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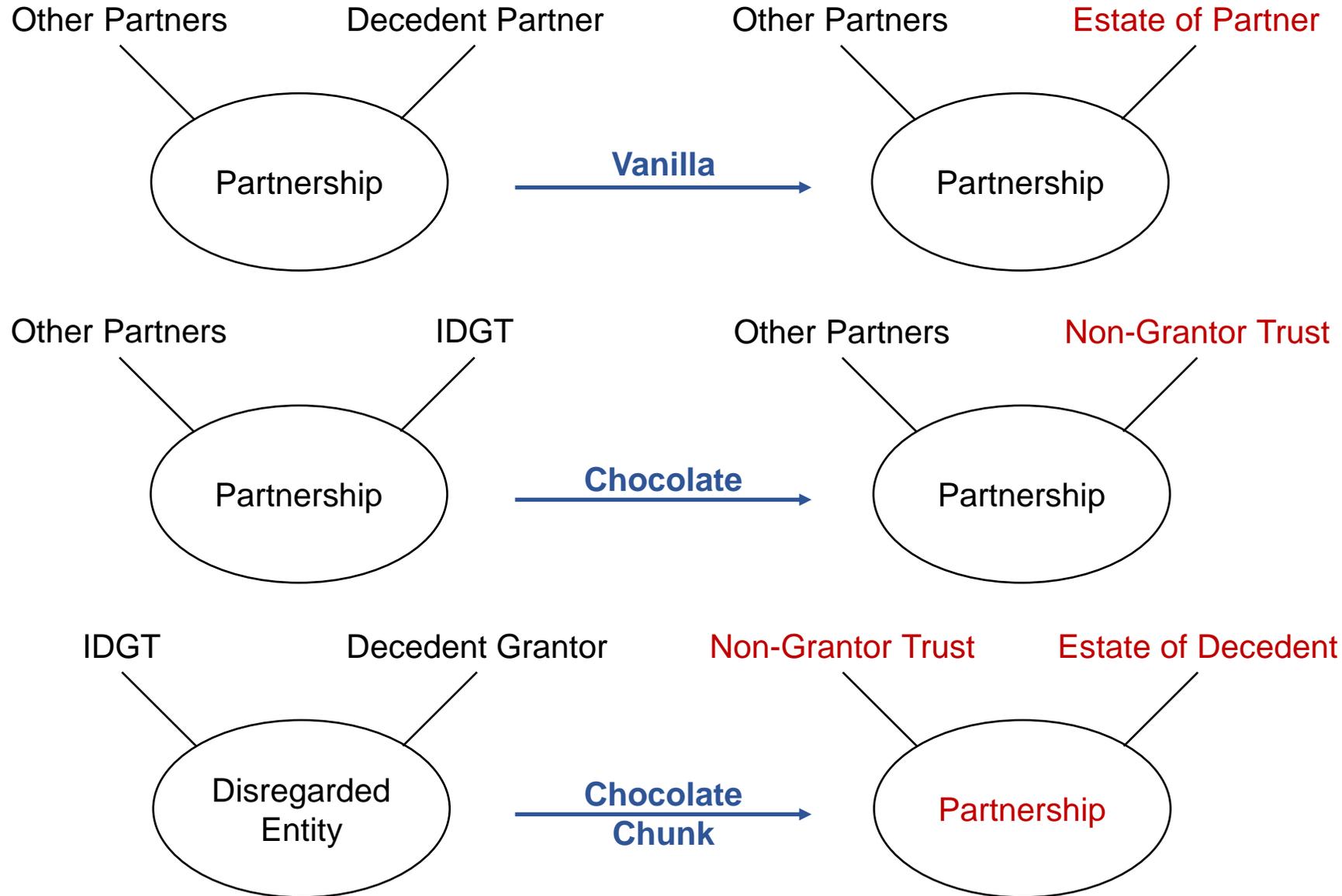
THE GREAT UNKNOWN:

What Really Happens When Partners Die?

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THE TRANSITION:
WHAT PATH ARE YOUR
CLIENTS GOING DOWN (OR UP)?

Transfers at Death of a Partner Come in Different Flavors



Fudge Swirl?
IDGT and decedent grantor own interests in the same partnership

Chunky Monkey?
IDGT owns interest in a partnership but a beneficiary dies holding or exercising a testamentary general power of appointment

A Venn Diagram (of Course): Transfers at Death of a Partner

Transfers of interests that get a § 1014 basis adjustment due to the death of another individual and partnership assets are eligible for a § 743(b) inside basis adjustment. Yet the interest is not deemed to be owned by the decedent anymore

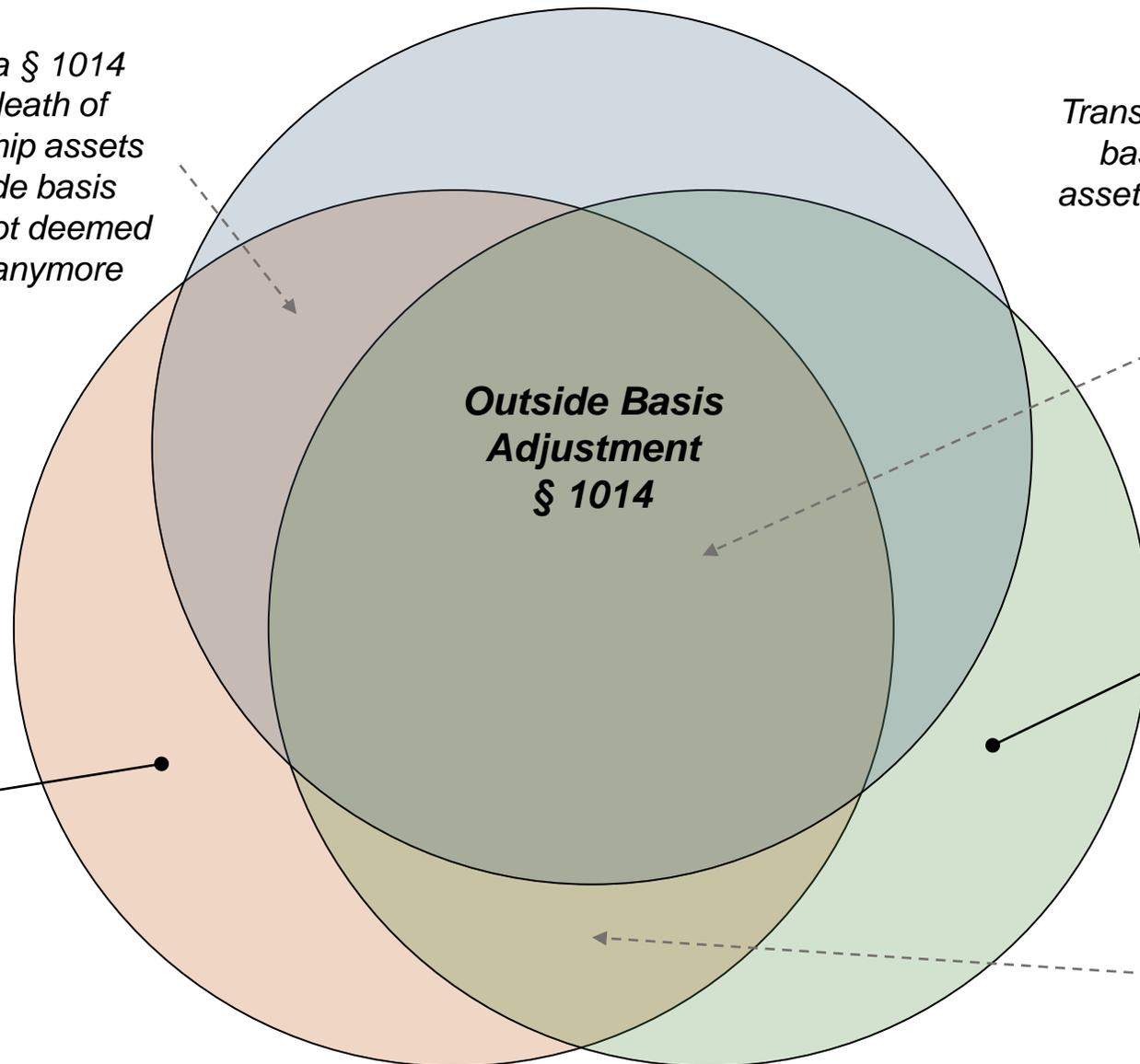
Transfers of interests that get a § 1014 basis adjustment and partnership assets are eligible for a § 743(b) inside basis adjustment

**Outside Basis Adjustment
§ 1014**

**Partnership Interest
Owned by Decedent or
Grantor Trust of
Decedent**

**Subject to
§ 743(b)
Inside Basis
Adjustment**

Transfers of interests that do not get a § 1014 basis adjustment but the partnership assets are eligible for a § 743(b) inside basis adjustment



Death of a Partner = Transfer of a Partnership Interest

Death of, or Transfer from	Transfer to	Outside Basis Adjustment	Inside Basis Adjustment	Recognition Event
Individual Partner (Owner)	Estate/ Successor-in-Interest	Yes	Yes	No
Revocable (Grantor) Trust	Non-Grantor Taxable Trust	Yes	Yes	No
Grantor of IDGT	Non-Grantor Taxable Trust	No	Yes	Yes if Debt > Basis
Holder of Testamentary GPOA of IDGT	Appointee (Exercise) Beneficiaries (Lapse)	Yes	Yes? (Exercise) No? (Lapse)	Yes? (Exercise) No? (Lapse)
Holder of Testamentary GPOA of Non-Grantor Trust	Appointee (Exercise) Beneficiaries (Lapse)	Yes	Yes	No
Owner of Disregarded Entity	Estate or Non-Grantor Trust (IDGT)	Yes (Estate) No (IDGT)	No	No

Deemed Transfers and Conversions of Grantor Trusts: A Review

Nonrecourse Debt in Excess of Basis

Crane, Tufts, and Treas. Reg. § 1.1001-1

- Nonrecourse debt is included in the cost basis of acquired property.
- Sale or other disposition (including a gift) of property subject to nonrecourse debt is considered a sale with an amount realized equal to the nonrecourse debt.
- The transferor will recognize gain to the extent the nonrecourse debt exceeds the basis of the transferred property.

Partnership Dispositions

Treas. Reg. § 1.1001-1 and § 752(d)

- Contributions and distributions between partnerships and partners are not considered “sales or other dispositions” of property.
- “In the case of a sale or exchange of an interest in a partnership, liabilities will be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships”
- “The Treasury decision makes it clear that the amount realized by the sale other disposition of a partnership interest includes the amount of the partnership liabilities from which a transferor is discharged as a result of the sale or other disposition.”

Conversion of Grantor Trust During Grantor’s Life

Rev. Rul. 77-402, Treas. Reg. § 1.1001-2(c), Ex. 5

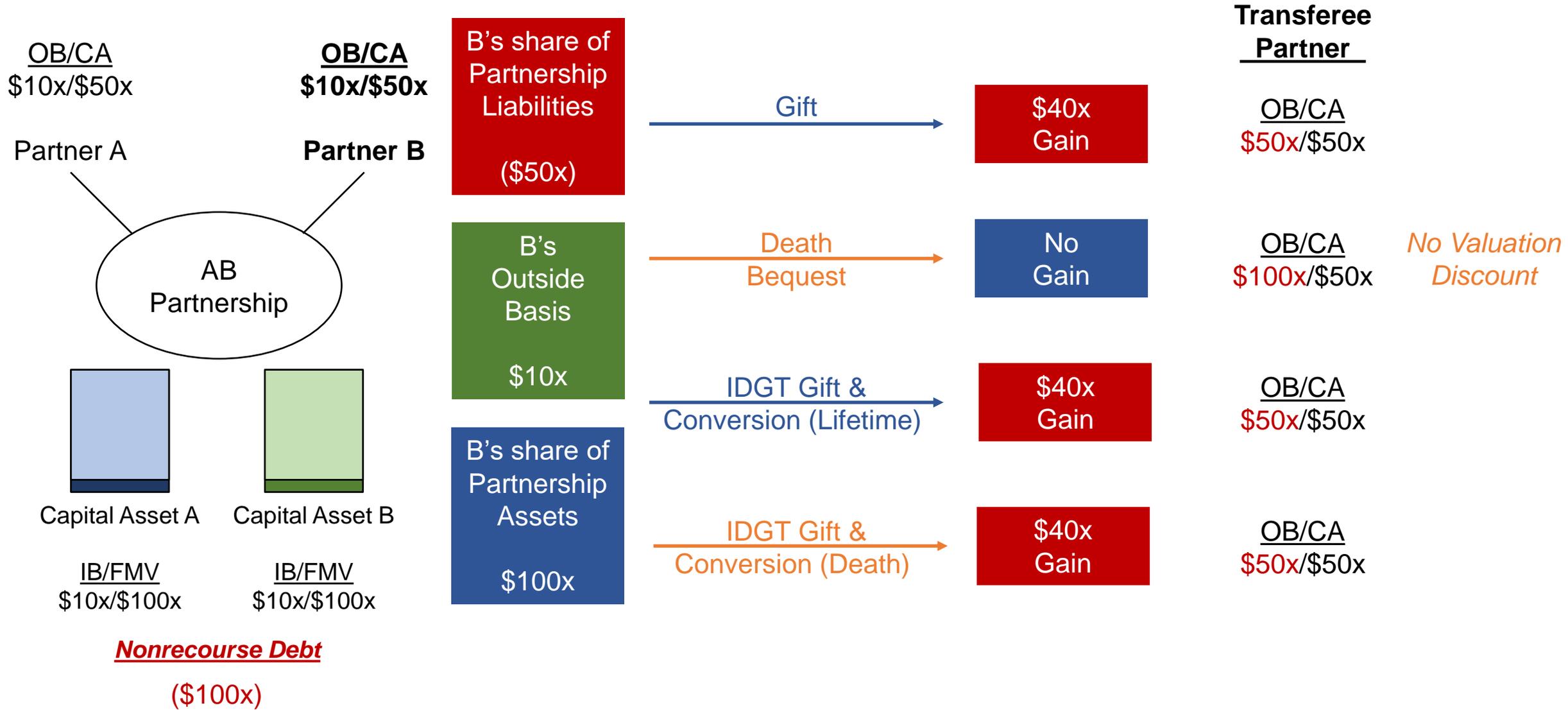
- Conversion is considered a transfer (deemed) of the trust property by the grantor to the non-grantor trust, now a separate taxable entity
- If the property is encumbered by nonrecourse debt (including partnership liabilities secured by partnership property) and the debt is in excess of the transferred property, then the transferor will recognize gain to the extent the debt exceeds the basis of the transferred property.

Conversion of Grantor Trust Due to the Death of Grantor

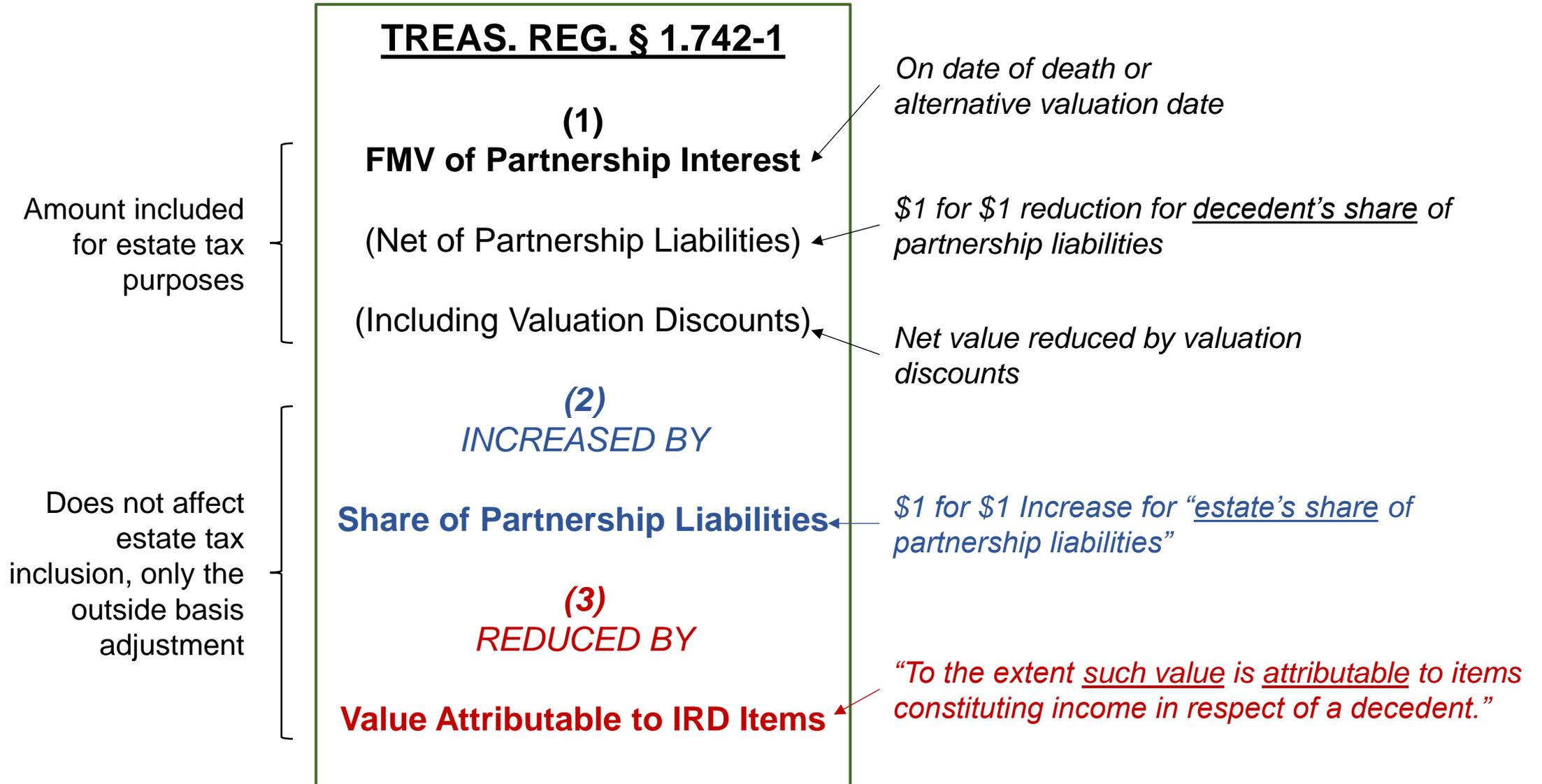
Rev. Ruls. 57-51 & 79-84 and Rev. Rul. 2023-2

- Death of the grantor is considered a transfer (deemed) of the trust property by the decedent to the non-grantor trust, now a separate taxable entity.
- The basis of the assets in the trust after death will be the same as the basis prior to the grantor’s death.

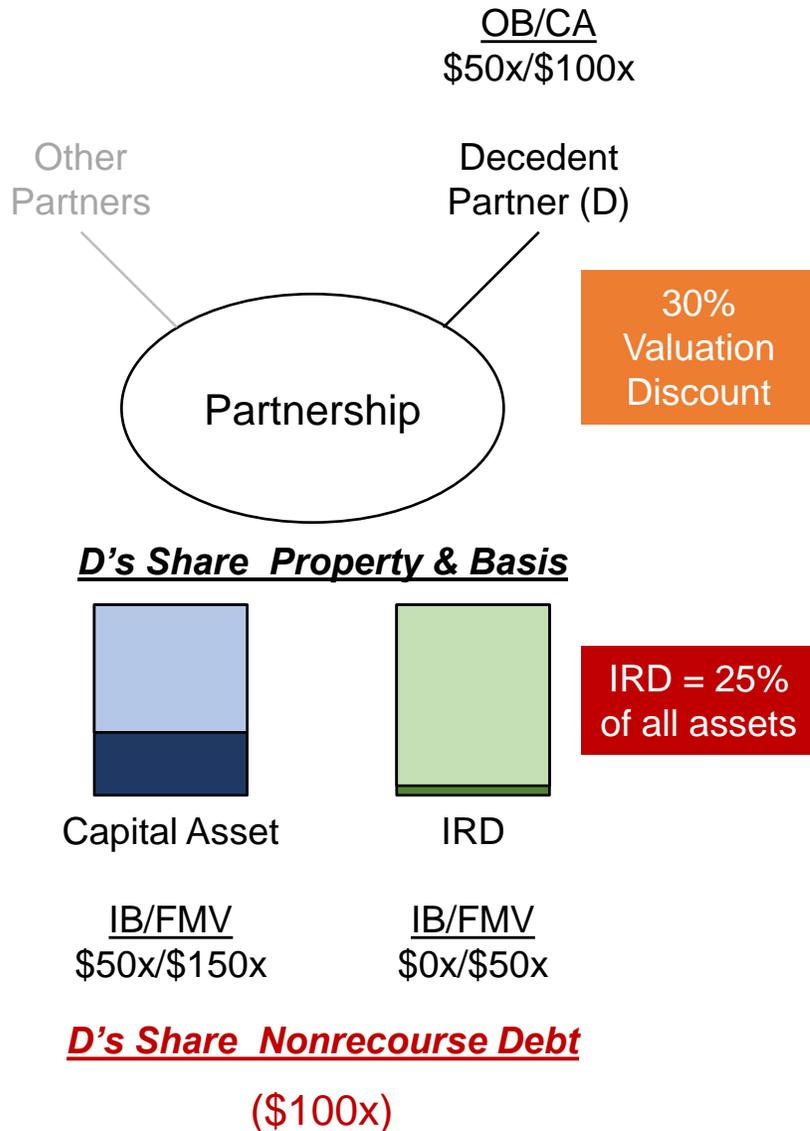
Gifts, Bequests, and Deemed Transfers: Beware of Liabilities



Outside Basis Adjustment at Death: Not What You Think



Outside Basis Adjustment with Discounts, Debt, and IRD



OUTSIDE BASIS ADJUSTMENT

(1) *FMV of Interest = \$70x*

$\$200x$ – Gross Value
 $(\$100x)$ – Partnership Debt
 $(\$30x)$ – 30% Valuation Discount

 $\$70x$ – Fair Market Value Interest

(2) *Increase by Share of Debt = \$170x*

$\$70x$ – Fair Market Value
 $\$100x$ – Estate's Share of Debt

 $\$170x$ – Adjustment Before IRD Reduction

(3) *Reduce by IRD = ?*

“To the extent such value is attributable to items constituting income in respect of a decedent.”

Options for IRD Reduction

(1) *Full Value of IRD*

$\$170x$ – FMV + Debt
 $(\$50x)$ – Value of 100% of the IRD

 $\$120x$ – **Outside Basis**

(2) *Proportionate (25% of Step 2)*

$\$170x$ – FMV + Debt
 $(\$42.5x)$ – 25% of $\$170x$

 $\$127.5x$ – **Outside Basis**

(3) *Discounted Value of IRD*

$\$170x$ – FMV + Debt
 $(\$35x)$ – 70% of $\$50x$

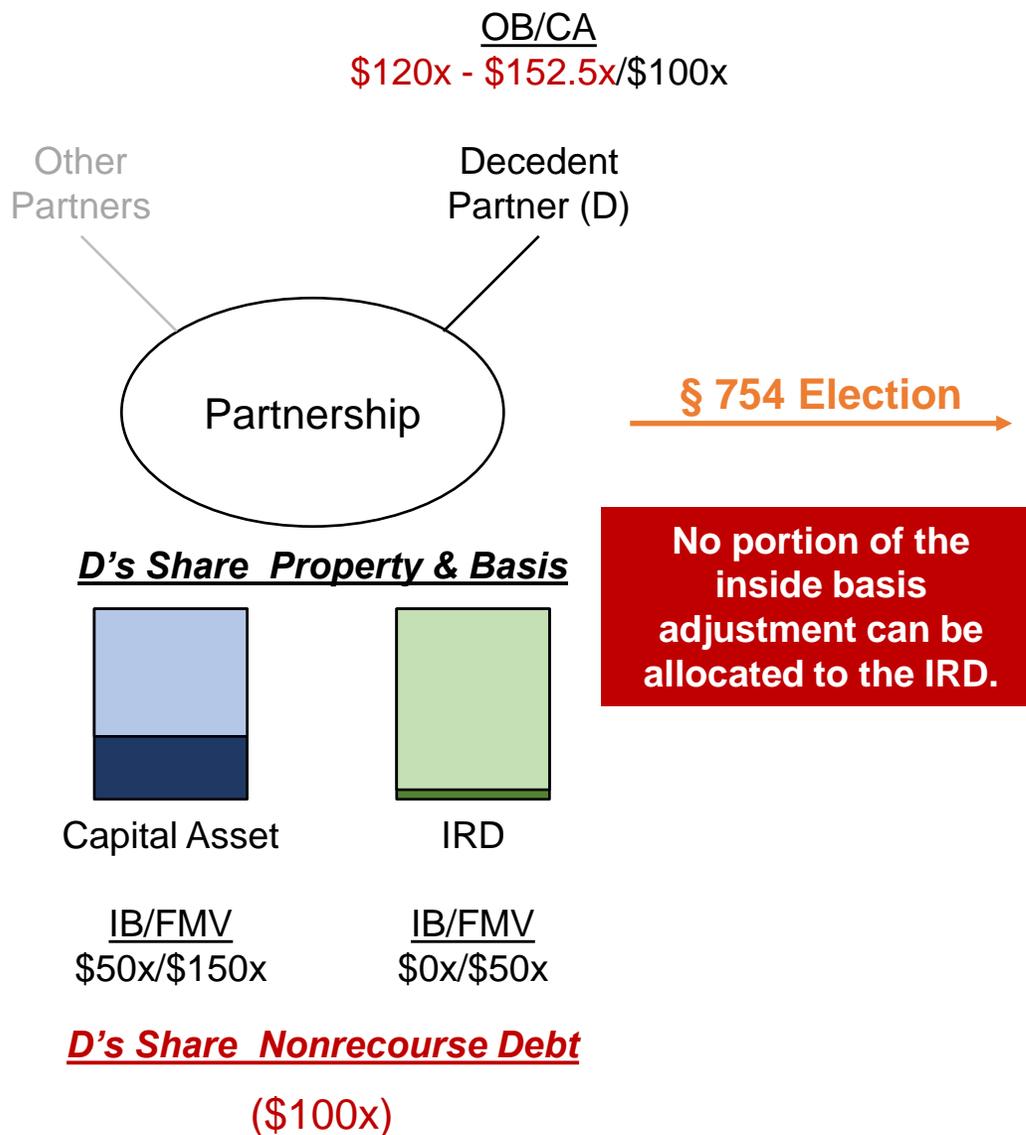
 $\$135x$ – **Outside Basis**

(4) *Proportionate (25% of Step 1)*

$\$170x$ – FMV + Debt
 $(\$17.5x)$ – 25% of $\$70x$

 $\$152.5x$ – **Outside Basis**

Inside Basis Adjustment with Discounts, Debt, and IRD



Basis Adjustment to Capital Asset

Option 1:

\$120x – Outside Basis
(\$50x) – Share of Inside Basis
\$70x – § 743(b) Amount
\$120x – Resulting Basis of Capital Asset

Option 2:

\$127.5x – Outside Basis
(\$50x) – Share of Inside Basis
\$77.5x – § 743(b) Amount
\$127.5x – Resulting Basis of Capital Asset

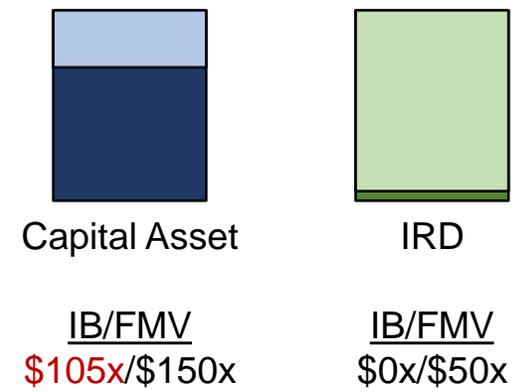
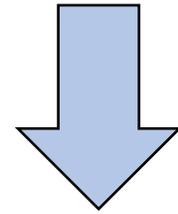
Option 3:

\$135x – Outside Basis
(\$50x) – Share of Inside Basis
\$85x – § 743(b) Amount
\$135x – Resulting Basis of Capital Asset

Option 4:

\$152.5x – Outside Basis
(\$50x) – Share of Inside Basis
\$102.5x – § 743(b) Amount
\$152.5x – Resulting Basis of Capital Asset

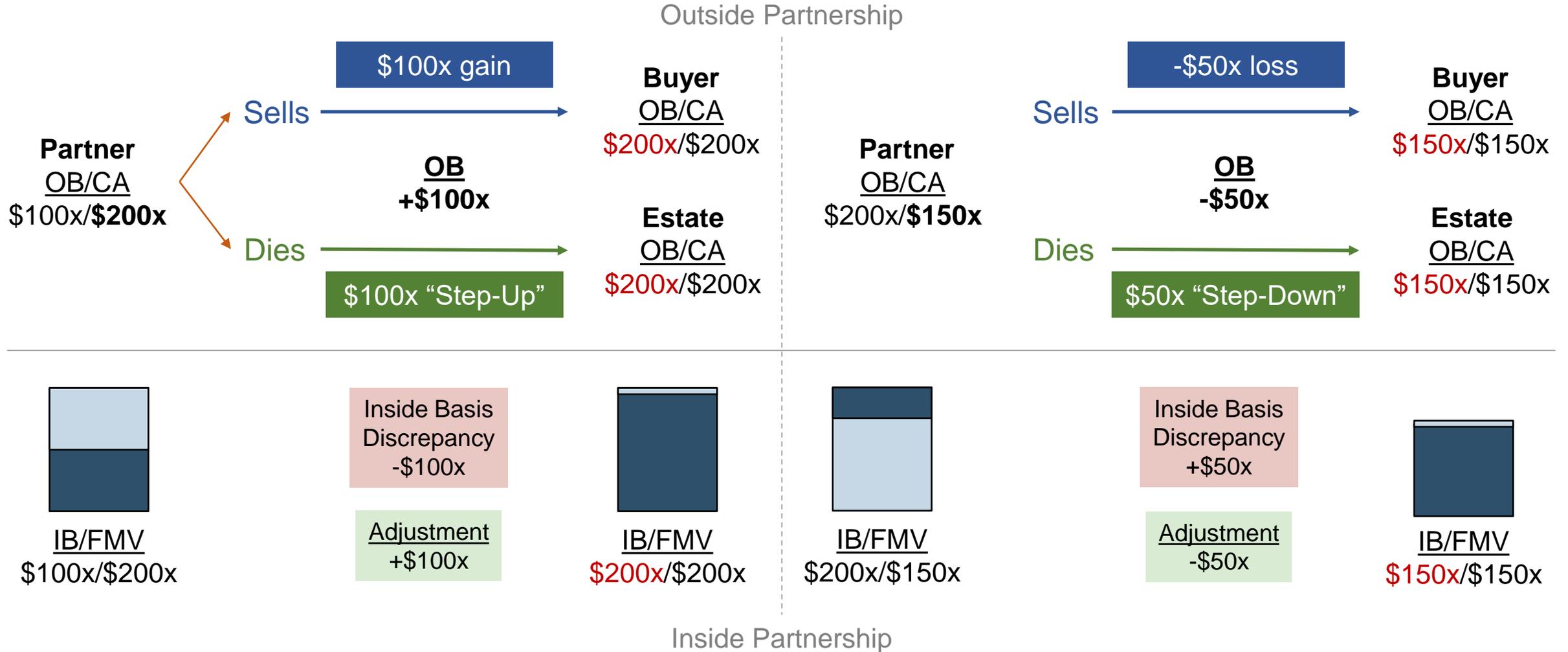
What would have been the result if the decedent died owning the capital and IRD assets directly, but they were subject to a 30% valuation discount?



Section 743: Equalizing Inside Basis with Outside Basis

Section 754 election allows the partnership to adjust the inside basis of assets under section 743 when there is a:

- **Sale** of a partnership interest; and
- **Death** of a partner.



Section 743(b) Inside Basis Adjustment: It's Complicated

Transferee Partner's
Outside Basis

>
 =
 <

~~Transferee Partner's~~
Proportionate Share
~~of Inside Basis~~

Because the formula is based, in part, on hypothetical gains and losses be cognizant of § 704(c) and "reverse" § 704(c) property

Previously Taxed Capital

PLUS

Share of Partnership Liabilities

Treas. Reg.
 § 1.742-1

Date of
 Death
 or
 Alternate
 Valuation
 Date

Partnership property
at a loss prior to
 death will increase
 previously taxed
 capital which, in turn,
reduces the inside
 basis adjustment
 under § 743(b)

Previously Taxed Capital

*Amount of cash the transferee partner would receive upon a liquidation of the partnership following a **hypothetical sale** of the partnership assets, immediately following the transfer of the partnership interest, in a fully taxable transaction for cash equal to the fair market value of the assets*

INCREASED BY

*Amount of **tax loss** that would be allocated to the partner in the hypothetical liquidation*

DECREASED BY

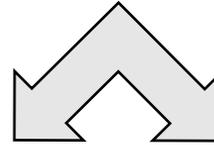
*Amount of **tax gain** that would be allocated to the partner in the hypothetical liquidation*

Allocating the Inside Basis Adjustment (Section 755)

Treated as a **net amount**, which means positive adjustments and negative adjustments can be made to each class of assets (or individual assets in each class).

§ 743(b) Adjustment

2 Classes of Assets



Partnership property **at a loss** prior to death will have its basis **reduced** and property **at a gain** will have its basis **increased**

Capital
Gain
Property

Capital Assets &
§ 1231 Property

All Other
Assets

Ordinary
Income
Property

The Hypothetical Transaction

Based on allocations of income, gain or loss that the transferee partner would receive if, immediately after the transfer of the partnership interest, all of the partnership property were disposed of in a fully taxable transaction for cash in an amount equal to the fair market value of such property.

Valuation Premium

Valuation Discount

Whatever
is left

§ 743(b) adjustment
allocated to ordinary first

The “shortfall” created by **valuation discounts** is allocated across the capital gain assets based on (i) unrealized appreciation (depreciation) and (ii) relative fair market values

If there is **NO valuation premium or discount**, then the inside basis adjustment will exactly eliminate all of the unrealized gain and loss that existed prior to the transfer (death)

~~*THE DEATHLY HALLOWS
(THE TALE OF THE
THREE BROTHERS)*~~

***“NEGATIVE” BASIS AND CAPITAL
(THE TALE OF THE
FOUR SIBLINGS)***

Phase One: Buy, Borrow, Build

- In 1990, 4 siblings (ABCD) create a partnership (ABCD Partnership) to develop a multi-family residential building
- Each partner contributes \$1 Mil. to ABCD Partnership
- ABCD Partnership buys undeveloped land for \$4 Mil. (Land)
- ABCD borrows \$36 Mil. from the bank, on a nonrecourse basis with the loan collateralized by the land and the building, when it is constructed
- The building is constructed (Building)
- The “balance sheet” would reflect the following...

ABCD Partnership 1990 “Balance Sheet”					
Assets			Nonrecourse Liabilities		
	Tax Basis	Book Value			Amount Outstanding
Land	\$4,000,000	\$4,000,000	A’s Share		\$9,000,000
Building	\$36,000,000	\$36,000,000	B’s Share		\$9,000,000
			C’s Share		\$9,000,000
			D’s Share		\$9,000,000
			Total		\$36,000,000
			Partner Equity		
				Outside Basis	Capital Account
			Partner A	\$10,000,000	\$1,000,000
			Partner B	\$10,000,000	\$1,000,000
			Partner C	\$10,000,000	\$1,000,000
			Partner D	\$10,000,000	\$1,000,000
Total	\$40,000,000	\$40,000,000	Total	\$40,000,000	\$4,000,000

Partnership liabilities are included in outside basis but NOT capital accounts.

Phase Two: Depreciate, Depreciate, Depreciate

- ABCD Partnership elects to depreciate the capital costs as quickly as possible
- A cost segregation study identifies 20% of the capital costs (\$7.2 Mil.) as items of personal property and items pertaining to land improvements that are eligible for accelerated depreciation over 5, 7, or 15 years
- Remaining capital costs are depreciable over 27.5 years on the straight-line method
- These deductions offset the rental income
- ABCD Partnership pays only interest on the loan and distributes all of the net cash flow to the partners
- At the end of 15 years (2005)...

ABCD Partnership 2005 "Balance Sheet"					
Assets			Nonrecourse Liabilities		
	Tax Basis	Book Value			Amount Outstanding
Land	\$4,000,000	\$4,000,000	A's Share		\$9,000,000
Building	\$13,090,909	\$13,090,909	B's Share		\$9,000,000
			C's Share		\$9,000,000
			D's Share		\$9,000,000
			Total		\$36,000,000
			Partner Equity		
				Outside Basis	Capital Account
			Partner A	\$4,272,727	(\$4,727,273)
			Partner B	\$4,272,727	(\$4,727,273)
			Partner C	\$4,272,727	(\$4,727,273)
			Partner D	\$4,272,727	(\$4,727,273)
Total	\$17,090,909	\$17,090,909	Total	\$17,090,909	(\$18,909,091)

Because depreciation deductions reduce outside basis and capital accounts, each partner has a negative capital account balance, and each partner's share of partnership liabilities is in excess of their outside basis ("negative basis").

Phase Two: Depreciate, Depreciate, Depreciate

- 30 years later (2020), ABCD partnership no longer has any capital costs to depreciate
- The balance sheet looks, as follows...
- But they have an idea...

ABCD Partnership 2020 "Balance Sheet"					
Assets			Nonrecourse Liabilities		
	Tax Basis	Book Value			Amount Outstanding
Land	\$4,000,000	\$4,000,000	A's Share		\$9,000,000
Building	\$0	\$0	B's Share		\$9,000,000
			C's Share		\$9,000,000
			D's Share		\$9,000,000
			Total		\$36,000,000
			Partner Equity		
				Outside Basis	Capital Account
			Partner A	\$1,000,000	(\$8,000,000)
			Partner B	\$1,000,000	(\$8,000,000)
			Partner C	\$1,000,000	(\$8,000,000)
			Partner D	\$1,000,000	(\$8,000,000)
Total	\$4,000,000	\$4,000,000	Total	\$4,000,000	(\$32,000,000)

Each partner's "negative capital" and "negative basis" problem is even larger.

Phase Three: Revalue and “Book-Up”

- The partners agree to revalue (“book-up”) the partnership assets to their fair market values
- The partners also agree to adjust (“book-up”) capital accounts accordingly (as if all assets were sold for fair market value and resulting gain (or loss) is allocated to the partners according to the partnership agreement)
- According to the revaluation of the partnership assets, the Land and the Building have doubled in value
- As a result of the revaluation and book-up, the balance sheet...

ABCD Partnership 2020 “Booked-Up Balance Sheet”					
Assets			Nonrecourse Liabilities		
	Tax Basis	Book Value			Amount Outstanding
Land	\$4,000,000	\$8,000,000	A's Share		\$9,000,000
Building	\$0	\$72,000,000	B's Share		\$9,000,000
			C's Share		\$9,000,000
			D's Share		\$9,000,000
			Total		\$36,000,000
			Partner Equity		
				Outside Basis	Capital Account
			Partner A	\$1,000,000	\$11,000,000
			Partner B	\$1,000,000	\$11,000,000
			Partner C	\$1,000,000	\$11,000,000
			Partner D	\$1,000,000	\$11,000,000
Total	\$4,000,000	\$80,000,000	Total	\$4,000,000	\$44,000,000

The “book-up” erases the negative capital account balances, but the “negative basis” issue remains.

Phase Three: Revalue and Refinance

- As a result of the revaluation, ABCD now has \$44 mil. of “net equity” in the project (\$80 Mil. for Land and Building less \$36 Mil. in nonrecourse debt)
- ABCD negotiates with the bank to refinance the existing loan and increase the nonrecourse debt to \$74 Mil.
- This provides ABCD with an additional \$38 mil. of cash
- As a result of the refinancing, the balance sheet...
- The partners have a decision to make about the \$38 mil. of cash...

ABCD Partnership 2020 “Refinanced Balance Sheet”					
Assets			Nonrecourse Liabilities		
	Tax Basis	Book Value			Amount Outstanding
Land	\$4,000,000	\$8,000,000	A’s Share		\$18,500,000
Building	\$0	\$72,000,000	B’s Share		\$18,500,000
Cash	\$38,000,000	\$38,000,000	C’s Share		\$18,500,000
			D’s Share		\$18,500,000
			Total		\$74,000,000
			Partner Equity		
				Outside Basis	Capital Account
			Partner A	\$10,500,000	\$11,000,000
			Partner B	\$10,500,000	\$11,000,000
			Partner C	\$10,500,000	\$11,000,000
			Partner D	\$10,500,000	\$11,000,000
Total	\$42,000,000	\$118,000,000	Total	\$42,000,000	\$44,000,000

The addition of cash increases each partner’s outside basis (but not capital account because of the offsetting debt).

Phase Four: Distribute Tax-Free

- Rather than using the funds to improve the property, ABCD Partnership decides to distribute \$38 mil. of cash
- Each of the partners receive \$9.5 mil. of tax-free
- As a result of the revaluation, book-up, refinancing, and tax-free distribution...

ABCD Partnership 2020 "Tax-Free Distribution Balance Sheet"					
Assets			Nonrecourse Liabilities		
	Tax Basis	Book Value			Amount Outstanding
Land	\$4,000,000	\$8,000,000	A's Share		\$18,500,000
Building	\$0	\$72,000,000	B's Share		\$18,500,000
Cash	\$0	\$0	C's Share		\$18,500,000
			D's Share		\$18,500,000
			Total		\$74,000,000
			Partner Equity		
				Outside Basis	Capital Account
			Partner A	\$1,000,000	\$1,500,000
			Partner B	\$1,000,000	\$1,500,000
			Partner C	\$1,000,000	\$1,500,000
			Partner D	\$1,000,000	\$1,500,000
Total	\$4,000,000	\$80,000,000	Total	\$4,000,000	\$6,000,000

Because the additional nonrecourse debt was reflected in outside basis, the distribution reduces outside basis (but not below zero) and capital account.

Taxable Sale, No Like-Kind Exchange

- A, B, C, and D are anxious to do some tax planning, so they first consider selling the Building and Land in a taxable sale with no like-kind exchange...
- A, B, C, and D understand they can't do a taxable sale for cash and liquidate their interests in ABCD partners, and they turn their attention to other types of planning.
- Each partner decides to do something different...

SUMMARY OF TAXABLE SALE AFTER TAX CASH FLOW		
SALES PROCEEDS		\$80,000,000
LOAN REPAYMENT		(\$74,000,000)
INCOME TAXES		
§ 1245 Recapture (37%)	\$7,200,000	(\$2,736,000)
§ 1250 Recapture (25%)	\$28,800,000	(\$7,200,000)
Long-Term Capital Gain (20%)	\$40,000,000	(\$8,000,000)
State Income Tax (6%)	\$76,000,000	(\$4,560,000)
	TOTAL	(\$16,496,000)

Based on an \$80 mil. sale, the amount each partner would receive on liquidation of ABCD Partnership \$1.5 each (\$6 mil. in total). That would require the partners to come up more than \$10 mil. to pay the bank and resulting income taxes.

Partner A: Death, Step-Up, and the Inside Basis Adjustment

- Partner A decides to hold on to the partnership interest until death
- Assuming a 33.33% valuation discount, the FMV for estate tax purposes is \$1 Mil. and the estate's share of partnership liabilities is \$18.5 Mil.
- The outside basis of the partnership is adjusted to \$19.5 Mil.
- Without a section 754 election in place, the balance sheet would look...

ABCD Partnership Death of Partner A "Balance Sheet"					
Assets			Nonrecourse Liabilities		
	Tax Basis	Book Value			Amount Outstanding
Land	\$4,000,000	\$8,000,000	A's Share		\$18,500,000
Building	\$0	\$72,000,000	B's Share		\$18,500,000
			C's Share		\$18,500,000
			D's Share		\$18,500,000
			Total		\$74,000,000
			Partner Equity		
				Outside Basis	Capital Account
			A's Estate	\$19,500,000 (+\$18,500,000)	\$1,500,000
			Partner B	\$1,000,000	\$1,500,000
			Partner C	\$1,000,000	\$1,500,000
			Partner D	\$1,000,000	\$1,500,000
Total	\$4,000,000	\$80,000,000	Total	\$22,500,000 (+\$18,500,000)	\$6,000,000

Fair market value of the partnership interest is \$1.0 Mil. and with an \$8.5 Mil. share of partnership liabilities the outside basis is "stepped-up" to \$19.5 Mil.

Partner A: Death, Step-Up, and the Inside Basis Adjustment

- ABCD makes a section 754 election in the year of A's death...
- The inside basis of the partnership assets to the Land and Building is adjusted upward by \$18.5 Mil. under section 734(b)
- Under section 755, the recapture (§ 1245) on the accelerated depreciation (\$7.2 Mil.) is considered ordinary income property
- Remaining § 734(b) adjustment is allocated between the Land and the Building based on unrealized appreciation and relative fair market values...

ABCD Partnership (with Section 754 Election) "Balance Sheet" Death of Partner					
Assets			Nonrecourse Liabilities		
	Tax Basis	Book Value			Amount Outstanding
Land	\$4,782,609 (+\$782,609)	\$8,000,000	A's Estate		\$18,500,000
Building	\$17,717,391 (+\$17,717,391)	\$72,000,000	B's Share		\$18,500,000
			C's Share		\$18,500,000
			D's Share		\$18,500,000
			Total		\$74,000,000
			Partner Equity		
				Outside Basis	Capital Account
			A's Estate	\$19,500,000 (+\$18,500,000)	\$1,500,000
			Partner B	\$1,000,000	\$1,500,000
			Partner C	\$1,000,000	\$1,500,000
			Partner D	\$1,000,000	\$1,500,000
Total	\$22,500,000 (+\$18,500,000)	\$80,000,000	Total	\$22,500,000 (+\$18,500,000)	\$6,000,000

The inside basis adjustments only apply to A's Estate (and successors), so only the estate (and successor-in-interest) gets the benefit of additional depreciation deductions from the building of approx. \$17.7 Mil.

Partner B: Gift of the Partnership Interest

- Partner B makes a gift of the partnership interest directly to B's child
- At that time the outside basis of the partnership is \$1.0 Mil., the capital account balance is \$1.5 Mil., and B's share of partnership liabilities is (-\$18.5 Mil.)
- The transfer is covered by B's base exclusion amount (no gift tax payable)
- Under § 752(d), the disposition is treated as a part gift, part sale transfer, and B is deemed to receive an amount realized of \$18.5 Mil.
- With \$1.0 Mil. of outside basis, the gain recognized by B is \$17.5 Mil. and the resulting income tax liability is...

INCOME TAX CONSEQUENCES OF GIFT OF PARTNERSHIP INTEREST		
DEEMED NET AMOUNT RECOGNIZED		\$17,500,000
INCOME TAXES		
§ 1245 Recapture (37%)	\$1,657,895	(\$613,421)
§ 1250 Recapture (25%)	\$6,631,579	(\$1,657,895)
Long-Term Capital Gain (20%)	\$9,210,526	(\$1,842,105)
State Income Tax (6%)	\$17,500,000	(\$1,050,000)
TOTAL		(\$5,163,421)

Partner B: Gift of the Partnership Interest

- ABCD Partnership has a section 754 election in place
- As a result of this part gift, part sale transfer, the adjustment to inside basis under § 743(b) and to outside basis (no gift tax) are reflected on the balance sheet...

ABCD Partnership (with Section 754 Election) "Balance Sheet" Gift of Partnership Interest					
Assets			Nonrecourse Liabilities		
	Tax Basis	Book Value			Amount Outstanding
Land	\$4,637,681 (+\$637,681)	\$8,000,000	A's Share		\$18,500,000
Building	\$16,862,319 (+\$16,862,319)	\$72,000,000	Donee of B's Share		\$18,500,000
			C's Share		\$18,500,000
			D's Share		\$18,500,000
			Total		\$74,000,000
			Partner Equity		
				Outside Basis	Capital Account
			Partner A	\$1,000,000	\$1,500,000
			Donee of Partner B	\$18,500,000 (+\$17,500,000)	\$1,500,000
			Partner C	\$1,000,000	\$1,500,000
			Partner D	\$1,000,000	\$1,500,000
Total	\$21,500,000 (+\$17,500,000)	\$80,000,000	Total	\$21,500,000 (+\$17,500,000)	\$6,000,000

Partner C: Gift to an IDGT and then Death of the Grantor

- Partner C gifts the partnership interest to an IDGT
- The transfer is covered by C's base exclusion amount (no gift tax payable)
- Because of Rev. Rul. 85-13, there are no income tax consequences at the time of the gift
- Unfortunately, soon thereafter, C passes away, and there is a deemed transfer of the partnership interest from C as the grantor to a non-grantor trust, as a separate taxable entity
- The outside basis of the partnership interest is \$1.0 mil., and C's share of partnership liabilities is (-\$18.5 mil.)
- Part gift, part sale...

INCOME TAX CONSEQUENCES OF DEEMED TRANSFER OF PARTNERSHIP INTEREST UPON CONVERSION OF IDGT DURING C'S LIFETIME		
DEEMED NET AMOUNT RECOGNIZED		\$17,500,000
INCOME TAXES		
§ 1245 Recapture (37%)	\$1,657,895	(\$613,421)
§ 1250 Recapture (25%)	\$6,631,579	(\$1,657,895)
Long-Term Capital Gain (20%)	\$9,210,526	(\$1,842,105)
State Income Tax (6%)	\$17,500,000	(\$1,050,000)
TOTAL		(\$5,163,421)

The results for Partner C are the same as for Partner B. Deemed transfer with debt in excess of basis, \$17.5 Mil. is recognized by C's estate.

Partner D: Gift to an IDGT, Death of a Beneficiary with a GPOA

- Partner D gifts the partnership interest to an IDGT
- The IDGT grants D's father with a testamentary general power of appointment over the interest
- D's father **exercises** the power of appointment in favor of another trust (Trust 2)
- The partnership interest is included in the gross of estate of D's father (\$1.0 Mil.- 33.33% valuation deduction)
- Assuming ABCD Partnership has a section 754 election in place
- The resulting balance sheet...

**Treas. Reg. § 1.671-2(e)(5)
and § 1.671-2(e)(6), Ex. 9**

ABCD Partnership (with Section 754 Election) "Balance Sheet" <i>Exercise of a General Power of Appointment</i>					
Assets			Nonrecourse Liabilities		
	Tax Basis	Book Value			Amount Outstanding
Land	\$4,782,609 (+\$782,609)	\$8,000,000	A's Share		\$18,500,000
Building	\$17,717,391 (+\$17,717,391)	\$72,000,000	B's Share		\$18,500,000
			C's Share		\$18,500,000
			Trust 2		\$18,500,000
			Total		\$74,000,000
			Partner Equity		
				Outside Basis	Capital Account
			Partner A	\$1,000,000	\$1,500,000
			Partner B	\$1,000,000	\$1,500,000
			Partner C	\$1,000,000	\$1,500,000
			Trust 2	\$19,500,000 (+\$18,500,000)	\$1,500,000
Total	\$22,500,000 (+\$18,500,000)	\$80,000,000	Total	\$22,500,000 (+\$18,500,000)	\$6,000,000

The results in this instance are essentially the same as when Partner A died owning the interest. The benefits of the inside basis adjustment would be shared by Trust 2, whose beneficiaries could include Partner D.

Partner D: Gift to an IDGT, Death of a Beneficiary with a GPOA

- Partner D gifts the partnership interest to an IDGT
- The IDGT grants D's father with a testamentary general power of appointment over the interest
- D's father lets the power of appointment of appointment *lapse* while D is still alive
- The partnership interest is included in the gross of estate of D's father (\$1.0 Mil.)
- Assuming ABCD Partnership has a section 754 election in place
- The resulting balance sheet...

ABCD Partnership (with Section 754 Election) "Balance Sheet" <i>Lapse of a General Power of Appointment</i>					
Assets			Nonrecourse Liabilities		
	Tax Basis	Book Value			Amount Outstanding
Land	\$4,000,000	\$8,000,000	A's Share		\$18,500,000
Building	\$0	\$72,000,000	B's Share		\$18,500,000
			C's Share		\$18,500,000
			IDGT (D)		\$18,500,000
			Total		\$74,000,000
			Partner Equity		
				Outside Basis	Capital Account
			Partner A	\$1,000,000	\$1,500,000
			Partner B	\$1,000,000	\$1,500,000
			Partner C	\$1,000,000	\$1,500,000
			IDGT (D)	\$1,000,000	\$1,500,000
Total	\$4,000,000	\$80,000,000	Total	\$4,000,000	\$6,000,000

The estate of D's father is entitled to a basis adjustment, but with the valuation discount and the fact that **D continues to be the owner of the partnership interest, the estate of D's father does not get any share of the partnership liabilities.** Even with a section 754 election in place, there is no § 743(b) net adjustment because outside basis (\$1.0 Mil.) was already equal to the partner's proportionate share of the inside basis (\$1.0 Mil.) of the partnership property.

Summary of the Options and Important Caveat

SUMMARY OF OPTIONS		
	Inside Basis Adjustment	Tax Cost
Death of Partner	\$18,500,000	\$400,000 Estate Tax (Max.)
Gift of Interest	\$17,500,000	\$5,163,421 Income Tax
Gift to IDGT (Death of Grantor)	\$17,500,000	\$5,163,421 Income Tax
Gift to IDGT (Exercise of GPOA)	\$18,500,000	\$400,000 Estate Tax (Max.)
Gift to IDGT (Lapse of GPOA)	\$0	\$400,000 Estate Tax (Max.)

CAVEAT:

IRS could argue with the exercise of the testamentary GPOA, there is a transfer from the grantor to the power holder first before inclusion in the power holder's estate, causing a recognition of gain as a part gift, part sale

Section 743(b) Inside Basis Adjustments: Problems

- **Administratively Burdensome:** adjustments are “notional” or “hypothetical” requiring separate calculations
- **Irrevocable:** Once section 754 election is made, it is irrevocable unless IRS allows revocation
- **Lose Inside Basis if:**
 - Unrealized losses in the partnership property prior to death (even if outside basis gets a “step-up” in basis)
 - Outside basis is greater than the basis adjustment at death (even if **due to valuation discounts**)
 - Loss of inside basis is doubled if the partnership interest is community property
- **Blunt Instrument:**
 - Inside basis adjustment is spread across all of the partnership assets according to a formula
 - Does not allow planners to proactively place basis in the optimal manner

Section 743(b) Mandatory Inside Basis Adjustment if “Substantial Built-In Loss”

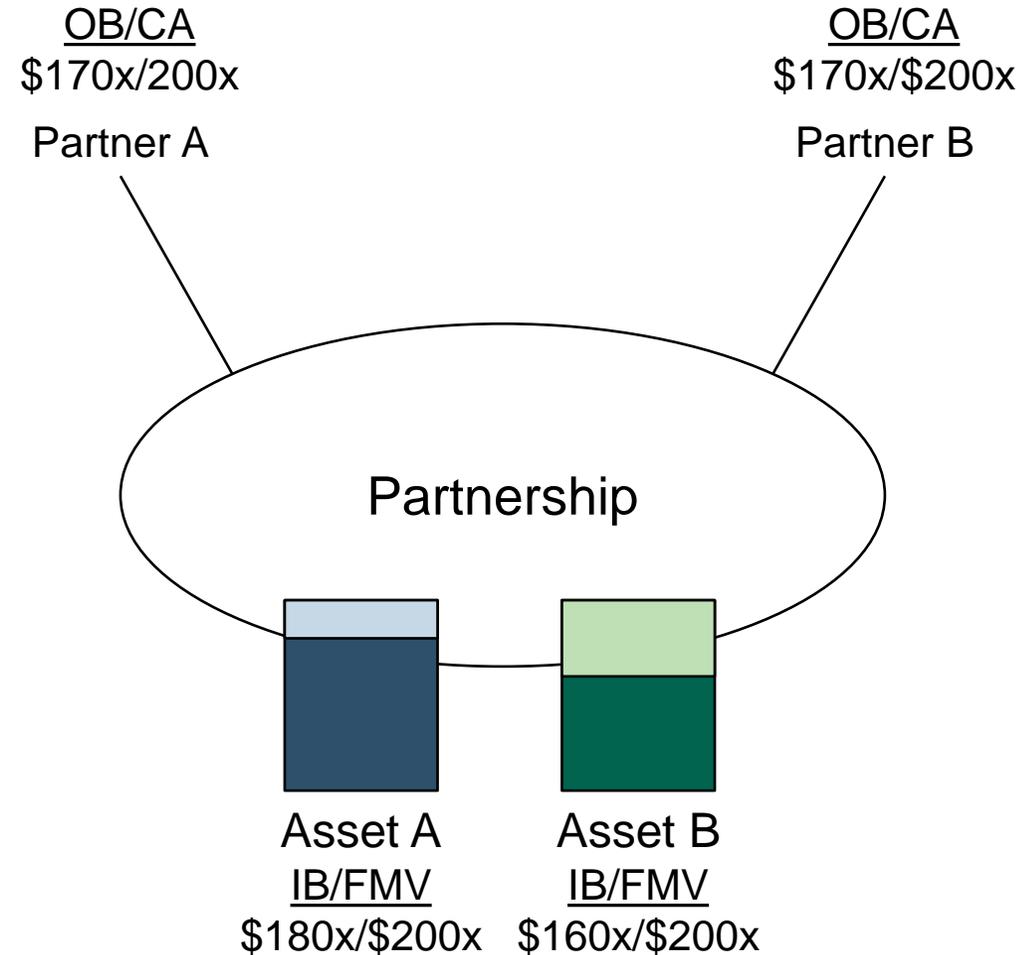
A partnership has a “substantial built-in loss” if, immediately after a transfer of a partnership interest:

- **Partnership’s** total inside bases in partnership property exceeds by more than \$250,000 the total fair market value of such properties; or
- **Transferee** would be allocated more than \$250,000 in loss if all partnership assets are sold for fair market value.

THE PROBLEM WITH
VALUATION DISCOUNTS
AND
THE INSIDE BASIS ADJUSTMENT

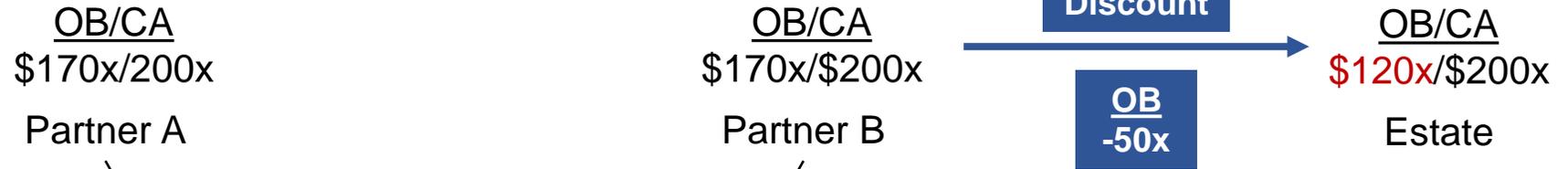
Valuation Discounts May Cause a “Step-Down” in Basis

Prior to the death of Partner B, the partnership is situated, as follows:

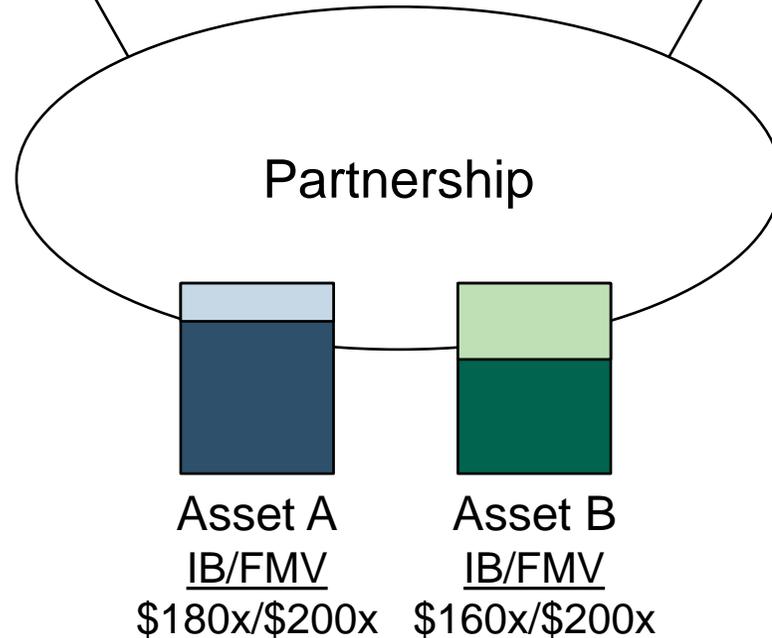


Valuation Discounts Can Cause a “Step-Down” in Basis

Partner B passes away. *With no section 754 election...*



With no inside basis adjustment, the estate's 50% share of partnership gain remains at \$30x, but the gain reflected in the outside basis of the estate (in comparison to capital account) is \$80x.

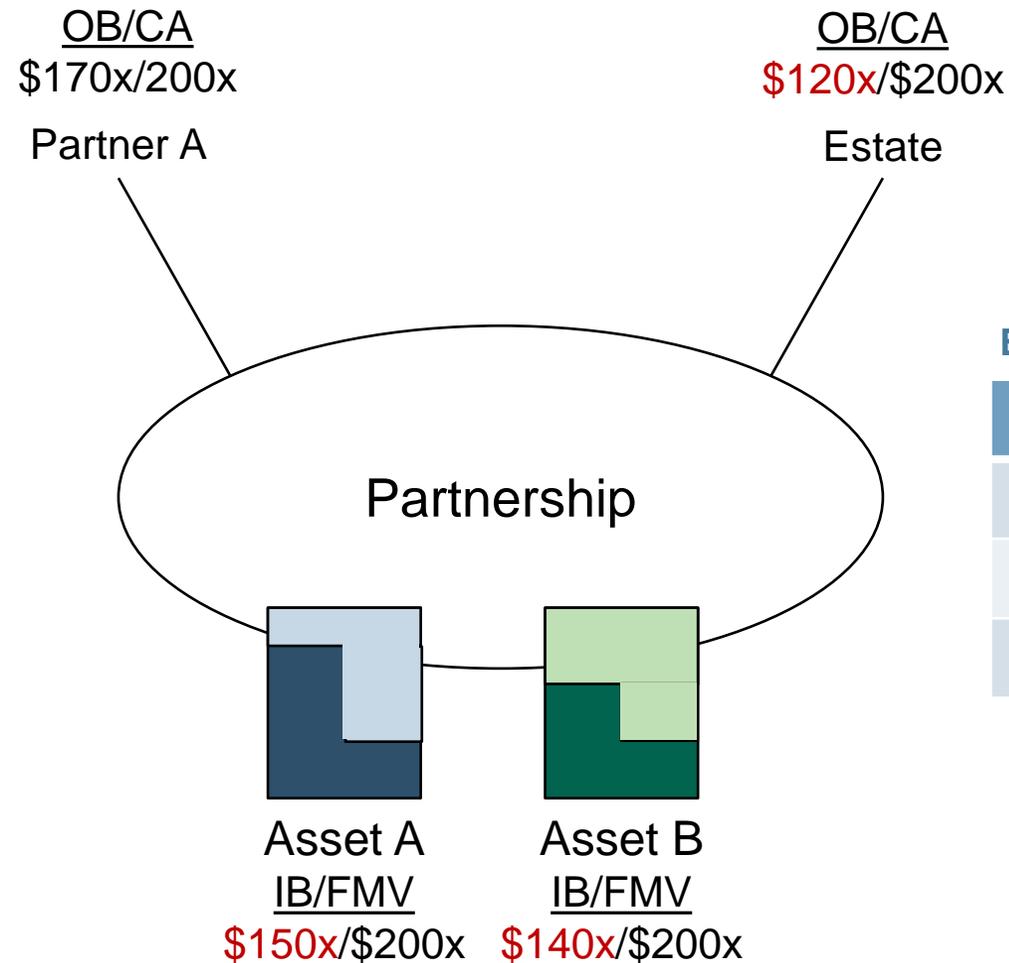


EACH PARTNER'S SHARE OF INSIDE BASIS

Basis	Partner A	Estate	Totals
Asset A	\$90x	\$90x	\$180x
Asset B	\$80x	\$80x	\$160x
Totals	\$170x	\$120x	\$290x

Valuation Discounts Can Mean May Cause a “Step-Down” in Basis

Partner B passes away. *If the partnership has a section 754 election in place...*



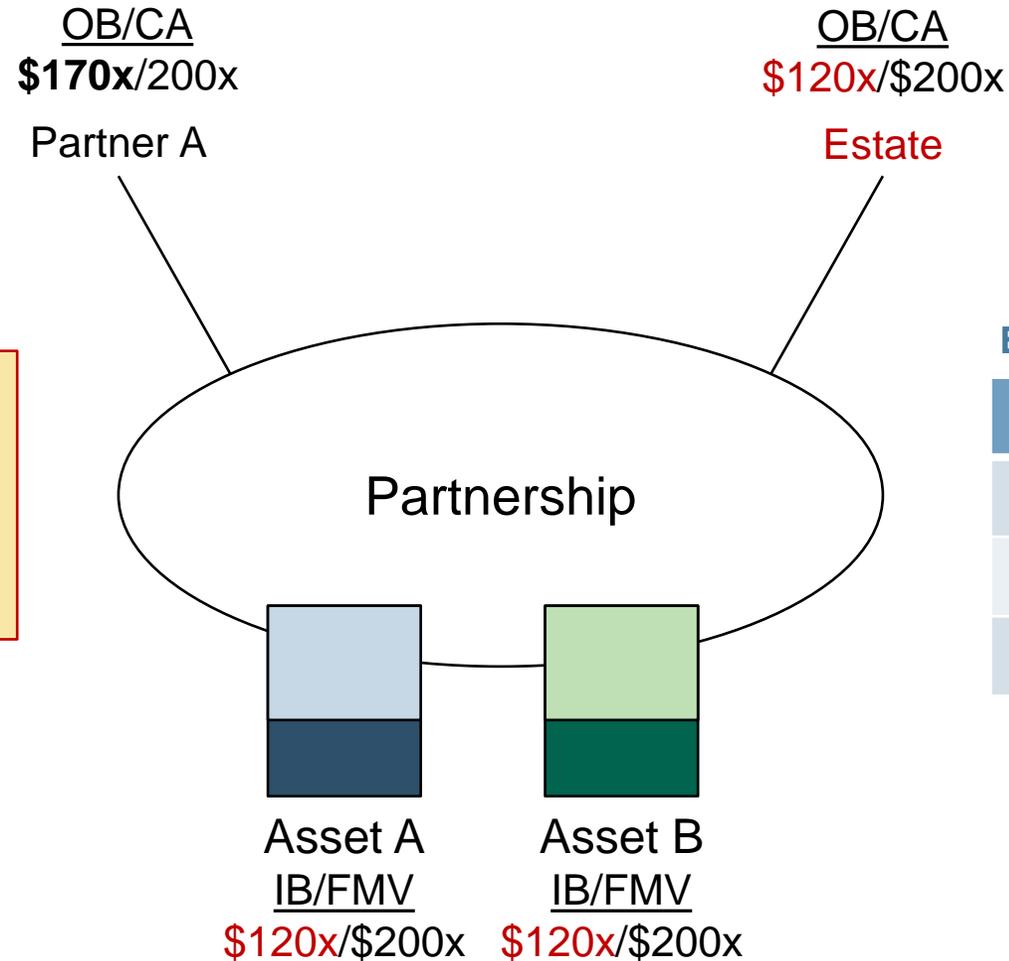
EACH PARTNER'S SHARE OF INSIDE BASIS

Basis	Partner A	Estate	Totals
Asset A	\$90x	\$60x	\$150x
Asset B	\$80x	\$60x	\$140x
Totals	\$170x	\$120x	\$290x

Valuation Discounts Can Mean May Cause a “Step-Down” in Basis

Partner B passes away. *If Partner B and Partner A were married, and they held as community property...*

Outside basis for the surviving spouse remains the same. The reduction inside basis can be “cured” by liquidating Partner A’s partnership interest.



EACH PARTNER’S SHARE OF INSIDE BASIS

Basis	Partner A	Estate	Totals
Asset A	\$60x	\$60x	\$120x
Asset B	\$60x	\$60x	\$120x
Totals	\$120x	\$120x	\$240x

Wild Cards: Unrealized Losses, Valuation Discounts & Liabilities

- PARTNERSHIP PROPERTY WITH UNREALIZED LOSSES

- With a section 754 election in effect, inside basis will be reduced
- May trigger a mandatory inside basis adjustment even without a section 754 election
- Consider distributions of built-in loss or recognizing the losses prior to death

- PARTNERSHIP LIABILITIES

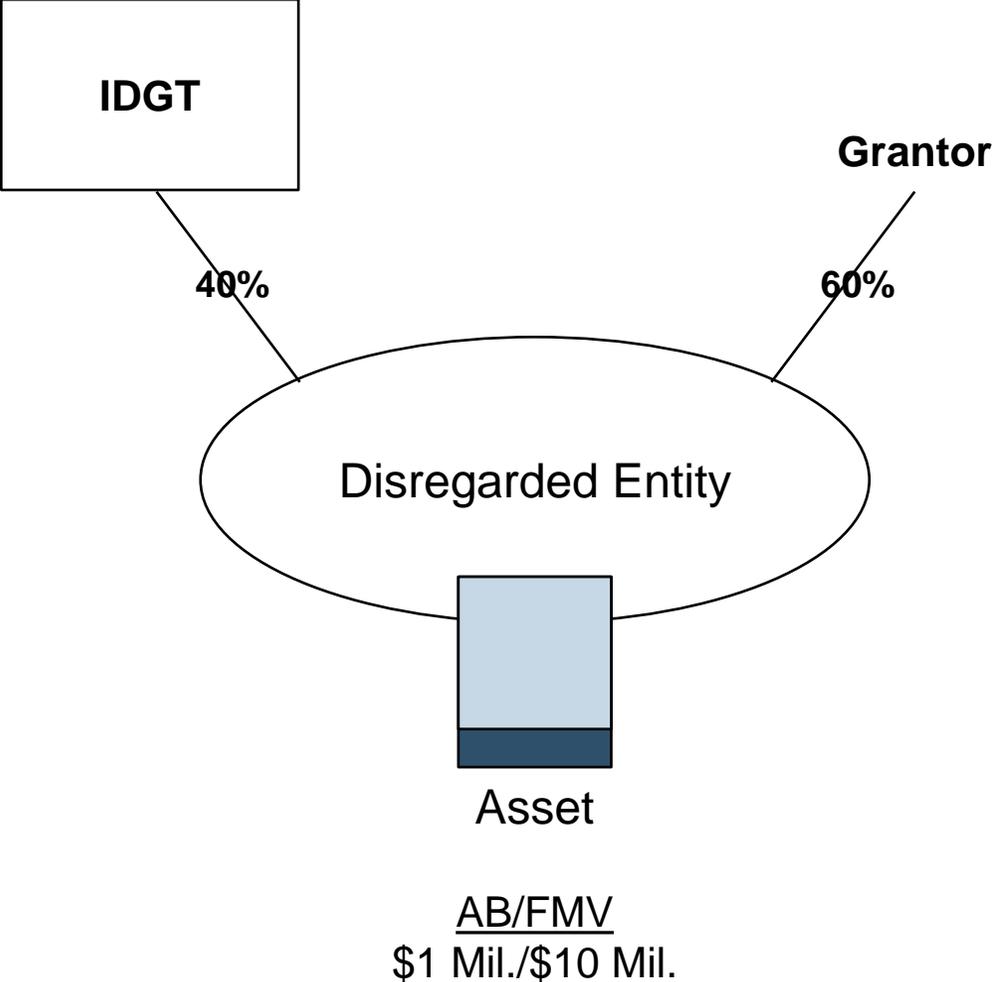
- If a partner's share of liabilities are greater than outside basis, deemed transfers from IDGTs to non-grantor trusts will cause recognition of gain
- Increase outside basis adjustment at death
- Be wary of recourse debts of a decedent which might become recourse as to other partners (surviving spouse) or nonrecourse

- HIGH VALUATION DISCOUNTS

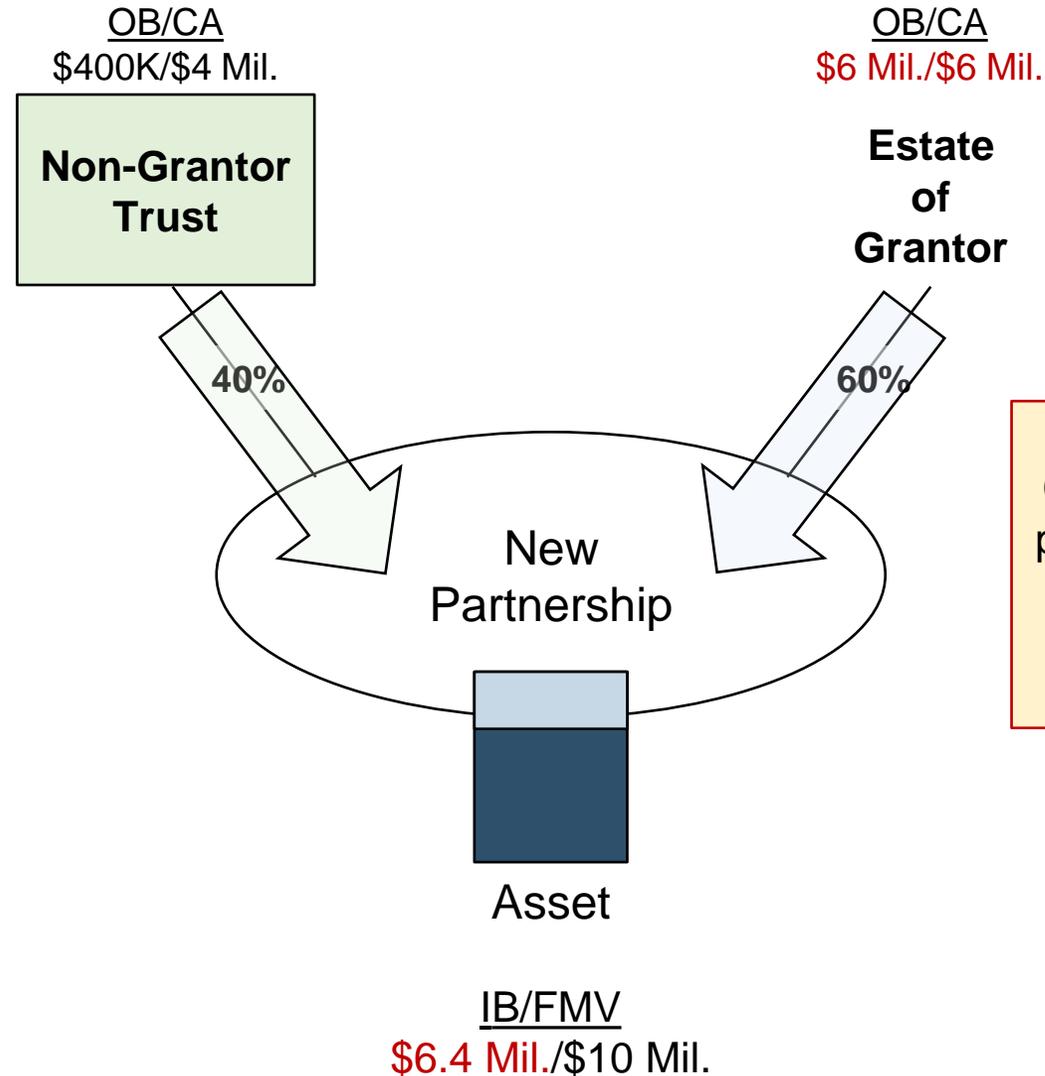
- Reduce the outside basis adjustment at death
- May cause a reduction in inside basis

INTEREST TRANSFERS
THAT ARE REALLY
TRANSFERS OF PROPERTY

Conversions of Disregarded Entities to Partnerships at Death



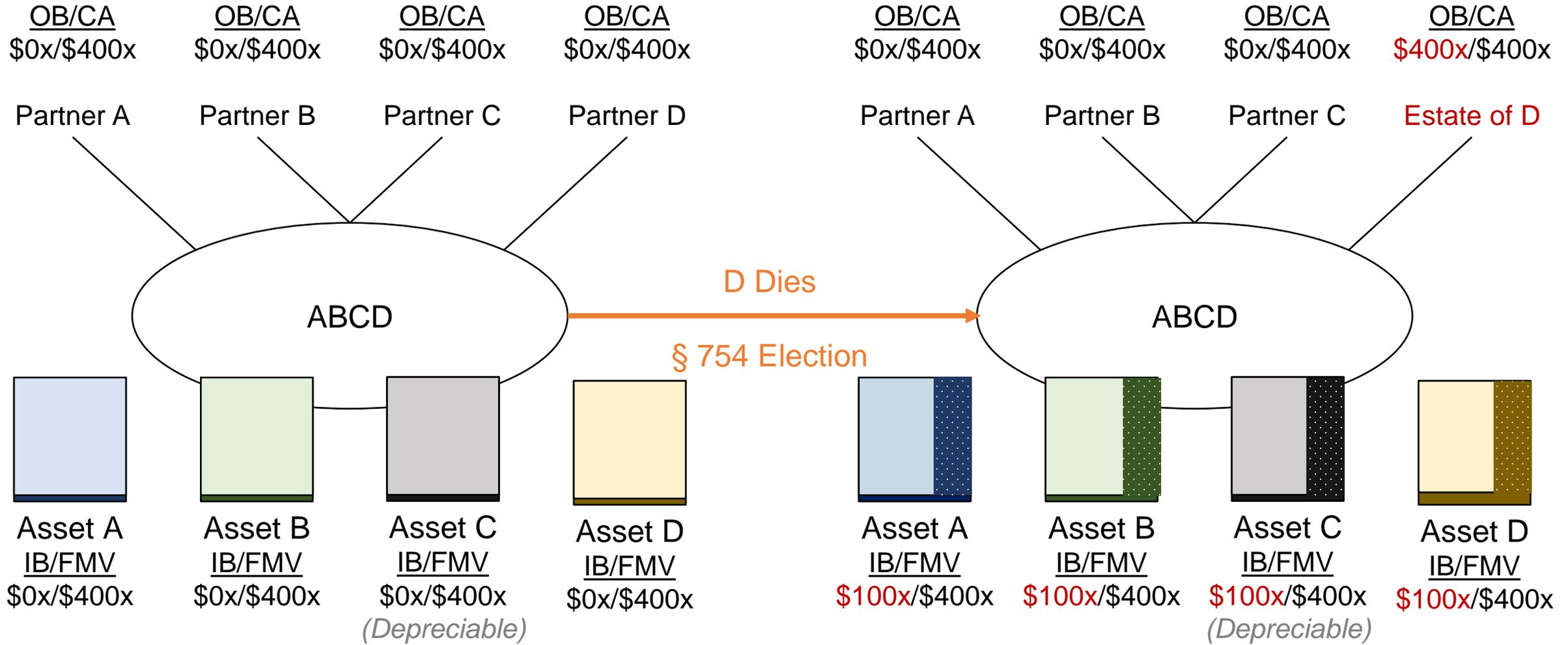
Conversions of Disregarded Entities to Partnerships at Death



Rev. Rul. 99-5
Conversion of a disregarded entity to a partnership, created by a transfer (sale) of an LLC Interest to another taxpayer is treated as a purchase of assets and a contribution to a new partnership.

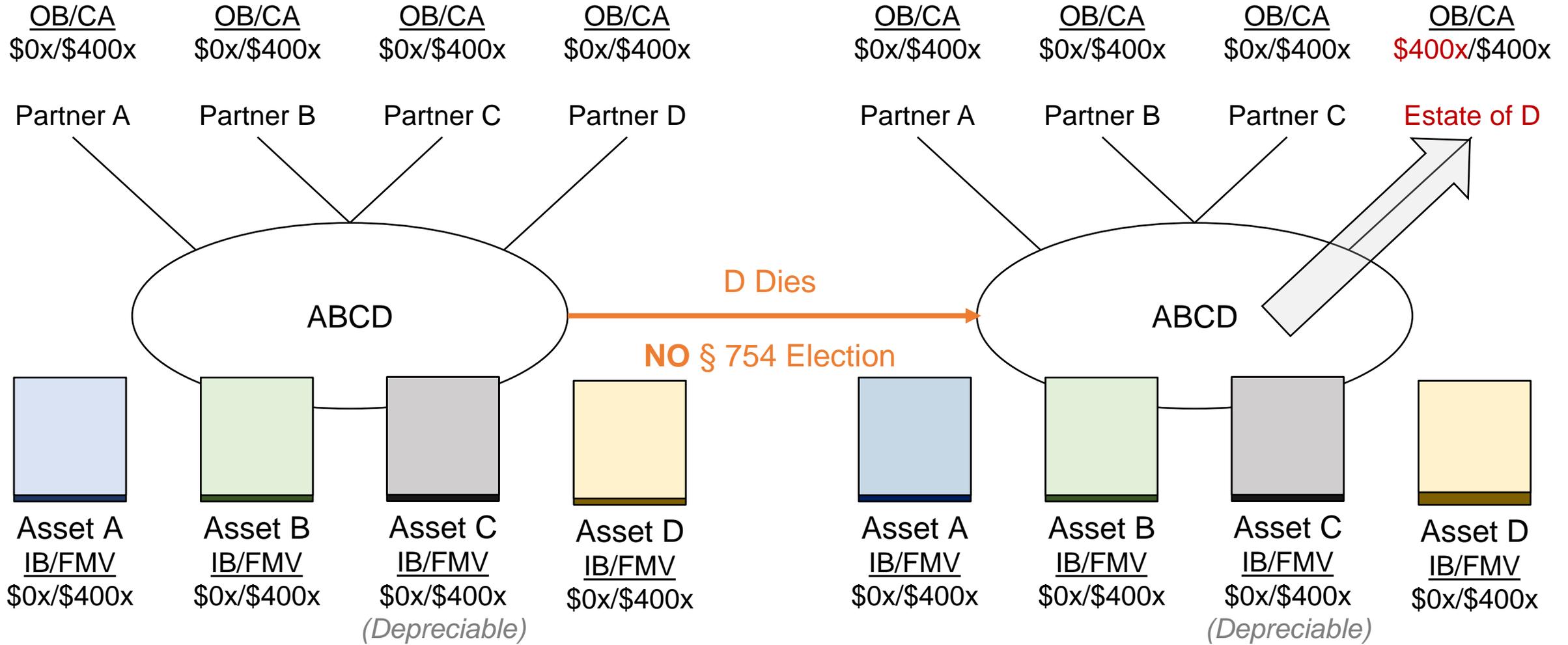
AVOIDING THE
SECTION 754 ELECTION
AND THE
INSIDE BASIS ADJUSTMENT

Simple Example: Choosing the Asset to “Step-Up”

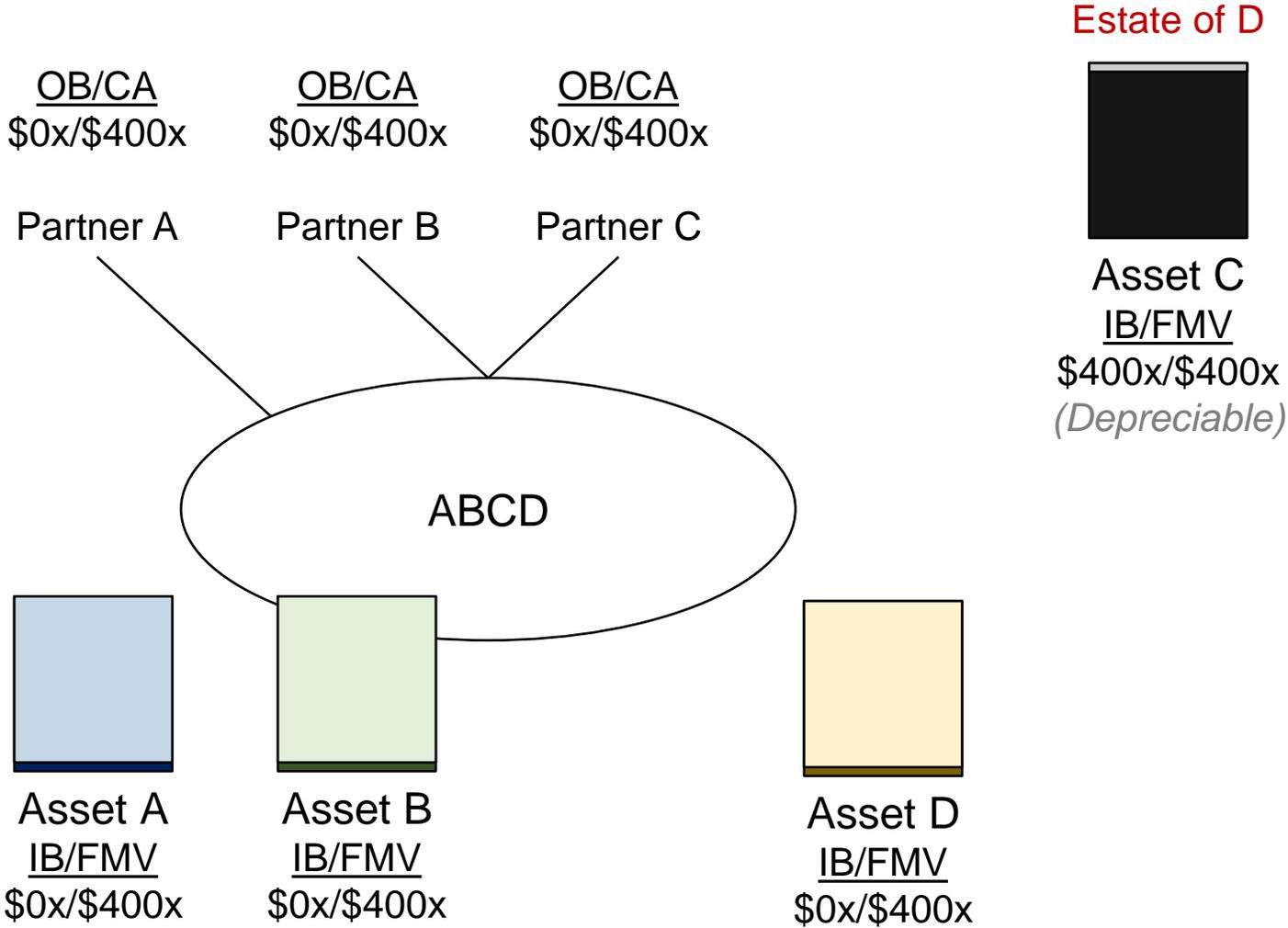


If § 743(b) adjustments were applied

Simple Example: Choosing the Asset to “Step-Up”



Simple Example: Choosing the Asset to “Step-Up”



Final Regs: Partnership Related-Party Basis Adjustment Transaction

TD 10028, 90 F.R. 2958 (January 14, 2025)

§ 1.6011-18: Certain Partnership Related-Party Basis Adjustments as Transactions of Interest

- **Section 734(b):** Distribution of property (including cash) to a person who is a related partner, and the partnership increases remaining partnership property under § 734(b)
(Distribution of High Inside Basis Property to Low Outside Basis Partner-§ 754 Election)
- **Section 732(b):** Liquidating distribution of property to a person who is related to another partner, and the basis of the distributed property is increased under § 732(b)
(Distribution of Low Inside Basis Property to High Outside Basis Partner)
- **Section 732(d):** Distribution of property to a partner who is related to another partner, and the basis of the distributed property is increased under § 732(d) and the partner acquired the interest in a “nonrecognition transfer”
(Distributions of Property with Basis as if a § 743(b) Adjustment Had been Applied-No § 754 Election)
- **Section 743(b):** Partner transfers a partnership interest to a related transferee or a person related to a partner in a “nonrecognition transfer,” and the basis of partnership property is increased under § 743(b)
(Tax-Free Transfers of Partnership Interests Increasing Inside Basis-§ 754 Election)

Transfers on the Death of a Partner:

- Partnership interest transfers from partner to partner's estate or from a grantor trust to a trust that becomes a separate entity
- NOT a Section 732(d) Transaction of Interest
- NOT a “substantially similar transaction”

Threshold Amount:

- Total basis increases (no netting for decreases) during a taxable year, reduced by gain recognized, equal or exceed \$10 mil.
- Six-year lookback of \$25 mil. for transactions before effective date of the regulations
- If threshold is met, all transactions of interest are reportable

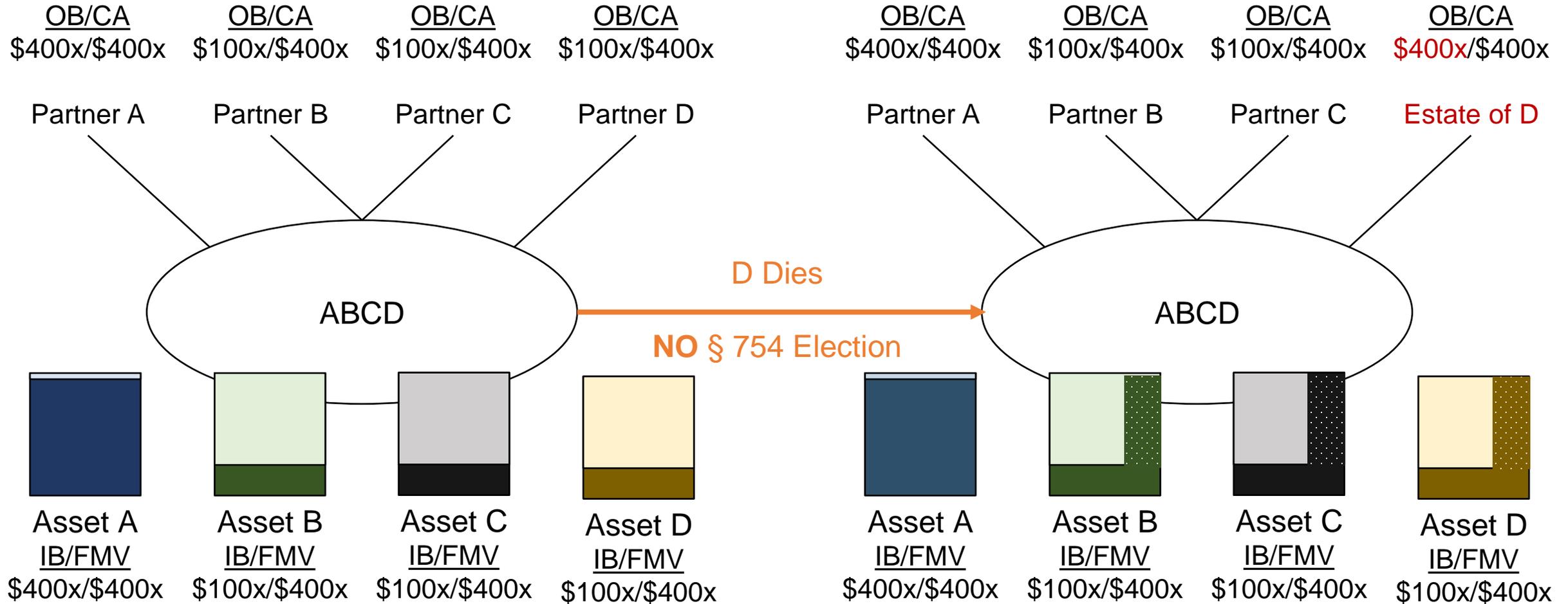
Elective Section 732(d) Distributions

- A partner
 - who acquires a partnership interest (upon the death of a partner or sale)
 - Which does not have a section 754 election is not in effect
- To whom a distribution of property is made
- Within 2 years after the transfer
- May elect
 - In the year of distribution if the property is depreciable, depletable or amortizable, or
 - If it does not include such property, until the year basis has tax significance
- To treat such property as having an adjusted basis as provided in section 743(b)

- If property is distributed to a transferee partner who elects § 732(d) and the property is not the same property that would have had an inside basis adjustment under § 743(b), then such adjustment shall apply to any “like property” received in the distribution
- Transferee must relinquish his or her interest in the property that would have received the adjustment under § 743(b)

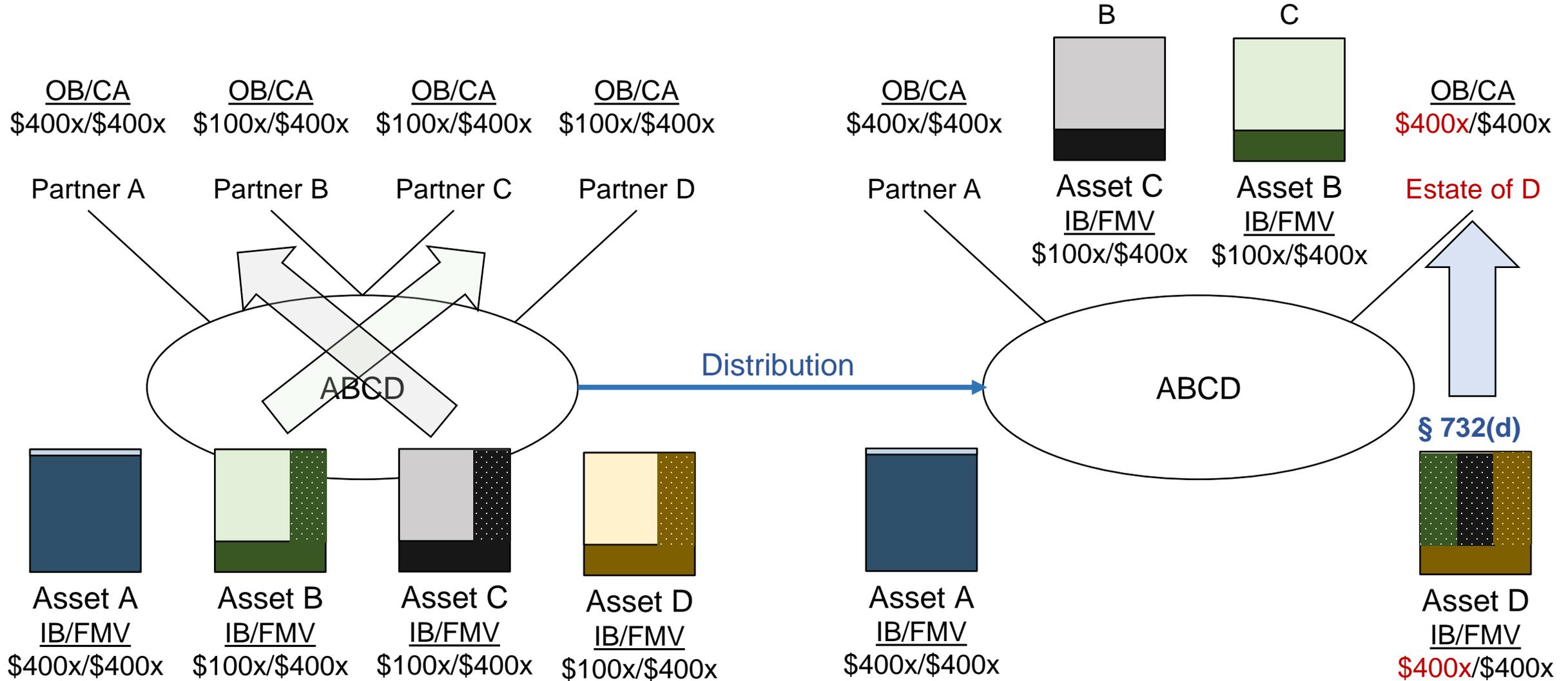
- If property that would have received an inside basis adjustment under § 743(b) is distributed to another partner, the inside basis adjustment is reallocated to the remaining partnership property

Elective Section 732(d) Distributions



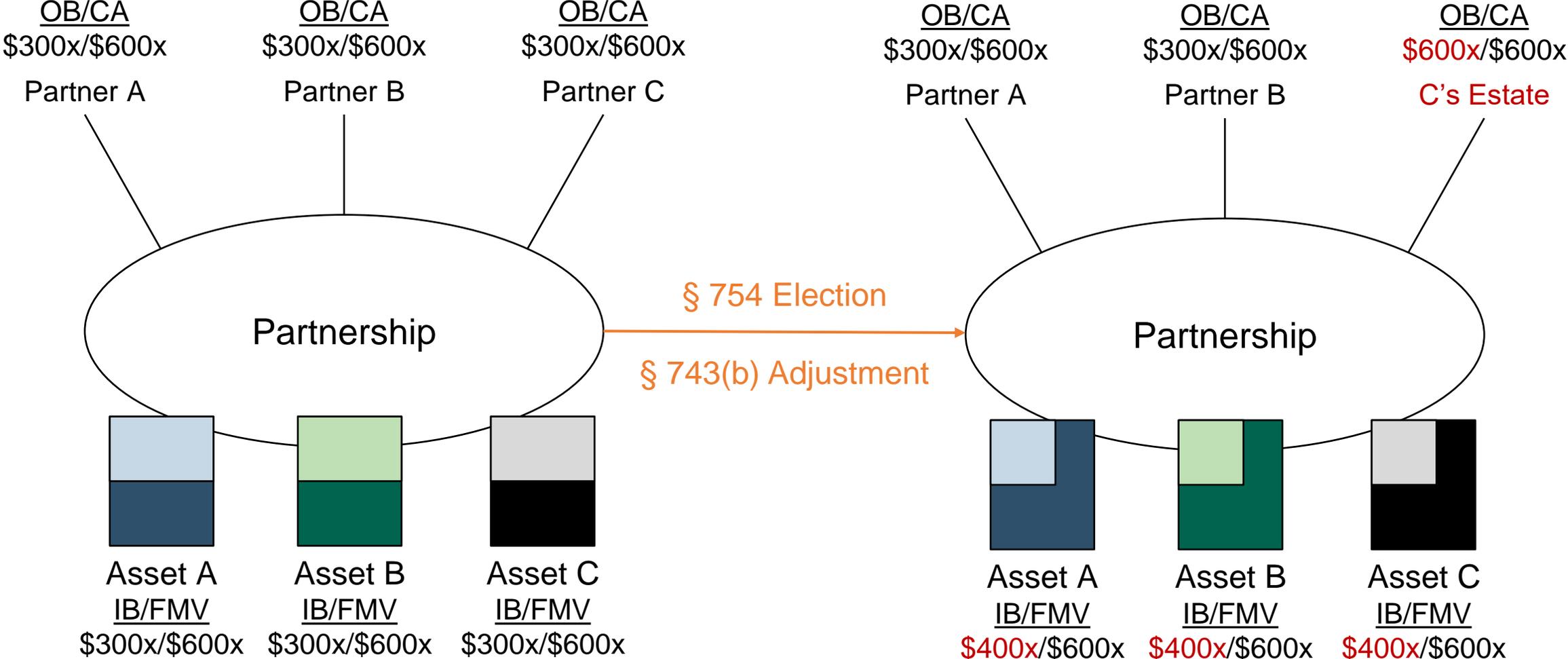
If § 743(b) adjustments were applied

Elective Section 732(d) Distributions



If § 743(b) adjustments were applied

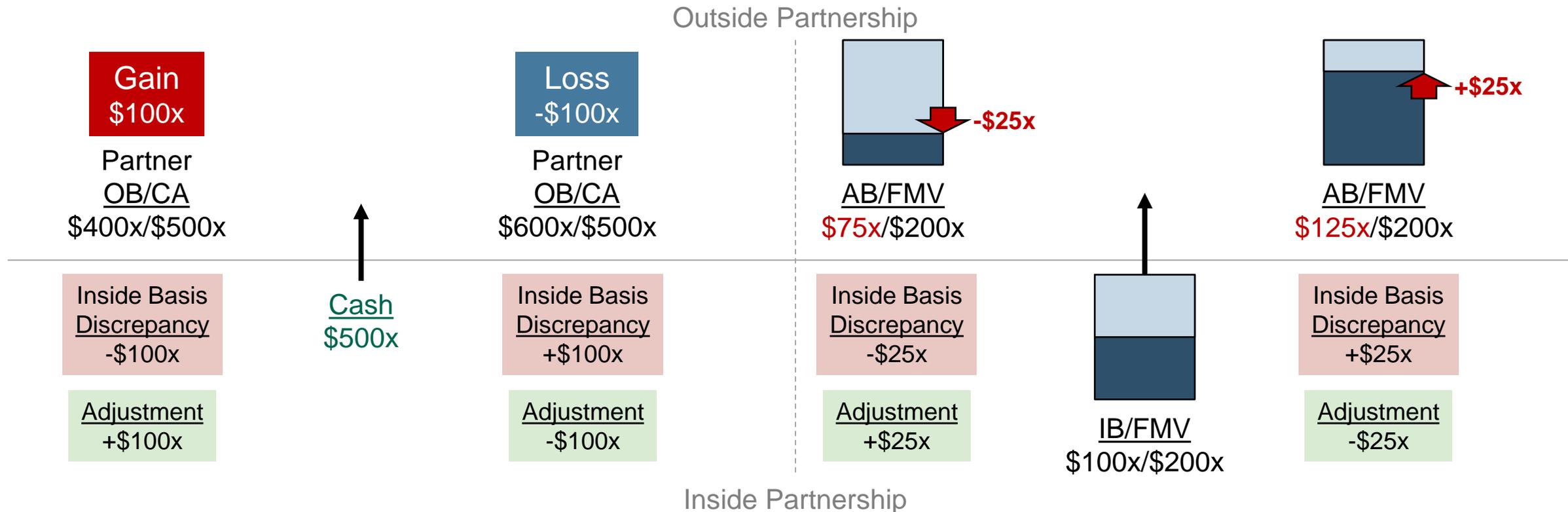
Section 743(b) Basis Adjustment Is Formulaic



Section 734: Inside Basis Adjustments (Actual)

Section 754 election allows the partnership to adjust the inside basis of assets under section 734 when there is:

- **Distribution** of cash resulting in gain or loss; and
- **Distribution** of property resulting in a change of basis;



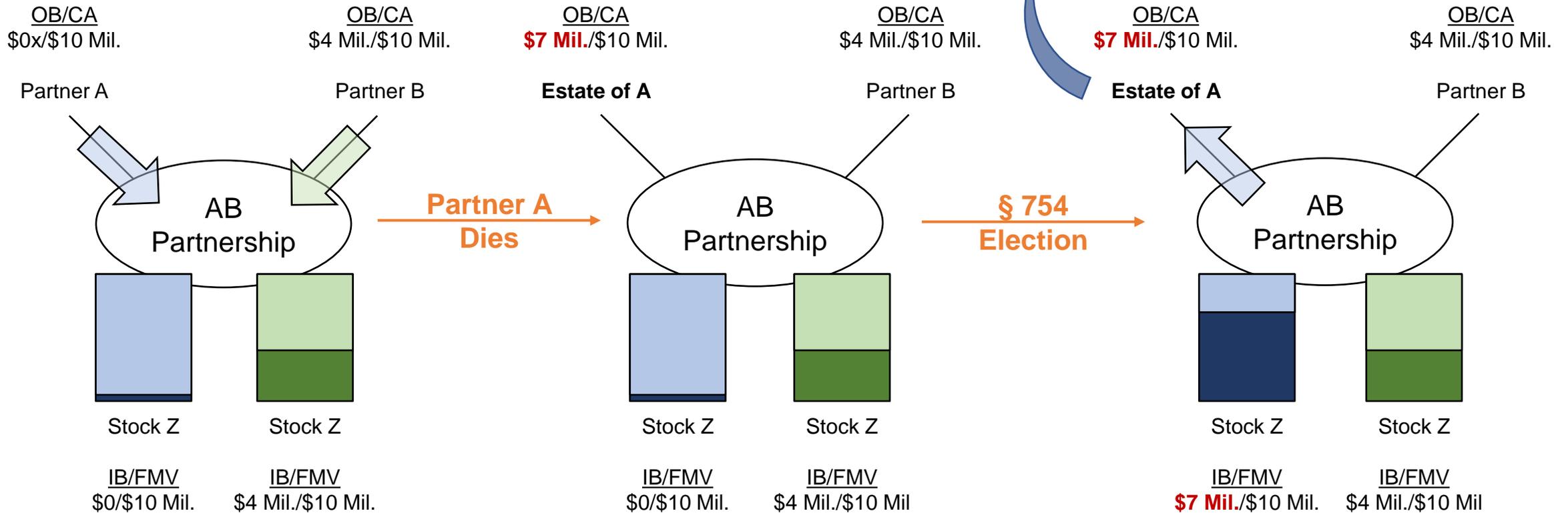
Mandatory inside basis adjustment required, if:

- Basis of distributed asset (in liquidation) is **increased** by more than **\$250,000**;
- Partner recognizes a **loss** of more than **\$250,000**; or
- A combination of the two.

“STAGGERING DISTRIBUTIONS”
IN THE ABSENCE
OF THE SECTION 754 ELECTION

Inside Basis Adjustment at Death Is a Blunt Instrument

30%
Valuation
Discount



Beneficiary (C):
Donates \$5 Mil. to Charity
Sells \$5 Mil. to Diversify

Section 743(b)
Inside Basis
Adjustment

No Section 754 Election: "Staggering Distributions"

30%
Valuation
Discount

OB/CA
\$0x/\$10 Mil.

OB/CA
\$4 Mil./\$10 Mil.

OB/CA
\$7 Mil./\$10 Mil.

OB/CA
\$4 Mil./\$10 Mil.

OB/CA
\$7 Mil./\$5 Mil.

OB/CA
\$4 Mil./\$10 Mil.

Partner A

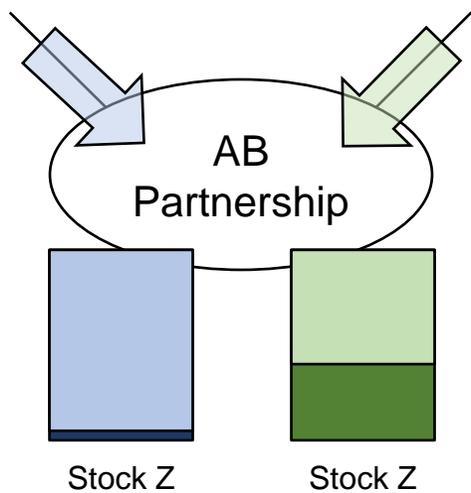
Partner B

Estate of A

Partner B

Estate of A

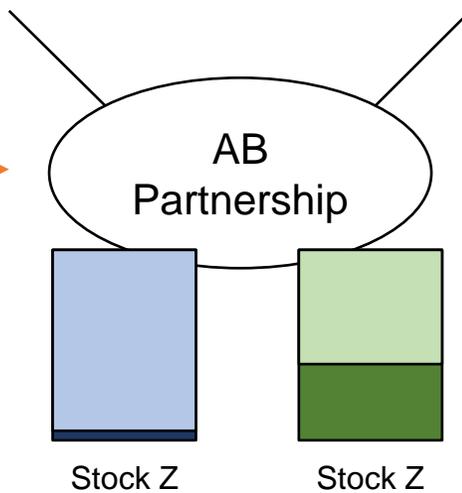
Partner B



IB/FMV
\$0/\$10 Mil.

IB/FMV
\$4 Mil./\$10 Mil.

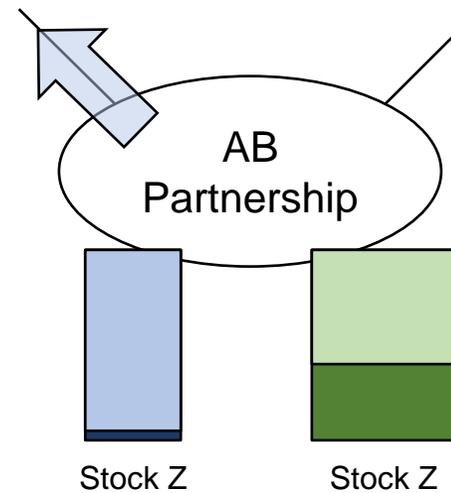
Partner A Dies



IB/FMV
\$0/\$10 Mil.

IB/FMV
\$4 Mil./\$10 Mil.

Current Distribution



IB/FMV
\$0/\$5 Mil.

IB/FMV
\$4 Mil./\$10 Mil.

Estate Distribution



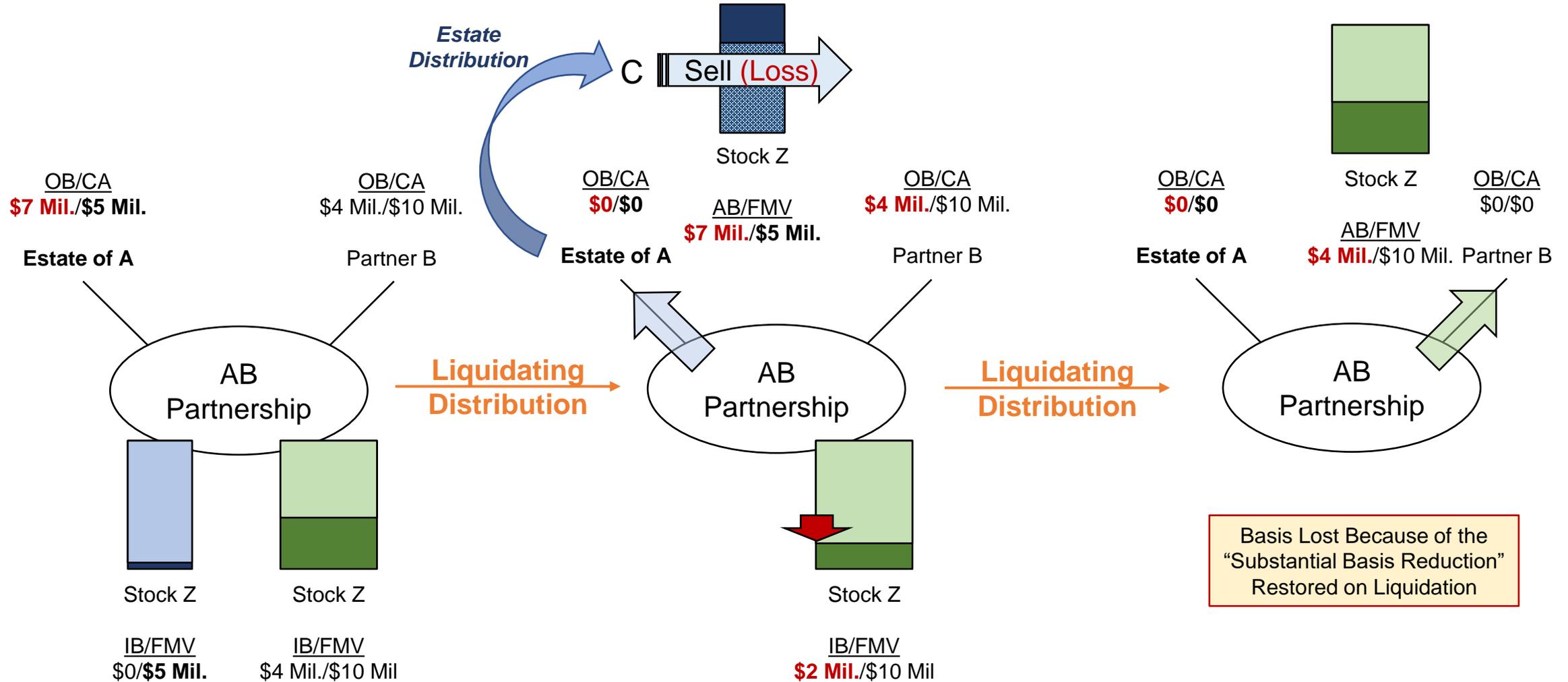
C

Charity

Stock Z

AB/FMV
\$0/\$5 Mil.

No Section 754 Election: "Staggering Distributions"



"Substantial Basis Reduction"
Mandatory Section 734(b)
Inside Basis Adjustment

Basis Lost Because of the
"Substantial Basis Reduction"
Restored on Liquidation

Inside Basis Adjustment v. “Staggering Distributions”

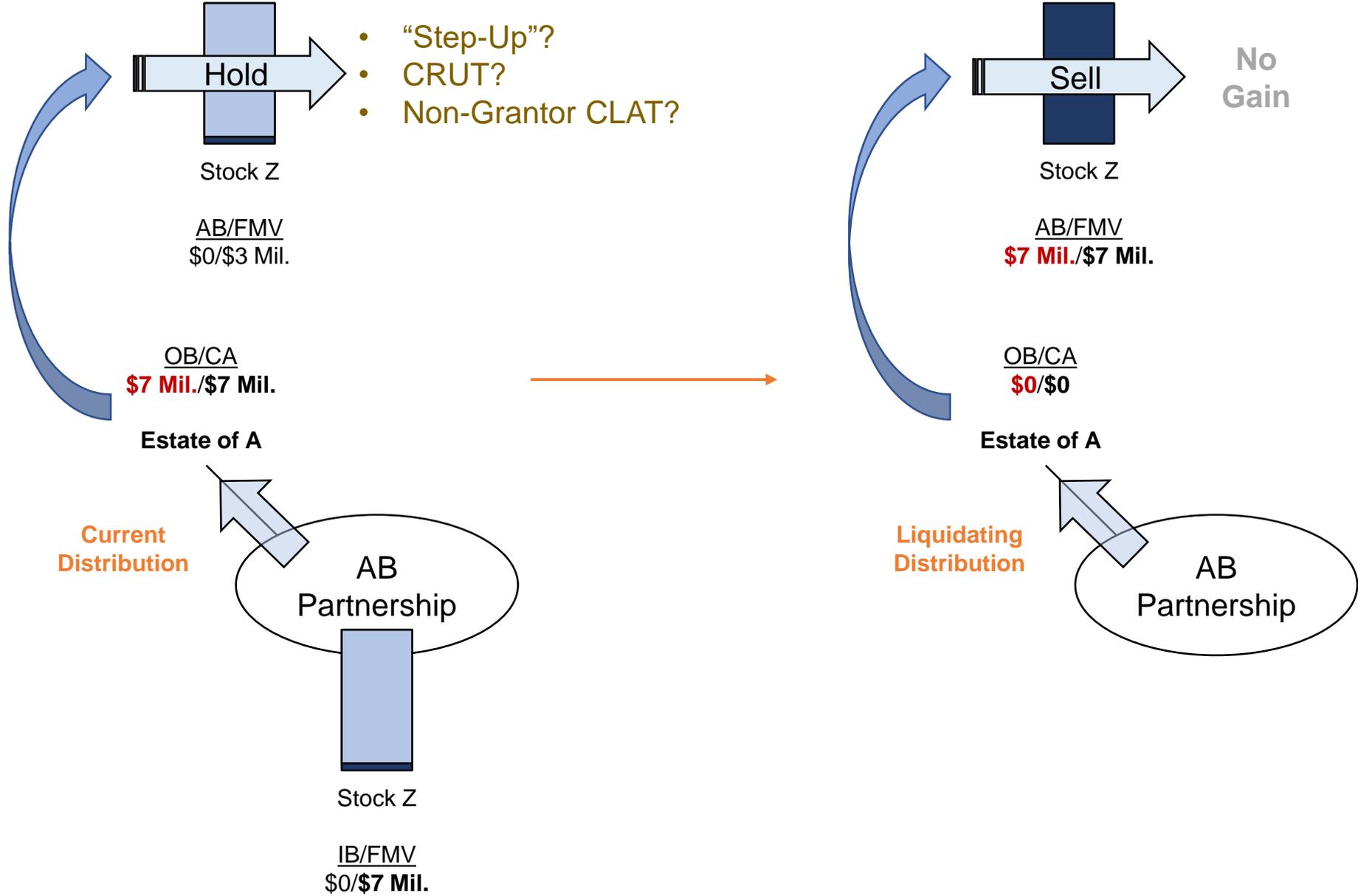
SUMMARY OF THE SECTION 743(b) INSIDE BASIS ADJUSTMENT	
Savings Due to \$5 Mil. Charitable Deduction @ 37.0% Rate	\$1,850,000
Unrecognized Gain of \$1.5 Mil. Due to Charitable Donation @ 23.8% Rate	\$357,000
\$1.5 Mil. Recognized Capital Gain Tax on \$5 Mil. Sale of Stock Z @ 23.8%	(\$357,000)
Total Net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

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

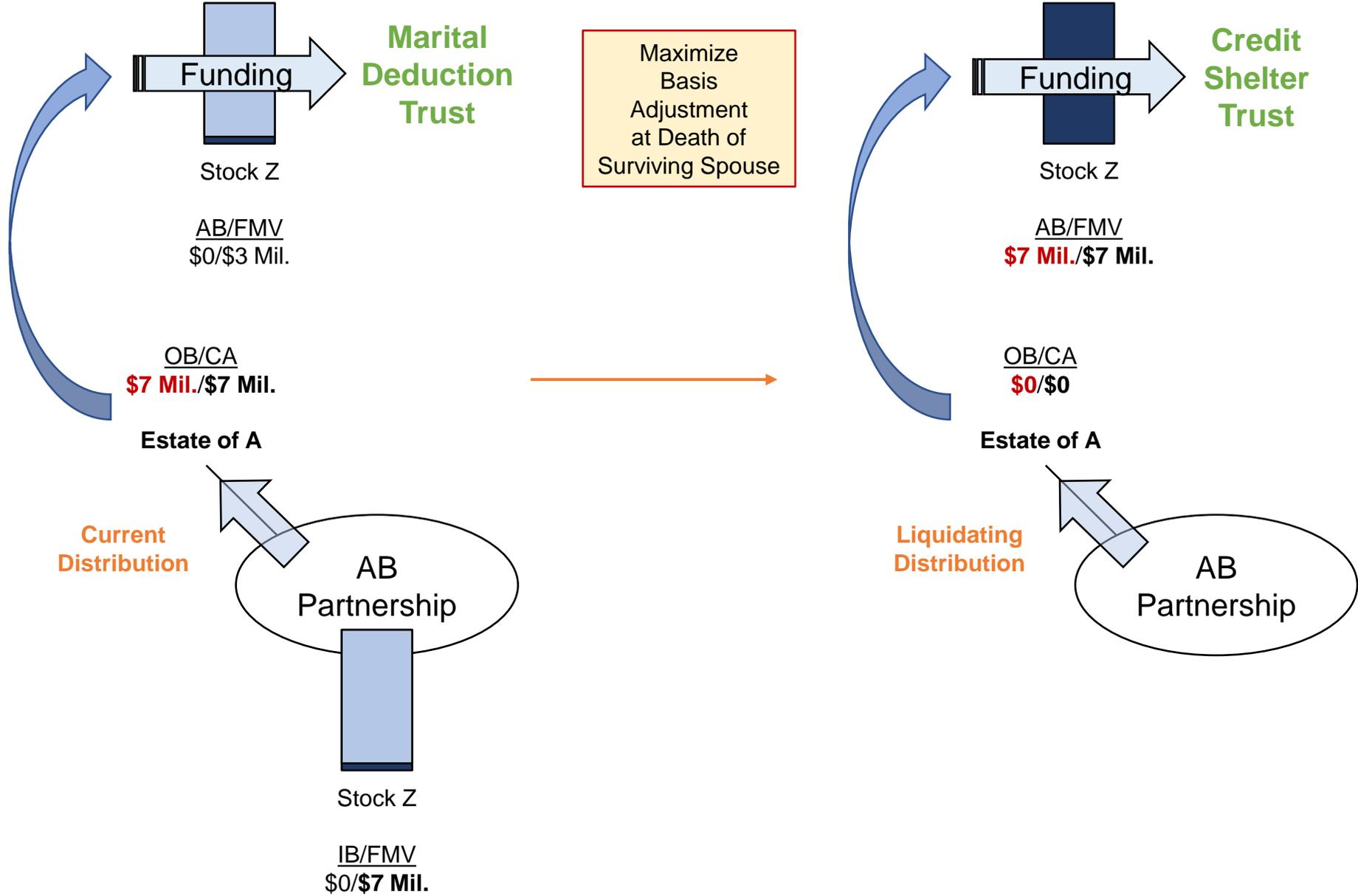
**+\$2,023,000
Economic
Benefit**



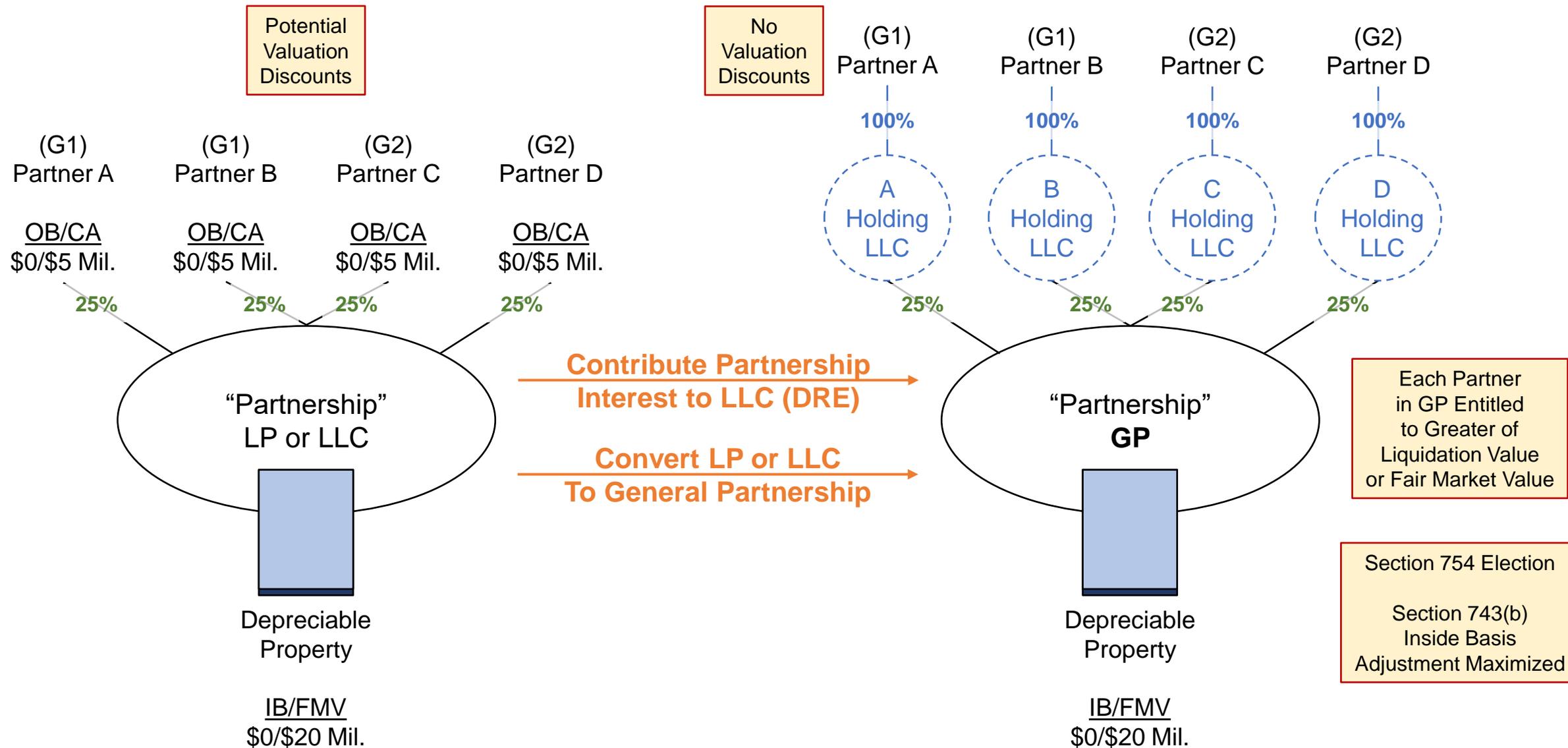
Other Applications for “Staggering Distributions”



Other Applications for “Staggering Distributions”

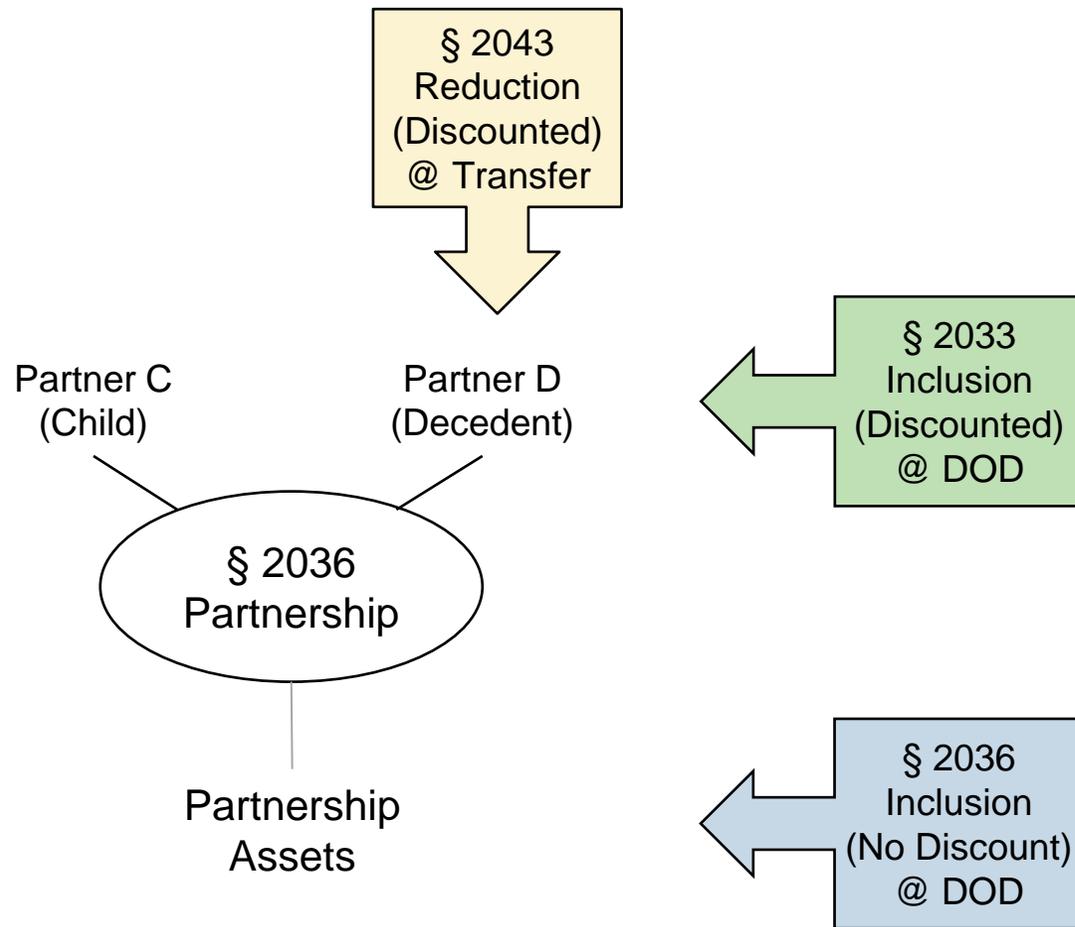


Eliminating Valuation Discounts on Pre-Existing Partnerships



SECTION 2036 AND
THE INSIDE/OUTSIDE
BASIS CONUNDRUM

Section 2036: Inside/Outside Basis Conundrum



Estate of Powell/Estate of Moore

$$V_{\text{included}} = C_d + FMV_d - C_t$$

V_{included} = value that must be added to the gross estate

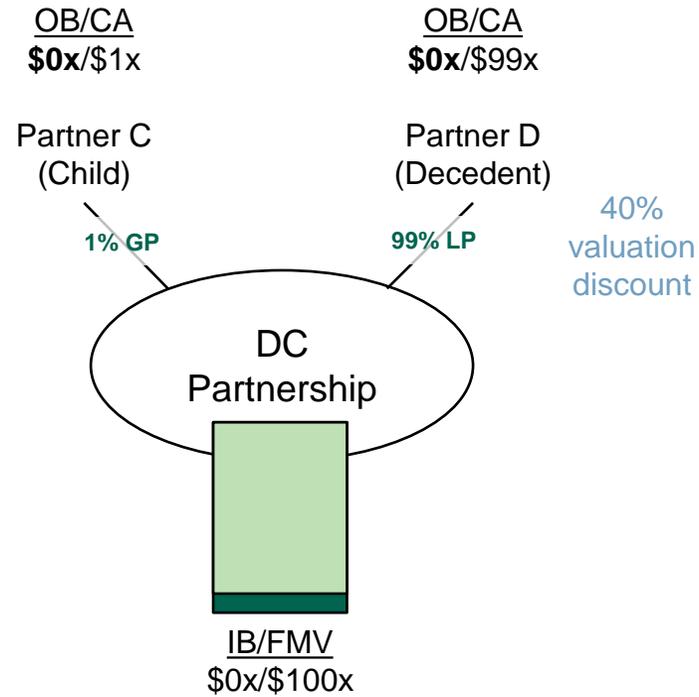
C_d = date-of-death value of the consideration received by the decedent from the transaction that remains in his estate under section 2033

FMV_d = fair market value at date of death of property transferred by the decedent whose value is included in the gross estate under section 2036

C_t = consideration received by the decedent at the time of the transfer, which has to be subtracted under section 2043(a)

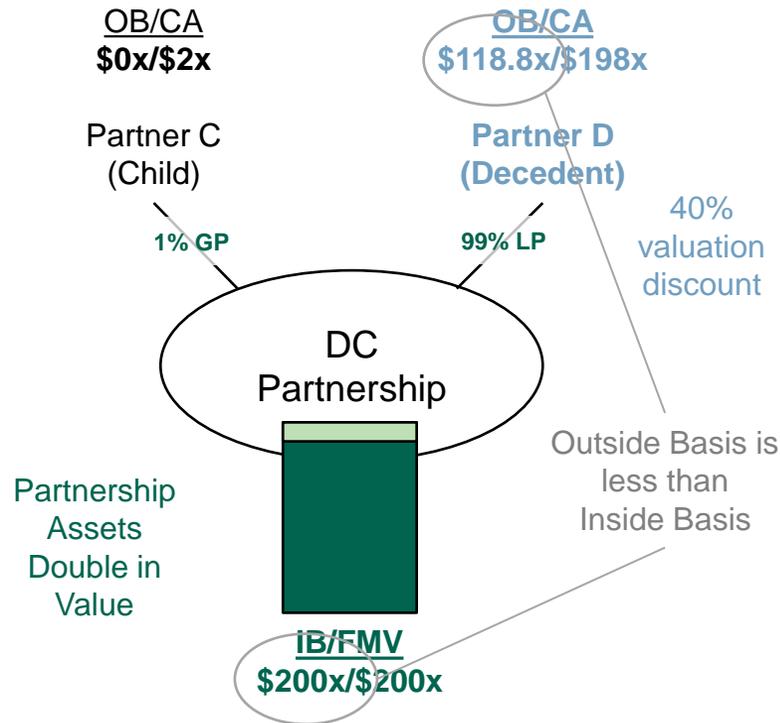
Section 2036: Inside/Outside Basis Conundrum

Example: D and D's child, C, create DC Partnership. D and C contribute assets with \$0x adjusted basis and with a fair market value of \$99x and \$1x, respectively, in exchange for a 99% LP interest and 1% GP interest. At the time of the contribution, the 99% LP interest is subject to a 40% valuation discount.



Section 2036: Inside/Outside Basis Conundrum

Scenario 1: Prior to any transfers by D, D passes away and the assets of the DC partnership have doubled in value (\$200x). D continued to own the 99% LP interest, subject to a 40% valuation discount. It is determined that the assets of DC Partnership are subject to inclusion under § 2036.



§ 754 election would cause a "step-down" in Inside Basis under § 743(b) to \$118.8x with respect to D

Net Inclusion Amount

§ 2033
 $(99\% * \$200x * 60\%)$
 99% LP @ 40% Discount = \$118.8x

PLUS
§ 2036
 Partnership Assets = \$200x

LESS
§ 2043
 $(99\% * \$100x * 60\%)$
 99% LP @ 40% Discount at "Transfer" = \$59.4x
\$259.4x

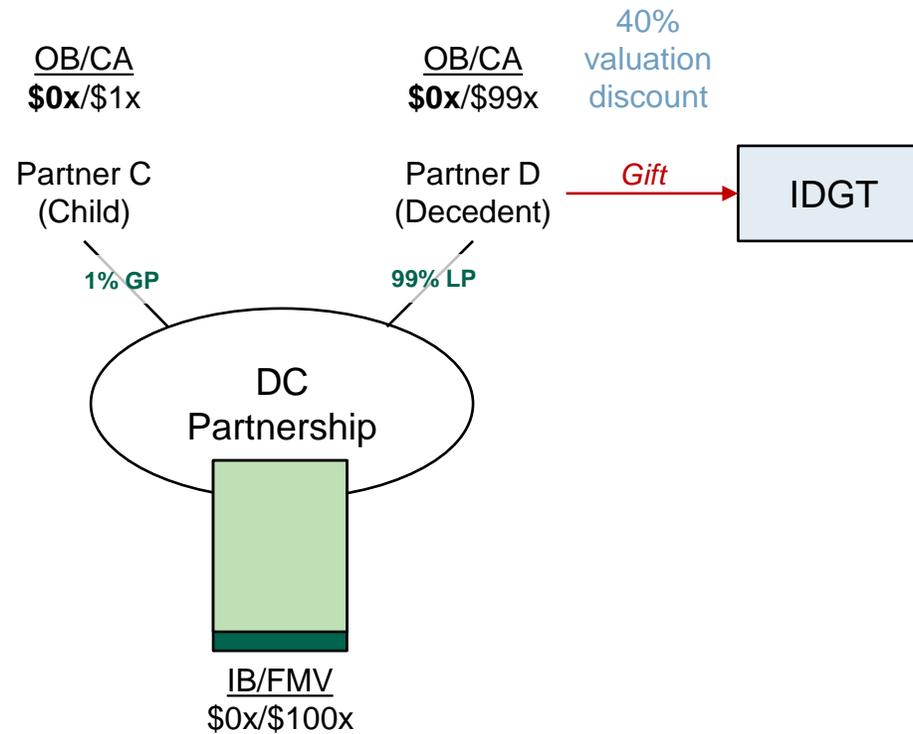
Resulting Basis (Assuming No § 754 Election)

§ 1014(b)(9)
 Inside Basis of DC Partnership = \$200x

§ 1014(b)(1)
 Outside Basis of D = \$118.8x

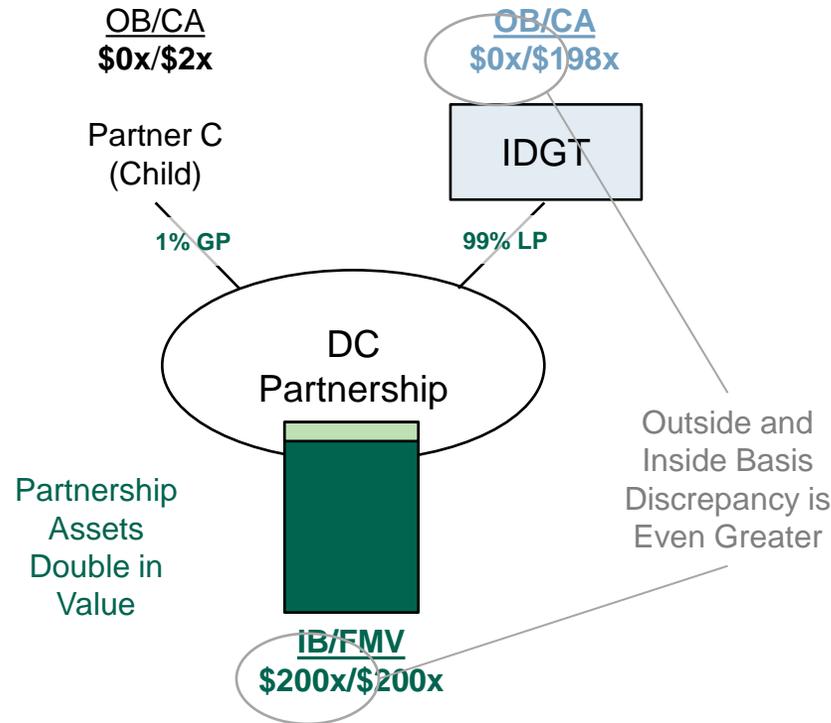
Section 2036: Inside/Outside Basis Conundrum

Scenario 2: After the creation of DC Partnership, D gifts the 99% LP to an IDGT, subject to a 40% valuation discount.



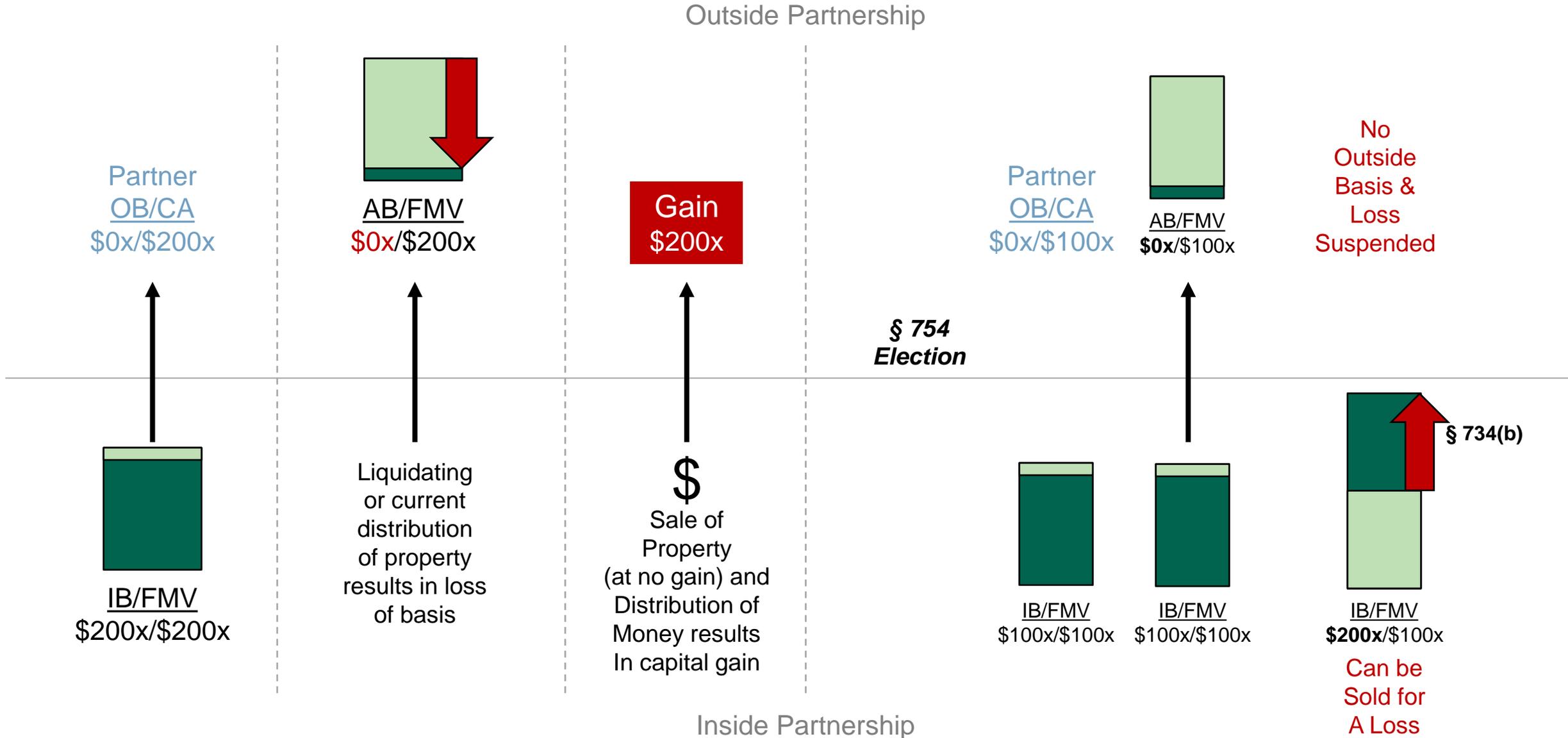
Section 2036: Inside/Outside Basis Conundrum

Scenario 2: D passes away and the assets of the DC partnership have double in value (\$200x). It is determined that the assets of DC Partnership are subject to inclusion under § 2036. The 99% LP interest of the IDGT is not included in the gross estate of D.



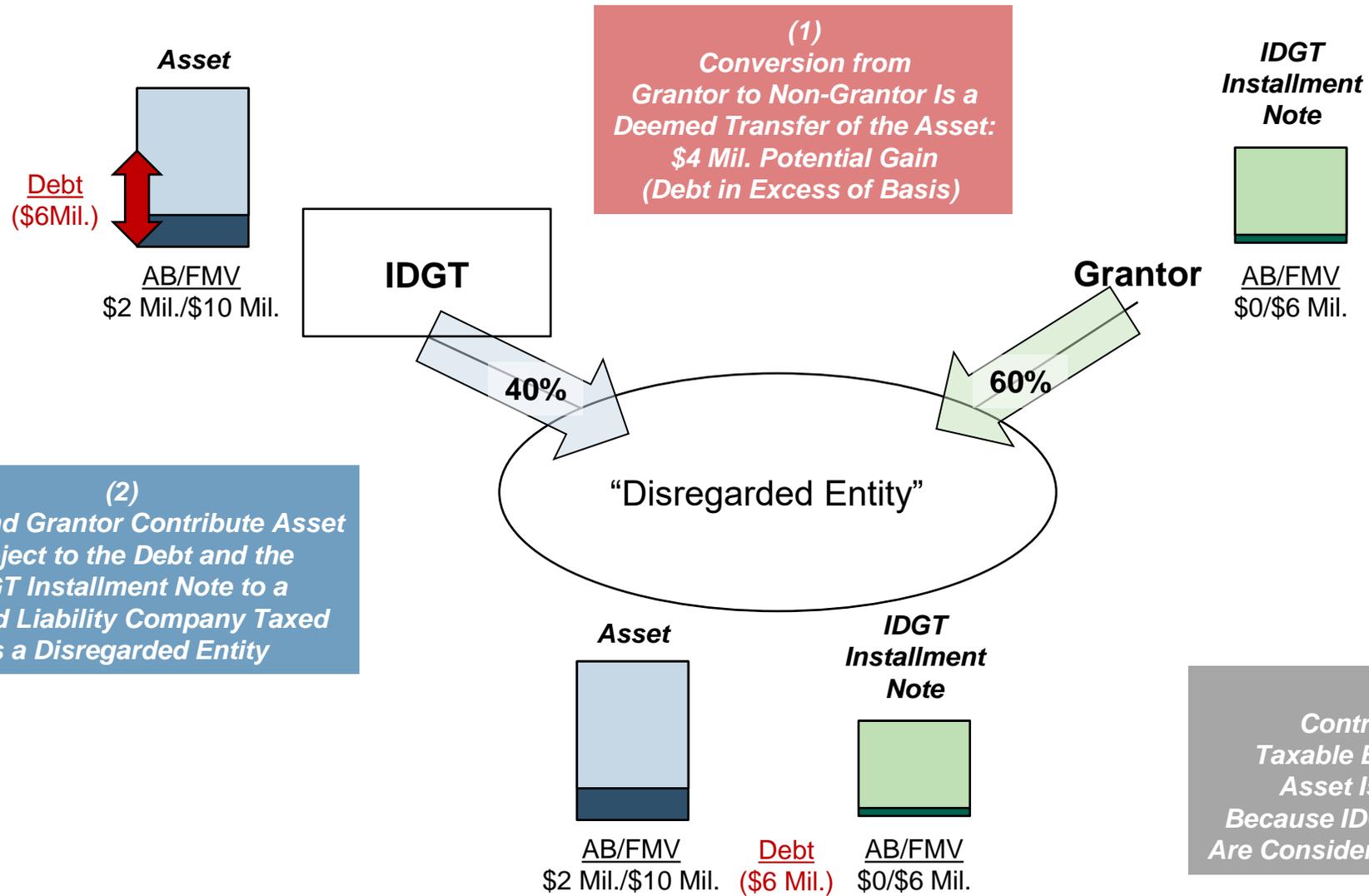
Net Inclusion Amount	
§ 2033	\$0x
PLUS	
§ 2036	Partnership Assets = \$200x
LESS	
§ 2043	(99% * \$100x * 60%)
	99% LP @ 40% Discount at "Transfer" = \$59.4x
	\$140.6x
Resulting Basis (Assuming No § 754 Election)	
§ 1014(b)(9)	Inside Basis of DC Partnership = \$200x
§ 1015	Outside Basis of IDGT = \$0x

Outside Inside Basis Discrepancy Is Not Easily Cured

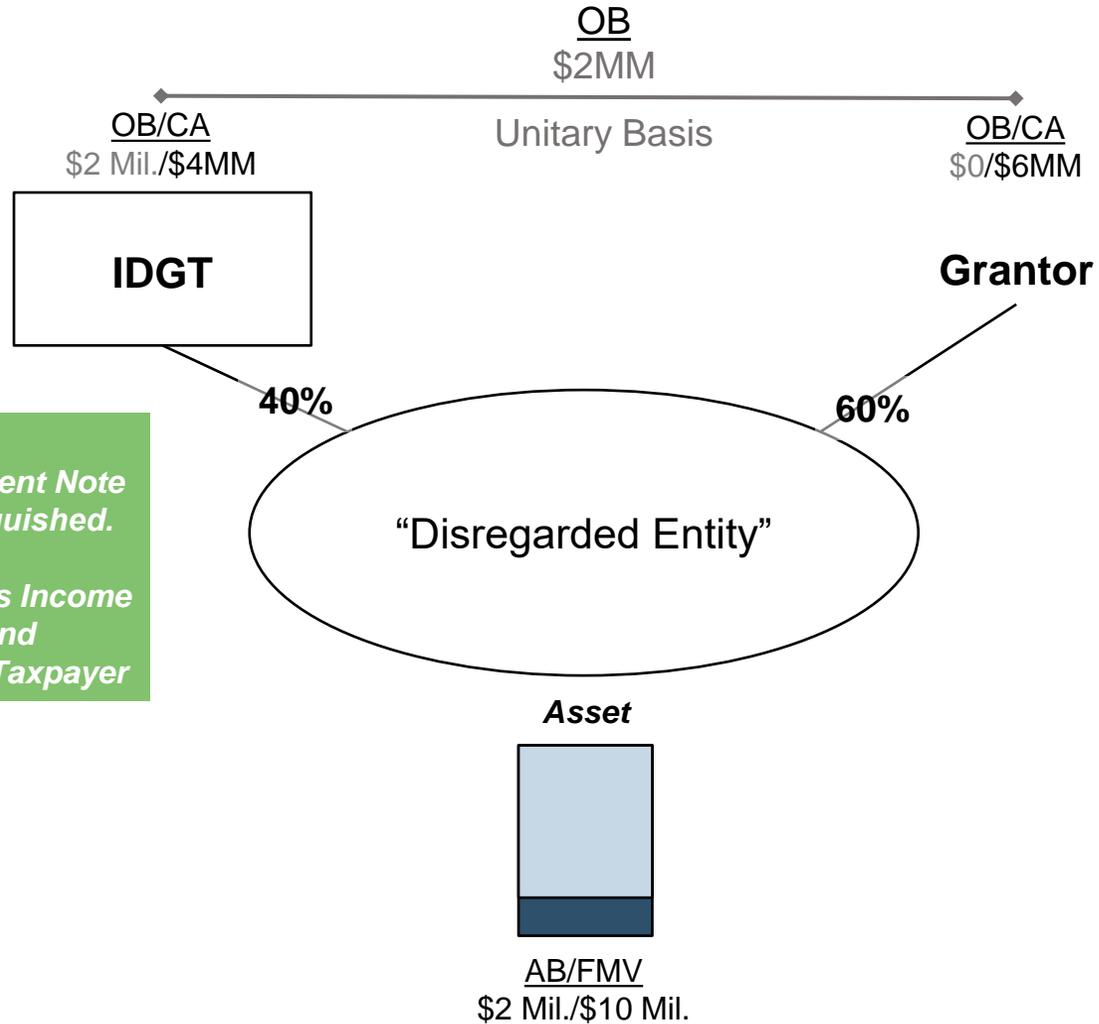


AVOIDING GAIN
UPON THE DEATH OF
THE GRANTOR

Making the Debt Disappear with a Disregarded Entity



Debt “Merges” and Disappears: Non-Taxable Event



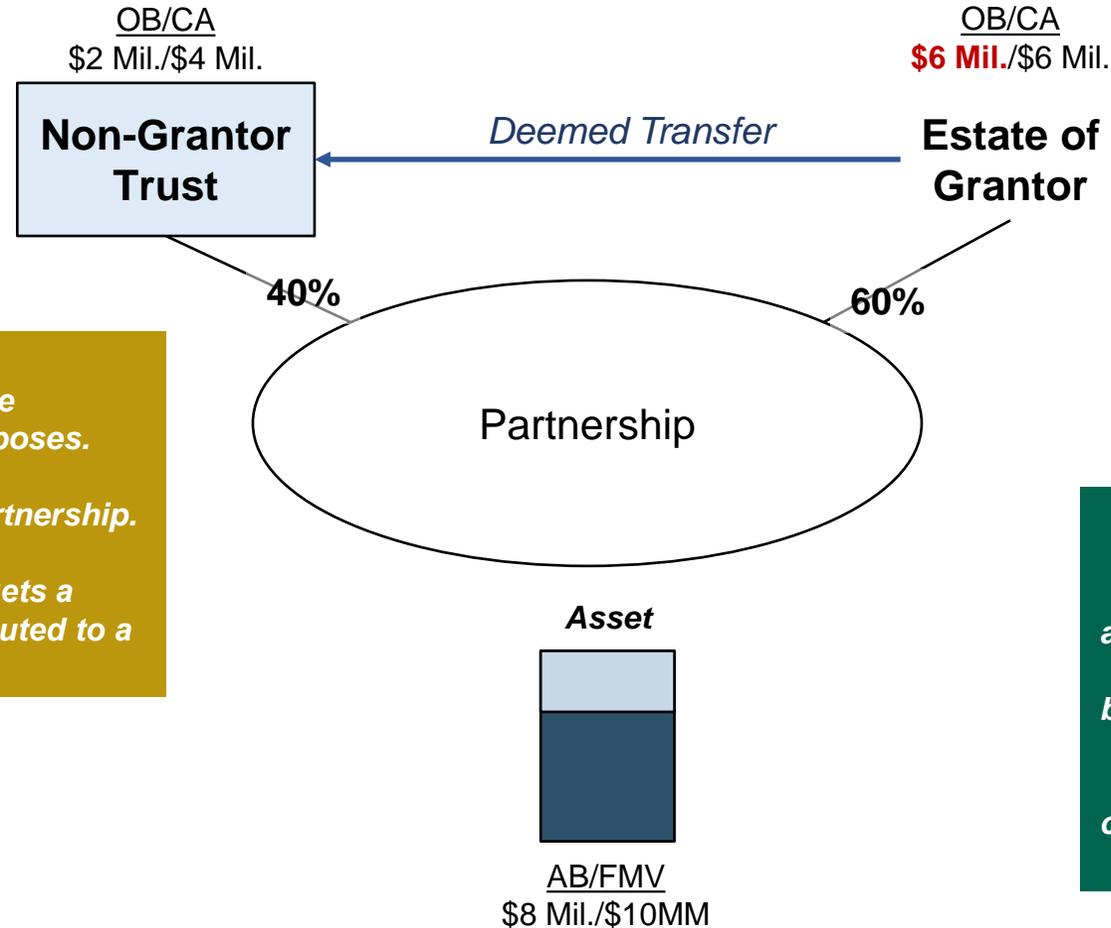
(4)
*The Debt and the IDGT Installment Note
 “Merge” and the Debt Is Extinguished.*

*No Cancellation of Indebtedness Income
 Because IDGT, Grantor, and
 LLC Are Considered the Same Taxpayer*

Death of Grantor Converts Disregarded Entity to a Partnership

Rev. Rul. 99-5

Conversion of Disregarded Entity to Partnership Created by Transfer of an LLC Interest to Another Taxpayer Treated as Purchase of Assets and Contribution to a New Partnership.



(5)
Grantor's Death Converts the LLC to a Partnership for Tax Purposes.

Treated as the Creation of a New Partnership.

Grantor's Portion of the Asset Gets a "Step-Up" in Basis, and it is Contributed to a Newly-Formed Partnership.

(6)
End Results:

- a) No Gain at Grantor's Death.*
- b) Asset Gets a Partial Basis Adjustment under Section 1014.*
- c) No Installment Note Included in Grantor's Estate.*

Disclosures

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