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.⁶

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.⁷

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.⁸ The regulations also allow the partnership to ignore "small disparities" between value and basis.⁹ A small disparity exists when the total difference between the basis and fair 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 total difference for all properties is no more than \$20,000. The small disparity and limited aggregation exceptions are little help to the typical family limited partnership that consists primarily of investment assets and the disparity is nearly always greater than the 15 percent or \$20,000 safe harbor.

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.¹⁰ However, the § 754 election has no effect on the other partners.¹¹ 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.

⁶ Reg. § 1.704-3(a)(1).

⁷ Reg. § 1.704-1(b)(5), Example 13(i).

⁸ Reg. § 1.704-3(e)(2).

⁹ Reg. § 1.704-3(e)(1).

¹⁰ Reg. § 1.743-1(j).

¹¹ Reg. § 1.743-1(j)(1).

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.¹² 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, 2004.¹³ 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:

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

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	<u>-0-</u>	<u>4,999.50</u>	<u>4,999.50</u>	<u>50</u>
Total	<u>9,999.00</u>	<u>-0-</u>	<u>9,999.00</u>	<u>100</u>

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 25-75 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:

¹² Reg. § 1.704-3(a)(7).

¹³ IRC § 704(c)(1)(C), added by the American Jobs Creation Act § 833; see discussion at Section II.B.3. *infra*.

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

In this case, Son's basis in his interest is the same as Dad and Mom's.¹⁴ 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 pre-contribution 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.¹⁵

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.

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

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.

3. Contributions of Built-in Loss Property

The American Jobs Creation Act of 2004 enacted new § 704(c)(1)(C), which allows only the contributing partner to use pre-contribution losses on property contributed after October 22, 2004.¹⁶ 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

¹⁴ IRC § 1015(a).

¹⁵ 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.B.3. *infra*.

¹⁶ IRC § 704(c)(1)(C)(i).

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.¹⁷ 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)."¹⁸ 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.¹⁹

To carry out its purpose, the new statute provides a special basis rule for the transferee partner.²⁰ 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.²¹ 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 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

¹⁷ P.L. No. 108-457, § 833(a).

¹⁸ H.R. Rep. No. 108-548, pt.1.

¹⁹ Reg. § 1.704-3(a)(7).

²⁰ IRC § 704(c)(1)(C)(ii).

²¹ Reg. § 1.704-3(a)(2).

built-in losses on transferred or liquidated interests are eliminated.²² 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.²³ In the case of a gifted interest, the transferee partner inherits the contributing partner's basis in the gifted interest.²⁴ 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.²⁵

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 2005-32.²⁶

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.²⁷ 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, 2004²⁸ or the mixing bowl rules.²⁹ 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.

C. 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

²² H.R. Rep. No. 108-548, pt. 1.

²³ IRC § 731(a).

²⁴ IRC § 1015(a).

²⁵ *Id.*

²⁶ Notice 2005-32, 2005-16 I.R.B. 895 (Apr.1, 2005).

²⁷ Regs. §§ 1.704-1(b)(2)(iv)(f), 1.704-3(a)(6).

²⁸ *See* discussion at Section II.B.3. *infra*.

²⁹ *See* discussion at Section IV.C. *infra*.

decedent under his method of accounting before he died.³⁰ 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).³¹ 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.³² 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.³³ Nor does IRD attributable to a partnership interest receive a stepped-up basis.³⁴ This holds whether or not the partnership made a § 754 election.³⁵ 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."³⁶ 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.³⁷

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 under § 736(b) and do not constitute IRD.³⁸

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.³⁹

³⁰ IRC § 691(a)(1).

³¹ IRC § 691(b).

³² IRC § 1014(c).

³³ IRC § 691(c).

³⁴ Reg. § 1.742-1.

³⁵ Reg. § 1.755-1(b)(4)(ii), Example (as amended Dec. 14, 1999 by T.D. 8847).

³⁶ IRC § 753.

³⁷ IRC § 736(b)(2).

³⁸ IRC § 736(b)(2)(B).

³⁹ Reg. § 1.736-1(a)(1)(i).

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.”⁴⁰

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.⁴¹ 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.”⁴² 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.”⁴³ 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 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)]⁴⁴

⁴⁰ Reg. § 1.1367-1(j).

⁴¹ 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.

⁴² § 7806(a) provides that cross references in the Internal Revenue Code are made only for convenience, and shall be given no legal effect.

⁴³ See H. Rept. No. 1337, 83d Cong., 2d Sess., p. 71 (1954); S. Rept. No. 1622, 83d Cong., 2d Sess., p. 99 (1954).

⁴⁴ *Quick Trust v. Comm’r*, 54 T.C. 1336, 1345, *aff’d* 444 F.2d 90 (8th Cir. 1971).

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.⁴⁵ 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."⁴⁶

Whether the courts will expand the scope of *Quick* and *Woodhall* 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.⁴⁷ 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.⁴⁸ 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.⁴⁹ 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 neither the § 691(c) regulations nor the instructions to the partnership Form 1065 require the partnership to identify or report IRD it pays to an estate or other successor of a deceased partner.

D. Promissory Notes from Irrevocable Grantor Trusts

Partnership interests are commonly owned by an intentionally defective grantor trust (IDGT). A partner may have gifted or sold his partnership interest to the IDGT. A popular estate planning technique is to sell a partnership interest to an 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.⁵⁰ But 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, if the trust converts to a nongrantor trust, either because the grantor power ceases during the grantor's lifetime or on account of his 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

⁴⁵ *Woodhall v. Comm'r*, 28 T.C.M. 1438, *aff'd* 454 F.2d 226 (9th Cir. 1972).

⁴⁶ H.R. 1337, to accompany H.R. 8300 (P.L. 591), 83rd Cong., 2d Sess., pp. 70-71 (1954).

⁴⁷ McKee, Nelson, & Whitmire ¶ 23.02[2][b] (4th ed. 2007).

⁴⁸ Reg. § 1.753-1.

⁴⁹ Reg. § 1.691(c)-2.

⁵⁰ Rev. Rul. 85-13, 1985-1 CB 184.

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.⁵¹ 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.⁵² 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.⁵³

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.⁵⁴ 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.⁵⁵ 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.⁵⁶ 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 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.⁵⁷

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. There are no cases holding that a transfer of

⁵¹ 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.

⁵² 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).

⁵³ *Id.*

⁵⁴ 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).

⁵⁵ 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).

⁵⁶ 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.)

⁵⁷ *Id.*

property to trust at death for consideration is tax free. In fact, IRC § 1022(g) suggests just the opposite by its provision that in determining whether gain is recognized on the acquisition of property from a decedent by a decedent's estate, liabilities in excess of basis will be disregarded. There would be no point in making that special provision 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 case or statute 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.⁵⁸ 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.⁵⁹ 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.⁶⁰ 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, either during the grantor's lifetime or at his death, and the cessation will have income tax consequences to the extent any consideration exceeds the grantor's basis at that time.

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 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.⁶¹ If the deemed transfer qualifies for installment reporting, the estate or successor should report the gain as payments are collected.

⁵⁸ IRC §§ 691(a)(5), 453B(f).

⁵⁹ IRC § 408A(d)(3)(E)(ii).

⁶⁰ Reg. § 1.451-5(f).

⁶¹ Reg. § 1.451-1.

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.”⁶² 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.⁶³

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.”⁶⁴ 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.”⁶⁵ 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 351.⁶⁶ 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.⁶⁷ However, to the extent the deferred gain constitutes IRD, the note is not entitled to a step up in basis.⁶⁸ 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 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.⁶⁹

⁶² Rev. Rul. 85-13, 1985-1 CB 184.

⁶³ 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.)

⁶⁴ IRC § 453(b)(1).

⁶⁵ Reg. § 1.691(a)-5(a).

⁶⁶ 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)).

⁶⁷ IRC § 1014(b)(9).

⁶⁸ IRC § 1014(c).

⁶⁹ IRC § 453B(b); IRC § 1014(c).

But in no event is the property owned by the trust entitled to an adjusted basis under Section 1014 because it was not included in the decedent's taxable estate.⁷⁰ 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.⁷¹ 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.⁷² 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.⁷³

EXAMPLE

Joe Brown sold a partnership interest on the installment basis to the Brown Family IDGT for \$60,000 in 2005. The trust is a grantor trust and therefore the sale is ignored for federal income tax purposes. Joe died in 2009 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).⁷⁴ If the transfer qualifies for installment sale reporting, Joe's estate or successor reports the \$10,000 as IRD. If the transaction does not qualify for installment sale treatment, 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. But the Service is unlikely to hold that the unpaid note balance has no income tax consequences to the grantor or his estate. Nonetheless, there is comfort in the fact that any gain would likely be eligible for installment sale reporting and should also increase the trust's basis in the property.

E. Valuation Discounts When There's No Estate Tax

Family partnerships are often discounted anywhere from 25 to 60 percent in the estate inventory due to restrictions on the partnership interests that make them worth less than the underlying assets. Discounts have been popular because they allowed the estate to transfer more value to the bypass trust on the first death, which reduces the estate tax on the second death. But with fewer estates exceeding the exemption amount, the advent of portability, the IRS's attack on discounts, the Administration's Revenue Proposal⁷⁵ to statutorily restrict them, and the IRS's plan to restrict them through regulations,⁷⁶ the question arises whether it is still prudent to claim large discounts, especially in smaller estates.

⁷⁰ CCA200937028 (Sept. 11, 2009).

⁷¹ Reg. § 1.1015-4(a).

⁷² Ltr. Rul. 7752001; Reg. § 1.1015-4.

⁷³ *Id.*

⁷⁴ Reg. § 1.1001-1(e).

⁷⁵ General Explanation of the Administration's Fiscal Year 2013 Revenue Proposals, U.S. Dept. of the Treasury (Feb. 2012), p. 80.

⁷⁶ Dept. of the Treasury 2012-2013 Priority Guidance Plan (Feb. 5, 2013), available at http://www.irs.gov/pub/irs-utl/2012-2013_pgp_2nd_quarter_update.pdf.

The downside of discounts is that the partnership basis is reduced (whether outside or inside), which may ultimately cause more income tax on sale of the partnership assets or dissolution of the partnership. If a discount is not necessary to reduce the estate tax, it seems pointless to claim it if it increases the income tax. But that analysis assumes that discounts are optional, when in fact, they are real. In most cases, the restricted partnership units are not worth as much as the underlying assets. Moreover, the donor has probably been claiming fairly aggressive discounts in his or her multi-year gifting program. Therefore, it would be hard to justify a sudden change.

There seems to be little support for ignoring the discount altogether in a nontaxable estate. As a result, many practitioners are still claiming discounts on family partnerships when filing Form 706, even if they are filing solely to make the portability election under IRC § 2010(c). But they are generally not being overly aggressive on the size of the discount, claiming about a 15-20 percent discount. If the idea of discounts increasing the heirs' income tax is not palatable, consideration should be given to dissolving the partnership before death. On the other hand, discounts can still be valuable in maximizing the amount transferred to trust if the benefits of a trust outweigh the potential additional income taxes.

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.⁷⁷ In addition, the estate or successor partner receives a long-term holding period in his partnership interest.⁷⁸ 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.⁷⁹

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

⁷⁷ IRC § 1014(a)(1); Reg. § 1.742-1; *see also* discussion at Section II.C. *infra*.

⁷⁸ IRC § 1223(9).

⁷⁹ Reg. § 1.743-1(j)(1).

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.⁸⁰ 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.⁸¹ 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.⁸² In short, it affects every partner from that point forward.

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.⁸³ A distribution of a partnership interest is also a sale or exchange for purposes of § 754.⁸⁴ 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.⁸⁵ 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

⁸⁰ 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).

⁸¹ See discussion at Section III.E. *infra*.

⁸² See discussion at Section III.H. *infra*.

⁸³ IRC §§ 734(a), 743(a).

⁸⁴ IRC § 761(e).

⁸⁵ S. Rep. 313, 99th Cong., 2nd Sess., 1986-3 C.B. Vol. 3 924.

up the inside basis of the partnership assets to the decedent partner's outside basis.⁸⁶ 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.⁸⁷ 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.⁸⁸ 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.

Step One - Determine the difference between the partner's basis of his partnership interest and his share of the adjusted basis of partnership property.⁸⁹ 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.⁹⁰

Step Two – Separate the adjustment into two classes - ordinary income and capital gain property.⁹¹ 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.⁹²

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.⁹³

⁸⁶ PLR 200442028.

⁸⁷ IRC § 1014(a).

⁸⁸ Regs. §§ 1.743-1, 1.755-1.

⁸⁹ Reg. § 1.743-1(b)-(d).

⁹⁰ Reg. § 1.742-1.

⁹¹ Reg. § 1.755-1(a).

⁹² Reg. § 1.755-1(b)(2).

⁹³ Reg. § 1.755-1(b)(3).

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
	<u>743 Adj</u>	<u>FMV</u>	<u>Adj.</u>
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	<u>100</u>	<u>3,500</u>	<u>+ 3,400</u>
Total	<u>\$11,200</u>	<u>17,500</u>	<u>6,300</u>

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.⁹⁴ In the example, the discount is allocated to the partnership’s capital gain assets based on each property’s relative fair market value as a percentage of all the capital gain assets.⁹⁵

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:⁹⁶

	Basis before		§ 743	Discount Adjusted	
	<u>743 Adj</u>	<u>FMV</u>	<u>Adj.</u>	<u>Allocated</u>	<u>Basis</u>
Stock A	6,000	2,000	-4,000	-400 ⁹⁷	\$ 1,600
Stock B	1,800	9,200	+7,400	-1,840	7,360

⁹⁴ Reg. § 1.755-1(b)(3)(iii), Ex. 2.

⁹⁵ Reg. § 1.755-1(b)(3)(iii), Ex. 2.

⁹⁶ *Id.*

⁹⁷ \$2000/\$17,500 X \$3,500 = \$400.

Stock C	3,300	2,800 - 500	-560	2,240
Stock D	<u>100</u>	<u>3,500 + 3,400</u>	<u>-700</u>	<u>2,800</u>
Total	<u>\$11,200</u>	<u>17,500</u> <u>6,300</u>	<u>-\$ 3,500</u>	<u>\$14,000</u>

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.⁹⁸ 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.⁹⁹ The same result applies if the nonpartner spouse predeceases the partner spouse.¹⁰⁰ While seemingly incorrect, the ruling is favorable to 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 \$250,000.¹⁰¹

EXAMPLE

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

⁹⁸ Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin are community property states.

⁹⁹ Rev. Rul. 79-124, 1979-1 C.B. 224.

¹⁰⁰ *Id.*

¹⁰¹ See discussion at Section III.F. *infra*.

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

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

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.¹⁰² The partnership should base its decision whether to make a § 754 election on how soon 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 IRS adjustment to the partnership 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 later reduces the discount such 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 examination.¹⁰³ First, it is impossible to predict in the year of death 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.¹⁰⁴

Unless the § 754 election will produce significant short term 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 fully utilize its outside basis in calculating its gain or loss with no need for the inside step-up afforded by the election. Or if the partnership does not

¹⁰² See Exhibit B, Section 754 Decision Tree *infra*.

¹⁰³ *Id.*

¹⁰⁴ *Jorgensen v. Comm'r*, T.C. Memo 2009-66 (Mar. 26, 2009), *aff'd* 107 AFTR 2d 2011-2069 (9th Cir 2011).

plan to sell any of its major assets anytime soon, a step-up on the inside basis from the § 754 election does not produce any immediate tax savings. In both cases, if the partnership had made the election, it might have wasted it for little or no benefit, while causing significant impact on the remaining partners for the duration of the partnership. So in cases like these where the estate's interest is very small or assets will not be sold or depreciated, the partnership should probably not make the election. Whether or not to make the election is one of the hardest decisions a partnership can make.¹⁰⁵

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.¹⁰⁶ 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.¹⁰⁷

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.

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 loss property and escape the rule as long as it has sufficient built-in gains to offset the built-in losses to below \$250,000. On its face, 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 parent's partnership interest in a subsidiary partnership be 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.¹⁰⁸ Congress also anticipated that taxpayers might be tempted to transfer appreciated property to a partnership just before a death or transfer to reduce the built-in loss and 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.¹⁰⁹

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

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

¹⁰⁶ IRC § 743(d).

¹⁰⁷ 2009 Form 1065, Schedule B, line 12c.

¹⁰⁸ IRC § 743(d)(2).

¹⁰⁹ *Id.*

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?¹¹⁰

The estate's alternate valuation election does not affect the determination of whether a partnership has a substantial built-in loss under § 743(d). Section 743(d) measures the difference between the inside basis of the partnership assets and their market value on the date of death or transfer. Section 743(d) 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, then the *amount* of its mandatory basis adjustment under § 743(b) depends upon whether the estate elects AVD or not. 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 would be impractical to make the partnership's determination of whether it has a substantial built-in loss depend upon whether the executor makes an AVD election or not.

2. The Mechanics

Once the partnership determines that it has a substantial built-in loss on the date of a transfer by sale or exchange or on the 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 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 transfer of any size, or the death of even a 1 percent partner, requires this adjustment. There is no de minimis rule. Like a § 754 election, this adjustment only affects the transferee partner. But unlike the new mandatory rules for distributions under § 734(b), basis adjustments under § 743(b) can be positive or negative.

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 basis of its property exceeds the market value by more than \$250,000.

	(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.

¹¹⁰ See discussion at Section II.B.3. *infra*.

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/decendent partner's basis in his partnership interest determines the amount of the mandatory basis adjustment made on the partnership books.¹¹¹

EXAMPLE

Dad died with a 25 percent interest in a family partnership that has assets worth \$4,000,000 and a basis of \$4,300,000. The estate's interest is valued at \$700,000 using a 30 percent discount. The partnership has a substantial built-in loss of \$300,000 [$\$4,300,000 - \$4,000,000$].¹¹² Therefore, it is subject to the mandatory basis adjustments. It must reduce the estate's share of the basis of the partnership assets of \$1,075,000 [$25\% \times \$4,300,000$] by the excess over his estate's basis in the partnership interest, \$700,000. The mandatory downward adjustment for the estate is therefore \$375,000 [$\$1,075,000 - \$700,000$].

	(a) FMV of Pship Assets	(b) Cost 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 always 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 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.¹¹³ These adjustments apply only to the transferee partner and his successors.¹¹⁴

¹¹¹ IRC § 743(b)(2).

¹¹² Adapted from Notice 2005-32, 2005-16 I.R.B. 895 (Apr. 1, 2005).

¹¹³ IRC § 6511; *see also* Exhibit B, Section 754 Decision Tree *infra*.

¹¹⁴ Reg. §§ 1.743-1(f), (j)(1).

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).¹¹⁵ 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 rules must notify the partnership in writing of its acquisition within one year of the partner's death.¹¹⁶ 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.¹¹⁷

G. Recordkeeping Responsibility

The regulations require a partnership to attach a statement to its return when it acquires knowledge of a transfer subject to the optional basis adjustment rules.¹¹⁸ The statement must contain the partner's name, taxpayer ID number, and the computation of the partner's adjustment under § 743(b). Transferees (i.e. purchasers or successors in interest) must also notify the partnership of the basis in their acquired interest.¹¹⁹ Transferors have no obligation to report anything to the partnership. When there has been a transfer by death, the successor partner must notify the partnership within one year of death.¹²⁰ 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.¹²¹

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;¹²²
- (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;¹²³
- (c) A partner receives property that has an adjusted basis in excess of the partner's basis in his partnership interest;¹²⁴ and

¹¹⁵ See discussion at Section II.B.2.

¹¹⁶ Notice 2005-32, 2005-16 I.R.B. 895 (Apr. 1, 2005); Reg. § 1.743-1(k)(2)(ii).

¹¹⁷ Notice 2005-32, 2005-16 I.R.B. 895 (Apr. 1, 2005); Reg. § 1.743-1(k)(l).

¹¹⁸ Reg. § 1.743-1(k)(1).

¹¹⁹ Reg. § 1.743-1(k)(2).

¹²⁰ Reg. § 1.743-1(k)(2)(ii).

¹²¹ Reg. § 1.743-1(k)(3).

¹²² IRC §§ 731(a)(1), 734(b)(1)(A).

¹²³ IRC §§ 731(a)(2), 734(b)(2)(A).

¹²⁴ IRC §§ 732(a)(2), 734(b)(1)(B).

- (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.¹²⁵

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.¹²⁶ 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 \$250,000.¹²⁷

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.¹²⁸ 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 \$100.¹²⁹

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

¹²⁵ IRC §§ 732(b), 734(b)(2)(B).

¹²⁶ P.L. 108-457, § 833.

¹²⁷ *Id.*

¹²⁸ IRC § 732(b).

¹²⁹ *Id.*

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, 2004.¹³⁰

While these rules may sound like hocus-pocus, they are only temporary adjustments. When all partnership interests are liquidated and all 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 here is to anticipate the effect of a § 754 election on all future distributions of the type described in (a)-(d) above. The partnership should 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 partnership attaches a written statement, signed by any one of the partners, to its timely filed return (including extensions thereof) for the year in which the partner died or the transfer occurred.¹³¹ The partnership should also check the box on new line 12a of Form 1065, Schedule B, indicating that it is making the election. It is not enough to reflect the adjustments to basis as if the election were in place. The election must actually be made.¹³²

The IRS gives independent effect to each partnership's § 754 election (or lack thereof). Thus, a parent's § 754 election does not grant the lower-tier partnership the right to adjust the basis in its assets under § 754, absent a separate election by the lower tier partnership.¹³³ However, where a lower tier partnership inadvertently fails to make a § 754 election, the IRS has been surprisingly generous in cases where the upper tier partnership has made a timely election.¹³⁴ If both an upper and its lower-tier partnership make a § 754 election, the upper-tier's election causes a basis adjustment of property for both tiers.¹³⁵ The corollary to this is that if only the lower-tier partnership makes a § 754 election, no basis adjustment is available at either the upper-tier or the lower-tier level.¹³⁶ 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 final extended due date for partnership returns is September 15.¹³⁷ The partnership should attach the election with: "**FILED PURSUANT TO REG. 301.9100-2**" printed at the top. No user fees apply.¹³⁸ Thus the

¹³⁰ P.L. 108-457, § 833.

¹³¹ Reg. § 1.754-1(b).

¹³² Ltr. Ruls. 200901015, 200903068, 200901016.

¹³³ Rev. Rul. 87-115, 1987-2 C.B. 163.

¹³⁴ Ltr. Ruls. 9338004, 9338005, 9338006, 9327068.

¹³⁵ *Id.*

¹³⁶ 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.

¹³⁷ Temp. Reg. § 1.6081-12T (June 30, 2008).

¹³⁸ Reg. § 301.9100-2(d).

partnership can make an election effective for 2012 as late as September 15, 2014, which is one year from the final extended due date of September 15, 2013.

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.¹³⁹ 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 very generous in granting relief for late § 754 elections where the failure was inadvertent. Examples of acting in good faith include complications of administering the estate, extended litigation,¹⁴⁰ reliance on accountants who made an error or failed to properly inform them,¹⁴¹ preparation of the election statement, but failure to attach it to the return,¹⁴² and simple inadvertent failure, where the taxpayer acted in good faith.¹⁴³ While the IRS forgives many late filed elections, the process requires a \$10,000 user fee (\$2,000-\$4,000 for small taxpayers) and takes months to complete.¹⁴⁴

If several years are closed under the statute of limitations, the IRS has denied relief.¹⁴⁵ 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."¹⁴⁶

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.¹⁴⁷ A request for revocation must be filed within 30 days of the partnership year end for which the election is intended to be effective, usually the partnership year within which the partner died.¹⁴⁸ The IRS will only 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 such that an increased administrative burden would befall the partnership from the election. No application for revocation will be approved if its primary purpose is to avoid stepping down the

¹³⁹ Rev. Proc. 2013-1, 2013-1 I.R.B., Appendix A.

¹⁴⁰ Ltr. Ruls. 200531016, 200530015.

¹⁴¹ Ltr. Ruls. 201102025-26, 201012031, 201011004, 201012032, 200906026, 200835007, 200827031, 200815008, 200808022, 200738009, 200530018, 200507007.

¹⁴² Ltr. Rul. 200802001.

¹⁴³ Ltr. Rul. 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.

¹⁴⁴ Rev. Proc. 2012-1, 2012-1 I.R.B. 1 (for ruling requests received by IRS after Feb. 4, 2012)

¹⁴⁵ Ltr. Rul. 9452025.

¹⁴⁶ 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.).

¹⁴⁷ Reg. § 1.754-1(c).

¹⁴⁸ Reg. § 1.754-1(c)(1).

basis of partnership assets.

If the partnership is beyond the 30 day revocation window under Reg. § 1.754-1(c), it can seek nonautomatic relief for a late filed revocation under Reg. § 301.9100-1, which defines the standards for relief under Reg. § 301.9100-2.¹⁴⁹ The partnership will need to send a \$10,000 user fee along with a detailed explanation of why a revocation should be granted under Reg. § 301.9100-1, and hope for the best.¹⁵⁰

On the other hand, if the partnership discovers that a § 754 election was made in error, it may be possible to rescind the initial 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.¹⁵¹ 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. But 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.”¹⁵²

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.¹⁵³ 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.¹⁵⁴ 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.¹⁵⁵ 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.¹⁵⁶ 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 §

¹⁴⁹ Ltr. Ruls. 9234022, 9228018.

¹⁵⁰ Rev. Proc. 2013-1, 2013-1 I.R.B. 1, Appendix A, category 3(c) (for requests received by IRS after Feb. 4, 2012).

¹⁵¹ Reg. § 1.754-1(c)(2).

¹⁵² 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.)

¹⁵³ Reg. § 1.708-1(b)(2).

¹⁵⁴ Reg. § 1.708-1(b)(5).

¹⁵⁵ Reg. § 1.708-1(b)(1)(iii)(b).

¹⁵⁶ IRC § 761(e).

708(b).”¹⁵⁷ To date the IRS has excluded the following transactions from sale or exchange treatment under § 708:

- A transfer by gift, bequest, or inheritance.¹⁵⁸
- A liquidation of a partnership interest.¹⁵⁹
- Contributions of property by new or existing partners causing a shift in partnership interests of more than 50 percent.¹⁶⁰

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.¹⁶¹ 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 § 661.¹⁶² 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 § 708.¹⁶³ 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.¹⁶⁴

A partnership that does not constructively terminate might voluntarily dissolve itself if it desired to impose the partnership’s outside basis on the partnership assets.¹⁶⁵ Alternatively, the partnership could divide itself as discussed below.

b. Dividing the Partnership

A partnership also terminates, along with any elections, when it divides into two or more partnerships, and none of the resulting partnerships are owned by partners who had an interest in more than 50 percent of the capital and profits of the prior partnership.¹⁶⁶ In this case, any 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.¹⁶⁷ Any resulting partnership that consists of partners owning more than 50 percent of the prior partnership’s capital and profits is

¹⁵⁷ S. Rep. No. 313, 99th Cong., 2d Sess. 924 (1986).

¹⁵⁸ Reg. § 1.708-1(b)(1)(ii).

¹⁵⁹ Reg. § 1.708-1(b)(2).

¹⁶⁰ *Id.*

¹⁶¹ Reg. § 1.708-1(b)(1)(ii).

¹⁶² Reg. § 1.661(a)-2(f)(1).

¹⁶³ Reg. § 1.761-1(e).

¹⁶⁴ S. Rep. No. 313, 99th Cong., 2d Sess. 924 (1986).

¹⁶⁵ IRC § 732(d).

¹⁶⁶ IRC § 708(b)(2)(B).

¹⁶⁷ Reg. § 1.708-1(d).

considered a continuation of the prior partnership, with its elections intact.¹⁶⁸

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 highly appreciated and depreciated assets, it should consider dividing into two partnerships owned by the same partners. 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.¹⁶⁹ One must be careful that the cost basis of the depreciated assets does not exceed their fair market value by more than \$250,000, or else the mandatory basis adjustment rules require the cost basis to be stepped down regardless.¹⁷⁰ In addition, it is important to complete the division and have the new partnership make the § 754 election by the time it files its return that includes the year of the partner's death. 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 and the other partnership must obtain a new ID number.¹⁷¹

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

¹⁶⁸ *Id.*

¹⁶⁹ Reg. § 1.708-1(d)(2)(ii).

¹⁷⁰ IRC § 743(d).

¹⁷¹ Reg. § 1.708-1(d)(2)(i); Reg. § 1.708-1(d)(4)(i).

purposes, while benefiting from discounted values for estate tax purposes.¹⁷² It refers to *Janis v. Commissioner* in which the trustee used the undiscounted basis for determining cost of goods sold in an art inventory, even though a heavily discounted basis was used when valuing the art inventory for estate tax purposes.¹⁷³ 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.¹⁷⁴

K. Consequences of Overstating the Basis

A critical question is 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 the same as an understatement of gross income for purposes of the 6 year statute of limitation.¹⁷⁵ However, the U.S. Supreme Court invalidated those regulations in April 2012 in *United States v. Home Concrete & Supply* and held that 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.¹⁷⁶

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.¹⁷⁷ Even though it may be difficult to quantify the exact discount

¹⁷² APPEALS SETTLEMENT GUIDELINES, FAMILY LIMITED PARTNERSHIPS AND FAMILY LIMITED LIABILITY CORPORATIONS, Uniform Issue List (UIL) 2031.01-00 (Jan. 29, 2007).

¹⁷³ *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).

¹⁷⁴ General Explanation of the Administration's Fiscal Year 2013 Revenue Proposals, U.S. Dept. of the Treasury (Feb. 2012), p. 77.

¹⁷⁵ Reg. § 301.6501(e)-1(a)(1)(iii).

¹⁷⁶ *United States v. Home Concrete & Supply*, 132 S.Ct. 1836 (2012).

¹⁷⁷ See discussion at Sections II.B.3. and IV.B. *infra*.

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.

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 § 754.¹⁷⁸ 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,¹⁷⁹ or 12 months later under the automatic relief provision of Reg. § 301.9901-2.¹⁸⁰ 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).¹⁸¹

N. Partnerships Included under § 2036

Partnership interests included in a decedent’s estate under § 2036 should also be eligible to make a § 754 election and be subject to the mandatory basis adjustment rules under § 743(b) if there is a substantial built-in loss. In Ltr. Rul. 200626003 the IRS denied an LLC permission to make a late § 754 after a partner died and the IRS included the LLC assets in the decedent’s gross estate under § 2036(a)(1).¹⁸² Section 2036(a)(1) requires the decedent’s estate to include “the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer [] by trust or otherwise, under which he has retained for his life...the possession or enjoyment of, or the right to the income, from the property.” The amount included is “the value of the entire property...at the time of the decedent’s death.”¹⁸³ Letter Ruling 200626003 involved a decedent who had transferred an interest in real estate before he died to his three children, while retaining the right to all of the income from it. Later, he and his three

¹⁷⁸ 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).

¹⁷⁹ Reg. § 1.754-1(b).

¹⁸⁰ Reg. § 301.9901-2(a)(2)(vi).

¹⁸¹ See discussion at Section III.F. of this outline.

¹⁸² Ltr. Rul. 200626003 (July 28, 2006).

¹⁸³ Reg. 20.2036-1(a)(1)(ii).

children transferred their interests in the property to an LLC in exchange for a 25 percent interest each. The father continued to retain all of the income from the property.

After he died, the estate distributed the father's LLC interest to the children and the LLC timely filed its partnership return, but did not make a § 754 election. 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. The IRS denied their request because they not meet the requirements for a late election under §§ 301.9100-1 and 301.9100-3, which require them to have acted reasonably and in good faith and not on the basis of hindsight.

Nonetheless, the IRS allowed a stepped up basis for the real estate 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)." ¹⁸⁴ 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. ¹⁸⁵ This is particularly significant because the assets in the Jorgensen's estate included partnership interests owned by other family members who had been gifted their interests many years prior to Jorgensen's death. Nonetheless, the Tax Court relied on the doctrine of equitable recoupment in § 6214(b) to allow the other family members to step up the inside basis of partnership assets and reduce gains previously reported even though the statute of limitations had long since passed.

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. ¹⁸⁶ 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. ¹⁸⁷ 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

¹⁸⁴ IRC § 1014(b)(9).

¹⁸⁵ *Jorgensen v. Comm'r*, T.C. Memo 2009-66 (Mar. 26, 2009), *aff'd* 107 AFTR 2d 2011-2069 (9th Cir 2011).

¹⁸⁶ IRC §§ 731(a), (b).

¹⁸⁷ 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.)

partnership.¹⁸⁸ 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 property 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.¹⁸⁹ However, certain distributions that are treated as “disguised sales” under § 707(a) are deemed to occur on the actual day of the transaction.¹⁹⁰ 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.¹⁹¹

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.¹⁹² If the basis of the distributed property exceeds the partner’s basis in his partnership interest, the excess “disappears,” unless the partnership has a § 754 election in effect.¹⁹³ 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.¹⁹⁴ 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.¹⁹⁵ 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 \$250,000.¹⁹⁶

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.¹⁹⁷

¹⁸⁸ Rev. Rul. 2007-40, 2007-25 I.R.B. 1426 (June 1, 2007).

¹⁸⁹ Reg. § 1.731-1(a)(1)(ii).

¹⁹⁰ Reg. § 1.707-3(a)(2).

¹⁹¹ Reg. §§ 1.704-4(b), 1.737-1(d).

¹⁹² Reg. § 1.732-1(a).

¹⁹³ See discussion at Section III.H. for adjustments to the basis of the partnership’s remaining property where a § 754 election is in effect.

¹⁹⁴ Reg. § 1.732-1(b).

¹⁹⁵ See discussion at Section III.H. for adjustments to the basis of the partnership’s remaining property where a § 754 election is in effect.

¹⁹⁶ See discussion at Section IV.B.

¹⁹⁷ Reg. § 1.732-1(c).

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.¹⁹⁸ 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.¹⁹⁹ 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.²⁰⁰ 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 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 2012-13 Priority Guidance Plan.²⁰¹

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 \$250,000.²⁰² 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 \$250,000.²⁰³ 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.

¹⁹⁸ IRC § 735(b).

¹⁹⁹ 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.)

²⁰⁰ IRC §§ 704(c)(1)(C), 734(a) and 743(a).

²⁰¹ Dept. of the Treasury 2012-2013 Priority Guidance Plan (Feb. 5, 2013), *available at* http://www.irs.gov/pub/irs-utl/2012-2013_pgp_2nd_quarter_update.pdf.

²⁰² IRC §§ 734(d), 734(b)(2).

²⁰³ *Id.*

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.²⁰⁴

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 \$2,000,000.²⁰⁵

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 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 §

²⁰⁴ IRC §§ 734(b)(2)(A), (d)(1); see also H.R. Rep. No. 108-548, pt.1 (June 16, 2004).

²⁰⁵ IRC §§ 734(b)(2)(B),(d)(1); Example adapted from Notice 2005-32, 2005-16 I.R.B. 895 (Apr. 1, 2005).

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.²⁰⁶ 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.

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. IRS Chief Counsel Abraham “Hap” Shashy nicknamed these “mixing bowl” transactions in a speech before the ABA Tax Section Partnerships Committee in May 1990.²⁰⁷ The term is also now enshrined in the IRS’s audit training manual and described 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.”²⁰⁸ 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

²⁰⁶ See Exhibit B, Section 754 Decision Tree *infra*.

²⁰⁷ 90 TNT 97-46.

²⁰⁸ Glossary, IRS Market Segment Specialization Program Guideline, 2002 WL 32076538.

must recognize gain or loss.²⁰⁹ 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.²¹⁰ The partnership adjusts the basis of the property by the contributing partner's recognized gain or loss.²¹¹ And the contributing partner adjusts his basis in the partnership interest accordingly.²¹²

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 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 distribute partner.²¹³ The *character* of the gain or loss is also determined as if the property had been sold to the distribute partner.²¹⁴ 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.²¹⁵ However, there are no cases, regulations, or rulings on this point.

b. Character of Gain or Loss

²⁰⁹ IRC § 704(c)(1)(B).

²¹⁰ IRC § 704(c)(1)(B)(i); *see also* Section IV.C.1. *infra*.

²¹¹ Reg. § 1.704-4(e)(2).

²¹² IRC § 704(c)(1)(B)(iii); Reg. § 1.704-4(e)(1).

²¹³ Reg. § 1.704-4(a)(1).

²¹⁴ IRC § 704(c)(1)(B)(ii)

²¹⁵ Preamble to Reg. § 1.704-4, T.D. 8642 (Dec. 22, 1995).

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.²¹⁶ 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.²¹⁷

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, 2004.²¹⁸ 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, 2004.²¹⁹

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.²²⁰ 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.

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.²²¹ Distributions of a partner’s own previously contributed

²¹⁶ IRC § 704(c)(1)(B)(ii).

²¹⁷ Reg. § 1.704-4(b)(2)(iii).

²¹⁸ Reg. § 1.704-4(d)(2); *but see* IRC § 704(c)(1)(C) added by P.L. 108-457, § 833 (October 22, 2004).

²¹⁹ IRC § 704(c)(1)(C) added by P.L. 108-457, § 833 (October 22, 2004); *see* discussion at Section IV.C.3. *infra*.

²²⁰ H. Rep’t. No. 102-1018, 102nd Cong., 2d Sess., 1992 U.S.C.C.&A.N. 2472, 2519-2520 (10/5/92).

²²¹ Reg. § 1.737-1(c)(1).

property are not taken into account under § 737.²²² 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.²²³ The basis of the distributee's § 704(c) property remaining in the partnership is also increased.²²⁴ 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.²²⁵ 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 (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.²²⁶ 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 <u>Y to Ptr. A</u>	Less prev. contributed <u>Property X</u>	Rest subject <u>to §737</u>
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

²²² IRC § 737(d)(1).

²²³ IRC § 737(c)(1).

²²⁴ IRC § 731(c)(2).

²²⁵ IRC § 737(d)(1).

²²⁶ Reg. § 1.737-3(b)(2).

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.²²⁷ 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.²²⁸ 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.²²⁹ 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 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.²³⁰

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.²³¹ This author also assumes that the two statutes work in tandem as they were designed to, and that

²²⁷ Reg. § 1.737-1(d).

²²⁸ Reg. § 1.702-1(a).

²²⁹ "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).

²³⁰ T.D. 8642, 60 Fed. Reg. 66,727 (Dec. 26, 1995).

²³¹ 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.

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).²³² Any gain recognized on the distribution of marketable securities increases the basis of the distributed securities.²³³

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.²³⁴ 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).²³⁵ In addition, privately issued notes are not marketable securities.²³⁶ 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.

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.²³⁷ To determine his share of unrealized gain in the distributed securities, his share of gain is measured both before and after the distribution. For this purpose, all marketable securities held by the partnership are aggregated.²³⁸ In other words, regardless of which marketable securities the partnership distributes, the distributee partner's share of the gain before and after the distribution is measured in the aggregate. That difference reduces the amount of the distribution treated like money. Thus, the partner's share of total built-in gain on

²³² See discussion at IV.C.2 of this outline.

²³³ Reg. § 1.731-2(f)(1).

²³⁴ IRC § 731(c)(2).

²³⁵ Ltr. Rul. 200651023 (Sept. 21, 2006).

²³⁶ *Countryside Limited Partnership v. Comm'r*, T.C. Memo 2008-3 (Jan. 2, 2008).

²³⁷ IRC § 731(c)(3)(B); Reg. § 1.732-2(b)(2).

²³⁸ IRC § 731(c)(3)(B); Reg. § 1.731-2(b)(1).

marketable securities acts as a ceiling on the amount that can reduce the portion treated like money on a distribution. The regulations provide a good example.²³⁹

EXAMPLE

Able and Baker 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 Able in a current distribution. His share of the gain before the distribution is \$20 and his share after the distribution is \$5. Thus, Able 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.

<u>WITH X:</u>	<u>Value</u>	<u>Basis</u>	<u>Gain or Loss</u>	<u>Able's Share</u>
X	100	70	30	
Y	100	80	20	
Z	<u>100</u>	<u>110</u>	<u>-10</u>	
	300	260	40	\$20

<u>WITHOUT X:</u>	<u>Value</u>	<u>Basis</u>	<u>Gain or Loss</u>	<u>Able's Share</u>
Y	100	80	20	
Z	<u>100</u>	<u>110</u>	<u>-10</u>	
	200	190	10	<u>5</u>
Difference				\$15

Notice that all we have done up to this point is figure the amount of the distribution that is treated like cash to Able. To the extent that the \$85 distribution does not exceed the basis in his partnership interest, Able will not report any gain in connection with the distribution. Able's basis in his partnership interest is not reduced by the cash component and he simply takes a carryover basis in the distributed securities under the normal rules of § 732.

Also note the opportunity to select specific securities in such a combination that the portion treated like cash will either be minimized or maximized, depending on the goal. If the partner's partnership basis is large enough to absorb any amount of a cash distribution without recognizing gain and if a property distribution would have negative consequences for him under § 737, then it may be advantageous to maximize the portion of the distribution treated like cash. In the above example, if the partnership had distributed Y instead of X, the amount treated like cash would have been \$90 instead of \$85.²⁴⁰ 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 successor partner's

²³⁹ Reg. § 1.731-2(j).

²⁴⁰ \$100 value of Y less Able's \$10 share of gain in Y.

discounted outside basis in the partnership, the partner recognizes gain on the distribution.²⁴¹ Although § 731(c)(3)(B) reduces the amount treated like money by the partner's share of gain that he would recognize if the partnership sold the securities immediately before the distribution, this reduction may not be sufficient to completely avoid gain recognition.

EXAMPLE

Mabel died owning an 80 percent interest in XYZ partnership, which owned \$2,000,000 of bonds with a basis of \$1,500,000. An appraiser applied a 35 percent discount to the partnership to arrive at a \$1,300,000 value. Thus, the estate's outside basis of the partnership interest is \$1,040,000. The partnership redeems Mabel's estate by distributing \$1,600,000 of bonds. Ordinarily this distribution would be treated like cash, resulting in a \$560,000 gain to Mabel's estate. But the amount treated like cash is reduced by the estate's share of gain if the partnership sold the bonds immediately before the distribution, or \$400,000. Thus the amount treated like cash is only \$1,200,000. This exceeds the estate's outside basis of \$1,040,000, causing the estate to recognize gain of \$160,000 on receipt of the bonds.²⁴²

	<u>Total</u>	<u>Mabel's 80%</u>
FMV of Securities	\$ 2,000,000	\$ 1,600,000
Tax Basis	<u>1,500,000</u>	<u>1,200,000</u>
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).²⁴³ Note that making a § 754 election in this case runs counter to intuition because it reduces the estate's 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 §

²⁴¹ IRC § 731(a), (c).

²⁴² IRC § 731(c)(4)(A); The estate is also entitled to increase the basis of the distributed securities by \$160,000.

²⁴³ Reg. § 1.731-2(b)(3).

754 election, but without the consequences of a § 754 election on the other partners.²⁴⁴ 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.²⁴⁵ 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.²⁴⁶

- 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.”²⁴⁷ 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 money.²⁴⁸ 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

²⁴⁴ See discussion at III.H. for impact of a § 754 election on the other partners.

²⁴⁵ Reg. § 1.743-1(g)(2)(ii).

²⁴⁶ IRC § 731(c)(3)(A).

²⁴⁷ Reg. § 1.731-2(d).

²⁴⁸ Reg. § 1.731-2(c)(3).

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.²⁴⁹ 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 § 737.²⁵⁰ 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 election²⁵¹ or was subject to the mandatory basis adjustment rules,²⁵² 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.
- 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.

²⁴⁹ *Id.*; see also Reg. § 351-1(c)(6); IRC § 368(a)(2)(F)(ii).

²⁵⁰ Reg. § 1.731-2(g)(1); see Exhibit A, Mixing Bowl Flowchart for Partnership Property Distributions *infra*.

²⁵¹ See discussion at Section III.B. *infra*.

²⁵² See discussion at Section III.F. *infra*.

- 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.)”²⁵³ 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 which other events besides death, liquidation, or sale 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.²⁵⁴

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 disposition.²⁵⁵ 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:

²⁵³ IRC § 706(c)(2)(A).

²⁵⁴ Reg. § 1.706-1(c)(5).

²⁵⁵ Prop. Reg. § 706-1(c)(2)(i), REG-144689-04, Fed. Reg. Vol. 74, No. 70 p. 17119 (4/14/2009).

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.²⁵⁶ 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.²⁵⁷ 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.²⁵⁸

2. Closing Methods

Partnerships use two basic methods to allocate items when a partner terminates his interest during the year.²⁵⁹ The default method is the *interim closing* of the books, which separates the partnership into two or more segments during the year.²⁶⁰ 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.²⁶¹ Neither the final nor the proposed regulations are clear which partners must agree. Presumably only the *affected* partners must agree, similar to the rule for terminating an interest in a Subchapter S corporation.²⁶² 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

²⁵⁶ Reg. § 1.661(a)-2(f); Reg. § 1.663(a)-1(b)(1).

²⁵⁷ *Id.*

²⁵⁸ Prop. Reg. § 1.706-1(c)(2)(i) (4/14/09); Reg. § 1.706-1(c)(3)(iv).

²⁵⁹ 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).

²⁶⁰ Prop. Reg. § 1.706-4(c) (4/14/09); Reg. § 1.706-1(c)(2)(ii).

²⁶¹ Prop. Reg. § 1.706-4(d) (4/14/09); Reg. § 1.706-1(c)(2)(ii).

²⁶² IRC § 1377(a)(2); Reg. § 1.1377-1(a).

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.²⁶³ 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 706.²⁶⁴ 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.²⁶⁵ The estate reports the other \$125,000 of capital gain allocable to 3/12 of 50 percent of the capital gain.

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

²⁶³ 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).

²⁶⁴ Reg. § 20.2053-6(f).

²⁶⁵ Reg. § 20.2053-6(f).

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.²⁶⁶ 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.²⁶⁷ 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.²⁶⁸

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.²⁶⁹ 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.²⁷⁰

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.²⁷¹ Nor are residuary bequests.²⁷² 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.²⁷³ For pecuniary bequests by decedents who died in 2010, gain is only recognized on the post death appreciation.²⁷⁴ Pecuniary bequest means a gift of a fixed dollar amount or a formula pecuniary amount.²⁷⁵ If a 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.²⁷⁶

²⁶⁶ See discussion at III.I.3. of this outline.

²⁶⁷ Reg. § 1.708-1(b)(5); IRC § 168(i)(7).

²⁶⁸ See discussion starting at IV.A. of this outline.

²⁶⁹ Reg. § 1.708-1(b)(1)(ii).

²⁷⁰ IRC § 761(e); See discussion at III.I.3. of this outline.

²⁷¹ IRC § 663(a)(1); Reg. § 1.663(a)-1(a),(b).

²⁷² Reg. § 1.661(a)-2(f).

²⁷³ *Id.*

²⁷⁴ IRC § 1040.

²⁷⁵ Rev. Rul. 60-87, 1960-1 CB 286.

²⁷⁶ IRC § 642(h).

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.²⁷⁷ On the other hand, if the estate transfers IRD assets pursuant to a specific or residuary bequest, only the legatee recognizes income when collected.²⁷⁸ 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.²⁷⁹ Therefore, there cannot be any IRD in an investment partnership.²⁸⁰

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.²⁸¹ 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.²⁸² 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.²⁸³ The deduction, however, cannot exceed the fiduciary's DNI.²⁸⁴

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.²⁸⁵ 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.²⁸⁶

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 bequests²⁸⁷
- bequests to charitable beneficiaries which are governed by § 642(c),²⁸⁸ and
- 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)²⁸⁹

²⁷⁷ Reg. § 1.691(a)-4(b)(2); Ltr. Ruls. 9123036, 9315016, 9507008.

²⁷⁸ *Id.*

²⁷⁹ IRC §§ 691(e), 736(a), and 753; *see* comprehensive discussion at II.C. of this outline.

²⁸⁰ *See* discussion at II.C.1 of this outline.

²⁸¹ IRC §§ 651(a), 661(a).

²⁸² Reg. § 1.661(a)-2(f).

²⁸³ IRC § 643(e)(1) and (2).

²⁸⁴ IRC §§ 651(b), 661(a).

²⁸⁵ IRC §§ 652(a), 662(a).

²⁸⁶ Reg. §§ 1.652(b)-2(a) and 1.662(b)-1.

²⁸⁷ IRC § 663(a).

²⁸⁸ *Id.*

²⁸⁹ Reg. § 1.663(c)-2(b)(2).

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.²⁹⁰ 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.²⁹¹ 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.²⁹²

A separate share exists if the economic interests of the beneficiary or class of beneficiaries neither affect nor are affected by the economic interests accruing to another beneficiary or class of beneficiaries. For example, a formula pecuniary bequest and a residuary bequest are separate shares.²⁹³ 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 § 663(a)(1) is specifically excluded from separate share treatment.²⁹⁴ The regulations contain 11 examples of situations that may invoke the separate share rule.²⁹⁵

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.²⁹⁶ 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.²⁹⁷

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 estate

²⁹⁰ Reg. § 1.663(c)-4(a).

²⁹¹ Reg. §§ 1.663(c)-4(a), 1.663(c)-2(b)(2).

²⁹² Reg. § 1.662(a)-2(b).

²⁹³ Reg. § 1.663(c)-5, Example 4.

²⁹⁴ Reg. § 1.663(c)-4(a).

²⁹⁵ Reg. § 1.663(c)-5, T.D. 8849, Dec. 27, 1999.

²⁹⁶ Reg. § 1.663(c)-2(b)(2).

²⁹⁷ Reg. § 1.663(c)-5, at Example 4.

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 distributable net income 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.²⁹⁸

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.²⁹⁹

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.³⁰⁰

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.³⁰¹

²⁹⁸ Reg. § 1.663(c)-2(b)(4).

²⁹⁹ Reg. § 1.663(c)-5, Example 5.

³⁰⁰ Reg. § 1.663(c)-2(b)(3).

³⁰¹ 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.³⁰²

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.³⁰³ 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.³⁰⁴ 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.³⁰⁵ 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.³⁰⁶ 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 details of the investment agreement should be carefully documented. In delegating his

³⁰² Reg. § 1.663(c)-2(b)(2).

³⁰³ UNIF. PRUDENT INVESTOR ACT §§ 2, 3, 6 (1994).

³⁰⁴ UNIF. PRUDENT INVESTOR ACT § 2.

³⁰⁵ UNIF. PRUDENT INVESTOR ACT § 9.

³⁰⁶ UNIF. PRUDENT INVESTOR ACT § 3, cmt.

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.³⁰⁷ The agent should accept the delegation cautiously because he assumes full liability as a fiduciary under the Uniform Prudent Investor Act.³⁰⁸ 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.³⁰⁹ 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 2013.³¹⁰

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.³¹¹ 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.³¹² 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.³¹³ 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.³¹⁴ 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 "Crummey" rights. However, this could complicate the accounting if the partners actually

³⁰⁷ UNIF. PRUDENT INVESTOR ACT (1994) § 9(a).

³⁰⁸ *Id.* at §§ (b),(d).

³⁰⁹ IRC § 2503(b); Rev. Proc. 2012-41, 2012-45 I.R.B. 539 (Oct. 18, 2012).

³¹⁰ IRC §§ 2523(a), 2523(i)(2); Rev. Proc. 2012-41, 2012-45 I.R.B. 539 (Oct. 18, 2012).

³¹¹ 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").

³¹² *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).

³¹³ *Id.*

³¹⁴ 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.

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.

This is exactly what the donor did in *Wimmer v. Commissioner*.³¹⁵ There, the Tax Court allowed the annual exclusion for gifts of partnership interests because the gifts were made in trust. The Court found that the trust had the immediate use, possession or enjoyment of the income from the partnerships because its sole asset was the partnership and the general partner had a duty to distribute sufficient cash to the trusts to pay their income taxes on partnership income. And because the partnership was required to make prorata distributions to all partners, all partners had an expectation of distributions. Thus the gifts passed the income prong of the two-part test and were entitled to the annual exclusion. *Wimmer* suggests that gifts of partnership interest should be made in trust in order to be assured of the annual exclusion.

But perhaps the safest and simplest 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 generally qualify for the annual exclusion if all the income is required to be distributed or the beneficiary has a present temporary right to withdraw the gifts immediately after they are made.³¹⁶ Such rights are known as Crummey powers after the 1968 case of *Crummey v. Commissioner*.³¹⁷

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

³¹⁵ *Wimmer v. Comm'r*, TC Memo 2012-157 (June 4, 2012).

³¹⁶ Reg. § 25.2503-3(b), (c), example 3.

³¹⁷ *Crummey v. Comm'r*, 397 F2d 82 (9th Cir 1968).

to all other taxes imposed by Subtitle A (Income Taxes).³¹⁸ 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.³¹⁹ 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.³²⁰ 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.³²¹

The IRS issued proposed regulations under IRC § 1411 on December 5, 2012 fleshing out many details of its application.³²² The proposed regulations explain how section 1411 interacts with many other code sections such as the 2 and 3 percent floors under IRC §§ 67 and 68, the passive and at risk rules under IRC §§ 465 and 469, net operating losses, investment interest limitations, and others. They do not, however, attempt to update or clarify these other areas, even where it is sorely needed, such as passive losses and administrative expenses for estates and trusts. The proposed regulations apply to tax years beginning after December 31, 2013 even though the statute is effective January 1, 2013. In the meantime, taxpayers may rely on the regulations.

Adjusted Gross Income

The proposed regulations clarify that the adjusted gross income (AGI) of an estate or trust is determined under § 67(e) for purposes of the Medicare tax.³²³ Thus, an estate or trust's AGI is computed in the same manner as for an individual, except that deductions are allowed for charitable contributions, the personal exemption, distributions to beneficiaries, and costs "which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate." This last category has been interpreted by the Supreme Court and in Proposed Regulation 1.67-4.³²⁴ Unfortunately, there is still a great deal of confusion over what this means.

Undistributed Net Investment Income

"Undistributed net investment income" means net investment income minus distributions of net investment income to beneficiaries.³²⁵ Distributions reduce both AGI and net investment income. Therefore, the trustee may want to make distributions to beneficiaries if their AGI is below the \$250,000/\$125,000 threshold that applies to individuals.

Net investment income includes gross income from interest, dividends, rents, royalties, annuities, gains from the disposition of property, passive activities, and trading activities less

³¹⁸ IRC § 1411(a)(1).

³¹⁹ IRC § 1411(a)(2).

³²⁰ IRC § 1(f); IRC § 1411(b).

³²¹ IRC § 643(f).

³²² Notice of Proposed Rulemaking, Fed. Reg. Vol. 77, No. 234, p. 72611. 12/05/2012.

³²³ Reg. § 1.1411-3(a)(1)(ii)(B).

³²⁴ *Knight v. CIR*, 552 U.S. 181 (2008).

³²⁵ Prop. Reg. § 1.1411-3(d)(2).

“properly allocable” expenses.³²⁶ Several types of income are excluded from net investment income. The statute expressly excludes distributions from IRAs and qualified plans.³²⁷ It also excludes nonpassive trade or business income.³²⁸

Net investment income also excludes tax exempt income and the internal build-up of annuities because they are excluded from gross income. It also excludes guaranteed payments from partnerships, first because § 1411(c)(6) specifically excludes any item subject to self-employment tax. And second because guaranteed payments that are not subject to self-employment tax, such as those from investment partnerships, are simply not on the list of items that constitute investment income under § 1411(c)(1)(A).

Allocating Expenses

The trustee’s classification of expenses will impact the amount of the surtax in two ways. First, expenses classified as miscellaneous itemized deductions subject to the 2 percent floor are not deductible in computing AGI. Therefore, the trustee may want to consider allocating as many expenses as it can to “above the line” deductions not subject to the 2 percent floor to minimize the surtax.

Second, in determining the character of income distributed to beneficiaries, the regulations require that expenses deducted in determining DNI be allocated to various classes of income included in DNI, including tax exempt income.³²⁹ Direct expenses must be allocated to the class of income to which they relate. Indirect expenses may be allocated to any category as long as a portion is allocated to tax exempt income.³³⁰ The regulations list trustee fees, safe deposit box rental, and state income and personal property taxes as examples of indirect expenses.³³¹ Thus to the extent that expenses are allocated to income excluded from the surtax base, such as tax-exempt income, these deductions are wasted for purposes of the surtax. Therefore, the trustee may want to allocate as few expenses as reasonably possible to tax exempt and other classes of income that are not subject to the surtax.

Capital Gains

Net capital gains are part of both AGI and undistributed net investment income in computing the surtax. Capital losses can only reduce AGI up to the \$3,000 annual limit, but do not reduce net investment income. Capital gains that are part of corpus are trapped in the trust and subject to the surtax. However, not all capital gains are part of corpus as discussed below.

The IRS regulations describe the circumstances under which capital gains can be included in DNI.³³² These circumstances include a) where the trust instrument provides that capital gains are included in trust income (rare), b) the distributions are in full or partial liquidation of the trust, c) the trustee has the power to adjust and consistently designates principal

³²⁶ IRC § 1411(c)(1).

³²⁷ IRC § 1411(c)(5).

³²⁸ IRC § 1411(c)(1)(A)(ii).

³²⁹ IRC § 652(b); Reg. § 1.652(b)-3.

³³⁰ *Id.*

³³¹ Reg. § 1.652(b)-3(c).

³³² Reg. § 1.643(a)-3.

distributions as capital gains, or d) the gains are included in a unitrust distribution. In addition to these specified circumstances, capital gains flowing from a partnership K-1 are included in DNI.³³³ Therefore, the trustee may want to consider investing through a partnership so that capital gains can be distributed and escape the surtax.

IRA Distributions

IRA distributions are included in AGI, but not net investment income.³³⁴ Therefore, if a trust is receiving IRA distributions, its undistributed net investment income will likely be lower than its AGI in excess of the threshold. Therefore, because IRA distributions will likely escape the surtax, it may be good planning to name a trust as an IRA beneficiary. To the extent that the trust distributes the IRA distribution to the beneficiary, the distribution retains the same character in the hands of the beneficiary as it had in the hands of the trust.³³⁵ Thus, IRA distributions from an estate or trust should be exempt from the net investment income of the individual.

Passive Income

Passive income is included in both AGI and net investment income. Passive income is trade or business income in which the taxpayer does not materially participate.³³⁶ In the case of an estate or trust, the IRS has ruled that the trustee himself needs to meet the material participation test.³³⁷ Rental income is, however, per se passive.³³⁸ Nonetheless, it can be offset by favorable depreciation deductions. A trust with passive income might consider investing in passive loss activities to shelter its passive income.

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.³³⁹ 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.³⁴⁰

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.³⁴¹ These seven tests are:

1. The individual participates in the activity for more than 500 hours during such year.

³³³ See discussion at Section VI.G. of this outline.

³³⁴ IRC § 1411(c)(5).

³³⁵ IRC § 652(b).

³³⁶ IRC § 469(c).

³³⁷ TAM 200733023; see discussion at Section VI.C. of this outline.

³³⁸ IRC § 469(b)(2).

³³⁹ IRC § 469(h)(1).

³⁴⁰ Reg. § 1.469-8 [Reserved], T.D. 8417 (May 12, 1992).

³⁴¹ Temp. Reg. § 1.469-5T, T.D. 8175 (Feb. 19, 1988).

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;
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.³⁴² 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.³⁴³ 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 seven safe harbor tests or the three exceptions for limited partners. In addition, the question arises as to 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*.³⁴⁴ The Carter Trust was a testamentary trust that owned a 15,000 acre working cattle ranch with mineral interests. The trustee had extensive business,

³⁴² *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).

³⁴³ REG-109369-10, Prop. Reg. § 1.469-5 (Nov. 28, 2011).

³⁴⁴ *Carter v. United States*, 256 F. Supp. 2d 536 (N.D. Tex. 2003).

managerial and financial experience and maintained regular office hours pertaining to trust business. However, he delegated certain aspects of the ranch operations to a full-time ranch manager and several employees who performed all of the activities for the ranch. The trust claimed losses of \$856,518 and \$796,687 in 1994 and 1995 in connection with the ranch operations, which the IRS disallowed as passive activity losses under § 469. The IRS maintained that the “material participation” of a trust is determined by evaluating only the activities of the trustee in his capacity as such. Because he delegated so much of his responsibility, the IRS argued that he himself 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 Carter 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 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.³⁴⁵ Trades or businesses generally involve employees or agents and therefore allowing an owner to be treated as materially participating in any trade or business in which 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.³⁴⁶ The trust in the ruling was a complex trust whose trustee was also a beneficiary. The trust held a tiered partnership interest in B, which owned C, which owned D and requested a ruling on whether the trustee materially participated in the activities of D. The IRS concluded that the trustee materially participate in D’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 D’s activities.

³⁴⁵ Tax Reform Act of 1986, Sen. Rep. No. 99-313, at 735 (“the activities of [employees]... are not attributed to the taxpayer.”)

³⁴⁶ TAM 2007 33023 (Aug. 17, 2007).

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 Act treats money distributions from “entities” as income and property distributions as principal.³⁴⁷ 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.³⁴⁸ 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.³⁴⁹

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.³⁵⁰ 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.³⁵¹ 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.³⁵²

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.³⁵³ In addition, the spouse must be able to compel the trustee to make the property productive.³⁵⁴

³⁴⁷ UNIF. PRINCIPAL & INCOME ACT §§ 401(b), (c).

³⁴⁸ *Id.* at § 401(d)(1).

³⁴⁹ *Id.* at § 401(f).

³⁵⁰ *Id.* at § (d)(2).

³⁵¹ *Id.* at § (e).

³⁵² 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).

³⁵³ Rev. Rul. 2006-26, 2006-22 I.R.B. 939.

³⁵⁴ Reg. §§ 20.2056(b)-5(f)(4) and (5).

Although this Revenue Ruling deals strictly with income from IRAs 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 either 3 to 5 percent of its assets or its “traditional” income, the IRS could find that the trust does not qualify as a QTIP under § 2056(b)(7). Thus, 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 under the Uniform Prudent Investor Act.

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 than 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.³⁵⁵ The Court of Appeal agreed that the statute was capable of that interpretation and held in favor of the beneficiary. In reaction to

³⁵⁵ *Thomas v. Elder*, 21 Cal. Rptr. 3d 741 (Dec. 2, 2004)

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 a more recent California Court of Appeal, *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 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. But a footnote to the financial statements disclosed that the company actually had \$630 million of assets under a GAAP basis consolidated method of reporting.³⁵⁶ This was confirmed by the company's chief financial officer in deposition testimony. Both the court and the parties struggled to interpret the company's complex financial statements. But in the end the court found that the company's true assets were \$630 million rather than \$133 million and classified the distributions as income.

The most recent case addressing the 20-percent rule is *Manson v. Shepherd*.³⁵⁷ Here a California Appeal Court determined that a \$3 million distribution to a trust from its primary asset, Wave Crest Development Corporation, was a distribution in partial liquidation of the company and therefore principal to the trust. The court found that the corporation's board had sufficiently "indicated" that the distribution was principal by stating in its minutes that the cash arose from selling its High Street property and was distributed to the trust shareholder because it had promised to repay its debt to the company. From those minutes, the court inferred that Wave Crest made it known, or "indicated," at the time of the board meeting that the \$3 million distribution was a liquidating distribution under § 16350(d)(1)(A) of the Cal. Uniform Principal and Income Act 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 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 trust's taxes and how much is owed to the beneficiary, UPIA § 505(d) requires the trustee to take into account the fact that distributions to the beneficiary may be tax deductible to the trust.³⁵⁸ Prior to amendment in October 2008, Act sections 505(c) and (d) were unclear as to how they were intended to apply. To remove the ambiguity, NCCUSL amended § 505 to read as follows:

³⁵⁶ *Hasso v. Hasso*, 55 Cal. Rptr. 3d 667 (Mar. 6, 2007), pet. for review denied, No. S1511873 (May 16, 2007).

³⁵⁷ *Manson v. Shepherd*, 188 Cal. App. 4th 1244 (Cal. App. 6th Dist. 2010).

³⁵⁸ 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.

UPIA § 505 INCOME TAXES

(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;
- (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.

Twenty-seven states have already adopted the 2008 amendments to UPIA § 505 and six have legislation pending to do so.³⁵⁹ The seventeen states that operate under the pre-2008 UPIA § 505, potentially face two different interpretations of their state statute, which produce vastly different results. However, it is likely that any such dispute will be resolved on the basis of NCCUSL's intended meaning of the statute as clarified in the 2008 amendment.

The goal of UPIA § 505 is to require 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.

³⁵⁹ States adopting the 2008 amendments to UPIA § 505 include Alabama, Arizona, Arkansas, California, Colorado, Connecticut, District of Columbia, Delaware, Idaho, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Michigan, Mississippi, Missouri, Montana, Nebraska, Nevada, New Mexico, North Carolina, North Dakota, Oklahoma, Oregon, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, Washington, and West Virginia. [http://www.uniformlaws.org/LegislativeFactSheet.aspx?title=Principal and Income Amendments \(2008\)](http://www.uniformlaws.org/LegislativeFactSheet.aspx?title=Principal%20and%20Income%20Amendments%20(2008)).

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.³⁶⁰

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 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.³⁶¹ 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

ABC Trust receives a K-1 from Partnership reflecting taxable income of \$1 million. Partnership distributes \$500,000 to the trust, which it represents to be income. The trust 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. But because the trust can deduct the \$150,000 payment to the beneficiary, it must apply the algebraic formula to determine the amount owed the beneficiary so that after deducting the distribution, there is exactly enough to pay its tax on the remaining taxable income from the entity.

³⁶⁰ UPIA § 505, cmt. Example 1.

³⁶¹ UPIA § 505(d) and comments.

Taxable Income per K-1	1,000,000
Payment to beneficiary	<u>230,769³⁶²</u>
Trust Taxable Income	\$ 769,231
35 percent tax	269,231

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

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 [\$269,231 + \$80,769], or the entire tax liability on the entity's \$1,000,000 of Schedule K-1 income.³⁶³

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 because capital gains are generally not able to be distributed. Thus, they keep the estate or trust's AGI high for purposes of the two-percent floor and the Medicare tax, which are both based on AGI.

Capital gains are no small amount for estates and trusts. Historically, they account for about 50 percent of an estate or trust's gross income.³⁶⁴ If these gains are not "income" under the governing instrument or local law, they cannot be distributed to the beneficiary.³⁶⁵ 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 AGI, much of it might be below the beneficiary's Medicare tax threshold, particularly if the distribution is spread among several beneficiaries.

The regulations, however, describe certain circumstances under which capital gains can be distributed.

³⁶² $D = (C - R * K) / (1 - R) = (500,000 - 350,000) / (1 - .35) = \$230,769$. (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).

³⁶³ UPIA § 505, cmt. Example 2.

³⁶⁴ <http://www.irs.gov/uac/SOI-Tax-Stats---Fiduciary>Returns---Sources-of-Income,-Deductions,-and-Tax-Liability---Type-of-Entity>.

³⁶⁵ IRC § 643(a)(3).

1. Capital Gain Distributions Under the Regulations

IRS regulations provide that a trustee may include capital gains in DNI and distribute it to the beneficiaries only when:³⁶⁶

- a) capital gains are allocated to income by the governing instrument or local law;³⁶⁷
- b) the fiduciary has discretion to allocate capital gains to income under the governing instrument or local law;³⁶⁸
- c) the fiduciary *consistently* distributes capital gains to the beneficiary;³⁶⁹
- 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.³⁷⁰

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.³⁷¹ However, these examples in the regulations are safe harbors only.³⁷² 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 capital gains are allocated to a unitrust distribution in the same proportion the trust's total capital gains bear to its total taxable income for the year. Thus, unitrust distributions would carryout a cross section of the trust's capital gains and other classes of income. It is not clear whether the IRS will recognize this as a valid means of distributing capital gains. Regardless, it should not adversely affect the trust's qualification as a marital trust because the § 2056 regulations require only that the trustee's power to adjust meet the requirements of Reg. § 1.643(b)-1, which addresses the *amount* and not the character of the income distributed.³⁷³

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.³⁷⁴ 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

³⁶⁶ Reg. § 1.643(a)-3.

³⁶⁷ Reg. § 1.643(a)-3(b)(1).

³⁶⁸ *Id.*

³⁶⁹ Reg. § 1.643(a)-3(b)(2).

³⁷⁰ Reg. § 1.643(a)-3(b)(3).

³⁷¹ Reg. § 1.643(a)-3(e), Examples 11 and 13.

³⁷² Reg. § 1.643(a)-3(e), Examples 11 and 13.

³⁷³ Reg. § 1.2056(b)-7(d)(1).

³⁷⁴ S.D. CODIFIED LAWS § 55-13A-104.

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 comments on the proposed regulations under IRC § 643 in 2001.³⁷⁵ 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.”³⁷⁶

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. Note that partnership capital gains are not “gains from the sale or exchange of capital assets...allocated to corpus.” They are 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.³⁷⁷

The United States Court of Federal Claims addressed this very issue in *Crisp v. United States*.³⁷⁸ 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 §§ 701 and 702, but mere conduits through which tax items flow through to their partners. As a conduit, the partnership capital gains are corpus and should not be included in DNI. However, the Court noted that the Internal Revenue Code does not control the allocation between income and principal. Second, the IRS analogized partnership profits 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 hold title to 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 §

³⁷⁵ 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)).

³⁷⁶ T.D. 9102.

³⁷⁷ See also E. James Gamble, Trust Accounting and Income Taxes, AICPA Conference (June 2005).

³⁷⁸ *Crisp v. United States*, 34 Fed. Cl. 112 (1995).

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 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.³⁷⁹ 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 allocating its profits to income did not jeopardize the interests of the remaindermen. But even if the trustee's allocation favored the income beneficiary, the facts indicate that the settlors intended that result. Therefore, the 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.³⁸⁰ 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.³⁸¹ 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 not clear whether the IRS will recognize this as a valid means of determining DNI under § 643. But regardless of whether the IRS recognizes the allocation as valid, it should not adversely affect the trust's qualification as a marital trust. The regulations under § 2056 require only that the trustee's power to adjust between principal and income meet the requirements of Reg. § 1.642(b)-1, which addresses the *amount* and not the character of the income distributed.³⁸²

³⁷⁹ *Crisp v. United States*, 34 Fed. Cl. 112 at 118-120.

³⁸⁰ Reg. § 1.643(a)-3(e), Examples 11 and 13.

³⁸¹ Reg. § 1.643(a)-3(b)(1).

³⁸² Reg. § 1.2056(b)-7(d)(1).

H. The 2-Percent Floor

Estates and trusts incur a significant amount of administrative costs each year in carrying out their fiduciary duties. Most of these expenses can be deducted on either Form 706 or Form 1041, but not both places.³⁸³ Examples of administrative costs include:

- Trustee fees
- Accounting fees
- Legal fees
- Costs related to decanting
- Costs related to mergers, divisions, and terminations of trusts
- Cost of obtaining a private letter ruling
- Litigation costs for breach of fiduciary duty or family disputes
- Cost of defending an IRS audit
- Investment advice
- Specialized investment managers
- Consultants
- Bank charges
- Safe deposit box and storage fees
- Insurance
- Appraisal fees
- Family office expenses (rent, salaries, supplies, telephones, etc.)
- Tax advice and preparation
- Property maintenance
- Costs from passthrough entities

Many of these costs are classified as “miscellaneous itemized deductions” under § 67(b) and subject to the 2-percent “floor” under IRC § 67(a). This means that they are deductible to the estate or trust only to the extent that they exceed two percent of the estate or trust’s adjusted gross income (AGI).

Adjusted gross income of an estate or trust is determined in the same manner as for an individual, except that the estate or trust may deduct from AGI its \$100/300/600 personal exemption, charitable contributions, distributions to beneficiaries, and certain other costs that are exempt from the floor under IRC § 67(e).

An estate or trust can minimize the impact of the 2-percent floor by making distributions to beneficiaries to reduce its AGI against which the two-percent floor is applied. The miscellaneous itemized deductions are then deducted from the estate or trust’s DNI and carried out “net” to the beneficiary rather than passed through as a separate line item on the Schedule K-1. However, the estate or trust is generally not able to distribute capital gains because they are considered corpus. Therefore, it will not be easy for an estate or trust with significant capital gains to reduce its AGI for purposes of the two-percent floor.

The fiduciary must parse through each of its costs and determine which of them is fully deductible and which are subject to the two percent floor. Section 67(e) provides that administrative costs are not subject to the two-percent floor if they “would not have been

³⁸³ IRC § 642(g); Reg. § 20.2053-3.

incurred if the property were not held in such trust or estate.” The Supreme Court attempted to clarify the meaning of this phrase in *Knight v. Commissioner*, and held that IRC § 67(e)(1) means that estates and trusts may claim a full deduction only for costs that hypothetical individuals do not “commonly” incur.³⁸⁴

1. The AMT Impact

Subjecting costs to the 2-percent floor also implicates the alternative minimum tax, because costs classified as “miscellaneous itemized deductions” are an AMT adjustment that must be added to the estate or trust’s taxable income in determining its alternative minimum taxable income (AMTI). After applying a \$23,100 exemption and a 26 or 28 percent AMT tax rate to the estate’s AMTI, if the fiduciary’s tentative minimum tax exceeds its regular tax, it will owe the greater of the two.

The fiduciary can reduce or eliminate its alternative minimum tax by making distributions to the beneficiaries. However, because of the structure of the DNI carryout rules for AMT, the AMT adjustment items are the last items to be carried out. Therefore, the fiduciary must distribute nearly all of its DNI before it carries out the AMT preferences and adjustments.³⁸⁵ The AMT adjustments are carried out to the beneficiary on Schedule K-1. Although this exposes the beneficiary to additional AMT taxes, the impact can be lessened if there are multiple beneficiaries. To the extent the AMT adjustment is divided among multiple beneficiaries, the amount allocated to any single beneficiary is likely to be too small to cause the beneficiary to incur an AMT.

2. Medicare Tax Impact

Starting in 2013, estates and trusts will be subject to the new 3.8 percent Medicare surtax on investment income.³⁸⁶ IRC § 1411 imposes a surtax of 3.8 percent on the unearned income of an estate or trust in addition to all other taxes imposed by Subtitle A (Income Taxes), including the alternative minimum tax.³⁸⁷ The surtax applies to the lesser of a) adjusted gross income under § 67(e) in excess of a threshold equal to the dollar amount at which the highest income tax bracket begins for the year (\$11,950 estimated for 2013) or b) undistributed net investment income.³⁸⁸ The threshold is indexed for inflation each year, unlike the threshold for individuals, which is fixed at \$250,000 for married individuals, \$125,000 for married individuals filing separately, and \$200,000 for other individuals.³⁸⁹

Because adjusted gross income (AGI) of an estate or trust for the Medicare tax is determined under § 67(e), expenses that are subject to the two-percent floor on miscellaneous itemized deductions will have a triple negative impact. They will be subject to the two-percent floor, expose the fiduciary and its beneficiaries to additional AMT taxes, and cause the estate or trust to incur additional Medicare taxes.

³⁸⁴ *Knight v. Comm’r*, 552 U.S. 181 (2008).

³⁸⁵ IRC § 59(c); IRC § 661(a); IRC § 662(b).

³⁸⁶ IRC § 1411.

³⁸⁷ IRC § 1411(a)(1).

³⁸⁸ IRC § 1411(a)(2).

³⁸⁹ IRC § 1(f); IRC § 1411(b).

The fiduciary can lessen the impact of its Medicare tax by making distributions to the beneficiaries. This reduces both its AGI and its undistributed net investment income against which the 3.8 percent Medicare tax is applied. While a distribution carries out the investment income to the beneficiaries, they will be able to apply the higher individual Medicare tax thresholds of \$250,000 for married individuals, \$125,000 for married individuals filing separately, and \$200,000 for other individuals, compared to the fiduciary's meager threshold of \$11,950 (estimated for 2013).

3. Revised Proposed Regulations

Prior to the Supreme Court's decision in *Knight*, the IRS had issued proposed regulations allowing costs to be fully deductible only if they were "unique" to an estate or trust.³⁹⁰ If a cost is not unique to an estate or trust, meaning that an individual could have incurred the cost, then that cost is subject to the 2-percent floor. The proposed regulations clarified that it is the type of product or service provided to the estate or trust rather than its description that is tested to determine its uniqueness. The proposed regulations also required costs that are included as part of a comprehensive commission or fee paid to the trustee or executor ("Bundled Fiduciary Fee") to be separated between those subject to the floor and those not.

But because the Supreme Court found that the IRS's interpretation of IRC § 67(e) "flies in the face" of the statute, the IRS issued a series of announcements waiving any requirement for fiduciaries to unbundle their fees until final regulations are published in the federal register.³⁹¹ They also issued a new set of proposed regulations on September 7, 2011 to replace the ones invalidated by the Supreme Court. The new proposed regulations are intended to reflect the reasoning and holding in *Knight*.³⁹²

"Commonly" or "Customarily" Incurred

Prop. Reg. § 1.67-4 provides that a cost is "commonly" or "customarily" incurred if a hypothetical individual owning the *same property* would have incurred the same cost. It provides examples of such commonly or customarily incurred costs as those incurred in defending a claim against the estate, the decedent, or the non-grantor trust that is *not* related to the existence, validity, or administration of the estate or trust.³⁹³ Although this sounds like a "but for" test, it is not. The Supreme Court rejected any interpretation of IRC § 67(e) that allows a full deduction for costs that would not have been incurred "but for" the existence of the trust because all administrative costs would pass that test, according to the Court. Therefore, the regulations focus on whether the cost is related to the existence, validity, or administration of the estate or trust.

The good news is that the proposed regulations would appear to allow a full deduction for costs incurred to decant, merge, or divide a trust or to resolve litigation involving the existence, validity, or administration of the estate or trust. The bad news is that grantor trusts will not be

³⁹⁰ Prop. Reg. § 1.67-4, REG-128224-06, 2007-36 IRB 551, 72 FR 41243 (July 27, 2007).

³⁹¹ Notice 2010-32, 2010-16 I.R.B. 594 (Apr. 1, 2010); Notice 2008-116, 2008-2 C.B. 1372 (Dec. 11, 2008); Notice 2008-32, 2008-1 C.B. 593 (Feb. 27, 2008).

³⁹² Preamble to Prop Regs., Notice of Proposed Rulemaking, Fed. Reg. Vol. 76, No. 173, p. 55322 (09/07/2011).

³⁹³ Prop. Reg. § 1.67-4(b)(1).

allowed a full deduction under IRC § 67(e) because it does not apply to grantor trusts.³⁹⁴ Thus, the grantor will be treated as incurring those expenses individually and will be subject to the two-percent floor and the AMT adjustment.³⁹⁵

Ownership Costs

The regulation also creates a new class of costs called “ownership costs” which are subject to the floor. Ownership costs are those chargeable to or incurred by an owner of property simply by reason of being the owner of the property.³⁹⁶ It gives the following examples: condominium fees, real estate taxes, insurance premiums, maintenance and lawn services, automobile registration and insurance costs, and partnership costs deemed to be passed through to and reportable by a partner. However, it has been pointed out to the IRS that the examples are problematic because real estate taxes are statutorily exempt from the floor under IRC § 67(b)(2).³⁹⁷

Tax Preparation Fees

The proposed regulations allow a full deduction for the cost of preparing estate and generation-skipping transfer tax returns, fiduciary income tax returns, and the decedent's final individual income tax return.³⁹⁸ The costs of preparing other individual income tax returns, gift tax returns, and tax returns for a sole proprietorship or a retirement plan, for example, are costs commonly and customarily incurred by individuals and thus are subject to the 2-percent floor.

Investment Advisory Fees

To the extent an investment advisory fee *exceeds* the fee generally charged to an individual investor, *and* that excess is attributable to an unusual investment objective of the trust or estate or to a specialized balancing of the beneficiaries' interests such that a reasonable comparison with individual investors would be improper, that excess is not subject to the 2-percent floor.³⁹⁹ In other words, the investment fees incurred by the fiduciary must exceed those charged to an individual investor or they will be subject to the 2-percent floor. The IRS rationalizes its approach by noting that individual investors commonly have investment objectives that may require a balance between investing for income and investing for growth and/or a specialized approach for particular assets.⁴⁰⁰

“Bundled” Fees

The proposed regulations also address “bundled fees,” which are defined as a “single fee, commission, or other expense (such as a fiduciary's commission, attorney's fee, or accountant's

³⁹⁴ Conference Rep. No. 99-841, 99th CONGRESS, 2nd Session, H.R. 3838 (Sept. 18, 1986), p. 34; General Explanation of the Tax Reform Act of 1986 H.R. 3838, JCS-10-87, 99th Cong. P.L. No. 99-514 (May 4, 1987), p. 81.; IRC § 56(b)(1)(A)(i) (no deduction is allowed for miscellaneous itemized deductions as defined in section 67(b) for purposes of the AMT).

³⁹⁵ Reg § 1.67-2T(b)(1) ; Bay v. Comm’r, T.C. Memo 1998-411.

³⁹⁶ Prop. Reg. § 1.67-4(b)(2).

³⁹⁷ Comments by ABA RPTE Section on IRS REG-128224-06 (Dec. 7, 2011), *available at* [http://www.regulations.gov/#!searchResults;rpp=25;po=0;s=67\(e\)%257Cestates](http://www.regulations.gov/#!searchResults;rpp=25;po=0;s=67(e)%257Cestates).

³⁹⁸ Prop. Reg. § 1.67-4(b)(3).

³⁹⁹ Prop. Reg. § 1.67-4(b)(4).

⁴⁰⁰ *Id.*

fee) for both costs that are subject to the 2-percent floor and costs (in more than a de minimus amount) that are not.”⁴⁰¹ It is difficult to think of attorneys’ and accountants’ fees as bundled fees, especially if they are computed hourly. Nonetheless, the regulations provide three basic rules for bundled fees.

First, the portion of a bundled fee attributable to investment advice must be identified and subjected to the two-percent floor.⁴⁰² The rest is fully deductible. This is a hard and fast rule, requiring no analysis of the nature of the investment services. The only exception is for fees computed on an hourly basis, which do not require unbundling.

Second, payments to a third party that are paid out of a bundled fee are subject to the two-percent floor if they would have been subject to the floor if paid directly by the estate or trust.⁴⁰³ And third, any fee separately assessed by the fiduciary or other service provider to the estate or trust that are commonly or customarily incurred by an individual owner of such property are subject to the floor. The regulations provide as an example of a separately assessed expense subject to the floor as a fee charged by the fiduciary for managing rental real estate owned by the trust or estate. However, it has been pointed out to the Service that fees for managing real estate would be deductible above the line under IRC § 62(a)(4) as an expense attributable to the production of rents and royalties.⁴⁰⁴

Any Reasonable Method

Finally, the proposed regulations allow the fiduciary to use any reasonable method to allocate a bundled fee between costs that are subject to the 2-percent floor and those that are not, including the portion of a fiduciary commission attributable to investment advice.⁴⁰⁵ The reasonable method standard does not apply to determine the portion of the bundled fee attributable to payments made to third parties for expenses subject to the 2-percent floor or to any other separately assessed expense commonly or customarily incurred by an individual, because those payments and expenses are readily identifiable without any discretion on the part of the fiduciary or return preparer.

Comments on the Proposed Regulations

The IRS received four comment letters in response to the September 2011 proposed regulations and dozens of comment letters in response to its earlier proposed regulations.⁴⁰⁶ The comments were nearly unanimous that fiduciary fees should not be unbundled. They pointed out the impossibility of parsing fiduciary fees into the myriad of duties fiduciaries carry out on a daily basis. They also noted that fiduciaries are already heavily regulated by various state and federal agencies and their duties cannot be compared to that of an agent or investment advisor for

⁴⁰¹ Prop. Reg. § 1.67-4(c)(1).

⁴⁰² *Id.*

⁴⁰³ Prop. Reg. § 1.67-4(c)(2).

⁴⁰⁴ Comments by ABA RPTE Section on IRS REG-128224-06 (Dec. 7, 2011), *available at* [http://www.regulations.gov/#!searchResults:rpp=25;po=0;s=67\(e\)%257Cestates](http://www.regulations.gov/#!searchResults:rpp=25;po=0;s=67(e)%257Cestates).

⁴⁰⁵ Prop. Reg. § 1.67-4(c)(3).

⁴⁰⁶ [http://www.regulations.gov/#!searchResults:rpp=25;po=0;s=67\(e\)%257Cestates](http://www.regulations.gov/#!searchResults:rpp=25;po=0;s=67(e)%257Cestates) (See comments from The American Bar Association RPTE Section, the Texas Society of CPAs, the New York City Bar and Northern Trust Co.).

an individual.

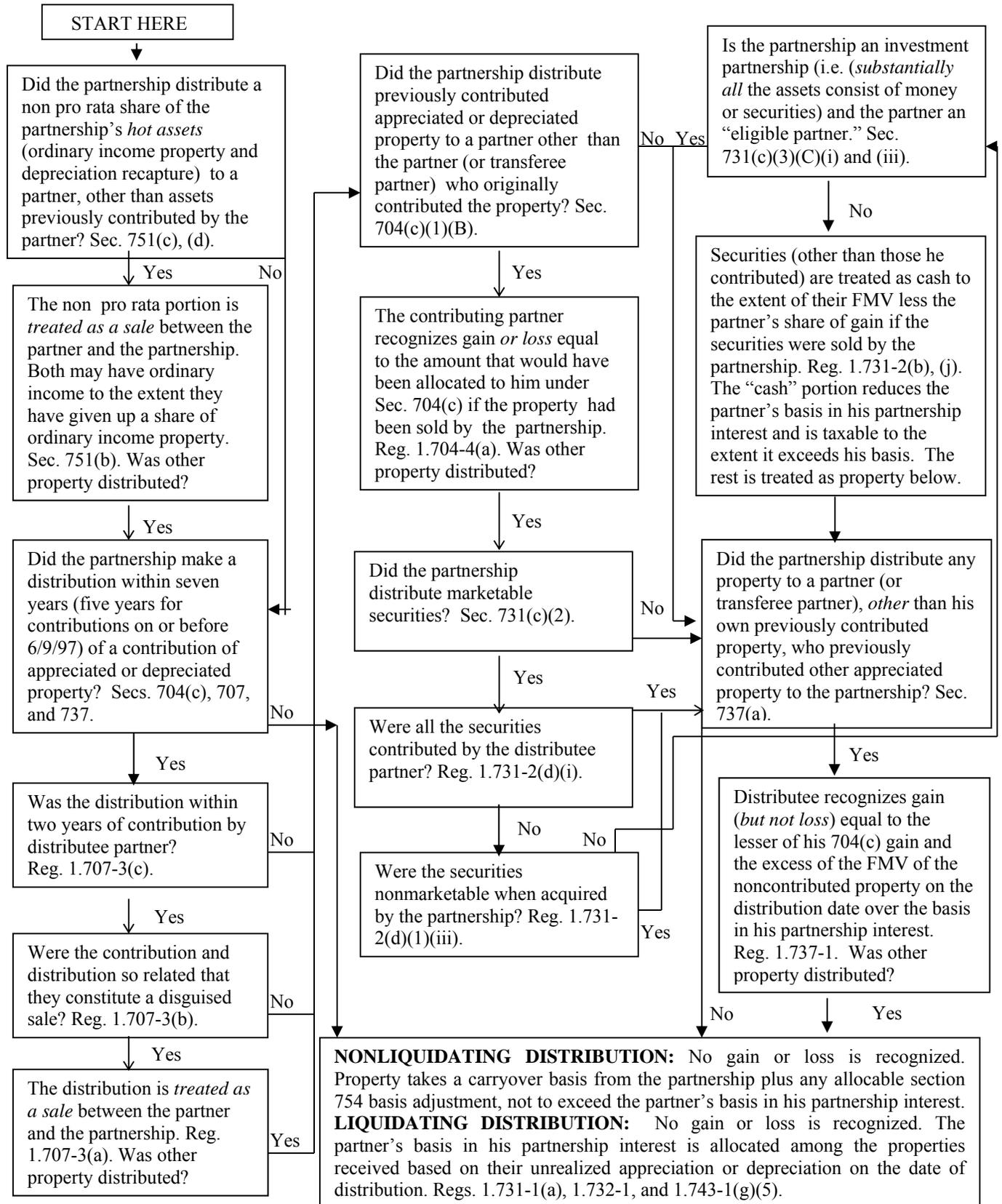
If the IRS decides not to require trustees to unbundle their fees based on the comment letters it received, all that would be subject to the floor are investment advisory fees and numerous other insignificant deductions. In that case, smaller trusts would be disadvantaged because nearly all of their costs would be subject to the floor. Nonetheless, the status of the IRC § 67(e) regulations has been upgraded to “final” on the Treasury Department’s 2012-2013 Priority Guidance Plan, which was released November 19, 2012.⁴⁰⁷

VII. CONCLUSION

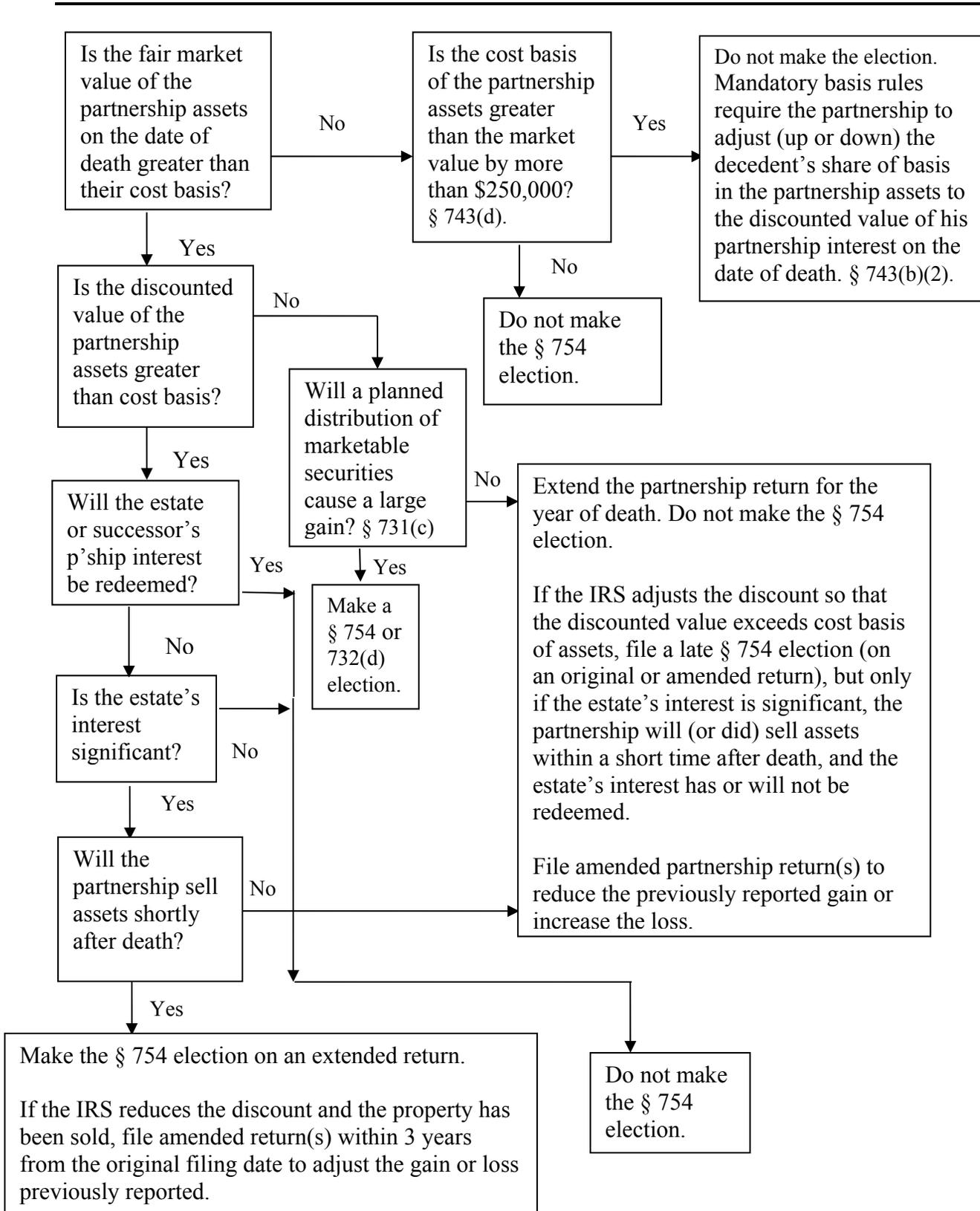
The executor or trustee with partnership interests has a challenge. He or she must have a working knowledge of the income tax rules as well as the estate tax rules for both trusts and partnerships. The job also demands active communication with the partnership management and recognizing when the fiduciary 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.

⁴⁰⁷ Department of the Treasury 2012-2013 Priority Guidance Plan, Nov. 19, 2012, *available at* <http://www.irs.gov/uac/Priority-Guidance-Plan>.

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**

